HILLIARD LYONS

Consumer Staples
Analyst: Jeffrey S. Thomison, CFA
502.588.9137 / JThomison@hilliard.com
Institutional Sales Desk: George Moorin
502.588.9141 / GMoorin@hilliard.com
J.J.B. Hilliard, W.L. Lyons, LLC
July 11, 2017

COMPANY UPDATE / ESTIMATE CHANGE / RATING CHANGE

The J.M. Smucker Company

SJM — NYSE — Long-term Buy-2

Raising Rating to LT Buy

- **We are raising our rating on SJM to LT Buy from Neutral.** With the stock down 11% for the calendar YTD period and down 26% for the past twelve months, valuation has declined to a level we find attractive. SJM shares are now trading at about 15x trailing earnings (excluding amortization expense and nonrecurring items). This is below a 20x figure one year ago and a five-year historical average of roughly 18x.
- **We view dynamics in the food retailing industry as both a challenge and an opportunity.** The planned acquisition of Whole Foods Market by Amazon.com, Inc. has many unknowns, in our view, with uncertainties surrounding private label vs. national brand market shares and margins of packaged food companies. We believe SJM is in a relatively solid competitive position with its strong, leading portfolio of brands.
- **Fiscal 4Q results were a bit above expectations.** Net sales for the quarter ended 4/30/17 declined 1% to $1.784 billion, or $15 million above the street consensus expectation. Adjusted earnings per share (excluding amortization) were $1.80 compared to $1.81 in the year ago period when excluding a one-time tax benefit. The street consensus expectation was $1.72.
- **FY18 is expected to get off to a slow start.** The current 1Q is expected to produce a double-digit percentage EPS decline due to higher marketing spending, unfavorable price/cost dynamics in the coffee and pet segments, and a tough comparison to year ago results (a 17% EPS gain). We expect double-digit growth in the second half of the fiscal year. Moreover, we have generally favorable views of FY19 and beyond.
- **Our two-year price target is $140 per share.** Based on the current price, this equates to 13% annualized total return, including dividends. Our outlook assumes low single digit EPS growth this year, ramping up to mid to upper single digit growth in subsequent years. Also, we assume a future stock valuation in line with the current level. Our Suitability rating on SJM remains 2.

Key Metrics

SJM - NYSE (as of 7/10/17)		$114.41
Two Year Price Target		$140.00
52-Week Range		$114.39 - $157.31
Shares Outstanding-Basic (mil.)		114.8
Market Cap. ($ mil.)		$13,136
3-Mo. Average Daily Volume		865,810
Institutional Ownership		81%
Total Debt/Total Capital (4/17)		44%
ROE (TTM ended 4/17)		13%
Book Value/Share (4/17)		$59.66
Price/Book Value		1.9x
Annual Dividend & Yield	$3.00	2.6%
EBITDA Margin (TTM ended 4/17)		22%

Adjusted EPS FY 4/30 (excludes nonrecurring items and amort.)

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	$1.86	$1.60	$1.59		
2Q	$2.05	$2.13	$2.10		
3Q	$2.00	$2.21	$2.20		
4Q	$1.80	$2.01	$2.01		
Year	$7.72	$7.95	$7.90		$8.35
P/E	14.8x		14.5x		13.7x

Note: EPS figures exclude nonrecurring items and amortization expense. Quarterly figures may not add to annual figure due to rounding.

Revenue ($ mil)

	2017	Prior 2018E	Curr. 2018E	Prior 2019E	Curr. 2019E
1Q	$1,816	$1,805	$1,800		
2Q	$1,914	$1,930	$1,925		
3Q	$1,879	$1,915	$1,908		
4Q	$1,784	$1,820	$1,817		
Year	$7,392	$7,470	$7,450		$7,600

Company Description: *Established in 1897, The J.M. Smucker Company is a leading marketer and manufacturer of consumer foods, beverage products, and pet food/snacks in North America. Its portfolio of food & beverage brands includes Smucker's, Folgers, Dunkin' Donuts (packaged coffee), Jif, Crisco, Pillsbury, R.W. Knudsen, Hungry Jack, Café Bustelo, Martha White, Sahale Snacks, and Bick's. The Pet food/snack portfolio of brands (from the purchase of Big Heart Pet Brands in March 2015) includes Meow Mix, Milk-Bone, Kibbles 'n Bits, and 9Lives.*

Note Important Disclosures on Pages 7-8.
Note Analyst Certification on Page 7.

