Coca-Cola FEMSA (KOF) – $39.38
8/28/2007

Buy Now, Intrinsic Value $49

Summary: KOF offers a way to invest in the Coca-Cola brand name, but in the faster growing Latin American market. Its shares have fallen from a 52-week high of $48.90, largely because of short-term margin pressures, but I believe the company is working through those issues. Part of the stock price decline was also likely the result of concerns stemming from Felipe Calderon winning the Presidential election last year, since his political views tend to be pro-competition. However, I believe a recent ruling by the Mexican Antitrust Commission suggests any anti-trust concerns against KOF are overblown. I arrived at my $49 intrinsic value estimate using what I believe are pretty conservative financial estimates.

Background: Coca-Cola FEMSA is the Latin America bottler and distributor of Coca Cola products. Coca-Cola branded products accounted for 95% of its sales volume in 2006. The other 5% are primarily beer products that are produced by the Mexican alcoholic beverages company FEMSA. Mexico represents ~53% of total sales, while the faster growing Brazil, Venezuela, Columbia, and Argentina markets each contribute more than 10% of revenue. The Coca-Cola Company (KO) and FEMSA (FMX) indirectly own 32% and 53% of the company, respectively.

Excellent brand with good growth prospects. Coca-Cola is obviously one of the strongest brand names in the world. Half of KOF's sales are in the relatively mature Mexican market, but the other half are concentrated in faster growing Latin American countries. I think this provides an intriguing mix – solid, stable cash flow generation from its Mexican business, with the growth upside from the other countries.

Stock has fallen in response to short-term margin pressures, but KOF is working through these issues.

- Gross margins fell 1.3% y/y in 2Q. In fact, Y/Y gross margins have declined the last 4 qtrs, but on a positive note, they were higher sequentially in the 2Q07 (at ~48.1%).
- Their biggest raw material expense is concentrate prices, and these are determined solely by the Coca-Cola Company (KO). Although concentrate prices are currently somewhat high by historical standards, early indications are that KOF has been able to pass along these higher costs to customers without a noticeable downturn in volume sales. Plus, I note that KO owns 32% of company, so I would argue it would be in KO's best long-term interests to keep those concentrate prices reasonable.
- KOF's second biggest variable expense is sweetner, and sweetner prices began falling late last year. That should lead to an improvement in comparable gross margins over the next several quarters.

It looks like KOF will emerge from anti-trust investigations relatively unscathed. The Mexican Antitrust Commission (CFC) has been conducting an ongoing investigation against KOF since 2000 about possible monopolistic behavior. The main issue is whether KOF abused its market power by forcing OXXO convenience stores to enter into exclusive agreements to carry only Coca-Cola products. OXXO stores are the equivalent of Mexican 7-11s, and they just so happen to be owned by FEMSA, who in turn owns more than half of KOF's shares. The main risk is that KOF will be found guilty of illegal monopolistic practices because of its exclusivity arrangements, and could be forced to in essence break up its vertically integrated monopoly. That could potentially cripple its operating margins. The final ruling on this is expected sometime by the end of 2007.

I believe the recent ruling from the CFC regarding KOF's proposed $380 million acquisition of Jugos de Valle shows the risk of any dramatic change to KOF's operations is unlikely. Long story short, the CFC originally rejected the proposed acquisition, but later allowed it, subject to KOF allowing competitors to sell products through OXXO stores (basically rescinding the exclusivity arrangements). KOF was even able to work with the CFC in determining how competitors would be able to access those OXXO stores, and in the words of the company CEO, the resolution "is more than acceptable to us." The bottom line is it looks like KOF will not be subject to any serious fines or forced dissolution of its business model when the CFC renders its final decision later this year. That is a major positive for the stock, in my opinion.

Balance sheet in good shape. KOF's Debt/cap ratio is a bit high at 31%, but its debt coverage ratios are good. Plus, they are owned 32% by Coca-Cola and 50% by Mexican beverage giant FEMSA. It seems reasonable to argue those companies would stand by KOF in the event of any liquidity crisis, much like the U.S. government implicitly would guarantee agency bonds.

Valuation – KOF is trading at 12.4x its NTM EPS estimate, a multiple that is slightly higher than the median 11.5x at which it has traded over the last five years. However, its forward PEG ratio is just 1.04, and I think that is extremely reasonable for just about any company, especially one that has KOF's strong market position and growth prospects. My discounted cash flow model yields a $49 intrinsic value, and that's assuming KOF's sales growth rate gets cut in half in five years. That assumption is likely too conservative.

