U.S. Food & Staples Retailing

The Storm Before the Calm

We initiate coverage of the Food & Staples Retailing industry with a Neutral view. Sentiment on the group is negative, and many stocks are down meaningfully year to date – some in the double digits. The third quarter is set to be the most challenging for food retailers in well over a decade as they grapple with deflation on top of deflation year over year – a phenomenon not experienced since 1960. This headwind coincides with Walmart’s re-emergence as a disruptor, so the combination has the potential to wreak havoc on many companies in our universe. As a result, we believe many names will remain range-bound for the next several quarters. To reflect this view, we have an Overweight rating on 3 names, an Underweight on 2, and an Equal Weight on 14 names. We also assume coverage of Costco and Wal-Mart, keeping COST at Equal Weight and upgrading WMT to Overweight, making it our Top Pick. We see an average return of 17.9% for our Overweight names and 4.9% for our Equal Weight names, with downside of -0.4% for our Underweight names.

We segment our diverse coverage universe into four quadrants: 1) Growth Stars, 2) Stable Staples, 3) In Transition, and 4) Attempting to Reinvent, and with this lifecycle framework, our ratings reflect our view of whether a company’s go-to market and capital-deployment strategy is appropriate and sustainable. Said differently: We look for whether a company’s strategy can generate or reduce shareholder value in the context of a growing top line and increasing ROIC, as in most cases there is a very high correlation between stock price performance and ROIC. Names squarely in the Growth Stars or Stable Staples quadrant are gaining share (positive traffic), and have appropriate long-term strategies, in our view. Names in the In Transition quadrant either: 1) face secular challenges that may keep them in this quadrant in the intermediate term despite their best efforts and appropriate strategy, or 2) need to alter their strategy to create incremental shareholder value and transition to the Growth Star or Stable Staple quadrant. Names in the Attempting to Reinvent quadrant face meaningful secular challenges, and in most cases valuation reflects these challenges.

Given this quadrant methodology, our initiations focus on what – if anything – we believe each company should do to create more shareholder value. We also use EV/EBITDA (R) as our primary valuation methodology, and incorporate a very rigid upside and downside analysis (and probability weightings for each scenario) for our recommendations. With this as a backdrop (in order of market capitalization):

* Our Growth Stars are Casey’s (CASY), Sprouts (SFM), Five Below (FIVE), and Smart & Final (SFS).
* Our Stable Staples are Walmart (WMT), Costco (COST), Kroger (KR), Sysco (SYY), Performance Food Group (PFGC), and SpartanNash (SPTN).
* Our In Transition names are Dollar General (DG), Dollar Tree (DLTR), Whole Foods (WFM), Big Lots (BIG), United Natural Foods (UNFI), Chef’s Warehouse (CHEF), and Natural Grocers by Vitamin Cottage (NGVC).
* Our Attempting to Reinvent names are GNC (GNC) and Vitamin Shoppe (VSI).

The combination of our quadrant analysis and our detailed upside and downside scenario analysis results in the following key ratings (in order of market capitalization):

* **Our Overweight recommendations** (price targets/upside) are Walmart ($87, 20.7%), Sprouts ($24, 17.1%), and Performance Food Group ($28, 16.0%).
* **Our Underweight recommendations** (price targets/downside) are Sysco ($48, -2.5%) and United Natural Foods ($40, 1.8%).

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| --- |
| INITIATING COVERAGE |
|  |
| U.S. Food & Staples Retailing |
| NEUTRAL |
| from N/A |
|  |
| For a full list of our ratings, price target and earnings changes in this report, please see table on page 2. |

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| U.S. Food & Staples Retailing |
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| Summary of our Ratings, Price Targets and Earnings Changes in this Report (all changes are shown in bold) | | | | | | | | | | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Company | Rating | | Price | Price Target | | | EPS FY1 (E) | | | EPS FY2 (E) | | |
|  | Old | New | 19-Sep-16 | Old | New | %Chg | Old | New | %Chg | Old | New | %Chg |
| U.S. Food & Staples Retailing | NR | Neu |  |  |  |  |  |  |  |  |  |  |
| [Big Lots, Inc. (BIG)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=BIG) | N/A | EW | 47.00 | N/A | 51.00 | - | N/A | 3.52 | - | N/A | 3.89 | - |
| [Casey's General Stores Inc (CASY)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=CASY) | N/A | EW | 119.72 | N/A | 116.00 | - | N/A | 5.60 | - | N/A | 6.00 | - |
| [Chefs' Warehouse Inc (CHEF)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=CHEF) | N/A | EW | 11.83 | N/A | 12.00 | - | N/A | 0.38 | - | N/A | 0.45 | - |
| [Costco Wholesale Corp. (COST)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=COST) | EW | EW | 151.79 | 180.00 | 158.00 | -12 | 5.30 | 5.29 | 0 | 5.95 | 5.95 | - |
| [Dollar General Corporation (DG)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=DG) | N/A | EW | 71.83 | N/A | 74.00 | - | N/A | 4.50 | - | N/A | 4.90 | - |
| [Dollar Tree Inc (DLTR)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=DLTR) | N/A | EW | 80.22 | N/A | 88.00 | - | N/A | 3.79 | - | N/A | 4.46 | - |
| [Five Below, Inc. (FIVE)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=FIVE) | N/A | EW | 40.38 | N/A | 42.00 | - | N/A | 1.32 | - | N/A | 1.60 | - |
| [GNC Holdings Inc. (GNC)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=GNC) | N/A | EW | 20.72 | N/A | 21.00 | - | N/A | 2.74 | - | N/A | 2.78 | - |
| [Kroger Co. (KR)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=KR) | N/A | EW | 30.79 | N/A | 33.00 | - | N/A | 2.13 | - | N/A | 2.32 | - |
| [Natural Grocers by Vitamin Cottage Inc (NGVC)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=NGVC) | N/A | EW | 10.97 | N/A | 12.00 | - | N/A | 0.52 | - | N/A | 0.55 | - |
| [Performance Food Group Co. (PFGC)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=PFGC) | N/A | OW | 24.13 | N/A | 28.00 | - | N/A | 1.20 | - | N/A | 1.34 | - |
| [Smart & Final Stores Inc (SFS)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=SFS) | N/A | EW | 12.58 | N/A | 13.00 | - | N/A | 0.30 | - | N/A | 0.49 | - |
| [SpartanNash Co (SPTN)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=SPTN) | N/A | EW | 29.18 | N/A | 31.00 | - | N/A | 2.13 | - | N/A | 2.24 | - |
| [Sprouts Farmers Market Inc (SFM)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=SFM) | N/A | OW | 20.50 | N/A | 24.00 | - | N/A | 0.85 | - | N/A | 1.03 | - |
| [SYSCO Corp. (SYY)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=SYY) | N/A | UW | 49.25 | N/A | 48.00 | - | N/A | 2.32 | - | N/A | 2.59 | - |
| [United Natural Foods, Inc. (UNFI)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=UNFI) | N/A | UW | 39.31 | N/A | 40.00 | - | N/A | 2.58 | - | N/A | 2.71 | - |
| [Vitamin Shoppe Inc (VSI)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=VSI) | N/A | EW | 26.66 | N/A | 29.00 | - | N/A | 2.21 | - | N/A | 2.39 | - |
| [Wal-Mart Stores (WMT)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=WMT) | EW | OW | 72.09 | 70.00 | 87.00 | 24 | 4.35 | 4.33 | 0 | 4.60 | 4.50 | -2 |
| [Whole Foods Market Inc (WFM)](http://my.barcapint.com/BC/composite/GER_COMPANY?ticker=WFM) | N/A | EW | 28.58 | N/A | 30.00 | - | N/A | 1.52 | - | N/A | 1.39 | - |
| Source: Barclays Research. Share prices and target prices are shown in the primary listing currency and EPS estimates are shown in the reporting currency.FY1(E): Current fiscal year estimates by Barclays Research. FY2(E): Next fiscal year estimates by Barclays Research.Stock Rating: OW: Overweight; EW: Equal Weight; UW: Underweight; RS: Rating SuspendedIndustry View: Pos: Positive; Neu: Neutral; Neg: Negative | | | | | | | | | | | | |

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|  |

Figure   
Food & Staples Retailing Coverage Universe (as of September 19, 2016)



Source: Barclays Research, Company Reports, Thomson

INITIATING COVERAGE: U.S. FOOD & STAPLES RETAILING

We initiate coverage of the Food & Staples Retailing industry with a Neutral view. Sentiment on the group is negative, and many stocks are down meaningfully year to date – some in the double digits. The third quarter is set to be the most challenging for food retailers in well over a decade as they grapple with deflation on top of deflation year over year – a phenomenon not experienced since 1960. This headwind coincides with Walmart’s re-emergence as a disruptor, so the combination has the potential to wreak havoc on many companies in our universe. As a result, we believe many names will remain range-bound for the next several quarters. To reflect this view, we have an Overweight rating on 3 names, an Underweight on 2, and an Equal Weight on 14 names. We also assume coverage of Costco and Wal-Mart, keeping COST at Equal Weight and upgrading WMT to Overweight, making it our Top Pick. We see an average return of 17.9% for our Overweight names and 4.9% for our Equal Weight names, with downside of -0.4% for our Underweight names.

Our four-quadrant grid informs our view of how effectively each company will create shareholder value.

We segment our diverse coverage universe into four quadrants: 1) Growth Stars, 2) Stable Staples, 3) In Transition, and 4) Attempting to Reinvent, and with this lifecycle framework, our ratings reflect our view of whether a company’s go-to market and capital-deployment strategy is appropriate and sustainable. Said differently: We look for whether a company’s strategy can generate or reduce shareholder value in the context of a growing top line and increasing ROIC, as in most cases there is a very high correlation between stock price performance and ROIC. Names squarely in the Growth Stars or Stable Staples quadrant are gaining share (positive traffic), and have appropriate long-term strategies, in our view. Names in the In Transition quadrant either: 1) face secular challenges that may keep them in this quadrant in the intermediate term despite their best efforts and appropriate strategy, or 2) need to alter their strategy to create incremental shareholder value and transition to the Growth Star or Stable Staple quadrant. Names in the Attempting to Reinvent quadrant face meaningful secular challenges, and in most cases valuation reflects these challenges.

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our differentiated views

Our Differentiated Views (based on consensus recommendations):

**Casey’s**: Currently 77% of analysts covering the name have a favorable view on the stock. A $0.01 change in gas margins impacts annual EPS by ~$0.37, and from our long history covering the stock, we know historical gas margins and RIN values are irrelevant as it relates to future projections. Given Barclays view that oil is likely to rise in 2017, we believe gas margins are likely to decline (gas margins and gas prices are generally inversely related for CASY). As a result, our forward EBITDA and EPS estimates are below consensus. We also factor in an accelerating low-teens growth rate for opex, and we do not believe the street accurately accounts for these headwinds.

**Costco**: Currently 65% of analysts covering the name have a favorable view on the stock. Our caution stems from tepid traffic growth more recently, declining comps in general in the U.S. more recently, as well as the competitive landscape.

**Dollar Tree**: We are generally much more conservative on upside to synergies because we believe upside will likely get reinvested in price, as a result we are much more conservative on upside to EPS and EBITDA in FY17, FY18 and beyond. We are also concerned the competitive landscape will deteriorate and think this will further impact upside to synergies.

**Dollar General**: Despite the 17.8%% decline in DG’s stock when the company reported 2Q results on August 25th, we do not believe the current level presents investors with an attractive entry point because we believe the stock will remain range bound for the next several quarters. Our view is based on the belief that Walmart will continue to become more formidable, Family Dollar’s execution will continue to improve and Aldi will continue to infringe on dollar stores in general.

**Kroger:** Currently 63% of analysts covering the name have a favorable view on the stock. We believe the competitive environment will become more challenging for KR on a go-forward basis, believe capex is too high given returns, and therefore believe the stock will remain range-bound for the foreseeable future irrespective of whether or not deflation abates given the high capex and uninspiring ROIC.

**Walmart:** Given the fact that only 20% of analysts covering the stock have a favorable view, our Top Pick stance and overweight weighting are differentiated. After years of struggling, we believe the changes made under new Walmart U.S leadership are gaining traction – and we believe the turnaround is in the early stages. We also believe competitors have become somewhat dismissive of Walmart – and we believe this will prove to be a fatal strategic error. Walmart’s resurgence has a ripple effect across our entire landscape.

|  |  |
| --- | --- |
|  | Figure  Barclays vs. the Street |
|  |  |
| Note: Shaded area represents consensus Source: Barclays Research, Bloomberg  Stock rating: OW=Overweight; EW=Equal Weight; UW=Underweight  Industry View=Neutral |

Our four quadrants in more detail

**Growth Stars:** Companies in this quadrant are generally high growth share gainers with positive traffic comps. Gaining scale for this group matters and scale is achieved through unit growth and positive comps. As a result, companies in this quadrant generally allocate free cash flow to top line growth. Valuation multiples tend to be high in this quadrant.

**Stable Staples:** Companies in this quadrant generally have positive comps, although some also have respectable, single digit unit growth. These companies tend to be more mature and as such, companies in this quadrant typically generate respectable free cash flow, and deploy cash flow to unit growth, dividends and or buybacks – attributes more closely aligned with Consumer Staple names. Many names in this quadrant could be considered best-in-class and as such valuation multiples in this quadrant are not “cheap”, but we would argue are not excessive, especially in the context of valuation multiples in the broader Staples universe.

**In Transition**: Companies in this quadrant were, at one stage, “Growth Stars” or “Stable Staples” and were best-in-class but the environment has changed – and in our view, these companies are now facing some (or in some cases many) challenges to reinvent themselves. Most are generating weak or negative comps and most have negative traffic comps. Some will succeed, some will fail, and in some cases, management may not have control of the outcome given changes in the secular landscape. Companies in this quadrant may still be growing, but growth is not necessarily creating shareholder value, and they may generate respectable free cash flow. Companies in this segment will eventually transition to one of the other three quadrants.

**Attempting to Reinvent:** Companies in this quadrant generally have negative comps – both traffic and basket – so are therefore losing share, and are “cheap” on valuation but for a reason. EBITDA is declining or lumpy, top line is weak, share losses are evident, and EPS growth (if there is any) is only achieved through buybacks – a strategy that rarely rewards shareholders and one that we are generally very opposed to when top and bottom line are weakening.

Figure   
U.S. Food & Staples Retailing Four Quadrants

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Weak/Negative Traffic Trends |  |  | |  | |  | Positive Traffic Trends |
|  |  | | | | | | | |
| Slow/ No Unit  High Unit Growth | In Transition | | |  | | Growth Stars | | |
| Description: At one stage – best-in-class but now facing (in some cases) significant changes to the competitive landscape requiring alterations in go-to-market strategies. Depending on the strategy – the outcome could put these companies in any of the other three quadrants.   * Said differently – a turning point in the company’s life stage, * Traffic comp weakening or negative – so gaining share primarily through unit growth * Top line slowing despite commitment to unit growth (in most cases), * Unclear if “protective” moat still exists, * Unclear if capital allocation strategy is appropriate, * ROIC no longer consistently increasing, * EBITDA/EPS/FCF lumpy, * Balance sheet respectable so some optionality. | | |  | | Description: High growth, gaining share through unit growth and comp gains in traffic. Scale matters and becomes an increasing competitive advantage so top line is a critical component of this quadrant’s strategy.   * Traffic comping positively/gaining share, * Strong unit growth, * Comps MSD – driven – in some cases – by real estate strategy to be in high growth regions of the country, * Control over destiny – a “moat” * DD EPS and EBITDA growth, * Strong balance sheets, * ROIC mid teens and improving, * Positive FCF/improving ROIC ultimately leading to increasing FCF, * Higher multiple stocks – justified given higher unit growth and higher ROIC, * Capital allocation strategy is appropriate given growth. | | |
|  | | |  | |  | | |
| Attempting to Reinvent | | |  | | Stable Staples | | |
| Description: “attractive” valuation – potential value traps.   * Negative (or at best flat) traffic comp, * Flat to negative comps, losing share, * Questionable moat, * Significant competitive intrusions, * Low population growth in new and existing locations, * EBITDA/ROIC deteriorating, * Frequently a more levered balance sheet, * FCF yield may be decent so some financial engineering possible, * Dividend may or may not exist but if there is a dividend, the yield does not provide valuation support because deteriorating fundamentals could put the dividend at risk * Buyback generated EPS growth is never rewarded when business isn’t stable. | | |  | | Description: Slightly slower top line growth (lower unit growth or comps), traffic positive. Top line growth is not paramount to achieving scale – so generally stable businesses and in general, multiples for names in this quadrant reflect the ability to deliver consistently. Said differently, many similar attributes to true “Staples” names, yet trading at a (in some cases unwarranted) discount.   * Single digit unit growth, traffic comps positive – so gaining organic share, * Most are best in class, more mature names with moderate degree of moat, * MSD EBITDA growth, DD EPS growth through buybacks, * Returning cash to shareholders in form of Buybacks and dividend – or deleverage stories (strong record of capital allocation), * Respectable dividend yield and MSD FCF yield, * ROIC trends flat to slightly improving. | | |
|  |  | | |  | |  | | |
|  |  | | | | | | | |
|  | Deteriorating ROIC |  |  | |  | |  | Stable/ Improving ROIC |

Source: Barclays Research

General Valuation for Metrics for Each Quadrant

**Growth Stars:** Generally high multiple (double digit/teens on EV/EBITDA), with positive traffic, comps and top line (gaining share), free cash flow is less relevant given the growth profile, and in general, ROIC is improving.

**Stable Staples:** Generally high multiple (high single digit to low double digit on EV/EBITDA), with positive traffic, comps and top line (still gaining share), respectable free cash flow yields resulting in buybacks and dividend payouts, improving ROIC.

**In Transition:** Generally trading below Growth Stars and Staple Staples for a reason. Top line is still growing – but top line growth is almost entirely a function of unit growth. Comps are generally at best slightly positive – but for most names in this quadrant are flat to declining. The goal in this quadrant is to determine an identity – and commit to either becoming a Stable Staple or re-establish a position as a Growth Star.

**Attempting to Reinvent:** Generally “cheap” stocks with mid-single digit multiples on EV/EBITDA for many reasons: top line is deteriorating (losing share), EBITDA is flat to declining, margins are – at best – stable. Companies in this quadrant may still generate respectable cash flow, and some may redeploy cash to shareholders, but buyback driven EPS growth is rarely rewarded – and multiples reflect the many challenges these companies are facing.

Figure   
General Valuation Metrics for Each Quadrant

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Weak/Negative Traffic Trends |  |  | |  | |  | Positive Traffic Trends |
|  |  | | | | | | | |
| Slow/ No Unit  High Unit Growth | In Transition | | |  | | Growth Stars | | |
| * Traffic comps slowing or negative, * MSD top line, LSD (at best) comps – but trend is slowing despite unit growth, * EV/EBITDA in HSD – unclear if this is warranted, * ROIC MDD but starting to deteriorate, * Could easily transition to any one of the other three quadrants, * Reasonable FCF yield, * Potentially early stage dividend or buybacks. | | |  | | * Positive traffic comps, * DD Top line, * Sustainable MSD comps, * EV/EBITDA in low to high DD, * ROIC in mid to high DD, * FCF yield less relevant, * No dividend, * Rarely buybacks, * Capex used for growth. | | |
|  | | |  | |  | | |
| Attempting To Reinvent | | |  | | Stable Staples | | |
| * Flat to negative traffic, * Flat to declining top line, * Flat to down comps, * Running to stand still on margins, * EV/EBITDA in HSD, * ROIC in LDD to MSD, * Maintenance Capex only, * LSD-MSD FCF Yield, * LSD Dividend Yield but questionable sustainability, * No organic EPS growth. | | |  | | * Traffic slightly positive, * SD top line, * SD Comps, * EV/EBITDA in HSD, * ROIC in LDD to MDD – but ROIC improving, * Maintenance Capex only, * LSD-MSD FCF Yield, * LSD Dividend Yield but payout ratios have significant cushion, * Buybacks contribute to EPS Growth, * “Think like a staple, behave like a staple and get valuation closer to a “Staple”. | | |
|  |  | | |  | |  | | |
|  |  | | | | | | | |
|  | Deteriorating ROIC |  |  | |  | |  | Stable/ Improving ROIC |

Source: Barclays Research

Our View of Where Each Company Sits Within Each Quadrant

**Note:** Ratings and recommendations are not necessarily a function of positioning within our quadrant segmentation. Rather, our segmentation serves as a road map on positioning within our universe of Food and Staple Retail names. Our ratings and recommendations reflect our view of each company’s prospects within the context of the current (extremely challenging) competitive environment, the strength of a company’s go-to-market strategy, and absolute and directional ROIC. Relative and absolute valuation as well as detailed upside and downside analysis rounds out our recommendation process.

**Our Growth Stars are:** Casey’s (CASY), Spouts (SFM), Five Below (FIVE), and Smart & Final (SFS).

**Our Stable Staples are:** Walmart (WMT), Costco (COST), Kroger (KR), Sysco (SYY), Performance Food Group (PFGC) and SpartanNash (SPTN).

**Our In Transition names are:** Dollar General (DG), Dollar Tree (DLTR), Whole Foods (WFM), Big Lots (BIG), United Natural Foods (UNFI), Chef’s Warehouse (CHEF) and Natural Grocer Vitamin Cottage (NGVC).

**Our “Attempting To Reinvent” names are:** GNC (GNC), and Vitamin Shoppe (VSI).

Figure   
Company Placement

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Weak/Negative Traffic Trends |  |  | |  | |  | Positive Traffic Trends |
|  |  | | | | | | | |
| Slow/ No Unit  High Unit Growth | In Transition | | |  | | Growth Stars | | |
| * DG (EW) * DLTR (EW) * WFM (EW) * BIG (EW) * CHEF (EW) * NGVC (EW) * UNFI (UW) | | |  | | * SFM (OW) * SFS (EW) * CASY (EW) * FIVE (EW) | | |
|  | | |  | |  | | |
| Attempting To Reinvent | | |  | | Stable Staples | | |
| * GNC (EW) * VSI (EW) | | |  | | * WMT (OW) * COST (EW) * KR (EW) * SYY (UW) * PFGC (OW) * SPTN (EW) | | |
|  |  | | |  | |  | | |
|  |  | | | | | | | |
|  | Deteriorating ROIC |  |  | |  | |  | Stable/ Improving ROIC |

Source: Barclays Research

With this framework – for all of our names we consider:

* Market share gains or losses as evidenced by traffic,
* Lease adjusted ROIC – and the direction of ROIC, and the correlation between ROIC and stock price performance for our Food and Staples Universe,

|  |  |
| --- | --- |
|  | Figure  Correlation: Lease-Adjusted ROIC vs. Stock Prices |
|  |  |
| Note: PFGC is excluded due to small sample size.  Source: Company Reports, Barclays Research, Thomson |

* Valuation relative to ROIC (a relative valuation multiple) – and the direction of this ratio,

|  |  |
| --- | --- |
|  | Figure  FY17 EV/EBITDAR Relative to FY17 Lease-Adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Research |

Our definition for lease-adjusted ROIC is below:

|  |  |
| --- | --- |
|  | Figure  Our Lease-Adjusted ROIC Definition |
|  |  |
| \*Capitalize operating leases using 8x for retailers and 5x for distributors.  Source: Barclays Research |

* Free cash flow yield,

|  |  |
| --- | --- |
|  | Figure  CY2017 Free Cash Flow Yield |
|  |  |
| Source: Company Reports, Barclays Research |

* Dividend yield,

|  |  |
| --- | --- |
|  | Figure  Forward Dividend Yield |
|  |  |
| Source: Company Reports, Barclays Research, Thomson |

* Leverage on a lease adjusted and unadjusted basis,

|  |  |  |
| --- | --- | --- |
| Figure  Net Debt to EBITDA |  | Figure  Lease-Adjusted Net Debt to EBITDAR |
|  |  |  |
| Data based on our estimate for current fiscal year-end.  Source: Barclays Research |  | Data based on our estimate for current fiscal year-end  Source: Barclays Research |

* Short interest as a percent of float,

|  |  |
| --- | --- |
|  | Figure  Short Interest as a Percentage of the Float |
|  |  |
| Source: Bloomberg |

* Year to date and quarter to date performance on an absolute and relative basis,

|  |  |
| --- | --- |
|  | Figure  Stock Price Performance |
|  |  |
| Source: Thomson |

* Current and historical valuation on EV/EBITDA, EV/EBITDAR, and P/E (see the individual company sections for company-specific valuation data),
* Upside and downside scenarios for each of our names – and we assign a probability to each scenario – the weighted average of each scenario gets us to our price target,
* Our estimates versus consensus,
* Inflation/Deflation and the spread between CPI and PPI.

In general, and irrespective of our ratings, we highlight nine themes we view as contributing to our very cautious stance despite significant underperformance of our Food and Staples Retailing universe.

Our 9 Themes in General

1. **The Resurgence of Walmart as a Disruptor:** In our view, Walmart is in the early stages of a turnaround. Labor changes are having a positive impact on morale and execution, merchandising changes are being made, execution is improving, product quality is improving – yet competition is still fairly dismissive. At 3,499 Supercenters in the U.S., changes do not happen overnight, and momentum takes time to build, but once the positive momentum gains strength, it likely won’t dissipate for the foreseeable future, so we believe Walmart will be a force to be reckoned with in the U.S Food retailing landscape.
2. **Deflation Is Lapping Deflation Year-Over-Year for the First Time Since 1960:** In our view, 3Q16 could be the most challenging quarter for food retailers in well over a decade. This is the first quarter since 1960 where food retailers will experience deflation on top of deflation year over year – and it remains to be seen how retailers react to perceived share losses. The last time retailers experienced significant deflation following meaningful inflation transpired in 2009-2010 – and at that time retailers acted irrationally to maintain share in the face of a very weak consumer environment. At that time, however, retailers were not lapping deflation year over year.

|  |  |
| --- | --- |
|  | Figure  CPI Food at Home Y/Y Inflation/Deflation |
|  |  |
| Source: BLS |

The next figure shows inflation trends by major category starting in July 2015. Unfortunately, deflation in PPI for Farm products actually further deteriorated sequentially in August 2016 (i.e., versus July 2016).

|  |
| --- |
| Figure  CPI Inflation Data by Category |
|  |
| Source: BLS |

Today, consumer sentiment and confidence is significantly higher versus the 2009-2010 period. But deflation is lapping deflation and our concern is that as retailers see both gross profit dollar and margin pressure on top of weak sales, they could become even more irrational versus 2009-2010 irrespective of the state of the consumer.

|  |  |
| --- | --- |
|  | Figure  Consumer Sentiment |
|  |  |
| Source: University of Michigan Consumer Sentiment, FRED database |

1. **The CPI-PPI Spread Is at an All Time High: A Few Rules of Thumb**: 1) CPI usually lags PPI, 2) CPI is a good proxy for comps, and 3) the spread between CPI and PPI is a good proxy for gross margins and gross profit dollars. For the last several quarters, comps have been pressured by disinflation or weakening CPI, but gross margins and gross profit dollars have benefited from the CPI/PPI spread. In 3Q16, the spread will cease to widen and we believe the persistence of deflation combined with an abating gross margin tailwind will cause very irrational behavior.

|  |  |
| --- | --- |
|  | Figure  CPI-PPI Spread Has Ceased Widening |
|  |  |
| Source: BLS |

1. **When Hard Discounters Are Also Making a Bigger Push in the U.S.:** Aldi currently operates 1,517 units in the U.S. with plans to open ~500 over the next several years. Lidl has not officially commented on its unit opening plans but it has built considerable distribution capacity on the east coast to support its growth. Meanwhile, other domestic hard discounters have continued to grow in recent years. We believe these hard discounters have cracked the code on offering fresh (produce and periphery) at meaningful discounts to conventional operators – and while private label penetration at these formats is very high (especially for Aldi and Lidl) – and potentially too high to ever replicate their UK success in the U.S. – they will disrupt the U.S. landscape.
2. **The E-Commerce/Click and Collect Risk:** E-Commerce and Click and Collect is here to stay irrespective of the cost to the retailer because the consumer is demanding the service. As a result, any retailer who is dismissive of this shift and threat to their competitive positioning (whether it be from Amazon, Walmart or any other Ecommerce operator) will not prevail going forward.

|  |  |
| --- | --- |
|  | Figure  Food Retail - 2015 Format Ranking by Percentage of Sales Growth |
|  |  |
| Source: Willard Bishop, The Future of Food Retailing |

1. **And Consumers in All Income Brackets Are Seeking Healthier, Fresh and Perishable Options:** It is no secret that volumes at conventional food manufacturers have been anaemic for years, raising the basic question: are consumers just eating less? It now seems clear – the answer is simple: irrespective of the income demographic, consumers are eating more on the periphery, more fresh and more “random weight” SKUs. In addition, what they purchase from the center of the store is increasingly natural/organic. This shift in behavior is shaping how our Food and Staples universe is going to market in order to gain share going forward. Below highlights the y/y sales growth in natural/organic scan data vs. non-natural/organic.

|  |  |
| --- | --- |
|  | Figure  Y/Y Growth of Natural & Organic vs. Not Natural & Organic Products |
|  |  |
| Source: Nielsen Total US xAOC Incl Conv and Barclays Research |

1. **Labor Costs Are Rising For Names With Non-Union Labor Exposure:** Non-union operators are experiencing wage pressure on two fronts: 1) rising minimum wages, and 2) changes to the Fair Labor Standards Act (FLS). While this is a headwind to non-union operators, higher wages can have a ripple effect in three ways: 1) workers earning above the minimum wage also tend to get rate increases in order to maintain a gap with minimum wage earners, 2) higher wages in theory can lead to reduced turnover, and 3) a higher minimum wage, in theory, shifts income to a higher consuming demographic.

|  |  |
| --- | --- |
|  | Figure  Y/Y Percentage Change in Minimum Wage by State\* |
|  |  |
| Note: Includes Washington D.C. Source: Barclays Research |

The FLS sets wage and overtime standards, including qualifications that exempt higher-salaried, professional, and managerial workers from overtime pay when they work more than 40 hours in a week. The most notable and wide-reaching of these exemptions—the white collar salary level exemption—is subject to change, which would raise the minimum salary for exempt employees from $23,600 annually to $50,440 annually. The change is estimated to affect around 5 million American workers.

