# “History doesn’t repeat itself, but it often rhymes”

**Sohn Conference | May 2019**

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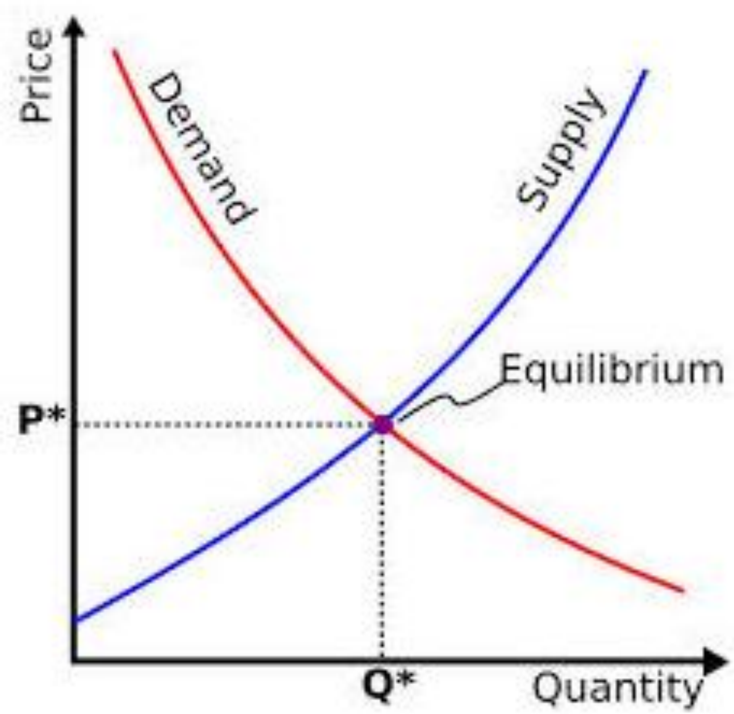
# Econ 101…the laws of supply and demand

**The market clears at an equilibrium price where supply meets demand**

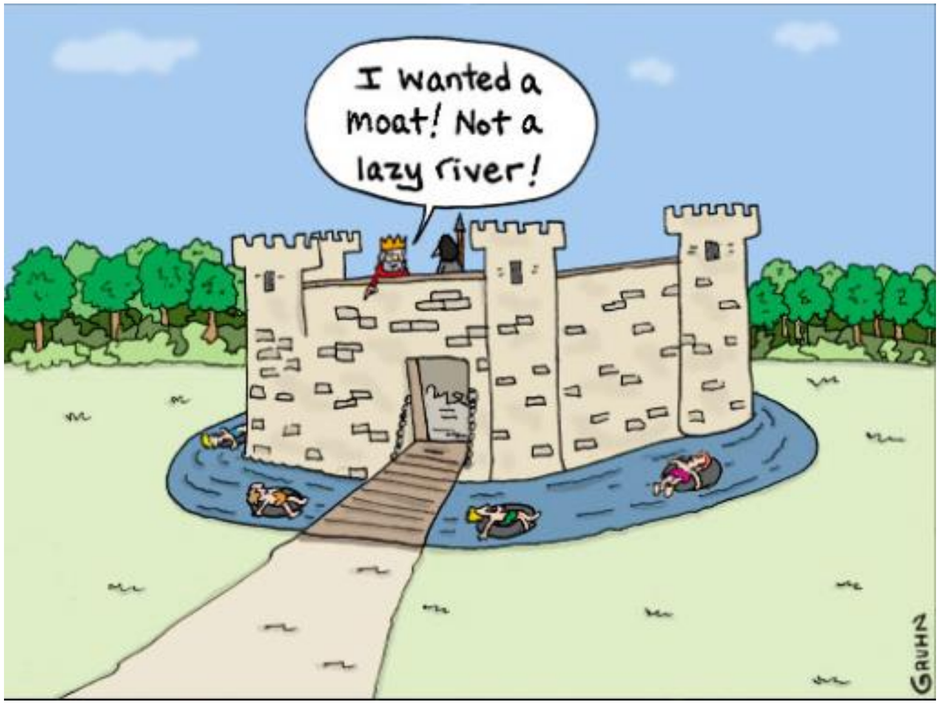
- Supply growth > Demand growth = Prices ↓
- Demand growth > Supply growth = Prices ↑




 Source: Google images.

# “The cure for high prices is high prices”

*“Typically, capital is attracted into high-return businesses and leaves when returns fall below the cost of capital. This process is not static, but cyclical – there is a constant flux. The inflow of capital leads to new investment, which over time increases capacity in the sector and eventually pushes down returns. Conversely, when returns are low, capital exits and capacity is reduced; over time, then profitability recovers” – Capital Returns (Marathon Asset Management)*




 Source: Capital Returns by Edward Chancellor and Marathon Asset Management, Google images, Web Donuts and Gruhn.

# Why am I telling you this?

**These are basic ideas underpinning a <u>repeatable investment framework</u>**

 Source: Google images, Karate Kid.

# Boom/bust framework

**From time to time industry S&D growth gets meaningfully imbalanced leading to boom and bust cycles that create asymmetric and profitable short and long opportunities across sectors and geographies**

- Situations get mispriced for several durable reasons including those rooted in human behavior
  - People have a **<u>tendency towards overextrapolation of recent experience</u>** into the future
  - People have a **<u>tendency towards forecasting linearly</u>** vs. changes in S&D lead to impacts that are often non-linear and unintuitive
- **<u>Analysts often capitalize boom-time earnings at peak-multiples and bust-time earnings at trough-multiples</u>**…this leads to asymmetry as there is a coiled effect working for you in both a variance to earnings and a multiple re-rating if your timing and analysis of S&D are good
- Cycles can last for months or decades, but when barriers to entry are low, economic gravity leads to a mean reversion/normalization in economic returns over time
- Most powerful when applied to industries/businesses where S&D analysis is not standard

# Despite its simplicity, this framework works!

COMMODITIES JULY 18, 2016 / 3:31 PM / 3 YEARS AGO

**U.S. pork packing plant boom may boost hog prices**

**The lithium-ion battery boom and its impact on raw material markets**

Published
William Adams
August 09, 2018

**The Great Bourbon Boom Shakeout Could Be Coming Next Year**

By Bailey Lipschultz
December 13, 2018, 12:32 PM EST *Updated on December 13, 2018, 5:10 PM EST*

