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GLOBAL IDEAS

14 FEBRUARY 2013

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Herbalife — Compelling valuation, but binary outcome?

Background

Herbalife is one of the more interesting offshore shares we have encountered in recent times. This is a company whose share price peaked at over $70 in early 2012, dropped to a low of $26 in December 2012 and has now recovered to around $36 – roughly half its peak levels. At the same time, all that has changed for the business has been the conviction expressed by a very high profile US hedge fund manager (Bill Ackman) that the business is nothing more than a thinly-disguised pyramid scheme – leading him to short $1bn worth of stock in the expectation that regulators will shut it down. Operationally, the business continues to perform as strong as ever, posting record financial results.

Herbalife's metrics are as follows:

Spot ($)	36.4
Mkt Cap ($mn)	3 931
12M trailing P/E	9.38
12M fwd P/E	8.08
10-year average P/E	15.6
10-year average DY	2.27
FYE	31-Dec
P/Book ratio	10.57
12M trailing DY	3.3
12M fwd DY	3.3

Source: Bloomberg, Anchor Capital

What does Herbalife do?

Herbalife is what is known as a multi-level-marketing (MLM) company. This means that it sells its products not through the traditional retail channel, but rather through independent third-party distributors who earn commissions or royalties on the basis of the amount of product they buy from the company and sell to end-consumers. The company's products are focussed on weight-management dietary supplements such shakes, powders and snack bars. Herbalife has been in business for 32 years.

A very profitable model

The business model is an immensely profitable one -for every $100 of sales the company generates (which is not the sales price to the end-consumer, but rather distributors), it makes a gross profit of $80, pays royalties of $33 to distributors and has other selling and general costs of $31, leaving operating profit of $16. This mid-teen margin may not sound overly sexy, except when one considers that the $562mn of operating profit in FY11 was generated off average shareholders' equity of only $524mn. This implies a post-tax RoE of 80%, a number we believe will rise materially in FY12 and beyond (probably >100% RoE) given growing profitability and share buybacks.

Importantly, the group's profits are generated in cash as working capital is broadly neutral or negative (accounts payable, royalty overrides and accrued expenses are generally more than accounts receivable and inventories) and apart from normal capital expenditure and a $0.30/share quarterly dividend (~3.5-4x dividend cover on FY12e), the group is utilising a large portion of its free cash flows in buying back stock.

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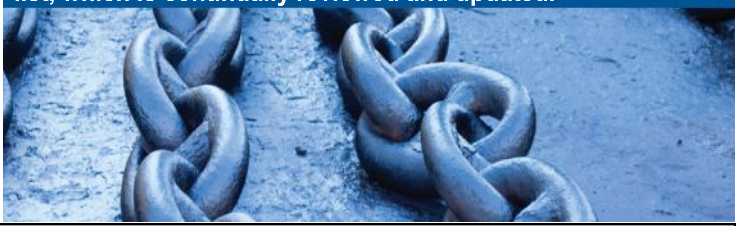
We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.



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Share buybacks are strongly accretive, even more so given recent price weakness

Allied to the final point above, in FY11 the group announced a fresh $1bn share buyback programme, which amounts to approximately 25% of the company's current $3.9bn market cap. Given the strong cash flows ($509mn cash generated from operations in FY11 vs capex of only $90mn), we expect the group to easily fund these buybacks from cash flows which implies no interest drag. We estimate that if the group took three years to effect a $1bn buyback (i.e. $300mn+ p.a.), this would result in shares in issue declining by ~8mn p.a. (using the current share price), or <u>7% of the current diluted shares base</u> – and there would be no associated income statement interest drag (interest foregone on positive cash balances is minimal too given near-zero rates). So simplistically, this programme adds 7% p.a. to EPS.

Above this line, the group's strong operational momentum appears to have been sustained – operating profit grew 45% in FY11, followed by 17% growth in the first nine months of FY12 (December year-end). The one negative in the recent results was the 5% EBIT growth in 3Q12, which appears to have been partially influenced by severe currency devaluation in Venezuela. The company has guided for diluted EPS of $3.99-$4.03 for FY12 (+21% YoY), followed by a range of $4.40-$4.55 for FY13 – we note that the group has generally been conservative with guidance (leading to sequential guidance upgrades) and we think the FY13 guidance looks light in the context of the likely impact of share buybacks.

Valuation enormously compelling, but risks pose a binary outcome?

Given Herbalife's turnover growth profile (two-year CAGR +19% p.a. FY10-12e), cash generation and RoE/growth profile, the stock looks ridiculously cheap at a **8x P/E multiple to December 2013**. In our view, from current share price levels the risk to investors is that the Federal Trade Commission (FTC) in the US (or any other relevant regulatory body) adopts the view that Ackman's allegations have merit and, consequently, take steps to force change within the company and its practices, impose fines or – at worst – shut the company down.

We are not fully equipped to assess the legal risk associated with this, but we would take the view that the company being shut down is probably an unlikely outcome (the premise of Ackman's $0 target price for the share). In addition, the negative press generated by Ackman's allegations could also result in the departure of some of the groups' independent distributors (so-called 'self-fulfilling prophesy') – we suspect this could be part of Ackman's strategy.

We would, however, also add that the US market represents ~20% of group revenue, so the complete demise of the company would require other regulators around the world declaring the company an illegal pyramid scheme. Nevertheless, while the fundamentals of the company look very strong at present this is a risk of which one needs to be fully aware.

Sean Ashton

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