General Mills
Making Food People Love

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Sum Zero – Top Stocks for 2019
Company: General Mills (NYSE: GIS)
Market Capitalization: $22.9B
Enterprise Value: $38B
Current Price: $38.48 (12/7/18 market close)
Target Price: $53.52
Expected Return: 39%
Disclosure: I have an ownership in shares of General Mills at the time of writing

Business Background

General Mills is a branded consumer foods producer with food marketed in more than 100 countries. It has been in business since 1856 when it was founded in Minneapolis, Minnesota. It is currently headquartered in Golden Valley, Minnesota and is a part of the Consumer Defensive sector and the Packaged Foods industry.

General Mills categorizes their sales into the following business segments: North American Retail, Europe and Australia, Asia and Latin America, Convenience Stores & Foodservice, Pet, and Joint Ventures. Their leading business segment is North American Retail with 65% of net sales followed by Europe & Australia with 12%, Convenience Stores and Foodservice with 12%, and Asia and Latin America with 11%.

Some of their leading brands are shown below along with General Mills' revenue broken down by product group and business segment.

Fiber One

Wheaties

Cheerios

Betty Crocker

Bisquick

Pillsbury

Annie's

Nature Valley

Totino's / Jeno's

Blue Buffalo

Food Should Taste Good

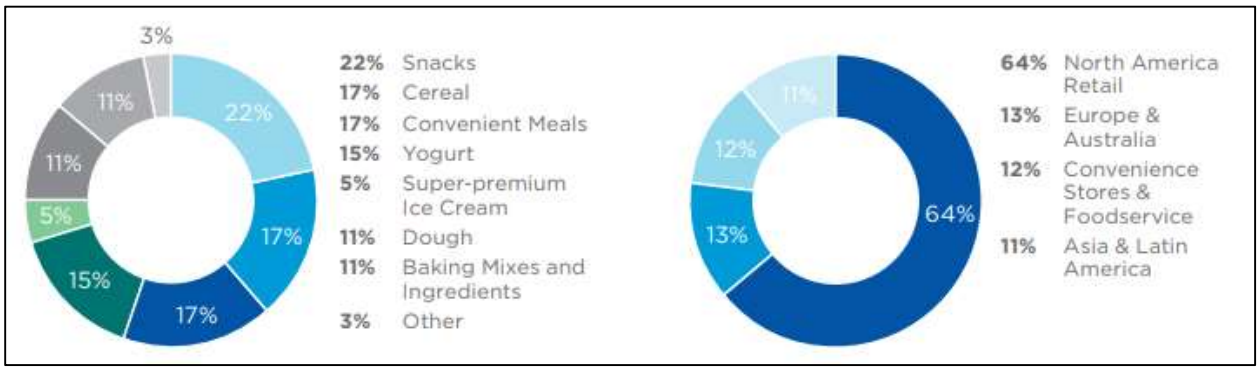
Häagen-Dazs

Yoplait

Yoki

Progresso

Chex



Source: 2018 Annual Report

Management

The current CEO is Jeffrey L Harmening who was just appointed as CEO in 2017 and Chairman of the Board in 2018. He has been with the company since 1994 and has had a variety of positions throughout the company including Vice President of Marketing for Cereal Partners Worldwide, Chief Operating Officer of their U.S. Retail division, and Chief Operating Officer of General Mills. He has a good understanding of the culture of the organization and has been with the company over 20 years serving in a variety of operating roles which should give him the needed experience to lead the company forward. He also has a +5% ownership stake with 156,295 shares that he owns which translates into a value of a little above $6,000,000 at a current share price of $38.48.

Investment Thesis

General Mills still has some of the most well recognized brands in an industry that is recession proof because people need to eat. They earn high returns on equity, have consistently earned above 10% net profit margins, and earn returns on invested capital in excess of their cost of capital. Despite the fears of private label competition, trade wars, changing consumer trends, increased debt and slow revenue growth I believe General Mills will continue to compound capital for shareholders. The equity is currently trading at its lowest levels in over 10 years on several equity value metrics. The TTM P/E ratio is 11, TTM P/FCF is 10, EV/EBIT is 14, and P/S is 1.4. I am estimating a target price of $53.52 which would result in a return of 39% from its current price of $38.48 and I estimate that in 5 years the company will reach around $70 per share which was the range that it was trading at in 2016. In the meantime, investors will get a 5% dividend yield while they wait.

Why is Mr. Market Offering Us a Bargain?

