SPECTRUM UPDATES

February 12, 2025

Thank you for your continued trust and confidence. We would like to inform you that we recently made changes to the Liberty One's Spectrum portfolio. We sold Hormel Foods (HRL) and Kimberly Clark (KMB) and replaced them with The Kroger Company (KR) and Domino's Pizza Inc. (DPZ).

Sell - Hormel Foods (HRL)

Hormel is currently struggling with stagnant revenue growth, shrinking margins, commodity price volatility, and increasing competition from private-label brands and retailer-owned alternatives, which present substantial risks. While Hormel has maintained a strong dividend history, its modest payout growth and uncertainties surrounding its cost-cutting initiatives limit its appeal as a long-term investment.

Although core brands like SPAM, Jennie-O, and Applegate performed well, these gains were outweighed by declines in value-added meats, snacking, and convenient meals. Increased competition from private-label brands, such as Kroger's Simple Truth, Costco's Kirkland, and Walmart's Great Value, continues to put downward pressure on Hormel's pricing power, threatening its long-term profitability. Rising costs and margin compression in premium meats and poultry products are also contributing to underperformance in their foodservice segment while declining demand for turkey exports has continued to put downward pressure on its international business.

To address these challenges, Hormel has implemented its Transform & Modernize (T&M) initiative, aimed at improving operational efficiency and reducing costs. While the initiative generated $75 million in operating income in fiscal 2024, it was not enough to significantly impact overall earnings. Management anticipates an additional $100-$150 million in benefits in fiscal 2025, but given the broader headwinds facing the company, these cost savings may not be sufficient to offset weak sales and margin pressures. There is also execution risk associated with the initiative.
Overall, Hormel's lack of meaningful revenue growth, increasing competition from private-label brands, reliance on volatile commodity markets, and uncertain execution of its cost-saving initiatives make its stock unattractive at this time as we believe there are better opportunities elsewhere to drive alpha.

Sell - Kimberly Clark (KMB)

KMB faces several near and long-term structural challenges that prompted our decision to make a change. These include mounting margin pressures, declining sales volume, a reliance on cost-cutting measures to maintain earnings, and increasing competition from private-label brands, all of which pose significant challenges to the company's future profitability.

Despite reporting organic sales growth of 3.2% in 2024, a significant portion of this increase came from higher pricing rather than demand expansion. This suggests that consumers are either shifting to cheaper alternatives or reducing their purchases altogether. Price-driven revenue growth is ultimately unsustainable, as customers tend to push back against continued price hikes, opting instead for competitive brands. The North American segment, a key revenue driver, saw flat market share across core categories. While Baby & Child Care posted modest growth of 3.3%, Family Care and Professional segments exhibited weakness, reflecting soft consumer demand and growing competition from private labels. Meanwhile, the International Personal Care segment's 9.2% growth was largely driven by hyperinflationary pricing rather than organic expansion. The reliance on price increases rather than volume growth raises concerns about the strength of KMB's products.

KMB is also facing intensifying competition from private-label brands, particularly in key categories such as tissues, diapers, and feminine care. As inflation-weary consumers seek lower-cost alternatives, store brands are gaining market share, further pressuring Kimberly-Clark's pricing power. More importantly, there is no indication that lost customers are returning to KMB despite some stabilization in inflation and price increases. Increased marketing initiatives have also not resulted in a change of fortunes for volume.

Given the ongoing volume declines, rising input costs, and increasing competition from private-label brands, we believe KMB faces several challenges that would require new investments or a change in strategy to combat. This would also limit its continued dividend increases and would put a strain on its balance sheet. With a weaker guidance outlook and continued exposure to foreign exchange risks, we believe that the stock presents further downside risks.

