Recommendation: Purchase 400 shares of PepsiCo stock at market order

Industry: Food and Beverage

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Share Data:
Price - $42.65
Date – April 25, 2003
Target Price - $50.65
52 Week Price Range - $53.23 - $34.00
Market Capitalization – 74.5 billion
Shares Outstanding – 1.72 billion
Revenue 2002 – $25.112 billion

Stock Chart:
MEMORANDUM

TO: Student Managed Investment Fund
    St. John’s University

FROM: Kristopher Cartagena
       Dion Demetropoulos
       Tenisha Martin

DATE: April 29, 2003

SUBJECT: ANALYSIS OF PEPSICO STOCK AS AN UNDervalued SECURITY

This is the research report that was requested on January 23, 2003 about PepsiCo stock and whether it should be incorporated in to the Student Managed Investment Fund. The analysis was done primarily through secondary research. The analysis revealed that PepsiCo’s stock is currently undervalued at $42.65, as of April 25, 2003.

We used a relative valuation model, and determined PepsiCo’s target price to be $50.65. In addition, we used a multi-stage dividend discount model, and determined the stock’s intrinsic value to be $56.83. PepsiCo’s current price of $42.65 is lower than both our target price and its intrinsic value. This confirmed our belief that the stock was undervalued. We also analyzed the company’s management strategies, financial data, products, performance in its markets, as well as other business indicators of the health of a company.

After conducting a complete analysis of the stock, we recommended:

1. Purchase 400 shares of PepsiCo stock at market order
2. Incorporate PepsiCo stock into the Student Managed Investment Fund

We are grateful for the opportunity of researching this security, and providing recommendations.

For additional information, or answers needed for any questions, you can contact us via e-mail. Our e-mail addresses are listed on the first page of this report.
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EXECUTIVE SUMMARY

Purpose of the Report

The purposes of this research report are to (1) introduce PepsiCo and inform the reader on its operations, (2) determine if PepsiCo’s stock is undervalued at $42.65, and (3) determine whether PepsiCo should be purchased for the Student Managed Investment Fund.

The information in this report was gathered through secondary sources, including Internet research, information from Multex Fundamentals (a periodical), the 2000 and 2002 annual reports from PepsiCo, and PepsiCo’s 10K.

PepsiCo

PepsiCo’s major dealings include the creation and distribution of convenient foods and beverages. It is comprised of four major divisions. They are Frito-Lay, Pepsi-Cola beverages, Gatorade/Tropicana, and Quaker Foods. Each division has its own line of products and their own international markets.

Analysis of PepsiCo Stock

PepsiCo is financially healthy and among the industry leaders in financial performance. The ratio analysis confirms this. In addition, PepsiCo’s stock is currently undervalued. Its current price of $42.65 is lower than the target price for the company, $50.65, and the intrinsic value, $56.83. The technical analysis also displays that the stock could be entering a potential upward trend.

Recommendation

Based on this analysis, we recommend the purchase of 400 shares of PepsiCo stock at the market order. We recommend the purchase because (1) PepsiCo’s stock is undervalued at $42.65, (2) it is a diversified company with the ability to generate substantial, and (3) it will be a good addition to the Student Managed Investment Fund, adding to the fund’s diversity.
PEPSICO CORPORATION
STOCK ANALYSIS

COMPANY OVERVIEW

PepsiCo is a world leader in convenient foods and beverages, with revenues of about $25 billion and over 143,000 employees. The company consists of (1) the snack businesses of Frito-Lay North America and Frito-Lay International, (2) the beverage businesses of Pepsi-Cola North America and PepsiCo Beverages International, (3) Gatorade/Tropicana North America juice products, and (4) Quaker Foods North America, manufacturer and marketer of ready-to-eat cereals and other food products. PepsiCo brands are available in nearly 200 countries and territories. Many of PepsiCo’s brand names are over 100-years-old, but the corporation is relatively young. PepsiCo was founded in 1965 through the merger of Pepsi-Cola and Frito-Lay. Tropicana was acquired in 1998 and PepsiCo merged with The Quaker Oats Company, including Gatorade, in 2001.

PepsiCo (symbol: PEP) is a publicly traded company. Its shares are traded principally on the New York Stock Exchange in the United States. The company is also listed on the Amsterdam, Chicago, Swiss and Tokyo stock exchanges. PepsiCo has consistently paid cash dividends since the corporation was founded in 1965. It currently pays $0.60 per share in dividends to its stockholders. The stock currently trades at $41.84 as of Monday, April 21, 2003.

PepsiCo World Headquarters is located in Purchase, New York, approximately 45 minutes from New York City. Edward Durrell Stone designed the seven-building headquarters complex. The building occupies ten acres of a 144-acre complex that includes the Donald M. Kendall Sculpture Gardens, “a world acclaimed sculpture collection in a garden setting” designed by Russell Page (Enrico 2).

PepsiCo’s success is the result of superior products, high standards of performance, distinctive competitive strategies and the high integrity of its people. The corporation’s mission statement is as follows:

“Our mission is to be the world’s premier consumer products company focused on convenience foods and beverages. We seek to produce healthy financial rewards to investors as we provide opportunities for growth and enrichment to our employees, our business partners and the communities in which we operate. And in everything we do, we strive for honesty, fairness and integrity.”

Frito-Lay North America and Frito-Lay International

PepsiCo’s snack food operations had their start in 1932, in San Antonio, Texas. It was there that Elmer Doolin bought the recipe for the Fritos brand corn chip, and started his firm, the Frito Company. In that same year in Nashville, Tennessee, Herman W. Lay started his own business distributing potato chips. Mr. Lay later bought the company that supplied him with product and changed its name to H.W. Lay Company. The Frito

PepsiCo began its international snack food operations in 1966. Today, with operations in more than 40 countries, it is the leading multinational snack chip company. It accounts for more than one quarter of international retail snack chip sales. Products are available in over 120 countries. Frito-Lay North America includes Canada and the United States. Major Frito-Lay International markets include Australia, Brazil, Mexico, the Netherlands, South Africa, the United Kingdom and Spain.

Major Frito-Lay products include Ruffles, Lay’s and Doritos brands snack chips. Other major brands include Cheetos cheese flavored snacks, Tostitos tortilla chips, Santitas tortilla chips, Rold Gold pretzels and SunChips multigrain snacks. Frito-Lay also sells a variety of snack dips and cookies, nuts and crackers. The company markets Frito-Lay brands on a global level, and introduces unique products for local tastes.

Frito-Lay North America (FLNA) produced very solid results, building on its position as the industry leader in salty snacks while pursuing new opportunities in the broader market of foods for people on the go. Volume grew 4% in 2002, revenue increased 4% from $8.216 billion in 2001 to $8.565 in 2002, and operating profit rose by 8% from $2.056 billion in 2001 to $2.216 billion in 2002. Frito-Lay International (FLI) posted solid growth despite the challenge of difficult conditions in several important markets. Volume grew 6% in 2002, revenue increased 4% from $5.492 billion in 2001 to $5.713 billion in 2002, and operating profit rose 20% from $651 million in 2001 to $781 million in 2002. Frito-Lay holds a 59% market share in the United States Snack Chip Industry.