Grocery industry in flux. On 6/16/17, Amazon.com, Inc. and Whole Foods Market announced a definitive merger agreement under which Amazon would acquire Whole Foods Market for $42 per share in an all-cash transaction valued at $13.7 billion. With regulatory approvals, the deal could close in the second half of this year. The deal would combine the most powerful and successful online retailer with a mid-sized, physical store operator in the grocery industry and would represent entry into an industry in which AMZN has only limited experience.

Founded in 1994, AMZN is an online retail juggernaut. With operating acumen, a cash-rich balance sheet, and a visionary leader, AMZN has been one of the great success stories in corporate America. Founded in 1978, WFM has grown to become a major grocery store operator focusing on natural and organic foods. Financial results and stock price performance with WFM had been disappointing to many investors, especially in recent years.

We believe AMZN likely sees some future combination of online and physical store retailing for the grocery industry, and WFM would give it the ability to form and refine business concepts in the grocery industry over time. WFM's store base could take on a variety of uses, including pure retail locations or delivery/distribution centers, or a hybrid of those uses. The deal could also give AMZN negotiating leverage with food suppliers given its potential size in the food retailing industry.

Challenges for AMZN could be navigating a new industry that is known for low margins and fierce market share battles, as well as applying its online shopping and delivery model to common hands-on perishable grocery categories such as meats and produce and refrigerated staples such as milk and eggs.

While there are more unknown than known aspects of the deal at this time, we believe it is likely to have an impact on not only the grocery industry, but the Consumer Staples sector in general as factors such as cost of goods, retail prices, and supply & demand go through changes. For packaged foods companies, issues to monitor include private label vs. national brand market share positions, and price negotiations between retailers and suppliers (such as SJM). However, we believe any food retailing entity with lofty ambitions will need strong relations with providers of leading packaged food brands.

We like SJM's diverse business mix (essentially three $2 billion segments), high product quality, enviable operating history, and strong market share positions. We believe potential challenges stemming from the planned AMZN/WFM combination are not likely to materially impact SJM's business in the short-term, and perhaps by less of a degree than what seems to be inferred (based on SJM's price drop following the announcement) over the longer term.

Wesson oil joins the portfolio. On 5/30/17, SJM announced an agreement to acquire the *Wesson* oil brand from Conagra Brands. The *Wesson* brand is considered a complement to SJM's *Crisco* brand. The all-cash transaction is valued at $285 million, before an expected tax benefit valued at $45 million. SJM management expects *Wesson* to add about $230 million in annual sales, $30 million in EBITDA, and $0.10 in EPS in the first full year under SJM ownership. The $285 million purchase price represents 9.5x EBITDA prior to the tax benefit. Including that benefit, and expected synergies, the multiple is expected to drop to about 5.0x. The deal is subject to customary closing conditions and regulatory approvals. We will incorporate *Wesson* in our financial model for SJM when the transaction becomes official.

4Q FY17 results. In the U.S. Retail Coffee segment, 4Q sales declined 1% while profits dropped 14%. This reflected lower volume (primarily *Folgers*) and higher net price realization following a recent price hike. Business was encouraging for the *Dunkin' Donuts* (bagged and K-Cup offerings) and *Cafe Bustelo* brands. Segment profit margin declined a substantial 428 basis points in the quarter.

The U.S. Retail Consumer Foods segment posted roughly flat sales and a 19% increase in profits. This reflected lower volume, but beneficial impacts of lower manufacturing overhead and higher net pricing. The *Uncrustables* frozen sandwich product line continued to perform well despite tough comparisons. Segment profit margin, excluding the divested business—rose 358 basis points.

In the U.S. Retail Pet Foods segment, sales declined 5% and segment profit dropped 15% as lower net price realization and lower volume reflected a competitive environment. In addition, distribution expense was higher as more products are being sold in more channels. Segment profit margin for the quarter was down 246 basis points.

Sales from the smaller International and Foodservice segment increased 4% and profits surged 26%. The sales gain reflected higher volume while the profit increase reflected a gain from the sale of a minority interest held by SJM. Segment profit margin rose 309 basis points compared to a year ago.