1. **The Spread Between CPI Food at Home and CPI Food Away From Home Is at a Historical High (Wide):** For distributors, we believe this spread could ultimately become a headwind as the value equation between Food At Home and Food Away from Home becomes increasingly out of whack. Below shows the y/y change in Food At Home (food retail) prices vs. Food Away from Home (restaurants) prices. As indicated, Food At Home prices have recently trended -LSD negative while restaurant prices are +LSD positive, which makes Food At Home prices relatively more attractive.

|  |  |
| --- | --- |
|  | Figure  CPI Food At Home vs. Food Away From Home: At Home Prices Are Increasingly Cheaper |
|  |  |
| Source: BLS |

1. **And Fuel Costs Will Likely Start to Rise:** Historically low fuel prices have benefited consumers (higher disposable income), distributors (lower freight costs; lower cost per case including fuel), and convenience store operators (higher gas margins). We believe this trend will reverse, leading to headwinds (or fewer tailwinds) in FY17 and beyond.

|  |  |  |
| --- | --- | --- |
| Figure  US Gasoline Prices (All Grades Retail Price Including Taxes) |  | Figure  US Diesel Prices (Including Taxes) |
|  |  |  |
| Source: EIA Short-Term Energy Outlook |  | Source: EIA Short-Term Energy Outlook |

The following table captures our take on how the above themes impact each of the companies in our universe.

|  |
| --- |
| Figure  Nine Major Themes’ Impact on Coverage Universe |
|  |
| Source: Barclays Research |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Costco Wholesale Corp. (COST)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=COST) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 151.79 | | Price Target | USD 158.00 | | **Why Equal Weight?** Reflects: 1) A fair valuation based on some of the ongoing changes in the competitive landscape - both on-line and bricks and mortar, 2) recently decelerating comp, 3) flat ROIC. | | |  | | | Upside case | USD 180.00 | | Reflect: 1) A valuation multiple at a 40% premium to historical (on EV/EBITDA), 2) a re-acceleration of the U.S. comp - especially traffic, 3) a re-acceleration of traffic in the U.S., 4) a FY17 fee increase (with no negative impact to traffic or | | |  | | | Downside case | USD 125.00 | | Reflects: 1) A slowdown in comps in the US - both total comps (ex fuel) and traffic, 2) a slowdown in e-commerce trends, 3) a deterioration in ROIC. If these three factors played out it could cause a rebasing of COST's multiple. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 116,199 | 118,714 | 125,640 | 133,954 | 4.9% |  |
| EBITDA (adj) | 4,751 | 4,859 | 5,348 | 5,757 | 6.6% |  |
| EBIT (adj) | 3,624 | 3,656 | 4,116 | 4,441 | 7.0% |  |
| Pre-tax income (adj) | 3,604 | 3,590 | 4,024 | 4,349 | 6.5% |  |
| Net income (adj) | 2,377 | 2,330 | 2,613 | 2,827 | 6.0% |  |
| EPS (adj) ($) | 5.37 | 5.29 | 5.95 | 6.42 | 6.1% |  |
| Diluted shares (mn) | 442.7 | 440.3 | 439.3 | 440.6 | -0.2% |  |
| DPS ($) | N/A | 1.80 | 1.80 | 1.90 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 4.1 | 4.1 | 4.3 | 4.3 | 4.2 |  |
| EBIT (adj) margin (%) | 3.2 | 3.1 | 3.4 | 3.4 | 3.3 |  |
| Pre-tax (adj) margin (%) | 3.1 | 3.0 | 3.2 | 3.2 | 3.1 |  |
| Net (adj) margin (%) | 2.0 | 2.0 | 2.1 | 2.1 | 2.0 |  |
| ROIC (%) | 17.0 | 16.5 | 17.1 | 16.5 | 16.8 |  |
| ROE (%) | 20.4 | 20.4 | 20.5 | 19.9 | 20.3 |  |
| ROA (lease adjusted) (%) | 7.3 | 7.2 | 7.8 | 7.9 | 7.5 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 15,401 | 17,334 | 19,102 | 20,786 | 10.5% |  |
| Intangible fixed assets | 0 | 0 | 0 | 0 | N/A |  |
| Cash and equivalents | 4,801 | 4,508 | 4,061 | 3,855 | -7.1% |  |
| Total assets | 33,440 | 34,321 | 36,168 | 38,202 | 4.5% |  |
| Short and long-term debt | 6,147 | 5,114 | 5,114 | 5,114 | -5.9% |  |
| Total liabilities | 22,597 | 22,308 | 22,732 | 23,175 | 0.8% |  |
| Net debt/(funds) | 1,346 | 606 | 1,053 | 1,259 | -2.2% |  |
| Shareholders' equity | 10,843 | 12,013 | 13,436 | 15,027 | 11.5% |  |
| Change in working capital | 547 | N/A | N/A | N/A | N/A |  |
| Cash flow from operations | 4,285 | 4,778 | 3,743 | 4,030 | -2.0% |  |
| Capital expenditure | -2,393 | -3,000 | -3,000 | -3,000 | N/A |  |
| Free cash flow | 1,690 | 1,067 | 1,383 | 1,682 | -0.2% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 28.3 | 28.7 | 25.5 | 23.7 | 26.6 |  |
| EV/EBITDA (adj) (x) | 14.4 | 13.9 | 12.7 | 11.8 | 13.2 |  |
| Equity FCF yield (%) | 7.3 | 4.6 | 6.0 | 7.3 | 6.3 |  |
| P/Sales (x) | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 |  |
| P/BV (x) | 6.2 | 5.6 | 5.0 | 4.5 | 5.3 |  |
| Dividend yield (%) | N/A | 1.2 | 1.2 | 1.3 | 1.2 |  |
| Adj debt/EBITDAR (x) | N/A | N/A | N/A | N/A | N/A |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 1.0 | 0.0 | 3.3 | 4.1 | 2.1 |  |
| Square footage growth (%) | 3.6 | 4.1 | 4.8 | 4.6 | 4.3 |  |
| Inventory growth (%) | 5.3 | 0.0 | 5.9 | 5.9 | 4.3 |  |
| Capex/sales (%) | 2.1 | 2.8 | 2.8 | 2.8 | 2.6 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Aug | | | | | | | |

CostCO

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Costco Wholesale Corp.(COST): Quarterly and Annual EPS (USD)   |  | | --- | | COST | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 158.00 | | Price (19-Sep-2016) | | USD 151.79 | | Potential Upside/Downside | | +4.1% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Aug | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 1.12A | 1.09A | 1.09A | 1.09A | 1.23E | N/A | 1.22E | -3% | N/A |
| Q2 | 1.35A | 1.24A | 1.24A | 1.24A | 1.40E | N/A | 1.38E | -8% | N/A |
| Q3 | 1.16A | 1.24A | 1.24A | 1.24A | 1.31E | N/A | 1.39E | 7% | N/A |
| Q4 | 1.81A | 1.74E | 1.74E | 1.74E | 2.00E | N/A | 2.00E | -4% | N/A |
| Year | 5.37A | 5.30E | 5.29E | 5.30E | 5.95E | 5.95E | 5.98E | -1% | 12% |
| P/E | 28.3 |  | 28.7 |  |  | 25.5 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

How Do You Keep Over Achieving When You Are Already Best-In-Class?

Valuation reflects continued momentum despite changes in the competitive landscape; assuming coverage at Equal Weight with a $158 price target

As a best-in-class retailer, the company has been viewed and valued as a Growth Star for the better part of a decade given its remarkable consistency in comp, earnings growth and impressive ROIC. The company’s comp (and traffic within the comp), however, does appear to be slowing, and we believe this is a function of changes in the competitive landscape and shopping behavior – in part a function of Amazon’s increasing dominance. We believe the slowdown could also be a function of the changing e-commerce competitive landscape in general given the proliferation of online food purchasing options – including click and collect (Walmart and Kroger), order delivery (Amazon, Walmart, Kroger), and outsourced solutions (Instacart and Google Express).

As a result, we are concerned that COST’s comp slowdown might not be transitory but could potentially be secular. As such, we are concerned comps might not see a re-acceleration – even with the transition from American Express to Visa. Given the potential for a slowing comp, low single-digit unit growth in the U.S. and only low double-digit to high single-digit EPS and EBITDA growth, we believe COST’s valuation at a CY17 EV/EBITDA of 12.7x is appropriate because we believe COST should be viewed and valued more consistently with other Stable Staples – more or less in line with where COST is trading today.

We would need to value COST at a meaningful premium to the Staple Universe to justify an Overweight rating. Our universe of Stable Staples exhibit the following: low unit growth (generally consistent with COST’s U.S. unit growth), generally positive traffic, flat to slightly improving ROIC, and these names are generally best-in-class with a history of consistency and a defensible moat.

Equal Weight rating based on upside/downside scenario analysis

On valuation, if traffic remains in the low single digits, we see downside to $140 (-18%, 40% probability) – or 10.1x our CY17 EV/EBITDA, and if traffic and comp re-accelerates, we see upside to $180 (+19%, 60% probability). The weighted average of these two scenarios gets us to our Equal Weight rating and $158 (+4%) price target. If traffic were to slow on a more prolonged basis – we would re-evaluate our rating.

|  |
| --- |
| Figure  COST Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Summary of Financials

Below we highlight our estimates vs. consensus. In general, we are in line with to slightly below consensus as we believe the benefits of strong merchandising and the new Visa card will be partially offset by some leakage to other retailers, including e-commerce companies and brick and mortar, which offer increased convenience and choice.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research Estimates, ConsensusMetrix |

Price Target and Current Valuation

Below we highlight our price target and current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  COST Price Target Valuation |  | Figure  COST Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Free Cash Flow

We expect increasing free cash flow from FY16-FY18 driven by EBITDA gains.

|  |  |
| --- | --- |
|  | Figure  COST Free Cash Flow |
|  |  |
| Source: Barclays Research |

Our view in greater detail

Our Equal Weight rating on COST is based on the following:

1. COST is clearly a best-in-class retailer with an exceptional business model. The company has demonstrated: 1) extremely consistent comps, 2) annual profit growth of 10% over an extended period of time, and 3) strong and improving ROIC.
2. Given the company’s strong track record, COST is trading at the high end of its historical ranges on EV/EBITDA and P/E and is trading at a premium on a P/E basis to many large cap Staple Peers.
3. This valuation comes at a time when comps have started slow modestly, putting in question whether or not high valuations are sustainable.
4. We analyze Amazon’s potential impact to COST’s U.S. footprint.
5. We separately discuss emerging e-commerce trends.
6. Given all of the above, we believe valuation based on COST’s peer set of Stable Staples is fair. The company is trading at a slight premium to large cap staples on a P/E basis, and in line on EV/EBITDA.
7. An exceptional and resilient business model

Comps Have Historically Been Steady; FX and Fuel Have Pressured Them Recently

COST is the second-largest global retailer based on worldwide sales, according to the National Retail Federation, and the company estimates that its Kirkland Signature private brand has global brand sales that exceed many well known brands such as Coca-Cola, Frito Lay, and Nestle. The company’s only direct competitors in the US are Sam’s Club and BJ’s.

US comps excluding fuel at COST have been positive in varying economic environments as the company’s limited assortment and low prices have resonated with customers. Helping drive these gains has been the addition of ancillary services to stores. An example is gas stations. These were added at a 15%+ annual rate for much of the 2000s – but further expansion domestically is more or less limited to new units only (12 out of 60 units could potentially be expanded to include fuel). More recently, US comps have been boosted by the company’s assortment of fresh foods. We estimate that fresh foods will be 15% of sales in FY16, up from 10% in FY12. COST has added more organic products over this time and discovered this had little impact on its non-organic business. In fact, the additional skus have helped broaden COST’s appeal to new demographics, especially millennials.

International results have been particularly strong as the company has few or essentially no direct competitors. In markets without a club store competitor, the concept has been able to take share from conventional competition.

|  |  |  |
| --- | --- | --- |
| Figure  COST US Comps Excluding Fuel |  | Figure  COST Total Company Comps Excluding FX and Fuel |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Traffic has been strong since FY09 but has been slowing recently

Traffic comps at COST have been positive throughout many different economic environments. Results since FY09 suggest that the company has benefited to some degree from the “great recession,” with traffic comps averaging 2.0% from FY03-FY08, but averaging more than double this amount at 4.3% from FY09-FY15. Traffic comps have moderated recently. We believe this is due to various factors, including the lapping of many years of strong gains, the evolving competitive landscape, and low fuel prices; consumers tend to go to COST less frequently when prices are low because in a rising price environment, COST’s price advantage in fuel is more obvious to the consumer. COST estimates conversion is in the 50% range.

|  |  |
| --- | --- |
|  | Figure  COST Frequency (Traffic Comps) |
|  |  |
| Note: Fiscal periods. 4Q16E is Barclays estimate and adjusts for one less selling day in July.  Source: Company reports and Barclays Research estimates |

Annual profit growth has averaged 10% over many years

EPS and EBITDA have both grown at 10% and 9%, respectively, on average since FY03. Profit growth only declined in FY09 but then quickly rebounded. The growth in profits was driven by steady comps, as discussed above, as well as ~5% annual unit growth. Domestic unit growth averaged 6% from FY03 to FY08 then slowed to 3% from FY09 to FY15; unit growth in Canada followed a similar cadence. Meanwhile other international growth has been robust at nearly 10% in recent years. The operating margin has been stable at ~2.8% over this time frame but increased to 3.1% in FY15 due to strong fuel profits.

|  |  |  |
| --- | --- | --- |
| Figure  COST Historical and Projected EPS Growth |  | Figure  COST Historical and Projected EBITDA Growth |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Solid and improving lease adjusted returns on invested capital

COST has industry leading lease adjusted returns on invested capital. ROIC has improved from a low of 11.5% in FY09 to 17% in FY15. We expect ROIC to decline slightly in FY16, mostly due to adverse foreign exchange movements.

|  |  |
| --- | --- |
|  | Figure  COST Lease Adjusted Return on Invested Capital |
|  |  |
| Note: Lease adjusted ROIC calculated as tax-affected operating income + rent divided by lease adjusted invested capital. Lease adjusted invested capital calculated as total assets plus capitalized rent expense (8x) less non-interest bearing current liabilities and cash.  Source: Company reports and Barclays Research |

Among the reasons for the strong improvement in ROIC in recent years is that International (mostly Asian) became a greater area of focus for growth and as a result, started accounting for a greater percent of the unit mix. Warehouses in these countries tend to generate the strongest ROIC since there is generally not a direct competitor and SG&A is generally lower as governments pay for the healthcare of its employees and wage rates are generally lower.

|  |  |
| --- | --- |
|  | Figure  Percentage of warehouses by country or region |
|  |  |
| Source: Company reports and Barclays Research |

1. **Stock is trading at high end of historical valuation range given Best-In-Class Attributes**

Strong comps ex-fuel and improving lease adjusted ROIC have led to COST trading near the high end of its historical valuation. COST’s forward NTM P/E multiple of 25.0x is 3x (15%) above its long-term average of 21.8x. COST’s forward NTM EV/EBITDA multiple of 12.3x is 2x (23%) above its long-term average of 10.3x. The following figure illustrates COST’s NTM forward EPS and EV/EBITDA multiples for the last 15 years.

|  |  |  |
| --- | --- | --- |
| Figure  COST NTM Forward P/E |  | Figure  COST NTM Forward EV/EBITDA |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

1. Comps have decelerated as competitive landscape and shopping behavior evolve

US comps excluding fuel have been decelerating

As can be seen in the below figure, comps excluding fuel began decelerating in 2015 and this general trend has continued into 2016. Deflation has been a pressure over this time period, but we also believe that the company is also beginning to experience some pressure from new business models and evolving shopping behavior.

|  |  |
| --- | --- |
|  | Figure  COST Monthly Comps – US Ex. Fuel |
|  |  |
| Source: Company Reports and Barclays Research |

1. **We analyze Amazon’s potential Impact to COST’s U.S. footprint**

Over half of COST’s US store base overlaps with top Amazon markets

While COST’s price/value equation in food is unmatched, the combination of endless aisles, competitive pricing, and speed of delivery has made Amazon a formidable competitor to nearly all retailers, and we believe that COST is increasingly at risk. Data from Oliver Wyman suggests that nearly 60% of COST’s stores are in markets where Amazon would have the lowest breakeven market share in Fresh. Also, some of these markets may be among the company’s most profitable given its density in the market. The table below identifies Amazon’s top markets and the number of COST warehouses in that market.

Figure   
Most Desirable Amazon Markets for Amazon Fresh and Number of COST Warehouses



Source: Oliver Wyman, Metro Market Studies, Company Reports, and Barclays Research

Amazon Prime membership has expanded rapidly

Amazon introduced Prime in 2005, offering customers unlimited free two-day shipping on one million items for $79 per year. Membership stood at 1 million at the end of the year. By the end of 2012, Amazon significantly increased the benefits of Prime. It added over 14 million eligible items, introduced Prime Instant Video, and other benefits. Prime membership benefits now include free same day delivery (or even within hours) in eligible zip codes, deals and discounts through Amazon Family, unlimited streaming of select video and music, and other benefits. As of June 2016, there were over 60 million Prime members compared to 46.9 million total global paid members at COST and 85.5 million cardholders as of the end of May 2016.

|  |  |
| --- | --- |
|  | Figure  US Amazon Prime Members |
|  |  |
| Source: Consumer Intelligence Research Partners and Barclays Research |

Amazon offers free same-day delivery to Prime members in 28 cities in the US on over one million items. The company also has Fulfilment by Amazon (FBA) warehouses in key geographies. These warehouses store a vendor’s product and Amazon picks, packs, ships, and provides customer service for these products. This gives vendors increasing reach for their products while expanding the breadth of product available on Amazon.

|  |
| --- |
| Figure  Amazon Footprint – Cities with Free Same-Day Delivery to Prime Members & Warehouses that Store and Ship for FBA Sellers |
|  |
| Source: Amazon, TaxJar, and Barclays Research |

Amazon Prime markets include nearly every major US market and overlap with over half of COST’s US warehouses.

Figure   
Amazon Prime Markets and Number of COST Warehouses



Source: Amazon, Metro Market Studies, and Barclays Research

While Amazon has made great strides with many consumable products, we still believe that it has not yet “cracked the code” on fresh. Our research suggests that many customers in north-eastern markets have found the service to be inferior to other offerings – such as Peapod and FreshDirect – but its customer perception scores have been improving. Also, Amazon has partnered with retailers such as Sprouts (SFM) in various markets. We believe this move by the company will improve its fresh quality. So while the Amazon Fresh threat is not yet a meaningful issue for COST, we believe COST will be unable to compete when (and if) Amazon does crack the code on Fresh.

1. **E-commerce will play a greater role for all retailers – irrespective of format**

Costco appreciates its e-commerce efforts have upside, and the online business is growing quickly (off of a small base)

E-commerce at COST has been growing at a double-digit rate for many years, but at $4 billion in annual revenue, it is still only a small percentage of its overall business. The speed of delivery has improved recently as the company ships from multiple depots across the US. Up until last year, all orders were shipped from California, and shipping could take 7-10 business days. The company does not plan to offer next day delivery as it doesn’t believe it can do this economically today, given its margin structure. That said, online sales at Costco.com are margin accretive since there is little incremental SG&A and over half of online orders are fulfilled by suppliers.

Big ticket items that are difficult to merchandise or that need “white-glove” delivery have done well online. This includes such products as patio sets, beds and bed sets, exercise equipment, and TVs. The company has been expanding the number of SKUs available online and they now total 9,000 compared to about 4,000 at a typical warehouse; only about a third of SKUs overlap. The expanded number of SKUs is largely due to its expanding the apparel category to include more sizes and colors than can be found in a warehouse. This has led to apparel being one of the strongest categories on Costco.com (and has been a factor in declining on line ticket). There are many fresh items available for purchase online, including fruits and vegetables, beef, poultry, and seafood. When ordering these perishable items, it is necessary to use Express shipping. Customers that do not have a Costco membership can still shop on the website but they will pay a 5% non-member surcharge over the member’s posted product prices.

Key players now offering increased convenience

Competitors such as Wal-Mart (WMT) and Kroger (KR) have been investing in their e-commerce and “click and collect” businesses, while other operators such as Instacart and Google Express provide customers access to many brick-and-mortar retailers. COST has been slow to embrace to embrace e-commerce and it does not offer “click and collect.”

**Wal-Mart**: WMT has built seven domestic next generation dedicated fulfilment centers in the past year and a half and another is planned bringing the total to eight. These will allow the company to efficiently fulfil customer orders and meet expectations for fast delivery. As part of its push to become an e-commerce destination, the company launched ShippingPass. Members pay $49 annually for free unlimited 2-day shipping, free returns online or in-store, and no minimum orders.

In addition, the company launched grocery pick-up (“click and collect”), which is now in 60 markets and nearly 400 stores. Customers order online and set a time for pick up. When the customer is at the store, they use the Walmart app to alert an associate they are in the pickup area. Then, a Walmart employee will bring the order to the customer’s car. There is no charge for this service and it has been popular with families as it can be difficult to get children in and out of the car. Sam’s Club offers a pickup option as well and is the only club player to offer this service. COST has stated that it does not plan to offer this service in the near or intermediate term given the productivity of its warehouses, the difficulty in managing this type of fulfilment given the volume at an average COST location (making execution extremely challenging for a click and collect model), and the fact that when customers go into the store they typically buy more than they came for.

WMT demonstrated the seriousness of its ambitions to become a credible e-commerce player with the purchase of Jet.com. On August 8, 2016 WMT and Jet.com announced they had entered into a definitive agreement for WMT to acquire Jet for ~$3.3 billion. The acquisition will close in the middle of WMT’s 3Q. Jet sells more than 12 million SKUs and offers free delivery on thousands of items while not charging a membership or annual fee. The company has more than 2,400 retailer and brand partners, and its best-in-class technology reduces supply-chain and logistics costs.

**Kroger**: Kroger acquired Harris Teeter Supermarkets in 2013 to expand its geographic footprint and to gain insight into click and collect operations. KR studied and tested Harris Teeter’s click and collect operations, known as Express Lane, to see if the concept could apply across a broader set of its stores and geographies. After successful testing, the company is now rolling out this functionality, known as ClickList, to stores in markets where there is likely to be demand for the service. As of mid-summer 2016, we believe the company had either ClickList or Express Lane in 400 locations and at least 25 markets and it continues to add more locations. Meanwhile, in 2014 KR moved into e-commerce with the purchase of Vitacost. Vitacost sells beauty products, natural and organic foods, and vitamins and supplements. The investment provided the company with technology expertise and a platform for fulfilling home delivery of online orders.

**Instacart**: Instacart connects shoppers with retailers and its dedicated staff make at home deliveries. Customers place an order and pay through Instacart for items at a given retailer. Retail partners include such companies as Whole Foods, Fairway, Costco, Food Emporium, Publix, and Trader Joe’s. A personal shopper receives the order and starts collecting order items. The personal shopper pays the bill through Instacart’s prepaid debit card which is accepted at the store. The shopper then goes to deliver the groceries to the customer as per the address mentioned in the order. The service is offered in 19 states across the country, including 364 cities, and Washington, DC. The delivery fee depends on the size of the order and the delivery time that is chosen. Instacart Express members pay $149 a year and get free two hour and scheduled delivery on orders over $35. Prices are not always the same as in-store prices. At COST, Instacart is available in the following states: California, Colorado Connecticut, Florida, Georgia, Illinois, Indiana, Maryland, Massachusetts, Michigan Minnesota, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Texas, Virginia, Washington, as well as the District of Columbia. For COST, the Instacart shopper is treated like any other member – and similar to most other Instacart arrangements, COST has no control over price.

**Google Express**: Similar to Instacart, Google Express connects shoppers with retailers, and its dedicated staff make at-home deliveries. Partnering companies include retailers spanning grocery, health & beauty, home, baby, toys, electronics, and others; COST is a partner. Depending on the customer’s area, delivery day availability and the retailer, orders arrive within two days. In contrast to Instacart, COST considers Google Express a partnership: customers using Google Express are COST members (and therefore receive COST price points), and warehouses have dedicated real estate inside the store. Google Express is offered in fewer markets than Instacart but includes many major cities including Boston, Chicago, Los Angeles, New York, San Diego, San Francisco, and Washington DC. Delivery costs start at $4.99 per store for eligible orders for non-members. Members pay $10/month or $99/year for free delivery on eligible orders. An eligible order needs to reach a store minimum in the delivery area and it excludes restricted items such those that need to be chilled or alcohol.

Valuation of stock is appropriate given ROIC and growth outlook

We expect total reported comps at COST will improve over the next two fiscal years as the company anniversaries substantial FX and gas headwinds.

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| --- | --- |
|  | Figure  Barclays’ Comp Forecast |
|  |  |
| Source: Barclays Research estimates |

In FY16, we forecast EBITDA will increase 2.3% and EPS will decline 1.5%. The company will report 4Q16 results on September 29th, 2016, with a call at 5 pm EST. The tepid results are due to adverse foreign exchange movements and strong profits in its fuel in FY15. Looking forward, we expect profit growth will return to a more normal level in FY17. We forecast EBITDA growth of 10.1% in FY17 and slightly faster EPS growth at 12.4%. We forecast EBITDA and EPS growth of nearly 8% in FY18. Our numbers do not include a membership fee increase. The last fee increase took place in January 2012, and fee increases generally take place every 5-6 years. We do not anticipate a free increase this year but we would not be surprised to see an increase in January 2018.

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| --- | --- |
|  | Figure  Barclays’ EBITDA and EPS Growth Forecast |
|  |  |
| Note: Estimates do not include a membership fee increase. Source: Barclays Research estimates |

1. **Valuation is fair when compared to the current peer set**

The below comp table shows COST relative to Staples and “staple-type” companies in our coverage. We believe the company meets the criteria for a Stable Staple with low unit growth, traffic generally positive, flat to slightly improving ROIC, and a best in class company with a defensible moat. COST’s lease adjusted ROIC is much higher than the average Staple and “staple-type” companies in our coverage but EBITDA and EPS growth are lower. At 12.4x CY17 EV/EBITDA, COST trades at a slight discount to the large cap Staples average CY17 EV/EBITDA at 13.3x although it’s more expensive at on FCF yield basis at 2.2% vs. 5.3% for Staples. COST’s sales and EBITDA growth are well ahead of “staple-type” companies in our coverage as is its lease adjusted ROIC. As such, it trades a higher valuation than this group.

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| Figure  Comp Table - COST vs. Staples and “Staple-Type” Companies in Our Coverage |
|  |
| Source: Barclays Research estimates |

**Valuation and Conclusion**

Given the above, we initiate with an Equal Weight rating and a $158 PT based on our upside/downside scenario analysis. If traffic remains in the +LSD, we see downside to $140 (-18%, 40% probability) – or 10.1x our CY17 EV/EBITDA of $5.6 billion, and if traffic and comp re-accelerates, we see upside to $180 (+19%, 60% probability). The weighted average of these two scenarios gets us to our Equal Weight rating and $158 (+4%) price target. If traffic were to slow on a more prolonged basis – we would re-evaluate our rating.

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| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Kroger Co. (KR)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=KR) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 30.79 | | Price Target | USD 33.00 | | **Why Equal Weight?** While our price target multiple is slightly above KR's 13 year average, we do not believe KR is a "Growth Stock" and believe capex is too high - so until KR reduces capex and we see evidence that ROIC will improve, we believe the stock and valuation valuation will remain range-bound. | | |  | | | Upside case | USD 45.00 | | Reflects: 1) KR reduced capex, 2) a more robust buyback program, 3) an inflationary and more normalized competitive landscape, and 4) improving ROIC. | | |  | | | Downside case | USD 30.00 | | Reflects: 1) Persistent deflation, 2) a "price war", 3) KR trading closer to its trough valuation. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 109,830 | 115,268 | 119,903 | 125,317 | 4.5% |  |
| EBITDA (adj) | 5,665 | 5,938 | 6,195 | 6,560 | 5.0% |  |
| EBIT (adj) | 3,576 | 3,645 | 3,787 | 4,056 | 4.3% |  |
| Pre-tax income (adj) | 3,094 | 3,141 | 3,293 | 3,572 | 4.9% |  |
| Net income (adj) | 2,049 | 2,047 | 2,140 | 2,322 | 4.3% |  |
| EPS (adj) ($) | 2.08 | 2.13 | 2.32 | 2.54 | 6.8% |  |
| Diluted shares (mn) | 980.3 | 961.8 | 921.7 | 915.7 | -2.2% |  |
| DPS ($) | 0.41 | 0.47 | 0.51 | 0.56 | 11.4% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 4.7 | 4.8 | 5.2 | 5.3 | 5.0 |  |
| EBIT (adj) margin (%) | 3.3 | 3.2 | 3.2 | 3.3 | 3.2 |  |
| Pre-tax (adj) margin (%) | 2.8 | 2.7 | 2.7 | 2.9 | 2.8 |  |
| Net (adj) margin (%) | 1.9 | 1.8 | 1.8 | 1.9 | 1.8 |  |
| ROIC (%) | 10.1 | 9.7 | 9.4 | 9.5 | 9.7 |  |
| ROE (%) | 33.3 | 29.4 | 27.0 | 24.2 | 28.5 |  |
| ROA (lease adjusted) (%) | 7.3 | 7.0 | 6.7 | 6.6 | 6.9 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 19,619 | 21,076 | 22,418 | 24,264 | 7.3% |  |
| Intangible fixed assets | 2,724 | 2,724 | 2,724 | 2,724 | 0.0% |  |
| Cash and equivalents | 277 | 902 | 2,364 | 3,520 | 133.4% |  |
| Total assets | 33,897 | 36,366 | 39,621 | 43,018 | 8.3% |  |
| Short and long-term debt | 12,079 | 13,579 | 14,579 | 15,579 | 8.9% |  |
| Total liabilities | 27,108 | 29,212 | 30,918 | 32,535 | 6.3% |  |
| Net debt/(funds) | 11,802 | 12,677 | 12,215 | 12,059 | 0.7% |  |
| Shareholders' equity | 6,789 | 7,154 | 8,703 | 10,484 | 15.6% |  |
| Change in working capital | -18 | 218 | 254 | 222 | N/A |  |
| Cash flow from operations | 4,846 | 4,698 | 4,938 | 5,184 | 2.3% |  |
| Capital expenditure | -3,349 | -3,750 | -3,750 | -4,350 | N/A |  |
| Free cash flow | 881 | 928 | 1,179 | 829 | -2.0% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 14.8 | 14.4 | 13.3 | 12.1 | 13.7 |  |
| EV/EBITDA (adj) (x) | 7.3 | 7.1 | 6.7 | 6.3 | 6.9 |  |
| Equity FCF yield (%) | 2.9 | 3.1 | 4.2 | 2.9 | 3.3 |  |
| P/Sales (x) | 0.3 | 0.3 | 0.2 | 0.2 | 0.3 |  |
| P/BV (x) | 5.5 | 4.4 | 4.0 | 3.2 | 4.3 |  |
| Dividend yield (%) | 1.3 | 1.5 | 1.7 | 1.8 | 1.6 |  |
| Adj debt/EBITDAR (x) | 2.8 | 3.0 | 3.1 | 3.1 | 3.0 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 5.0 | 1.6 | 2.0 | 3.0 | 2.9 |  |
| Square footage growth (%) | 7.3 | 3.0 | 2.0 | 2.0 | 3.6 |  |
| Inventory growth (%) | 8.4 | 4.0 | 4.5 | 3.8 | 5.2 |  |
| Capex/sales (%) | 3.7 | 3.9 | 3.8 | 4.2 | 3.9 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

kroger

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Kroger Co.(KR): Quarterly and Annual EPS (USD)   |  | | --- | | KR | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 33.00 | | Price (19-Sep-2016) | | USD 30.79 | | Potential Upside/Downside | | +7.2% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.63A | N/A | 0.70A | 0.70A | N/A | N/A | 0.75E | 11% | N/A |
| Q2 | 0.44A | N/A | 0.47A | 0.45E | N/A | N/A | 0.49E | 7% | N/A |
| Q3 | 0.44A | N/A | 0.41E | 0.45E | N/A | N/A | 0.50E | -7% | N/A |
| Q4 | 0.57A | N/A | 0.55E | 0.60E | N/A | N/A | 0.66E | -4% | N/A |
| Year | 2.08A | N/A | 2.13E | 2.21E | N/A | 2.32E | 2.40E | 2% | 9% |
| P/E | 14.8 |  | 14.4 |  |  | 13.3 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

High Capex + Persistent Deflation + ROIC Pressure = Equal Weight

Initiate at Equal Weight with a $33 price target given high capex, ROIC trends, and uninspiring free cash flow

Despite the company’s underperformance YTD (down 26% vs the S&P up 5%) and despite the fact that we believe KR is a best-in-class Stable Staple with significant opportunity to create shareholder value longer term, we are initiating with an Equal Weight rating and a $33 price target for the following reasons:

1. Despite an impressive track record on comps (including traffic), KR is not a growth company, and as such, we believe capex – even after the most recent reduction to ~3.9% of food sales, is too high given KR’s lower ROIC versus the Staple universe. We believe 2.5% is more appropriate, and with a higher FCF yield (and a higher ROIC), believe KR’s valuation multiple would expand.
2. Capex is pressuring ROIC and we estimate ROIC will be down in FY16 and FY17 – KR’s ROIC has over a 60% correlation with its stock price.
3. With lower capex, and a higher yield (pre dividend), we believe the incremental cash (~$1 billion) in additional reduction on top of the $500 million that was just announced for redeployment) would be better used to increase the dividend (1.6% yield and 22% payout currently) or greater share buybacks – and believe either would lead to a multiple closer to some of the other names in the staple universe.
4. On the margin, we believe Walmart – a share donor for 12 years – is finally gaining momentum, and given KR’s overlap (Walmart is a major competitor in 45 of its 51 major markets), we believe KR might be negatively impacted irrespective of exceptionally strong execution on the four keys.
5. While it is obvious the environment is tough, we are concerned 3Q16/4Q16 will prove to be much more challenging than feared given that deflation will lap deflation in 3Q16/4Q16 for the first time since March 1960 – and it is likely this phenomenon will create even more irrational behavior.
6. As long as deflation persists (and irrespective of the competitive landscape), comps will likely be pressured – and unfortunately, although tonnage is impressive, investors appear to care more about comps. So in the face of weaker comps, valuation could remain compressed in the near term.

Equal Weight rating based on upside/downside scenario analysis

In the event weak comps persist, capex remains elevated (albeit at recently reduced levels) and ROIC gradually drifts down, we believe the stock will remain range bound. Although we see $30 as the downside, or 6.5x our FY17 EBITDA, we place an 80% probability on the downside scenario persisting for several quarters. If, however, deflation abated and capex were further reduced, this could result in a 9%+ free cash flow yield – and with $1 billion in incremental balance sheet optionality, we see potential upside to $45 – or 8.6x our FY17 EBITDA. We only place a 20% probability on an additional reduction in capex – since capital commitments only have so much flexibility and wiggle room in outer years.

Our upside multiple values KR at a multiple seen more recently, yet not quite at a peak, while our downside multiple is still well above the trough multiple of 4.3x seen in years 2011-2012.

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| --- |
| Figure  KR Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Summary of financials

Below we highlight our estimates vs. consensus.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

Price target and current valuation

Below we highlight our price target and current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  KR Price Target Valuation |  | Figure  KR Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Free cash flow

We expect increasing free cash flow in FY16 and FY17, but a lower yield again in FY18 because we assume capital expenditures once again increase beyond FY17.

|  |  |
| --- | --- |
|  | Figure  KR Free Cash Flow |
|  |  |
| Source: Barclays Research |

Our view in greater detail

Despite KR’s weak year-to-date performance, we are initiating on KR with an Equal Weight rating and $33 price target. Our Equal Weight rating on KR is based on the following:

1. We believe capex is still too high even after the most recent reduction. We compare KR’s capex as a % of sales to a wide range of staple peers.
2. High capex is pressuring ROIC, and KR’s ROIC is below peers. KR’s stock has a 60% correlation with ROIC.
3. A further reduction in capex would result in a much higher free cash flow yield and dividend yield and we believe this would lead to multiple expansion. Furthermore, we do not believe a reduction in capex to 2.5% of food sales would compromise KR’s competitive positioning.
4. For now, WMT is no longer a share donor.
5. Deflation is likely to persist. This will likely impact the competitive landscape and pressure KR’s comps – so even if tonnage remains strong – comps could lag and KR’s stock performance is correlation with comps.
6. With these concerns, KR appears fairly valued. If capex were further reduced, and/or if the stock showed further weakness, we would reconsider our rating.