Pepsi-Cola North America and PepsiCo Beverages International

Caleb Bradham, a New Bern, North Carolina druggist founded PepsiCo’s beverage business at the turn of the century. He first formulated Pepsi-Cola in 1898. Today consumers spend about $33 billion on Pepsi-Cola beverages. Brand Pepsi and other Pepsi-Cola products, including Diet Pepsi, Pepsi-One, Mountain Dew, Slice, Sierra Mist and Mug brands, account for nearly one-third of total soft drink sales in the United States, a consumer market totaling about $60 billion. The company provides fountain beverage products to certain restaurant chains, such as Pizza Hut, and fast-food restaurants, such as Taco Bell. Pepsi-Cola also offers a variety of non-carbonated beverages, including Aquafina bottled water, Fruitworks and All Sport.

In 1992 Pepsi-Cola formed a partnership with Thomas J. Lipton Co. Today Lipton is the largest selling ready-to-drink tea brands in the United States. Pepsi-Cola also markets Frappuccino ready-to-drink coffee through a partnership with Starbucks. In 2001 Sobe became a part of Pepsi-Cola. Sobe manufactures and markets an innovative line of beverages including fruit blends, energy drinks, dairy-based drinks, exotic teas and other
beverages with herbal ingredients. Outside the United States, Pepsi-Cola soft drink operations include the business of Seven-Up International.

Pepsi-Cola began selling its products internationally in 1934 with its operations in Canada. In addition to brands marketed in the United States, its major products include Mirinda and Pepsi Max. Pepsi-Cola North America includes the United States and Canada. Key international markets include Argentina, Brazil, China, India, Mexico, Philippines, Saudi Arabia, Spain, Thailand and the United Kingdom. PepsiCo Beverages International also produces, sells and distributes Gatorade sports drinks as well as Tropicana and other juices internationally.

Pepsi-Cola also provides advertising, marketing, sales and promotional support to Pepsi-Cola bottlers, such as the Pepsi Bottling Corporation, and food service customers.

Pepsi-Cola North America (PCNA) posted solid gains in the marketplace and generated healthy financial results as it displayed strength across the spectrum of beverage categories. Volume grew 2% in 2002, revenue was up 6% from $3.189 billion in 2001 to $3.365 billion in 2002, and operating profit increased 12% from $881 million in 2001 to $987 million in 2002. PepsiCo Beverages International (PBI) produced very solid results by continuing to pursue a highly focused growth strategy. Volume grew 5% in 2002, revenue increased 1% from $2.012 billion in 2001 to $2.036 billion in 2002, and operating profit jumped 23% from $212 million in 2001 to $261 million in 2002. PepsiCo Beverages International produced these results despite political and macroeconomic challenges in many markets, including a boycott of American brands in the Middle East and particularly weak local macroeconomic conditions in Latin America. Pepsi-Cola has a 35% market share in the United States Carbonated Soft Drink Industry, second only to Coca-Cola.

**Gatorade/Tropicana North America**

Tropicana was founded in 1947 by Anthony Rossi as a Florida fruit packaging business. In 1954 Rossi pioneered a pasteurization process for orange juice. The juice was Tropicana Pure Premium, and it became the company’s flagship product. In 1957 it became a leading producing of ready-to-serve premium orange juice, and the name of the company was changed to Tropicana Products. The company went public in 1957, and was purchased by Beatrice Foods Co. in 1978. It was acquired by Kohlberg Kravis & Roberts in 1986 and sold to The Seagram Company Ltd. in 1988. Seagram purchased the Dole global juice business in 1995. PepsiCo acquired Tropicana, including the Dole juice business, in August 1998.

Tropicana’s principal brands in North America are Tropicana Pure Premium, Tropicana Season’s Best, Dole Juices and Tropicana Twister. Internationally, principal brands include Tropicana Pure Premium and Dole juices along with Frui’Vita, Lo’oza and Copella. Tropicana Pure Premium is the third largest brand of all food products sold in grocery stores in the United States.
Gatorade sports drinks were acquired by the Quaker Oats Company in 1983 and became a part of PepsiCo with the merger in 2001. Gatorade is the first isotonic sports drink. It was created in 1965 by researchers at the University of Florida for the school’s football team, “The Gators.” Gatorade is now the world’s leading sport’s drink.

Gatorade/Tropicana North America (GTNA) generated healthy volume growth overall for 2002, and more modest gains in revenue and profit. Volume was up 8%, revenue grew 4% from $3.699 billion in 2001 to $3.835 billion in 2002, and operating profit increased 1% from $585 million in 2001 to $590 million in 2002.

Quaker Foods North America

The Quaker Oats Company was formed in 1901 when several American pioneers in oat milling came together to incorporate. In Ravenna, Ohio, Henry D. Seymour and William Heston had established the Quaker Mill Company and registered the now famous trademark. Seymour wanted his product to be a symbol of honesty, integrity and strength. The figures of a man in Quaker clothes became the first registered trademark for breakfast cereal. It remains the hallmark for Quaker Oats today.

In Cedar Rapids, Iowa, John Stuart and his son, Robert, and their partner, George Douglas, operated the largest cereal mill of the time. Ferdinand Schumacher, known as "The Oatmeal King," had founded German Mills American Oatmeal Company in 1856. Combining The Quaker Mill Company with the Stuart and Schumacher businesses brought together the top oats milling expertise in the country as The Quaker Oats Company. The first major acquisition of the company was Aunt Jemina Mills Company in 1926, which is today the leading manufacturer of pancake mixes and syrup. In 1986, The Quaker Oats Company acquired the Golden Grain Company, producers of Rice-A-Roni. PepsiCo merged with The Quaker Oats Company in 2001. Its products still have the eminence of wholesome, good-for-you food, as envisioned by the company over a century ago.

Quaker Foods North America (QFNA) posted solid volume gains and strong profits with its portfolio of strong, well-established brands, such as Quaker Oatmeal and Life cereal. Volume increased 2% in 2002, revenue grew 2% from $1.466 billion in 2001 to $1.491 billion in 2002, and operating profit surged 21% from $399 million in 2001 to $481 million in 2002.

A breakdown of each division’s contributions to PepsiCo’s net sales in 2002 is provided in Figure 1.

MANAGEMENT

Officers

Steven S. Reinemund is the Chairman of the Board and Chief Executive Officer of PepsiCo, Inc. He is 54 years old with 18 years of service with the company, and has been
the CEO since 2001. His total annual compensation, including salary and bonuses, is $4,305,885. He has exercised 334,172 options of his stock options in the company.

Indra K. Nooyi is the President and Chief Financial Officer of PepsiCo. She is 47 years old, with nine years of service with the company. Her total annual compensation, including salary and bonuses, is $2,057,064. She has exercised 56,769 options of her stock options in the company.

PepsiCo's principal divisions and officers are:

- **Frito-Lay North America** - Abelardo E. Bru is the Chairman and Chief Executive Officer. He is 54 years old, and has been with the company for 26 years.
- **PepsiCo Beverages & Foods North America** - Gary M. Rodkin is the Chairman and Chief Executive Officer. He is 50 years old, and has been with the company for 6 years.
- **PepsiCo International** - Michael D. White is the Chairman and Chief Executive Officer. He is 51 years old, and has been with the company for 13 years.
- **Frito-Lay International** - Rogelio M. Rebolledo is the President and Chief Executive Officer. He is 58 years old, and has been with the company for 26 years.
- **PepsiCo Beverages International** - Peter M. Thompson is the President and Chief Executive Officer. He is 56 years old, and has been with the company for 12 years.