Share repurchases helped the EPS calculation. Non-GAAP net income fell 22%, yet EPS dropped only 1% due to a 3% decline in the weighted average share count. Non-GAAP diluted EPS for the 4Q period were $1.80 compared to $2.23 in the year ago quarter. The year ago figure was boosted by $0.42 per share nonrecurring tax benefit. Excluding that item, the year ago period produced non-GAAP EPS of $1.81, similar to the recent 4Q figure. The street consensus expectation was $1.72.

Financial condition. The company's balance sheet is solid, in our view. As of April 30, 2017, total cash and equivalents were $167 million. Receivables and inventories were at sufficient levels, in our view. Total debt was $5.398 billion, or 44% of total capitalization. At the end of FY17, total debt stood at $5.430 billion. Shareholders' equity at the recent quarter end was $6.850 billion.

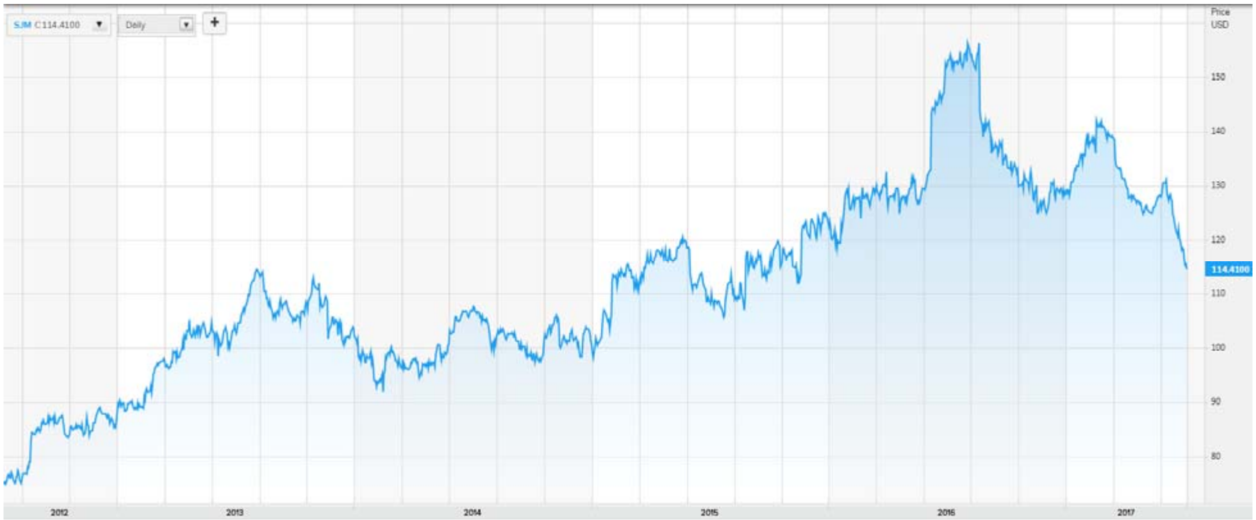
For fiscal 2017, net cash provided by operations was $1.059 billion. After capital expenditures of $192 million, free cash flow was approximately $867 million. This was below company guidance of $950 million to $1.000 billion. The fiscal year's EBITDA (earnings before interest, taxes, depreciation & amortization) of $1.594 billion led to a leverage ratio of approximately 3.4x, down from 4.1x after the acquisition of the Big Heart pet food business in March 2015.

Outlook. Management issued FY18 financial guidance, with key factors being expected higher net price realization, various cost reductions, gross margin expansion, and a continuation of recent challenging factors (i.e. higher marketing spending, and pricing and competitive dynamics in the coffee and pet segments) in the early part of the fiscal year. Annual guidance for net sales called for a 1% increase. Gross margin is expected to rise about 50 basis points. Synergies and cost reduction initiatives are expected to continue, leading to higher operating margin. Reflecting share repurchases, non-GAAP EPS are expected in a range of $7.85-$8.05, the mid-point of which represents 3% growth from the recent FY17 figure.

We have updated our FY18 outlook. Our net sales estimate is $7.450 billion, down modestly from our previous figure of $7.470 billion. After updates to various line items and our share count assumption, our non-GAAP EPS estimate is $7.90, or $0.05 below our previous figure. After planned capital expenditures of about $310 million (above FY17's figure of $192 million), FY18 free cash flow is projected at $775 million. In FY17, free cash flow was $867 million.