Stock price performance

The following figures show KR’s absolute and relative YTD stock price performance. The stock is down 26% YTD compared to the S&P 500, which is up 5%.

|  |  |  |
| --- | --- | --- |
| Figure  KR Stock Price |  | Figure  YTD % Change |
|  |  |  |
| Source: Thomson Reuters, Barclays Research |  | Source: Thomson Reuters, Barclays Research |

1. Capex as a percent of food sales is above average and higher than peers

Capex as a percent of food sales is expected to remain high

Capex as a percent of food sales at KR was just over 3% from 2005-2015. This year, we expect capex to be at ~3.9% based on the company’s revised guidance after reporting 2Q16; prior to this, capex at as a percent of food sales was over 4.2% by our estimate. While a step in the right direction, and we applaud the company’s decision to respond to changes in the environment, we believe that the projected level of capital spending is still too high. We believe shareholders would be better served through a further reduction in capex, and an increase in the dividend payout ratio and/or an increase in share repurchases.

|  |  |
| --- | --- |
|  | Figure  KR Capex as a Percent of Food Sales |
|  |  |
| Source: Company reports, Barclays Research |

KR’s capex as a percent of food sales is the highest among peers

Among staple-type companies in our coverage, KR’s capex is by far the highest at nearly 4% of food sales in CY16. Looking at our coverage, this is nearly double the average of 2.0%. Excluding foodservice distributors the average is ~2.5%, still well below KR. Looking more broadly and including Staples, KR’s capex as a percent of sales is about in line with the average Staples companies – however as we discuss later in this report, KR’s lease adjusted ROIC is below average for large market capitalization Staples – so the in line with Staple peer capex is not justified in our view. Please refer to figures 58, 60, and 76 for this analysis.

|  |  |  |
| --- | --- | --- |
| Figure  “Staple-Type” Companies in Our Coverage - Capex as Percent of Food Sales |  | Figure  Broader Staples Universe & KR - Capex as Percent of Sales |
|  |  |  |
| Note: USFD excludes capital leases. COST excludes estimated fuel sales and membership income. WMT includes Walmart US division sales and capex. Source: Thomson Reuters, Barclays Research |  | Source: Thomson Reuters, Barclays Research |

1. Lease adjusted ROIC is below average and will likely remain pressured

KR’s ROIC is below average and the valuation is high after adjusting for its ROIC

At 10.3%, KR’s lease adjusted return on invested capital (ROIC) is below average for staple-type companies in our coverage. Excluding foodservice and other distributors, the company’s ROIC is at the bottom of the list. Valuation has seemingly already reflected the below average ROIC at KR given that its CY17 EV/EBITDA and EV/EBITDAR multiples are also below average or among the lowest of the group if we exclude foodservice and other distributors. While this valuation might appear compelling, after taking a ratio of valuation relative to ROIC ((EV/EBITDAR)/ROIC), KR is no longer as compelling. In fact, it’s near the middle of the entire group or essentially in line with COST if we exclude foodservice and other distributors.

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| --- | --- |
|  | Figure  “Staple-Type” Companies in Our Coverage – ROIC, EV/EBITDA, and EV/EBITDAR/ROIC |
|  |  |
| Note: ROIC is adjusted for operating leases. Excludes goodwill and intangibles for DG and DLTR.  Source: Thomson Reuters, Barclays Research |

As can be seen more clearly below, KR’s lease adjusted ROIC is below average for the group and at the bottom if we only consider retailers.

|  |  |
| --- | --- |
|  | Figure  “Staple-Type” Companies in Our Coverage – ROIC |
|  |  |
| Note: ROIC is adjusted for operating leases. Excludes goodwill and intangibles for DG and DLTR.  Source: Thomson Reuters, Barclays Research |

As can be seen below, KR’s LTM ROIC is below the average staples company as well. Many of these stocks have a higher EV/EBITDA multiple but, as was discussed prior, KR’s business is among the most capital intensive of the businesses we follow – as measured by capex as a percent of sales. Its capital spending is similar to the average staples company.

|  |  |
| --- | --- |
|  | Figure  Broader Staples Universe - ROIC and EV/EBITDA |
|  |  |
| Source: Thomson Reuters, Barclays Research |

KR’s return on invested capital may have peaked at 10% in FY15

Lease adjusted return on invested capital has been volatile at KR, in part due to the profitability of its fuel business. In the recent past, ROIC has peaked at 10.8% and been as low as 8.8%. Looking forward, we expect that ROIC will trend downward in part due to ramping capex as the company increases its square footage growth. Unlike small box retailers, it takes supermarkets a long time to reach maturity and this depresses returns in the short- to medium-term – so in our view, accelerating growth is a questionable use of capital for KR unless capital is used to offensively increase share and ROIC in a particular market.

|  |  |
| --- | --- |
|  | Figure  KR - Lease Adjusted Return on Invested Capital |
|  |  |
| Note: Lease adjusted ROIC calculated as tax-affected operating income + rent divided by lease adjusted invested capital. Lease adjusted invested capital calculated as total assets plus capitalized rent expense (8x) less non-interest bearing current liabilities and cash.  Source: Barclays Research |

KR’s stock price correlates strongly with ROIC

As can be seen in the chart below, KR’s lease adjusted ROIC has a strong correlation to its stock price. The correlation was quite strong up until 2010. The correlation has weakened somewhat since then because comps started to displace ROIC in terms of correlation to stock price – but nevertheless correlation to ROIC remains high. Give this relationship and our forecast for lower comps, ROIC becomes more important as a determinant for stock performance. Given our view that ROIC will decline in FY17, we believe KR’s stock price will have difficulty outperforming over the next year.

|  |  |
| --- | --- |
|  | Figure  KR – Stock Price and Return on Invested Capital (Lease Adjusted) |
|  |  |
| Source: Barclays Research |

1. Free cash flow and dividend yields are low relative to other stocks

KR’s free cash flow yield is below peers

Among staple-type companies in our coverage excluding KR, CY17 free cash flow yields range from 2.2% to 8.5%. This compares to KR’s yield at 4.2% – near the bottom of the range. Meanwhile, KR’s free cash flow yield doesn’t compare favorably to the broader Staples universe either. These companies have free cash flow yields ranging from 3.5% to 9.6%. The median for the Staples universe is 5%, so KR is still at the bottom of the range.

|  |  |  |
| --- | --- | --- |
| Figure  “Staple-Type” Companies in Our Coverage – CY17 Free Cash Flow Yield |  | Figure  Broader Staples Universe & KR - CY17 Free Cash Flow Yield |
|  |  |  |
| Source: Thomson Reuters, Barclays Research |  | Source: Thomson Reuters, Barclays Research |

KR’s forward free cash flow yield has not been this low in many years

KR’s NTM free cash flow yield has ranged from a high of 8.5% in 4Q09 to essentially flat during much of 2007 and 2008 as working capital and capital expenditures consumed nearly all of the company’s operating cash flow. Since 2009, the NTM free cash flow yield has averaged ~4.0%, and the current NTM free cash flow yield is below average. We believe this yield is too low and believe KR’s multiple would expand with a higher yield.

|  |  |
| --- | --- |
|  | Figure  KR NTM Free Cash Flow Yield |
|  |  |
| Source: Barclays Research |

In Figure 66, we have reduced capex to a more reasonable 2.5% of food sales from 2016-2018. We believe this capex spend would provide KR with the ability to gain share in existing markets and continue to increase ROIC. In this scenario, free cash flow yield increases to 9.2% by FY18.

|  |  |
| --- | --- |
|  | Figure  KR Free Cash Flow Yield with Capex at 2.5% of Food Sales |
|  |  |
| Source: Barclays Research |

Dividend yield screens low relative to other companies

KR’s forward dividend yield at 1.5% is slightly above average for staple-type companies in our coverage since many do not pay a dividend although KR’s yield is below average if we include only stocks that pay dividends. Relative to the Staples universe, KR’s dividend is quite low and is well under the 2.0% average for this group.

|  |  |  |
| --- | --- | --- |
| Figure  “Staple-Type” Companies in Our Coverage – Forward Dividend Yield & CY17 EV/EBITDA |  | Figure  Broader Staples Universe – Forward Dividend Yield & CY17 EV/EBITDA |
|  |  |  |
| Source: Thomson Reuters, Barclays Research |  | Source: Thomson Reuters, Barclays Research |

1. “Customer first” strategy has generated impressive results, but Walmart’s gaining momentum may turn into a headwind

Four keys have led to strong ID sales growth

With 51 consecutive quarters of positive ID sales ex-fuel growth, it’s clear that the company’s “customer first” strategy has been successful at driving tonnage growth and improving market share. Many retailers will focus exclusively on only one or two factors that influence customer’s shopping decisions such as shopping experience and price. KR undertakes considerable consumer research to determine how deeply and in which ways to invest in each of its four keys: people, product, shopping experience, and price.

The company previously partnered with dunnhumby USA to better understand the breadth and depth of price investments. The partnership was very successful in helping KR recapture market share from Walmart in our view. KR acquired the balance of the 50-50 partnership with Tesco in 2015. The new entity, known as 84.51, has a perpetual license to use dunnhumby's analytical tools. Dunnhumby will provide service and maintenance on the systems for five years but will no longer have access to Kroger customer data. The new entity now focuses exclusively on working with KR. Also, 84.51 is able to partner with other data intelligence companies, something that was prohibited under the prior agreement with dunnhumby USA/Tesco. In addition, 84.51 can provide services to other retailers and manufacturers for an exclusive fee – the prior arrangement was more prohibitive and all fees were shared under the joint venture agreement. As such, we believe that KR will continue to have among the best technological tools for customer research in the space.

But Stronger Walmart US sales may pressure KR’s comps

Walmart US has had weak comps in recent years for a variety of reasons, including merchandising that had failed to evolve, poor service levels in stores, a value proposition that drifted away from EDLP, and changing consumer behavior. More recently, traffic at Walmart US has improved and the segment is now reporting gains in two-year stacked comps, and comps adjusted for inflation are accelerating. Given the large size of Walmart US and its overlap with KR, a stronger Walmart could lead to ID pressure at KR. We estimate that at a 15-20% strain rate, KR’s comps could be pressured by 20-60 bp if Walmart US were to be comping in the 0.5-1.0% range. Walmart US reported comps ex. fuel of 1.6% in its most recent quarter.

|  |  |
| --- | --- |
|  | Figure  Impact to KR IDs from an Increase/(Decrease) in Walmart US Comps |
|  |  |
| Source: Barclays Research |

5a) Deflation may lead to irrational behavior

The last episode of CPI food at home deflation on top of deflation was February 1959 to March 1960. There have been other sporadic deflationary periods and only two other episodes of note in which deflation occurred for a period of 3 to 9 months. Currently, the industry has experienced CPI food at home deflation for 9 months and this is expected to continue. Of course, the CPI food deflation is an average over a basket of goods and some individual commodities have already been cycling deflation.

To explain in detail: at the onset, deflation can actually be good because initially:

1. deflation drives tonnage (elasticity of demand with lower prices),
2. costs decline faster than retail prices,
3. this leads to gross margin expansion,
4. and gross profit dollar growth.

So initially operators behave rationally because any deflation pressures on the top line are generally offset by tonnage growth, and while fixed cost leverage may be flattish, gross margin expansion and gross profit dollar growth offset the muted fixed cost leverage. As a result, short term deflation, is in not in fact, negative.

When deflation persists and laps year-over-year however, the dynamics change:

1. consumption (tonnage) no longer increases (elasticity of demand),
2. gross margins no longer expand,
3. gross profit dollars no longer increase (with no increase in consumption), and
4. operators conclude they are losing market share and respond with excessive promotions to drive traffic.

At this stage – excessive promotions are useless because consumption won’t increase – it becomes a zero-sum game.

More sophisticated operators generally realize that sales dollars are contracting due to the deflation and realize they aren’t “losing” share, but many conventional operators panic when top line, traffic and profit decline, and these operators will act irrationally to preserve share. This is the environment KR (and others) are operating in today.

|  |  |
| --- | --- |
|  | Figure  CPI Food at Home Y/Y Inflation/Deflation |
|  |  |
| Source: BLS |

The next figure shows inflation trends by major category starting in July 2015.

|  |
| --- |
| Figure  CPI Inflation Data by Category |
|  |
| Source: BLS |

The following figure compares deflationary periods since 1959. The current deflationary period is set to be the longest since 1960.

|  |
| --- |
| Figure  Comparison of Deflationary Periods in Last 60 Years |
|  |
| Source: BLS and Barclays Research |

KR has indicated that it was generally not seeing irrational behavior in its markets, unlike some other operators, but it did lower its FY16 guidance for IDs ex. fuel and EPS when it reported 2Q16 results. The company also maintained its 8%-11% diluted EPS growth guidance (plus a growing dividend) over the longer term – however – it is unclear whether or not this growth rate will be specifically maintained for FY17. It also now expects its non-fuel FIFO operating margin will contract for the year compared to its prior guidance for it to be slightly higher. We believe this is due to a combination of KR investing in price as well as it adding service to stores given the growing tonnage at its fresh departments. While KR may not be seeing irrational behaviour currently, we view this as a risk.

5b) Deflation will pressure IDs despite tonnage growth, which may in turn hurt KR’s stock price

Tonnage has remained solid at KR

Tonnage as measured by IDs ex. fuel less inflation/(deflation) has been robust at KR. As can be seen in the chart below, tonnage has averaged over 6% on a two-year stacked basis for the past seven quarters, and has accelerated over the most recent two – while tonnage and share gains are critical for longer term survival – the tonnage gains near term are resulting in incremental labor costs in the near to intermediate term.

|  |  |
| --- | --- |
|  | Figure  KR Tonnage (IDs ex. Fuel less inflation/(deflation)) |
|  |  |
| Note: Tonnage is equal to IDs ex. fuel less inflation. Source: Barclays Research |

Deflation is expected to be headwind to comps; pressure may not abate until 2017

When KR reported its 2Q16 results it lowered its FY16 guidance range for ID sales ex-fuel to 0.5-1.5% from 2.5-3.5%, driven by significant deflation in milk, eggs, and cheese. Producer price forecasts for various proteins, eggs, and dairy by the USDA show little relief is expected next year; in fact beef and egg prices are expected to decline again with only slim inflation from other categories.

|  |  |
| --- | --- |
|  | Figure  Forecast Protein and Dairy Producer Price Y/Y Percent Change |
|  |  |
| Source: USDA Economic Research Service, Barclays Research |

Moderate correlation between IDs (ex-fuel) and KR’s stock price

As can be seen below, KR’s stock price has a moderate correlation with its ID sales ex-fuel. Therefore, we believe the trajectory of ID’s will likely influence the direction of the stock price. Tonnage may remain strong but valuation could remain compressed in the near term given the impact of deflation comps.

|  |  |
| --- | --- |
|  | Figure  KR ID Sales (ex-fuel) and Stock Price |
|  |  |
| Source: Barclays Research |

6) Various metrics suggest KR’s stock is fully valued

As can be seen in the chart below, KR trades at a considerable discount to large market capitalization staples stocks as well as “staple-type” companies in our coverage. At 6.6x CY17 EV/EBITDA, KR trades at a 50.5% discount to the large cap average Staples and a 29.6% discount to “staple-type” companies in our coverage however, we believe KR is fairly valued because KR has nearly a 21.0% lower free cash flow yield and a 38.7% lower dividend yield than other Staple names. KR also has a considerably lower free cash flow and dividend yield than “staple-type” companies in our coverage. Meanwhile, KR’s lease adjusted ROIC is below both Staples and “staple-type” companies in our coverage at 10.1% vs. slightly above 14% for the other groups. Also, its 2015-2018 growth CAGR for sales, EBITDA, and EPS is also below both groups. Given the disparity in valuation, ROIC, and growth, we do not believe shares of KR are compelling at these levels.

|  |
| --- |
| Figure  Comp Table – KR vs. Staples and “Staple-Type” Companies in Our Coverage |
|  |
| Source: Barclays Research estimates |

Valuation and Conclusion

Given the above considerations, we initiate with an Equal Weight rating and a $33 price target based on our upside/downside scenario analysis. In the event weak comps persist, capex remains elevated (albeit at recently reduced levels) and ROIC gradually drifts down, we believe the stock will remain range bound. Although we see $30 as the downside, or 6.5x our FY17 EBITDA of $6.2 billion, we place an 80% probability on the downside scenario persisting for several quarters. If, however, deflation abated and capex were further reduced, this could result in a 9%+ free cash flow yield – and with $1 billion in incremental balance sheet optionality, we see potential upside to $45 – or 8.6x our FY17 EBITDA. We only place a 20% probability on an additional reduction in capex – since capital commitments only have so much flexibility and wiggle room in outer years. Our upside multiple values KR at a multiple seen more recently, yet not quite at a peak, while our downside multiple is still well above trough multiple of 4.3x seen in years 2011-2012

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Wal-Mart Stores (WMT)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=WMT) | | | | | | | Stock Rating: OVERWEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2016A | 2017E | 2018E | 2019E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 72.09 | | Price Target | USD 87.00 | | **Why Overweight?** WMT at a meaningful discount to the "Stable Staples" given that WMT is still early stage in its turnaround - despite many of the same metrics including: 1) comps and traffic, 2) an eventual return to EBITDA growth and core (ex buyback) EPS growth, 4) ROIC, 5) dividend yield, 6) free cash flow yield, and 7) leverage. | | |  | | | Upside case | USD 95.00 | | Reflects: 1) A continuation of recent comp and traffic trends in the US Walmart division, 2) Improving ROIC, 3) embracing the metrics of a Stable Staple - free cash flow yield, dividend yield, balance sheet optionality - ultimately resulting in a multiple in line with Staple peers. | | |  | | | Downside case | USD 68.00 | | Reflects: 1) A reversal of current top line trends, 2) A reversal of improved customer feedback trends, 3) deteriorating ROIC, 4) increasing capex, and 5) yet another decision to explore an alternate format. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 482,130 | 485,989 | 495,139 | 506,333 | 1.6% |  |
| EBITDA (adj) | 33,559 | 32,849 | 33,288 | 34,196 | 0.6% |  |
| EBIT (adj) | 24,105 | 22,699 | 22,891 | 23,563 | -0.8% |  |
| Pre-tax income (adj) | 21,638 | 20,442 | 20,631 | 21,303 | -0.5% |  |
| Net income (adj) | 14,694 | 13,469 | 13,525 | 13,983 | -1.6% |  |
| EPS (adj) ($) | 4.57 | 4.33 | 4.50 | 4.76 | 1.4% |  |
| Diluted shares (mn) | 3,217.0 | 3,107.6 | 3,002.4 | 2,934.5 | -3.0% |  |
| DPS ($) | N/A | 2.00 | 2.04 | 2.08 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 7.0 | 6.8 | 6.7 | 6.8 | 6.8 |  |
| EBIT (adj) margin (%) | 5.0 | 4.7 | 4.6 | 4.7 | 4.7 |  |
| Pre-tax (adj) margin (%) | N/A | N/A | N/A | N/A | N/A |  |
| Net (adj) margin (%) | 3.0 | 2.8 | 2.7 | 2.8 | 2.8 |  |
| ROIC (%) | 11.7 | 11.4 | 11.7 | 12.0 | 11.7 |  |
| ROE (%) | 17.3 | 16.6 | 17.3 | 17.8 | 17.3 |  |
| ROA (lease adjusted) (%) | 8.1 | 7.9 | 8.0 | 8.1 | 8.1 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 110,171 | 109,822 | 110,324 | 110,591 | 0.1% |  |
| Intangible fixed assets | N/A | N/A | N/A | N/A | N/A |  |
| Cash and equivalents | 8,705 | 5,250 | 5,080 | 8,323 | -1.5% |  |
| Total assets | 199,581 | 194,288 | 195,308 | 200,513 | 0.2% |  |
| Short and long-term debt | 47,289 | 45,226 | 45,226 | 45,226 | -1.5% |  |
| Total liabilities | 115,970 | 115,571 | 117,991 | 120,617 | 1.3% |  |
| Net debt/(funds) | 38,584 | 39,976 | 40,146 | 36,903 | -1.5% |  |
| Shareholders' equity | 83,611 | 78,717 | 77,316 | 79,896 | -1.5% |  |
| Change in working capital | 2,117 | 3,548 | 2,314 | 1,642 | -8.1% |  |
| Cash flow from operations | 27,389 | 26,183 | 25,655 | 25,547 | -2.3% |  |
| Capital expenditure | -10,842 | -10,819 | -10,900 | -10,900 | N/A |  |
| Free cash flow | 16,257 | 17,327 | 16,326 | 16,358 | 0.2% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 15.8 | 16.6 | 16.0 | 15.1 | 15.9 |  |
| EV/EBITDA (adj) (x) | 7.8 | 8.1 | 8.0 | 7.7 | 7.9 |  |
| Equity FCF yield (%) | 7.0 | 7.7 | 7.5 | 7.7 | 7.5 |  |
| P/Sales (x) | 0.5 | 0.5 | 0.5 | 0.4 | 0.5 |  |
| P/BV (x) | 2.8 | 2.8 | 2.8 | 2.6 | 2.8 |  |
| Dividend yield (%) | N/A | 2.8 | 2.8 | 2.9 | 2.8 |  |
| Adj debt/EBITDAR (x) | N/A | N/A | N/A | N/A | N/A |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | 1.4 | 1.6 | 1.2 | 1.1 | 1.3 |  |
| Inventory growth (%) | -1.5 | -4.0 | 0.0 | 2.0 | -0.9 |  |
| Capex/sales (%) | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

Walmart

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Wal-Mart Stores(WMT): Quarterly and Annual EPS (USD)   |  | | --- | | WMT | | Stock Rating | | OVERWEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 87.00 | | Price (19-Sep-2016) | | USD 72.09 | | Potential Upside/Downside | | +20.7% | | | | | | | | | | |
|  | 2016 | 2017 | | | 2018 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2017 | 2018 |
| Q1 | 1.03A | 0.98A | 0.98A | 0.98A | 1.09E | N/A | 0.99E | -5% | N/A |
| Q2 | 1.08A | 1.07A | 1.07A | 1.07A | 1.11E | N/A | 1.10E | -0.93% | N/A |
| Q3 | 1.03A | 1.00E | 0.97E | 0.97E | 1.04E | N/A | 0.99E | -6% | N/A |
| Q4 | 1.43A | 1.31E | 1.32E | 1.33E | 1.35E | N/A | 1.39E | -8% | N/A |
| Year | 4.57A | 4.35E | 4.33E | 4.34E | 4.60E | 4.50E | 4.50E | -5% | 4% |
| P/E | 15.8 |  | 16.6 |  |  | 16.0 |  |  |  |
| Source: Barclays Research.Thomson | | | | | | | | | |

Regaining Momentum – Top Pick, $87 Price Target

Turnaround not priced into stock; assuming coverage and upgrading to Overweight with an $87 price target. Walmart is our Top Pick.

As background, Walmart was once the most revered and feared retailer in the U.S., with such meaningful price gaps in conventional food – the company single-handedly caused consolidation in the space during the better part of a decade (1999-2009). In the last six years, however, as weaker players exited, the stronger players persevered: these retailers succeeded by gradually and deliberately narrowing the price gap on food – and with more convenient locations, higher quality product offerings, superior data analytics and loyalty programs and better service levels – the tide turned.

This created an identity crisis for Walmart because not only are locations inconvenient, but the narrower price gaps and inferior quality failed to justify the shop – and share loses began. Said differently: Walmart offered none of the three fundamental pillars of retailing: not convenience, not price, and not merchandising.

Today, however, we believe the tide is turning. Investments in labor appear to be resonating with the employees and therefore the customers, the quality of the product offering is improving, and service and execution has improved. Based on recent results, it also appears the customers agree – they are voting with their footsteps – and U.S. comps have turned positive (including positive traffic) despite never before seen deflation trends – and unfortunately deflation, combined with Walmart’s renewed strength, is only exacerbating the pain felt broadly across most of food retail.

Overweight rating based on upside/downside scenario analysis

We believe the momentum is here to stay, and given that Walmart exhibits all of the traits of a Stable Staple (positive traffic, 2.8% dividend yield, 7.5% FCF yield, respectable lease-adjusted ROIC, positive traffic), yet is trading at a significant discount, we are assuming coverage with an Overweight rating and an $87 price target (32% upside). Our price target values Walmart at 7.8x our FY18 EBITDA (CY17) – hardly a heroic multiple for a Staple retailer in the early stages of a turnaround. In our view – if trends were to reverse – we see downside to $68 (6%) – or 6.3x our CY17 EBITDA – and we place a 30% probability on a scenario where its momentum stumbles. If momentum continues, we see upside to $95 – or 8.5x our CY17 EBITDA – with a 70% probability. The weighted average gets us to our $87 price target.

|  |
| --- |
| Figure  WMT Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  WMT Price Target Valuation |  | Figure  WMT Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  WMT Free Cash Flow |
|  |  |
| Source: Barclays Research |

Our view in greater detail

Our Overweight rating on WMT is based on the following:

1. In our view, WMT is in the early stage of a turnaround, and given the company’s metrics on free cash flow yield, dividend yield and ROIC, we believe WMT should trade more in line with the universe of Stable Staples. The stock is trading at a meaningful discount to the Staples universe, and is clearly not being valued as a turnaround.
2. Walmart was once a juggernaut – and feared by most. From 2002-2009, square footage growth, comp growth, and EPS growth averaged 14.6%, 3.4%, and 12.9% respectively. As a result, independents lost meaningful share, and margins declined industry wide, and conventional retailers struggled.
3. The juggernaut lost its way, however. As square footage and comp growth slowed, the company started focusing on operating profit growth – and this resulted in deteriorating service levels. At this stage in WMT’s life, the company started to lose its way – and it did not resonate with the customer on price, convenience or merchandising. In this same phase, independents stabilized, and conventionals recovered.
4. We believe WMT’s recent initiatives are driving a turnaround and believe once momentum gains steam – retailers of WMT’s size and scale rarely lose the momentum. A better assortment, improved service, labor investments and price are contributing to recent success. We believe the momentum is here to stay.
5. Given all of the above, we believe WMT’s discount to the Staples universe is unwarranted. As a result, WMT is our Top Pick and we value the stock at $87. Our price target still values WMT at a meaningful discount to the staple universe – justified for now given the fact that the company has been struggling for years to recapture share and recent gains do not yet necessarily give investors confidence the trend is permanent. Once investors gain greater conviction, we see further upside to the stock.
6. WMT’s stock doesn’t trade at a Staples or a turnaround multiple

As can be seen in the chart below, WMT trades at a considerable discount to large market capitalization staples stocks as well as “staple-type” companies in our coverage. At 7.5x CY17 EV/EBITDA, WMT trades at over a 43.3% discount to the large cap average Staples and also a considerable discount to “staple-type” companies in our coverage. WMT has a 43.4% higher free cash flow yield than Staples and a 15% higher dividend yield than this group. WMT also has a higher free cash flow and dividend yield than “staple-type” companies in our coverage. We believe this discount is too wide considering the company is in the midst of a turnaround that appears to be gaining momentum.

|  |
| --- |
| Figure  Comp Table - WMT vs. Staples and “Staple-Type” Companies in Our Coverage |
|  |
| Source: Barclays Research estimates |

Free cash flow yield above 10-year average

At 7.0%, WMT’s NTM free cash flow yield is slightly above its 10-year average.

|  |  |
| --- | --- |
|  | Figure  WMT NTM Free Cash Flow Yield |
|  |  |
| Note: Calendar quarters  Source: Company Reports and Barclays Research |

Dividend yield continues to increase

The dividend yield at WMT has steadily risen over time. The yield is now ~2.8% compared to the 10-year average of 2.3%.

|  |  |
| --- | --- |
|  | Figure  WMT Dividend Yield |
|  |  |
| Note: Annualized most recent payment. Source: Company Reports and Barclays Research |

ROIC has been trending lower but we expect improvements in CY17 and CY18

The lease adjusted ROIC had been stable for many years between 13-14% but began to deteriorate in CY12; ROIC has deteriorated by ~280 bp since that time. We forecast that ROIC will trough in CY16 and will then show moderate improvements in CY17 and CY18.

|  |  |
| --- | --- |
|  | Figure  WMT Lease Adjusted ROIC History |
|  |  |
| Note: Calendar quarters  Source: Company Reports and Barclays Research |

ROIC correlation moderate in recent years

As WMT has matured and growth has slowed, its stock has shown an increasing degree of correlation with its lease adjusted ROIC. Given our outlook for improving ROIC over the next two years, this should be a tailwind for the stock.

|  |  |
| --- | --- |
|  | Figure  WMT Stock Price and Lease Adjusted ROIC Correlation |
|  |  |
| Note: Calendar quarters  Source: Company Reports and Barclays Research |

2) The retail juggernaut feared by most

Walmart’s supercenter format was a growth engine for many years

From 1999 to 2009, the number of Walmart supercenters opened at a 14.3% CAGR while the company closed or converted its discount stores at a 7.7% CAGR. Over this 10-year period, the number of supercenters grew by over 2,000 stores to 2,755 from 721 while the number of discount stores declined by slightly less that 1,000 going from 1,801 to 810.

|  |  |  |
| --- | --- | --- |
| Figure  Walmart US Discount Stores |  | Figure  Walmart US Supercenters |
|  |  |  |
| Note: Calendar year end Source: Company Reports and Barclays Research |  | Note: Calendar year end Source: Company Reports and Barclays Research |

Walmart discount store and supercenter units increased by 40% over this time frame, but total Walmart US square footage doubled given a supercenter is a much larger store.

|  |  |
| --- | --- |
|  | Figure  Walmart US Square Footage and Square Footage Growth |
|  |  |
| Note: Calendar year end.  Source: Company Reports and Barclays Research |

Comps eventually slowed at WMT as it cannibalized itself yet gained dominance

Comps for Walmart’s domestic operations were at 8% in 1999 but comps slowed as it quickly built out supercenters across the US.

|  |  |
| --- | --- |
|  | Figure  Walmart US Comps (Ex. Fuel) |
|  |  |
| Note: Calendar year end. Walmart US comps from 2001-2009. Domestic comps for 1999 and 2000. Source: Company Reports and Barclays Research |

Independents lost significant share during Walmart’s rapid growth

At the start of 1999, independent supermarkets were 20% of industry revenues. In nearly each subsequent year, independents lost ground to Walmart as they were no match for the retailer’s scale in advertising and procurement. Independents also lost share of voice and they could not match Walmart’s everyday low prices. Many independent operators went out of business or sold to larger companies. By 2009, independents were only 5% of industry revenues, a 15 percentage point drop in only 10 years.

|  |  |
| --- | --- |
|  | Figure  Independent Supermarket Share of Industry Revenues |
|  |  |
| Note: Defined as operators with 10 or fewer stores.  Source: Progressive Grocer and Barclays Research |

Even large chains had difficulty competing with Walmart during this timeframe

Using KR as a proxy for large chain supermarkets at the time, the chart below shows that even sophisticated operators had difficulty competing with Walmart. From 2001-2004 KR had essentially flat comps as it lost share to Walmart, and it was only through deep price investments that it was able to drive better IDs ex. fuel from 2005-2009. In fact, it took KR 14 consecutive quarters of price investments to finally see some recovery in comps.

|  |  |
| --- | --- |
|  | Figure  KR ID Sales Ex. Fuel vs. WMT US Comps Ex. Fuel |
|  |  |
| Source: Company Reports and Barclays Research |

The comp recovery came at a price however. Over this time period, KR’s non-fuel FIFO gross margin fell ~275 bp, a substantial fall for an industry with low operating margins.

|  |  |
| --- | --- |
|  | Figure  KR Merchandise Margin (Ex. Fuel) |
|  |  |
| Note: 2001 includes the impact of fuel. Source: Company Reports and Barclays Research |

In this same period, acquisitions made in the late 1990s at peak multiples were underperforming, and as the tables below highlight, asset and goodwill impairments as well as store closure/exit charges at both KR and Safeway were prevalent.

|  |  |  |
| --- | --- | --- |
| Figure  Kroger Impairments and Other Charges ($ in millions) |  | Figure  Safeway Impairments and Other Charges ($ in millions) |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

3) Eventually, the juggernaut that lost its way

Supercenter growth has slowed since 2010

After many years of rapid supercenter openings, unit growth began to slow as the concept reached saturation.

|  |  |
| --- | --- |
|  | Figure  WMT Supercenters |
|  |  |
| Note: Calendar year end Source: Company Reports and Barclays Research |

Service levels reduced overtime

During its rapid unit growth phase and after, Walmart continued to strive for maximizing efficiency through improving labor utilization. As can be seen below, we estimate that the number of employees per 1,000 square feet steadily came down over time and likely bottomed between 2012 and 2014. Given management’s comments and actions in recent years, it seems the company went too far in reducing labor at its stores. This was likely due, in part, to a greater focus on profits at the expense of sales. Some of this may have also been driven by the store manager bonus structure; there was an incentive to preserve profits if sales weakened – the latter is generally out of the control of store managers over short periods of time. With fewer employees to stock shelves, get customers through checkout, and handle other tasks, the shopping experience deteriorated.

|  |  |  |
| --- | --- | --- |
| Figure  Number of Walmart US Employees Per 1,000 Square Feet |  | Figure  Number of Walmart US Employees per Store (All Formats) |
|  |  |  |
| Note: Assumes 1.25 employees per 1,000 sq. ft. at Sam’s Club Source: Company Reports and Barclays Research estimates |  | Source: Company Reports and Barclays Research estimates |

Independents from 2009-2015

As Walmart struggled, independents stabilized. After many years of nearly continuous declines, independents’ share of supermarket industry revenues increased (albeit modestly) from 2009-2011, going from 5.2% to 5.7%. Share has moderated some in recent years but has remained steady at 5.6%.

|  |  |
| --- | --- |
|  | Figure  Independent Supermarket Share of Industry Revenues |
|  |  |
| Note: Defined as operators with 10 or fewer stores.  Source: Progressive Grocer and Barclays Research |

KR’s IDs ex. fuel were strong from 2010-2015 while Walmart’s stagnated

Again using KR as a proxy for a large chain supermarket, its IDs ex. fuel remained strong from 2010-2015 at over a 4% average while Walmart’s US comps ex. fuel were essentially flat (and turned negative in 2014), though Kroger was also likely gaining share from other, weaker conventional operators. We believe this was due to KR and others narrowing their price gap on food, serving higher quality products, targeting customers with superior analytics and loyalty programs, and/or better service levels.

|  |  |
| --- | --- |
|  | Figure  KR ID Sales Ex. Fuel vs. WMT US Comps Ex. Fuel |
|  |  |
| Source: Company Reports and Barclays Research |

KR’s merchandise margin declined from 2009-2015 but its operating margin grew

KR’s merchandise margin declined during the 2009-2015 time period but the company was able to drive IDs and tonnage growth, which allowed it to leverage its fixed costs, and FIFO operating profit ex-fuel expanded by ~30 bp.

|  |  |  |
| --- | --- | --- |
| Figure  KR Merchandise Margin (Ex. Fuel) |  | Figure  KR FIFO Operating Margin (Ex. Fuel) – Barclays Estimate |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

4) Walmart’s recent initiatives are driving a turnaround

In response to its tepid comp sales ex. fuel, WMT has made a number of significant changes to management and the operations at Walmart US. Greg Foran replaced Bill Simon as CEO of Walmart US in July 2014. Key opportunities identified for improvement included assortment, fresh, service, labor, in stocks, inventory, a better integration between digital and physical, and price.