**After 70% Crash in Stocks, Some Frack-Sand Miners Are Desperate**

By David Wethe
April 3, 2019, 7:00 AM EDT

**How the Cobalt Market Fell Victim to Allure of Electric Cars**

By Mark Burton
February 28, 2019, 7:00 PM EST *Updated on March 1, 2019, 3:02 AM EST*

**Pilgrim's Pride CEO Predicts Chicken Industry Boom to Continue**

Domestic Consumers and Foreign Importers Continue to Favor Poultry

COMMODITIES SEPTEMBER 21, 2017 / 3:43 AM / 2 YEARS AGO

**The graphite fix: Inside China's newest commodity addiction**

THE GLOBE AND MAIL › Annotations

**Canada's great pot boom could be headed for a giant bust – for investors and consumers**

JUNE 26, 2018

**The $18 Billion Electric-Car Bubble at Risk of Bursting in China**

Bloomberg News
April 14, 2019, 5:00 PM EDT *Updated on April 15, 2019, 6:04 AM EDT*

*JUNE 9, 2017*

**Excimers for OLED Production are on a roll**

**Can't Find a PlayStation 4? Blame It On a Part Barely Bigger Than a Speck**

Tiny components called multilayer ceramic capacitors power everything from smartphones to cars. And there's a global shortage of them.



Source: CNBC, Reuters, Bloomberg, WSJ, Globe and Mail, Metal Bulletin, Laser Market Research.

# What’s next?…a short opportunity in Idaho

 Source: Google images, Disney.

# Lamb Weston (LW) is a short

LambWeston
SEEING POSSIBILITIES IN POTATOES

**LW is a supply-driven boom/bust short with 40-50% absolute downside over the next 12 months and a skewed risk/return**

- A period of perfect industry dynamics driven by a sexy demand story and minimal new supply led to an unsustainable surge in per-unit pricing and margins for LW's processed potato products
- The market is extrapolating profit growth and margins linearly into future years
- Extrapolation has led the market to capitalize peak-margins at a big multiple befitting a safe and growing staple, when the business is in fact much more vulnerable to S&D dynamics than investors believe – the current valuation implies that LW is trading at 2.0-3.0x replacement cost
- Above-normal profits and attractive returns on capital have incented an observable supply response, with a **wave of +10-12% capacity coming online in the next 6-12 months (and +16% in the next 24 months) vs. demand growing at 1.5-2.5% p.a.**
- As new capacity overwhelms demand and capacity utilization heads much lower, per unit margins should deteriorate and the myth that LW is a bulletproof staple should be debunked
- **LW should miss Consensus earnings estimates by 30-40% in FY20/FY21 (5/30 YE) and the multiple should de-rate, leading to 40-50% equity downside**
- If this hypothesis is wrong and per-unit margins continue to improve, there is ~10-15% upside if prices re-set to fair value today and 20-25% in the next 12 months if LW hits its numbers/sustains elevated profitability levels and its multiple re-rates up

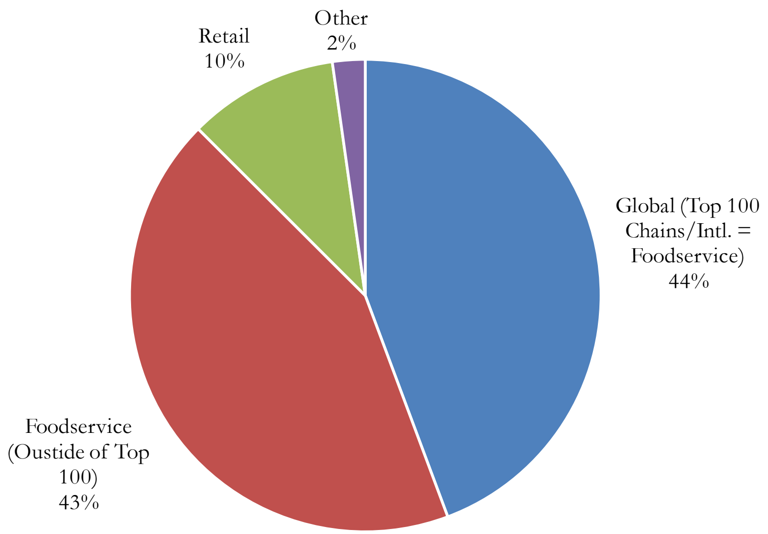


Source: Proprietary estimates, primary research, company filings, Bloomberg.

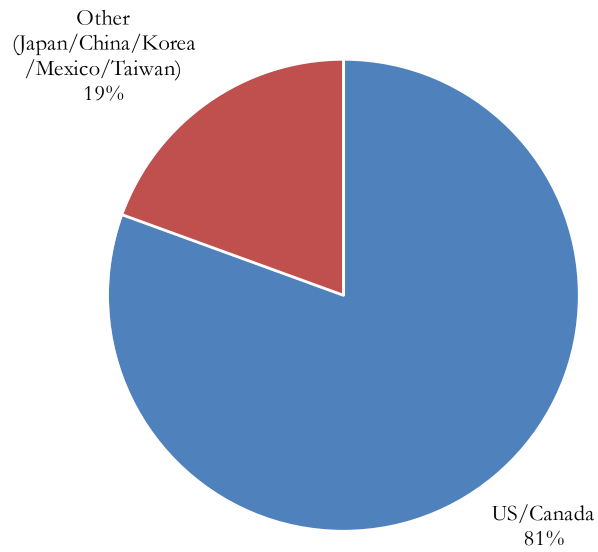
# Business description

- Lamb Weston is in the business of potato processing – purchasing raw potatoes and processing them primarily into fries (and to a lesser degree tater tots, hash browns and chips) that are sold to foodservice (QSRs and restaurants) end customers
- Purchase potatoes from fragmented base of growers primarily in the Pacific Northwest (typically negotiated annually) and sells through a network of independent brokers/distributors
- Spends 0.4% of sales on R&D (commodity business); MCD accounts for 11% of sales
- Only publicly traded player in NA potato oligopoly (controls 80-90% of supply) after spin-off from ConAgra in 11/2016 – McCain/Simplot/Cavendish are private and family owned

**FY18 EBIT by End-Market**




**FY18 Sales by Geography**




 Source: Company filings.