Source: Morningstar

As described in the 3-year chart above, General Mills' stock price has languished over the last 3 years. It hit an all-time high in July 2016 when it was trading a little above $70 per share but currently trades at $38.48 at of the close of the market on 12/7/18 which translates into around a 45% depreciation in price since July 2016.

The reasons for the stock's decline are due to negative sentiment regarding the overall packaged food industry, changing consumer taste from less processed foods to more health conscious and natural food, languishing sales and growth due to increased competition from private labels, increased debt due to the acquisition of natural pet food producer Blue Buffalo which was also viewed by the street as being purchased with too high of a premium, fears over a trade war, increasing commodity and transportation costs, and the possibility of a dividend cut.

Although some of these can impose real risks to their business model, I don't see any of these having a permanent long-term effect. All of these factors affecting the share price are manageable and management has already taken steps to counter some of these risks. In order to counter a shift in consumer taste from less processed food to more natural and organic food management has branched out into the organic and natural food category. Some of those brands include Annie's, Cascadian Farm, Epic, Food Should Taste Good, Immaculate Baking and Mountain High. And in order to counter slow organic driven sales growth management decided to acquire Blue Buffalo whom has compounded sales at 10%.

Also, organic and natural food cost more money to buy which makes it more difficult for consumers to pay the higher prices during a recession or a less buoyant time in the economy as their budgets get constrained. It is noteworthy to keep in mind that one of the biggest consumers of more natural and organic food has been the millennial generation whom the great majority of haven't fully lived through a recession yet. It remains to be seen whether they will choose to stay with the more expensive but healthier options.

Is the Dividend Sustainable?

The 5% dividend yield should keep a good support level for the stock but the important question to ask is, "Is the dividend sustainable?" My answer to this question is yes, it is sustainable and although they could still cut it for reasons such as freeing up capital to make acquisitions or to pay down debt, I believe the dividend will still be sustained because it is currently being adequately funded through free cash flow and earnings. In other words, the payout ratio doesn't look high right now. And even if interest rates were to lead to higher interest costs there is still enough extra cash flow to cover both.

General Mills currently pays out a quarterly dividend of $.49 which translates into an annual dividend of $1.96. With a dividend of $1.96 and a current share price of $38.48 this gives General Mills a 5% yield. The dividend is an annual cash outflow of $1.17B. There are three metrics I used to test the dividend outflow against: 1. earnings, 2. free cash flow, and 3. whether an increase in interest rates will make it too difficult to fund the dividend if interest expense increases too much.

Over the last 12 months, General Mills' free cash flow was $2.2B and the dividend outlay was $1.15B so based on free cash flow it was overfunded by $1.05B which is a sizable amount of cushion. Net income was $2.12B so against TTM net income it was adequately funded with a surplus of $920M. Their earnings and cash flow are also more resilient to recessions since people need to eat in both good and

bad times. During the years of 2007-2009 through the last recession their net income was $1.14B, $1.30B, and $1.30B.

I will discuss a possible increase in interest rates and interest expense in the next section but with an overfunding of $1 billion, the company could withstand an increase in interest rates. Total debt is currently $14.2B with $1.6B due this year and with an increase in interest rates of 1% it would result in an increase in interest expense of $142 million and 2% would be $284 million which is much less than $1 billion. This also doesn't factor in that most of the debt financing is fixed as opposed to variable.

Payout Ratios	
Dividend/Free Cash Flow	54%
Dividend/Net Income	57%

TTM Free Cash Flow	2,200.00
Dividend	(1,150.00)
Surplus	1,050.00

TTM Net Income	2,119.00
Dividend	(1,150.00)
Surplus	969.00

Is the Debt Level A Cause for Concern?

General Mills acquired natural pet food maker Blue Buffalo recently and this resulted in General Mills' total debt increasing from $9.45B in 2017 to $15.8B in 2018. A pretty big increase in debt but definitely manageable because the majority of the debt as shown below is fixed as opposed to floating. 81% is fixed and 19% is floating. The weighted average maturity of the fixed debt is 3.2% which is very low. Even if I assume that the interest rate on all of their floating rate debt is 5.5%, which I think is a high assumption, than the weighted average interest rate is still very manageable with a rate of 4%. And a 1% increase in interest rates would result in a little less than $150M extra interest expense and a 2% increase in interest rates would result in a little less than $290 in extra interest expense.

Both increases in interest expense are manageable due to the defensive nature of the business and the excess free cash flow even after the dividend. A little bit more of a concern is that $2B will be due in 2019, $1.2B in 2020, and $2.7B in 2021. This is a total of almost $6B due within 3 years which could always be refinanced but will very likely be financed at slightly higher interest rates than they currently are at with an exception of the 5.65% note due 2019 which is already at a rate higher than normal for General Mills.

