Potato Pros Lamb Weston Invest in Volume

Price $65.69 **Dividend Holding** **September 17, 2024**

- 2.2% Yield.
- LW holds #1 market share in North America, and #2 for the rest of the world for frozen-potato products.
- Dominance in the frozen-potato product market, being the provider for French-fries for customers such as McDonalds, Chic Fil A, Arby's and Sonic.
- Transitioning to a volume-focused growth strategy rather than pricing-focused.
- Expects headwinds in restaurant traffic to begin to alleviate in the middle of 2025.

Investment Thesis

Lamb Weston (LW) is a consumer-staples company specializing in the production of frozen-potato products. Across 27 factories and in more than 100 countries, LW holds #1 market share in North America, and #2 for the rest of the world.

As consumer finances have become strained, we believe that consumers will continue to segregate spending away from sit-down restaurants and more toward quick-service options or at-home cooking. As a result of a general global slowdown in restaurant traffic, LW's stock price has been hammered down by 36% over the trailing 6 months.

Despite short-term pressures, LW is transitioning to focus on volume-based growth rather than price-based growth. We believe that this volume strategy and a strong-existing customer base will provide strong growth over the next 5 years. Until then, investors can take advantage of LW's 2.2% yield.

Estimated Fair Value

EFV (Estimated Fair Value) = EFY25 EPS (Earnings Per Share) times P/E (Price/EPS)

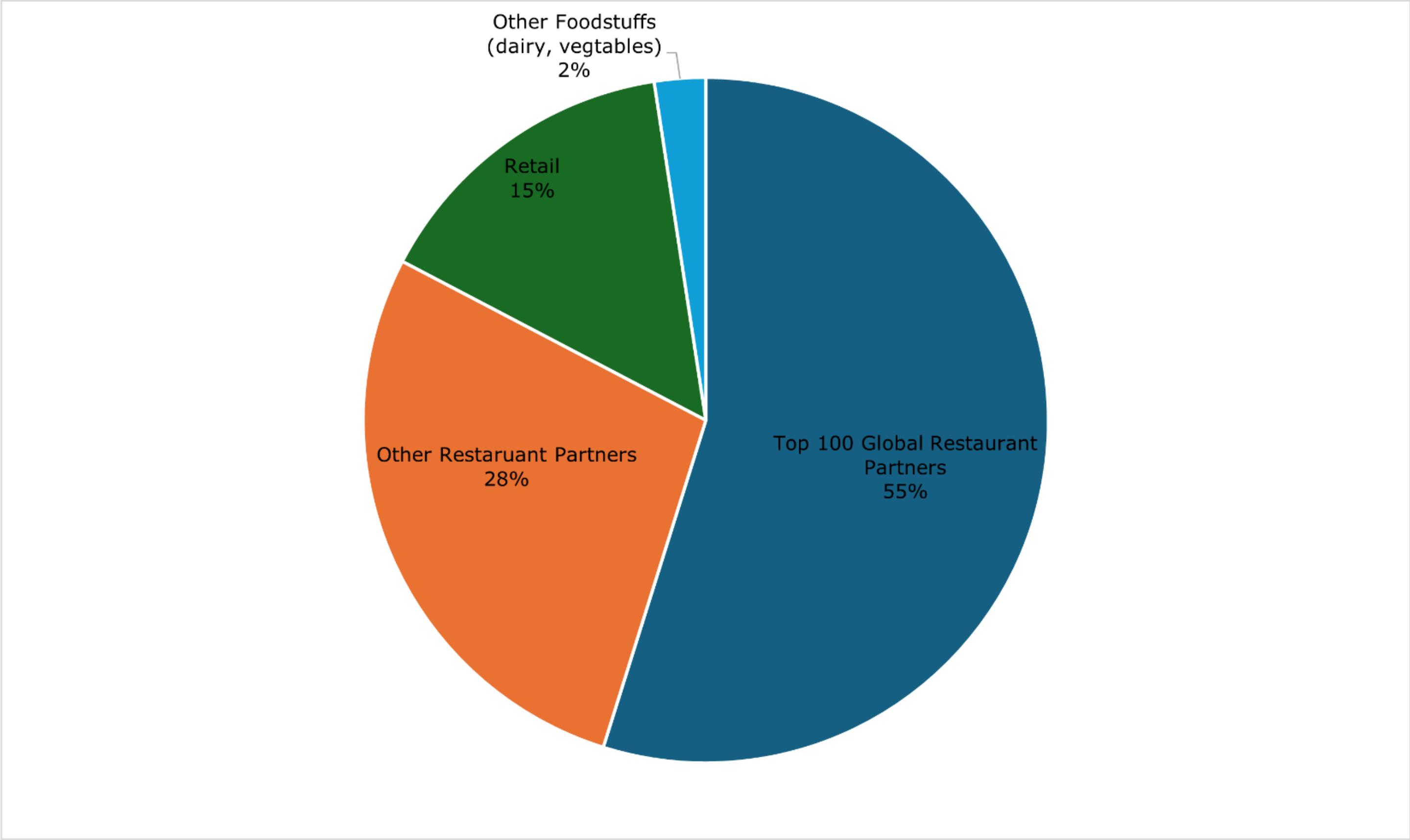
EFV = E25 EPS X P/E = $5.07 X 16.9 = $85.68

