

SYSKO CORPORATION

Sometimes confused with the similarly-named technology firm Cisco Systems, Sysco Corp. (SYK) is less glamorous but very much a standout in its own right. As North America's largest food distributor, it supplies more than 400,000 restaurants, hotels, hospitals and schools with quality food products. In its fiscal year ended in June of 2009, Sysco generated nearly \$37 billion in sales via operations in the U.S. and Canada.

Much of Sysco's success derives from its ability to help in consolidating a large, very fragmented industry. Yet, despite last year's impressive revenues, Sysco controls just 15% of the overall market in which it competes. Historically, it has acquired regional competitors, thereby building unmatched size and scale, which allows it to achieve unique cost advantages. In a relatively low margin, high turnover business, the low cost operator will typically be the most successful firm. It also helps to have a capable distribution network, and Sysco boasts the largest private truck fleet in North America, with over 9,000 trucks.

Another advantage is Sysco's focus on client diversity. Sales to large restaurant chains, which typically seek to lock in favorable (for the chains) long-term agreements, are limited to just 30% of revenue. This allows Sysco more leverage in negotiating sales with smaller operators and results in greater flexibility. This means it is able to pass along price increases related to food or fuel inflation more quickly than its competitors. Obviously, the current macroeconomic weakness will affect restaurant sales, and it's likely that the small independent food operators preferred by Sysco will suffer more during difficult economic times. However, the company is also very successful in using teams of consultants to help food retailers plan menus and manage purchasing in order to reduce costs. Being able to help your customers save money while increasing your own sales is a powerful business model, especially during tough times.

Although recently named to Sysco's top spot, CEO William DeLaney has been with the firm since 1987. In his previous role as CFO, DeLaney helped oversee many successful acquisitions and established a strong track record of managing costs effectively throughout the organization. In terms of compensation, Sysco is noted for tying executive payouts to long-term incentives, and the board of directors has practiced discipline in withholding bonuses when performance has lagged, rather than the fairly common practice of lowering standards to trigger a payout. In 2008, top executives accepted a 5% reduction in base pay, setting the standard for other managers in anticipation of what was expected to be a tough year. We also like the company's dividend policy: they have a long history of dividend growth (4% last year), and the payout ratio remains close to 50%. Thus,

in addition to Sysco's use of cash to support operations and finance acquisitions, it manages to pay its shareholders, rather than hoard or squander funds.

Going forward, we expect to see further consolidation in the food distribution industry, and we believe Sysco will continue to be a major catalyst and likely beneficiary. Barring major missteps by management, given the dynamics of the industry and Sysco's current position, we believe it is a good example of a company whose "moat" will likely increase over time to the benefit of shareholders.

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