![Figure 1](image-url)

**Source:** PepsiCo Annual Report - 2003

**Management Strategies**

In 2002, management put forth a number of programs and strategies to improve the work environment and atmosphere at all PepsiCo work locations. Three of these programs and strategies are:

- **Multi-Year Education Program** - PepsiCo is dedicated to promoting diversity in both its product promotion and its employees. This program was launched in 2002 to increase the awareness of cultural diversity amongst its employees. It is a day-and-a-
half diversity/inclusion training session for all their salaried employees in the United States.

- **Internal Controls** - Management maintains a system of internal controls designed to provide reasonable assurance as to the reliability of their financial statements, as well as to safeguard assets from unauthorized use or disposition. The system is supported by formal policies and procedures, including an active Code of Conduct program intended to ensure employees adhere to the highest standards of personal and professional integrity.

- **Open Communication** - To promote high ethical standards across a global organization, the company tries to ensure that employees have clear lines of communication to inform senior management of potential issues. The company has telephone "hotlines" for this purpose, which are accessible at no charge to employees.

**Flexible Distribution System**

Management has five large-scale distribution systems, enabling PepsiCo to cost effectively distribute a wide range of products. These five distribution systems make up PepsiCo's flexible distribution system. The five distribution systems are:

- **Direct-Store-Delivery** - Direct-Store-Delivery systems at Frito-Lay and through Pepsi-Cola bottlers are ideal for products that move through stores quickly, require delicate handling, or benefit from careful merchandising. These systems reach more than 2 million retail customers each week, from the largest club stores to the smallest "mom-and-pop" outlets.

- **Broker-Warehouse** - A large Broker-Warehouse distribution system moves Quaker, Gatorade, and Tropicana products to large retail outlets at a lower cost. It also allows PepsiCo to test new products that are too small for economic distribution via Direct-Store-Delivery.

- **National Distribution** - a National Distribution system focused on foodservice and vending accounts, gives Frito-Lay, Quaker, Gatorade, and Tropicana access to a growing channel that few competitors can serve efficiently.

- **"Chilled" Direct-Store-Delivery** - a small but growing "Chilled" Direct-Store-Delivery system distributes products requiring refrigeration. Created for Tropicana juices, it could carry many other products as well.

- **Hybrid** - Hybrid systems, using elements of the other distribution systems, enables PepsiCo to reach large numbers of retailers in emerging markets like India and China.

**PEPSICO’S RECENT NEWS**

**Projected Volume and Revenue Growth for 2003**

On February 6, 2003, PepsiCo announced that over the long-term, the company believes it can grow volume and net revenues in the mid-single digits and earnings per share in the low double-digits. The company reported full year 2002 earnings of $1.96 per share on revenues of $25.1 billion. In addition, the Dow Jones reported that the company expects to meet analysts' estimates for the full year 2003. Wall Street analysts on average are expecting the Company to earn $2.20 per share on revenues of $26.36 billion in the full
year 2003 and $2.44 per share on revenues of $27.82 billion in the full year 2004, according to Multex.

On March 4, 2003, PepsiCo confirmed that, for the full year 2003, it expects to grow volume and revenue in the mid-single digit range and earnings per share in the low double-digit range. According to Multex, analysts came to a consensus that the company would report earnings per share of $2.20 in the same period.

**Pepsi Unveils a New Look**

Pepsi has introduced updates, bolder-looking package graphics for Pepsi-Cola and Caffeine Free Pepsi-Cola. This is going to give Pepsi a new, more modern look. Pepsi is adapting to a youthful attitude mixed with boldness and excitement. The new look capitalizes on Pepsi’s “globe” which is one of the word’s most recognizable icons. Pepsi is making the “globe” larger and more pronounced. The word “Pepsi” is printed in a bolder, more stylized font with a touch of silver for more contemporary look and feel. Ice shards highlight the blue background to give it a more three-dimensional look. On the cans, the word “Pepsi” is written across the top instead of along the side.

Pepsi Twist and Diet Pepsi Twist, the popular lemon-flavored versions of Pepsi and Diet Pepsi also are going to have a new look. Pepsi Twist and Diet Pepsi Twist now have a distinctive yellow band. They also have enhanced their tastes with more lemon flavor adding to its already successful product.

Whenever a product changes its look the consumers realize this and want to purchase this “new product”. The marketing department of Pepsi did research on what to do in order to spice up their already stabilized product. Pepsi’s look has been well known for many years, and being that they wanted to boost revenues, they combined these two thoughts and came up with changing its look. When a product changes something slightly, it adds reason to advertise the product and places it in the consumer’s mind. This should stir up some new sales for Pepsi.

**Pepsi Weighs Vanilla Option**

Coca-Cola had come out with a new product called Vanilla Coke in 2002. So far Coca-Cola has been successful with this new product. Due to the high feud with Coca Cola, Pepsi wants to counteract this new product with their own product of Pepsi Vanilla. The product includes the original Pepsi-Cola flavor with a hint of Vanilla flavoring. Pepsi Vanilla is currently being tested in selected test markets across the country. It is expected to make its national debut by the end of the summer in 2003. PepsiCo plans to have a strong marketing campaign behind its new product.

**Pepsi Electrifies Summer with Mountain Dew Live Wire**

From Memorial Day 2003 through Labor Day, Pepsi-Cola will offer Mountain Dew Live Wire, which is an orange-ignited new Dew, to consumers across the United States. Combining the unique citrus taste of Mountain Dew with a bold orange flavor, Mountain
Dew “Live Wire” initially will be available in 20-ounce plastic bottles, with plans to expand into two-liter plastic bottles and 12-packs of 12-ounce aluminum cans. Mountain Dew “Live Wire” will be targeted to teens and young adults. This new product will be heavily supported by a 3-month marketing plan, including TV, radio, online, outdoor and point of sale advertising.

INDUSTRY ANALYSIS

Industry Overview

The U.S. food and nonalcoholic beverage industry comprises establishments that process or manufacture foods and beverages for human consumption, plus related products like chewing gum and vegetable and animal fats and oils. According to estimates by the U.S. Department of Agriculture (USDA), total food and beverage expenditures rose 3.8% to $844.2 billion in 2001, from $813.4 billion in 2000. Total expenditures include products for consumption at home ($443.9 billion in 2001) and away from home ($400.3 billion). Figure 2 displays the world’s leading food and beverage companies according to sales in 2002. PepsiCo is ranked fourth behind Nestle, Kraft Foods, and Unilever.

![World's Leading Food and Beverage Companies](image)

*Source: PepsiCo Annual Report – 2003*

Food and Beverage Restructuring

Several food companies have undertaken some form of restructuring or realignment in recent years in an effort to improve volume growth and profitability. These actions, the
benefits of which are now being fully realized, have addressed the need to cut costs in a competitive marketplace that leaves little room for price increases.

Food and beverage companies have also targeted logistics and supply chain costs for improvement. A number of business-to-business (B2B) electronic marketplaces have been launched to aid these efforts. These marketplaces allow buyers and sellers of similar goods to carry out procurement activities over the Internet. They may help companies update business transactions with their suppliers, buyers, and distributors. They may also reduce transaction costs, generate volume-related scale economies by combining orders from multiple purchasers, improve inventory management, and facilitate bidding by a broad spectrum of potential suppliers. Given the mature state of the U.S. food industry and our expectation for low levels of food price inflation, we expect that realignment and cost-cutting activities will remain a major focus within the industry.

