**Recommendation: SELL** **Target Price until (Dec, 2015): $94**

## 1. Reasons for the Recommendation

Since the purchase date on Nov 21 2009, the Regents Portfolio's holdings of PepsiCo have had a total return of 41.6% with an active return of 11.4% vs the S&P 500, and of -27.2% vs the sector. Yahoo Finance gives the company an expected annual return of 6.5%. Looking forward, the company stock should continue to increase in value over the next few years. Consequently, the recommendation to sell does not stem from the stock's ability to perform, but from the question: Would an alternative investment have a higher return? After analyzing the company, it seems that PepsiCo may not be the best investment. Firstly, many of the company's major products are facing declines in demand, mainly due to health focused consumer trends. Secondly, PepsiCo not reaching its potential as it does not have a high enough focus on developing markets, and is missing many opportunities. Furthermore in its efforts abroad, PepsiCo is reactive, and is consequently late in many of its efforts. Thirdly the company's PE ratio is high, and its forward PE is higher than all of the company's competitors, limiting the stocks ability for future growth. Fourthly the low return vs the sector is indicative that it is being outperformed, and that a different company would have had a higher return. Finally in an upward market, a firm with a higher beta may be a more appropriate investment.

Many major products like soft drinks and junk food are facing decreased demand. Consumer trends towards, healthy foods and beverages are in conflict with many of PepsiCo's current products. Exacerbating the problem is the fact that many of PepsiCo's "healthy" products like zero calorie sodas, are not considered to be healthy by many consumers. Additionally, the company has been reactive to these trends and not proactive. As PepsiCo continues to act in such a manner, it will not be realizing its potential gains. Finally in the energy drinks arena, an industry that has high potential for growth, PepsiCo's product AMP only has a 3% market share (caffeineinformer.) PepsiCo announced a 1% boost in its outlook for the year, after reporting as its 3rd quarter profits were higher than expected (Athavaley.) While the market responded positively boosting the stock price, the reaction seemed excessive, as using the company's new guidance did not boost the forecasted stock price significantly.

In developing market PepsiCo, faces a similar problem, but the issue is intensified by the success of its rival, Coca-Cola. As a widely recognized, global brand, Coca-Cola is expanding into emerging markets, and is developing a strong position. Consequently, as PepsiCo enters these markets it will face a high degree of competition. With a more proactive approach, the company could have entered these markets early, and capitalized on the growth that Coca-Cola is currently benefiting from. In order to expand into these markets, PepsiCo will face at the very least, increased costs from needed marketing campaigns. Some of the company's efforts are beneficial, like the sale of its bottling operations in China to Tingyi-Asashi in a joint venture, allowing the company to license its beverages and to focus its efforts on snack foods (Tudor et al.) Additionally the company entered a deal with Disney to supply food and drinks, to the Shanghai Disneyland Park. However these efforts again illustrate that the company in too reactive, as Coca-Cola already had a 15% share of China's soda market ahead of PepsiCo's 4.5 (Jourdan.) PepsiCo has been successful in Latin America, using a more proactive approach, tailoring products to domestic tastes, and preferences. It merely needs to apply this concept to new markets, especially Asia.

PepsiCo's PE of 20.92 is the highest of all its competitors, except for in the beverage industry where Coca-Cola leads with a PE of 22.81. In terms of forward PE, PepsiCo has the highest at 19.27. This could limit the company's stock price from future growth, indicate that the stock price is overvalued, and could show that the stock price is approaching a peak. This is reinforced by the fact that the forward PE is lower than the current. This effect is mirrored in the PB ratio at 6.07 is much higher than all others except its snack food competitor Kraft at 6.16. The PS ratio does not support this as PepsiCo's is in the middle at 2.1, well below Coca-Cola's 3.87. This is not exactly comparable as Coca-Cola is purely a beverage company; however its other competitors across the other industries are more similar.

PepsiCo outperformed the S&P 500, but failed to outperform the sector, furthermore it underperformed the sector by 27.2%. This demonstrates that the company may not have been able to match its peers. As it is a large company, it may not have the same opportunity for growth as smaller firms do. While this figure is not very meaningful by itself to the future performance of the company, it does set a context. Combined with the company's forecast stock price compared to the current stock price, this figure is more informative. As the forecast is based off growth, and the company is not expected to see a negative rate, and that the current stock price is higher than the forecast, then the stock may be overvalued.