Global consumption of potatoes has been slowly increasing with more product innovation in developed markets and income increases in developing countries. LW estimates that demand for frozen-potato products will increase at a 3% CAGR to 2027. In addition, LW has been the primary provider of global leaders in QSR (quick service restaurants) including McDonalds, Chic Fil A, Arby's and Sonic.

	E2024	E2025	E2026
Price-to-Sales	1.4	1.3	1.3
Price-to-Earnings	14.41	12.77	11.81

Core Business

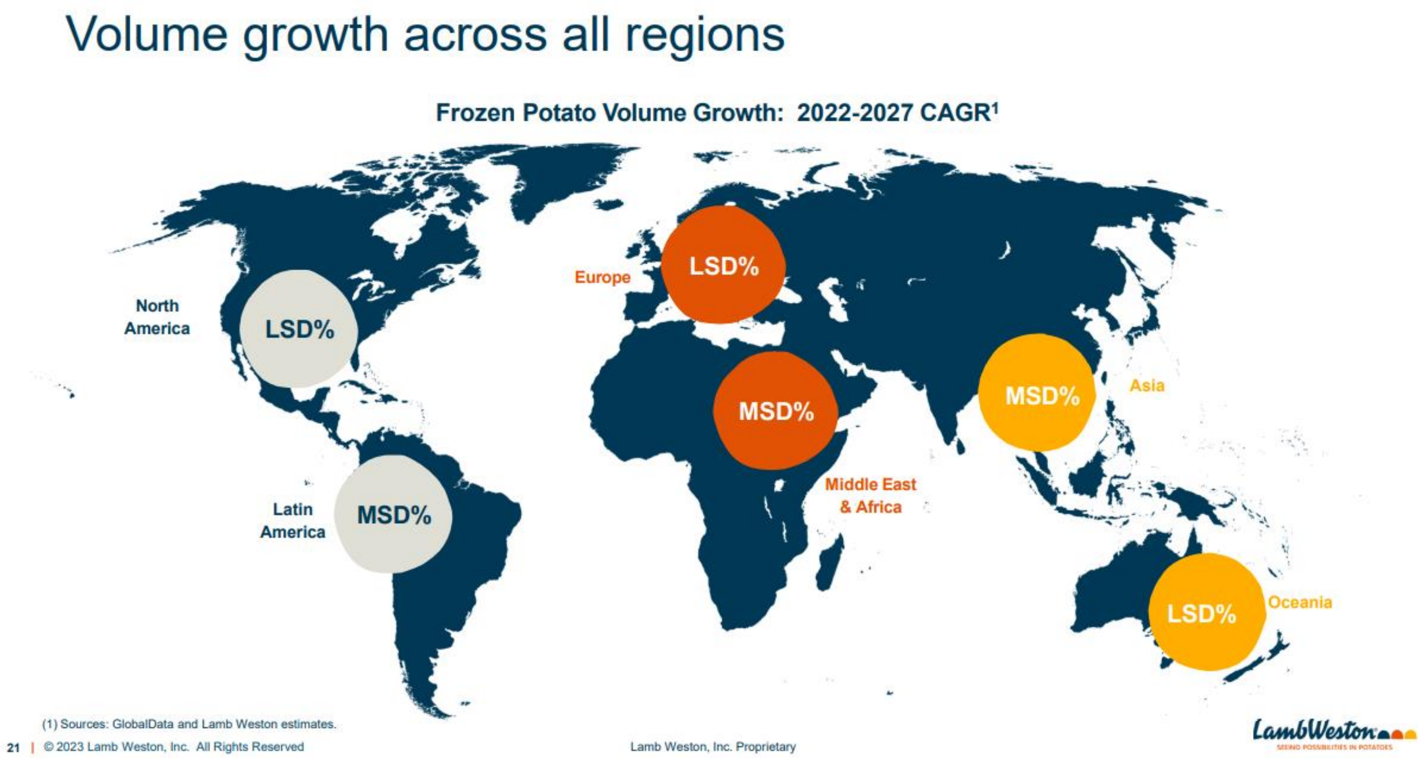
As of the quarter ending May 2024, around 70% of revenue comes from US-based customers, with the remaining coming from international segments.