Interest Rate for Fixed Rate Debt	%
< 4%	49%
> 4%	23%
> 5%	12%
	84%

Type of Rate	Amount	%
Floating	11,668	81%
Fixed	2,682	19%
Total	14,351*	100%
*(Not including other)		

In Millions	May 27, 2018	May 28, 2017
4.2% notes due April 17, 2028	$ 1,400.0	$ -
5.65% notes due February 15, 2019	1,150.0	1,150.0
3.15% notes due December 15, 2021	1,000.0	1,000.0
3.7% notes due October 17, 2023	850.0	-
Floating-rate notes due April 16, 2021	850.0	-
4.0% notes due April 17, 2025	800.0	-
3.2% notes due February 10, 2027	750.0	750.0
4.7% notes due April 17, 2048	650.0	-
3.2% notes due April 16, 2021	600.0	-
Euro-denominated 2.1% notes due November 16, 2020	582.6	559.2
Euro-denominated 1.0% notes due April 27, 2023	582.6	559.2
Euro-denominated floating-rate notes due January 15, 2020	582.6	559.2
1.4% notes due October 20, 2017	-	500.0
4.55% notes due April 17, 2038	500.0	-
2.6% notes due October 12, 2022	500.0	-
5.4% notes due June 15, 2040	500.0	500.0
4.15% notes due February 15, 2043	500.0	500.0
3.65% notes due February 15, 2024	500.0	500.0
2.2% notes due October 21, 2019	500.0	500.0
Euro-denominated 1.5% notes due April 27, 2027	466.1	447.3
Floating-rate notes due October 17, 2023	400.0	-
Euro-denominated floating-rate notes due March 20, 2019	349.6	335.5
Euro-denominated 2.2% notes due June 24, 2021	232.8	222.8
Medium-term notes, 2.36% to 6.59%, due fiscal 2022 or later	104.2	204.2
Other, including debt issuance costs and capital leases	(81.7)	(39.8)
	14,268.8	8,247.6
Less amount due within one year	(1,600.1)	(604.7)
Total long-term debt	$ 12,668.7	$ 7,642.9

% of total	Interest Rate	Amount	Maturity	Type	Years Due
10%	4.2	1,400	2028	Fixed	11
8%	5.65	1,150	2019	Fixed	2
7%	3.15	1,000	2021	Fixed	4
6%	3.7	850	2023	Fixed	6
6%	floating	850	2021	Floating	4
6%	4	800	2025	Fixed	8
5%	3.2	750	2027	Fixed	8
5%	4.7	650	2048	Fixed	31
4%	3.2	600	2021	Fixed	4
4%	euro 2.1	583	2020	Fixed	3
4%	euro 1	583	2023	Fixed	6
4%	euro floating	583	2020	Floating	3
4%	4.55	500	2038	Fixed	21
4%	2.6	500	2022	Fixed	5
4%	5.4	500	2040	Fixed	23
4%	4.15	500	2043	Fixed	26
4%	3.65	500	2024	Floating	7
4%	2.2	500	2019	Fixed	2
3%	euro 1.5	466	2027	Fixed	10
3%	floating	400	2023	Floating	6
2%	euro floating	350	2019	Floating	2
2%	euro 2.2	233	2021	Fixed	4
1%	medium fixed	104	2022 or later	Fixed	5
-1%	other	(82)	N/A	N/A	
100%	Total	14,268.80			
	due this year	(1,600)			
		12,668.70			

Source: 2018 Annual Report

Moat

General Mills has some of the most recognizable brands which include Cheerios, Yoplait, Wheaties, Nature Valley and Haagan Dazs which have leading market share in their categories. Despite competition from Greek Yogurt and a loss of market share, Yoplait is still a leader in the yogurt space and Cheerios, Wheaties, Cinnamon Toast Crunch, Trix and Cocoa Puffs are still some of the most recognizable brands in the cereal category. There snack brands such as Chex, Fiber One, and Nature Valley are also very recognizable and these plus their cereal and Yoplait yogurt brands give General Mills some leveraging power over supermarkets and other grocery retailers since these retailers rely on these foods to bring in customers. These brands also allow them to establish shelf space in supermarkets which allow their products to be seen and purchased by consumers.

