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Investment Review
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Investment Review by
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THE COLGATE-PALMOLIVE COMPANY

A Global Consumer Franchise

During the market decline in the winter of 2008/2009, Colgate-Palmolive's stock traded at the same level that it had reached nearly ten years before, despite the company's earnings per share being significantly higher. This would be a signal to Sire Line Capital that Colgate might represent an attractive opportunity for our portfolios. Remember that when searching for suitable investments for our portfolios, Sire Line Capital looks for high-quality businesses that I.) are simple to understand, II.) have a consistent operating history and favorable long-term prospects, III.) are managed by honest and able managers whose interests are aligned with ours and IV.) can be purchased at a significant discount to intrinsic value. Let's see how Colgate looked relative to these tenets back in early 2009?

I. Simple to Understand

Colgate has been in business for more than two hundred years, ever since William Colgate started a starch, soap and candle business in New York City back in 1806. In 1873, the company introduced the first toothpaste in a jar and by 1896 it was selling toothpaste in a collapsible tube. Palmolive soap was introduced by the B. J. Johnson Soap Co. in 1898. In 1926, Colgate merged with the Palmolive-Peet Company to become Colgate-Palmolive-Peet. The company's name officially changed to Colgate-Palmolive in 1953.

Today, with worldwide sales over $15 billion, Colgate is a best-in-class personal and home care company whose products are sold in more than 200 countries worldwide. The Company manufactures and sells a wide range of products in two distinct business segments: Oral, Personal and Home Care; and Pet Nutrition. Oral, Personal and Home Care products include toothpaste and other oral care products, soaps, shower gels, shampoos, conditioners, deodorants and antiperspirants, shave products, laundry and dishwashing detergents, cleansers and cleaners, bleaches and other similar items. These products are sold primarily to wholesale and retail distributors worldwide. Pet Nutrition products include pet food products manufactured and marketed by Hill's Pet Nutrition. Pet Nutrition products are primarily sold to veterinarians and specialty pet retailers. The company's global brands include Colgate, Palmolive, Mennen, Speed Stick, Lady Speed Stick, Softsoap, Irish Spring, Tom's of Maine, Ajax and Hill's Science Diet and Hill's Prescription Diet, among others.

Not only is the company simple to understand, but many of its products are staples in most households around the world.

II. Consistent Operating History and Favorable Long-term Prospects

Colgate has experienced consistent and above-average growth and profitability for many years, including the most recent five years. As you can see from chart #1, earnings per share have compounded at an annual rate of 12% since 2004:

CHART #1
($ in millions, except per share)

Colgate-Palmolive	2004	2008	CAGR
Revenues	$10,584	$15,330	10%
Operating income*	$2,181	$3,261	11%
Earnings per share*	$2.42	$3.87	12%

*Adjusted for restructurings and other one-time items.
Source: Company reports and SLC analysis

Not only is the company generating above-average growth, it is consistently generating very profitable growth (Chart #2):

CHART #2

Colgate-Palmolive	2004	2008
Return on invested capital (ROIC)	37%	36%
ROIC - adjusted for write-offs	37%	31%
Return on equity	146%	121%

Source: Company reports and SLC Analysis

These returns are the envy of the industry (of any industry for that matter!). But where is this profitable growth coming from, and is it likely to continue? As you can see from the next chart (Chart #3), almost half of the company's sales are being generated in faster-growing regions of the world (Latin America and Asia):

CHART #3

Colgate-Palmolive Segment Data:

Sales:	2008 % of Total	Growth 2007	Growth 2008
Oral, Personal and Home Care			
North America	19%	5%	5%
Latin America	**27%**	**16%**	**17%**
Europe/South Pacific*	23%	15%	6%
Greater Asia/Africa	**17%**	**17%**	**14%**
Pet Nutrition	14%	11%	16%
Total Sales	100%	13%	11%

*Europe/South Pacific segment impacted by currency in 2008.

Source: Company reports and SLC Analysis

Colgate has been a consistent performer and appears to have a bright future.