Other Positives/Notables

- I really like that they don't have an options program. Rather, they reward their managers based on economic value added (EVA). That better aligns management interests with those of the shareholders.
- Excellent disclosure in their financial reporting. You don't always get this with foreign companies.
- Another good defensive stock, with a 1.8% dividend yield.
- ROIC > WACC

Risks

KOF’s financial results would be depressed if the Mexican peso depreciates vs. the U.S. dollar. Their biggest raw material cost is concentrate, which is priced in U.S. dollars, and they have lots of U.S denominated debt. KOF doesn’t do much forex hedging. However, the peso has strengthened vs. the dollar since March 2006.

The Mexican Antitrust Commission rules KOF willfully engaged in monopolistic practices, and orders drastic measures against the company. Again, however, I believe the risk of this is very low.

Free Cash Flow to the Firm

		From Output
5-Yr Sales Growth Rate	10.5%	10.5%
EBIT Margin	17.5%	17.0%
Cash Tax Rate	35.0%	35.0%
Cap Ex as % of Sales	4.0%	
Working Cap As % of Sales	1.0%	
% Other Net Liabilities as a % of Sales	0.0%	

	2006	2007	2008	2009	2010	2011	2012+	5-yr g rate
Sales	6,093	6,335	6,688	7,181	7,934	8,768	9,206	7.6%
Pre-Tax Operating Profit	1,066	953	1,175	1,295	1,389	1,534	1,482	

	2006	2007	2008	2009	2010	2011	2012+	
After Tax Earnings Before Interest & Taxes (EBIT*(1-t))	693	620	764	842	903	997	963	7.6%
Depreciation & Amorrtization (Assumes grows with cap ex)	151	163	174	186	198	212	227	7.0%
Increases in Deferred Liabilities (Assets) (IMBEDDED IN CASH TAX RATE)	-	-	-	-	-	-	-	
Cap Ex (Cap Ex less disposals)	(189)	(300)	(268)	(287)	(317)	(351)	(368)	13.2%
Change To Working Capital	(26)	(63)	(67)	(72)	(79)	(88)	(92)	27.5%
Increase in Net Other Liabilities		-	-	-	-	-	-	
Free Cash Flow	629	420	603	669	704	771	730	4.1%
Terminal Value							13,857	
Discounted FCF		381	496	498	476	472	8,487	

CHECK DEPRECIATION	2001	2002	2003	2004	2005	2006	2007	Avg
Sales		1,685	3,183	4,173	4,733	5,346		
Depreciation/Amort		77	154	147	240	328		
% of Sales	#DIV/0!	4.6%	4.8%	3.5%	5.1%	6.1%		#DIV/0!
Dollar Change		77	76	-7	93	88		

		2007	2008	2009	2010	2011	2012+	
Net PP&E		3,250	3,387	3,480	3,582	3,701	3,839	
Plus: CapEx		300	268	287	317	351	368	
Less: Depreciation		-163	-174	-186	-198	-212	-227	
Ending PP&E	3250	3,387	3,480	3,582	3,701	3,839	3,980	
% of Sales		2.6%	2.6%	2.6%	2.5%	2.4%	2.5%	2.5%
Dollar Change		-165	11	11	13	14	15	

CHECK AMORTIZATION							
Amortizable Base		0	0	0	0	0	0
Annual Amortization		0	0	0	0	0	0
Ending Balance		0	0	0	0	0	0

Total Discounted FCF		10,810	
Current Diluted Shares Outstanding		185	
FCFF per share	$	58.53	0
Plus: Cash & Investments	$	3.76	
Less: Debt Per Share		9.43	
Less: Preferred Shares Per Share		0.00	
Less: Underfunded Pension Obligations Per Share		0.32	
Less: Equity Options Per Share		0.00	
Less: Off-Balance Sheet Debt Per Share		0.29	
FCFE per share	$	52.25	

CURRENT SHARE PRICE	52.2

Assumed Y/Y Changes	2012+
Sales	5.0%
EBIT Margin	16.1%
Cash Tax Rate	35.0%
Cap Ex as % of Sales	4.0%
Working Cap as a % of Sales	1.0%
Other Net Liabilities as a % of Sales	0.0%
Required rate of return after 2012	12.2%
Constant growth rate of FCFE after 2012	6.9%

WACC	**10.30%**
Required Rate of Return on Equity	12.20%