Our presentation of EPS is consistent with the methodology used by the company, that is, excluding amortization expense. However, for valuation purposes, we also consider the more conservative approach of including amortization expense (mostly related to the acquisition of Big Heart Pet Brands in March 2015). Our new FY18 EPS estimate of $7.90 equates to roughly $6.72 including amortization expense.

Exhibit 1
SJM Share Price History (through 7/10/17)



Source: Thomson Reuters Eikon

Valuation. Recent share price weakness has resulted in an attractive valuation, in our view. SJM shares are down approximately 11% for the calendar YTD period and down 26% for the past twelve months. Based on the recent closing price, the shares are trading at 14.5x our FY18 adjusted EPS estimate of $7.90. Including amortization expense in the methodology (most earnings figures from our covered companies include amortization expense), the current stock price represents 17.0x an estimated FY18 EPS figure of $6.72, subtracting annual amortization of $1.18 per share related to the Big Heart Pet Brands acquisition in 2015. We believe comparing SJM's commonly presented and discussed price/earnings multiples to historical figures has some limitations due to changing methodologies behind EPS figures (perhaps a mix of the two methodologies—with and without amortization expense). However, we note the following:

- The 14.8x multiple on trailing (FY17) EPS excluding amortization expense compares to a comparable figure of 20x one year ago and an approximate 18x average figure over the past five years.
- The 14.5x multiple on our FY18 EPS estimate excluding amortization expense is near the lower end of an historical range we estimate at 12x-20x (adjusting past EPS figures to exclude amortization expense).
- The current 17.0x multiple on our FY18 EPS estimate including amortization expense compares to 22.0x our FY17 EPS estimate one year ago and 19.5x our FY16 EPS estimate two years ago.
- The 17.0x multiple on our FY18 EPS estimate including amortization expense compares to forward multiples of 17.8x for the S&P 500 and 19.4x for the S&P Consumer Staples sector.
- On an Enterprise Value/EBITDA basis, SJM is trading at just under 11x our adjusted EBITDA estimate for FY18. This is the lowest level since June 2015, below a recent high mark of 13x, and in the middle of a five year historical range we estimate at 9x-13x.

Opinion. We like SJM's extensive operating history, diverse product portfolio, and seasoned management team. In time, we believe the Big Heart pet food business can become more of a growth vehicle for the company and a meaningful cash flow generator, particularly with some improved industry dynamics, greater distribution, and fully realized synergies. In addition, a new manufacturing facility is planned for the fast-growing *Uncrustables* frozen sandwich line, which could add to growth in the consumer foods segment. Finally, we would not be surprised to see one or more acquisitions over the next few years.

We are mindful of the "investment year" represented by FY18, as the company injects money back into the business to boost innovation, add capacity in certain product lines, and improve its overall competitive position. This should have a limiting impact on 1H profits, in our view, with the 2H outlook notably better. Beyond that, we feel good about the company's prospects in FY19 and beyond.

Longer term, earnings growth could potentially come from factors such as improved volumes, market share gains, product development/brand extensions, operating margin improvement, debt reduction (lower interest expense), and share repurchases. Also, we expect annual dividend increases, with declarations around July of each year. We consider the balance sheet solid and note management's recent comment that it was "aggressively pursuing a variety of growth opportunities." We project long-term annual EPS growth in the upper single digit percentages.

Rating and price target. We rate SJM shares Long-term Buy. We consider the company a high achiever, with notable histories of both organic and external growth. Given some expected near-term earnings pressure, but a more favorable outlook over the next few years, we believe our Long-term Buy rating is most appropriate. Our two year price target is $140 per share. This assumes modest EPS growth in FY18, rising to mid or upper single digit growth in FY19 and FY20. Our target is based on a price/earnings multiple of 14.6x applied to a FY20 EPS estimate of $9.60. This essentially matches the current multiple on our current FY18 EPS estimate.

Suitability. Our Suitability rating on SJM is 2 on a 1 (most conservative) to 4 (most aggressive) scale. Contributing factors in determining our Suitability rating include the company's debt level (particularly following the March 2015 acquisition of Big Heart Pet Brands), market capitalization, liquidity/trading volume, diversity of revenues, the industry in which the company operates, the company's competitive position within the industry, and the company's long-term earnings and dividend history.