Beverage Industry

Earnings for major soft-drink companies showed substantial improvement in the first three quarters of 2002, and full-year operating earnings increased 7% to 9% on average. Companies are still dealing with sluggish carbonated soft drink trends in the United States. However, despite higher levels of marketing and promotional spending, and economic weakness in many international markets, noncarbonated beverage products continue to drive growth. Operating profits for the beverage industry are projected to rise 9%-10% in 2003 reflecting 7%-8% higher North American profits, a strong 14%-15% increase in Gatorade/Tropicana profits and a 4%-5% increase for international beverages. Beverage profits should benefit from a favorably pricing environment.

For 2003, modestly higher prices for soft drinks and other beverage products in U.S. supermarkets should boost profits for manufacturers. Noncarbonated drinks should continue to show strong growth, while volume trends for carbonated beverages should continue to show improvement. In addition to marketing and promotions, aggressive new product introductions by the major manufacturers should also help to boost volume trends.

The projected increases in operating profits for the beverage industry in 2003 will be driven by a further rise in per capita consumption in the United States and abroad, strong growth in sales of new products, lower advertising costs, and modest price increases. The consolidation of bottling networks by both the Coca-Cola Co. and PepsiCo has helped to reduce retail price competition; after several years of intense pressure, soft-drink prices have risen steadily since mid-1999. While raw material costs appear more challenging than in recent years, most companies are not expecting substantial increases in their overall cost structure.
Year to date the S&P Soft Drink Index fell 3.8% versus a 1.4% rise in the S&P 1500. During 2002, the industry index significantly outperformed the broader market with a decline of 8.0% versus a 22.5% decrease in the S&P 1500. Performances in recent months has been affected by volatility in the shares of Coca-Cola as investors question whether drink volumes and earnings will resume their historical growth patterns. Shares of PepsiCo have also experienced some weakness on concerns of slowing growth. We however expect the industry to outperform the market in the near term with rebounds in growth and margin trends.

Sales and earnings for PepsiCo in 2003 are expected to show positive gains, benefiting from favorable material costs and retail pricing in the U.S Domestic unit sales. Volumes in 2003 should benefit from increased penetration into non-traditional distribution channels and growing consumer demand for non-alcoholic beverage products (soft drinks, ready to drink teas, juices, bottled water and sport drinks) which should continue to raise non-alcoholic beverage consumption levels and margin per capita.

Snack Food Industry

The Beverage Sector shows some bright spots for the future for non-alcoholic beverage industry like innovation, although there are concerns surrounding whether or not the bottlers can find the right balance between volume and pricing, leading to profitable market share growth. However, our primary concern is the factors that they have no control over which includes a weak retail channel, consumer acceptance of higher price points, the sluggish economy, and intense competition. PepsiCo is our investment choice primarily because we believe that Frito-Lay is PepsiCo’s sustainable competitive advantage in the snack food industry. The company also plans to generate faster growth in its healthier snack segment. Snack food profits are expected to rise 8%-9% reflecting a 4%-5% unit volume growth, a 1%-2% improvement in price/mix, along with favorable raw material costs. In addition, the Quaker Foods business should see profits rise 5%-10% on a modest volume growth and cost savings in 2003.

Analysis of Competitive Forces

PepsiCo’s top competitors are Coca-Cola, Cadbury Schweppes, and Panamerican Beverages. As of April 22, 2003, Coca-Cola (KO) was trading at $40.00 per share, Cadbury Schweppes (CSG) at $22.06, and Panamerican Beverages (PB) at $21.85. Beverage stocks overall have generated mixed returns. Coca-Cola was up 2.07%, PepsiCo was down 3.2%, Panamerican Beverages was down 2.3%, and Cadbury Schweppes was down 4.8%. The S&P 500 was up 1.8% and NASDAQ gained 1.0% within that same period. A graphic illustration of how PepsiCo fared against the beverage industry and the S&P 500 index is displayed in Figure 3.

Coca-Cola generates the lion’s share of its revenues by selling concentrate globally in comparison to PepsiCo’s business which is approximately 65% food. However, despite the differences, the two companies exhibit a high correlation. Coca-Cola is much more exposed to currency fluctuation since it derives 75% of its revenue internationally, while
PepsiCo, having a large food business, has to deal with the vagaries in the commodities market.

**Figure 3**

![Chart showing PepsiCo Inc's stock performance](image)

Source: [www.salomonsmithbarney.com](http://www.salomonsmithbarney.com)

**Michael Porter Method of Analysis**

The use of the Michael Porter Method further analyzes PepsiCo’s competitive forces.

- **Rivalry** - There are many aspects of the competitive force of rivalry. Rivalry is the amount of direct companies in an industry. In most industries, such as the food and beverage industry, corporations are mutually dependent. A move by one firm can be expected to have an effect on its competitors. Just as if Pepsi comes out with a new flavor, its competitor Coca-Cola may want to duplicate it so they won’t fall behind.

- **Threat of new entrants** - Newcomers to an industry typically bring new capacity and a desire to gain market share. This is why they are a threat to an established corporation. An entry barrier is an obstacle that makes it difficult for a company
to enter an industry. There are various entry barriers in any industry. Some possible entry barriers are:

1. **Product Differentiation** - In the food and beverage industry, the companies have to have a good R&D so they can differentiate their products with new flavors and looks. They need to be able to be ahead of their competition so they can make their product look more appealing to the average consumer. Just like Pepsi is planning to come out with a new, rived look this summer.

2. **Economies of Scale** - The larger the companies, the more of a chance they will have for survival. This is why in the food and beverage industry only companies with a large scale of production and sale can last. Therefore companies such as PepsiCo make it hard for new entrants with low capital to enter.

**Threat of substitute products** - Substitute products are those products that appear to be different but can satisfy the same need as another product. According to Porter, “Substitutes limit the potential returns of an industry by placing a ceiling on the prices firms in the industry can profitably charge.” A substitute product in the food and beverage industry can be high since there are so many various products out there. In this industry, the consumer will stick with a brand because they like the taste, and they will stick with that for a while.

**Bargaining power of suppliers** - The bargaining power of suppliers has various characteristics affecting the industry. These characteristics are as follows:

- The industry is dominated by a few suppliers
- Suppliers are more concentrated than the buyers
- No substitutes in the industry
- The supplier has more important customers
- The supplier’s input is critical
- There is differentiation among products
- High switching costs
- Threat of forward integration

**Bargaining power of buyer** - The bargaining power of buyers’ characteristics are as follows:

- The industry is concentrated
- Buy in volume
- Big ticket items
- Standardization or undifferentiated products
- Low switching costs
- Low profit margins
- Threat of backward integration
- Purchase is not very important to buyer
- Buyer has all the relevant information
PepsiCo pursues a business level strategy to gain a competitive advantage that allows them to outperform rivals, including Coca-Cola, Cadbury Schweppes, and Panamerican Beverages. This allows PepsiCo to achieve above-average returns. The company has chosen to implement cost leadership, focus, currency swap, advertising, and growth strategies in order to remain competitive in the food and beverage industry.

PepsiCo’s cost leadership strategy is to outperform competitors by doing everything it can to produce goods or services at a cost lower than the other companies within the beverage sector. Due to the lower costs, the PepsiCo is able to charge a lower price than its competitors yet make the same level of profit. If Coca-Cola charges similar prices for their products, PepsiCo still makes a profit because of its lower costs. If on the other hand rivalry increases with its competitors to compete for price, they are equipped to withstand the competition better than the other companies, because of its accrued above average earnings.

