Recommendation: BUY

Target Price until (December 31, 2015): $96.89

1. Reasons for the Recommendation

Positives:

Pepsi Co. continues to be the largest multinational producer of both snack foods and beverages in the world. They operate through six business segments all of which have been very successful. They have captured 46.4% and 24.4% of the market share for snack foods and beverages respectively. PepsiCo. has recently partaken in mergers, acquisitions, and joint ventures in order to increase their productivity and flow of operations. In the 2013 third quarter report (10-Q), PepsiCo reported growth of 2% and 4% in organic growth thus far. This growth was mainly fueled by growth in its, AMEA (Asia, Middle East, and Africa) and its LAF (Latin America Foods) segments. PepsiCo. was founded in 1965, and continues to have a strong and loyal customer base. Coca-Cola is their largest competitor with the largest market share of carbonated drinks. However, PepsiCo’s snack food sales push them above and beyond Coca-Cola in terms of total revenues with a total difference of $17,475 million in 2012. With the long successful history and the size of PepsiCo, the event of a sell off or collapse is highly unlikely. With this strong market presence and the industry outlook PEP has a positive future. The industry is expected to shift towards emerging market economies. 123

The non-alcoholic beverage and snack food markets are highly developed with large market pools. In order to continue to grow PepsiCo has turned to a productivity plan that aims at increasing its efficiency. The plan includes all sectors, but has been more impactful on its less developed markets in terms of growth. Overall the plan is focused on improving their position in all market segments. As of the third quarter Frito Lay North America (FLNA) has experienced 5% growth in revenues, and Latin America Foods (LAF) has experienced 9% growth in revenues. Although this is a highly developed industry there is room for growth. In the AMEA segment growth will come from their productivity plan implementations and the growth of the industry. First, their transaction with Tingyi will provide growth by lowering operating costs and increasing operating profits in this segment. As of the third quarter 2013 operating profit has grown 59%. 2 The increase in operating profit reflects the restructuring and impairment charges impact related to the transaction. The strategic alliance will provide PEP with 5% indirect equity with the option to increase its position to 20% on its own terms until 2015. This will not only decrease costs but it will also increase revenues within this segment. Another contributor of growth of this segment will come from market volume growth, which means revenues are likely to follow. Additionally, I feel that the relaxation of the one child law will provide a boost in market volume in the future. An additional piece of the Productivity Plan that I feel will add and continue to add to the growth of this segment is the R&D plant that opened up in Shanghai in 2012. This will add to the growth of this segment because, as PEP continues to operate in other countries it is important to remember that they all have different preferences in tastes. This is an important aspect that PEP needs to cater to. China continues to be considered the leading market for this industry by 2017 growing by approximately 20%

2 10-Q PepsiCo, Financial Statements (2013)
3 10-K Coca-Cola, Financial Statements (2012)
within the four year time period. Although the rate of growth is expected to decelerate for the Soft Drink industry it is forecasted to see a large overall growth in the coming years (10% CAGR). With this said, I took the expected market growth rate and included the additional growth provided by the productivity plan that they have put in place. The snack food industry in China is expected to have the same decelerating trend in terms of market value growth rate, however, the overall growth rate for the next four years is similar to that of the beverage industry. Their productivity plan is still taking effect, which means that they should continue to see growth due to their implementations. As the emerging market of China develops, PepsiCo has positioned itself to capture the revenues of this market. Implementing a plan early on provides Pepsi with the opportunity to capture the max revenues the market has to offer. This is because majority of the restructuring and impairment charges related to this transaction will already have been paid. As PepsiCo continues to reduce the restructuring and impairment charges related to recent transactions, such as Tingyi, revenues should increase at the same time providing positive revenue growth. Pepsi has decreased these charges across all of its segments with large portions of the remaining charges to be paid by the end of 2013. 

Another Segment of PepsiCo expected to provide growth is the Latin American Foods Segment. Looking at the LAF segment of PEP, the forecasted growth is based upon the growth of PEP’s snack food revenues. This is mainly based upon the growth rate of the Brazilian market value. For the past five years it has been growing at about 6% CAGR. The market expects it to grow by about 31.8% over the next five years with a 5% CAGR. These numbers are also similar for the soft drink industry in Brazil. However, PEP is not one of the market share leaders for the soft drink industry. They are a market share leader in the snack food department, which is why I used this as an indicator for growth within this geographic segment. Mexico is another market that will provide growth for PEP. The Snack food Industry will be the fuel for growth in this segment. PEP has 39.9% market share of the snack food industry in Mexico. The Industry has a forecasted growth rate of 6% CAGR. The soft drink industry in Mexico is forecasted to see similar results in terms of growth.

In addition to continued growth within both industries PEP operates in, dividends play also large role in this buy recommendation. PEP has seen constant dividend growth over the past ten years and has consistently paid dividends on a quarterly basis. Though there has been one quarter where the dividend has decreased compared to the previous dividend. This occurred in 2012 during the implementation of its productivity plan. PEP has also increased the percentage of EPS returned to shareholders by an average of 46.65% over the past seven years. With the cost savings provided by their productivity plan and the growth of the industry as a whole, they should have enough free cash flow to execute the full $3 billion in approved shareholder returns. As of 11/24/2013 the dividend yield for PEP is 2.27%. 