Risks. There are numerous factors that could affect operations of The J.M. Smucker Company. A recent factor is the company's relationship with its retail partners (current and future, including AMZN/WFM) as it relates to unit volumes and pricing. Other factors include changes in consumer demand for the company's products; product competition, including private-label; price competition; volatility of commodity markets (green coffee beans, wheat, soybean oil, milk, peanuts, sugar, etc.); labor relations; extreme weather conditions or occurrences; crude oil price trends and the resulting impact on transportation, energy, and packaging costs; the ability to implement price changes in response to rising input costs; the success and costs of introducing new products; the impact of potential food safety concerns; risks associated with potential growth of international operations such as exchange rate fluctuations and geopolitical risks; potential future acquisitions; and the global economy.

The continued integration and positioning of Big Heart Pet Foods, purchased in March 2015, is another investment factor, in our view. Also, if SJM continues on an acquisition strategy, this could lead to risks such as cost of acquisitions, general balance sheet impact, and integration of acquired operations.

Labor contracts are another consideration. Recently, about 30% of SJM's employees were covered by union contracts at 11 facilities. One contract expired and was renewed in FY17, representing about 8% of SJM's total employees.

There were recently just under 115 million common shares outstanding and there is only one class of stock. Shareholders are typically entitled to one vote per share held; however, shareholders who have owned the stock for approximately four years are entitled to ten votes per share held on certain matters, including major issues such as a potential merger, consolidation, or liquidation of the company.

Exhibit 2
Consolidated Statements of Income
(figures in millions except percentages and per share data)

	FY19E	% chg.	FY18E	% chg.	FY17	% chg.	FY16
U.S. Retail - Coffee	$2,150	1.9%	$2,110	0.1%	$2,109	(5.8%)	$2,239
U.S. Retail - Consumer Foods	2,175	2.6%	2,120	1.7%	2,085	(8.1%)	2,270
U.S. Retail - Pet Foods	2,185	1.9%	2,145	0.4%	2,136	(5.1%)	2,250
International & Foodservice	1,090	1.4%	1,075	1.2%	1,062	1.0%	1,052
Total Net Sales	7,600	2.0%	7,450	0.8%	7,392	(5.4%)	7,811
Costs of Products Sold	4,648	1.9%	4,560	0.1%	4,557	(5.9%)	4,843
Gross Profit	2,952	2.1%	2,890	1.9%	2,835	(4.5%)	2,968
Selling, Distrib. & Admin. Exp.	1,460	1.7%	1,435	3.2%	1,391	(7.9%)	1,510
Amortization	212	1.0%	210	1.3%	207	(0.3%)	208
Impairment Charge	0		0		133		0
Special Project Costs	0		0		77		136
Other Operating Exp. (Inc.)	30		50		(4)		(32)
Operating Income	1,250	4.6%	1,195	15.9%	1,032	(9.9%)	1,145
Interest Expense, net	(150)	(9.1%)	(165)	1.2%	(163)	(4.6%)	(171)
Other Income (Expense)	5		4		10		4
Earnings Before Taxes	1,105	6.9%	1,034	17.7%	878	(10.2%)	978
Taxes	362	6.9%	339	18.4%	286	(1.1%)	289
GAAP-based Net Income	$743	6.9%	$695	17.4%	$592	(14.0%)	$689
Non-GAAP Adjustments:							
Income Tax Expense	362		339		286		289
Amortization	212		210		207		208
Unallocated Derivative Loss (Gain)	0		0		27		(12)
Impairment Charge	0		0		133		0
Costs of Products Sold - Special Costs	10		16		6		12
Other Special Project Costs	75		85		77		136
Pre-tax Income, Adjusted	1,402	4.2%	1,345	1.2%	1,329	0.5%	1,322
Income Tax Expense, Adjusted	459		440		433		391
Net Income, Adjusted	$943	4.2%	$905	1.0%	$896	(3.8%)	$931
Avg. Diluted Shares Outst.	112.9	(1.4%)	114.5	(1.4%)	116.1	(2.8%)	119.5
Non-GAAP EPS, diluted, as reported	**$8.35**	5.7%	**$7.90**	**2.4%**	**$7.72**	**(1.0%)**	**$7.79**
As a % of Net Sales:		**bp. chg.**		**bp. chg.**		**bp. chg.**	
Gross Profit	38.84%	5	38.79%	44	38.35%	36	37.99%
Selling, Distrib. & Admin. Exp.	19.21%	(5)	19.26%	45	18.81%	(52)	19.34%
Operating Income, GAAP-based	16.45%	41	16.04%	209	13.95%	(71)	14.66%
Net Income, GAAP-based	9.78%	44	9.33%	132	8.01%	(80)	8.82%
Net Income, Adjusted	12.41%	26	12.14%	2	12.12%	20	11.92%
Tax Rate, Adjusted	32.75%	0	32.75%	18	32.57%	299	29.58%