* **Assortment.** New disciplines have been put in place to use data more effectively. This includes decision trees, clustering analytics, and substitutability. Store managers have gained control over certain merchandise space for localization as well as the ability to markdown products.
* **Fresh.** The company made a commitment to improve its quality and have more local products, while also focusing on operational excellence and associate accountability. This involved a reassessment of its assortment, execution, processes, and supply chain. The company has also expanded its offering of organic products.
* **Service.** Stores have goals for achieving certain milestones for being “clean, fast, and friendly.” Store with higher “clean, fast, and friendly” scores tend to have stronger comps and the trend in the company’s net promoter score has been positive. The company also invested in wage rates and associate training, leading to more engaged and effective employees. Also, there has been a lot of work on labor scheduling to give employees more advanced notice and consistency of work hours.
* **Labor.** In April 2015, Walmart announced the first of two wage increases – the second wage increase will lap in the spring of 2017. The company also introduced 8,000 additional department manager positions to help drive the customer experience. In addition, the company also introduced a customer satisfaction component to store manager compensation (in addition to sales and operating profit), and all hourly employees at Walmart have been offered a quarterly bonus opportunity up to $550 (so $2,200 annually) based on sales, profit and customer experience. These wage increases have pressured operating expenses but have also led to improved employee morale and share gains in our view.
* **In stocks.** Hours were repurposed to commit more time to stocking products. Unnecessary item counts were removed and a simplified process for getting merchandise on the shelf was instituted, using best practices from around the world.
* **Inventory.** Initiatives included reengineering its inventory flow to take product out of back rooms (the “Top Stock” initiative) because too much product in back rooms led to undue shrink as well as out of stocks. While the latter is seemingly a paradox, with too much inventory it became hard for associates to find some products. In some cases, product intended to be on promotion was staged in the back rooms and this created clutter. Inventories are now lower as the company cleaned out its backrooms.
* **Digital/physical.** Grocery pick-up (“click and collect”) continues to expand, and as of F2Q17 was in 60 markets and nearly 400 stores.
* **Price.** Walmart acknowledges that it lost its ability to react quickly and it strayed from everyday low prices. The company wanted to clean up and improve its store operations (“fast, friendly, and clean”) before it began its price investment program. Walmart began investing in price in late in 2015 with a plan to invest several billion dollars over the next several years.

Traffic improving at Walmart US

The various changes at Walmart US have resulted in a noticeable improvement in traffic. Traffic turned positive during F4Q15 and the business has had positive two-year stacked comp traffic for three quarters. Looked at another way, Walmart US comps adjusted for deflation have also stabilized and accelerated in the most recent quarter.

|  |  |  |
| --- | --- | --- |
| Figure  Walmart US Traffic |  | Figure  Walmart US Total Adjusted Comp |
|  |  |  |
| Source: Company Reports and Barclays Research estimates |  | Source: Company Reports and Barclays Research estimates |

Walmart US comps ex. fuel have been accelerating on a stacked basis

As can be seen below, Walmart US comps have averaged just over 1.0% since F3Q15 and have been accelerating on a two-year stacked basis. The results are particularly impressive in light of the fact that food deflation has been a headwind over this period.

|  |  |  |
| --- | --- | --- |
| Figure  Walmart US Comps Ex. Fuel |  | Figure  Walmart US Comps Ex. Fuel – Two-Year Stack |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

1. WMT’s stock doesn’t trade at a Staples or a turnaround multiple

At 7.5x CY17 EV/EBITDA, WMT trades at over a 40% discount to the large cap average Staples and also a considerable discount to “staple-type” companies in our coverage. WMT has over a 40% higher free cash flow yield than Staples and a 15% higher dividend yield than this group. WMT also has a higher free cash flow and dividend yield than “staple-type” companies in our coverage. We believe this discount is too wide considering the company is in the midst of a turnaround that appears to be gaining momentum.

|  |
| --- |
| Figure  Comp Table - WMT vs. Staples and “Staple-Type” Companies in Our Coverage |
|  |
| Source: Barclays Research estimates |

Valuation and Conclusion

Given our view that Walmart is well positioned to be a meaningful disruptor once again, we are initiating with an Overweight rating and $87 price target based on our upside/downside scenario analysis. Our rating is based on our belief that momentum is here to stay, and our belief that Walmart is undervalued given that the company exhibits all of the traits of a Stable Staple (positive traffic, 2.8% dividend yield, 7.5% FCF yield, respectable lease-adjusted ROIC, positive traffic). Our price target values Walmart at 7.8x our FY18 EBITDA (CY17) – hardly a heroic multiple for a Staple retailer in the early stages of a turnaround. In our view – if trends were to reverse – we see downside to $68 (6%) – or 6.3x our CY17 EBITDA – and we place a 30% probability on a scenario where its momentum stumbles. If momentum continues, we see upside to $95 – or 8.5x our CY17 EBITDA – with a 70% probability. The weighted average gets us to our $87 price target.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Whole Foods Market Inc (WFM)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=WFM) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 28.58 | | Price Target | USD 30.00 | | **Why Equal Weight?** Our price target reflects: 1) our weighted average analysis, 2) our view that fundamentals likely haven't improved, 3) our below consensus est., and 4) our belief that WFM's strategy should shift focus to stabilizing the business, generating cash and becoming more of a "Staple" - but the current strategy focuses on a return to growth. | | |  | | | Upside case | USD 42.00 | | Reflects: 1) Slow unit growth well below <6% and use excess FCF to re-accelerate a remodel program, 2) Buy back stock, permanently increase the dividend, or issue a one-time dividend, 3) Focus on prepared foods as the growth vehicle, which is easier to execute with higher ROIC. | | |  | | | Downside case | USD 27.00 | | Reflects: 1) An EV/EBITDA valuation multiple below the trough multiple seen in FY09, 2) Staying the course: 6%+ unit growth, a continued focus on 365, slow, steady and unnoticeable price reductions, and 3) The likely scenario that FY17 Consensus is too high. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 15,388 | 15,738 | 16,208 | 16,927 | 3.2% |  |
| EBITDA (adj) | 1,381 | 1,337 | 1,301 | 1,335 | -1.1% |  |
| EBIT (adj) | 942 | 842 | 773 | 777 | -6.2% |  |
| Pre-tax income (adj) | 958 | 807 | 716 | 742 | -8.2% |  |
| Net income (adj) | 586 | 497 | 437 | 453 | -8.3% |  |
| EPS (adj) ($) | 1.63 | 1.52 | 1.39 | 1.46 | -3.5% |  |
| Diluted shares (mn) | 360.7 | 326.6 | 313.5 | 310.1 | -4.9% |  |
| DPS ($) | 0.52 | 0.54 | 0.57 | 0.60 | 4.6% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 9.0 | 8.5 | 8.0 | 7.9 | 8.3 |  |
| EBIT (adj) margin (%) | 6.1 | 5.4 | 4.8 | 4.6 | 5.2 |  |
| Pre-tax (adj) margin (%) | 6.2 | 5.1 | 4.4 | 4.4 | 5.0 |  |
| Net (adj) margin (%) | 3.8 | 3.2 | 2.7 | 2.7 | 3.1 |  |
| ROIC (%) | 11.9 | 10.7 | 10.0 | 9.7 | 10.6 |  |
| ROE (%) | 15.5 | 14.5 | 14.0 | 13.8 | 14.4 |  |
| ROA (lease adjusted) (%) | 9.3 | 8.4 | 7.8 | 7.7 | 8.3 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 3,163 | 3,408 | 3,622 | 3,850 | 6.8% |  |
| Intangible fixed assets | 789 | 742 | 736 | 729 | -2.6% |  |
| Cash and equivalents | 237 | 594 | 465 | 503 | 28.5% |  |
| Total assets | 5,741 | 6,129 | 6,232 | 6,527 | 4.4% |  |
| Short and long-term debt | 65 | 1,052 | 1,052 | 1,052 | 152.9% |  |
| Total liabilities | 1,972 | 3,038 | 3,081 | 3,108 | 16.4% |  |
| Net debt/(funds) | -517 | 305 | 378 | 277 | N/A |  |
| Shareholders' equity | 3,769 | 3,091 | 3,150 | 3,419 | -3.2% |  |
| Change in working capital | 34 | 101 | 27 | 2 | -61.5% |  |
| Cash flow from operations | 1,129 | 1,277 | 1,001 | 1,043 | -2.6% |  |
| Capital expenditure | -855 | -733 | -752 | -821 | N/A |  |
| Free cash flow | 269 | 353 | 305 | 285 | 1.8% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 17.6 | 18.8 | 20.5 | 19.6 | 19.1 |  |
| EV/EBITDA (adj) (x) | 6.3 | 7.0 | 7.2 | 7.0 | 6.9 |  |
| Equity FCF yield (%) | 2.6 | 3.8 | 3.4 | 3.2 | 3.3 |  |
| P/Sales (x) | 0.6 | 0.6 | 0.6 | 0.5 | 0.6 |  |
| P/BV (x) | 2.7 | 3.0 | 2.9 | 2.6 | 2.8 |  |
| Dividend yield (%) | 1.8 | 1.9 | 2.0 | 2.1 | 1.9 |  |
| Adj debt/EBITDAR (x) | 1.7 | 2.3 | 2.5 | 2.5 | 2.2 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 2.5 | -2.3 | -0.7 | 1.0 | 0.1 |  |
| Square footage growth (%) | 9.6 | 6.8 | 5.9 | 6.2 | 7.2 |  |
| Inventory growth (%) | 13.4 | 2.0 | 1.5 | 2.2 | 4.8 |  |
| Capex/sales (%) | 5.5 | 4.7 | 4.6 | 4.8 | 4.9 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Sep | | | | | | | |

Whole foods

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Whole Foods Market Inc(WFM): Quarterly and Annual EPS (USD)   |  | | --- | | WFM | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 30.00 | | Price (19-Sep-2016) | | USD 28.58 | | Potential Upside/Downside | | +5.0% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Sep | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.46A | N/A | 0.46A | 0.46A | N/A | N/A | 0.44E | 0% | N/A |
| Q2 | 0.43A | N/A | 0.44A | 0.44A | N/A | N/A | 0.44E | 2% | N/A |
| Q3 | 0.44A | N/A | 0.37A | 0.37A | N/A | N/A | 0.39E | -16% | N/A |
| Q4 | 0.30A | N/A | 0.24E | 0.24E | N/A | N/A | 0.26E | -20% | N/A |
| Year | 1.63A | N/A | 1.52E | 1.51E | N/A | 1.39E | 1.51E | -7% | -9% |
| P/E | 17.6 |  | 18.8 |  |  | 20.5 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Growing Up Is Hard to Do – But Embrace Your Age and Age Gracefully

Meaningful opportunities to create value, downside is limited, but so is upside with the current strategy; initiate at Equal Weight with a $30 price target

Despite weak year to date performance (down -14.7% vs. the S&P 500 +4.7%), we are initiating coverage with an Equal Weight rating and $30 price target. Our price target values WFM on a CY17 EV/EBITDA of 7.3x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $27, or 6.5x CY17 EV/EBITDA (~75% probability), while our upside scenario is $42, or 10x CY17 EV/EBITDA (~25% probability). We place a much greater weight on the downside scenario because we are not convinced the existing strategy will solidify WFM’s positioning strategically in the longer term.

Our view: Whole Foods was once a best-in-class Growth Star operating a highly differentiated and rarely replicated format. Unfortunately, the unparalleled success did not go unnoticed, and, as a result, today, many lower priced competitors have meaningfully narrowed the gap on quality and experience, and this heightened competition is pressuring results. As a result, WFM is, in our view, In Transition.

In some respects, WFM is in no-man’s land. We believe WFM aspires to re-accelerate growth and recapture its Growth Star status. However, recent unstable results are concerning (in FY3Q16, comps were -2.6% and EPS was -15.5% y/y), and our FY17 and FY18 estimates are well below consensus. In FY17, we estimate EBITDA will decline 2.7%, and in FY18, we optimistically assume EBITDA will be up slightly y/y, but is more or less flat vs. FY16.

In our view, transitioning to become a Stable Staple would be less risky and would create more shareholder value.

In our view, to accomplish this transition, we believe WFM should, in order of priority: 1) slow unit growth well below 6%, since new store cannibalization has been increasing – indicative of the fact that the legacy stores are reaching saturation, 2) use excess free cash flow to re-accelerate a remodel program (42% of stores are greater than 11 years old and comps at these stores are now negative, but have been but have been deteriorating for several years now), 3) reduce prices more consistently across all categories because, in our view, today’s approach resembles a high/low model and we do not believe it is helping improve price perception; 4) once prices have been lowered, advertise the new positioning to win back customers, 5) with lower unit growth and incremental free cash flow (taking into consideration price investments), use excess free cash flow to buy back stock, issue a one-time dividend, or increase the payout ratio; and 6) focus on prepared foods – not 365 - as the next growth vehicle (either through a brick-and-mortar format or online via a meals-to-go or meal-kit initiative) since farm to customer meal services are becoming more prevalent and disruptive, and a foodservice offering would be easy to execute, require minimal capex, and would generate higher ROIC.

With a stable comp, albeit lower than its historical average of ~7.5% since 1992, positive traffic, a higher free cash flow yield, improving ROIC (WFM shares have a +74% correlation with lease-adjusted ROIC), and a respectable dividend yield, we believe WFM’s multiple would expand to trade more in line with other best-in-class consumer staples companies.

Equal Weight rating based on upside/downside scenario analysis

Given our view that: 1) WFM will continue to face competitive headwinds for the foreseeable future, 2) the current strategy is unlikely to reposition WFM as a Growth Star, 3) the strategy should evolve to focus on becoming a best-in-class Stable Staple, and 4) FY17 and FY18 consensus estimates are too high, we are initiating on WFM with an Equal Weight rating and a $30 price target. Our rating and price target are based on our view of WFM’s upside and downside. Specifically, we believe the downside is $27 (-7% downside), or a CY17 EV/EBITDA of 6.5x, and reflects ongoing comp weakness, FY17 guidance below consensus estimates and more in line with our estimates, and an ongoing challenging environment. We place a 75% probability on the downside scenario. If, however, comps were to accelerate or WFM adopts any of our suggestions, we see upside to $42 (45% upside), or 10x CY17 EV/EBITDA. We assign a 25% probability to our upside scenario. The weighted average of these two outcomes gets us to our $30 price target and Equal Weight rating. The following figure captures our view on the upside and downside for WFM.

Figure   
WFM Valuation Snapshot



Source: Company Reports, Barclays Research

Our view in greater detail

We believe the current strategy – while well-intentioned – is not optimal because we believe WFM is reaching a more mature stage in its lifecycle, and as such, should alter its strategy accordingly to create shareholder value. Our view in greater detail:

1. WFM is in “In Transition” and is no longer a Growth Star. WFM was once a best-in-class Growth Star operating a highly differentiated and rarely replicated format. However, in recent years, many lower priced competitors have meaningfully narrowed the gap on quality and experience, and this heightened competition is pressuring results. As a result, WFM is In Transition. WFM is attempting to regain Growth Star status, but we think shareholders would be better served if WFM embraced maturity and became a Stable Staple.
2. Slow unit growth to improve free cash flow. With new store comps languishing (<5 year trailing four quarter comps were +1.5%), cannibalization increasing, traffic now negative, ROIC declining and older stores comping -2.7%, we believe the unit growth opportunity for legacy stores is well below the stated 1,200 unit growth estimate – at least for now until prices are reduced. For now, we believe WFM should slow total growth to a rate well below 6%, and use excess free cash flow to re-accelerate a remodel program (42% of stores are older than 11 years old),
3. Reduce prices more consistently across the store. In our view, the current pricing scheme resembles a high/low model, and we do not believe it is helping improve price perception. Once prices have been lowered, WFM should advertise the new positioning to win back customers
4. Use excess free cash flow to buy back stock, issue a one-time dividend, or increase the dividend payout ratio. Taking into consideration the impact of a more widespread price reduction and remodel initiative, and assuming the business stabilizes at a lower, sustainable, positive comp, we believe WFM should either increase the dividend permanently, issue a one-time dividend, or repurchase shares more aggressively.
5. Focus on prepared food. Regardless of whether 365 succeeds, the company’s prepared foods have a halo of health and quality and we believe this competitive advantage has not been adequately leveraged. We believe focusing on a prepared foods initiative (either through a brick and mortar format or online via a meals-to-go or meal-kit initiative) would have several advantages: 1) disintermediating farm to customer meal services are gaining in popularity – and a focus on a meal service in some form might prevent further share losses, 2) WFM has the expertise in house, 3) WFM has a halo of quality with prepared foods, 4) the initiative would be easier to execute versus a larger scale 365 rollout, 5) the capital requirements would be lower, and 6) this initiative would have higher margins – more in line with restaurant margins, and would likely also have higher ROIC.

Summary of Financials & Valuation

Below we highlight our estimates vs. Consensus. In general, we are in-line with Consensus in FY16, but below Consensus in FY17 and FY18 owing to lower sales and margin estimates.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, ConsensusMetrix |

The following figures show our price target valuation and WFM’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  WFM Price Target Valuation |  | Figure  WFM Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY16-FY18. We assume WFM generates a decent amount of free cash flow, which is consistent with recent history. (By our estimate, the last year WFM did not generate FCF was in FY08). Our forward estimates assume square footage growth of ~6% in each year. Our free cash flow estimates would obviously increase if unit growth was slowed to below 6%.

|  |  |
| --- | --- |
|  | Figure  WFM Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) A Company “In Transition”

In our view, WFM was once a best-in-class Growth Star operating a highly differentiated and rarely replicated format. As such, traffic and comp trends were best-in-class, and between FY10 and FY13 EPS growth averaged 32%. However, in recent years, many lower priced competitors have meaningfully narrowed the gap on quality and experience, and this heightened competition is pressuring results: traffic trends are negative, WFM is losing share and ROIC is declining. Therefore, we believe WFM is In Transition.

The following figure shows the cadence of WFM’s traffic trends over the last ~10 years. Traffic has been slowing since FY13, but its descent accelerated in FY15 following the Department of Consumer Affairs weights and measures issue and has not since recovered – despite the fact that the company just lapped the incident.

|  |  |
| --- | --- |
|  | Figure  WFM Traffic Trends Deteriorating |
|  |  |
| Source: Company Reports, Barclays Research |

WFM continues to open new stores despite pressured comps. In fact, comps at new stores have significantly decelerated recently. The trailing four quarter comp for stores open 5 years or less is only +1.5%, which is well below the average of +10% for 2-5 year old stores and +21% for <2 year old stores. The following figure shows comps for newer stores.

|  |  |
| --- | --- |
|  | Figure  WFM Newer Store Comps Have Slowed Significantly vs. Historical Averages |
|  |  |
| Source: Company Reports |

WFM’s lease-adjusted ROIC continues to decline after reaching its peak of 13.4% in 3Q13. The combination of negative comps and continued unit growth is pressuring ROIC. In addition, WFM’s lease-adjusted ROIC and WFM’s stock price have a relatively strong +74% correlation.

|  |  |  |
| --- | --- | --- |
| Figure  WFM Lease-Adjusted ROIC |  | Figure  WFM Lease-Adjusted ROIC vs. Stock Price |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research, Thomson Reuters |

2a) Slow unit growth and generate more free cash flow

While we believe WFM’s goal is to reclaim its Growth Star status, we believe shareholders would be better served if WFM embraced maturity and became a Stable Staple. Despite the recent setbacks, the company still has a powerful brand, already generates a respectable free cash flow yield (3.4% CY17 yield) and has a respectable dividend yield (2.0%). However, with a stable comp, albeit lower than its historical average of ~7.5% since 1992, positive traffic, a higher free cash flow yield, improving ROIC, and potentially a higher dividend, we believe WFM’s multiple would expand meaningfully to trade more in line with other best-in-class consumer staples companies.

|  |
| --- |
| Figure  Consumer Staples Comp Sheet |
|  |
| Source: Company Reports, Barclays Research |

The following figure compares WFM’s FCF yield, dividend yield and net debt to EBITDA leverage ratio vs. Costco, Kroger, Sprouts and Walmart. WFM’s FCF yield is in-line with the average while the dividend yield and net debt to EBITDA ratios are better than the peers.

|  |  |
| --- | --- |
|  | Figure  Respectable Free Cash Flow Yield, Dividend Yield and Balance Sheet |
|  |  |
| Source: Company Reports, Barclays Research |

The following figure illustrates the upside to the FCF yield with no unit growth. We assume capex declines to ~2.0% of sales in a no growth scenario – the elimination of the pre-opening expenses offsets a decline in EBITDA – so in our scenario for one year – EBITDA is unchanged in a growth and no growth scenario. In this scenario, the current FCF yield increases from 3.4% (based on our actual estimates) to 8.2% (no growth scenario), and FCF itself increases by ~$428M. We separately acknowledge this immediate scenario is not realistic because capital commitments have been made, but we provide this scenario for illustrative purposes.

|  |  |
| --- | --- |
|  | Figure  Free Cash Flow Yield Increases Substantially if Unit Growth is Stopped |
|  |  |
| Source: Barclays Research |

To state the obvious, halting unit growth would result in higher ROIC. In fact, before WFM stopped providing ROIC by age class, ROIC at stores older than 11 years old were in the 92%-110% range. For WFM, ROIC has a 74% correlation to the stock price, so valuation should also improve.

|  |  |
| --- | --- |
|  | Figure  Halting Unit Growth Should Improve Lease-Adjusted ROIC Immediately |
|  |  |
| Source: Company Reports, Barclays Research |

2b) Use excess cash flow to re-accelerate a remodel program.

With cannibalization increasing, and newer unit comps weakening, we believe the unit growth opportunity for legacy stores is nearing its end for now so we believe WFM should slow unit growth to a rate well below 6%, and use excess free cash flow to re-accelerate a remodel program since 42% of stores are older than 11 years old and these stores’ comps have decelerated since 2012, and have turned negative -LSD in FY16. The following chart shows mature store comps starting in 1Q11.

|  |  |
| --- | --- |
|  | Figure  “Mature” Store Comps (>11 Years Old) Have Deteriorated for Several Years |
|  |  |
| Source: Company Reports, Barclays Research |

3) Reduce prices more consistently across the store.

In our view, the current pricing strategy resembles a high/low model, and we do not believe it is helping improve price perception. In order to improve price perception, we believe WFM should lower prices more consistently across the store, and – if it keeps the 365 format – WFM should eliminate various price points for identical items at the different banners. Lowering prices and ensuring consistency will eliminate the risk of confusion for the customer. Once prices have been lowered, WFM should advertise the new positioning to win back customers.

4) Use excess free cash flow to repurchase stock, issue one-time dividend or increase the payout ratio

With much stronger free cash flow generation, WFM would have more capacity to repurchase stock, issue a one-time dividend or increase the dividend payout ratio.

WFM’s dividend payout ratio today – factoring in higher unit growth – is at ~34% and is in line with other retailers in the XRT retail ETF. However, it is well below the ~50% average payout for companies in the XRP consumer staples ETF. While we do not advocate moving the payout ratio to 50% immediately (especially as results remain unstable), but we do believe WFM needs to increase its payout ratio over time if it is to successfully become a Stable Staple. (Note our FY17 EPS estimate declines -8.3% to $1.39 so the dividend payout ratio is set to naturally increase next year if the dividend is at least held flat). The following figure compares WFM’s payout ratio vs. select peers.

|  |  |
| --- | --- |
|  | Figure  WFM’s Payout Ratio vs. Peers |
|  |  |
| Source: Company Reports, Thomson One, SPDRs |

The next two figures show the range of dividend yields that different payout ratios produce and how much cash is needed to increase the dividend to the respective payout ratio. Increasing the payout ratio to ~50% only requires an additional ~$60M in FY17 vs. the current run rate (~$169M). So, if WFM stopped unit growth, it would have enough cash to support a higher dividend and investments in remodels and/or a prepared foods concept.

|  |  |  |
| --- | --- | --- |
| Figure  Potential Dividend Yields Based on Different FY17E Payout Ratios |  | Figure  Potential Dividends Paid ($, Millions) Based on Different FY17E Payout Ratios |
|  |  |  |
| Source: Company Reports, Barclays Research  Our analysis assumes static EPS, but EPS would likely increase in a no growth scenario given abating pressures from new stores (e.g., pre-opening costs). |  | Source: Company Reports, Barclays Research |

5) Focus on prepared food as the next growth vehicle

Irrespective of whether or not the 365 format is successful, we believe shareholders would benefit more if WFM pursued prepared foods as a vehicle for growth. Prepared foods (either through a brick and mortar format or online via a meals-to-go or meal-kit initiative) have the advantages of being easier to execute and less of a distraction, requiring lower capex, and having higher margins. In addition, this initiative would benefit from:

1. In house expertise,
2. A halo of quality and value (especially when compared to fast casual restaurant peers),
3. Ease of execution especially when compared to a larger scale 365 roll-out,
4. Lower capital requirements,
5. Higher margins,
6. Eventually, if a prepared format proved to be a success, it would warrant a sum of the parts valuation for WFM – and restaurants trade higher than WFM.

|  |  |
| --- | --- |
|  | Figure  WFM CY2017 EBITDA Margins vs. Restaurants |
|  |  |
| Source: Barclays Research |

Valuation and Conclusion

Given our view that: 1) WFM will continue to face competitive headwinds for the foreseeable future, 2) the current strategy is unlikely to reposition WFM as a Growth Star, 3) the strategy should evolve to focus on becoming a best-in-class Stable Staple, and 4) FY17 and FY18 consensus estimates are too high, we are initiating on WFM with an Equal Weight rating and a $30 price target. Our rating and price target are based on our view of WFM’s upside and downside. Specifically, we believe the downside is $27 (-7% downside), or a CY17 EV/EBITDA of 6.5x, and reflects ongoing comp weakness, FY17 guidance below consensus estimates and more in line with our estimates, and an ongoing challenging environment. We place a 75% probability on the downside scenario. If, however, comps accelerated or WFM adopts any of our suggestions, we see upside to $42 (45% upside), or 10x CY17 EV/EBITDA. We assign a 25% probability to our upside scenario. The weighted average of these two outcomes gets us to our $30 price target and Equal Weight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Casey's General Stores Inc (CASY)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=CASY) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2016A | 2017E | 2018E | 2019E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 119.72 | | Price Target | USD 116.00 | | **Why Equal Weight?** Our PT reflects M-HSD inside comps that accelerate slightly from 1Q due to the major remodel and pizza delivery rollouts, but are still pressured by a soft farm economy. We expect gas margins to be slightly above the annual goal. Lastly, we assume a slight discount to Couche-Tard given the more concentrated footprint, slower EBITDA growth and worse FCF. | | |  | | | Upside case | USD 140.00 | | Reflects: 1) Inside comps re-accelerating for prepared foods to ~10% and for grocery to 6+%; 2) gas margins (pre-RINs) of $0.168 or better and RIN prices greater than last year's $0.54; 3) higher prepared food margins; and 4) opex growth at the low-end of low-teens guidance. | | |  | | | Downside case | USD 100.00 | | Reflects: 1) increasing gas prices; 2) continued farm economy pressures; 3) deteriorating instore comp trends; 4) RIN market reform; 5) increased promotional activity; 6) opex growth at the high-end of low-teens guidance. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 7,122 | 7,426 | 8,498 | 9,369 | 9.6% |  |
| EBITDA (adj) | 560 | 579 | 628 | 688 | 7.1% |  |
| EBIT (adj) | 389 | 382 | 411 | 449 | 4.9% |  |
| Pre-tax income (adj) | 349 | 339 | 367 | 405 | 5.1% |  |
| Net income (adj) | 226 | 222 | 238 | 263 | 5.2% |  |
| EPS (adj) ($) | 5.73 | 5.60 | 6.00 | 6.60 | 4.8% |  |
| Diluted shares (mn) | 39.4 | 39.6 | 39.8 | 39.9 | 0.4% |  |
| DPS ($) | 0.88 | 0.96 | 1.05 | 1.14 | 9.0% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 7.9 | 7.8 | 7.4 | 7.3 | 7.6 |  |
| EBIT (adj) margin (%) | 5.5 | 5.1 | 4.8 | 4.8 | 5.1 |  |
| Pre-tax (adj) margin (%) | 4.9 | 4.6 | 4.3 | 4.3 | 4.5 |  |
| Net (adj) margin (%) | 3.2 | 3.0 | 2.8 | 2.8 | 2.9 |  |
| ROIC (%) | 11.6 | 10.3 | 9.9 | 9.8 | 10.4 |  |
| ROE (%) | 23.1 | 18.9 | 17.4 | 16.7 | 19.0 |  |
| ROA (lease adjusted) (%) | 9.7 | 8.7 | 8.3 | 8.3 | 8.8 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 2,252 | 2,556 | 2,838 | 3,099 | 11.2% |  |
| Intangible fixed assets | 148 | 148 | 148 | 148 | 0.0% |  |
| Cash and equivalents | 76 | 86 | 88 | 94 | 7.5% |  |
| Total assets | 2,726 | 3,035 | 3,362 | 3,650 | 10.2% |  |
| Short and long-term debt | 838 | 938 | 938 | 938 | 3.8% |  |
| Total liabilities | 1,643 | 1,766 | 1,894 | 1,962 | 6.1% |  |
| Net debt/(funds) | 762 | 874 | 952 | 985 | 8.9% |  |
| Shareholders' equity | 1,083 | 1,269 | 1,468 | 1,688 | 15.9% |  |
| Change in working capital | 7 | 14 | 26 | -1 | N/A |  |
| Cash flow from operations | 465 | 447 | 541 | 550 | 5.7% |  |
| Capital expenditure | -393 | -500 | -500 | -500 | N/A |  |
| Free cash flow | 73 | -74 | -36 | 12 | -45.9% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 20.9 | 21.4 | 20.0 | 18.1 | 20.1 |  |
| EV/EBITDA (adj) (x) | 9.8 | 9.7 | 8.9 | 8.1 | 9.1 |  |
| Equity FCF yield (%) | 1.6 | -1.6 | -0.8 | 0.2 | -0.1 |  |
| P/Sales (x) | 0.7 | 0.6 | 0.6 | 0.5 | 0.6 |  |
| P/BV (x) | 4.4 | 3.7 | 3.2 | 2.8 | 3.5 |  |
| Dividend yield (%) | 0.7 | 0.8 | 0.9 | 1.0 | 0.8 |  |
| Adj debt/EBITDAR (x) | 1.4 | 1.5 | 1.5 | 1.4 | 1.5 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Inventory growth (%) | 3.9 | 1.4 | 14.4 | 10.3 | 7.5 |  |
| Capex/sales (%) | 5.5 | 6.7 | 5.9 | 5.3 | 5.9 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Apr | | | | | | | |

casey’s general stores

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Casey's General Stores Inc(CASY): Quarterly and Annual EPS (USD)   |  | | --- | | CASY | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 116.00 | | Price (19-Sep-2016) | | USD 119.72 | | Potential Upside/Downside | | -3.1% | | | | | | | | | | |
|  | 2016 | 2017 | | | 2018 | | | Change y/y | |
| FY Apr | Actual | Old | New | Cons | Old | New | Cons | 2017 | 2018 |
| Q1 | 1.57A | N/A | 1.70A | 1.81E | N/A | N/A | 2.00E | 8% | N/A |
| Q2 | 2.00A | N/A | 1.63E | 1.76E | N/A | N/A | 2.02E | -19% | N/A |
| Q3 | 0.97A | N/A | 1.06E | 1.07E | N/A | N/A | 1.22E | 9% | N/A |
| Q4 | 1.19A | N/A | 1.20E | 1.30E | N/A | N/A | 1.48E | 0.84% | N/A |
| Year | 5.73A | N/A | 5.60E | 5.94E | N/A | 6.00E | 6.63E | -2% | 7% |
| P/E | 20.9 |  | 21.4 |  |  | 20.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Overshadowed by Pending Macro Changes

Best-in-Class Growth Star set to continue gaining share over the long term, but near-term risks linger; initiate with Equal Weight and $116 PT

We are initiating coverage with an Equal Weight rating and $116 price target. Our price target values Casey’s General Stores (CASY) on a CY17 EV/EBITDA of 9.0x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $100, or 8.0x CY17 EV/EBITDA (~60% probability), while our upside scenario is $140, or 10.6x CY17 EV/EBITDA (~40% probability).