Finally as the market has turned upward and stock prices continue to rise across the board, it is clear that a stock with a higher Beta, would be more appropriate, and could have a higher return. PepsiCo's Beta is 0.28, expectedly low as a consumer staples product (Yahoo.) Another stock in the same sector, in order to maintain a diversified portfolio, with a higher beta would likely have a higher degree of benefit from the current trend of the market.

This recommendation is risky in that PepsiCo has a lot of potential but is not utilizing it to the fullest extent. If the company were to change, its stock could realize higher returns that the Regent's Portfolio would lose, if the stock is sold. However there should be several indicators, of higher performance. Firstly would be a new healthy brand launched by the company, a new name could distance the brand from PepsiCo's unhealthy image. Secondly would be increased investments in marketing and production in the developing world, namely in China and India. Finally an economic downturn could turn PepsiCo in to a safe haven for investments due to the low Beta.

## 2. Company Analysis

PepsiCo, is composed of 6 divisions Frito-Lay North America (FLNA), Quaker Foods North America (QFNA), Latin American food and snack businesses (LAF), PepsiCo Americas Beverages (PAB), PepsiCo Europe (Europe) and PepsiCo Asia, Middle East and Africa (AMEA). These divisions operate across several industries, namely beverage, snack, cereal and grain, wholesaling.

In 2013 FLNA contributed $14.1 billion to net revenue was, at about 21% of the total with an operating margin of 0.27. QFNA had $2.6 billion in revenue, 4% of the company's total, its operating margin was 0.23. The next division, LAF, brought in 12% of net revenue at $8.3 billion with a margin of 0.15. PAB is the largest division contributing 32% of total revenue at $21.1 billion that year at a margin of 0.14. Europe is another large segment making 21% of total revenue at $ 13.8 billion; it however, had the lowest operating margin at 0.09. Finally AMEA contributed $6.5 billion or about 11% of total revenue with a margin of 0.11(PepsiCo 10-K.)

PepsiCo's major strengths are its brands, the FLNA division and its management. The company has many well-known, diverse and global brands like Pepsi Cola, Lays and Gatorade. As PepsiCo's newest acquisition Frito Lay is a major strength of the company. Representing about 21% of revenue, it is not only a large division of the company, but it could potentially become the largest, due to consumer trends. Additionally Frito Lay and PepsiCo's combined supply and distribution network can reduce the cost of production and transportation for both products. PepsiCo's management team headed by Indra K. Nooyi, regularly leads the company to exceed analysts' forecasted performance and also regularly meets the company's highest benchmarks (PepsiCo Proxy.)

Its major weaknesses are its reactive approach, and its ability to compete with Coca Cola. PepsiCo often takes a reactive approach to changing trends. Additionally many of its responses to these trends are inadequate. For example, in addressing increasing demand for healthy products, PepsiCo merely offered low calorie versions of their products rather than a separate brand, unassociated with the company's unhealthy reputation. As for Coca-Cola, PepsiCo is unable compete with the company in the global arena. Coca-Cola has more brand recognition, and is already successful in the global market. Unfortunately for PepsiCo, the company has established a strong position in emerging market, limiting PepsiCo's growth in these areas.

The company has many opportunities for growth in emerging markets. With average income increasing in developing nations, PepsiCo has the potential to increase revenues by expanding into these markets. Countries like China and India are some of the largest potential markets, but will likely require a specialized approach, with specific products for each region. PepsiCo has already taken a similar approach in Latin America and Europe, but has yet to apply it to other regions.

There are also many threats in emerging markets, consumer trends and regulations. Coca-Cola represents a major threat to PepsiCo in emerging markets, as the company is already establishing a presence in the developing world. Changing consumer trends are another threat, as the majority of PepsiCo's revenue comes from North America, increases in demand for healthy foods and drinks, threaten sales of the company's products which are often considered unhealthy. Furthermore some of the company's "healthy" products like zero calorie sodas are not considered healthy by certain consumers. Finally changes in regulations are always a threat to PepsiCo, as they can limit its products or increase expenses. While the New York soda ban was deemed unconstitutional, other regulations like Mexico's junk food tax placed an 8% tax on junk foods and also a one peso per liter tax on sugary beverages (Villegas.)

## 3. Industry Analysis

PepsiCo operates in three major industries, Beverages, Snacks, and Cereals and Grains. All of these industries use agricultural products as inputs, and are therefore sensitive to commodity prices. Additionally, fuel prices and affect transport of the agricultural products, exposing these industries to increased volatility. Plastics are also a common input of all three industries, used mostly in packaging and while environmental concerns may reduce demand for products using plastic packaging, the effect is not significant.

