Since It's One of Warren Buffett's "Inevitables": Is it Okay to Pay a High P/E Ratio for Low Growth Coca-Cola (KO)?

Ask Geoff a Question of Your Own

Someone asked me this question:

"Warren Buffett had commented that Coca-Cola has a durable competitive advantage. It is one of his 'inevitables'. I am curious what is your thought on the investment merit of a business that may not grow much in an absolute sense, but has a durable competitive advantage like Coca-Cola?

Coca-Cola may not have be able to grow their sales at 10% a year like in the 1990s, but would it make sense to focus on sales per share going forward? Assuming the free cashflow margin is stable and predictable in the long-term because of its durable competitive advantage, the company can reduce the shares outstanding over time and still benefit shareholders."

I am not a big fan of investing in a business like Coca-Cola (KO) today. It does make sense to focus on sales per share (assuming free cash flow margin stays pretty stable). The problem that I see with something like Coca-Cola - no matter how inevitable it is - is that the company has only grown like 2-4% a year over the last 10+ years. Basically, it has grown at the rate of inflation. I've talked before about the idea of "free cash flow plus growth". What I mean by this is that your return in a stock can be calculated where you ask "how much growth will I get each year in this stock?" and "what is the free cash flow yield I am getting in this stock". This is a way of thinking of a stock like a perpetual bond. A perpetual bond would be something that pays a "coupon" each year (so $40 on a $1,000 face bond would be a 4% coupon rate) but never matures. So, in the example I just gave of a $1,000 face value bond that pays you $40 a year forever - you never get the $1,000 back.

Imagine this was the case with Coke. Say Coke stock is 100% safe with no risk of going to zero, no risk of earnings ever declining, etc. Okay. Most stocks and even bonds have some risk we have to account for. But, if this was truly as risk free a coupon as like a perpetual government bond then we could imagine that if you want to compound your money at 10% or better a year forever - all you have to do is buy a Coca-Cola type "earning coupon" at 10x earnings (this is a 10% earnings yield).

Because stocks retain part of their earnings, you can actually afford to pay a price-to-free cash flow higher than 10x. But, how much higher.

If the growth we are about to talk about was truly perpetual growth - it will never slow down or turn negative, then we can do a calculation that's very simple:

Desired Rate of Return < Free Cash Flow Yield + Growth --- then, buy the stock and hold forever

Say you want a 10% return. Then, free cash flow yield plus growth must be greater than 10% - or, you shouldn't buy the stock.

Let's fill in some of these unknowns.

Growth in this case is - according to me - like 2-4% a year.

Desired return is 10% a year.

This now becomes...

10% < Free Cash Flow Yield + 2-4% -- then, buy the stock.

Flipping that around...

10% minus 2% to 4% leads us to...

6-8% < Free Cash Flow Yield

Some people prefer thinking in terms of multiples. So, that'd be 1/8 = 12.5 and 1/6 = 16.67. Roughly speaking, 13-17 free cash flow multiple.

In other words, if you don't believe Coca-Cola will grow faster than 2-4% a year (by this, I mean you don't believe free cash flow will grow 2-4% a year over time) then you can't pay a price greater than 13-17 times free cash flow.

Right now, Coke is trading at like 22 times free cash flow maybe. Something in the 20-25 times range probably. And that's on a leveraged basis (it doesn't assume you should pay a lower price because Coke has some debt).

This is all theoretical stuff I've laid out above.

How should you think about this practically?

Personally, I would not buy Coke even if it traded pretty cheap. I think there are better stocks to buy in the sense that they will grow more and create more value. Coke is big. And it has exhausted its growth potential for many of its brands. It has really saturated its addressable market. So, would I buy Coke at 10 times free cash flow? Probably not. In a world where KO trades at 10x FCF - there will be other faster growing stuff I can also buy at free cash flows of 10 or less. So, it's unlikely I personally would ever buy Coke.