In our view, CASY is a best-in-class Growth Star. CASY has a 17+ year track record of generating best-in-class comps and gaining share. Since FY2000, comps have averaged + 7.7% for prepared foods and fountain, +5.5% for grocery and other merchandise, and +1.5% for fuel gallons. In addition, the company has increased units by ~3.5% annually during the same period. Combining comp growth with new store growth has produced robust EBITDA and EPS CAGRs of +10.7% and +13.5%. Recent performance is even stronger as LTM EBITDA and EPS is up +13.9% and +19.5%, respectively. In addition, CASY has a strong balance sheet with LTM net debt to EBITDA of 1.2x. The company owns 99% of its real estate. By all accounts, CASY is a Growth Star with further room to grow as the company continues to expand south and east in its geographies and rolls out its major remodels, 24 hour conversions and pizza delivery initiatives to its store base.

While CASY deserves much of the credit for its robust recent performance, CASY’s strong execution has been complemented by several external tailwinds such as low oil prices (which help fuel margins, operating expenses, and overall consumer spend), high RIN prices (which help fuel margins), and lower commodity input costs (which help prepared food margins).

In the near term, we fear that these tailwinds could reverse and pressure results. Specifically, we believe the tailwind provided by lower y/y fuel prices could be approaching its end; Barclays analysts forecast WTI crude increases from ~$45 currently to $51/bbl in 4Q16 and $56/bbl in 2017 (see “[Sunny today, but clouds not far away](https://live.barcap.com/go/publications/content?contentPubID=FC2259398),” published on 9/12/2016). In addition, the U.S. Energy Information Administration (EIA) predicts gasoline prices will be up y/y beginning in January 2017 and predicts diesel prices will be up y/y in December 2016. Since fuel margins typically move inversely to fuel prices, there is a possibility that rising fuel prices will have a compounding negative impact on CASY’s P&L: rising fuel prices pressure consumer spending and lower fuel margins while increasing operating expenses (e.g., credit card fees, distribution costs).

As a result, it is unsurprising that CASY shares and WTI crude spot prices have an -87% correlation. Given these concerns, we believe there is downside to CASY if oil prices increase. Separately, in the near term, CASY could be pressured by: 1) a softening economy caused by food commodity deflation and its subsequent harmful impact on farm profits, which directly hurts consumer spending in CASY’s trade areas; and 2) labor cost headwinds.

Equal Weight rating based on upside/downside scenario analysis

Given our near-term concerns, we would prefer to see a better entry point for this best-in-class Growth Star. If oil prices rise and/or a softer economy pressures comps, we see downside to $100 (-16%), or ~8x CY17 EV/EBITDA. We assign a 60% probability of this scenario playing out. If, however, oil prices are stable or lower, and the company is able to re-accelerate comps inside the store then we see upside to $140 (+17%), or 10.6x CY17 EV/EBITDA. We believe there is a 40% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $116 price target and Equal Weight rating.

We would become more constructive if CASY is able re-accelerate inside comps, especially prepared foods, back to ~10%, and if we gain greater confidence that fuel margins are unlikely to be structurally re-rated lower in the near term. The following figure captures our view on the upside and downside for CASY.

|  |
| --- |
| Figure  CASY Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We believe CASY is a best-in-class Growth Star that is well positioned for long-term growth. However, we believe there are several external risks that could temporarily stall growth in the near-term. As a result, we think upside and downside risk is fairly balanced at the current level. Our thesis reflects the following:

1. Recent tailwinds could reverse and temporarily stall growth. CASY deserves much of the credit for its robust recent performance, but CASY’s strong execution has been complemented by several external tailwinds such as low oil prices, high RIN prices, and lower commodity input costs. In fact, CASY shares and WTI crude spot prices have a negative -87% correlation. In the near term, we fear that these tailwinds could reverse and pressure results. Specifically, Barclays analysts forecast WTI crude increases from ~$44 currently to $51/bbl in 4Q16 and $56/bbl in 2017. Rising fuel prices have a compounding negative impact on CASY’s P&L: they pressure consumer spending, tend to lower fuel margins and increase operating expenses. In addition, there seems to be increasing noise about reforming RINs, which have helped structurally raise fuel margins in the last few years. Lastly, the commodity tailwind (e.g., locked in lower cheese and coffee costs) that has helped prepared food margins could abate after CY2016.
2. A challenged farm economy could pressure top-line and de-lever the P&L. The USDA forecasts net cash farm income declines by -13.3% in 2016. We believe food commodity deflation is a significant driver of the y/y decline. Since CASY’s footprint aligns closely with the farm belt, the deterioration in farm incomes could pressure CASY’s top-line. In addition, CASY’s plan to raise prices in prepared food later this year when their consumer is feeling pressured creates incremental risk. Lastly, the company guided to low-teens operating expense growth this year, so a slowdown in comps would likely lead to operating de-leverage.
3. Tobacco is a risk. Tobacco is ~36% of grocery sales, and cigarette comps were up +HSD in FY16 due to the company’s previous conversion to the Marlboro Leadership Program (MLP) and due to customers trading up because of lower gas prices. As a result, cigarettes were a fairly significant driver of the +7.1% grocery comp in FY16. Going forward, we expect cigarette sales to moderate as the MLP tailwinds abate and gas prices begin to increase. Consistent with our view, CASY guided to cigarette comps of +MSD in FY17. Separately, over the longer-term, we believe the growing movement to raise the minimum smoking age to 21 also presents risk. As of today, California and Hawaii and 190 localities in 14 states have raised the minimum age to 21. As a result, we believe the tobacco category could be a growing drag on grocery comps.
4. CASY is a best-in-class Growth Star. Despite these risks, CASY still has a 17+ year track record of generating best-in-class comps and gaining share. Since FY2000, comps have averaged +7.7% for prepared foods and fountain, +5.5% for grocery and other merchandise, and +1.5% for fuel gallons. In addition, the company has increased units by ~3.5% annually during the same period. Combining comp growth and new store growth has produced robust EBITDA and EPS CAGRs of +10.7% and +13.5% since FY2000. Recent performance is even stronger as LTM EBITDA and EPS is up +13.9% and +19.5%, respectively. In addition, CASY has a strong balance sheet with LTM net debt to EBITDA of 1.2x. CASY owns 99% of its real estate. By all accounts, CASY is a Growth Star with further room to grow as the company continues to expand south and east in its geographies and rolls out its major remodels, 24 hour conversions and pizza delivery initiatives to its store base.
5. Mixed track record at generating free cash flow. From FY10-FY16, free cash flow was negative -$63.9M. The primary uses of cash have been capex and acquisitions. Acquisition have been a ~$310M drag on free cash flow since FY10. While we believe the company has promising growth opportunities, in our view, valuation would improve if free cash flow became consistently positive. Looking forward, we estimate free cash flow will be negative for FY17 and FY18 due to elevated capex to support the company’s major remodel initiative and accelerated unit growth. In addition, two potential factors that could also be a drag on free cash flow that are currently not in our estimates: 1) CASY will likely need a new distribution center in several years, and 2) the company is actively looking for acquisitions. Note that CASY typically realizes significant synergies from acquisitions due to self-distribution, which we estimate to be about a ~400 bps benefit to grocery margins.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are below consensus on EPS through FY19. It is unclear what the consensus assumptions are for fuel margins (the biggest driver of EPS given that a $0.01 move in fuel margins impacts EPS by $0.37), comps and operating expense growth, but we assume fuel margins (including RINs) of $0.191, $0.184, and $0.184 in FY17, FY18 and FY19, respectively. In addition, we expect inside comps accelerate slightly for the remainder of FY17 as the company rolls out its major remodel and pizza delivery initiatives, but we believe comps remain pressured by a challenging farm economy.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, Thomson First Call |

The following figures show our price target valuation and CASY’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  CASY’s Price Target Valuation |  | Figure  CASY’s Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY17-FY19. We assume capex (before acquisitions) is $500M in FY17, which is at the low-end of management’s $496-$614M guidance because we assume ~4% unit growth which is also at the low-end of 4%-6% guidance. We assume working capital is net neutral to cash flow, which is basically consistent with FY16.

|  |  |
| --- | --- |
|  | Figure  CASY Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) Recent tailwinds could reverse and temporarily stall growth.

Recently, CASY’s strong execution has been complemented by several tailwinds such as low oil prices, high RIN prices, and lower commodity input costs. In the near term, we fear that these tailwinds could reverse and pressure results.

Oil prices set to rise; CASY shares have -87% correlation with WTI spot prices

Declining oil prices tend to result in higher fuel margins (oil prices and fuel margins are more or less inversely related), higher consumer spending, lower credit card fees, and lower distribution costs. Given this historical relationship, CASY shares and WTI crude spot prices have an -87% correlation. The relationship between CASY’s shares and WTI crude is statistically strong as the R^2 is 0.77 and the P Value is less than 0.0001, which means 77% of the variation in CASY’s share price is explained by WTI spot prices and that there is a 99+% probability that WTI crude prices have an influence on CASY’s share price. The following figure compares CASY shares vs. WTI crude oil spot prices.

|  |  |
| --- | --- |
|  | Figure  CASY Shares vs. WTI Crude Oil Spot Prices |
|  |  |
| Source: Thomson |

Going forward, both Barclays’ analysts and the US government’s Energy Information Administration (EIA) are predicting that WTI crude and gas/diesel prices stop declining y/y and begin to increase. Specifically, Barclays’ analysts forecast WTI crude increases from ~$44/bbl currently to $51/bbl in 4Q16 and $56/bbl in 2017. In addition, the EIA predicts that gasoline prices will be up y/y beginning in January 2017 and that diesel prices will be up y/y starting in December 2016. Higher fuel prices will likely result in lower fuel margins, consumers having less discretionary income, and higher credit card fees and distribution costs. The following two charts show the EIA’s forecast for gas and diesel prices going forward.

|  |  |  |
| --- | --- | --- |
| Figure  US Gasoline Prices (All Grades Retail Price Including Taxes) |  | Figure  US Diesel Prices (Including Taxes) |
|  |  |  |
| Source: EIA Short-Term Energy Outlook |  | Source: EIA Short-Term Energy Outlook |

Growing noise to reform the RIN market; RINs represent ~11% of EPS

In addition, CASY’s sale of Renewable Identification Numbers (RINs) has also benefitted fuel margins. CASY first called out RINs as benefitting fuel margins in 4Q13. While CASY does not own blending or terminal infrastructure, it is able to collect RINs when ethanol splashes into the company’s trucks in Iowa prior to heading to stores. RINs, on average since 4Q13, have added ~$0.017 to fuel margins, and as a reminder, a $0.01 change in fuel margins equates to ~$0.37 in EPS, so the impact from RINs is meaningful. The next figure shows the cent per gallon contribution to fuel margins from RINs and the average RIN sales price.

|  |  |
| --- | --- |
|  | Figure  RINs Contribution to Fuel Margins |
|  |  |
| Source: Company Reports, Barclays Research |

The next two charts show the EPS contribution from RINs and the percentage of EPS that RINs represent. As indicated, RINs represent about ~11% of EPS since 4Q13.

|  |  |  |
| --- | --- | --- |
| Figure  RINs Contribution to EPS |  | Figure  % of EPS Represented by RINs |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Barclays Research |

While we certainly are not experts on RINs, there is increasing noise (especially from refiners and their investors) regarding the need to reform the Environmental Protection Agency’s (EPA) Renewal Fuels Standard (RFS). For example, according to a Bloomberg article (“Icahn Calls on EPA to Fix ‘Mother of All Short Squeezes,’” 8/15/16), Carl Icahn wrote a letter to the EPA on August 9 where he asked the EPA to fix the RIN marketplace. In the same article, the president of the American Fuel and Petrochemical Manufacturers trade group was quoted as saying “the RFS is broken and needs to be reformed.” Declining RINs prices are a risk to EPS given their significant impact (~11% of EPS since 4Q13).

**Net**: Fuel margins have significantly benefitted from lower y/y fuel prices and the sale of RINs. The following figure shows the average fuel margin between 1Q00-3Q13 ($0.121) prior to the calling out of RINs by CASY and the significant decline in oil prices, and the average fuel margins since then. If oil prices increase or RINs prices decline, fuel margins could return to lower levels, which would pressure EPS.

|  |  |
| --- | --- |
|  | Figure  Quarterly Fuel Margins – Significantly Increased Due to Higher RINs and Lower Oil |
|  |  |
| Source: Company Reports, Barclays Research |

Cheese and coffee commodity tailwinds could abate after CY2016

Lower cheese and coffee costs have been a tailwind to prepared food gross margins. Locked-in cheese costs are set to provide a ~10 bps tailwind to margins through December 2016. The company has not locked in cheese prices beyond December because the forward prices are above current spot prices. In addition, locked-in coffee costs are set to provide another 10-15 bps margin tailwind through the end of FY17. These commodity tailwinds have contributed to strong prepared food gross margins of 62.5% in FY16, which are above the average margin of 60.5% since FY00. In fact, FY16’s margin is the third highest annual margin since FY00. The following figure shows prepared foods gross margins since FY00.

|  |  |
| --- | --- |
|  | Figure  Prepared Food Gross Margins |
|  |  |
| Source: Company Reports, Barclays Research |

As a result, we fear that margins could be pressured if these commodities once again become inflationary. In fact, coffee prices have been inflationary since June after being deflationary for the better part of the last year. We believe CASY is locked in the $1.40 range until April 2017, so when the company goes back to the market in FY17 it will likely face a price increase if current trends hold since futures prices are currently $1.50+. Cheese prices have been deflationary since 2015, but in September increased y/y for the first time since November 2014. In general, $0.10 changes in cheese and coffee costs impact prepared food margins by 35 bps and 3 bps, respectively. The following two charts show cheese and coffee cost trends, and highlight the potential for abating commodity cost tailwinds going forward.

|  |  |  |
| --- | --- | --- |
| Figure  Y/Y Cheese Cost Change |  | Figure  Y/Y Coffee Cost Change |
|  |  |  |
| Source: Bloomberg (CHCKBLCK) |  | Source: Bloomberg (KC1) |

2) A challenged farm economy could pressure top line and de-lever the P&L

CASY called out a softening farm belt economy recently on its FY1Q17 earnings call on 9/7/2016 as a reason for decelerating top-line trends. The USDA forecasts net cash farm income declines by -13.3% in 2016. We believe food commodity deflation is a significant driver of the y/y decline. Since CASY’s footprint aligns closely with the farm belt, the deterioration in farm incomes could pressure CASY’s top-line. The following figures show Net Cash Farm Income and its y/y change per the USDA.

|  |  |  |
| --- | --- | --- |
| Figure  Net Cash Farm Income |  | Figure  Y/Y Change in Net Cash Farm Income |
|  |  |  |
| Source: USDA |  | Source: USDA |

In addition, CASY plans to raise prepared food prices later this year to offset rising labor costs in December due to minimum exempt changes (~$10 million labor cost headwind). The company believes it is underpriced in key categories vs. its peers, but we note that the company price checks against other convenience stores and restaurants – not grocery stores that have lower y/y prices and may be drawing share from restaurants given the price disconnect. We believe taking another price increase (after already taking a price increase in May 2016) while their core consumer feels pressured creates incremental top-line risk and could further pressure comps.

Lastly, a slowdown in comps could lead to operating de-leverage in FY17 given that operating expenses are guided to increase at a “low-teens” rate. In FY17, operating expenses will be negatively impacted by several **fixed cost** headwinds: 1) accelerating unit growth throughout the year – unit growth was +2.4% in 1Q17 and we expect it to ramp to ~4% by the end of the year; 2) costs associated with the roll out of the major remodels (~94 to occur in 2Q-4Q), 24 hour conversions (85 rolled out in 1Q), and pizza delivery (~50 to roll out in 2Q-4Q); 3) rising labor costs associated with the minimum exempt changes on December 1 (~$10 million cost headwind); and 4) rising credit card fees (we expect credit card fees to be up y/y starting in 2Q).

3) Tobacco is a risk

Tobacco is ~36% of grocery sales and ~26% of grocery profit, and cigarette comps were up +HSD in FY16 due to the company’s previous conversion to the Marlboro Leadership Program (MLP) and due to customers trading up because of lower gas prices. As a result, cigarettes were a fairly significant driver of the +7.1% grocery comp in FY16. Going forward, we expect cigarette sales to moderate as the MLP tailwinds abate and gas prices begin to increase. Consistent with our view, CASY guided to cigarette comps of +MSD in FY17.

Separately, over the longer-term, we believe the growing movement to raise the minimum smoking age to 21 also presents risk. As of today, California and Hawaii and 190 localities in 14 states have raised the minimum age to 21. As a result, we believe the tobacco category could be a growing drag on grocery comps.

4) CASY is a best-in-class Growth Star

Consistent Track Record of Growing Inside Sales and Gross Profit

CASY has a 17+ year track record of generating best-in-class comps and gaining share. While the fuel business has accelerated EPS growth recently, CASY has a very strong track record of consistently growing inside sales and gross profit. Since FY2000, comps have averaged +7.7% for prepared foods and fountain comps and +5.5% for grocery and other merchandise comps. In addition, inside gross profit (defined as prepared food + grocery) has increased at a CAGR of +10.7%.

The figure below shows prepared food and fountain comps going back to FY2000. The prepared foods business is driven by its high-quality pizza business (~$450-$500M of the $880M prepared foods business– making CASY a top 10 pizza chain in the country).

|  |  |
| --- | --- |
|  | Figure  Prepared Food & Fountain Comps |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows grocery & other merchandise comps also going back to FY2000. At +5.5% comps, it is clear that CASY is gaining share. In FY16, comps increased +7.1%, but we note that cigarette sales helped drive the category as cigarette comps were up +HSD. We expect cigarette comps to slow to MSD in FY17, which is contributing to grocery comps slowing to the +5% range in FY17.

|  |  |
| --- | --- |
|  | Figure  Grocery & Other Merchandise Comps |
|  |  |
| Source: Company Reports, Barclays Research |

The next chart shows grocery and prepared food combined gross profit, or inside gross profit, since FY2000. CASY has grown this number by +10.7% annually through FY16, predominantly due to top-line growth, but also due to prepared food increasing its share of the business, which is higher margin.

|  |  |
| --- | --- |
|  | Figure  CASY Inside Gross Profit |
|  |  |
| Source: Company Reports, Barclays Research |

Over the intermediate term, we expect inside sales to maintain their momentum in a normalized economic environment (i.e., farm income stable/growing) driven by the company’s three initiatives: 1) major remodels, 2) pizza delivery, and 3) 24 hour conversions. The following figure shows the comp lifts associated with each of these initiatives and the percentage of stores that have had the initiative rolled out to it.

|  |  |
| --- | --- |
|  | Figure  CASY Initiatives |
|  |  |
| Source: Company Reports |

In addition, the company rolled out a mobile app in January 2016 that features online ordering. Downloads as of 9/7/2016 were 530,000, +32.5% increase vs. the last update on 6/7/2016. The app currently accounts for 7.5% of pizza sales. So far, online order has a 13% higher basket size than over-the-phone orders. We believe the mobile app will lead to incremental sales as the number of users grows.

CASY is also a share gainer in the retail fuel business

The following chart shows fuel gallon comps going back to FY2000. CASY’s average fuel gallon comp was up +1.5% since FY2000. While not a large number, it is impressive given that 1) national vehicle miles driven were up +1.1% annually over the same time period, and 2) fuel efficiency increased ~50% over the same time (per Department of Transportation data) – so, clearly CASY has consistently gained share. Some of these share gains are due to the company’s “Fuel Saver” partnership with Hy-Vee that began in December 2012. The Fuel Saver program allows Hy-Vee customers to redeem fuel savings at CASY locations. We note that the 4Q16 fuel gallon comp benefitted significantly from the Hy-Vee Fuel Saver program .

|  |  |
| --- | --- |
|  | Figure  Fuel Gallon Comps |
|  |  |
| Source: Company Reports, Barclays Research, Department of Transportation |

CASY is a scale player that is still growing

With 1,933 units, CASY is the fourth largest convenience store chain in the US and Canada (CASY does not have any Canadian stores). In addition, CASY’s is ~50% larger than soon-to-be fifth place Sunoco (if the Couche-Tard and CST Brands deal is completed). Scale is important in the convenience store industry because it helps combat cost pressures such as rising labor costs, credit card fees, EMV installation costs, regulatory costs, etc. Scale allows CASY to spread these costs over many stores. In addition, scale allows CASY to self-distribute, which is a meaningful margin advantage (~400 bps in grocery gross margins). The following table shows the top 10 convenience store chains in the US and Canada.

|  |  |
| --- | --- |
|  | Figure  Top 10 Convenience Store Chains |
|  |  |
| Source: CSP Magazine |

In addition, CASY’s scale is a competitive advantage in its markets where ~two-thirds of operators have 10 stores or less. These smaller operators often use pricing to offset cost pressures, especially gas prices, which structurally supports fuel margins in CASY’s operating area. Separately, CASY’s stores are primarily located in rural areas: ~57% of stores are located in areas with populations of fewer than 5,000 and ~82% of stores have populations fewer than 20,000. As a result, the lack of density in these markets helps deter new entrants, especially national pizza chain competitors to CASY’s prepared foods business.

The company also continues to grow its already large store base. CASY increased units by ~3.5% annually between FY2000 and FY2016. The following figures show unit counts and unit growth since FY2000. In the last five years, CASY also expanded its geographic footprint by entering Arkansas, Kentucky, North Dakota, Oklahoma and Tennessee. Going forward, the company is entering Ohio and, likely, Michigan. We believe the company’s new distribution center in Terre Haute, Indiana (opened February 2016) will help support growth south and east of CASY’s existing footprint. Lastly, we expect unit growth to accelerate from +2.8% in FY16 and +4% in FY16E to +4%-6% in the next few years. To support accelerated unit growth, CASY significantly increased its internal store development team in the last 12 months. For the first time, CASY has development professionals working permanently in different geographies so that they are closer to the field. In addition, the company will likely have opportunities to complement its organic unit growth with acquisitions; CASY is seeing more opportunities in the last 3-4 months than it has in the 12 months prior. We note that the company typically realizes significant synergies from acquisitions due to self-distribution, which we estimate to be about a ~400 bps benefit to grocery margins.

|  |  |  |
| --- | --- | --- |
| Figure  CASY Unit Count |  | Figure  CASY Annual Unit Growth |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Strong share gains have led to robust EBITDA and EPS growth

Combining comp growth and new store growth has produced robust EBITDA and EPS CAGRs of +10.7% and +13.5% since FY2000. Recent performance is even stronger as LTM EBITDA and EPS is up +13.9% and +19.5%, respectively.

|  |  |  |
| --- | --- | --- |
| Figure  FY2000-FY2016 EBITDA |  | Figure  FY200-FY2016 EPS |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Strong balance sheet supported by owned real estate

In addition, CASY has a strong balance sheet with LTM adj. net debt to EBITDAR of 1.2x and 99% owned real estate. The following figure compares CASY vs. other retailers in our universe.

|  |  |
| --- | --- |
|  | Figure  Adj. Net Debt to EBITDAR: CASY vs. Other Retailers in our Universe |
|  |  |
| Source: |

By all accounts, CASY is a Growth Star with further room to grow as the company continues to expand south and east in its geographies and rolls out its major remodels, 24 hour conversions and pizza delivery initiatives to its store base.

5) Mixed track record at generating free cash flow

From FY10-FY16, free cash flow was negative -$63.9M. The primary uses of cash have been capex and acquisitions. While we believe the company has promising growth opportunities, in our view, valuation would improve if free cash flow became consistently positive. Looking forward, we estimate free cash flow will be negative for FY17 and FY18 due to elevated capex to support the company’s major remodel initiative and accelerated unit growth. In addition, we expect CASY will likely need another new distribution center in several years to support its unit growth, which should be a further drag on cash flow. The following figure shows CASY’s free cash flow since FY10.

|  |
| --- |
| Figure  CASY Free Cash Flow |
|  |
| Source: Company Reports, Barclays Research |

In addition, CASY’s elevated capex outlook for the next few years could weigh on ROIC, and we note that ROIC and CASY shares have had a +86% correlation since 2Q14 (and a +71% correlation prior to 2Q14) – so, a deterioration on ROIC could weigh on the stock. However, CASY is testing a lower cost prototype that is ~3,200 square feet in size and should cost considerably less than the current ~$2.5M for the 2,100 square foot format.

Valuation and Conclusion

Given our near-term concerns, we would prefer to see a better entry point for this best-in-class Growth Star so we initiate with an Equal Weight rating and $116 price target. Our price target is based on our upside/downside scenario analysis. If oil prices rise and/or a softer economy pressures comps, we see downside to $100 (-16%), or ~8x CY17 EV/EBITDA of $612 million. We assign a 60% probability of this scenario playing out. If, however, oil prices are stable or lower, and the company is able to re-accelerate comps inside the store then we see upside to $140 (+17%), or 10.6x CY17 EV/EBITDA. We believe there is a 40% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $116 price target and Equal Weight rating. We would become more constructive if CASY is able re-accelerate inside comps, especially prepared foods, back to ~10%, and if we gain greater confidence that fuel margins are unlikely to be structurally re-rated lower in the near term.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Natural Grocers by Vitamin Cottage Inc (NGVC)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=NGVC) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 10.97 | | Price Target | USD 12.00 | | **Why Equal Weight?** Our PT reflects slightly positive comps in 4Q and +LSD comps in FY17. We expect that NGVC will maintain its high-teen unit growth strategy despite slowing comps leading to ROIC compression. Historical trading average (~10x over last 2 yrs) is not relevant given unprecedented comp slowdown and margin deterioration. Target multiple considers declining ROIC. | | |  | | | Upside case | USD 17.00 | | Reflects: 1) comps re-accelerating to +LSD-MSD based on traffic gains - demonstrating that the unit growth opportunity is credible; 2) near-term unit growth slowing to a rate that can be self-funded (~10%); and 3) higher y/y gross margins and ROIC. | | |  | | | Downside case | USD 9.00 | | Reflects: 1) flattish to negative comps that continue to decelerate on a 2-year stacked basis; 2) continued gross margin degradation; and 3) unchanged high-teens unit growth resulting in cash burn, higher leverage and lower ROIC. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 625 | 708 | 812 | 917 | 13.6% |  |
| EBITDA (adj) | 50 | 46 | 53 | 60 | 6.4% |  |
| EBIT (adj) | 29 | 21 | 23 | 25 | -3.9% |  |
| Pre-tax income (adj) | 26 | 18 | 20 | 22 | -4.7% |  |
| Net income (adj) | 16 | 12 | 12 | 14 | -5.3% |  |
| EPS (adj) ($) | 0.72 | 0.52 | 0.55 | 0.61 | -5.3% |  |
| Diluted shares (mn) | 22.5 | 22.5 | 22.5 | 22.5 | 0.0% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 8.0 | 6.5 | 6.6 | 6.6 | 6.9 |  |
| EBIT (adj) margin (%) | 4.6 | 2.9 | 2.9 | 2.8 | 3.3 |  |
| Pre-tax (adj) margin (%) | 4.1 | 2.5 | 2.5 | 2.4 | 2.9 |  |
| Net (adj) margin (%) | 2.6 | 1.7 | 1.5 | 1.5 | 1.8 |  |
| ROIC (%) | 10.2 | 8.1 | 7.9 | 7.8 | 8.5 |  |
| ROE (%) | 15.1 | 9.7 | 9.3 | 9.4 | 10.9 |  |
| ROA (lease adjusted) (%) | 8.5 | 6.9 | 6.8 | 6.8 | 7.2 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 145 | 175 | 201 | 227 | 16.1% |  |
| Intangible fixed assets | 6 | 6 | 6 | 6 | 0.0% |  |
| Cash and equivalents | 3 | 1 | 1 | -8 | N/A |  |
| Total assets | 234 | 277 | 314 | 344 | 13.7% |  |
| Short and long-term debt | 28 | 48 | 63 | 68 | 34.8% |  |
| Total liabilities | 118 | 150 | 175 | 190 | 17.1% |  |
| Net debt/(funds) | 25 | 42 | 55 | 67 | 39.5% |  |
| Shareholders' equity | 115 | 127 | 140 | 153 | 9.9% |  |
| Change in working capital | 2 | -4 | -1 | -1 | N/A |  |
| Cash flow from operations | 41 | 33 | 41 | 47 | 4.9% |  |
| Capital expenditure | -37 | -55 | -56 | -61 | N/A |  |
| Free cash flow | -1 | -17 | -13 | -12 | N/A |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 15.2 | 21.0 | 19.9 | 17.9 | 18.5 |  |
| EV/EBITDA (adj) (x) | 5.4 | 6.2 | 5.7 | 5.2 | 5.6 |  |
| Equity FCF yield (%) | -0.3 | -7.0 | -5.3 | -4.9 | -4.4 |  |
| P/Sales (x) | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |  |
| P/BV (x) | 2.1 | 1.9 | 1.8 | 1.6 | 1.9 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 2.0 | 2.7 | 2.9 | 3.0 | 2.7 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 5.9 | 1.6 | 2.5 | 3.0 | 3.3 |  |
| Square footage growth (%) | 23.2 | 25.5 | 17.7 | 16.5 | 20.7 |  |
| Inventory growth (%) | 28.2 | 20.0 | 12.0 | 11.0 | 17.8 |  |
| Capex/sales (%) | 6.8 | 7.8 | 6.9 | 6.7 | 7.0 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

natural grocers by vitamin cottage

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Natural Grocers by Vitamin Cottage Inc(NGVC): Quarterly and Annual EPS (USD)   |  | | --- | | NGVC | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 12.00 | | Price (19-Sep-2016) | | USD 10.97 | | Potential Upside/Downside | | +9.4% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Sep | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.16A | N/A | 0.17A | N/A | N/A | N/A | N/A | 6% | N/A |
| Q2 | 0.24A | N/A | 0.16A | N/A | N/A | N/A | N/A | -33% | N/A |
| Q3 | 0.19A | N/A | 0.12A | N/A | N/A | N/A | N/A | -37% | N/A |
| Q4 | 0.13A | N/A | 0.08E | N/A | N/A | N/A | N/A | -38% | N/A |
| Year | 0.72A | N/A | 0.52E | N/A | N/A | 0.55E | N/A | -28% | 6% |
| P/E | 15.2 |  | 21.0 |  |  | 19.9 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Slow Unit Growth Now to Stabilize the Business

Maintaining high-teens unit growth while comps are barely positive depresses margins, ROIC, and cash flow; initiate with an Equal Weight rating and $12 price target

We are initiating coverage with an Equal Weight rating and $12 price target. Our price target values Natural Grocers by Vitamin Cottage (NGVC) on a CY17 EV/EBITDA of ~6x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $9, or 4.7x CY17 EV/EBITDA (~60% probability), while our upside scenario is $17, or 8.0x CY17 EV/EBITDA (~40% probability).

In our view, NGVC is In Transition as the company was once a Growth Star, due to its 6.9% average comp since FY07 and ~20+% average unit growth. The company’s format offers an edited assortment of natural/organic products, and the strict product standards and focus on education differentiate it in an increasingly crowded space. Still, comps have slowed significantly to +0.7% in FY3Q due to increased cannibalization, softness in energy sensitive states (44% of sales), and greater competition. Meanwhile, despite the comp slowdown, the company is committed to unit growth of +22% in FY16 and +15%-18% in FY17, which is depressing margins, lease-adjusted ROIC and cash flow.

We believe the company can transition back to a Growth Star if it: 1) re-accelerates comps to +LSD-MSD sustainably; 2) slows unit growth to +10% in FY17 so that it is self-funded; and 3) stabilizes gross margins by lowering the comp needed to leverage fixed costs (currently ~3%) and increasing private label penetration. Ultimately, we believe slowing unit growth now improves the probability that the company returns to being a Growth Star later.