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4 “Soft Drinks in China” Market Line http://ehis.ebscohost.com
5 10-Q PepsiCo, Financial Statements (2013)
6 Savory Snacks in Brazil” Market Line http://ehis.ebscohost.com
7 “Savory Snacks in Mexico” Market Line http://ehis.ebscohost.com
8 YahooFinance.com
with the dividends PEP has been repurchasing shares of stock. With the combination of these two factors, shareholders should see increased returns and stock prices.

**Negatives:**

As consumer preferences continue to change, PepsiCo needs to continue finding ways to meet their ever-changing needs. The future sales of carbonated beverages are uncertain across the entire industry. This uncertainty is reflected by the recent decline in sales volume of carbonated beverages. Consumers have become more concerned with what they put in their body and this has been reflected in the sales of PepsiCo’s carbonated beverages. In the U.S Carbonated drink sales decreased 1% in 2011, and by 1.5% in 2012. This is something to be concerned with because the U.S. accounts for it’s largest portion revenue (51%, in 2012). PepsiCo experienced a decrease in market share in the use by .4 percentage points while Coca-Cola and Dr. Pepper saw increases of .1 percentage point.

The amount of leveraged debt in which PepsiCo has incurred over the past few years is another aspect to be concerned with. Although PepsiCo is entering into strategic alliances to better position itself for the future, it has done so with a cost. In 2007 it had a D/E ratio of 1.004 and in 2012 it had a ratio of 2.33. These ratios take into account Total Liabilities/Total Common Shareholders Equity. The company is much more highly leveraged at this point, which is something to be concerned about. Although they have become highly leveraged they will have enough cash flow to pay off these debts in the future.

2. **Company Analysis**

PepsiCo has long standing success within the industry in which it operates. Its six segments offer a large variety of products to its consumers. The six segments include Frito Lay North America (FLNA), Quaker Foods North America (QFNA), Latin America Foods (LAF), PepsiCo Americas Beverages (PAB), Europe, and Asia Middle East and Africa (AMEA). Three of the segments are grouped together and account for one of the four major segments. FLNA, QFNA, and LAF are responsible for the distribution and sales of the food products sold in the Americas. Together they accounted for 37% of net revenue for 2012. Individually they accounted for 21%, 4%, and 12% respectively. PAB is the second major segment, which accounted for 33% of net revenues for 2012. AMEA is the third major segment, and accounted for 10% of net revenues in 2012. The fourth major segment is Europe, which accounted for 20% of PepsiCo’s net revenue in 2012. Thus far in 2013, they have accounted for approximately the same amount in terms of net revenue. According to industry reports growth has slowed over the past few years and may be expected to slow to about 2% over the next few years until about 2015.

**Strengths:**

PepsiCo. has four major strengths that make it a strong competitor within its industry. First is the size of the company. Coupled with its size, its the strong brand equity and loyal customers provides for a strong company base. They are a household name in most households, particularly in the U.S. The second

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9 Report Linker “Beverage Industry: Market Research Reports, Statistics and Analysis”
10 PepsiCo, Inc. SWOT Analysis, Market Line Reports
strength of PepsiCo, is its diversification. The six major countries in which it operates include, the U.S., Russia, Mexico, Canada, U.K., and Brazil. More currently, they have begun operations in China through its strategic alliance with Tingyi. In terms of revenue, these countries account for, 51%, 7%, 6%, 5%, 3%, and 3% respectively, which allows them to diversify their target markets. By diversifying themselves, the overall market risk is reduced. The third strength of PepsiCo, is that it continues to experience growth in revenues and operating income, which are at the lease equivalent to its main competitor. This growth insures that the company stays competitive. As in any industry this growth is crucial. Lastly, its increasing presence in emerging markets as paid off for PepsiCo. As demand in developed markets for non-carbonated beverages decreases, developing markets are picking up the slack.

**Weaknesses:**

With PepsiCo there is one major weakness to consider. Decreased consumer confidence due to market controversies is its major weakness. Bad press or allegations against a food and beverage company are a regular occurrence. While allegations against its food sector would not hinder the company by a large margin, but if PAB sector were to take a hit from this it could see a large impact on revenues. This is due to the fact that PAB accounts for such a large portion of its revenue stream that if there was a large decrease in sales, the company would take a large hit.

**Opportunities:**

Although the industry is highly developed there are opportunities for the company to grow. The first opportunity for PepsiCo to consider is its presence in developing markets with respect to food sales. As the consumption of food increases in these markets PepsiCo can look to tap into these markets and turn the demand for products such as theirs into revenue. This demand provides room for the company to grow. Another opportunity for PepsiCo to consider is the changing preferences and demands of both developed and developing markets. As people become more health conscious, PepsiCo can develop and produce products that meet those needs. This provides room for the company to grow within segments that provide a smaller percentage of revenues such as QFNA. By growing segments such as these PepsiCo can reduce the risk that they are exposed to within the larger segments. The third major opportunity for PepsiCo to consider is the localization of raw materials used along with other materials involved with the production process. This can decrease the costs of the company along with making it easier to produce their products due to regulation differences between countries.