III. Managed by Honest and Able Managers Whose Interests are Aligned with Ours

Directors and executive officers of Colgate own over 1% of the outstanding shares of the company. In addition, the company has a unique stock ownership policy which requires certain members of senior management to own a minimum amount of company stock. The ownership minimums are based on a multiple of each manager's salary, ranging from one-to-five times (depending on the level of management). For example, the CEO of the company is required to directly own Colgate stock equal in value to five times his annual salary. This is a policy that further aligns the interests of management with that of its shareholders.

More importantly, how is management allocating capital? Are they reinvesting free cash back into the franchise? Are they acquiring businesses that are not part of their core competency? Are they returning value to shareholders? For a better understanding of what management is doing with the excess cash, we have to look at the firm's cash flow statement. There we find that in 2008 the company generated $2.2 billion in operating cash flow. Of this amount, they used $684 million—nearly one-third of the total—for capital expenditures and made no acquisitions. After including cash from asset sales and net debt issuance, total free cash flow available for equity shareholders amounted to just over $1.8 billion. So what did they do with such a large amount of excess cash? Admirably, they returned it all to the shareholders. Chart #4 shows this analysis:

CHART #4

($ in millions)

	Free Cash Flow to Equity	2008
	Operating cash flow	$2,238
-	Capital expenditures	684
-	Acquisitions	-
+	Assets sold	68
+	Increase in debt	195
=	Free cash flow	1,818
	$'s Returned to Shareholders	
	Dividends paid	797
	Share repurchases	1,073
	Total	1,870

Source: Company reports and SLC analysis

Even if you were to go back a few years with this exercise, you would see a similar story. This is exactly what we want to see in a management team. They are reinvesting back into the franchise, staying away from unnecessary acquisitions and returning value to shareholders. They are clearly thinking and acting like shareholders.

IV. Can it be Purchased at a Significant Discount to Intrinsic Value?

In October of 2008 and again in March of 2009, Colgate's stock hit a multi-year low of just under $55 per share—the same level it traded at in 1999! With over 500 million shares outstanding, the market value (MV) of the company's equity at its low was roughly $30 billion. That is what the general market thought the equity portion of the company was worth at the time. But if you believe, as we do, that markets are not always efficient and do not always reflect the true economic value of a company, an attempt to calculate the intrinsic value of Colgate must be made.

There are three primary sources of value for any company: assets, earnings power and profitable growth. Think of these sources as representing different points on the spectrum of value for a firm, with the value of a company's assets on one end of the spectrum (tangible and dependable), the value of a company's earnings power somewhere in the middle (less tangible than assets and more dependable than future estimates) and profitable growth at the other end (not tangible and less reliable than today's earnings). Once we are able to map out the value spectrum for Colgate, we will be in a better position to see if there is a margin of safety between the current MV of equity (our entry price) and the intrinsic value.

Where most investors go wrong in their estimate of a company's intrinsic value and trying to pick an entry point is that instead of starting with the most tangible and dependable information, many investors try to value a company based on the most unreliable information available—future expectations. At Sire Line Capital, a company's future expectations is the last variable we look at. When starting the valuation process, we follow Ben Graham's advice when he said, "Make sure of your ground. Start with net asset values as the fundamental departure point." Taking this sage advice, we begin by looking at the balance sheet.

First we calculate Colgate's net current asset value, which is simply its current assets less all liabilities (assigning no value to long-term assets). This is the most conservative point on our value spectrum. At the end of 2008, Colgate's net current asset value was -$4.2 billion. This would be the value (or lack thereof) to equity holders if the company was to be liquidated and fixed assets had no value. We know that's not the case with Colgate, but we use it as a "departure point."