In addition, we believe the company’s strict quality standards and commitment to educating consumers about nutrition and health somewhat mitigate the threat of a worsening competitive environment. Although the environment has clearly worsened since July, when NGVC hosted its FY3Q16 earnings call (as noted by Sprouts’ lowering of guidance in September), the company’s edited assortment of natural/organic limits the company’s exposure to categories that are currently deflationary. As of FY3Q16, the company only experienced deflation in bulk commodities (e.g., almonds) while the rest of the store was +1%-2% inflationary (CPI Food at Home was -0.8% deflationary during this time period).

A more aggressive promotional environment will impact all retailers that sell food, but NGVC should be relatively less at risk because its product standards are unmatched among medium-to-large chain peers. The company’s Nutritional Health Coaches, lectures, demos, community events and Every Day Affordable Prices (e.g., attractive produce prices vs. WFM and mass/SFM) all build engagement and foster loyalty.

Equal Weight rating based on upside/downside scenario analysis

In our view, the company’s current CY17 EV/EBITDA multiple of 5.6x, short interest of ~18% of the float and YTD performance of down -46.1% (vs. S&P 500 up +4.7%) imply that NGVC is not being given credit for a sustainable growth opportunity. So, if comps re-accelerate to +LSD-MSD and unit growth becomes self-funded, then NGVC’s growth opportunity becomes more credible and we believe there would be material upside to the multiple. In this case, we would see upside to $17 (+55%), or ~8x CY17 EV/EBITDA. We believe there is a 40% probability that this scenario plays out. However, NGVC, so far, remains committed to achieving critical mass as fast as possible regardless of comp trends, so if comps continue to be flattish while unit growth is +15%-18%, then we see downside to $9 (-18%), or 4.7x CY17 EV/EBITDA (estimates would probably be lower in this scenario than our current estimates). We assign a 60% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $12 price target and Equal Weight rating. The following figure captures our view on the upside and downside for NGVC.

|  |
| --- |
| Figure  NGVC Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We believe upside is limited for a retailer with high-teens unit growth and almost no comp growth. However, the current CY17 EV/EBITDA multiple of 5.6x, short interest of ~18% of the float and YTD performance of down -46% (vs. S&P500 up +4%) imply that sentiment is already extremely negative. As such, we believe the risk/reward is fairly balanced at the current level. Our thesis reflects the following:

1. In Transition: a former Growth Star. NGVC is a former Growth Star with average comps of +6.9% since FY07 and average unit growth of +20+% going back to FY09. As a result of the strong comp and unit growth, EBITDA increased 21.9% annually between FY09-FY15. However, more recently, comps have slowed to barely positive while unit growth remains very high. So, we expect FY16 EBITDA to be down -7.5%. As a result, the stock is down -46.1% YTD (vs. the S&P500’s +4.7%). In our view, the company can become a Growth Star again if comps re-accelerate to +LSD-MSD, unit growth is slowed and gross margins are stabilized. Going forward, comps should benefit from: 1) if energy drilling activity re-accelerates – 56% of sales are in energy-sensitive states and comps are -1.6% in these states vs. +2.6% in other states; 2) heightened cannibalization should cycle in FY1Q17; 3) the company launches a new digital strategy in FY1Q17 and a new TV campaign in FY2Q17; and 4) easier comparisons.
2. Unit growth should be slowed to +10% in FY17. We like that NGVC’s format is unique and differentiated, but we also believe that it appeals only to the most dedicated natural/organic consumers. As a result, we view the company’s 1,100 unit goal as unrealistic. In addition, the company’s high-teens unit growth while comps are barely positive depresses margins, lease-adjusted ROIC and cash flow (LTM EBITDA margins are down -130 bps y/y, lease-adj. ROIC is down -210 bps y/y and operating cash flow less capex is -$18.7M). We would prefer to see NGVC slow unit growth to +10% in FY17 (13 stores) so that it is self-funded, which would lower capex to ~5% of sales (vs. 7.8% in FY16). Ideally, in FY17, NGVC should only open the 13 stores already under contract as of FY3Q16. We estimate that the pre-opening savings from opening 13 stores in FY17 vs. 21 (the midpoint of FY17 guidance) would add 25 bps to EBITDA margins and $0.06 (~10%) to EPS, assuming ~$250K in pre-opening expenses per store. If unit growth is slowed, then we believe attention would move away from the cash burn and back to NGVC’s highly differentiated format in an increasingly commoditized space.
3. Differentiated format somewhat protects against worsening environment. NGVC’s strict quality standards and commitment to educating consumers about nutrition and health somewhat mitigate the threat of a worsening competitive environment. The company’s strict product standards earn NGVC a legitimate halo of health – it only sells organic produce, meat that fits its naturally raised meat standard (e.g., cage-free, fed GMO-free vegetarian diet, antibiotic/hormone free), and bulk/dairy/grocery products that do not contain hydrogenated oils, artificial colors, flavors, sweeteners or preservatives. As a result of its strict product standards, it mainly sells natural/organic products that have limited supply and growing demand, which typically keep prices inflationary. For example, in FY3Q16, the company only experienced deflation in bulk commodities (e.g., almonds) while the rest of the store was +1%-2% inflationary; CPI Food-at-Home was -0.8% deflationary over this same time period. In addition, the Nutritional Health Coaches, lectures, demos, community events and Every Day Affordable Prices (e.g., attractive produce prices vs. WFM and mass/SFM) all build engagement and foster loyalty. So, even though the overall food retail environment has worsened since July, when NGVC hosted its FY3Q16 earnings call (as indicated by Sprouts’ lowering of guidance in September), we believe the company’s positioning somewhat insulates it from this deterioration. The company still faces headwinds from higher cannibalization and over-indexing to energy sensitive states.
4. Merchandise margins reflect fair price positioning. The company’s merchandise margins of 33.4% are only slightly above larger competitors Kroger (~32.5% in natural/organic) and Sprouts (32.0%), and they are below WFM at 37.5%. The companies have much different sales mixes that obscure the comparison (e.g., higher-margin dietary supplements are 22% of sales at NGVC vs. 10%-15% at SFM, and NGVC does not sell traditional prepared food while the others do). The company’s Every Day Affordable Prices typically result in 8%-10% better prices than WFM and 5%-7% better prices than Sprouts. As a result, we believe NGVC is effectively positioned to compete with larger chains in a normalized environment.
5. Opportunities to lower the comp needed to leverage fixed costs. Currently, it takes a comp of ~3% or greater for NGVC to leverage fixed costs, which we believe is unsustainable, especially in light of recent comp trends. We believe the company can lower this number by: 1) slowing unit growth so occupancy costs become less of a headwind, 2) reducing shrink (especially in dairy, deli and meat), 3) optimizing labor costs, and 4) increasing private label penetration from its current M-HSD sales penetration. By lowering this comp hurdle, the company will make it easier to maintain or grow gross margins going forward.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are relatively in-line with Consensus. For 4Q16, we assume flat daily average comps, which is a +6.2% 2-year stacked comp vs. +6.5% in 3Q; note that July was trending +0.7%. We expect comps accelerate in FY17 to +LSD due to easy compares combined with: 1) the new digital campaign launching in 1Q and the new TV campaign launching in 2Q; 2) potential for rising oil prices (as predicted by Barclays analysts and the US Energy Information Administration) to improve sales trends in the states sensitive to the energy industry (56% of sales); and 3) cycling heightened cannibalization in 1Q.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Company Reports, Barclays Research, Bloomberg, Thomson First Call |

The following figures show our price target valuation and NGVC’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  Price Target Valuation |  | Figure  Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY16-FY18. We assume capex as a percentage of sales declines from 7.8% of sales to 6.9% of sales in FY17 and 6.7% in FY18 to account for the slightly slower unit growth (mid-teens growth in FY17-FY18 vs. 22.3% y/y growth in FY16). In addition, we assume working capital is neither a source nor drag on cash flow, which is fairly consistent with FY14-FY15 ($2M source of cash flow in each year).

|  |  |
| --- | --- |
|  | Figure  NGVC Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) In Transition: a former Growth Star.

NGVC is a former Growth Star with average comps of ~7% since FY07 and average unit growth of 20+% since FY08. The following chart shows annual total comps going back to FY07. The comps have been volatile, but with the exception of FY09-FY10, they have been at least +MSD until very recently.

|  |  |
| --- | --- |
|  | Figure  NGVC Reported Comps |
|  |  |
| Source: Company Reports, Barclays Research |

The following two charts show quarterly daily average comps on 1-year and 2-year stacked bases. As indicated below, comps slowed meaningfully in 1Q16 and have stayed muted since then. Also, note that comparisons become incrementally easier in 1Q17 (up against +3.6% comp in 1Q16 vs. a +6.2% comp in 4Q15).

|  |  |  |
| --- | --- | --- |
| Figure  NGVC Daily Average Comps |  | Figure  NGVC 2-year Stacked Daily Average Comps |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

The next figure shows the company’s unit growth. Starting in FY09, unit growth has not fallen below +18%. Irrespective of the deteriorating comp, NGVC remains committed to unit growth.

|  |  |
| --- | --- |
|  | Figure  NGVC Unit Growth |
|  |  |
| Source: Company Reports, Barclays Research |

As a result of the strong comp and unit growth, EBITDA increased +21.9% annually between FY09 and FY15. However, more recently, comps have slowed and are now only slightly positive while unit growth remains very high. So, we expect FY16 EBITDA to decline -7.5%. In FY17, we expect EBITDA to increase +15.1% to $53.2M based on a +2.5% comp, -20 bps gross margin contraction and flattish EBITDA margins.

|  |  |
| --- | --- |
|  | Figure  Y/Y Change in EBITDA |
|  |  |
| Source: Company Reports, Barclays Research |

As a result of the y/y lower EBITDA in FY16, the stock is down -46.1% YTD (vs. the S&P500’s +4.7%). Most of the decline came after the company pre-announced much lower than expected comps for FY2Q16 in April.

|  |  |
| --- | --- |
|  | Figure  NGVC Stock Performance |
|  |  |
| Source: Thomson |

In our view, NGVC can become a Growth Star again if comps re-accelerate to +LSD-MSD, unit growth is slowed and gross margins are stabilized. Going forward, comps should benefit from: 1) if energy drilling activity re-accelerates – 56% of sales are in energy-sensitive states and comps are -1.6% in these states vs. +2.6% in other states; 2) heightened cannibalization should cycle in FY1Q17; 3) the company launches a new digital strategy in FY1Q17 and a new TV campaign in FY2Q17; and 4) much easier comparisons.

2) Unit growth should be slowed to +10% in FY17.

We like that NGVC’s format is unique and differentiated, but we also believe that it appeals only to the most dedicated natural/organic consumers. As a result, we view the company’s 1,100 unit goal as unrealistic. In addition, the company’s high-teens unit growth while comps are barely positive depresses margins, lease-adjusted ROIC and cash flow (LTM EBITDA margins are down -130 bps y/y, lease-adj. ROIC is down -210 bps y/y and operating cash flow less capex is -$18.7M).

The following figure shows the trend of EBITDA margins since FY09. Note the significant contraction in FY16E.

|  |  |
| --- | --- |
|  | Figure  NGVC EBITDA Margins |
|  |  |
| Source: Company Reports, Barclays Research |

The next chart compares lease-adjusted ROIC vs. the stock price. ROIC trends started to decelerate in 1Q16, consistent with when comps began to slow. Note that the correlation between lease-adjusted ROIC and the stock is +50% for all periods, but it is stronger since 1Q15 (albeit a small sample size). Despite the limited sample size, we believe valuation would benefit if ROIC increases and we believe slowing unit growth would increase ROIC.

|  |  |
| --- | --- |
|  | Figure  NGVC Lease-Adjusted ROIC vs. Share Price |
|  |  |
| Source: Company Reports, Barclays Research, Thomson |

We would prefer to see NGVC slow unit growth so that it is self-funded. As a result, we believe NGVC should lower capex to ~5% of sales or lower (vs. the current 7.8%). Ideally, in FY17, NGVC would only open the 13 stores (+10% unit growth) already under contract as of FY3Q16, which we estimate would cost about ~5% of sales. At +13 stores (+10% unit growth), NGVC would be able to self-fund the unit growth.

|  |  |
| --- | --- |
|  | Figure  Free Cash Flow Scenarios – NGVC Can Self-Fund +10% Unit Growth |
|  |  |
| Source: Company Reports, Barclays Research |

In addition, we estimate that the pre-opening savings from opening 13 stores in FY17 vs. 21 (the midpoint of FY17 guidance) would add ~25 bps to EBITDA margins and $0.06 (~10%) to EPS, assuming ~$250K in pre-opening expenses per store. If unit growth is slowed, then we believe attention would move away from the cash burn and back to NGVC’s highly differentiated format in an increasingly commoditized space.

3) Differentiated format somewhat protects against worsening environment

NGVC’s strict quality standards and commitment to educating consumers about nutrition and health somewhat mitigate the threat of a worsening competitive environment. The company’s strict product standards earn NGVC a legitimate halo of health – the company only sells organic produce, meat that fits its naturally raised meat standard (e.g., cage-free, fed GMO-free vegetarian diet, antibiotic/hormone free), and bulk/dairy/grocery products that do not contain hydrogenated oils, artificial colors, flavors, sweeteners or preservatives. As a result of its strict product standards, it mainly sells natural/organic products that have limited supply and growing demand, which typically keep prices inflationary. For example, in FY3Q16, the company only experienced deflation in bulk commodities (e.g., almonds) while the rest of the store was +1%-2% inflationary; CPI Food-at-Home was -0.8% deflationary over this same time period. In addition, the Nutritional Health Coaches, lectures, demos, community events and Every Day Affordable Prices (e.g., attractive produce prices vs. WFM and mass/SFM) all build engagement and foster loyalty. So, even though the overall food retail environment has worsened since July when NGVC hosted its FY3Q16 earnings call (as indicated by Sprouts’ lowering of guidance in September), we believe the company’s positioning somewhat insulates the company from this deterioration. Note that the company still faces headwinds from higher cannibalization and over-indexing to energy sensitive states.

4) Merchandise margins reflect fair price positioning

The company’s merchandise margins of 33.4% are only slightly above larger competitors Kroger (~32.5% in natural/organic) and Sprouts (32.0%), and they are below WFM at 37.5%. The companies have much different sales mixes that obscure the comparison (e.g., higher-margin dietary supplements are 22% of sales at NGVC vs. 10%-15% at SFM, and NGVC does not sell traditional prepared food while the others do). The company’s Every Day Affordable Prices typically result in 8%-10% better prices than WFM and 5%-7% better prices than Sprouts. As a result, we believe NGVC is effectively positioned to compete with larger chains in a normalized environment. The following chart compares NGVC’s merchandise margins vs. Kroger (natural/organic only), Sprouts, and Whole Foods. Note that we assume Kroger’s merchandise margin in natural/organic is 800 bps higher than its overall blended merchandise margin.

|  |  |
| --- | --- |
|  | Figure  Merchandise Margins: NGVC vs. KR, SFM and WFM |
|  |  |
| Source: Company Reports, Barclays Research |

5) Opportunities to lower the comp needed to leverage fixed costs

Currently, NGVC needs to generate a +3% comp to leverage fixed costs – unrealistic in the near-term given recent comp trends, little or no inflation and a heightened competitive environment. We believe the company can lower this number by: 1) slowing unit growth so occupancy costs become less of a headwind, 2) reducing shrink by improving execution in shorter shelf life categories (e.g., dairy, deli, meat), 3) optimizing labor costs, and 4) increasing private label penetration from its current M-HSD sales penetration. By lowering this comp hurdle, the company will make it easier to maintain or grow gross margins going forward.

Valuation and Conclusion

Our Equal Weight rating and $12 price target is based on our upside/downside scenario analysis. In our view, the company’s current CY17 EV/EBITDA multiple of 5.6x, short interest of ~18% of the float and YTD performance of down -46.1% (vs. S&P500 up +4.7%) imply that NGVC is not being given credit for a sustainable growth opportunity. So, if comps re-accelerate to +LSD-MSD and unit growth becomes self-funded then NGVC’s growth opportunity becomes more credible and we believe there would be material upside to the multiple. In this case, we would see upside to $17 (+55%), or ~8x CY17 EV/EBITDA of $55 million. We believe there is a 40% probability that this scenario plays out. However, NGVC, so far, remains committed to achieving “critical mass” as fast as possible regardless of comp trends, so if comps continue to be flattish while unit growth is +15%-18% then we see downside to $9 (-18%), or 4.7x CY17 EV/EBITDA (note that estimates would probably be lower in this scenario than our current estimates). We assign a 60% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $12 price target and Equal Weight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Smart & Final Stores Inc (SFS)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=SFS) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 12.58 | | Price Target | USD 13.00 | | **Why Equal Weight?** Our Price Target reflects: 1) Our view that the competitive environment will remain challenging near term, 2) there is some downside risk to 3Q16 and 4Q16 estimates, 3) our valuation multiple factors in SFS's higher leverage and slightly lower ROIC versus other "Growth Star" peers. | | |  | | | Upside case | USD 15.00 | | Reflects: 1) Deflation abates, 2) Expense headwinds associated with the Haggen openings abate, 3) Cannibalization normalizes, and as a result, 4) Traffic and comps normalize, 5) ROIC (pressured by Haggen) improves, 6) Free cash flow improves, therefore, 7) Debt paydown is likely. | | |  | | | Downside case | USD 11.00 | | Reflects: 1) Leverage higher than Growth peers, 2) ROIC lower than Growth peers, 3) Ongoing deflation, 4) Fear that Aldi will irreversibly worsen the landscape, 5) the Smart & Final concept isn't leverageable beyond the Southwest, and 6) weak results at Cash & Carry. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 3,971 | 4,389 | 4,887 | 5,500 | 11.5% |  |
| EBITDA (adj) | 168 | 151 | 186 | 223 | 9.8% |  |
| EBIT (adj) | 100 | 69 | 95 | 121 | 6.7% |  |
| Pre-tax income (adj) | 68 | 39 | 63 | 90 | 9.5% |  |
| Net income (adj) | 42 | 24 | 39 | 55 | 8.8% |  |
| EPS (adj) ($) | 0.55 | 0.30 | 0.49 | 0.69 | 8.2% |  |
| Diluted shares (mn) | 77.1 | 78.6 | 78.6 | 78.6 | 0.6% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 4.2 | 3.5 | 3.8 | 4.1 | 3.9 |  |
| EBIT (adj) margin (%) | 2.5 | 1.6 | 1.9 | 2.2 | 2.1 |  |
| Pre-tax (adj) margin (%) | 1.7 | 0.9 | 1.3 | 1.6 | 1.4 |  |
| Net (adj) margin (%) | 1.1 | 0.5 | 0.8 | 1.0 | 0.8 |  |
| ROIC (%) | 7.8 | 7.0 | 7.1 | 7.6 | 7.4 |  |
| ROE (%) | 7.8 | 4.1 | 6.4 | 8.4 | 6.7 |  |
| ROA (lease adjusted) (%) | 6.3 | 5.8 | 6.1 | 6.5 | 6.2 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 380 | 453 | 508 | 566 | 14.2% |  |
| Intangible fixed assets | 999 | 999 | 999 | 999 | 0.0% |  |
| Cash and equivalents | 59 | 6 | 5 | 10 | -44.3% |  |
| Total assets | 1,821 | 1,887 | 1,989 | 2,107 | 5.0% |  |
| Short and long-term debt | 595 | 595 | 605 | 605 | 0.6% |  |
| Total liabilities | 1,255 | 1,302 | 1,365 | 1,429 | 4.4% |  |
| Net debt/(funds) | 536 | 560 | 559 | 545 | 0.5% |  |
| Shareholders' equity | 567 | 585 | 624 | 678 | 6.2% |  |
| Change in working capital | 20 | 0 | -6 | -7 | N/A |  |
| Cash flow from operations | 145 | 107 | 136 | 164 | 4.2% |  |
| Capital expenditure | -133 | -155 | -147 | -159 | N/A |  |
| Free cash flow | 13 | -29 | 1 | 14 | 2.9% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 22.9 | 41.8 | 25.6 | 18.1 | 27.1 |  |
| EV/EBITDA (adj) (x) | 9.1 | 10.4 | 8.6 | 7.1 | 8.8 |  |
| Equity FCF yield (%) | 1.4 | -2.9 | 0.1 | 1.5 | -0.0 |  |
| P/Sales (x) | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |  |
| P/BV (x) | 1.7 | 1.7 | 1.6 | 1.5 | 1.6 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 5.0 | 5.8 | 5.4 | 5.0 | 5.3 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 4.5 | 0.0 | 2.9 | 3.9 | 2.8 |  |
| Square footage growth (%) | 10.8 | 19.6 | 12.1 | 12.1 | 13.7 |  |
| Inventory growth (%) | 4.9 | 13.4 | 10.5 | 11.3 | 10.0 |  |
| Capex/sales (%) | 3.5 | 3.5 | 3.0 | 2.9 | 3.2 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

smart and final

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Smart & Final Stores Inc(SFS): Quarterly and Annual EPS (USD)   |  | | --- | | SFS | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 13.00 | | Price (19-Sep-2016) | | USD 12.58 | | Potential Upside/Downside | | +3.3% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.06A | N/A | -0.02A | 0.08A | N/A | N/A | 0.09E | N/A | N/A |
| Q2 | 0.18A | N/A | 0.11A | 0.20A | N/A | N/A | 0.18E | -39% | N/A |
| Q3 | 0.17A | N/A | 0.11E | 0.16E | N/A | N/A | 0.23E | -35% | N/A |
| Q4 | 0.14A | N/A | 0.10E | 0.12E | N/A | N/A | 0.16E | -29% | N/A |
| Year | 0.55A | N/A | 0.30E | 0.56E | N/A | 0.49E | 0.67E | -45% | 63% |
| P/E | 22.9 |  | 41.8 |  |  | 25.6 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Perfect Storm Will Linger Throughout 2016

Industry and company specific headwinds make us cautious for now; initiate at Equal Weight with a $13 price target

We view SFS as a Growth Star given the significant runway for unit growth, historical consistency of comp and share (traffic) gains, improving ROIC, and opportunities to delever. Near term, however, the environment remains very challenging, and we do not believe the downside risk is fully priced in. As a result, we are initiating coverage with an Equal Weight rating and $13 price target. Our price target values SFS on a FY17 EV/EBITDA of 8.5x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $11, or 7.5x FY17 EV/EBITDA (~40% probability), while our upside scenario is $15, or 9.5x FY17 EV/EBITDA (~60% probability).

As a backdrop: we view SFS as a Growth Star with significant opportunity to gain share and broaden its footprint within both its existing and adjacent footprint over the long-term.

Specifically, what we like about the SFS story: 1) the consistency of comps and tonnage (excluding the temporary Haggen cannibalization); 2) the unit growth story for both the Smart & Final (S&F) and Cash & Carry (C&C) banners; 3) FY17E EBITDA and EPS growth of +22.5% and +63.4%, respectively; 4) our expectation for improving ROIC in FY17; 5) SFS’ proven track record of offering fresh within the confines of a discount format – a combination that has eluded many retailers over the years; and 6) we believe SFS’ current geographic concentration shelters it from what could become a fairly heated land grab amongst mass, dollar stores and conventional supermarkets.

However, FY16 represents a perfect storm for SFS – with deflation and self-inflicted cannibalization impacting results. The stock reflects some of these issues – SFS is down -30.9% YTD vs. the S&P500’s +4.7%, but our concerns in the intermediate term are the following: 1) persistent deflation is resulting in an increasingly competitive environment across food retail; 2) the potential for tough 3Q16 results that reflect worsening deflation – note – SFM - a specialty retailer with a similar footprint recently reduced guidance meaningfully based on competitive challenges in the Southwest; and 3) the lumpiness to results and lack of visibility into core fundamentals that the Haggen acquisition has created.

Equal Weight rating based on upside/downside scenario analysis

As a result of the above, we see downside to $11 – or a FY17 EV/EBITDA of 7.5x. We assign a 40% probability to a sustained, challenging environment in FY17. Once the environment normalizes, we see upside to $15 – a FY17 EV/EBITDA of 9.5x (60% probability). The weighted average of these two scenarios gets us to our price target of $13 – +3% upside – warranting an Equal Weight rating. Please note that our price target and estimates do not add back stock compensation expense, pre-opening costs, or non-cash rent. As a result, our EBITDA is generally 10-15% below the company’s adjusted EBITDA, but we believe our estimates are more consistent with how investors view it – and our recommendation is based on our definition of EBITDA.

|  |
| --- |
| Figure  SFS Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

Despite the fact that we believe Smart & Final is a Growth Star with significant long-term upside, our Equal Weight rating is based on our belief that near term, the environment remains very challenging, and we do not believe the downside risk is fully priced in given the recently reduced guidance from SFM – a specialty retailer with very direct overlap with the Smart & Final banner. Longer term, we believe SFS is positioned to continue gaining share in existing and adjacent markets. Specifically, our Equal Weight thesis reflects the following:

1. Persistent deflation is pressuring the P&L. The current period of food price deflation is set to be the longest period of deflation in almost 50 years, and it is contributing to heightened competitive activity. Deflation obviously weighs on comps, but it also exacerbates the headwinds from growth investments leading to significant margin compression.
2. Further risk to the downside. Although SFS is down -30.9% YTD vs. the S&P 500’s +4.7%, we believe the environment deteriorated meaningfully in August and into September, just after it reported earnings (on 7/28/2016), so we see further risk to the downside. In addition, SFM (with locations in all of SFS’ states) recently lowered guidance due to heightened competitive (and irrational) behaviour from conventional operators. SFM is down -10.1% since 9/7/16 on the revised guidance vs. the S&P 500 -2.2% – so in our experience, downside is not always priced in. Leading up to the earnings revision, SFM was down -14.2% YTD (vs. the S&P 500 +7.0%). SFS does trade at a lower multiple than SFM (justified given lower ROIC, greater leverage and lower unit growth in a normalized environment), so it is possible we are being too cautious – nevertheless, we would prefer a conservative approach.

What We Like:

* SFS is a consistent share gainer as evidenced by its strong record of comp and tonnage growth. The company’s proven track record of offering fresh within the confines of a discount format while offering very competitive prices across the store support these share gains.
* Both banners (S&F and C&C) have strong and credible unit growth opportunities due to the banners’ strong track record at gaining share. We believe the opportunistic purchase of 33 Haggen stores in Southern California will ultimately pay off for SFS as the long-term benefits of density offset the near-term headwinds from cannibalization, but in the near-term the lumpiness of results and lack of visibility into core fundamentals create risk. In addition, while not to be dismissed, based on our store checks, we believe Aldi will likely have a minimal impact on S&F. We also like the decision to accelerate C&C’s unit growth to ~10% next year as the banner requires ~50% less capex than S&F and has exposure to a more benign competitive environment (foodservice vs. food retail).
* We expect EBITDA, lease-adjusted ROIC and free cash flow to improve in FY17. Implied in our forecasts are our assumptions that cannibalization returns to more normalized levels and deflation eases in FY17. We do suggest that SFS focus on de-leveraging the balance sheet when possible because we believe growth companies with less leverage warrant higher multiples.

Summary of Financials & Valuation

Below we highlight our estimates vs. Consensus. In general, we are below Consensus because we do not add back stock compensation expenses, pre-opening costs or non-cash rent.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, ConsensusMetrix |

The following figures show our price target valuation and SFS’ current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  SFS Price Target Valuation |  | Figure  SFS Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY16-FY18. We assume SFS is able to generate free cash flow in FY17 based on: 1) EBITDA recovers from the FY16 temporary Haggen-related cannibalization and expense investment headwinds; and 2) capex as a percentage of sales moderates to 3.0% (vs. 3.5% in FY16E).

|  |  |
| --- | --- |
|  | Figure  SFS Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) Persistent deflation is pressuring the P&L

The current period of food price deflation started 9 months ago, and at 9 months, it is tied with the 2009-2010 period as the longest in 50 years. Given that we believe deflation could extend through the end of CY2015, it has the potential to be the first period of “deflation on deflation” since 1960.

|  |  |
| --- | --- |
|  | Figure  CPI Food at Home Y/Y Inflation/Deflation |
|  |  |
| Source: BLS |

The next figure shows inflation trends by major category starting in July 2015. Unfortunately, deflation in PPI for Farm products actually further deteriorated sequentially in August 2016 (i.e., versus July 2016).

|  |
| --- |
| Figure  CPI Inflation Data by Category |
|  |
| Source: BLS |

The following figure compares deflationary periods since 1959. The current deflationary period is set to be the longest since 1960.

|  |
| --- |
| Figure  Comparison of Deflationary Periods in Last 60 Years |
|  |
| Source: BLS |

Deflation pressures comps

Comps at both banners are obviously impacted by inflation/deflation, so it is no surprise that comps have decelerated at both banners as deflation has worsened. The next figure shows how comps have decelerated along with food prices. (S&F comps also are negatively impacted by the cannibalization described later). Note we use banner-specific inflation data when available, and supplement it with CPI Food at Home data when necessary.

|  |  |  |
| --- | --- | --- |
| Figure  S&F Banner Comps vs. Inflation/Deflation |  | Figure  C&C Banner Comps vs. Inflation/Deflation |
|  |  |  |
| Source: Company Reports |  | Source: Company Reports, BLS |

Deflation for a growth story is particularly problematic and can meaningfully weigh on EBITDA

In 2015, SFS opened, converted and remodeled 20, 6 and 3 Smart & Final bannered stores to the Extra format. In 2016, the company plans to open, convert and remodel 33, 6 and 6 stores respectively (including the Haggen units). These new stores target a cash-on-cash return in excess of 25% in year 3, but are initially a drag on EBITDA as the stores ramp. The drag from less profitable, newer units combined with deleverage (in the face of a deflationary environment) are pressuring EBITDA. EBITDA was down -27% in 1Q and -15.6% in 2Q. S&F is facing almost a perfect storm in FY16: depressed comps are leading to significant operating de-leverage (~150 bps EBIT margin contraction in FY16E) because there are even less sales dollars to cover the heightened investments in growth (e.g., higher occupancy, labor, training and marketing costs).

|  |  |
| --- | --- |
|  | Figure  S&F Banner EBITDA Growth vs. Unit Growth |
|  |  |
| Source: Company Reports, Barclays Research |

Extended deflation also encourages more promotional behavior

Extended periods of deflation, like the one we are in today, also have the negative impact of encouraging more promotional behavior as retailers desperately attempt to maintain share. There is a risk that the increased promotional behavior creates a negative feedback loop which further pressures comps and encourages more promotional behavior. Sprouts’ 9/7/2016 pre-announcement and guidance reduction due to extended deflation and increasing promotional behavior suggests that this cycle could be beginning – at least in SFM’s markets. SFM specifically called out Texas as being hyper competitive, which SFS does not have a presence in, however SFM also indicated the heightened competitive environment was not limited only to Texas – it was widespread across SFM’s footprint, which includes California, Arizona and Nevada, where all of S&F’s stores are based. Nevertheless, this is a risk we will monitor.

2) YTD performance and current valuation suggest much of the downside could be priced in, but we prefer a conservative approach

While SFS shares are down -30.9% year to date (vs. the S&P 500’s +4.7%), and down -16.3% since reporting 2Q results on 7/28/2016 (vs. the S&P’s -1.4%), SFM indicated the environment meaningfully deteriorated in August and further into September. The company also indicated the irrational behavior was largely coming from conventional operators. Since SFM’s reduction of guidance on September 7th – SFM is down -10.1% while SFS is only down -3.2%. While SFS is down more than SFM YTD, and while SFS is a lower multiple stock – experience tells us bad news is rarely fully priced in. In addition, in our view – SFS’s lower CY17 valuation multiple (versus SFM) is warranted given SFS’s lower ROIC, higher leverage and lower unit growth (on an ongoing basis, excluding Haggen). The following figure compares SFS vs. SFM on lease-adjusted ROIC, FY17 unit growth, net debt to EBITDAR and EV/EBITDA and PE.

|  |  |
| --- | --- |
|  | Figure  SFS vs. SFM on Key Metrics |
|  |  |
| Source: Company Reports, Barclays Research |

The following exhibit shows SFS stock performance YTD.

|  |  |
| --- | --- |
|  | Figure  SFS vs. S&P 500 YTD Stock Price Performance |
|  |  |
| Source: Thomson Reuters |

The next two figures show historical valuation trends since SFS became public in September 2014. Current valuation is well below historical levels.

|  |  |  |
| --- | --- | --- |
| Figure  Historical Forward NTM EV/EBITDA Valuation |  | Figure  Historical Forward NTM P/E Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

As a basis of comparison the chart below shows SFS and SFM stock performance year-to-date.

|  |  |
| --- | --- |
|  | Figure  SFS vs. SFM YTD Stock Price Performance |
|  |  |
| Source: Thomson Reuters |

The next figure shows historical forward EV/EBITDA trends versus SFM since SFS became public in September 2014 (SFM went public in August 2013).

|  |  |
| --- | --- |
|  | Figure  SFS vs. SFM Forward NTM EV/EBITDA |
|  |  |
| Source: Company Reports, Barclays Research |

What We Like

3) SFS is a consistent share gainer.

