CONSUMER GOODS COMPANIES AS **BOND PROXIES**

SharePad's **Phil Oakley** investigates whether consumer staples really are 'bond proxies'

The financial crisis of 2008-09 scared the living daylights out of many investors. They learned that the stock market could lose them a lot of money as well as make it for them.

Scarred by the experience, it is easy to explain why many investors have been prepared to pay a premium for safety since then. The perceived safety of government bonds can explain why people are prepared to pay very high prices for them and accept very low rates of interest (or yields) in return.

This search for safety has also been played out in the stock market. The share prices of companies that sell the kind of branded goods people buy everyday – such as healthcare, food, tobacco, beverages and beauty products – have been on a stellar run and have delivered impressive returns for shareholders.

These consumer staples are seen as having such dependable products and profits that they are being viewed by some investors as 'bond proxies'. In fact, some investors have argued that they are even better than bonds because they offer higher interest rates (dividend yields) which can keep on growing – something that most conventional bonds cannot do.

This type of argument has been employed by high-profile fund managers, including Warren Buffett, Nick Train and Terry Smith, with great success. They believe that owning the shares of high-quality companies that are capable of earning high returns on capital (ROCE) and holding on to them for a long time is a much better way of making money than buying shares because they are cheap.

It is the combination of quality, dependability and an ability to grow that has pushed the valuation of some shares to levels that many investors would consider too high. The enthusiasm shown for these shares suggests that some of them are almost a buy at any price. History tells us that this kind of thinking can be harmful to investors' wealth.

In this article, I am going to put some of these popular shares under the microscope and see if they are capable of continuing their winning run, or whether their prices are too high for comfort. I'll be focusing on consumer goods giants **Reckitt Benckiser (RB.)** and **Unilever (ULVR)** in the UK and referencing them with **Procter & Gamble (US:PG)** and **Colgate-Palmolive (US:CL)** in the US.

Hallmarks of bond proxies

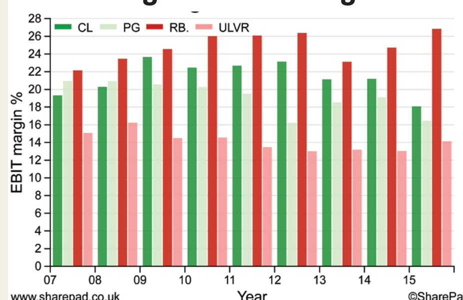
Companies that are considered to be 'bond proxies' tend to have the following characteristics:

1. High profit margins.
2. High returns on capital employed (ROCE).
3. Substantial surplus or free cash flows.
4. Rising dividends including special dividends and share buybacks.

Profit margins

These consumer goods companies have high profit margins. Reckitt Benckiser in particular looks to be extremely profitable, with margins of over 26 per cent, as shown in chart 1 below. This is a hallmark of a quality company. It is very hard for a company to achieve these types of profit margins unless it can do something that others cannot.

1. Ebit margin – consumer goods



20% (OR MORE) RETURN ON CAPITAL EMPLOYED (ROCE) IS CONSIDERED VERY GOOD

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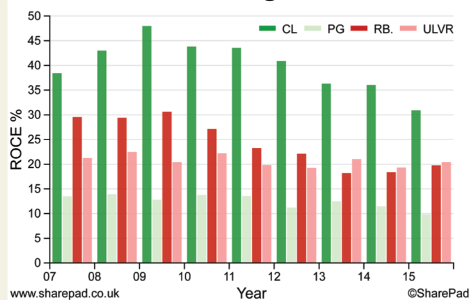
It is a basic tenet of company economics that high profit margins attract competition and can be competed away. Companies that have high profit margins usually have something a little bit special that stops this from happening, such as a brand or scale or a patent. This is known as an economic moat and all top-quality companies have them. High profit margins are a sign of an economic moat.

