Value Investor INSIGHT

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Sunny-Side Up

There's been somewhat of a perfect storm roiling in the U.S. market for fresh eggs, to the near-term detriment of long-time industry leader Cal-Maine Foods. Might this be a situation where it appears darkest before the dawn?

There are cyclical businesses, and then there's the business of selling eggs in the U.S. since early 2015. A worst-ever bout of avian influenza that year decimated the egg-laying hen population, restricting supply and causing egg prices to hit record highs. But the good times proved short-lived. The egg-laying flock was quickly replenished and increased productivity from younger hens and lower feed costs drove excess production. On the demand side, institutional buyers reformulated recipes to use fewer eggs, and the strong dollar decreased export demand. With supply and demand trends shifting sharply, wholesale egg prices have fallen off a cliff, down some 60% over the past two years.

None of which has been good news for Cal-Maine Foods, by far the largest domestic producer of fresh shell eggs, selling more than one billion dozen eggs per year, roughly 20% of the market. After earning $316 million in net income in its 2016 fiscal year, the company in fiscal 2017 (ended in May) recorded a $74 million loss. Its shares, above $60 in late 2015, recently traded at around $36.

"You can have either good news or cheap stock prices, but typically not both," says 1949 Value Advisors' Matthew Haynes, who considers Cal-Maine a bargain worth pursuing. Despite the cyclicality of its business, the company has long pursued a disciplined strategy mixing organic growth with acquisitions to enhance its industry-leading position. As a result, it has compounded book value at nearly 20% per year over the past 15 years while earning average returns on equity of more than 20%.

With wholesale egg prices well up from 2016 lows and the egg-laying hen population declining, Haynes is confident the U.S. egg market has bottomed. He also sees considerable upside from the company's investment in "specialty" eggs – most prominently cage-free and organic varieties – which earn higher margins and have consistently increasing demand. As specialty eggs make up a higher percentage of sales – in fiscal 2017 they accounted for 44% of company revenues – he expects more stability in future cash flows, deserv-

INVESTMENT SNAPSHOT

Cal-Maine Foods
(Nasdaq: CALM)

Business: Produces, grades, markets and distributes conventional, cage-free, organic and nutritionally enhanced fresh eggs.

Share Information (@8/30/17):

Price	**36.20**
52-Week Range	33.40 – 46.15
Dividend Yield	0.0%
Market Cap	$1.76 billion

Financials (TTM):

Revenue	$1.07 billion
Operating Profit Margin	(-11.9%)
Net Profit Margin	(-6.9%)

Valuation Metrics
(@8/30/17):

	CALM	S&P 500
P/E (TTM)	n/a	23.5
Forward P/E (Est.)	29.4	18.7

Largest Institutional Owners
(@6/30/17):

Company	% Owned
T. Rowe Price	8.9%
BlackRock	7.8%
Vanguard Group	6.1%

Short Interest (as of 8/15/17):

Shares Short/Float	23.8%

CALM PRICE HISTORY

THE BOTTOM LINE

The company has the scale, strategy and financial wherewithal to exit the terrible cycle in the U.S. market for fresh eggs stronger than ever, says Matthew Haynes. On his estimate of normalized EBIT, he pegs the firm's target share price within three years at $58 to $63.

Sources: Company reports, other publicly available information ing of a higher multiple.

He also expects the company to utilize its net-cash balance sheet to take advantage of the industry's travails and continue to consolidate a still-fragmented U.S. market in which the ten-largest egg producers comprise less than 60% of total sales. "The strongest not only survive," he says, "but emerge from downturns even stronger."

The potential upside in Cal-Maine's beaten-down shares? Assuming a normalized margin of 15%, he pegs Cal-Maine's estimated earnings before interest and taxes within the next three years at around $225 million. Applying what he considers a reasonable 12-13x multiple to that and adding back current net cash of nearly $150 million, the stock would trade at $58 to $63 per share – a result certainly worth crowing about. VII