SFS generated an average consolidated comp of +5.6% over the last 26 years, which is above the ~3.6% average annual increase in food-at-home spend over the same time period, demonstrating that SFS is a share gainer. The following figure shows SFS’ **consolidated** comps over the last 26 years.

|  |  |
| --- | --- |
|  | Figure  Consolidated Comps Show Consistent Share Gains Over Time |
|  |  |
| Source: Company Data, USDA |

Until very recently, quarterly comps have also been impressive since the company re-emerged as a public company in September 2014. However, beginning in FY16, comps have slowed at both banners due to: 1) deflation (impacting both banners), and 2) Haggen-related cannibalization (impacting S&F only).

Smart & Final banner comps

Comps at S&F slowed in 1Q16 when deflation started and S&F began opening the former Haggen stores. We expect S&F comps to re-accelerate to 3%-4% in FY17-FY18 once the company cycles the Haggen openings and deflation moderates. In our view, S&F is structurally positioned to gain share due to: 1) its materially lower prices vs. conventional supermarkets (enabled by its lower labor cost model – S&F is a non-union employer); 2) its in-line prices on ~2,100 EDLP prices vs. Walmart; and 3) the banner’s proven track record of offering fresh within the confines of a discount format, which has eluded many of its hard-discount competitors. The following figure shows quarterly comps at the S&F banner and our annual forecasts through FY18.

|  |  |
| --- | --- |
|  | Figure  S&F Banner Comps |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows S&F’s tonnage trends, which is comps less inflation. Note we use S&F-specific inflation data when disclosed, but supplement it with CPI Food-at-Home data when it is not available. The deterioration in tonnage trends coincided with the increased cannibalization related to Haggen.

|  |  |
| --- | --- |
|  | Figure  S&F Banner “Tonnage” (Comps Less Inflation) |
|  |  |
| Source: Company Reports, BLS |

Cash & Carry banner comps

C&C is a differentiated concept that competes with foodservice distributors and other cash and carry concepts such as Restaurant Depot. The cash and carry concept is positioned to continue gaining share from traditional foodservice distributors given the convenience (no minimum drop sizes) and competitive pricing. C&C comps are very sensitive to commodity prices, particularly beef, dairy and produce prices. Comps benefitted significantly from beef inflation in 2Q14-1Q15 (when comps were up an average of 10.8% and CPI for protein was up 8.0% on average during the same period). In 2Q15, comps began to slow when produce and dairy turned deflationary and meat was disinflationary. We believe comps should re-accelerate next year as deflation moderates. However, cannibalization will increase next year as the company accelerates unit growth to ~10% vs. 7% in FY16. The figure below shows C&C quarterly comps and our annual estimates in FY16-FY18.

|  |  |
| --- | --- |
|  | Figure  C&C Banner Comps |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure highlights C&C quarterly “tonnage” trends (comps less inflation). Note trends were very strong through FY14, but slowed late in FY15 and in FY16 due cycling very strong gains in the prior year. Similar to S&F data, we use C&C-specific inflation data when possible, and supplement the data with CPI Food-at-Home when necessary.

|  |  |
| --- | --- |
|  | Figure  C&C Banner Tonnage (Comps Less Inflation) |
|  |  |
| Source: Company Reports, BLS, Barclays Research |

4) Both banners have strong and credible unit growth opportunities.

We believe the S&F and C&C banners both have strong and credible long-term unit growth opportunities. Our belief is based on: 1) the banners’ strong track record at gaining share, 2) S&F’s proven success at opening stores, and 3) the new stores’ strong unit economics. In addition, we believe there is ample opportunity for the stores to grow in existing markets and adjacent markets. A longer-term opportunity is to bring S&F to the Pacific Northwest (C&C’s core market) and C&C to Southern California (S&F’s core market) with minimal cannibalization. The following figure shows S&F’s unit count since 1Q13.

|  |  |
| --- | --- |
|  | Figure  S&F Banner Unit Count |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows y/y unit growth for both banners. S&F has been growing at least at a HSD growth rate since 2H14. C&C opened its first store since 2009 in 4Q14. Since then, C&C has been slowly accelerating unit growth to +7.3% in FY16 and +10.2% in FY17. Note that S&F’s growth rate accelerated to 15-20% in FY16 as the company purchased 33 former Haggen stores. The acquisition helps S&F increase density and market share in existing markets – and while not evident today – the acquisition should increase returns in existing markets.

|  |  |
| --- | --- |
|  | Figure  Unit Growth by Banner |
|  |  |
| Source: Company Data, Barclays Research |

C&C has always been viewed as a strong generator of very stable free cash flow. In general –new store productivity at C&C is lower versus S&F given the mix of business customers at C&C (~90+%) versus S&F (~33%) because business customers are risk averse and therefore are generally reluctant to use alternate sources of supply (there is stickiness). As a result, the EBITDA and comp waterfall has not, historically, been as attractive as the waterfall at S&F.

Historically, this has led to caution on accelerating unit growth, but we believe management now feels confident returns at C&C will be similar to S&F and as a result, the company now plans to accelerate unit growth at the banner. In our view, C&C is a very attractive growth vehicle, with equal IRRs and lower capex, so we believe the banner represents an equal, if not greater, growth opportunity. As indicated in the following two figures, we believe the new store IRRs are similar (~20-25% range). The following figure shows our new store IRR estimates for S&F.

|  |
| --- |
| Figure  Smart & Final Banner New Store IRR |
|  |
| Source: Company Data, Barclays Research |

The next exhibit illustrates our new store IRR estimates for C&C stores. Note that the EBITDA per store at C&C is less than half of S&F, but the capex per store is also less than half so the returns are similar. We also note that margins are higher at the C&C format due to: 1) less labor per store (~12 employees per store vs. ~40 at S&F); and 2) lower rent per square foot, and 3) a more benign competitive environment in foodservice distribution versus food retail. We support the decision to accelerate unit growth at C&C to +10% because we believe the format is truly differentiated and has a long runway of growth.

|  |
| --- |
| Figure  Cash & Carry New Store IRR |
|  |
| Source: Company Data, Barclays Research |

Purchase of 33 former Haggen stores results in significantly higher cannibalization

The primary benefit of the purchase of the Haggen stores is that it adds significant density to some of S&F’s existing markets. However, a byproduct of adding significant density in a short period of time is heightened cannibalization, which is what the S&F banner is currently facing – and this headwind coincides with unprecedented deflation. The following figure shows cannibalization trends at S&F. Cannibalization should return to more normalized levels in FY17 once the Haggen stores are cycled in 1H17. Note that while cannibalization eases at the S&F banner next year, it should increase at C&C, but to a lesser degree.

|  |  |
| --- | --- |
|  | Figure  S&F Cannibalization: Extremely Elevated in FY16 |
|  |  |
| Source: Company Data; Barclays Research |

S&F banner comps slowed in FY16 due to this self-inflicted cannibalization. The next exhibit shows how the slowdown in comps coincides with a significant ramp in unit growth.

|  |  |
| --- | --- |
|  | Figure  S&F Banner Comps vs. Unit Growth |
|  |  |
| Source: Company Data, Barclays Research |

5) EBITDA, lease-adj. ROIC and FCF should improve in FY17

We expect EBITDA, lease-adjusted ROIC and free cash flow to improve next year as we believe cannibalization will return to more normalized levels, deflation will ease, and the company cycles heavy pre-opening expenses incurred to support the Haggen openings.

EBITDA

EBITDA will decline -10.1% in FY16 due to the Haggen openings and deflation pressures. We expect it to recover and grow significantly in FY17. We define EBITDA differently than SFS and consensus: we do not add back pre-opening costs, stock based comp or non cash-rent to our EBITDA. The following figure shows recent EBITDA trends and our forecasts for FY16-FY18.

|  |  |
| --- | --- |
|  | Figure  SFS Consolidated EBITDA Change |
|  |  |
| Source: Company Reports |

Lease-adjusted ROIC

In addition to EBITDA, lease-adjusted ROIC also deteriorated in FY16 due to the Haggen openings and deflation. We expect ROIC to recover next year – a function of a significant increase in EBITDA year-over-year.

|  |  |
| --- | --- |
|  | Figure  SFS Lease-adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Research |

However, ROIC is still the lowest in its peer class (even after adjusting for the goodwill associated with its take-out). We factor this in to our valuation methodology and price target.

|  |  |
| --- | --- |
|  | Figure  Lease-Adjusted ROIC: SFS vs. Peers |
|  |  |
| Source: Company Reports, Barclays Research |

Free Cash Flow

The purchase of the Haggen stores and deflation are a drag on free cash flow in FY16. However, we assume SFS is slightly free cash flow positive in FY17 based on our expectation for EBITDA to increase +22.5% and capex as a percentage of sales to decline to ~3.0% of sales (vs. ~3.5% in FY16). Our FY17 FCF estimate also assumes both banners grow units by ~10%. In addition, we believe FCF should improve further in FY18 as EBITDA continues to increase (e.g., the Haggen stores rise along the maturity curve) and capex as a percentage of sales declines slightly despite maintaining ~10% unit growth at both banners. The following figure shows our free cash flow estimates for FY16-FY18.

|  |  |
| --- | --- |
|  | Figure  Smart & Final (SFS) Free Cash Flow Estimates |
|  |  |
| Source: Company Reports, Barclays Research |

SFS has the lowest free cash flow yield relative to other retailers in our universe. We also factor this in to our valuation methodology and price target.

|  |  |
| --- | --- |
|  | Figure  CY2017 Free Cash Flow Yield: SFS vs. Peers |
|  |  |
| Source: Company Reports, Barclays Research |

SFS has the highest leverage among its Growth Star peers as shown in the next figure. In addition to growing units, we suggest SFS also focus on reducing leverage when possible. We estimate interest expense is currently a ~300 bps drag on free cash flow yield; so, FCF would increase substantially if debt was reduced. In addition, we believe growth companies with less leverage warrant higher multiples. The following charts show SFS’ leverage ratios vs. other retailers.

|  |  |  |
| --- | --- | --- |
| Figure  LTM Net Debt to EBITDA: SFS vs. Peers |  | Figure  LTM Adj. Net Debt to EBITDAR: SFS vs. Peers |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Valuation and Conclusion

As a result of the above, we see downside to $11 – or a FY17 EV/EBITDA of 7.5x on our EBITDA of $186 million. We assign a 40% probability to a sustained, challenging environment in FY17. Once the environment normalizes, we see upside to $15 – a FY17 EV/EBITDA of 9.5x (60% probability). The weighted average of these two scenarios gets us to our price target of $13 – +3% upside – warranting an Equal Weight rating. Please note that our price target and estimates do not add back stock compensation expense, pre-opening costs, or non-cash rent. As a result, our EBITDA is generally 10-15% below the company’s adjusted EBITDA, but we believe our estimates are more consistent with how investors view it – and our recommendation is based on our definition of EBITDA.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [SpartanNash Co (SPTN)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=SPTN) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 29.18 | | Price Target | USD 31.00 | | **Why Equal Weight?** We assume a CY17 EV/EBITDA multiple of 6.6x, which we believe is fair given the instability of retail, and we note that historically SPTN has not traded above ~7x without stable retail comps (ex 1H15 when the Nash Finch stores entered the comp base, but the legacy stores were still positive). | | |  | | | Upside case | USD 40.00 | | Reflects: 1) Increasing distribution sales; 2) growing military sales led by new category wins; 3) stable retail sales; 4) accelerating organic EBITDA growth as a result of a stable to increasing top-line; and 5) accretive acquisitions. | | |  | | | Downside case | USD 25.00 | | Reflects an unstable top-line caused by: 1) increasingly competitive environment at retail caused by extended deflation, a more aggressive Walmart, and/or competitive openings; 2) increasingly competitive environment among distributors for new business; and 3) no new account wins. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 7,652 | 7,722 | 7,794 | 7,875 | 1.0% |  |
| EBITDA (adj) | 223 | 227 | 231 | 237 | 2.1% |  |
| EBIT (adj) | 141 | 148 | 155 | 161 | 4.5% |  |
| Pre-tax income (adj) | 119 | 129 | 136 | 142 | 5.9% |  |
| Net income (adj) | 75 | 80 | 84 | 88 | 5.7% |  |
| EPS (adj) ($) | 1.98 | 2.13 | 2.24 | 2.32 | 5.5% |  |
| Diluted shares (mn) | 37.7 | 37.5 | 37.5 | 37.9 | 0.1% |  |
| DPS ($) | 0.54 | 0.60 | 0.63 | 0.66 | 7.0% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 2.9 | 2.9 | 3.0 | 3.0 | 3.0 |  |
| EBIT (adj) margin (%) | 1.8 | 1.9 | 2.0 | 2.0 | 1.9 |  |
| Pre-tax (adj) margin (%) | 1.6 | 1.7 | 1.7 | 1.8 | 1.7 |  |
| Net (adj) margin (%) | 1.0 | 1.0 | 1.1 | 1.1 | 1.1 |  |
| ROIC (%) | 6.6 | 6.8 | 7.0 | 7.2 | 6.9 |  |
| ROE (%) | 9.7 | 9.8 | 9.7 | 9.5 | 9.7 |  |
| ROA (lease adjusted) (%) | 5.2 | 5.4 | 5.4 | 5.5 | 5.4 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 584 | 581 | 583 | 586 | 0.1% |  |
| Intangible fixed assets | 323 | 323 | 323 | 323 | 0.0% |  |
| Cash and equivalents | 23 | 50 | 88 | 141 | 83.7% |  |
| Total assets | 1,925 | 1,961 | 2,016 | 2,084 | 2.7% |  |
| Short and long-term debt | 495 | 495 | 495 | 495 | 0.0% |  |
| Total liabilities | 1,135 | 1,121 | 1,126 | 1,131 | -0.1% |  |
| Net debt/(funds) | 472 | 409 | 353 | 285 | -15.5% |  |
| Shareholders' equity | 791 | 839 | 890 | 953 | 6.4% |  |
| Change in working capital | 53 | -43 | -9 | -7 | N/A |  |
| Cash flow from operations | 219 | 132 | 150 | 156 | -10.7% |  |
| Capital expenditure | -79 | -74 | -78 | -79 | N/A |  |
| Free cash flow | 140 | 95 | 89 | 93 | -12.7% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 14.8 | 13.7 | 13.0 | 12.6 | 13.5 |  |
| EV/EBITDA (adj) (x) | 7.0 | 6.6 | 6.3 | 5.8 | 6.4 |  |
| Equity FCF yield (%) | 12.7 | 8.6 | 8.2 | 8.4 | 9.5 |  |
| P/Sales (x) | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |  |
| P/BV (x) | 1.4 | 1.3 | 1.2 | 1.2 | 1.3 |  |
| Dividend yield (%) | 1.9 | 2.1 | 2.2 | 2.3 | 2.1 |  |
| Adj debt/EBITDAR (x) | 2.9 | 2.7 | 2.5 | 2.2 | 2.6 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | -2.9 | -2.2 | -1.0 | 0.5 | -1.4 |  |
| Square footage growth (%) | 0.6 | -2.5 | 0.0 | 0.0 | -0.5 |  |
| Inventory growth (%) | -9.7 | 8.2 | 6.7 | 7.2 | 3.1 |  |
| Capex/sales (%) | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

spartannash

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| SpartanNash Co(SPTN): Quarterly and Annual EPS (USD)   |  | | --- | | SPTN | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 31.00 | | Price (19-Sep-2016) | | USD 29.18 | | Potential Upside/Downside | | +6.2% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.44A | N/A | 0.54A | 0.54A | N/A | N/A | 0.58E | 23% | N/A |
| Q2 | 0.53A | N/A | 0.58A | 0.58A | N/A | N/A | 0.59E | 9% | N/A |
| Q3 | 0.49A | N/A | 0.53E | 0.54E | N/A | N/A | 0.54E | 8% | N/A |
| Q4 | 0.52A | N/A | 0.49E | 0.49E | N/A | N/A | 0.52E | -6% | N/A |
| Year | 1.98A | N/A | 2.13E | 2.15E | N/A | 2.24E | 2.27E | 8% | 5% |
| P/E | 14.8 |  | 13.7 |  |  | 13.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Limited Upside Until Retail Stabilizes

Consistent free cash flow generation offset by unstable retail top-line; initiate with an Equal Weight rating and $31 price target

We are initiating coverage with an Equal Weight rating and $31 price target. Our price target values SpartanNash (SPTN) on a CY17 EV/EBITDA of 6.6x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $25, or 5.5x CY17 EV/EBITDA (~60% probability), while our upside scenario is $40, or 8.0x CY17 EV/EBITDA (~40% probability).

In our view, SPTN is a Stable Staple with strong free cash flow generation (8.2% CY17 FCF yield), a solid balance sheet (2.1x LTM net debt to EBITDA) and a best-in-class management team – although, with lower than average ROIC at 7.0% vs. a 13%-14.0% staple peer average. We like the company’s good track record of maintaining profit despite shaky top-line trends (LTM operating profit is up +6.5% while sales is down -2.9%) and their creative solutions to growing the top-line by pursuing sales opportunities with non-traditional customers. In addition, we believe SPTN is well positioned to participate in industry consolidation – and the management team has a strong track record of realizing synergies (SPTN is set to exceed its $52M synergy target for the Nash Finch deal). We also believe the company’s strong free cash flow and balance sheet support increasing the payout ratio from its current ~27%.

However, the inconsistent top-line trends in the retail segment, particularly at the legacy Nash Finch stores, detract from the company’s cash flow story. Since 1Q15, when the Nash Finch stores entered the comp base, comps have declined ~3.0% on average. Some of the decline can be attributed to a more challenging operating environment vs. other regions of the country (for example, stores in North Dakota are negatively impacted by the decline in oil drilling), but at a minimum, it reflects share losses, especially at the legacy Nash Finch stores. In addition, it will be harder to maintain profit going forward with most of the Nash Finch synergies realized in FY16. In our view, SPTN should sell these Western stores to its distribution customers.

In addition, the operating environment for all of food retail appears to have worsened in 3Q16 due to extended deflation and a heightened competitive environment resulting from deflation. Sprouts lowered guidance on 9/7/2016. While SPTN is down -9.8% since SFM cut its guidance (vs. S&P500 -2.2% and SFM -10.1%), it is still up +34.8% YTD (vs. the S&P500 +4.7%), which suggests to us that a stepped-up competitive environment may not be entirely priced in. As a result, we believe a deteriorating competitive environment could keep comps negative -LSD for at least several quarters.

Equal Weight rating based on upside/downside scenario analysis

Given our concerns regarding the retail business and the potential for a worsening environment, we would prefer to wait for a better entry point. If the competitive environment further deteriorates, we see downside to $25 (-16% downside), or 5.5x CY17 EV/EBITDA. We assign a 60% probability of this scenario playing out. If, however, the company is able to stabilize comps and continue to win new distribution contracts then we see upside to $40 (+37% upside), or 8.0x CY17 EV/EBITDA. We believe there is a 40% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $31 price target and Equal Weight rating. The following figure captures our view on the upside and downside for SPTN.

|  |
| --- |
| Figure  SPTN Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We view SPTN as a Stable Staple with strong free cash flow, a solid balance sheet, and opportunities to grow the distribution business organically and through acquisitions. However, we are concerned that the competitive environment has worsened in retail and we believe upside is limited with negative retail comps. Our thesis reflects the following:

What concerns us:

1. The food retail competitive environment is deteriorating and may not be priced in. In 2Q16, comps were -3.0%, and were negatively impacted by a challenging economic environment, deflation and competitive openings. SPTN’s guidance as of 8/17/16 assumes comps improve to “slightly negative to flat” in 2H, but, recently, protracted deflation is contributing to a heightened competitive environment among conventional operators and has caused Sprouts (SFM) to lower guidance on 9/7/2016. While SPTN’s decline since then (-9.8%) is relatively in-line with SFM’s decline (-10.1%) (vs. S&P500 -2.2%), SPTN is still up +34.8% YTD (vs. the S&P 4.7%), which suggests that a stepped-up competitive environment may not be entirely priced in. In addition, Walmart represents an incremental risk if it becomes more aggressive on price in SPTN’s areas. As a result, we believe a -LSD negative comp could persist for several more quarters. Lastly, while the company has a strong track record of maintaining profit despite a shaky top-line (LTM retail EBITDA is up +1.3%; sales are down -4.4%), this will be harder to maintain without the help of fuel margins once the Nash Finch synergies are fully realized (the company is set to realize most of the synergies in FY16).
2. Upside to the multiple is capped by negative retail comps. Based on actual results, SPTN’s NTM forward EV/EBITDA multiple has ranged from ~3.0x-8.5x with an average multiple of 5.4x. Historically, SPTN has traded above 7x when it had positive retail comps. The exception is in 1H15 when the Nash Finch stores rolled into the comp base, dragging overall comps negative while the Michigan stores were still comping positive. SPTN is currently trading at a NTM EV/EBITDA of 6.4x, and, as a result, we believe upside to the multiple is limited while retail comps remain negative.
3. Fuel likely to become an opex headwind. After two years of declines, gasoline and diesel prices are both set to increase going forward according to the U.S. Energy Information Administration (EIA). The EIA predicts that gasoline prices will be up y/y beginning in January 2017 and that diesel prices will be up y/y starting in December 2016. If this plays out, gasoline would be a headwind to consumer spending and diesel would be a headwind to operating costs at SPTN. We believe SPTN does not utilize much forward buying so even though the company employs fuel surcharges, rising fuel prices would be an operating expense headwind.

What we like:

1. Strong free cash flow and balance sheet. SPTN has a long track record of generating operating cash flow that exceeds investing cash flow. Going back to FY2000, operating cash flow has exceeded investing cash flow in all but four years. In addition, we estimate a CY17 free cash flow yield of 8.2%, which compares very favorably against a group of consumer staples companies (average yield = 5%-6%). Lastly, the company has a solid balance sheet with net debt/EBITDA leverage of 2.1x, which gives the company flexibility to pursue accretive acquisitions and to increase its dividend payout ratio from 27% (we estimate increasing the payout ratio to 40% produces a dividend yield of 3.1% vs. the current 2.1% yield and only costs an incremental ~$11M).
2. Opportunity to supply non-traditional customers or new categories. SPTN is creatively looking to leverage its distribution network to serve non-traditional customers (i.e., not food retailers). SPTN is well positioned to act as a third party logistics (3PL) provider for any company that moves food because of its sophisticated logistics network that: 1) can handle multiple temperatures, 2) cover most of the US, and 3) export internationally (due to the company’s military business). There are many logistics providers that compete with SPTN, but few that can offer multiple temperature zones with SPTN’s domestic and global reach. Early wins include supplying dry and chilled products to Amazon’s Prime Now and AmazonFresh businesses and supplying fresh cut meat to military commissaries.
3. Well-positioned to participate in industry consolidation. SPTN merged with Nash Finch in November 2013, which essentially tripled sales. The company set out a three-year $52 million synergy plan and has delivered on it: SPTN is set to exceed $52M in synergies this year. In addition, with net debt/EBITDA leverage at ~2x, the company has the balance sheet capacity to pursue additional acquisition. We believe the company should look to acquire other traditional grocery wholesalers in its existing footprint or on its geographic boundaries.
4. ROIC is improving slightly. SPTN’s lease-adjusted ROIC of 7.0% is relatively low compared to other staples companies (e.g., SYY is 15.2%). However, the trend has improved slightly, up from 6.8% at 4Q15. Although the correlation between the stock price and lease-adjusted ROIC is almost zero (-4%), we believe valuation would improve if lease adjusted ROIC improved. In our view, the company’s strategy to increase capacity utilization by supplying non-traditional types of customers should help boost ROIC. In addition, we believe a sale of the Western retail assets (legacy Nash Finch) to independent customers would also improve ROIC.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are relatively in line with consensus. For FY16, we assume comps decline -2.2%, distribution sales are up +3.9%, and military sales are relatively flat. In addition, we assume EBITDA margins are relatively flat y/y.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Company Reports, Barclays Research, ConsensusMetrix, |

The following figures show our price target valuation and SPTN’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  Price Target Valuation |  | Figure  Current Valuation |
|  |  |  |
| Source: Company Estimates, Barclays Research |  | Source: Company Estimates, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY16-FY18. We assume capex as a percentage of sales is unchanged over the next few years. In addition, we also assume that working capital is a net neutral impact vs. +$53M and -$32.5M impacts in FY15 and FY14, respectively.

|  |  |
| --- | --- |
|  | Figure  SPTN Free Cash Flow |
|  |  |
| Source: Company Estimates, Barclays Research |

1) The overall food retail competitive environment is deteriorating and may not be priced in

SPTN’s retail comps have declined by ~3.0% on average since 1Q15 when the Nash Finch stores entered the comp base. In 2Q16, comps were -3.0%, and were negatively impacted by a challenging economic environment, deflation and competitive openings. In general, we believe the legacy Nash Finch stores, or the Western stores, are a drag on comps – although, the company has not provided comps by region.

|  |  |  |
| --- | --- | --- |
| Figure  Retail Comps |  | Figure  2-Year Stacked Retail Comps |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

SPTN’s guidance as of 8/17/16 assumes comps improve to “slightly negative to flat” in 2H. In theory, SPTN’s comps should improve sequentially throughout FY16 as the company cycles a ~100 bps impact from competitive openings in 3Q and starts to benefit from the remodeling of eight Omaha stores and from the relaunching of all 14 stores in Omaha to Family Fare. Beyond 2016, the company will focus its attention on improving the Wisconsin/Minnesota markets.

However, recently, protracted deflation is contributing to a heightened competitive environment and has caused Sprouts (SFM) to lower guidance on 9/7/2016. While SPTN’s decline since then (-9.8%) is relatively in-line with SFM’s decline (-10.1%) (vs. S&P500 -2.2%), SPTN is still up +34.8% YTD (vs. the S&P 4.7%), which suggests that a stepped-up competitive environment may not be entirely priced in.

|  |  |
| --- | --- |
|  | Figure  SPTN YTD Stock Performance |
|  |  |
| Source: Thomson |

The current period of deflation has lasted nine months so far, and it is set to be the longest period of deflation since 1960. Extended periods of deflation encourage more promotional behavior as retailers desperately attempt to “maintain” share. The following figure shows CPI Food at Home inflation trends going back to 1948. As indicated, nine months of deflation is tied for the second longest period of deflation (2009-2010) since 1960.

|  |  |
| --- | --- |
|  | Figure  CPI Food at Home Y/Y Inflation/Deflation |
|  |  |
| Source: BLS |

The next figure shows inflation trends by major category starting in July 2015.

|  |
| --- |
| Figure  CPI Inflation Data by Category |
|  |
| Source: BLS |

The following figure compares deflationary periods since 1959. The current deflationary period is set to be the longest since 1960.

|  |
| --- |
| Figure  Comparison of Deflationary Periods in Last 60 Years |
|  |
| Source: BLS |

In addition, Walmart represents an incremental risk if it becomes more aggressive on price in SPTN’s areas. As a result, we believe a -LSD negative comp could persist for at least several more quarters. Lastly, while the company has a strong track record of maintaining profit despite a shaky top-line (LTM retail EBITDA is up +1.3%; sales are down -4.4%), we note that this will be harder to maintain without the help of fuel margins once the Nash Finch synergies are fully realized (the company is set to realize most of the synergies in FY16).

2) Upside to the multiple is limited with negative retail comps

Based on actual results, SPTN’s NTM forward EV/EBITDA multiple has ranged from ~3.0x-8.5x with an average multiple of 5.4x. Historically, SPTN has traded above 7x when it has had positive retail comps. The two exceptions are in 1H15 when the Nash Finch stores rolled into the comp base, dragging overall comps negative while the Michigan stores were still comping positive. SPTN is currently trading at a NTM EV/EBITDA of 6.4x, and, as a result, we believe upside to the multiple is limited while retail comps are negative. The following figure contains SPTN’s historical NTM EV/EBITDA trading range based on actual results.

|  |  |
| --- | --- |
|  | Figure  Historical NTM EV/EBITDA Multiples |
|  |  |
| Source: Company Reports, Barclays Research, Thomson |

3) Fuel likely to become an opex headwind

After two years of declines, gasoline and diesel prices are both set to increase going forward according to the U.S. Energy Information Administration (EIA). The EIA predicts that gasoline prices will be up y/y beginning in January 2017 and that diesel prices will be up y/y starting in December 2016. If this plays out, gasoline would be a headwind to consumer spending and diesel would be a headwind to operating costs at SPTN. We believe SPTN does not utilize much forward buying so even though the company employs fuel surcharges, rising fuel prices would be an operating expense headwind.

|  |  |  |
| --- | --- | --- |
| Figure  US Gasoline Prices (All Grades Retail Price Including Taxes) |  | Figure  US Diesel Prices (Including Taxes) |
|  |  |  |
| Source: EIA Short-Term Energy Outlook |  | Source: EIA Short-Term Energy Outlook |

4) Strong free cash flow and balance sheet

SPTN has a long track record of generating operating cash flow that exceeds investing cash flow. Going back to FY2000, operating cash flow has exceeded investing cash flow in all but four years. The following chart compares operating cash flow vs. investing cash flow.

|  |  |
| --- | --- |
|  | Figure  Operating Cash Flow vs. Investing Cash Flow |
|  |  |
| Source: Company Reports |

In addition, we estimate a CY17 free cash flow yield of 8.2%, which compares very favorably against a group of consumer staples companies (average yield = ~5%-6%). The following table contains our free cash flow estimates for FY16-FY18.

|  |  |
| --- | --- |
|  | Figure  Current Free Cash Flow Yield |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure compares SPTN vs. a group of consumer staples and staples-type companies. As indicated, SPTN’s free cash flow is above the group average while ROIC and top-line growth are below average.

|  |
| --- |
| Figure  Staples Comp Sheet |
|  |
| Source: Company Reports, Barclays Research |

Lastly, the company has a solid balance sheet with net debt/EBITDA leverage of 2.1x, which gives the company flexibility to pursue accretive acquisitions and to increase its dividend payout ratio. While we believe participating in industry consolidation is the best use of the company’s capital (at the right price, of course), we also believe the company should increase its payout ratio. The company’s current payout ratio is 27%, which produces a ~$0.60 annual dividend and implies a ~2.0% yield. We estimate an increase of the payout ratio to 40% would produce a dividend yield of 3.1% and only cost an incremental ~$11 million (37.5M shares x $0.30).

|  |  |
| --- | --- |
|  | Figure  Potential FY17 Dividend Yields Based on Different Payout Ratio Scenarios |
|  |  |
| Source: Company Reports, Barclays Research |

5) Opportunity to supply non-traditional customers or new categories

SPTN is creatively looking to leverage its distribution network to serve non-traditional customers (i.e., not food retailers). For example, as of early May, SPTN was supplying dry and chilled products to Amazon’s Prime Now and AmazonFresh businesses. In addition, SPTN is also extending into new categories with existing customers. For example, the company recently began supplying fresh cut meat to military commissaries; this incremental business helps offset the DeCA same store sales headwind (-5.0% comps in 2Q). Going forward, we believe there are opportunities for SPTN to leverage its global reach with the military business and to export product overseas for CPG companies and private label product for retailers.

To support this effort, SPTN has a dedicated sales team of three people, but other sales people also become involved when necessary. In general, we believe that SPTN is well positioned to act as a third party logistics (3PL) provider for any company that moves food because of its sophisticated logistics network that: 1) can handle multiple temperatures, 2) cover most of the US, and 3) export internationally (due to the company’s military business). There are many logistics providers that compete with SPTN, but few that can offer multiple temperature zones with SPTN’s domestic and global reach. Lastly, we believe SPTN has the capacity to take on new wins without needing to build new facilities.

6) Well-positioned to participate in industry consolidation

SPTN merged with Nash Finch in November 2013, which essentially tripled sales. The company set out a three-year $52 million synergy plan and has delivered on it. SPTN is set to exceed $52M in synergies in FY16. In addition, with net debt/EBITDA leverage at ~2x, the company has the balance sheet capacity to pursue more deals. We believe the company would look to acquire other traditional grocery wholesalers in its existing footprint or on its geographic boundaries.