# Summary financials

| Capitalization | Normalized | Management |
|---|---|---|
| Share Price (5/2/19) | $66.37 | $66.37 |
| S/O FD | 147.4 | 147.4 |
| **MC ($mm)** | **$9,783** | **$9,783** |
| (+) Gross Debt | 2,425 | 2,425 |
| (−) Cash and Equivalents | (17) | (17) |
| (+) NCI/Equity Inv./Other | (223) | |
| **EV ($mm)** | **$11,968** | **$12,190** |
| | | |
| 3M ADTV ($mm) | | $106 |
| SI % of Float/Borrow | | 6.75% / GC |

Management definition of Adj. EBITDA includes proportional interest in unconsolidated JVs

| Financial Summary (Historical & Consensus) | 5/31/14 | 5/31/15 | 5/31/16 | 5/31/17 | 5/31/18 | 5/31/19 | 5/31/20 | 5/31/21 |
|---|---|---|---|---|---|---|---|---|
| | **2014A** | **2015A** | **2016A** | **2017A** | **2018A** | **2019E** | **2020E** | **2021E** |
| **Revenue** | **$2,815** | **$2,925** | **$2,994** | **$3,168** | **$3,424** | **$3,725** | **$3,942** | **$4,178** |
| y/y | | 3.9% | 2.4% | 5.8% | 8.1% | 8.8% | 5.8% | 6.0% |
| **Gross Profit** | | **$587** | **$662** | **$779** | **$880** | **$972** | **$1,035** | **$1,105** |
| % Margin | | 20.1% | 22.1% | 24.6% | 25.7% | 26.1% | 26.3% | 26.5% |
| **Adj. EBITDA (incl. Unconsolidated JVs)** | **$503** | **$526** | **$593** | **$707** | **$820** | **$902** | **$972** | **$1,016** |
| y/y | | 4.7% | 12.8% | 19.2% | 16.0% | 9.9% | 7.8% | 4.5% |
| % Margin | 17.8% | 18.0% | 19.8% | 22.3% | 24.0% | 24.2% | 24.7% | 24.3% |
| **EBITDA (excl. Unconsolidated JVs)** | **$466** | **$479** | **$534** | **$648** | **$728** | **$814** | **$862** | **$900** |
| y/y | | 2.7% | 11.6% | 21.4% | 12.2% | 11.9% | 5.9% | 4.5% |
| % Margin | 16.6% | 16.4% | 17.8% | 20.5% | 21.2% | 21.8% | 21.9% | 21.5% |
| **Adj. EPS** | | | **$2.14** | **$2.33** | **$2.68** | **$3.20** | **$3.50** | **$3.89** |
| y/y | | | | 8.7% | 15.1% | 19.4% | 9.4% | 11.1% |
| | | | | | | | | |
| **Est. Rev/lb. Processed** | **$0.512** | **$0.532** | **$0.536** | **$0.566** | **$0.611** | **$0.631** | **$0.657** | **$0.688** |
| **Est. GP/lb. Processed** | **$0.106** | **$0.107** | **$0.119** | **$0.139** | **$0.157** | **$0.171** | **$0.180** | **$0.188** |
| **Est. Segment EBIT/lb. Processed** | **$0.103** | **$0.103** | **$0.115** | **$0.137** | **$0.151** | **$0.164** | **$0.174** | **$0.182** |

| Consensus Multiples | 2019E | 2020E |
|---|---|---|
| EV/Revenue | 3.2x | 3.0x |
| EV/Adj. EBITDA | 13.5x | 12.5x |
| EV/EBITDA | 14.7x | 13.9x |
| P/E | 20.7x | 19.0x |
| | | |
| ND/EBITDA | 3.0x | 2.8x |

| **Guidance** | |
|---|---|
| MC/Reported FCF | 33.9x |
| MC/Normalized FCF | 20.0x |
| | |
| Reported FCF Yield | 2.9% |
| Normalized FCF Yield | 5.0% |

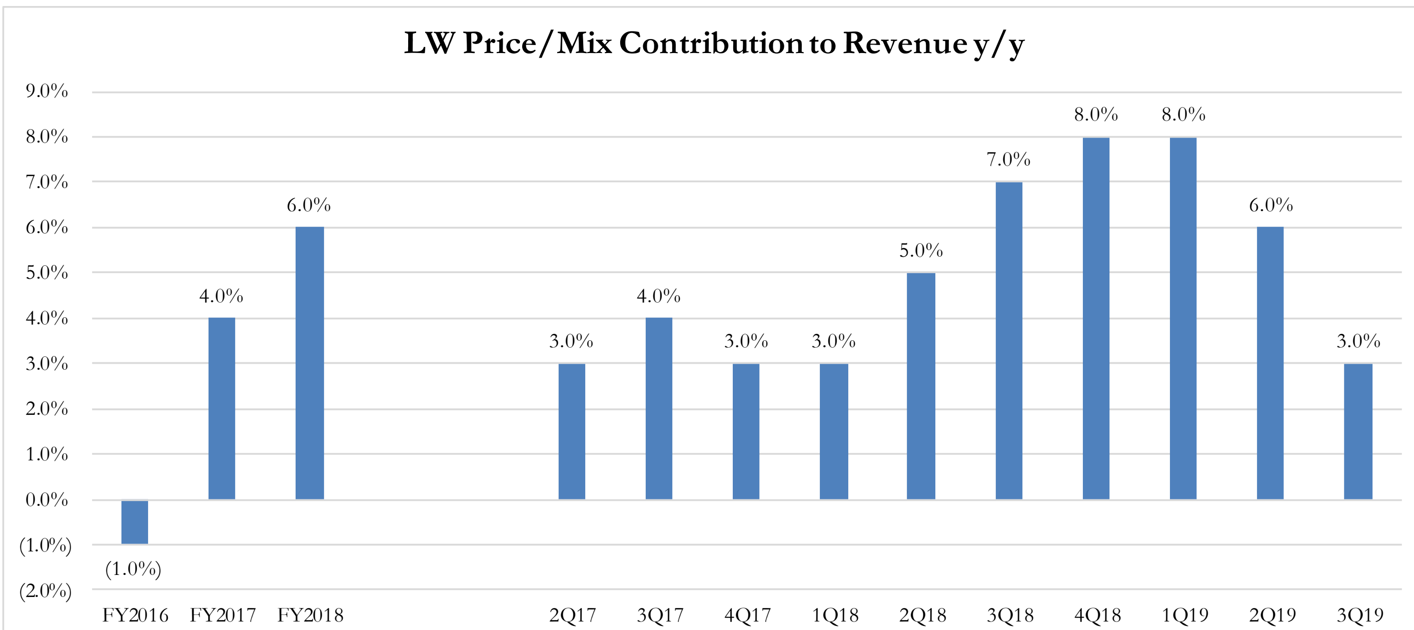
| 2019E Guidance and Bridge to FCF | Low | Mid | High |
|---|---|---|---|
| **Adj. EBITDA incl. Unconsolidated JVs** | **$895** | **$900** | **$905** |
| Est. JV EBITDA Bridge | (91) | (91) | (91) |
| **LW EBITDA** | **$804** | **$809** | **$814** |
| D&A | (150) | (150) | (150) |
| Interest | (110) | (110) | (110) |
| **Adj. EBIT** | **$544** | **$549** | **$554** |
| Tax Rate | 22.5% | 22.5% | 22.5% |
| **NI** | **$422** | **$426** | **$430** |
| Equity Method Earnings | 71 | 71 | 71 |
| Income to NCI | (9) | (9) | (9) |
| D&A | 150 | 150 | 150 |
| CapEx | (350) | (350) | (350) |
| **Reported FCF for LW Shareholders** | **$285** | **$288** | **$292** |
| **FCF at Normalized CapEx (CapEx = D&A)** | **$485** | **$488** | **$492** |