LW no longer publishes revenue by vertical. Data is from year ending May 2023.

Much of the growth in developed markets has been led by product innovations, continued penetration into the restaurant market and partnerships with taking restaurant products into grocery stores such as Arby's or Sonic. LW estimates that 43% of restaurants offer fries, with fries offering around 81% margin for restaurants. A recent addition is LW launching frozen products under its own brand in UK grocery stores, utilizing its existing supply-chain.

The developing world has consistently seen growth in frozen-potato product consumption as incomes have increased. According to Polaris, frozen foods are the fastest growing segment of the food industry with the global market expected to double by 2030. Growth will be driven by improving incomes and population growth.



Despite the recent decrease in restaurant traffic, LW is shifting toward volume-driven growth rather than price driven growth. The result is pricing actions in the future having lower impact than in previous years and much of the bottom-line growth coming from better mix and investments in efficiencies. Through calendar 2025, LW expects to spend around $850 million in capacity enhancements to support this volume-driven strategy.

Risk

LW has fumbled its transition to a new ERP (enterprise resource planning) system, causing severe problems and downtime. The downtime effected every component of the supply chain from processing orders, inventory management, to invoicing. Unfortunately for LW, these problems were particularly concentrated on high-margin customer accounts. This was on top of quality control issues that led to substantial shipments being recalled voluntarily.

With consumers moving away from eating at restaurants during times of economic strain, LW has seen some market share contraction. LW expects this trend to continue into 2025 and will likely not alleviate until the second half of calendar 2025. Restaurant traffic weakened by 3% year over year in the year ending May 2024. More importantly for LW, hamburger QSRs saw a 6% year-over-year drop in traffic.