Buy - The Kroger Company (KR)

KR is the largest traditional grocery supermarket chain in the US based on the number of stores and second largest grocery retailer based on sales volume. With groceries making up approximately 75% of annual revenue with the remainder from other segments like fuel and pharmacies, Kroger benefits from the stability in its end market, particularly with grocery spending and food-at-home trends. Additionally, of the approximately $112 billion sales generated from groceries, about $33 billion of that is generated by Kroger's private label products. With private label products generating between 6-8% higher margins for Kroger, the company has continued to expand their private label SKUs and sales volume. What started as a trade-off by the retailer to help ease inflationary pressures has amounted to a valuable customer loyalty tool that goes beyond lower prices. Customer behaviors have shifted, and private label brands are taking market share from national brands due to the perceived value, quality, and uniqueness that they offer. According to The Food Industry Association, surveys show that most shoppers bought more private brand goods over the past year, and more significantly, plan to purchase more even if grocery prices from national brands continue to fall. Private brands is one of the faster growing categories in staples and continue to provide grocers like Kroger with strong sales results and ongoing opportunities to lock in customer loyalty.

Additionally, KR has stayed on top of digital ordering trends by strategically developing its omnichannel infrastructure. The company generated $12 billion in digital sales comprised of delivery and in-store pickup at over 2,200 locations. Although small relative to their overall sales, the strategy shows that management can adapt to evolving industry trends. Growth of digital grocery shopping is also showing signs of stabilization, with surveys showing that most customers still prefer to shop in traditional brick-and-mortar stores for perishable groceries.

Financially, the national grocer has a healthy balance sheet with net debt/EDBITA at a manageable 1.2x, interest coverage ratio at 10x, and free cash flow generation of over $2 billion. The company's dividend is also covered by earnings and cash, with a typical payout ratio between 20%-30%. Although Kroger trails its larger rivals Walmart and Costco in terms of both operational and capital efficiencies, its valuation multiples are also less demanding than its peers. As a result, we believe that an investment in KR enables exposure to the nondiscretionary nature of grocery spending, increasing penetration of private label brands, consistent cash flow generation, and at a reasonable valuation.

Buy - Domino's Pizza Inc. (DPZ)

DPZ is a global restaurant operator and franchisor. With roughly $20 billion in systemwide sales, DPZ is the largest player in the global pizza market. The restaurant and consumer food industry is highly competitive with an abundant of choices for consumers to choose from. DPZ has built an enviable moat around the business driven by an enduring brand, good quality, competitive pricing, consistent customer experience, leading franchisee profitability, and scale advantages that make it harder for smaller and less focused competitors to challenge its dominance. As a result, DPZ has been able to grow comparable sales above the rate of its competitors while earning returns on capital in excess of 50% over the last 10 years, far outpacing its estimated cost of capital at 8%.

Despite being a pizza chain, DPZ has always prioritized its technology prowess, with management relentlessly investing in core process automation and data-driven insights. Domino's track record in innovation includes airtight dough storage, custom order sequencing algorithm, delivery hot bags, high-speed ovens, and AI-supported pricing and advertising systems. With over 20 years of customer data since the launch of its customized Pulse POS system, DPZ can advantageously leverage its customer-facing tech data to gauge everything from pricing optimization to customer order history.

Although the current consumer backdrop may not be as supportive for restaurant operators, DPZ has always exhibited sound resilience in the face of consumer weakness, primarily due to it being one of the lowest cost restaurant options to feed a family. We believe that further weakness may bode well for DPZ as the company could gain market share from its pizza competitors. Additionally, DPZ's unique franchise model also supports its financial strength.   DPZ grants franchise rights only to individuals who have worked for the company as a store employee, or a manager. An outside investor is unable to purchase the franchise without first working for the company. In the US, the company also operates a commissary business that sells ingredients to its franchise base. The operation accounts for approximately two-thirds of its revenue base with a 10% profit margin. All the cost is passed to the franchisee and DPZ has been good at keeping franchisee margin at a healthy level. DPZ has shown the ability to continue to innovate and scale its business by leveraging their scale, costs, digital, and profitability advantages. Management's strategy to focus on its core competencies gives us confidence in the company to achieve its 5-year growth target, supported by same-store sales growth, net new store openings, and stronger restaurant-level profitability.

If you have any questions, please don't hesitate to reach out to us. Thank you for your continued trust and confidence.