Next we look at reported book value and attempt to calculate the company's reproduction value by using all of the assets on the balance sheet, as well as making certain conservative assumptions about what it might cost a new entrant to replicate this company. The reported book value of equity (all assets less all liabilities) at the end of 2008 was $1.9 billion. This is significantly lower than the $30 billion of equity market value that we calculated earlier. But from what we already know about most consumer-related companies, only a small portion of the economic value is reflected on the balance sheet. It is safe to say that Colgate has a great deal of economic "goodwill" that does not show up on the balance sheet. This goodwill comes from intangible sources such as consumer awareness, customer and vendor loyalty, difficult-to-replicate distribution systems, etc. Part of the distribution system might be on the balance sheet as part of fixed assets. But what about consumer awareness and customer/vendor relationships? In 2008 alone, Colgate spent over $1.6 billion marketing its products around the world. In other words, Colgate is spending an amount nearly equal to the book value of its equity capital—roughly 11% of total sales—every year to market its products. That is a significant amount of money that is sure to be adding value to the firm in the form of future customer/vendor relationships. However, accounting rules require that 100% of the cost of marketing is to be expensed as incurred through the income statement, rather than being capitalized on the balance sheet the way capital expenditures and other items are that generate future value for the firm. For a competitor to replicate this company, they would have to spend multiples of this amount to establish and develop the relationships that Colgate has acquired over many decades. The same is true for certain general, administrative and research and development expenses, all of which are being expensed as incurred. If you were to capitalize a few years worth of these expenses (treat them like capital expenditures), you can easily get to a conservative estimate of the reproduction value for Colgate in the range of $15-$20 billion at the end of 2008.

Next on the value spectrum is the earnings power value. This calculation is performed by simply taking the company's current normalized annual earnings power (adjusted for any growth-related expenses), assume the company generates this same amount every year in the future (expect no growth), and then discounting these future earnings back to the present using an appropriate discount rate. For Colgate, the earnings power value looks to be in range of $25-$30 billion—nearly equal to the value that the market placed on Colgate between the fall of 2008 and the spring of 2009! Astonishingly, the market was saying that any and all future growth at Colgate was worthless. But we already know that the company generates envious returns on invested capital and that they are well positioned in attractive markets around the world to generate future growth. Barring a meteor strike that wipes out a large portion of the global population, Colgate is sure to generate profitable growth well into the future. But how much is Colgate's future growth actually worth?

The last data point on our value spectrum is the company's earnings power value with growth (represented by the green line in Chart #5). This value is essentially our best estimate of intrinsic value as it includes today's earnings power value and the value of all future growth. This is the most challenging of all the points on our spectrum because we now must incorporate certain "estimates" of future growth and profitability into our work. That said, if we were to use a conservative assumption of mid-to-high single-digit growth and lower profitability than what the company is currently experiencing (we assume market forces will lower profitability over time), we can arrive at an intrinsic value for Colgate in the range of $50-$55 billion—or, roughly $95-$100 per share. This would equate to a trailing price-to-EBITDA (earnings before interest, taxes, depreciation and amortization) in the range of 14x-15x and a price-to-sales of roughly 3.5x. This is well within the range of prices paid for similar assets in recent M&A transactions, which adds some support to our calculations. In addition, Colgate's underlying economic value is growing at an above-average rate. This means that if it takes the market an extended period of time to recognize the company's true value, our margin of safety will grow larger.

It is important to note that if we were able to acquire shares in Colgate at $55 back in the spring of 2009, we wouldn't care that much if we were off by a point or two in our growth estimate that we use to calculate Colgate's intrinsic value. We would feel comfortable enough knowing that our entry price was so attractive (being able to get any and all future growth for free) that any reasonable growth assumption would produce satisfactory returns for our clients.

Chart #5 is a 10-year graphical representation of the exercise we just went through for Colgate, as of March 9, 2009. As you can see from the chart, the low MV of equity (represented by the light blue line) in 2008 and 2009 was equal to our estimate of the company's earnings power value (represented by the red line), before factoring in any expected growth. This had not occurred at any other time in the last 10 years. At this point there looked to be a significant margin of safety between our entry price and any rational estimate of intrinsic value. Thus, Colgate met all of our requirements and would have been considered an attractive candidate for our portfolios.

CHART #5