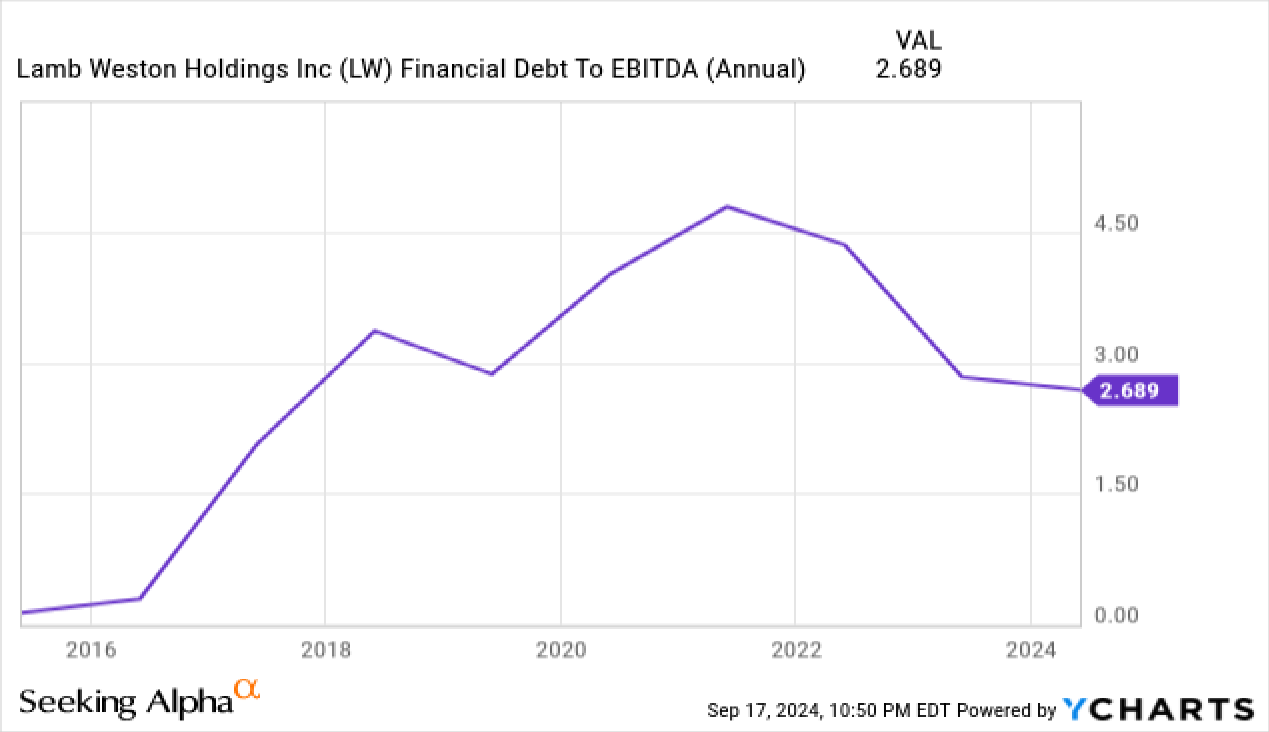
According to the Wall Street Journal, frozen food consumption increased 3.1% during the Great Recession. It is possible that some of the decrease in restaurant traffic could be captured as retail sales, especially if the economy slips into recession.

Financials

For the fiscal year ending May 2024, sales increased 21% year over year, with net income increasing 6% year over year. However, LW has seen some market share contraction. Additionally, gross margin for the quarter ending May 2024 was 250 bps below the 27% target, due to the voluntary product withdrawal and continued growing pains involving its IT infrastructure.

For 2025, LW expects sales to be up by 2-5% due to volume. However, it does expect net income to contract by 10-15%, due to both increased SG&A expenses and capex spend across its portfolio. This will be partially offset by lower input prices, with the average realized cost for potatoes going down by 3%, which will result in bottom line benefits starting in the quarter ending March 2025.

While LW is investing heavily in volume-based growth strategies, it believes that the second half of calendar 2025 will see some additional market share and volume contraction. It does believe that it can recover large parts of the lost market share with recovering restaurant traffic going into calendar 2025 and continued mix actions targeted at high-margin customers.



Overall debt was flat for the year ending May 2024, though there was increased borrowing in variable interest categories. LW Maintains a BB+ rating on its debt and has a current ratio of 1.3x. Additionally, LW has consistently had a return on invested capital of 14-16% which is in-line with peers.