Note the stability of both Reckitt Benckiser's and Unilever's profit margins as well. This is a sign that their competitive position has been durable over the years, which is why they are so attractive to many investors.

Companies with a track record of high profit margins also tend to be safer investments. High margins mean that profits can withstand temporary falls without putting the company into difficulty. Companies with low profit margins aren't always so fortunate and can start losing money when times are tough.

High returns on capital employed

The best hallmark of a quality company is the return it gets on the money it invests in its business – its ROCE, which we've shown for all four companies in chart 2.



A consistent ROCE of around 20 per cent or more is very good. Colgate, Reckitt Benckiser and Unilever match up to this threshold well, especially Colgate. However, ROCE can be affected by the company's strategy, as well as its underlying business economics. The best example of this in practice is buying other companies (acquisitions).

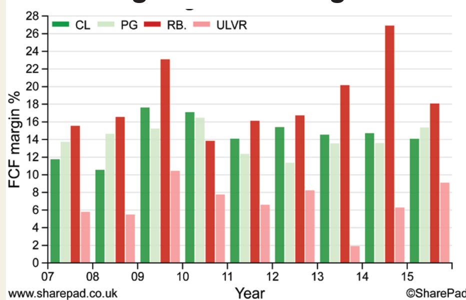
Procter & Gamble's ROCE has been mediocre since it spent a fortune buying Gillette in 2006. Colgate's has been falling for the past few years, although it still remains at a very high level.

Lots of free cash flow

High-quality companies generate lots of free cash flow, which allows them to reward their shareholders.

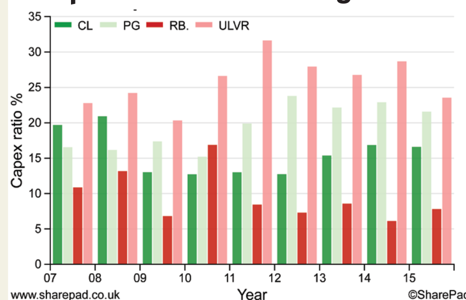
The amount of free cash flow a company produces doesn't actually tell the investor that much. It has to be compared with something to make it meaningful. One of the best measures of a company's free cash flow performance is its free cash flow margin – the percentage of its turnover that it converts into free cash flow.

A free cash flow margin of more than 10 per cent is generally considered to be good. As chart 3 shows, Reckitt Benckiser, Colgate and Procter & Gamble measure up well here, but Unilever's performance has not been so good.



The key driver of a company's free cash flow is the amount of money it has to spend on new assets (capital expenditure) to maintain and grow its sales. High-quality companies can grow and earn a high ROCE by spending a lower proportion of the cash that they generate (operating cash flow) than lower-quality ones.

It's easy to work this out by calculating something known as the Capex ratio – also known as Capex to operating cash flow, seen in chart 4. This compares the amount of money spent on capex with the amount of operating cash flow. Companies with a lower capex ratio over many years can produce more free cash flow and higher returns to shareholders.



Note how well Reckitt Benckiser scores on this measure, with a capex ratio much lower than its peers. Again, Unilever lags behind here. It is having to plough a lot of money back into its business, which goes a long way to explaining why it has a relatively low free cash flow margin compared with its peers.

Growing dividends

The financial returns that these businesses have been able to produce has allowed them to pay a

Dependable products and profits: consumer giants Reckitt Benckiser, Unilever and Procter & Gamble

▶ rising stream of dividends to shareholders. This has underpinned the very strong total returns their shares have delivered since the stock market bottomed in March 2009.

Dividends

Name	Latest DPS	DPS 10 years ago	CAGR	Total return since March 2009
Colgate-Palmolive	152p	58p	10.11%	198%
Procter & Gamble	266.5p	118p	8.49%	131%
Reckitt Benckiser	139p	39p	13.55%	231%
Unilever	88.5p	45.1p	6.97%	245%

Total return = price change + dividends Source: SharePad

Are these shares good investments today?