Dividend Data:	**FY19E**	**FY18E**	**FY17**	**FY16**
Dividends Paid During FY	$3.31	$3.12	$2.92	$2.65
Dividend Payout Ratio	40%	39%	38%	34%

Note: EPS figures exclude amortization expense.
Note: FY16 EPS includes $0.15 per share gain on the sale of U.S. canned milk business and a $0.42 per share nonrecurring tax benefit.

Source: Company reports and Hilliard Lyons estimates Note: April fiscal year

Additional information is available upon request.

Prices of other stocks mentioned:	Amazon.com, Inc. - AMZN - $996.47
	Whole Foods Market - WFM - $41.85
	Dunkin Brands Group - DNKN - $54.14
	Conagra Brands Inc. - CAG - $33.23

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

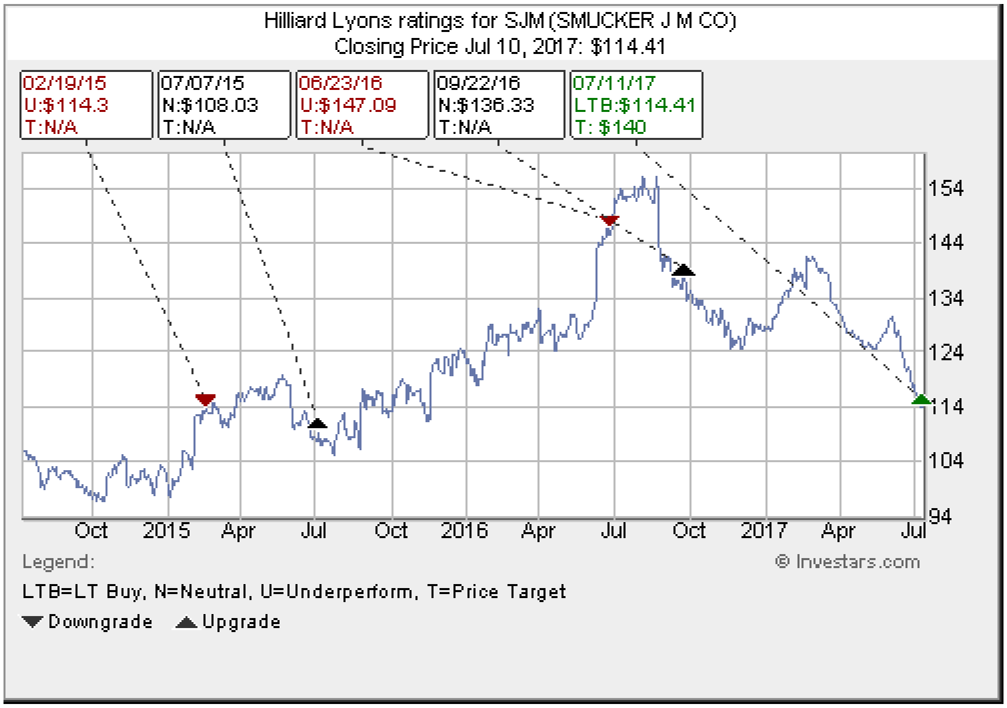
Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

J.J.B. Hilliard, W.L. Lyons, LLC is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as placement agent in private transactions.

The information herein has been obtained from sources we believe to be reliable but is not guaranteed and does not purport to be a complete statement of all material factors. This is for informational purposes and is not a solicitation of orders to purchase or sell securities. Reproduction is forbidden unless authorized. All rights reserved.