PepsiCo in their 10-k claims a market share of 24.3% with Coca-Cola is just behind at 21.1%. Forbes offers a less biased view giving PepsiCo and Coca-Cola market share of 30% and 40%, respectively. The next major competitors are much smaller, starting with DPSG or Dr. Pepper Snapple Group with an 8.9% market share, followed by Private Labels (retailer brands, i.e. Great Value by Wal-Mart) with 8%, Nestle with 5.2%, Red Bull with 4%, and Monster with 4%. While the last two competitors may be small, they have the potential to become significant players. Energy drinks are a relatively new market, but is growing at an annual rate of 10.1%. Additionally it is an unsaturated market as only 5.0% of consumers drink energy drinks on a regular basis (Jeon.) Bottled water, coffee and soft drinks are all mature markets with little to negative growth rates. Bottled water originally suffered from environmental concerns, but changes in packaging, such as the use of biodegradable bottles reversed this trend (Petrillo). Coffee is expected to remain profitable despite being a mature market. Increase in income may allow growth in high-end, gourmet coffee, increasing profitability Volatility in coffee bean prices are the largest threat to the industry, as consumed demand is not expected to decrease. The industry does face a threat from energy drinks which is considered a substitute good, as that market continues to grow (Turk). Soft drinks have, and are expected to decline in sales, health concerns and consumer preferences are the major force behind the decline. Healthy options like real sugar and zero calorie products, could alleviate, but not stop the trend (McKitterick.)

PepsiCo has the highest market share, according to its 10-k with 36.6%. However the industry has a high number of small firms, comprising 30.4% of the market. The largest competitors are Kellogg’s with a 6.9% market share, Mondelez with 5.6%, Kraft with 3.6%, Snyder-Lance with 3.5% and Conagra with 3.3%. Snack foods are mostly a mature, saturated market, except in developing nations. Growth in this area is slow but may increase in the long term, in developing nations. As most of this industries inputs are agricultural products it is vulnerable to increases in commodity prices, albeit in a minor way as existing, high margins, insulate firms against this (Ahmad.) Internationally undeveloped markets represent a major opportunity for growth, once again tied to rising levels of income. Products tailored to local tastes, like those offered by PepsiCo’s LAF, can and have been very successful. Countries in Asia and Africa, are largely untapped in this regard, and have very high potential for growth.

Cereals and grains are suffering due to alternative breakfast options, like fast food, instant breakfasts or even coffee are popular substitutes cutting into the industry’s sales (Team). Additionally healthy products like yogurt continue to grow as breakfast alternatives further hurting the market. High-end products, marketed as healthy alternatives have had some success in convincing consumers to return to cereals (Carter). Globally the industry is expected to grow at a rate of 5.5% per year until 2019; most of the growth is expected to come from markets like India and China as well as from other developing nations. Many firms are looking abroad to combat, decline in domestic markets (Schroeder). In the global market these products face competition from homemade meals, but are a popular alternative due to their convenience.

## Appendix: Inputs into valuation using multiples

| Forecast | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|
| Stock Price (PS) | | | | | | | | $ 91.10 | $ 93.60 |
| Stock Price (PE) | $ 75.55 | $ 55.97 | $ 60.80 | $ 65.33 | $ 66.35 | $ 69.46 | $ 82.04 | $ 91.10 | $ 93.60 |
| Diluted EPS | 3.41 | 3.21 | 3.77 | 3.91 | 4.03 | 3.92 | 4.32 | $ 4.07 | $ 3.91 |
| Rev | $39,474.00 | $43,251.00 | $43,232.00 | $57,838.00 | $66,504.00 | $65,492.00 | $66,415.00 | $67,322.71 | $68,810.93 |
| Rev/Share | 23.79 | 27.00 | 27.41 | 35.78 | 41.64 | 41.58 | 42.57 | $ 43.38 | $ 44.57 |
| PE | 22.3 | 17.1 | 16.1 | 16.7 | 16.4 | 17.5 | 19.2 | $ 22.40 | $ 23.93 |
| PS | 3.2 | 2 | 2.2 | 1.8 | 1.6 | 1.6 | 1.9 | 2.1 | 2.1 |
| | | | | | | | Shares | 1552 | 1544 |

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*

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