PepsiCo’s focus on their customer packaged goods business plays a tremendous role in the company’s success. They have taken the critical step of separating the bottling and concentrate parts of the beverage business so both can operate more effectively. PepsiCo has been expanding distribution, creating innovative products and packages along with adding powerful brands to their portfolio. The whole point is to make the company much stronger and more competitive for the long term, and able to whether economic storms and marketplace skirmishes with minimal disruption. The rewards accrued from the ongoing strategies manifested has aided to spend aggressively to reinvigorate sales momentum and deliver solid earnings per share growth to create a much more solid foundation for consistent, long-term growth and improved volumes.

In applying the currency swap strategy, PepsiCo manages its debt and investment opportunities and financial adversities by using interest rule and currency swaps to modify specific debt issuances in order to reduce overall borrowing costs. Any market risk or opportunity associated with these swaps are offset by the opposite market impact on the related debt.

PepsiCo’s advertising strategy, known as “Pepsi Generation,” has focused on creating the image that Pepsi products are the hip beverages for the youth market. PepsiCo has succeeded in drawing teens, and has maintained its “cool” image through celebrity spokespeople such as Britney Spears, Michael Jackson, Tiger Woods, Michael J. Fox and Shaquille O’Neal. Similarly, Gatorade has always been a beverage that had greater appeal for younger consumers. As the product supposedly gives an energy boost, young sports players are especially targeted for this beverage through endorsers such as Michael Jordan. As such, from a marketing perspective, Gatorade perfectly fits into the PepsiCo portfolio. The product capitalizes on their youth image. PepsiCo has made important strategic investment in advertising and strengthened their sales and distribution systems.
Quaker Oats and Gatorade has quenched PepsiCo’s thirst for their long-term growth strategy in the non-carbonated beverage industry and served as a formidable barrier to Coke’s market share. Furthermore, Quaker’s snack foods enabled PepsiCo to expand beyond the arena of salty and unhealthy foods into nutritional products just in the nick of time for the health craze that has swept America. In combining their resources, PepsiCo and Quaker Oats save money by increasing efficiency. The company’s decentralized structure and aggressive new product development activity have improved its ability to operate more effectively at the local market level.

Relative Industry Valuation

PepsiCo is involved in various types of products. These consist of food and beverage products. Therefore, we decided to divide the industry in which PepsiCo operates into the Soft Drink Industry Index and the Food and Beverage Industry. We compared the two industries to the S&P 500. The results are illustrated in Figure 4 (Soft Drink Industry) and in Figure 5 (Food & Beverage Industry).

Figure 4

MONTH DAILY CHART OF SOFT DRINK INDUSTRY VS S&P 500 INDEX

Source: www.bigcharts.com

The soft drink industry, as shown, has underperformed the S&P 500 index. They both hit their valleys around the month of March. In addition, they both hit their peaks around the month of April. It is evident that the soft drink industry moves along with the S&P 500 Index. They have almost identical peaks and valleys.
In contrast, the Food and Beverage Industry has outperformed the S&P 500 for most of the year. They have overlapped just recently, but they are both on upward trends.

In conclusion, we believe the S&P 500 is a good index as a benchmark for the two industries. In addition, as shown in the graph above, the Food and Beverage Industry is fairing well relative to the market.

FUNDAMENTAL ANALYSIS

Ratio Analysis

To illustrate PepsiCo’s efficiency as a good investment choice, we will use data from the annual reports of PepsiCo, Coca-Cola, Panamerican Beverages, and Cadbury Schweppes for the fiscal year 2002, in order to form comparative ratios. To realize the values of the ratios, it is necessary to compare them with benchmark values. One benchmark consists of similar firms in the same industry.

Liquidity:
Liquidity refers to a company's ability to meet its requirements for cash. Liquidity is necessary to meet both expected and unexpected cash demands. All businesses need liquidity to operate. Inadequate liquidity can stunt growth and ultimately lead to bankruptcy if debts cannot be repaid. However, too much liquidity can detract from profits because liquid assets are low returning investments.

The standard measure of liquidity is the current ratio, calculated by dividing "current assets" by "current liabilities". The current ratio for PepsiCo of 1.1 indicates it is the most liquid of the three companies, and also performing better than the beverage industry with a 1.00 figure. The ratios for Coca-Cola and Cadbury Schweppes are close to 1.00. However, this is not the norm for high quality companies with easy access to capital markets to finance unexpected cash requirements.

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<tbody>
<tr>
<td>Current Ratio</td>
<td>1.1</td>
<td>1.0</td>
<td>1.0</td>
<td>0.4</td>
<td>1.00</td>
</tr>
</tbody>
</table>

_Profitability:_

Two common measures of profitability are the net profit margin and the return on assets ratios. Each provides a different perspective about the firm's profits.

To measure the profitability of a company's operations, you calculate the net profit margin (NPM) by dividing "net income" with "sales". Both entries come from the income statement. Net profit margin indicates the percentage of each dollar of sales that the firm is able to flow to the bottom line as profit.

NPM is a function of the price of the product (which produces sales revenue) and efficiency of operations (cost of goods sold). A firm selling a unique product to a captive market may be able to charge a premium price and thus generate greater NPM. Conversely, a firm selling a generic product in a highly competitive market will have a low NPM. It must be a very efficient company, or it will not survive.

The net profit margins of our four sample firms illustrate these concepts. Coca-Cola’s NPM of 8.8 percent is low compared with PepsiCo’s NPM of 16.6 percent. In turn, PepsiCo’s NPM is much higher than Pan-American Beverages and Cadbury Schweppes. This is due primarily to its proprietary product and monopolies in certain foreign markets. PepsiCo derives the majority of its income from lower margin snack foods and restaurants. Less than half its sales come from soft drinks.

The Return on Assets ratio (ROA), which is also known as the Return on Investment ratio, is calculated by dividing "net profit" by "total assets". It indicates the rate of return provided by the book value of the company's assets. The higher the ROA, the more profitable the company is. Consistent with the NPM, PepsiCo has the highest ROA with 15.81 percent, making Coca-Cola's 14.46 percent second. This reflects PepsiCo’s ability to generate significant sales volume from its asset base.
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</thead>
<tbody>
<tr>
<td>Net profit margin</td>
<td>10.6</td>
<td>9.8</td>
<td>8.4</td>
<td>4.2</td>
<td>8.05</td>
</tr>
<tr>
<td>Return on assets</td>
<td>15.81</td>
<td>14.46</td>
<td>8.90</td>
<td>3.86</td>
<td>10.97</td>
</tr>
<tr>
<td>Total asset turnover</td>
<td>2.00</td>
<td>1.81</td>
<td>1.75</td>
<td>1.40</td>
<td>2.30</td>
</tr>
<tr>
<td>Inventory turnover</td>
<td>7.9</td>
<td>5.4</td>
<td>4.5</td>
<td>5.6</td>
<td>2.19</td>
</tr>
</tbody>
</table>

**Total Asset Turnover Ratio:**
Another indicator of a company's ability to generate profits is the total asset turnover ratio, calculated by dividing "sales" by "total assets". It indicates how effectively the company generates sales from its asset base. The more effective the company is in generating sales revenue, the higher the asset turnover ratio will be.

Cadbury Schweppes and Panamerican Beverages turnover ratios are slightly above 1.00, which is typical for big firms with large investments in fixed assets and inventories. However, PepsiCo and Coca-Cola's ratios are twice as large, 2.00 and 1.81 respectively. These are driven primarily by their high inventory turnover, and efficient use of fixed assets. Thus, Panamerican Beverages’ low NPM is offset to some extent by its ability to generate sales from its asset base (the company is a high volume, low overhead producer).