 Source: Proprietary estimates, primary research, company filings, Bloomberg.

# Perfect period of S&D led to a pricing spike

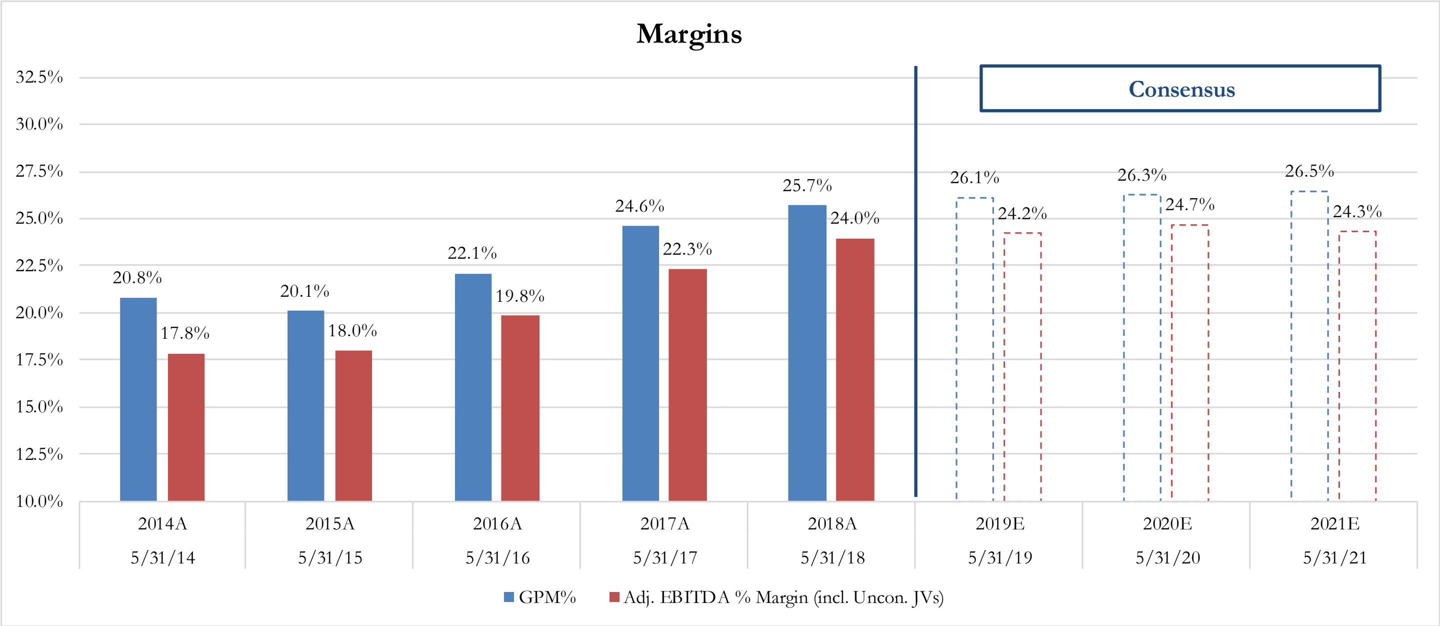
**Sexy demand story from QSR unit growth in EMs following the GFC + minimal industry supply additions = big tightening of industry utilization**

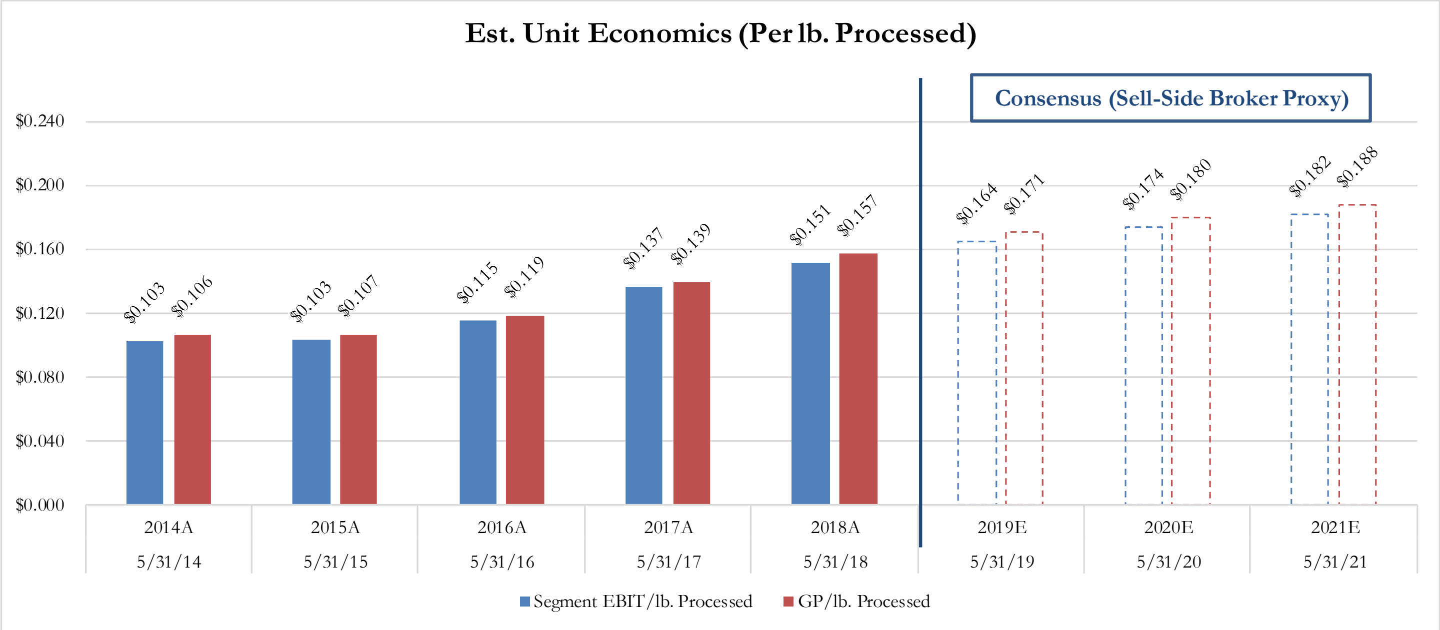
- Demand growth was negative-to-flat during the mid-2000s as health trends like the Atkins diet supported a shift towards low-carb diets and away from carb-heavy products like fries
- Combined with demand destruction during the GFC led to some shuttering of industry capacity and a reluctance to add new supply…LW was aggressive and benefitted by expanding a bit
- Tight industry backdrop allowed processors to take pricing while cost inflation was benign