The key question that investors need to answer is whether the shares of these high-quality 'bond proxies' can keep on delivering.

As you can see, these shares trade on high forecast PE ratios, which show how popular they are at the moment.

Can they deliver today?

Name	Close	Forecast PE	Forecast yield
Colgate-Palmolive	$73.62	26.5	2.2
Procter & Gamble	$88.66	19.5	3.1
Reckitt Benckiser	£72.90	24.5	2.1
Unilever	£37.08	23.7	2.8

Source: SharePad prices as at 3.10.2016

'The financial returns that these businesses have been able to produce has allowed them to pay a rising stream of dividends to shareholders'

One of the biggest risks that an investor can take is to pay too much for a share. This is because high valuations imply high future profits growth. If these expected profits fail to materialise then the usual outcome is that the share price falls and investors lose money.

However, another argument is being made in today's markets.

The low interest rates on government bonds justifies that bond proxy shares can also offer low interest rates too. To get a share's interest rate or yield you invert the PE ratio (turn it upside down). So Reckitt Benckiser with a forecast PE of 24.5 times is offering an interest rate (or earnings yield) of 4.1 per cent.

That's a low number. However, 10-year government bonds are offering a yield of 0.75 per cent at the time of writing. In this context, 4.1 per cent might look reasonable to some investors given the dependability and seemingly low-risk nature of Reckitt's business. Even more so if that interest rate can grow as future profits grow.

But is this a case of trying to justify the valuation of a share that isn't really justified? To try to work out whether this might be the case it is useful to look at how top investors such as Warren Buffett value shares.

Valuing a company's cash profits

Warren Buffett has been working out the cash profits of businesses for many years. In his 1986 letter to shareholders he described how he worked out what he called the "owner earnings" of a business. He did this because he believed the reported profit was not a conservative estimate of the amount of money that really belonged to the shareholders of a business.

Owner earnings are calculated as follows: Net income + depreciation & amortisation + other non cash items – maintenance capital expenditure.

Mr Buffett's view then was that the amount of money a company needed to spend to maintain its competitive position (known as maintenance or stay-in-business capex) often exceeded the depreciation and amortisation expense and therefore profits were overstated.

Also if a business needed extra working capital (more stock or more generous credit terms for customers) then this should be added to the maintenance capex figure. Generally speaking, though, this calculation ignores changes in working capital.

This is all very good in theory. But how does a company outsider and investor work out how much money a business needs to spend to remain competitive? The truth is they can't. Most companies don't tend to give a breakdown between money spent on maintaining assets and the proportion spent on growing the business.

Instead you are left with three practical alternatives for estimating the maintenance capex when calculating owner earnings:

1. Use a multiple of the annual depreciation and amortisation charge. This takes into account that the latest figure is out of date. By multiplying it by 120 per cent (or 1.2) you make some allowance for some extra working capital being needed.
2. Use the total amount of money spent on capital expenditure for the year. If you want to be very conservative then use this figure. If capex is less than

Of the four consumer goods giants, Colgate-Palmolive has the highest return on capital employed

depreciation then use the depreciation expense as a minimum figure.

3. Another alternative is to take an average of the past five or 10 years' capex and use that figure. This works best if there have not been big variations in the amount of money spent.

You will not get a true figure of owner earnings but, as Mr Buffett said in relation to this issue, he'd rather be "vaguely right than precisely wrong".

Once you have an estimate of cash profits, Mr Buffett says that a valuation of a company can be estimated by dividing that number by the yield on government bonds.

The figures you can use to estimate the cash profits of the consumer goods companies we have been looking at can be seen in the table above right.

Let's use these numbers to get a valuation for Reckitt Benckiser and Unilever shares.

Starting with Reckitt Benckiser, we can see that its capex and depreciation numbers are broadly similar. Its five-year and 10-year capex figures are slightly higher and this may be because of its pharmaceuticals business, which has been sold. In this case, I will use the most recent capex figure of £179m as an estimate of stay-in-business capex.