**Inventory Turnover Ratio:**
For companies that have a large investment in inventory, it is useful to calculate the Inventory turnover ratio, which is the "cost of goods sold" from the income statement divided by the "inventory" shown on the balance sheet. A low turnover ratio indicates too much investment in inventory. Whereas a high turnover ratio could cause lost sales due to lack of merchandise to meet customer demand. Coca-Cola and Panamerican Beverages have similar inventory turnover numbers, while PepsiCo's is higher. This reflects differences in their distribution methods, with Pepsi's snack foods driving the ratio higher than for typical merchandisers like Cadbury Schweppes.

**Financial Leverage:**
Financial leverage is the use of fixed cost funds such as debt or preferred stock to increase the common stockholder's return. Using debt in the firm produces a stream of earnings that has greater volatility (risk) than would occur in the same firm if it had less debt.

One major factor is management's willingness to accept financial risk. A second factor is earnings predictability. Two debt ratios that were computed are the debt to total assets ratio, or the "debt ratio," and the equity multiplier.
Debt Ratio:
The Debt ratio is calculated as the sum of all the liability accounts divided by "total assets." For our four sample firms, the numerator is the sum of everything on the right side of the balance sheet from "current liabilities" through "deferred income taxes".

As you can see for our firms, their debt ratios vary from Cadbury Schweppes’s 50.7 percent, to PepsiCo’s 71.2 percent. We can conclude that Pepsi is using more financial leverage in the firm and thus is exposed to more financial risk than Panamerican Beverages and Coca-Cola.

<table>
<thead>
<tr>
<th>Debt ratio</th>
<th>PEP</th>
<th>KO</th>
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<th>INDUSTRY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>71.2</td>
<td>64.2</td>
<td>50.7</td>
<td>40.1</td>
<td>52.00</td>
</tr>
<tr>
<td>Equity multiplier</td>
<td>1.87</td>
<td>1.62</td>
<td>1.41</td>
<td>2.01</td>
<td>1.55</td>
</tr>
</tbody>
</table>

Equity Multiplier:
The Equity multiplier is a similar calculation, determined by dividing "total assets" by the "common equity" account. If a firm is totally financed by equity, the equity multiplier will equal 1.00. The larger the number, the more highly leveraged is the firm. Consistent with the "debt ratio," the equity multipliers of the four firms display that Pepsi has the greatest amount of leverage, and Cadbury Schweppes has the lowest.

Return on Equity:
Many would argue that the most important ratio to calculate for a company is its return on equity (ROE), which is "net income available to common stockholders" divided by "common equity". ROE represents the rate of return the company earned on the book value of its equity investment. The higher the number, the greater the return the company is earning for its shareholders. For our companies, PepsiCo has the greatest ROE, 39.84 percent, which is an exceptionally high number. Coca-Cola’s is 28.73 percent, and Cadbury Schweppes is 20.72 percent. All three are relatively high compared with Panamerican Beverages, which is extremely low compared to the industry’s 28.69% consensus.

<table>
<thead>
<tr>
<th>Return on equity</th>
<th>PEP</th>
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<tbody>
<tr>
<td></td>
<td>39.84</td>
<td>28.73</td>
<td>20.72</td>
<td>11.81</td>
<td>28.69</td>
</tr>
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</table>

PepsiCo has an excellent ROE. It is a result of its high profit margin, effective asset utilization, and use of leverage. PepsiCo probably is pursuing an aggressive debt strategy because of the lower profitability of some of its product lines.

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<th>PEP</th>
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<tr>
<td>39.64</td>
<td>10.6</td>
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<td>10.6</td>
<td>2.00</td>
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<tr>
<td>1.87</td>
<td></td>
</tr>
<tr>
<td>28.73</td>
<td>9.8</td>
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<tr>
<td>1.62</td>
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Return on equity = Net profit margin x Total asset turnover x Equity multiplier
Price/Earnings Ratio:
The Price/Earnings Ratio is used to gauge the relative value of a security in the light of current market conditions. It is determined by dividing the price of a share of stock by its earnings per share for a 12-month period. Sometimes the P/E is referred to as the "multiple" because it shows how much investors are willing to pay per dollar of earnings. PepsiCo has a high P/E, which means high projected earnings in the future, in comparison to its competitors in the beverage industry.

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<tr>
<th></th>
<th>P/E</th>
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<tbody>
<tr>
<td>P/E</td>
<td>22.16</td>
<td>21.72</td>
<td>19.01</td>
<td>15.93</td>
<td>23.24</td>
</tr>
</tbody>
</table>

Price/Cash Flow:
The Price/Cash Flow is calculated by dividing the closing price with the cash flow per share from the last 12 months. An alternative to the P/E ratio, this ratio removes depreciation and other non-cash charges from the equation. Another advantage of the Price/Cash Flow ratio is that it makes it easier to analyze various companies across the board. As displayed above, Coca-Cola has the most efficient Price/Cash Flow ratio, and Panamerican Beverages has the lowest. Theirs is more than 40% less than PepsiCo’s 17.28 ratio, which displays that three of the four companies have ample money available to spend on research and development, to expand operations, and to pay dividends to investors.

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Gross Profit Margin Ratio:
The Gross Profit Margin ratio indicates how efficiently a business is using its materials and labor in the production process. In other words, gross margin is equal to gross income divided by net sales, and is expressed as a percentage. Coca-Cola and PepsiCo have the highest gross profit margins of 63.68 and 53.67. Both are outperforming the industry, which indicates that the companies can make a reasonable profit on sales, as long as it keeps overhead costs in control. Hence, Cadbury Schweppes and Panamerica Beverages has to be cautious, with very low ratios having less capital left over to spend on other business operations, such as research and development or marketing.

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<tr>
<td>Gross Margin</td>
<td>53.67</td>
<td>63.68</td>
<td>40.05</td>
<td>39.04</td>
<td>43.00</td>
</tr>
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</table>

Total Debt-Equity Ratio:
Total debt-equity ratio is the ratio of a company's long-term liabilities to its equity. Panamanian Beverages has the highest level of debt, making it very important for the company to have positive earnings and steady cash flow. Debt in and of itself is not harmful, but it does require the timely payout of interest to debt holders. PepsiCo has the lowest in both the current and long term debt to total equity ratio’s, decreasing the chances of defaulting on debt.

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<tr>
<td>Total Debt/Equity</td>
<td>.30</td>
<td>.45</td>
<td>.73</td>
<td>.99</td>
<td>.63</td>
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<tbody>
<tr>
<td>Long term debt to total Equity</td>
<td>.23</td>
<td>.24</td>
<td>.49</td>
<td>.61</td>
<td>.76</td>
</tr>
</tbody>
</table>

Earnings per Share:
Earnings per share is the proportionate amount of a company's profit, or earnings, for each outstanding share of common stock. It is calculated as net income minus dividends divided by average outstanding shares. This is the single most popular variable in dictating a share's price. EPS indicates the profitability of a company. PepsiCo, Coca-Cola, and Cadbury Schweppes are outperforming the industry average of 1.52.