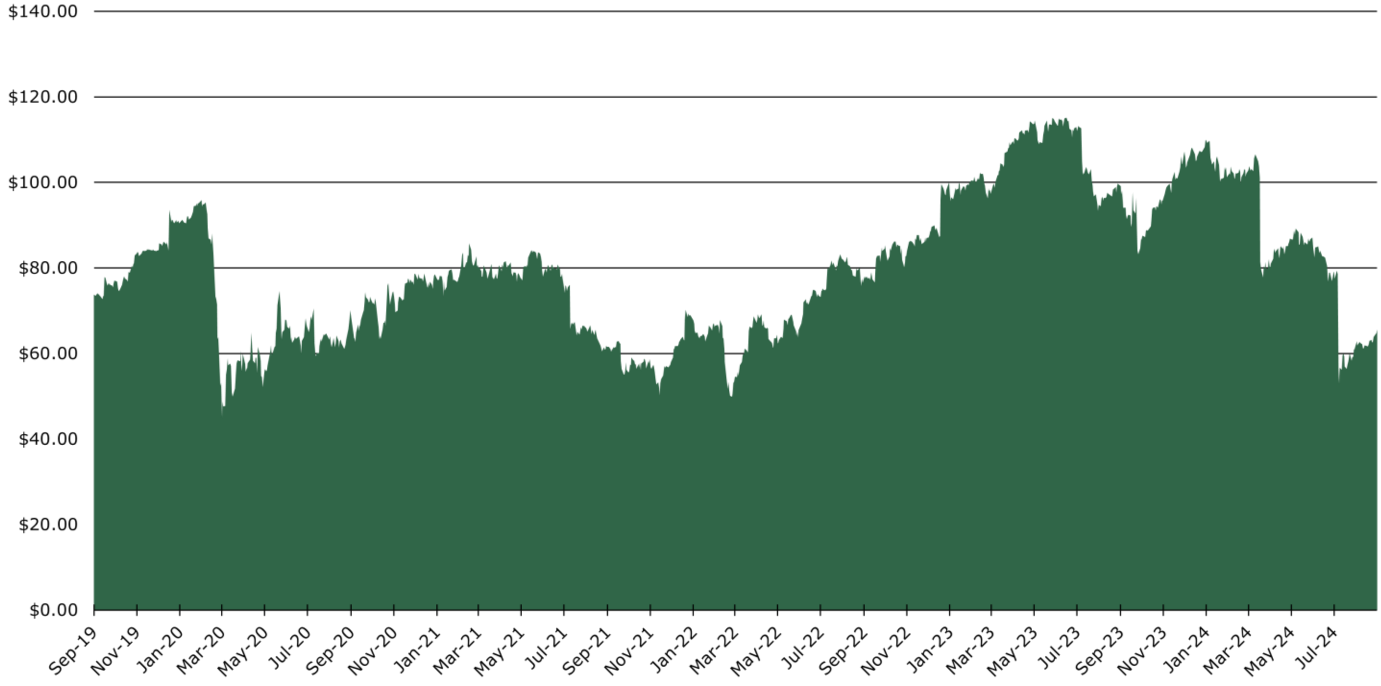
Conclusion

While it is likely that the short term will remain challenging for LW, we believe that it is well positioned with both its strong customer profile and volume-focused expansion. Thus, we expect LW to recover in the second half of FY2025 and then have 8-10% growth in EPS driven by secular unit growth of potatoes (mainly fries) and improving margins. In the meantime, we believe that LW's 2.22% dividend yield is safe and provides a good addition to a defensive portfolio.

Peer Comparisons

	Lamb Weston (LW)	Kraft Heinz (KHC)	BellRing Brands (BRBR)	BRF (BRFS)	Nomad Foods (NOMAD)
Price-to-Earnings	14.4	11.7	30.8	11.8	9.9
Price-to-Sales (TTM)	1.4	1.6	4.0	0.7	0.9
EV-to-EBITDA (FWD)	9.4	9.7	19.3	5.4	8.2
Net Income Margin	11.2%	7.3%	11.5%	3.3%	6.8%
Dividend Yield	2.22%	4.49%	-	-	3.09%

Lamb Weston (LW)



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