 Source: Company filings, primary research.

# Margins boomed and market is extrapolating




 Source: Company filings, proprietary estimates, Bloomberg, sell-side broker research.

# Attractive returns have led to a supply response

## 10-12%/16% new industry capacity to come on-line in the next 12/24 months

- All major players in the industry have projects coming on-line
- New greenfield capacity takes 18-24 months to bring on-line (expansions/restarts take less time)
- Size of economic new production line necessitates ~$200-400mm capital investment in expansion

| Est. Capacity | LW Fiscal Timing | mm lbs. Capacity | mm lbs. Cum. |
|---|---|---|---|
| McCain (Burley, ID) - Restart of Mothballed Facility | 3Q19 | 400 | 400 |
| LW (Hermiston, OR) - Expansion | 4Q19 | 300 | 700 |
| Cavendish (Lethbridge, Canada; Net Added Capacity) - Greenfield | 2Q20 | 255 | 955 |
| JR Simplot (Manitoba, Canada) - Expansion | 3Q20 | 455 | 1,410 |
| **Cumulative Capacity N12M Expansion** | | | **10.8%** |
| Est. Adjustment for More Efficient New vs. Old Capacity/Capacity Creep | | | 0.5% |
| **Including Efficiency Adjustment** | | | **11.4%** |
| | | | |
| Penobscot McCrum (Washburn, Maine) - Restart of Mothballed Facility | FY2021 | 191 | 1,601 |
| McCain (Othello, Washington) - Expansion | FY2021 | 400 | 2,001 |
| **Cumulative Capacity N24M Expansion** | | | **15.4%** |
| Est. Adjustment for More Efficient New vs. Old Capacity/Capacity Creep | | | 0.7% |
| **Including Efficiency Adjustment** | | | **16.1%** |
| | | | |
| JR Simplot (Walla Walla County, Washington) - Greenfield | FY2022 | 300 | 2,301 |
| **Cumulative Capacity N36M Expansion** | | | **17.7%** |
| Est. Adjustment for More Efficient New vs. Old Capacity/Capacity Creep | | | 0.8% |
| **Including Efficiency Adjustment** | | | **18.5%** |

 Source: Company filings, press, proprietary estimates, primary research.

# Industry capacity utilization to step-down

**Capacity utilization is heading much lower starting now as DD% supply comes on-line – as more capacity enters in FY21 and beyond, utilization rates are likely to remain at 90-95% in the coming years**

- Pricing is contracted annually in the summer/fall and negotiated rates depend on (i) industry capacity utilization/competition (ii) input cost inflation (iii) negotiating leverage (iv) specific product
- Put option on domestic QSR demand destruction or menu-shifts towards non-fry products
- LT demand is inherently difficult to forecast and has been susceptible to fashion/fad risk in the past

| | 5/31/16 | 5/31/17 | 5/31/18 | 5/31/19 | 5/31/20 | 5/31/21 | 5/31/22 | 11/30/19 |
|---|---|---|---|---|---|---|---|---|
| | FY16A | FY17A | FY18A | FY19E | FY20E | FY21E | FY22E | 1H20E |
| Capacity | 12,650 | 12,650 | 13,000 | 14,000 | 14,477 | 15,096 | 15,411 | 14,477 |
| y/y | | 0.0% | 2.8% | 7.7% | 3.4% | 4.3% | 2.1% | |
| vs. Current | | | | 7.7% | 11.4% | 16.1% | 18.5% | 11.4% |
| Demand (Production/Export) | 12,777 | 13,032 | 13,293 | 13,559 | 13,830 | 14,106 | 14,388 | 13,694 |
| y/y | | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% | 1.0% |
| vs. Current | | | | 2.0% | 4.0% | 6.1% | 8.2% | |
| **Est. North America Utilization** | **101.0%** | **103.0%** | **102.3%** | **96.8%** | **95.5%** | **93.4%** | **93.4%** | **94.6%** |
| y/y | | 2.0% | (0.8%) | (5.4%) | (1.3%) | (2.1%) | (0.1%) | |
| vs. Current | | | | (5.4%) | (6.7%) | (8.8%) | (8.9%) | (7.7%) |

 Source: Company filings, press, proprietary estimates, primary research.

