Why Moats Take the Discretion Out of Consumer Discretionary Stocks

September 15, 2010

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

We at Smead Capital Management (SCM) have argued for nearly two years that long duration common stocks are undervalued in relation to shorter duration stocks. Moats have a great deal to do with long durations because to last a long time with high levels of profitability requires that competition gets fought off for decades. Your moat is what defends you from competition. Most long duration investors gravitate to consumer staple stocks and they have been particularly good performers over the last three-year period, which includes the meltdown of 2008. We would argue that despite good performance from the markets low in March of 2009 that there are consumer discretionary companies with moats strong enough to be considered staples. Since the moats exist, these companies should be valued alongside long-duration staple stocks like Coke or Pepsi or Costco or Hershey at a Price-to-Earnings Ratio (PE) premium of 20%. With the current multiple on the S&P 500 Index at around 14x trailing and 12x 2011 consensus earnings, this would give us some opportunities to look for undervalued franchises with PE multiple discounts.

To understand how moats affect duration and why we believe many “staple” stocks are hiding in the consumer discretionary category I will take you back to a conversation I had with a media person recently. She had interviewed an analyst commenting on Disney’s (DIS) earnings report and was comparing Disney’s Toy Story III with a movie released by another studio. What she didn’t take the time to consider and what the vast majority of both professional and amateur investors don’t consider is the duration of a Disney movie compared to almost any other studio. We at SCM believe that five-year old kids around the world will be watching those shows for one hundred years. Your kids, grandkids, great-grand kids and all future generations are going to be entertained by images created in the past, which can be reproduced inexpensively with very high profit margins. Disney gets to re-release movies in the theater every seven to ten years because of the sentimental attachment and goodwill associated with wholesome family entertainment. This is a powerful moat.

Disney shares trade for around $34 and they are consensus estimated to earn around $2.39/share by the Thomson Reuters news service in 2011. This means that the owner of ESPN, the world’s most successful theme parks, ABC and cable networks and the most awesome film library that ever babysat a child, trades for 14x next year’s earnings. We believe the greatest brands deserve a healthy premium to that average. At a PE of 18 sometime during the next year, Disney could trade up 30% from where it trades today.

Nordstrom (JWN) started out selling shoes and supplies to folks headed to Alaska by boat from Seattle. They have given customers a level of service for decades that is commensurate with how they would like to be treated themselves. The ability to improve the self image of customers is a competitive advantage which precedes the company. They now operate in a three-tiered business model. They have their flagship stores, Nordstrom Rack stores and one of the fastest growing and most successful online stores in the world. When Nordstrom opens a store in the area it is an event. They opened a Rack store in lower Manhattan a few months ago and it appears to be ripping the cover off of the ball. Imagine well-chosen inventory and very personal, courteous service. The goodwill in the brand and the ongoing, reinforcing experiences has caused Nordstrom to sail through the worst consumer recession in 70 years as their moat defended them from competition.

Nordstrom is projected to earn around $2.50 per share in the fiscal year ended January of 2011 and $3.00 in year ending January of 2012. At a market multiple of 15 PE on next year's earnings it would trade at $45 per share as compared to current prices around $33 per share. At the premium of a wide-moat consumer staple, JWN would trade above $50 per share in the next one to two years.

Can you name the number two worldwide gourmet coffee company? Starbuck's (SBUX) has so many intriguing aspects to its wide moat that we hardly know where to begin. Their product is legal and addictive. They cause customers to feel better about themselves. They now are seeking to dominate three huge market niches. First, they are growing their flagship stores and offerings around the world. Second, they are rolling out Seattle's Best Coffee as a gourmet coffee to the masses at Subway, Burger King and outlets everywhere. Third, they are going to use their strong brand to tackle the instant coffee market through VIA. With the product respect and goodwill this company has, who would bet against them.

Starbucks trades currently around $24 per share. We have compared them to the Wrigley Corporation. Wrigley made the generic product chewing gum synonymous with their name. We rarely saw the stock trade at less than a 20 PE multiple in the last 30 years before going private. Starbuck's owns the gourmet coffee category the way Wrigley owns chewing gum and trades at 16x the earnings estimate for the fiscal year that starts in October. A 20 PE multiple would create a 25% gain in the next 12 months.

These are three examples of powerful moats causing what we believe are "staple" businesses in the consumer discretionary category. Time will tell if the marketplace gives them the PE multiples we think those moats and their stability deserves.

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.