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<tr>
<td>EPS</td>
<td>1.85</td>
<td>1.60</td>
<td>1.55</td>
<td>0.27</td>
<td>1.52</td>
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</table>

PEG Ratio:
The idea behind the PEG Ratio is to relate price to growth, given that some expectations about growth -- or the lack thereof -- are built into every P/E ratio. The PEG ratio is considered particularly helpful in valuing small and mid-cap growth stocks. It is an indicator of whether a stock is undervalued or overvalued. To obtain the PEG ratio, a stock's price/earnings ratio (P/E) is divided by its forecasted earnings growth rate. A fairly valued stock would have a PEG ratio of 1 (its current P/E and future earnings growth rate being equal). PepsiCo, Coca-Cola, Cadbury Schweppes, and Panamanian Beverages all have a ratio of less than 1.0. This is an indication that the stocks are undervalued, and poised to grow.

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<tbody>
<tr>
<td>PEG</td>
<td>1.7</td>
<td>2.1</td>
<td>1.1</td>
<td>1.5</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Return on Sales:
This ratio is a measure of profitability expressed as a percent of sales. It is the usual definition of percent profit. The calculation is net income divided by net sales. It can help you determine if you are making enough of a return on your sales effort. If your company is experiencing a cash flow crunch, it could be because its mark-up is not enough to cover expenses. Return on sales can help point this out, and allow you to
adjust prices for an adequate profit. Also, be sure to look for trends in this figure. If it appears to be dropping over time, it could be a signal that you will soon be experiencing financial problems. Coca-Cola has the highest Return on Sales ratio, 20.32, detecting operational efficiency, accompanied by PepsiCo’s 13.19 ratio. On the other hand, Panamerican Beverages is accumulating the least financial efficiency from its product innovations.

<table>
<thead>
<tr>
<th>Return on Sales</th>
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<th>INDUSTRY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Sales</td>
<td>13.19</td>
<td>20.32</td>
<td>11.15</td>
<td>7.5</td>
<td>10.51</td>
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**Historical Pattern of Ratios**

We analyzed PepsiCo’s earnings per share in a historical context, going back the last five years.

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<tr>
<td>1Q</td>
<td>.36</td>
<td>.32</td>
<td>.29</td>
<td>.22</td>
<td>.24</td>
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<tr>
<td>2Q</td>
<td>.49</td>
<td>.44</td>
<td>.38</td>
<td>.49</td>
<td>.35</td>
</tr>
<tr>
<td>3Q</td>
<td>.54</td>
<td>.34</td>
<td>.40</td>
<td>.32</td>
<td>.50</td>
</tr>
<tr>
<td>4Q</td>
<td>.46</td>
<td>.37</td>
<td>.41</td>
<td>.33</td>
<td>.24</td>
</tr>
<tr>
<td>YEAR</td>
<td>1.85</td>
<td>1.47</td>
<td>1.48</td>
<td>1.37</td>
<td>1.31</td>
</tr>
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</table>

PepsiCo’s earnings per share has systematically increased over the five-year period due to its range of all-star products. Their principal source of liquidity is operating cash flow, which is derived from net income. This cash generating capability is one of PepsiCo’s fundamental strengths, and provides substantial financial flexibility in meeting operating cash flow, which is a key element in achieving maximum shareholder value.

The current ratio for PepsiCo has been performing steadily for the past 10 consecutive years, indicating the company's ability to meet short-term debt obligations.

Their percentage long term debt of capitalization has slowly decreased consecutively from 1993, having a 47.1% value, to 50% less in 2002, with 16.6% due primarily to reduced financial leverage of the company. This was due in part to the reduction of its long term debt from $8.439 million in 1998 to $2.187 million in 2002. This ratio displays the relationship between PepsiCo’s long-term debt and its available capital. The decrease also implies less financial risks, all else being equal. Reduced debt leverage without a decrease in return on equity displays the potential cash flow accomplishment.

The percentage net income of revenues has slightly increased throughout the years, stemming from the company’s increased profitability, followed by its innovation efforts, restructuring of product offerings, and increased distribution channels. By evaluating the increase in the ratio it implies less expense for higher net income.
The revenue growth serves as an indication of PepsiCo’s financial, economic, and strategic health. The increase was also caused by the acquisitions that had taken place, which skewed revenue growth figures.

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</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>1.1</td>
<td>1.2</td>
<td>1.2</td>
<td>1.1</td>
<td>0.6</td>
<td>1.5</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>0.8</td>
</tr>
<tr>
<td>% Long term Debt of Cap.</td>
<td>16.6</td>
<td>20.7</td>
<td>21.4</td>
<td>25.8</td>
<td>32.4</td>
<td>36.4</td>
<td>50.1</td>
<td>48.1</td>
<td>50.0</td>
<td>47.1</td>
</tr>
<tr>
<td>% Net Inc. of Revs.</td>
<td>13.2</td>
<td>9.9</td>
<td>10.7</td>
<td>10.1</td>
<td>8.9</td>
<td>7.1</td>
<td>3.6</td>
<td>5.3</td>
<td>6.3</td>
<td>6.3</td>
</tr>
<tr>
<td>% Ret. On Assets</td>
<td>14.7</td>
<td>12.5</td>
<td>12.2</td>
<td>10.2</td>
<td>9.3</td>
<td>7.1</td>
<td>4.6</td>
<td>6.4</td>
<td>7.4</td>
<td>7.1</td>
</tr>
<tr>
<td>% Ret. On Equity</td>
<td>37.0</td>
<td>32.8</td>
<td>30.9</td>
<td>30.9</td>
<td>29.9</td>
<td>22.0</td>
<td>16.5</td>
<td>22.7</td>
<td>27.2</td>
<td>27.2</td>
</tr>
</tbody>
</table>

**DuPont Analysis**

The return on assets percentage has significantly increased from 1993, with 7.1% doubling the value in 2002 to 14.7%. This depicts the profitability of PepsiCo relative to its total assets.

The return on equity has also increased steadily from a year-to-year basis. The components of the boost in returns are derived from the strong profit margin of 10.80 compared to Coca-Cola’s 9.8 and Panamerican Beverages’ 3.7, but lower asset turnover, and a higher leverage ratio. To improve asset turnover PepsiCo needs to increase production efficiency, or price levels, or reduce current or non-current assets. This performance measurement reveals capital efficiency, assessing the investment return management can earn on PepsiCo’s existing capital base.

The historical financial ratios have improved because of PepsiCo’s fundamental strengths, like great brands, strong distribution, innovation capabilities and global experiences. Implementing initiatives across PepsiCo, which accelerate strategic imperatives, improve operating effectiveness and cut costs to fuel growth.

The DuPont analysis is an excellent method to determine the strengths and weaknesses of PepsiCo. Having a systematic ROE is a signal that the strengths outweigh the weaknesses, which is the situation that PepsiCo is in. However, using the analysis you can better determine the source of weakness. Asset management, expense control,
production efficiency, and marketing are potential sources of weakness within the company.

Having a free cash flow per share of $1.04 in 2002, rampantly doubling that of the industry $0.50 figure, we expect strong free cash flow growth over the next several years. We assume it will be used to fund acquisitions and substantial repurchase activity.

With a recent P/E multiple of 22x our 2003 EPS estimate, the shares are valued at a discount to comparable global consumer product companies, but at a modest premium to the S&P 500 Index. PepsiCo trades at a premium to the S&P because it is a well established company, and among the industry leaders. With a target price of $50.65, and an intrinsic value of $56.83, it can be determined that PepsiCo is currently undervalued at its current trading price of $42.65 as of Friday, April 25, 2003.

Risk Factors

In the normal course of business, PepsiCo manages risks through a variety of strategies, including the use of derivatives designated as cash flow and fair value hedges. There are many risks PepsiCo is exposed to which vary from commodity prices to foreign exchange rates.