**Threats:**

As private companies begin to pop up within the industry, PepsiCo needs to be aware of what is out there. This is because, with the recent recession and change in consumer preferences, consumers are turning to alternatives such as private labels and generic brands. In order to stay competitive they need to continue staying price competitive along with offering products their consumers are demanding. Rising food and commodity prices pose an additional risk to the company. This is one of the reasons why PepsiCo needs to continue localizing their operations as much as possible. The last threat to be aware of is the continued competition that is Coca-Cola. In order to be successful PepsiCo needs to continue with its product offerings and price competitiveness.
3. **Industry Analysis:**

PepsiCo (PEP) operates and competes in the consumer goods sector. They offer beverages and snack food both of which are distributed worldwide. However, not all of their products are distributed to every market segment. Additionally, these two industries can be further broken down. The beverage industry consists of alcoholic and non-alcoholic beverages, and the snack food industry includes, snack food, frozen dishes, and condiments. PepsiCo also competes in the cereal industry, which is considered as part of the snack food industry in which they compete. The year-to-date growth rate of the beverage industry is 8.36%, and has only seen two years where there was a negative growth rate (2004 and 2008). This industry has a relatively low growth rate, which means there is a high level of intensity when competing for market share. Within both of the industries PepsiCo operates there is a moderate to low level of differentiation along with low switching costs. Consumers can choose to switch to a competitor at a low cost. Due to the economies of scale within the industry consumers have the bargaining power. Meaning, that the consumers can switch to a competitors product if the price of PepsiCo’s products increase to the point where the consumers do not feel that the product is worth the price.12

PepsiCo operates within the non-alcoholic beverage industry. It is one of the market leaders within this industry. PepsiCo is involved with production and distribution of, syrup and flavorings, juices, soft drinks, and bottled water (sub-industries). In 2012 the total revenue in the US for the syrup and flavorings industry was, $10,001.80 (million), $90.2 (million) less than the previous year. The total revenue in the US for the soft drink production industry in 2012 was, $18,263.40 (million) also less than the previous year by $860.1 (million). The Juice industry in the US had total revenue of $21,471.5 (million) in 2012 an increase from the previous year of $1,118.8 (million). In addition to these numbers, the soft drink and the syrup and flavoring industries are both expected to see a decrease in revenue by the end of 2013. The Juice industry however, is expected to see an increase in revenue by the end or 2013. Within this industry, North America, the EU, Russia, and Japan are the main market segments in which PepsiCo operates. The major competitors that PepsiCo faces in this industry include Coca-Cola Company, Dr. Pepper Snapple Group, Inc., Nestle, and Cott. There are concerns when operating in this industry. It depends highly upon demand from supermarkets and wholesalers. This demand has begun to decrease due to the health kick that consumers have been turning to. Additionally, consumer spending must continue for PepsiCo to be profitable. This industry is highly competitive due to the economies of scale and the number of companies that control a large percentage of the market share. There are only a few companies that have a large percent of the market share, which creates intense competition. There are also many local and small businesses, which operate on a much smaller scale. Some of these companies are successful but don’t pose a great threat individually, because of their size.13

The Snack Food industry includes products like cookies, chips, nuts and seeds, and other snacks. Over the past five years there has been a growth rate of 2.3% including 2013 for this industry. The main market segments for this industry are North America and the Europe. Along with these developed markets PepsiCo also provides their products to emerging markets such as Latin America and Asia. Within this industry their major competitors are ConAgra Foods, The Kellogg Company, Diamond Foods Inc., and General Mills. Grocery wholesaling and supermarkets are the main customers in this industry. They are the intermediaries in which snack foods go from producers to consumers. This industry faces challenges like those of the beverage industry. The turn to healthier alternatives or products have forced the industry

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suppliers to tailor to the ever-changing consumer behavior. Although consumers continuously change their preferences the diversity of this industry allows producers to offer products meet their needs.\textsuperscript{14,15}

The profitability of the industry has remained stable over the years. However, lately there has been a small decrease in the amount of revenue that the industry has seen compared to past years. One of the reasons for this is because of the shift in consumer needs and purchasing behavior and the development position within emerging markets. This industry has a low growth rate and will be expected to continue in the future. Due to the nature of consumer goods, producers have to compete intensely for market share. The threat of new entrants is also low. This means that it is unlikely that there will be a new major competitor to enter the market, which means that in the future changes within the industry will be the acquisitions and mergers. It can be expected to see the continued growth of the two industries however; the rate at which it will grow is expected to decline until 2016. In order for the industry to grow producers will have to find a way to entice customers to continue demanding their products.

\textsuperscript{14} \url{http://clients1.ibisworld.com.libproxy.unm.edu/reports/us/industry/default.aspx?entid=271} \textsuperscript{15} \url{http://clients1.ibisworld.com.libproxy.unm.edu/reports/us/industry/default.aspx?entid=275}
Appendix: Inputs into valuation using multiples

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