# Economics suggest margins should compress

**Segment EBIT/lb. processed could fall 50%+ before returns on expansion CapEx fall below the cost of capital…new expansion announcements should continue as current returns are unsustainable and will continue to incent new supply until above-normal returns are competed down**

- Processors are achieving 20-25% pre-tax and 15-20% post-tax RoC on expansion CapEx at current profitability levels (assuming LW has a cost advantage still implies very high RoC for other players)
- Signpost: McCain just announced additional ~400mm lb. expansion in Othello, WA on 5/2/19

**RoC on Expansion/Newbuild CapEx**

| *LW Achieved* | | | *FY15* | *FY16* | | | *FY17* | *FY18* | | *Run-Rate* | *Consensus FY20/21* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Segment EBIT/lb. Processed** | **\$0.080** | **\$0.090** | **\$0.100** | **\$0.110** | **\$0.120** | **\$0.130** | **\$0.140** | **\$0.150** | **\$0.160** | **\$0.166** | **\$0.170** | **\$0.180** | **\$0.190** |
| *% to LW Current Run-Rate* | *(52%)* | *(46%)* | *(40%)* | *(34%)* | *(28%)* | *(22%)* | *(16%)* | *(10%)* | *(4%)* | *0%* | *2%* | *8%* | *14%* |
| **Pre-Tax RoC** | | | | | | | | | | | | | |
| CapEx/lb. \$0.90 | 8.9% | 10.0% | 11.1% | 12.2% | 13.3% | 14.4% | 15.6% | 16.7% | 17.8% | 18.4% | 18.9% | 20.0% | 21.1% |
| CapEx/lb. \$0.85 | 9.4% | 10.6% | 11.8% | 12.9% | 14.1% | 15.3% | 16.5% | 17.6% | 18.8% | 19.5% | 20.0% | 21.2% | 22.4% |
| CapEx/lb. \$0.80 | 10.0% | 11.3% | 12.5% | 13.8% | 15.0% | 16.3% | 17.5% | 18.8% | 20.0% | **20.8%** | 21.3% | 22.5% | 23.8% |
| CapEx/lb. \$0.75 | 10.7% | 12.0% | 13.3% | 14.7% | 16.0% | 17.3% | 18.7% | 20.0% | 21.3% | **22.1%** | 22.7% | 24.0% | 25.3% |
| CapEx/lb. \$0.70 | 11.4% | 12.9% | 14.3% | 15.7% | 17.1% | 18.6% | 20.0% | 21.4% | 22.9% | 23.7% | 24.3% | 25.7% | 27.1% |
| **Post-Tax RoC (Assumes 22.5% Tax Rate)** | | | | | | | | | | | | | |
| CapEx/lb. \$0.90 | 6.9% | 7.8% | 8.6% | 9.5% | 10.3% | 11.2% | 12.1% | 12.9% | 13.8% | 14.3% | 14.6% | 15.5% | 16.4% |
| CapEx/lb. \$0.85 | 7.3% | 8.2% | 9.1% | 10.0% | 10.9% | 11.9% | 12.8% | 13.7% | 14.6% | 15.1% | 15.5% | 16.4% | 17.3% |
| CapEx/lb. \$0.80 | 7.8% | 8.7% | 9.7% | 10.7% | 11.6% | 12.6% | 13.6% | 14.5% | 15.5% | **16.1%** | 16.5% | 17.4% | 18.4% |
| CapEx/lb. \$0.75 | 8.3% | 9.3% | 10.3% | 11.4% | 12.4% | 13.4% | 14.5% | 15.5% | 16.5% | **17.2%** | 17.6% | 18.6% | 19.6% |
| CapEx/lb. \$0.70 | 8.9% | 10.0% | 11.1% | 12.2% | 13.3% | 14.4% | 15.5% | 16.6% | 17.7% | 18.4% | 18.8% | 19.9% | 21.0% |

 Source: Company filings, press, proprietary estimates, primary research.

# We’ve seen this movie before

**While historical industry data is opaque and today’s situation differs from the past, in the late 1990s a boom in potato processing supply greater than demand growth led to a period where processor economics deteriorated**

## *Competitive Forces Threaten to Knock Idaho From Top*

By STEPHEN STUEBNER APRIL 12, 1997

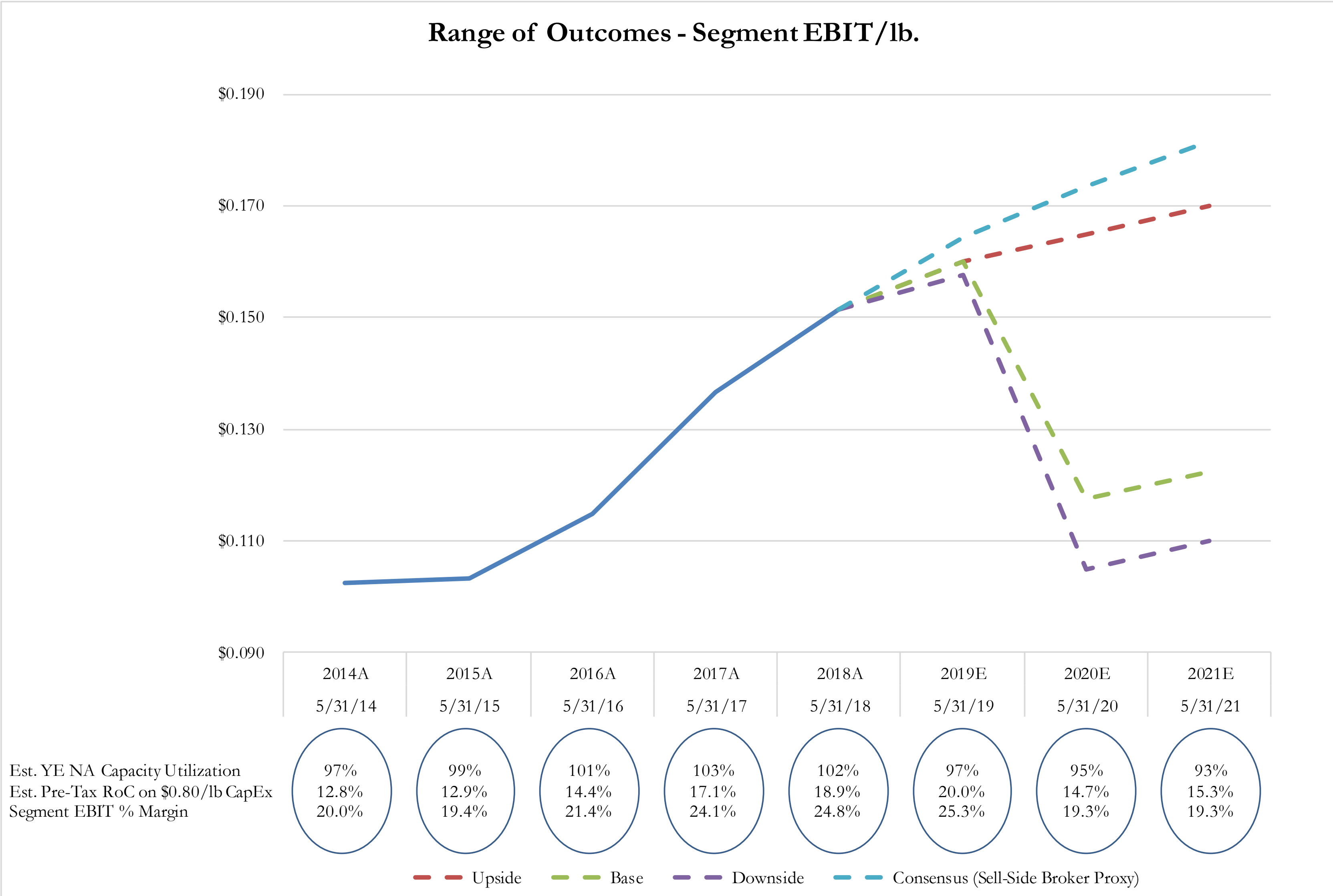
*“The Canadians' bargain-basement exports created a french-fry glut in the United States, prompting the nation's largest processors, Lamb-Weston Inc., a Conagra Inc. subsidiary, and the J. R. Simplot Company to cut production and lay off about 500 workers at plants in southern Idaho”*