Would I recommend others buy Coke?

Only at 13x free cash flow or less. If you really like the business and really believe in it and really like owning an almost riskless stock (but, like me, you think it'll only grow 2-4% a year) - then, you can buy the stock when it hits 13x FCF or less. But, not before then.

Why not?

Doesn't the very low risk on Coca-Cola's "coupon" justify paying a higher price and getting a lower yield compared to other stocks? For example, if an index has a pricing situation where it's at 5% free cash flow yield and 5% growth rate and Coke is at 5% free cash flow yield and 2-4% growth rate, isn't the 1-3% lower expected return in Coke justified by a "risk premium" being present in stocks generally but not Coke specifically.

A lot of people believe that.

I don't.

It's like a government bond. A government bond might have a riskless yield of 1.5% a year and a solid corporate bond might have a yield of 3.5% a year over the same 30-year period. It could be correct from a speculative standpoint to prefer the government bond for now vs. the corporate bond if you think that spread of 2% a year is insufficient. But, unless you actually expect losses on high quality corporate bonds to average greater than 2% a year - as an investment rather than a speculation, you are better off in the corporate bond than the government bond.

Do I think Coke can be a good speculation when it is priced the same as the S&P 500?

Yes. I think people may sometimes bid up Coke stock based on its safety, quality, etc.

But, ultimately, if you are an investor - I think it's a mistake to hold Coke stock unless you can get it at a discount.

An asset should really be priced on what it returns its owner over the entirety of the future. Anything else is speculation. So, honestly, Coke as a stock doesn't warrant any premium over a general index. That's my view. Others disagree. Coke is regularly priced above the index. But, I believe this is a mistake in the sense that investors are overpaying for the "safety" of Coke. The math just doesn't work. You can't pay 20-25x free cash flow for something that isn't going to grow at least 5-6% a year and still expect to make 10% a year.

To be fair, most investors in today's market probably don't expect to make anywhere near 10% a year. So, Coke is not overpriced. It is just not priced to deliver 10%+ returns over time. For me, if a stock isn't priced to offer double-digit returns - you just move on.

So, is Coke overpriced as a stock right now?

Relative to other investment options out there - I don't think so.

Should you buy Coke stock?

Absolutely not. It's just not cheap enough for a stock that grows so little.

There are hundreds and hundreds of lesser known stocks that deserve to trade at much higher multiples of free cash flow than Coke. That's because they are growing their free cash flow faster. If you can find a stock growing free cash flow by 7% a year with a real chance - because the stock is still so small and the business has still not won over much of the market it is in - of continuing to grow at 7% a year for another couple decades, that stock deserves a much higher multiple than Coke.

Another way I can approach this is to compare Coke to some other businesses with similar past growth. Coke and Omnicom aren't very far off in growth in free cash flow and such over the last 10 years or more. There may be some differences. Coke may have a somewhat brighter future. But, is it possibly enough to justify the pricing difference?

Here's the problem.

Coke is priced on a leveraged basis at something like a 4% to 5% free cash flow yield.

Omnicom is priced on a leveraged basis at something like a 12% to 15% free cash flow yield.

You see the problem. Coke just can't possibly grow at a rate that can offset the yield advantage on Omnicom. So, the only way to explain this is the idea of "riskiness". Perhaps the riskiness of Omnicom stock relative to the "risklessness" of Coke is so great hat it can justify something like a 7-11% difference in yield.

That's very difficult to believe. Coke and Omnicom are not identical. Coke is a safer stock, no doubt. But, it is not like Coke is an investment grade stock and Omnicom junk. It is not like Coke has 30+ straight years of positive earnings and Omnicom plenty of losses. It is not like margins are much more stable at Coke than Omnicom. By some measures of safety - Coke is a bit safer. But, by most quantitative measures of safety I know of - both Coke and Omnicom would score in like the top 5% of even the biggest and best known stocks in terms of safety. Neither of these are junky businesses.