For Unilever, capex is substantially more than depreciation. Here, I will use the 10-year average capex figure of £1,440.2m.

The other decision to make is what interest rate to divide the cash earnings by. Ten-year government bonds offer a yield to maturity of 0.75 per cent. Using this number is not sensible as bonds are at high valuations due to interference by central banks through quantitative easing – and are arguably overvalued.

To get a sensible valuation using Mr Buffett's cash profits measure, you need to make some adjustment to current bond yields. Over the past 30 years, yields on UK 10-year government bonds have averaged around 3 per cent more than inflation as measured by the retail prices index (RPI). With the RPI currently at 1.8 per cent, this would give an adjusted yield of 4.8 per cent.

This then gives estimated valuations for Reckitt Benckiser and Unilever as shown in the table below.

According to this analysis, both shares are significantly overvalued.

They would look less expensive if based on forecast net income figures, where continued growth and a significant boost from the falling value of the pound (which increases the value of overseas profits) would boost valuations. Both companies are expected to grow their post-tax profits by around 20 per cent, which would still not make them look cheap using this valuation approach.

Cash profits

Name	Net income (£m)	D&A (£m)	Capex (£m)	Capex 5-yr avg (£m)	Capex 10-yr avg (£m)
Colgate-Palmolive	1,384	449	691	644	608.9
Procter & Gamble	10,508	3,078	3,314	3,774	3,447.2
Reckitt Benckiser	1743	170	179	193.8	193.9
Unilever	3,571.7	996.8	1,601.4	1,806.9	1,440.2

Source: SharePad. D&A = depreciation & amortisation

Estimated valuations

£m	RB.	ULVR
Net income	1,743	3,571.7
Depreciation & amortisation	170	996.8
Stay-in-business capex	-179	-1,440.2
Cash profit = A	1,734	3,128.3
Interest rate = B	4.80%	4.80%
Value of Equity = A/B	36,125	65,173
Shares (m)	702.6	2,838
Value per share	£51.42	£22.96
Share price	£72.90	£37.08
Difference	-29.47%	-38.07%

Bond proxies and the risks of higher interest rates

The reason why historically many investors have liked bonds is because they know how much and when they are going to get paid. A 10-year bond will pay interest twice a year and return the initial investment at the end of the tenth year.

There is no such certainty with shares. You have no certainty what profits will be in 10 years' time and what you will be able to sell them for. You hope that both profits and the share price will be higher, but there is no guarantee that they will be.

The other factor to consider is the risk of higher interest rates.

Bond prices and interest rates move in opposite directions. They are like a see-saw. When one is up the other is down and vice versa. Other than not getting their money back, the biggest risk facing bond investors is that interest rates go up.

Interest rate risk is measured by something known as duration. It measures how long it takes for the investor to get the purchase price of the bond back in today's money. In simple terms, the longer a bond's duration the more sensitive its price is to changes in interest rates.

A 10-year bond will be more sensitive than a one-year bond because a higher interest rate will lower the present value of future interest payments and the bond repayment value because the holder has longer to wait for them.

Now ask yourself what is the duration of a bond proxy share such as Reckitt Benckiser or Unilever? You don't know for sure, but they are effectively irredeemable bonds – bonds with no maturity date. This means they have much longer durations than most bonds and will be much more sensitive to increases in interest rates.

If interest rates do rise then these shares – and shares in general – could see their prices fall significantly. What we have seen so far is a rise in share prices caused by falling interest rates. With interest rates at rock bottom levels it is difficult to see that this trend has much further to go.

Food for thought.

Phil Oakley is a stock analyst for Ionic Information, maker of SharePad and ShareScope investment software. Read more from Phil, including his excellent Step-by-Step Guide to Investment Analysis at www.sharepad.co.uk/philoakley.

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