*“United States french-fry market expands only about 3 percent a year, while the capacity of American and Canadian processing plants is growing faster. That means future competition for french-fry sales will be equally fierce”*

 Source: “Competitive Forces Threaten to Knock Idaho from Top” in NY Times on 4/12/1997, primary research.

# Framing the range of outcomes

## Base/downside cases assume RoC approaches FY15-FY16 levels vs. Consensus assumes continued surge in per-unit margins and RoC




 Source: Company filings, press, proprietary estimates, primary research.

# Variant perception

| Prevailing view | Variant view |
|---|---|
| ✓ LW is a high-quality business and a safe/growing staple with attractive Asia fry export end-market demand | × LW is a good, cyclical business being misunderstood as a bulletproof staple and more downside vs. upside LT demand risk |
| ✓ LW has secular pricing power | × Cyclical pricing power masquerading as secular and not being viewed holistically with inflating costs (need pricing > costs for margin expansion) |
| ✓ LW will take pricing that will drop-through at high incremental margins (which the sell-side mis-models) and will drive earnings beats | × Well understood by most investors such that the "market" is higher than Consensus |
| ✓ Management is conservative and consistently beats/raises | × Well understood by buy-side/sell-side and management benefitted from demand tailwind |
| ✓ European drought will lead to an NA export demand surge offsetting new supply | × Potential demand upside is over-blown and export tracking data so far suggests it is not necessarily materializing |

# Refuting common bull arguments

- North America potato processing is a well-behaving and disciplined oligopoly that will phase capacity
  - Primary research suggest incumbent processors view the game as a war for market share in a low-growth pie
  - DD% capacity coming on at once is dis-confirmatory evidence – one would assume rationality would influence the decision point of whether to bring on new capacity…it is much harder to be rational when processors need to fill new lines that come online after spending ~$200-400mm in investment capital…the best way to fill capacity is with large volume customers and those customers typically need to be stolen from other processors
  - Industry has been consolidated for a long time and LW was earning 10-12% post-tax RoC in FY2014-2016
  - *"None of these companies is likely to be idle while their competitors build new production lines, for fear of losing market share. Therefore, capacity expansion could come in increments of 1.2-1.6 billion pounds. That creates the potential for three to four years of incremental capacity to come online simultaneously. That could result in bidding wars between processors to fill the new capacity" – Bruce Huffaker, North America Potato Market News*
- French fries are high GP $ and GPM% products, so processors can push through price increases because QSRs pay pennies on the dollar and can pass pricing on to customers
  - Competition is from the processor side to bid down pricing and win volumes to fill new lines/take market share
  - Large QSRs have sophisticated raw material procurement teams in place and keep tabs on industry dynamics and negotiate hard on pricing; in recent years large QSRs have approved more global fry suppliers, allowing them to retaliate in other regions if NA processors get greedy…restaurants run on thin margins and cost savings matter
- Demand is strong and has been capacity constrained
  - Industry should follow the laws of S&D – price should already reflect demand and it follows that if pent-up demand is so strong that existing/new customers would have bid the price up (especially because they are high GPM%) in order to support adding fries or new fry products to their menus
  - Last few years have benefitted from positive demand shocks such as all-day breakfast
  - Growing export demand is already reflected in LW's 1.5-2.5% y/y global demand growth estimate

 Source: Company filings, press, proprietary estimates, primary research, North America Potato Market News, Potato Country.

# Valuation and risk/return

## ~40-50% absolute downside and a skewed R/R

| | 5/2/19<br>PV at 10% CoE | 5/31/20<br>'20 Valuation | Forward<br>EV/EBITDA | 5/31/21<br>'21 EBITDA | 5/31/21<br>21 Seg. EBIT/lb. | 5/31/21<br>'21 EPS | Forward<br>Implied P/E | 5/31/20<br>'20 Net Lev. |
|---|---|---|---|---|---|---|---|---|
| Upside | $74.40 | $82.46 | 14.2x | $996 | $0.170 | $3.92 | 21.0x | 2.5x |
| *% U/(D)* | *12%* | *24%* | *13%* | *(2%)* | *(6%)* | *1%* | *11%* | |
| Base | $35.65 | $39.51 | 11.4x | $708 | $0.118 | $2.32 | 17.0x | 4.2x |
| *% U/(D)* | *(46%)* | *(40%)* | *(9%)* | *(30%)* | *(35%)* | *(40%)* | *(10%)* | |
| Downside | $25.73 | $28.52 | 10.4x | $632 | $0.105 | $1.90 | 15.0x | 5.0x |
| *% U/(D)* | *(61%)* | *(57%)* | *(17%)* | *(38%)* | *(42%)* | *(51%)* | *(21%)* | |
| Current | $66.37 | $66.37 | | | Consensus Estimates | | | |
| R/R (Base/Up) | 3.8x | 1.7x | | | | | | |
| R/R (Down/Up) | 5.1x | 2.4x | 12.5x | $1,016 | $0.182 | $3.89 | 19.0x | 2.8x |
| Dividend Yield | 1.2% | 1.2% | | | | | | |

