***Analyst Report: Pepsico - PEP***

Our recent analysis of Pepsico’s (PEP) forecasted future cash flows imply a 5-year price target of $ 165.12 based on the company’s cash flows being discounted at their current cost of equity. This would ultimately suggest a return on investment of 22.6 % from the July 17th price of $134.66. The firm’s forecasted free cash flows for the years 2020-2024 discounted at the company’s weighted average cost of capital yield a similar price target of $ 164.60. Furthermore, the firm's unlevered cost of capital discounted at the company’s unlevered cost of capital yields a 5-year price target of $ 161.72. Based on the above calculations, we believe the 5-year price target for Pepsico is between $ 161.72 and $ 165.12. Considering that if the company’s stock is able to reach the high end price target of $ 165.12, this will still only yield investors with a yearly return of 4.52% on their investment in Pepsico, underperforming the overall S&P 500’s yearly average return of 9.8%. We believe investors should strongly consider selling Pepsico because of the company’s stocks speculative underperformance of the S&P 500 and slowed growth in sales volumes over the past years furthers our doubts that Pepsico will provide investors with strong future returns.

The decline and slow growth in sales volume of their divisions is listed down below. We think that this tells the story of their company fairly well and leads one to be slightly pessimistic of their long term growth. They appear to be a mature company that has growth opportunities through acquisition. The new CEO [Ramon Laguarta](https://www.google.com/search?sxsrf=ALeKk03Pr2o6fUycdGRAm7xVYwUTFn3lvQ:1595109645154&q=Ramon+Laguarta&stick=H4sIAAAAAAAAAONgVuLVT9c3NEzLyjMqKDE2ecRowS3w8sc9YSn9SWtOXmPU5OIKzsgvd80rySypFJLmYoOyBKX4uVB18ixi5QtKzM3PU_BJTC9NLCpJBABOSjc8XQAAAA) came in at the time of the 2018 soda stream acquisition which has turned out very well, leading to optimism around continuing growth through acquisition. According to their 2018 10-k sales volume increases are said to come mainly from their acquisition of sodastream.

‘Quaker Foods North America-.5% in 2018

Frito-Lay North America +1% in 2018

North America Beverages -1% in 2018

Latin America, Beverage volume declined 1% in 2018

Europe Sub-Saharan Africa Beverage sales grew 7% in 2018 (growth mainly from sodastream)

Asia, Middle East and North Africa, Beverage volume slight decline in 2018’(2018, Pepsico)

Our second issue is that we do not expect the stock to perform better than the market as a whole. We estimate Pepsico is going to underperform the S&P 500 index over the next five years. You would thus be better off buying an index fund. The valuation we are basing this on is the Equity Cash Flow Model, Adjusted Present Value Model, and the Corporate Valuation Model. Their 2018 acquisition has adjusted their downsloping FCFF and resulted in a slightly optimistic valuation. From this we can say again their growth through acquisition would be optimal but at this time speculative to assume further actions from the new CEO. Historically their common seems to be trading around their P/S and P/E valuations which we found to be 141.47 and 142.81 respectively at year end 2019. We went with the higher valuation figures because of the increased liquidity in the system from covid and the subsequent increasing inflation will prompt price adjustments. According to the Beuro of Labor Statistics Consumer Price Index at home snack foods are generally getting less expensive than dine out snack foods like Mcdonalds, a pepsico price adjustment is well overdue and inflation might cause this. Understanding this is mainly speculation, we decided to go with a current value of ~160 instead of the P/S and P/E valuations. We however are still pessimistic because all things considered, the upside in the value of this stock does not represent sufficient value to condone a buy recommendation without being overly speculative.

Some key points to focus on are looking at the firm's free cash flow for this year and the past several years. Forecasting their numbers for the next 4 years is very promising because Pepsico has traditionally done well even with following stock market crashes. While this company is well insulated against disasters like COVID-19, it also has to continuously research and create new products to compete against its market competitors. Outgrowing where it is now will continue to prove more difficult because the company already operates in over 200 countries. A company this huge also faces many obstacles with growing trends like the green movement, soda taxes, and healthy drink movements. We mark this stock as a sell or possibly hold because all though it is very reliable, has great cash flow to cover buybacks, and even has a high dividend yield, the stock market has done incredibly well in recent years. Index funds and technology stocks outperform the S&P regularly, and are just as safe in most cases or even safer. Depending on the outcome of the next year or so, analysis may change because of volatility in the stock market, however at this time there are much more viable options for higher returns.

The three methodologies we used in our evaluation of Pepsico are the Equity Cash Flow Model, the Corporate Valuation Model, and the Adjusted Present Value Model. These models resulted in 5-year price targets of $165.12, $164.60, and $161.72 respectively. To determine Pepsico’s unlevered beta, we calculated the unlevered betas of 10 comparable firms and used the average of those figures. Our cash flow computations were based on a constant 1.60% growth of balance sheet items over the next 5 years, a 1.60% terminal growth rate, and an interest expense that remained constant at 2.53% of all debt obligations. To determine the depreciation and amortization expense for future years, we took a moving average of the previous five years expenses. Lastly, we used a constant tax rate of 21% based on the 2019 tax rate for the company. For the Equity Cash Flow Model computation, we used Pepsico’s cost of equity to discount our equity cash flow forecasts, which was derived by multiplying the market risk premium (MRP) by the company’s levered beta and adding the risk-free rate (Rf) on the filing date. To get the levered beta, we multiplied the unlevered beta figure by Pepsico’s tax adjusted market value of debt to equity ratio. When doing the Corporate Valuation Model, we used Pepsico’s Weighted Average Cost of Capital (WACC) to discount the free cash flow figures that we forecasted. We calculated the WACC from our cost of equity and cost of debt calculations, along with the respective weights of debt and equity that the company holds. Lastly, in the Adjusted Present Value Model, we used our unlevered cost of capital as the discount rate for our free cash flow forecasts. The unlevered cost of capital figure was derived by multiplying the MRP by the unlevered beta summed with the risk-free rate.

With the long-term effects of the recent COVID-19 outbreak being unknown, the state of the worldwide economy poses a great risk to Pepsico. Although Pepsico’s stock has bounced back since it saw a large drop in March, we cannot be certain how long the pandemic will last or what effects it will have over the upcoming years. With continued economic shutdowns throughout the world, particularly in the United States where Pepsico generates the majority of its revenues, there is a chance the economy enters a recessionary period. With a recession comes a decrease in consumer spending, which would most likely have adverse effects on Pepsico’s financial condition and results of operations.

Another significant investment risk that Pepsico faces is the upcoming United States presidential election. The political landscape of the countries that Pepsico operates in, particularly the United States, could have various effects on the company’s operations and financial results. To start, the corporate tax rate is uncertain. The decreased tax rate that was put into effect by the Trump campaign in 2018 proved beneficial to Pepsico’s 2018 and 2019 net income, however, we could see this tax rate increase again with a democratic president in office. New laws and regulations regarding the materials and practices Pepsico uses for manufacturing, packaging and distribution could also have adverse effects on the company. The global push for sustainability could threaten both the costs of operations and the consumer demand for Pepsico products, as not all of their products’ manufacturing processes and packaging are done in a sustainable manner.

Citations:

Consumer Price Index News Release. (2019, April 10). Retrieved July 19, 2020, from https://www.bls.gov/news.release/archives/cpi\_04102019.htm

FORM 10-K. (2019, February 15). Retrieved July 19, 2020, from https://www.sec.gov/Archives/edgar/data/77476/000007747619000017/pepsico201810-k.htm