Commodity Risk:
PepsiCo’s commodity derivatives were increased from $70million to $252million (Dec 29, 2001). These derivatives resulted in a net unrealized gain of $6million at Dec 28 2002 and an unrealized loss of $16million at Dec 29, 2001. Commodity prices affect the cost of raw materials and fuel.

Foreign Exchange and International Risks:
Operating in international markets involves exposure to movement in currency exchange rates, which offset economic growth, inflation and interest rates. Changes in currency exchange rates would have the largest impact on translating international operating profits. Foreign exchange gains and losses reflect transaction gains and losses arising from the re-measurement of the company monetary assets.

Interest Rates:
Late in 2002, PepsiCo ended the majority of their interest rate swaps used to manage their interest rates risk. As a result, 12% of their debt was exposed to variable interest rates compared to approximately 45% in 2001. An increase of 1% in rates reflects higher investment balances and lower variable debt balances.

Market Risk:
PepsiCo manages the market risk related to their deferred compensation liability, which is indexed to certain market indices and their stock price, with mutual fund investments and prepaid forward contracts for the purchase of their own stock. The combined losses on these investments are offset by changes in their deferred compensation liability which is included in corporate selling, and general and administrative expenses.

Innovation Risk:
PepsiCo is dependent heavily on innovation to help drive volume in both beverage and food businesses. As always there are risks associated with innovation such as:

- Maintaining a full pipeline of new products
- Maintaining a high rate with new products
- Absorbing costs associated with bringing new products to the market
- Execution

*Obesity Issue:*
Frito-Lay has decided to emphasize its “better for you” products, but there are risks that Americans might not accept this if they decide to become more health conscious, they may shun Frito-Lay’s core salty snack business.

**Investment Drivers**

PepsiCo has various reasons why it is a good investment. It has a high standard of performance, meaning that their products will always be superior to their competitors. PepsiCo is a company that can be divided into many different branches in the food and beverage industry. In addition, they produce many products that are very well known to the average consumer. This is a plus, due to the fact that if one of its products hasn’t been selling as well as its competitors, then another of PepsiCo’s products might. This gives PepsiCo a lot of flexibility and options to work with. PepsiCo’s main investment driver will be the innovation or improvement of its existing products. Examples of these are Pepsi Vanilla, a new flavor, and a new look that Pepsi is coming out with this summer. PepsiCo is always changing its products and adding new flavors thus developing a buzz to the common consumer and investor.

Many analysts from the Wall Street and Dow Jones are expecting earnings per share to increase next year to $2.44, from $0.44 last year. In addition, revenue is also predicted to increase to $27.7 billion next year from $6.4 billion as of this quarter. The non-alcoholic industry as a whole is expected to increase from 9% to 12% in operating earnings. Finally, the 52-week high for PepsiCo is $53.23, leaving reason to believe that there is a great potential for growth once there is a turnaround in the sluggish economy.
In order to study the historical activity of PepsiCo’s stock price, we have studied a one year chart, two year chart, five year chart, and ten year chart. As displayed in our first chart, the 1 year chart, the stock price experienced a tremendous drop about one year ago. Between the months of May and August of 2002, the price of PepsiCo had dropped from $54 to $35. In 2002, PepsiCo reorganized to unite all North American beverage operations, including Pepsi-Cola, Tropicana and Gatorade, into one new division - PepsiCo Beverages and Foods North America. We feel this restructuring might have been a slight setback for PepsiCo.

After all was settled, PepsiCo’s stock price reached our support level of approximately $46. Then the stock price fluctuated up and down for the next couple of months. We have also set a resistance level of $49. In the most recent months, the price of the stock has stayed between these two bounds. Towards the end however, we do see a trend of an increase of stock price in the months of March and April.
As shown in the 2 year chart, PepsiCo, in 2001, had made a huge surge upwards in price. We believe this is due to the change of the CEO. On May 2, 2001, PepsiCo’s Board of Directors announced Steven S. Reinemund as their new CEO. Once a new CEO enters a company, investor expectations may turn towards the positive. Even in the beginning months of 2002, PepsiCo had been doing well, and then once it hits the month of April in 2002, its stock price plummeted. PepsiCo was still able to bounce back after this slide and still has potential of being where it once was 2 years ago.
PepsiCo is a mature, stable company, where large price fluctuations rarely occur. PepsiCo isn’t really a volatile company. Its stock price will move due to new management, acquisitions and mergers and introduction of new products. An example of this is displayed from 1998 to early 1999. A major reason for its stock to move so much was because of PepsiCo’s acquisition of Tropicana Products in 1998.

Source: www.bigcharts.com
This chart shows a long term trend. It shows the growth of PepsiCo as a company through the years. In the beginning of the chart, one can see that PepsiCo’s stock price was increasing from ’93 up until now predominantly. This displays that PepsiCo is in a maturity stage, and it is a strong company with stable earnings.
Williams Percentage R

Figure 10

Source: www.bigcharts.com

The Williams Percentage R chart displays the momentum indicators. It indicates whether a stock is overbought or if it is oversold. These will tell us whether the average investor is bullish or bearish. Technically, if the stock is trading between the -100% and -80% indicators, the stock is considered oversold. This would indicate that it is in a bullish market. Conversely, if the stock is trading between the -0% and -20% the stock is considered overbought. This would indicate the stock is trading in a bearish market. In the beginning of April, we see that the stock was trading close -100%, which proved that PepsiCo was being sold at a large rate, causing it to be a bullish stock. Right now, we feel PepsiCo is in a good state, because it just passed the -0% to -20% range. Thus, we just passed the bearish market. As shown in the graph (Figure 10), it is heading towards a bullish market.

CONCLUSIONS

Based on the analysis of PepsiCo’s stock, the following conclusions are drawn:

1. PepsiCo stock is undervalued. At a price of $42.65, as of Friday, April 25, 2003, it is trading $8.00 lower than our target price of $50.65, and $14.18 lower than its intrinsic value of $56.83. This allows room for growth according to our estimates.
2. PepsiCo is a diversified company. Its ability to generate substantial returns is embedded in its diversified products, and strong position in the markets in which those products are sold.

3. PepsiCo will continue to grow and succeed in the future. With great innovations and new products, PepsiCo constantly stays one step ahead of its competitors. The company has a long, sustainable future due to its constant drive for new innovations, and products that will please consumers.

RECOMMENDATIONS

Supported by the findings and conclusions of this analysis, the following recommendations are offered:

1. We recommend the purchase of 400 shares of PepsiCo at market order.
2. We recommend that PepsiCo be incorporated into the St. John’s University Student Managed Investment Fund. PepsiCo would contribute to the diversity of the fund, being one of only two companies in the fund that operate within the food and beverage industry (the other being Starbucks). In addition, PepsiCo’s ability to generate increasing profits year after year, and its status as a stable company, fits in line with the philosophy of the fund, which is investing for the long-term.

PEPSICO AT A GLANCE

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<th>Recent Price (4-25-2003)</th>
<th>$42.65</th>
<th>Volume</th>
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<tr>
<td>52 Week High</td>
<td>$53.23</td>
<td>52-Week Change Relative to S&amp;P500</td>
<td>-1.1%</td>
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<tr>
<td>52-Week Low</td>
<td>$34.00</td>
<td>Sales</td>
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<td>52-Week Change</td>
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<td>Market Capitalization</td>
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<td>Shares Outstanding</td>
<td>1.72B</td>
<td>Beta</td>
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</tr>
</tbody>
</table>

Annual divided = $0.60
LIST OF SOURCES

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