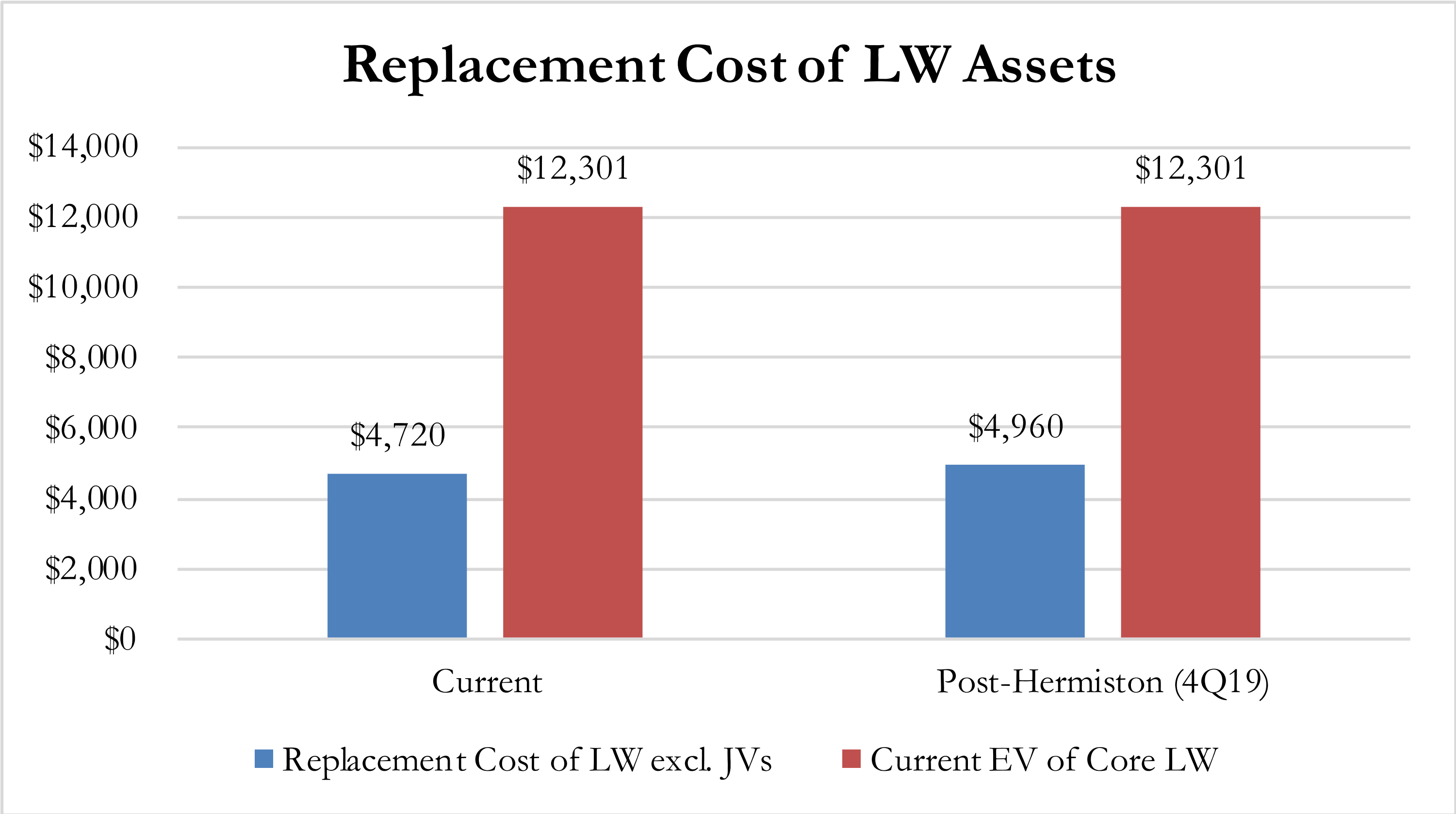
- **Upside case:** Segment EBIT/lb. expands $0.005/lb. in FY20/FY21 and implied pre-tax RoC on newbuilds to 20-22%...LW EBITDA roughly in-line with consensus and multiple re-rates up
- **Base case:** Segment EBIT/lb. declines to FY16 levels and implied pre-tax RoC on newbuilds to 14-15%...EBITDA misses consensus by ~30% and multiple de-rates ~10%
- **Downside case:** Segment EBIT/lb. declines to FY15/FY16 levels and implied pre-tax RoC on newbuilds to 13-14%...EBITDA misses consensus by ~35-40% and multiple de-rates ~15-20%

 Source: Company filings, proprietary estimates, Bloomberg.

# Valuation implies big EV/replacement cost

## LW is trading at 2.0-3.0x the replacement cost of its assets

- LW has ~5.9bn lbs./year of processing capacity (~6.2bn after 4Q19E Hermiston, OR expansion)
- New capacity CapEx is $0.75-0.85/lb. based on recent/planned industry additions




 Source: Company filings, press, proprietary estimates, primary research.

# Where could this hypothesis be wrong?

- NT mark-to-market risk: LW has a good 4Q19E print in 7/2019 and guides for strong FY20 (negotiations for next year's pricing conclude in the fall) and the multiple re-rates up as bulls argue a strong guide invalidates the bear case
- Processors shutter existing capacity or new supply is delayed/phased in slowly, and the industry proves to be a "rational" oligopoly
    - Have not observed or discovered intent to shutter capacity in primary research, but can track it
    - Note industry maintenance tends to take 1-2 months, so if incumbents take down existing lines to upgrade them it would be temporary and upgraded lines allow for capacity creep
    - If per-unit margins improve as capacity ramps up, it will be a signal to exit as the thesis would be broken
- Europe export demand is strong and offsets supply in near-term and bull view on demand is proven correct
    - Export data so far suggests this is not materializing; can track via USA/EU export and World Potato Market data
- LW currently has 3.0x net leverage on consensus FY19E EBITDA vs. a stated target ratio of 3.5-4.0x
    - LW could lever-up and repurchase 5-6% of its S/O or engage in potentially accretive M&A (KHC is rumored to be selling its Ore-Ida business)…if the short thesis proves correct LW would be levering up on peak-margins
- Buyout by struggling CPG company
    - Assuming a 20% premium, an acquiror would generate a ~5% unlevered ROIC (including full synergies equal to 7% of sales on top of what may be peak-margins, which is aggressive) – share price likely needs to drop quite a bit before an acquisition would generate an attractive enough ROIC to make sense – still, always a possible risk

 Source: Company filings, press, proprietary estimates, primary research, USDA, World Potato Market.

# Potato processor boom/bust?

**Asset bubble checklist**

1. Big pricing spike ✓
2. Above-normal profits achieved by incumbents ✓
3. Observable supply response ✓
4. Sell-side forecasts linearly and extrapolates recent history ✓