General Mills has also consistently earned returns on invested capital in excess of its cost of capital. According to Gurufocus, General Mill's weighted average cost of capital is 5.16% while

their return on invested capital is 15.63%. Low interest rates driven by the Fed's monetary policy over the last decade has helped General Mills finance its debt at low rates and General Mills being a consistent company with recessionary proof products and consistent earnings and margins has helped keep its cost of equity down resulting in a low weighted average cost of capital. Meanwhile strong brands, economies of scale, and leverage over retailers have helped keep General Mills' returns on invested capital consistently above 10%.

Financial Ratios

General Mills' valuation based on some standard valuation ratios are very favorable for value investors. With a market cap of $22.9B and net income, free cash flow and sales of $2.12B, $2.24B, and 16B respectively, the company currently trades at a price to TTM earnings ratio 11, price to TTM free cash flow ratio of 10, and price to sales ratio at 1.4. These are very favorable value metrics for a company with several established brands, a consistent dividend paying history, a defensive company with recession-proof products in the food industry, and a history of earning high returns on equity and on capital. Returns on equity have averaged over 20% over the past 10 years and returns on invested capital have averaged over 10% for the past 10 years with one exception for ROIC in 2015 when it was 9.69%.

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Equity %	22.9	28.94	30.56	24.51	28.34	27.63	21.18	34.2	35.81	40.71
Reutrn on Invested Capital	12.17	14.88	16.28	13.33	14.6	13.52	9.69	13.82	13.75	13.95

Source: Morningstar

With the addition of $6 billion in debt added to the balance sheet to fund the Blue Buffalo acquisition it could be said that the equity appears cheaper due to the addition of debt but even when looking at the enterprise value to operating profit ratio the company still looks to be trading at an attractive valuation. With a market cap of $22.9B, total debt of $15.6B, and cash of $433M the enterprise value is $38B. Meanwhile operating profit over the last 12 months was $2.6B - this figure has stayed consistent over the past 10 years due to the defensive nature of the business – so with an enterprise value of $38B and $2.6 in operating profit that is an earnings yield of 7% or a multiple of 14.3 which I consider attractive for a consumer staples company that usually trades more around 20 when Mr. Market isn't as fearful.

As shown on the charts below, the blue line represents General Mills and the orange line represents the S&P 500. General Mills' P/E ratio was as high as 23.8 in 2015 and as low as 14.7 in 2009. With its current ratio of 10 it is not only cheap but there is a margin of safety built in if there were to be an increase in debt service costs from the debt taken on to buy Blue Buffalo, increased costs of good sold due to higher commodity and transportation costs, and further competition from private labels.

Price/TTM Net Income	11
Price/Free Cash Flow	10
Price/TTM Sales	1.4

Market Cap	22.9B
TTM Free Cash flow	2.24B
TTM Net Income	2.12B
TTM Sales	16B

TTM Return on Equity	34%
TTM Return on Invested Capital	12%

Sources: Morningstar

Valuation

General Mills currently has a market cap of $22.9B and free cash flow of $2.2B which results in a multiple of 10. If free cash flow stays consistent and there is multiple expansion, then this could result in a multiple more in line with its historical standards which would range around 15 to 20. At 15, the price per share would be $55 and if the P/E doubled to 20 which is more on the high side of the historical average the share price would be a little less than $74. If free cash flow dropped by 25% and the P/E went back to its historical average of 15 the price per share would be $41.53 which is almost 10% above the current price now and that doesn't factor in the 5% dividend yield that investors would receive also.

In order to find the intrinsic value, I start with TTM free cash flow and estimate that this grows at 2% over the next 5 years which is equal to the average of what the US economy – where most of the company's sales come from – has grown at in the post Great Recession period. I use a cost of equity of 10% and assume the same 2% growth beyond year 5 due to General Mills being a more stable company that grows in line with the economy. Lastly, I assume a P/FCF multiple of 15 which is right around the company's historical average.

Assumptions:

TTM Free Cash Flow: $2.2B
Growth Rate: 2%
Cost of Equity: 10%
Terminal Year Growth Rate: 2%
P/FCF Multiple: 15

With 596 shares outstanding, these assumptions show a value per share of $53.52 which gives investors a 28% margin of safety at the current share price of $38.48. Investors also get paid a 5% dividend yield while they wait. And looking further beyond to a 2-5 year period, if the P/FCF ratio expands to the more optimistic side of its long term average at a multiple of 20 then the share price could be around $66-$70 which is where it was trading at in 2016.

Insider Activity

Lastly, something to point out is that I see insider activity giving a bullish signal for General Mills right now. Over the last 3 months there have been 15 open market buys and only 4 sells. The number of shares bought over the last 3 months was 51,944 and the number of shares sold was 6,878 which nets into a total of 45,066 shares bought. The stock has traded between 38 and 47 so with an average of $42.50 there has been a total of $1.9 million worth of insider buying. In the charts below, you will find a list of some of the officers whom have been doing the insider activity as well as an overall summary.