I'm not saying there can't be a situation where one business is priced at 6x free cash flow and another at 25x free cash flow and the 25x free cash flow stock is the better one. That happens all the time. But, honestly, it has to happen because of growth. You need additional upside potential to justify paying such high multiples. There is no long-term upside potential in Coke. It can work as a speculation. And it can work as a single-digit returning investment over the long-term. But, it just can't work as an investment that over the long-term will outperform adequate quality, higher growth, but much less well known companies.

Coke is just too expensive a stock versus its growth prospects.

So, you can buy Coke for one of two reasons:

1) You view it as a speculation that you intend to buy now and then sell if the P/FCF multiple expands over time as others look for an especially safe stock (the logic on this one is fine - it's just not my approach: I invest, I don't speculate like this)
2) You view it as an especially low risk but also especially low return long-term investment. Basically, you see holding Coke stock indefinitely as a better alternative to owning bonds (I 100% agree with you on this, Coke stock is a better investment than high quality bonds of any kind)

If you want to take the approach mentioned in #2 - you can. But, it will lower your wealth over the very long-term. You will be trading a lot of future compound returns to achieve a level of risk reduction that is honestly excessive.

What I mean by this is compare a low-growth fairly expensive stock like Coke to two alternatives:

1) A low growth but cheap stock like Omnicom (OMC has the much higher FCF yield plus growth vs. Coke)
2) An expensive but higher growth stock like Disney (DIS has the much higher FCF yield plus growth vs. Coke)

Then, consider that you can diversify into this situation: instead of putting $10,000 into Coke - you put $5,000 in Omnicom and $5,000 in Disney.

Is Coke more inevitable, less risky, etc. than Omnicom? Almost certainly. Than Disney? I don't know. Maybe. I mean, beverages are a slower changing thing societally than movies and TV and some stuff like that. So, maybe Coke is safer than Disney.

But, is your risk return mix from buying a clearly lower FCF yield + growth "equity bond" (as Buffett likes to call the stock of an "inevitable”) really better than creating an "equity bond" that is half the high yield but stagnant OMC or the low yield but growing a bit Disney?

I think the Disney/Omnicom combo offers so much higher reward relative to the risk you're taking - when measured over a true investment lifetime (more like 30 years than 30 months or 30 weeks) - that you should not consider Coke.

There are some caveats to this judgment.

Could KO stock outperform a basket of OMC and DIS?

Over the next 30 days, 30 weeks, or 30 months - absolutely. The multiple on KO could expand to anything. So, even if business results are mediocre - the stock could be an excellent performer over 3 years or less if you correctly guess which way investor sentiment will shift on the stock.

Secondly, Coke could 100% outperform stocks like OMC and DIS taken separately or even as a pair over 30+ years simply because I may have misjudged the future prospects of these businesses. Basically, Coke might be about to rejuvenate its growth for a long time to come in a way I can't foresee.

So, the number to use in your FCF yield plus growth calculation is your estimate of FUTURE growth. Don't just use past growth. If you honestly believe Coke is going to grow 7%+ a year as far as the eye can see - buy it. Don't let the fact it had a bad decade stop you from buying a business on the cusp of a good decade. The past is irrelevant except insofar as it can be used as a guide to the future.

I have no reason to believe Coke can grow fast enough to ever justify paying more than 13x free cash flow for it. So, I'll never buy Coke at 13x FCF or higher. But, if you have different assumptions than I do - you should come to different conclusions.

The process I've laid out here is going to work for you. But, it's only going to work for you if you are using good assumptions. So, if I see a low growth stock when I look at Coke and you see a high growth one and you're right and I'm wrong - then, go ahead and buy Coke even at very high multiples. But, if we are both seeing this as a low growth business for as far as the eye can see - then, you just can't pay more than 13x FCF for Coke no matter how much you like it as a business.

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