	3 MO.
# of Open Market Buys	15
# of Sells	4
Total Insider Trades	19

Source: NASDAQ

	3 MO.
# of Shares Bought	51,944
# of Shares Sold	6,878
Total Shares Traded	58,822
Net Activity	45,066

Source: NASDAQ

Date*	Name/Title	Shares	Transaction	Value
11/25/2018	David M. Cordani Independent Director	565	Acquisition	24,961
11/25/2018	Eric D. Sprunk Independent Director	452	Acquisition	19,969
11/25/2018	Stephen A. Odland Independent Director	509	Acquisition	22,487
11/25/2018	Maria G. Henry Independent Director	537	Acquisition	23,724
11/25/2018	Jorge A. Uribe Independent Director	102	Disposition	4,506
11/25/2018	Jorge A. Uribe Independent Director	424	Acquisition	18,732
11/05/2018	Diane L. Neal Independent Director	4,189	Acquisition	0
11/01/2018	Jacqueline Williams-Roll Senior Vice President and Chief Human Resources Officer	943	Disposition	41,793
09/25/2018	David M. Cordani Independent Director	4,111	Acquisition	0
09/25/2018	Eric D. Sprunk Independent Director	4,111	Acquisition	0
09/25/2018	Heidi G. Miller Independent Director	4,111	Acquisition	0
09/25/2018	Maria A. Sastre Independent Director	4,111	Acquisition	0
09/25/2018	Stephen A. Odland Independent Director	4,111	Acquisition	0
09/25/2018	R. Kerry Clark Lead Independent Director	4,111	Acquisition	0
09/25/2018	Roger W. Ferguson Independent Director	4,111	Acquisition	0
09/25/2018	Maria G. Henry Independent Director	4,111	Acquisition	0
09/25/2018	Jorge A. Uribe Independent Director	714	Disposition	31,258

Source: Morningstar

Intrinsic Valuation Model

	Growth	2.0%					
	Required return	10%					
	Terminal Growth	2%					
	0	1	2	3	4	5	Terminal Value
	TTM	2019 (Exp.)	2020 (Exp.)	2021 (Exp.)	2022 (Exp.)	2023 (Exp.)	2024 (Exp.)
Free Cash Flow	$ 2,200.00	$ 2,244.00	$ 2,288.88	$ 2,334.66	$ 2,381.35	$ 2,428.98	$ 2,477.56
Discount Rates		0.91	0.83	0.75	0.68	0.62	
Discounted FCF		$ 2,040.00	$ 1,891.64	$ 1,754.06	$ 1,626.49	$ 1,508.20	
Sum of Discounted FCF	$ 8,820.40						
FCF in 2022	$ 2,477.56						
Multiple	15						
Terminal Value	$ 37,163.36						
Discount Rate	0.62						
Discounted Terminal Value	$ 23,075.52						
Terminal Value Plus Total Disc cash flows	$ 31,895.92						
Shares Outstanding	596.00						
Value Per share	$ 53.52						
*All data except per share and percentages are in millions							

Valuation Scenarios

	Bear Case	Bear Case	Base Case	Bull Case	Bull Case
5 yr growth rate	2%	2.0%	3.0%	3.0%	5%
Required Rate of Return	15%	15%	10%	10%	7.5%
Terminal Value growth rate	2%	2%	3%	3%	3%
Sum of Discounted FCFs	7,786.28	7,786.28	9,069.89	9,069.89	10,255.94
FCF in Terminal Value Year	2,477.56	2,477.56	2,626.92	2,626.92	2,892.05
P/FCF Multiple	10	15	15	20	20
Terminal Value	24,775.60	37,163.40	39,403.80	52,538.40	57,841.00
Discount rate at year 5	0.50	0.50	0.62	0.62	0.62
Discounted Terminal Value	12,387.80	18,581.70	24,430.36	32,573.81	35,861.42
Sum of discounted FCF plus Discounted Terminal Value	20,174.08	26,367.98	33,500.25	41,643.70	46,117.36
Shares outstanding	596.00	596.00	596.00	596.00	596.00
Value Per Share	$33.85	$44.24	$56.21	$69.87	$77.38
Price Per Share (Market Close 12/7)	$38.48	$38.48	$38.48	$38.48	$38.48
Potential Upside (Downside)	-12%	15%	46%	82%	101%

*All data except per share and percentages are in millions