7) ROIC is improving slightly

SPTN’s lease-adjusted ROIC of 7.0% is relatively low compared to other staples companies (e.g., SYY is 15.2%). However, the trend has improved slightly, up from 6.8% at 4Q15. Although the correlation between the stock price and lease-adjusted ROIC is almost zero (-4%), we believe valuation would improve if lease adjusted ROIC improved. In our view, the company’s strategy to increase capacity utilization by supplying non-traditional types of customers should help boost ROIC. In addition, we believe a sale of the Western retail assets (legacy Nash Finch) to independent customers would also enhance ROIC.

|  |  |
| --- | --- |
|  | Figure  SPTN Lease-Adjusted ROIC vs. Stock Price |
|  |  |
| Source: Company Reports, Barclays Research, Thomson |

The following chart compares SPTN’s lease-adjusted ROIC vs. other retailers and distributors.

|  |  |
| --- | --- |
|  | Figure  Lease-Adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Research |

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating. Given our concerns regarding the retail business and the potential for a worsening environment, we would prefer to wait for a better entry point. If the competitive environment worsens, we see downside to $25 (-16% downside), or 5.5x CY17 EV/EBITDA of $231 million. We assign a 60% probability of this scenario playing out. If, however, the company is able to stabilize comps and continue to win new distribution contracts then we see upside to $40 (+37% upside), or 8.0x CY17 EV/EBITDA. We believe there is a 40% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $31 price target and Equal Weight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Sprouts Farmers Market Inc (SFM)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=SFM) | | | | | | | Stock Rating: OVERWEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 20.50 | | Price Target | USD 24.00 | | **Why Overweight?** Our Price Target reflects our view that: 1) downside is more or less priced in given recent lowering of the bar, 2) SFM is a best-in-class growth story, 3) medium term growth algorithm is sustainable given our view of the company's price positioning, 4) the strong balance sheet, and 5) strategic value. | | |  | | | Upside case | USD 27.00 | | Reflects: 1) Deflation abates and food retailers in general lap deflation on top of deflation, 2) The competitive landscape is benign, and 3) SFM returns to the Medium Term growth algorithm. | | |  | | | Downside case | USD 18.00 | | Reflects: 1) The Competitive landscape remains choppy, 2) Conventional and natural operators fight for share aggressively, 3) Deflation pressures results at least through CYE 2016 - reported in March 2017, so 4) SFM is unable to reaffirm Medium Term growth algorithm. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 3,593 | 3,998 | 4,514 | 5,137 | 12.7% |  |
| EBITDA (adj) | 302 | 296 | 336 | 379 | 7.9% |  |
| EBIT (adj) | 232 | 218 | 246 | 276 | 5.9% |  |
| Pre-tax income (adj) | 208 | 203 | 233 | 264 | 8.3% |  |
| Net income (adj) | 127 | 126 | 144 | 164 | 8.8% |  |
| EPS (adj) ($) | 0.86 | 0.85 | 1.03 | 1.17 | 10.5% |  |
| Diluted shares (mn) | 155.8 | 147.5 | 140.4 | 140.4 | -3.4% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 8.4 | 7.4 | 7.4 | 7.4 | 7.7 |  |
| EBIT (adj) margin (%) | 6.5 | 5.4 | 5.4 | 5.4 | 5.7 |  |
| Pre-tax (adj) margin (%) | 5.8 | 5.1 | 5.2 | 5.1 | 5.3 |  |
| Net (adj) margin (%) | 3.5 | 3.1 | 3.2 | 3.2 | 3.3 |  |
| ROIC (%) | 12.6 | 11.3 | 11.3 | 11.4 | 11.7 |  |
| ROE (%) | 16.9 | 16.9 | 20.8 | 20.6 | 18.8 |  |
| ROA (lease adjusted) (%) | 10.4 | 9.6 | 9.9 | 10.0 | 10.0 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 494 | 575 | 660 | 755 | 15.2% |  |
| Intangible fixed assets | 567 | 567 | 567 | 567 | 0.0% |  |
| Cash and equivalents | 136 | 45 | 5 | 42 | -32.4% |  |
| Total assets | 1,426 | 1,495 | 1,590 | 1,777 | 7.6% |  |
| Short and long-term debt | 290 | 490 | 490 | 490 | 19.1% |  |
| Total liabilities | 603 | 830 | 869 | 905 | 14.5% |  |
| Net debt/(funds) | 154 | 402 | 442 | 400 | 37.3% |  |
| Shareholders' equity | 823 | 665 | 721 | 872 | 2.0% |  |
| Change in working capital | -21 | 7 | -13 | -23 | N/A |  |
| Cash flow from operations | 240 | 153 | 224 | 247 | 0.9% |  |
| Capital expenditure | -125 | -160 | -175 | -197 | N/A |  |
| Free cash flow | 105 | 37 | 48 | 55 | -19.5% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 23.7 | 24.1 | 20.0 | 17.6 | 21.4 |  |
| EV/EBITDA (adj) (x) | 10.8 | 12.0 | 10.7 | 9.4 | 10.7 |  |
| Equity FCF yield (%) | 3.3 | 1.2 | 1.7 | 1.9 | 2.0 |  |
| P/Sales (x) | 0.9 | 0.8 | 0.7 | 0.6 | 0.7 |  |
| P/BV (x) | 3.9 | 4.6 | 4.0 | 3.3 | 3.9 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 2.2 | 3.1 | 3.1 | 3.0 | 2.8 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 5.8 | 1.9 | 2.5 | 3.0 | 3.3 |  |
| Square footage growth (%) | 13.8 | 17.5 | 14.9 | 14.4 | 15.1 |  |
| Inventory growth (%) | 15.9 | 19.5 | 17.7 | 16.7 | 17.4 |  |
| Capex/sales (%) | 3.5 | 4.0 | 3.9 | 3.8 | 3.8 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

sprouts Farmers Market

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Sprouts Farmers Market Inc(SFM): Quarterly and Annual EPS (USD)   |  | | --- | | SFM | | Stock Rating | | OVERWEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 24.00 | | Price (19-Sep-2016) | | USD 20.50 | | Potential Upside/Downside | | +17.1% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.25A | N/A | 0.30A | 0.29E | N/A | N/A | 0.34E | 20% | N/A |
| Q2 | 0.22A | N/A | 0.25A | 0.26E | N/A | N/A | 0.30E | 14% | N/A |
| Q3 | 0.21A | N/A | 0.17E | 0.24E | N/A | N/A | 0.28E | -19% | N/A |
| Q4 | 0.18A | N/A | 0.13E | 0.19E | N/A | N/A | 0.22E | -28% | N/A |
| Year | 0.86A | N/A | 0.85E | 0.98E | N/A | 1.03E | 1.16E | -1% | 21% |
| P/E | 23.7 |  | 24.1 |  |  | 20.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Deja Vu: We’ve Been Here Before

Sprouts is down 22.9% year-to-date, the bar has been reset, and downside is limited; initiate at Overweight with a $24 price target

We are initiating coverage with an Overweight rating and $24 price target given: 1) recently lowered guidance, 2) year-to-date performance, and 3) our view that SFM is a best-in-class Growth Star (high unit growth, positive traffic, low leverage, high ROIC). Our price target values SFM on a FY17 EV/EBITDA of 11.4x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $18, or 8.8x FY17 EV/EBITDA (~30% probability), while our upside scenario is $27 or 12.5x FY17 EV/EBITDA (~70% probability). Our estimates reflect the utilization of the $250 million buyback by FY17 year-end.

Specifically, we view Sprouts (SFM) as a best-in-class Growth Star given: 1) the significant opportunity to gain share through strong basket and traffic comps as well as through 14+% unit growth; 2) the company’s ability to continue widening the price and quality gap vs. both conventional and natural competitors; 3) its 12-16% annual EBITDA growth in a normalized environment which we believe is sustainable, 4) the strong balance sheet – at 2.3x LTM net debt/EBITDAR and 0.6x Debt/EBITDA, 5) the strong track record of improving ROIC, and 6) SFM’s strategic value, which provides downside protection to the stock.

Near term – it is very clear that 2H16 will be extremely challenging given that CPI Food at Home deflation has extended to nine months, and it is set to be the longest period of deflation since 1960 – which could lead to irrational competitive behavior. Consistent with this view, on September 7, SFM lowered its FY16 comp and EPS guidance due to persistent deflation and a stepped-up promotional environment. Specifically, the company called out one unnamed retailer in Texas (17% of stores for SFM) as the primary driver behind the irrational behavior – but irrational behavior was fairly widespread. As a result, shares are down -10.1% since September 7 (vs. the S&P 500’s -2.2%) and -22.9% YTD (vs. S&P +4.7%) – and we believe the stock already reflects the potential for the current environment to persist through 4Q16.

Longer term, there are additional ways to create value, including: 1) reducing debt, and once free cash flow generation increases, introducing a dividend, 2) accelerating expansion in Florida – a market with significant opportunity to take share given the margin structure (i.e., operators in Florida are over-earning) in the state, and 3) continuing to focus on other merchandising initiatives, including the expanded deli offering, the introduction of an affinity program, and a more aggressive e-commerce approach in markets where this strategy is appropriate.

Overweight rating based on upside/downside scenario analysis

Given SFM’s decline this year, we believe downside is more or less priced in, and we see downside to $18 (-12%), or 8.8x FY17 EV/EBITDA. We assign a ~30% probability to this scenario. Assuming the environment normalizes, we believe SFM will return to its medium-term growth algorithm, and in this scenario see potential upside to $27 (+30%), or 12.5x FY17 EV/EBITDA. We assign a ~70% probability of this upside scenario. The weighted average of these two scenarios gets us to our $24 price target and Overweight rating.

|  |
| --- |
| Figure  SFM Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

Our Overweight rating is based on our belief that SFM is a best-in-class Growth Star and that near-term risk from extended deflation and heightened promotional activity is already priced in. As a result, we believe the risk/reward is attractive. Our thesis reflects the following:

1. SFM is a best-in-class Growth Star. We believe SFM has a significant opportunity to continue gaining share through strong basket and traffic comps as well as through self-funded 14+% unit growth. The company’s ability to continue widening the price and quality gap vs. both conventional and natural competitors underpins SFM’s growth opportunity. As such, we believe SFM will generate industry-leading EBITDA growth of 12%-16% annually over the mid-term. The EBITDA growth algorithm, combined modest free cash flow generation (on top of unit growth of 14+%), strong balance sheet at a net debt/EBITDA of 0.6x and a net debt/EBITDAR of 2.3x, as well as industry leading ROIC firmly positions SFM as a Growth Star. We also believe SFM has strategic value and believe this value provides downside protection to the stock.
2. We believe near-term risk from a heightened competitive environment is more or less priced in. The current period of deflation has lasted nine months so far, and it is set to be the longest period of deflation since 1960. Extended periods of deflation encourage more promotional behavior as retailers desperately attempt to maintain share – or recapture perceived traffic losses. SFM lowered FY16 guidance (on 9/7/2016) due to the stepped-up competitive environment – and we believe the current stock price already reflects the risk that the environment remains challenging for the next several quarters.
3. We see further upside if SFM opportunistically reduces debt and eventually institutes a dividend. SFM has a strong balance sheet with LTM net debt to EBITDAR of 2.3x. However, we believe SFM’s valuation would benefit if it opportunistically reduced debt with its growing free cash flow. In addition, we believe SFM would also benefit if a dividend was eventually instituted. We estimate a 10%-20% payout in FY18 would result in an $0.11-$0.22 per share dividend, or 0.6%-1.1% yield.
4. Florida is a significant opportunity and we believe SFM should enter the Florida market aggressively. We have long viewed the state as a highly concentrated market with very limited, high-quality, affordable conventional options. One only needs to compare Publix’s EBITDAR margins (~11.0%) vs. Kroger’s (~5.5%) to get a sense for how benign the competitive environment is in Florida. As a result, we believe SFM should enter Florida aggressively, especially in light of Kroger recently gaining a small footprint in Florida through its Lucky’s investment (four stores currently in Florida; soon to be eight).
5. Continuing to focus on other merchandising initiatives including: 1) the expanded deli offering, 2) the introduction of an affinity program, and 3) a more aggressive e-commerce approach in markets where this strategy is appropriate. **Deli:** SFM currently offers an expanded deli/grab and go offering in 55 units and plans to continue to increase this going forward. Deli currently accounts for less than 10% of sales by our estimate, and is one of the higher margin categories in the store despite the fact that the offering is extremely competitive on price versus some of the other specialty peers. **Affinity**: We also believe SFM is in the early stages of introducing some form of affinity to its customer base and believe SFM has a significant opportunity to leverage data analytics and become even more relevant to its consumers, especially to Millennials. **Lastly, E-commerce**: We believe SFM should aggressively pursue an online presence. We believe the future of food retail in the US includes both click and collect and online delivery regardless of the profitability. These services will eventually be considered just another cost of doing business. As a result, we believe SFM should invest in developing a click and collect and/or online solution to further widen the gap vs. its peers.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are slightly below consensus on EBITDA due to a lower comp. Our EPS estimates are in line with consensus presumably because we are assuming more share repurchases (13M shares in FY16 and 4M shares in FY17).

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, First Call, Bloomberg |

The following figures show our price target valuation and SFM’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  Price Target Valuation |  | Figure  Current Valuation |
|  |  |  |
| Source: Company Estimates, Barclays Research |  | Source: Company Estimates, Barclays Research |

The first of the next two figures contains our free cash flow estimates for FY16-FY18. We assume capex is ~4% of sales for the next three years. In addition, we assume working capital is a $20-$30M drag on cash flow in each year, which is consistent with the changes in working capital in FY14-FY15. Impressively, free cash flow is positive for SFM despite the company growing units 14+% annually. We expect the free cash flow yield to remain modestly positive for the next few years as indicated in the second chart below.

|  |  |  |
| --- | --- | --- |
| Figure  SFM Free Cash Flow |  | Figure  SFM Free Cash Flow Yield Based on $24 PT |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

1) SFM is a best-in-class Growth Star

We believe SFM has a significant opportunity to continue gaining share through strong basket and traffic comps as well as through self-funded 14+% unit growth. The following figure shows SFM’s comps going back to FY10.

|  |  |
| --- | --- |
|  | Figure  SFM Comparable Store Sales Growth |
|  |  |
| Source: Company Reports, Barclays Research |

The following two charts show SFM’s traffic and basket trends going back to 3Q13. In FY16, comps have slowed from the impact of deflation and heightened competitive activity due to extended deflation. We believe SFM will return to generating MSD comps once deflation abates because with normal inflation, the competitive landscape generally normalizes.

|  |  |  |
| --- | --- | --- |
| Figure  SFM Quarterly Traffic Growth |  | Figure  SFM Quarterly Basket Change |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

SFM also has a best-in-class unit growth story. The company’s share gains make the unit growth opportunity credible. The following figure shows SFM’s store count since FY10. The company significantly expanded its store count with the Henry’s and Sunflower deals. Since then, units have grown annually in the mid-teens range.

|  |  |
| --- | --- |
|  | Figure  SFM Store Count |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows SFM’s unit growth by year.

|  |  |
| --- | --- |
|  | Figure  SFM Unit Growth |
|  |  |
| Source: Company Reports, Barclays Research |

In our view, the company’s ability to continue widening the price and quality gap vs. both conventional and natural competitors underpins SFM’s growth opportunity. The following chart shows our estimates for merchandise margins at SFM, Whole Foods and Kroger. For SFM and Whole Foods, we back out the cost of rent and LIFO (for WFM only) to estimate merchandise margins. For Kroger, we start with Kroger’s blended FIFO ex-fuel merchandise margin and then apply a ~8-10% premium on top of that to account for our belief that natural/organic SKUs are higher than average margin products at KR (note we believe the 10% premium has fallen to 8% recently). As indicated in the figure, SFM’s merchandise margins are consistently below both Kroger and Whole Foods. This suggests SFM is already priced competitively, which should support future share gains.

|  |  |
| --- | --- |
|  | Figure  Merchandise Margins |
|  |  |
| Source: Barclays Estimates |

We believe SFM’s industry-best unit growth combined with consistent share gains on a comp store basis will lead to 12-16% annual EBITDA growth over the intermediate-term. However, in the near-term, EBITDA growth should be below this range given the extended period of deflation and heightened competitive environment.

|  |  |
| --- | --- |
|  | Figure  SFM EBITDA Growth |
|  |  |
| Source: Company Reports, Barclays Research |

The following figure contains SFM’s mid-term financial targets first provided on 11/5/2016. These targets, if achieved, are industry-best growth metrics and we believe they are realistic targets in a normalized environment. However, for now, at least in FY16, deflation and heightened promotional activity will pressure these targets.

|  |  |
| --- | --- |
|  | Figure  Mid-Term Financial Targets Provided on 11/5/2015 |
|  |  |
| Source: Company Reports |

The company also has a strong balance sheet. Leverage ratios as measured by net debt to EBITDA or adj. net debt to EBITDAR both show significant improvement over the last three years. The next figure shows SFM’s historical leverage ratios. Note – leverage increases in FY16 and beyond due to the recently announced $250 million buyback.

|  |  |
| --- | --- |
|  | Figure  SFM Leverage Ratios Show Strong Balance Sheet |
|  |  |
| Source: Company Reports, Barclays Research |

The de-leveraging of the balance sheet has resulted in modest free cash flow generation. We believe SFM’s free cash flow generation is extremely impressive given the 3.5%-4.0% of sales the company spends each year to support 14+% unit growth.

|  |
| --- |
| Figure  SFM Has Strong Track Record of Generating Free Cash Flow Despite Industry-Best Unit Growth |
|  |
| Source: Company Reports, Barclays Research |

SFM’s lease-adjusted ROIC has increased steadily since the IPO. We estimate it was 10.4% in 4Q13 and 12.7% in 2Q16 – a 230 bps improvement. ROIC’s relationship with the stock price historically is not strong: the two variables have a -70% correlation since the IPO, but we believe the significant price increase following the IPO distorts the relationship. Since 3Q15, the correlation has improved to +77% and we believe that the two variables will be more closely correlated going forward.

|  |  |  |
| --- | --- | --- |
| Figure  LTM Lease-Adjusted ROIC |  | Figure  LTM Lease-Adjusted ROIC vs. Stock Price |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

The following figure compares SFM’s lease-adjusted ROIC vs. a group of peers. SFM’s ROIC is respectable, and only lower than DLTR, DG and COST.

|  |  |
| --- | --- |
|  | Figure  SFM Lease-Adjusted ROIC vs. Peers |
|  |  |
| Source: Company Reports, Barclays Research |

2) Near-term risk from heightened competitive environment is more or less priced in

The current period of deflation has lasted nine months so far, and it is set to be the longest period of deflation since 1960. Extended periods of deflation encourage more promotional behavior as retailers desperately attempt to maintain share. SFM lowered FY16 guidance (on 9/7/2016, one month after 3Q earnings) because of a stepped-up competitive environment in Texas (which highlights the risk of having concentrated geographic exposure), but given the stock’s performance since the company reduced guidance, we believe the downside is largely priced in.

|  |  |  |
| --- | --- | --- |
| Figure  SFM Stock Performance YTD |  | Figure  SFM Stock Performance since 9/7/2016 Guidance Cut |
|  |  |  |
| Source: Thomson |  | Source: Thomson |

The following figure shows CPI Food at Home inflation trends going back to 1948. As indicated, nine months of deflation is tied for the second longest period of deflation (2009-2010) since 1960.

|  |  |
| --- | --- |
|  | Figure  CPI Food at Home Y/Y Inflation/Deflation |
|  |  |
| Source: BLS |

The next figure shows inflation trends by major category starting in July 2015. Unfortunately, August results for Farm Products PPI (a further deterioration) does not bode well for a return to inflation, but we believe this risk is priced in.

|  |
| --- |
| Figure  CPI Inflation Data by Category |
|  |
| Source: BLS |

The following figure compares deflationary periods since 1959. The current deflationary period is set to be the longest since 1960.

|  |
| --- |
| Figure  Comparison of Deflationary Periods in Last 60 Years |
|  |
| Source: BLS |

Below, we compile a list of recent quotes from the company’s most recent investor presentation and earnings call that highlight the challenges SFM faces in 2H.

* “We found times when cost deflation expands across multiple categories and it flows through to the consumer, i.e., you keep your margin rate the same. When that extends for three, six, nine months, it's not uncommon for somebody in the industry to get a little itchy with comps and they start to react and it moves fast. And that's exactly what we saw happening end of June into July, but we weren't seeing a big impact to our business. And the investments in the industry have just deepened. And when that happens, in the short term, the retailer who started first, it's a sheer, short-term game of buying some traffic, until everybody else gets into it, because our industry's always been very competitive **and no one lays down on price.**” – CEO, Investor Conference (9/8/2016)
* “And when you have 60% of your business is perishables, and it just so happens that today almost every single one of those categories is highly deflationary... And the more perishable you are probably the more exposed you are in the near term.” – CEO, Investor Conference (9/8/2016)
* “And the last time we witnessed this deep as this was in 2009, and we were in the same situation where traffic was softer, pricing was much deeper than cost deflation, so it was deep into retail deflation. And it lasted about six months in 2009, 2010.” – CEO, Investor Conference (9/8/2016)
* “It's all short term and interesting on one hand and maybe not as interesting in the long term, but, certainly, something that we've got to deal with on a day-in/day-out basis. But we've just made the assumption, **given that it's still competitive and deeply competitive that it lasts through the rest of the year**. What we've seen is, we've not seen shelf, retails at the shelf move significantly. We've seen a lot of ad promotions and in-store promotions, that's where we've seen the heaviest of the activity inside the stores.” – CEO, Investor Conference (9/8/2016)
* “Once you have sustained deflation over several quarters crossing several categories, eventually the competitors stop sweeping up the margin and start investing on a short-term basis to try and drive that traffic. And with 60% of our business being in those perishable business and subject to that deep deflationary over an extended period of time, you get caught up in that.” – CFO, Investor Conference (9/8/2016)
* “But vastly, where a lot of our stores are, it's been fairly competitive. Parts of Texas have been fairly competitive because you just have regional players as well as the national chains there. Houston's been – we have five stores in Houston, so we're not overexposed there. But Houston's a good example of a market sets, probably one of the most competitive in the country today.” – CEO, Investor Conference (9/8/2016)

3) We see further upside if SFM opportunistically reduces debt and eventually institutes a dividend.

SFM has a strong balance sheet with LTM net debt to EBITDAR of 2.3x (see previous figure for leverage trends over time). However, we believe SFM’s valuation would benefit if it opportunistically reduced debt with its growing free cash flow. In addition, we believe SFM would also benefit if a dividend was eventually instituted. We estimate a 10%-20% payout in FY18 would pay a $0.11-$0.22 per share dividend, or 0.6%-1.1% yield based on the current price of $20.50.

The following figure shows a range of potential FY18 dividend yields based on different payout ratios.

|  |  |
| --- | --- |
|  | Figure  SFM Potential FY18 Dividend Yields Based on Current $20.50 Price |
|  |  |
| Source: Barclays Research |

4) Florida is a significant opportunity.

We believe SFM should enter Florida aggressively. We have long viewed the state as a highly concentrated market with very limited, high-quality affordable conventional options. The following chart compares Publix’s EBITDAR margins vs. Kroger’s to get a sense for how benign the competitive environment is in Florida. As a result, we believe SFM should enter Florida aggressively, especially in light of Kroger recently gaining a small footprint in Florida through its Lucky’s investment (currently four stores in Florida, but soon to be eight). In addition, SFM should be able to leverage the new Atlanta-area distribution center that is opening in 2016 to support growth well into Florida.

|  |  |
| --- | --- |
|  | Figure  Publix’s Margin Structure Suggest Benign Competitive Environment in Florida |
|  |  |
| Source: Company Reports, Barclays Research |

The following chart highlights Publix’s market position in each of its Florida markets. In general, Publix has a top two market position in each market. In addition, Publix’s markets do not feature a strong #2 conventional grocer as evidenced by Winn-Dixie’s top 3 share in almost all of Publix’s markets (Winn-Dixie has historically been a share donor). Walmart also has a strong presence in Publix’s markets. In our view, SFM is well positioned to take share from conventional operators in these markets given the company’s attractive price points, high-quality product offering, and well appointed stores. A recent article in the Tampa Bay Business Journal (“Sprouts confirms Florida expansion,” 8/9/2016) indicated that there are several confirmed future SFM locations in the Tampa-St. Petersburg market.

|  |  |
| --- | --- |
|  | Figure  Publix’s Market Position in Florida |
|  |  |
| Source: Metro Market Studies |

5) Other Initiatives to create value and gain share:

**Deli:** Recently, the company has been focused on expanding the deli and grab and go offering – called the Sprouts Market Corner Deli. The company offers the expanded offering in 23% of the store base (or 55 stores), and expanded offerings include a wider variety of offerings within the salad bar – including blue cheese wedge salad, quinoa salads, kale salads, a separate protein service case (with grilled salmon, roasted potatoes, chicken parmesan, parmesan acorn crusted squash, chicken Florentine), an expanded sandwich bar with hot and cold made-to-order sandwiches and paninis, a carving station, an expanded soup station, daily freshly squeezed juice offerings and a market Corner specialty coffee bar. We believe the company should continue to expand these offerings.

**Affinity:** We believe SFM is currently evaluating how to approach affinity broadly. Kroger was obviously at the forefront of data analytics – and in our view 84.51 has provided Kroger with a significant competitive advantage given the sophistication of the data and the ability to tailor offerings to specific customers or households. Several years ago, Whole Foods began testing an affinity program in Philadelphia and more recently expanded the test to the Dallas market – and the company plans to roll out the program nationwide next year. The program is available at all three of the new 365 stores.

**E-commerce**: SFM’s current presence consists of Amazon Prime Now partnership in four markets: LA, San Diego, San Jose and Dallas. In our view – e-commerce and/or some form of click and collect will not just be limited to more urban, densely populated markets as evidenced by both Kroger (ClickList now at 400 stores) and Walmart (in more than 400 stores across 60 markets nationwide). In addition, WMT’s purchase of Jet.com demonstrates its commitment to the channel. Even AmazonFresh is testing click and collect in three locations (Sunnyvale, CA, San Carlos, CA, and Seattle, WA). We believe SFM appreciates the need to offer some form of e-commerce solution to the customer (in addition to the existing Amazon Prime Now partnership), so we would look for an update on e-commerce in the near term.

Valuation and Conclusion

Based on the above, we are initiating with an Overweight rating based on upside/downside scenario analysis. Given the stock’s decline this year, we believe downside is more or less priced in, and we see downside to $18 (-12%), or 8.8x FY17 EV/EBITDA of $336 million. We assign a ~30% probability of this scenario playing out. Assuming the environment normalizes, we believe SFM will return to its medium-term growth algorithm, and in this scenario see potential upside to $27 (+30%), or 12.5x FY17 EV/EBITDA. We assign a ~70% probability of this upside scenario. The weighted average of these two scenarios gets us to our $24 price target and Overweight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [GNC Holdings Inc. (GNC)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=GNC) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 20.72 | | Price Target | USD 21.00 | | **Why Equal Weight?** The difficult competitive landscape is likely to continue. We expect the company will continue to trade at a premium valuation over other turnaround names given its dominant position in the industry, asset base, and the BoD's review of strategic & financial alternatives. | | |  | | | Upside case | USD 27.00 | | Reflects: 1) a moderation in the competitive landscape, 2) innovative new products drive traffic, 3) moderation in market share loss to other channels, a large number of company owned-stores are re-franchised stores, 5) net store openings, and 6) multiple expansion. | | |  | | | Downside case | USD 17.00 | | Reflects: 1) a heightened competitive landscape, 2) a lack of new product introductions, 3) consumers substitute "healthy eating" for supplements, 4) market shares loss to other channels , 5) few re-franchised stores, 6) reduced store base, and 7) multiple contraction. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 2,683 | 2,605 | 2,582 | 2,563 | -1.5% |  |
| EBITDA (adj) | 485 | 416 | 405 | 395 | -6.6% |  |
| EBIT (adj) | 428 | 358 | 343 | 331 | -8.2% |  |
| Pre-tax income (adj) | 377 | 298 | 283 | 271 | -10.4% |  |
| Net income (adj) | 242 | 191 | 181 | 173 | -10.6% |  |
| EPS (adj) ($) | 2.88 | 2.74 | 2.78 | 2.86 | -0.2% |  |
| Diluted shares (mn) | 84 | 70 | 65 | 61 | -10.3% |  |
| DPS ($) | 0.72 | 0.80 | 0.88 | 0.96 | 10.1% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 18.1 | 16.0 | 15.7 | 15.4 | 16.3 |  |
| EBIT (adj) margin (%) | 15.9 | 13.7 | 13.3 | 12.9 | 14.0 |  |
| Pre-tax (adj) margin (%) | 14.0 | 11.4 | 11.0 | 10.6 | 11.8 |  |
| Net (adj) margin (%) | 9.0 | 7.3 | 7.0 | 6.8 | 7.5 |  |
| ROIC (%) | 15.9 | 14.2 | 14.5 | 14.3 | 14.7 |  |
| ROE (%) | 39.5 | 43.5 | 45.0 | 43.2 | 42.8 |  |
| ROA (lease adjusted) (%) | 10.5 | 8.8 | 8.4 | 8.1 | 8.9 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 231 | 231 | 229 | 225 | -0.8% |  |
| Intangible fixed assets | 1,489 | 1,478 | 1,474 | 1,470 | -0.4% |  |
| Cash and equivalents | 56 | 184 | 180 | 201 | 52.7% |  |
| Total assets | 2,552 | 2,633 | 2,617 | 2,625 | 0.9% |  |
| Short and long-term debt | 1,452 | 1,595 | 1,595 | 1,595 | 3.2% |  |
| Total liabilities | 2,083 | 2,223 | 2,221 | 2,219 | 2.1% |  |
| Net debt/(funds) | 1,396 | 1,411 | 1,415 | 1,394 | -0.1% |  |
| Shareholders' equity | 469 | 410 | 397 | 406 | -4.7% |  |
| Change in working capital | 44 | 57 | 4 | 4 | -56.9% |  |
| Cash flow from operations | 355 | 315 | 255 | 249 | -11.1% |  |
| Capital expenditure | -46 | -59 | -60 | -60 | N/A |  |
| Free cash flow | 304 | 254 | 193 | 187 | -14.9% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 7.2 | 7.6 | 7.4 | 7.3 | 7.4 |  |
| EV/EBITDA (adj) (x) | 5.8 | 6.8 | 7.0 | 7.1 | 6.7 |  |
| Equity FCF yield (%) | 17.4 | 17.6 | 14.3 | 14.9 | 16.1 |  |
| P/Sales (x) | 0.5 | 0.5 | 0.5 | 0.6 | 0.5 |  |
| P/BV (x) | 3.7 | 3.5 | 3.4 | 3.1 | 3.4 |  |
| Dividend yield (%) | 3.5 | 3.9 | 4.2 | 4.6 | 4.1 |  |
| Adj debt/EBITDAR (x) | 4.5 | 5.0 | 5.1 | 5.1 | 4.9 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | -1.6 | -3.7 | -0.8 | -0.5 | -1.6 |  |
| Square footage growth (%) | 1.4 | 0.6 | 0.9 | 0.9 | 0.9 |  |
| Inventory growth (%) | -2.3 | -5.3 | -0.9 | -0.7 | -2.3 |  |
| Capex/sales (%) | 1.7 | 2.3 | 2.3 | 2.3 | 2.2 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

gnc holdings

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| GNC Holdings Inc.(GNC): Quarterly and Annual EPS (USD)   |  | | --- | | GNC | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 21.00 | | Price (19-Sep-2016) | | USD 20.72 | | Potential Upside/Downside | | +1.4% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.75A | N/A | 0.69A | 0.69A | N/A | N/A | 0.70E | -8% | N/A |
| Q2 | 0.78A | N/A | 0.79A | 0.79A | N/A | N/A | 0.75E | 1% | N/A |
| Q3 | 0.75A | N/A | 0.69E | 0.71E | N/A | N/A | 0.71E | -8% | N/A |
| Q4 | 0.59A | N/A | 0.57E | 0.56E | N/A | N/A | 0.58E | -3% | N/A |
| Year | 2.88A | N/A | 2.74E | 2.75E | N/A | 2.78E | 2.74E | -5% | 1% |
| P/E | 7.2 |  | 7.6 |  |  | 7.4 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Difficult to See Through the Haze

Much remains uncertain and we see limited options, but stock likely has support while BoD finalizes review of financial and strategic alternatives; initiate at Equal Weight with a $21 price target

So far in 2016, GNC has engaged an outside firm to help with financial communications, changed its reportable segments, announced a strategic and financial review to increase shareholder value, and announced an interim CEO. We view the company as Attempting to Reinvent itself. This has played out in various ways in recent years, through changes in product, merchandising, customer engagement, and by selling company-owned stores to licensees. Going back even further, the company tried various initiatives and tests to drive stronger performance including giving away Gold Cards and offering everyday discounts for Gold Card holders. As the company struggled, it continued to use its free cash flow to repurchase substantial amounts of stock – and even issued convertible notes – and we now believe that the company has lost considerable financial flexibility. We believe GNC may be in a precarious place but that it can likely manage through its challenges given its dominant position and strong brand name. In our view, the company needs to focus on returning the business to health and not financial engineering.

We rate the stock Equal Weight and take the following into consideration:

1. Industry fundamentals remain challenging.
2. Retail business profitability may not be sustainable.
3. GNC’s domestic store base may be saturated.
4. Re-franchising plan unlikely to be successful given current business trends.
5. Stock is valued at a premium relative to other retail turnarounds.

While we think the business can manage through its challenges, we think the stock will be vulnerable as comps and earnings are likely to remain weak, in our view, and leadership remains uncertain. Even with financial volatility, we expect the stock will be buffered by its strategic shareholder review, which includes the evaluation of a potential sale of the business.

Equal Weight rating based on upside/downside scenario analysis

Our price target values GNC at 8x our FY17 EBITDA. If comps were to weaken and margins were to contract, we see downside to $17 (18%) – or 6.4x our FY17 EBITDA. We place a 60% probability on this scenario. If the competitive landscape improves, comps and margins stabilize, the company is able to re-franchise a large number of stores, and the company’s valuation expands, we see upside to $27 – or 8.0x our CY17 EBITDA – with a 40% probability. The weighted average gets us to our $21 price target. We would re-evaluate our rating if traffic were to improve, comps accelerate, and/or both the absolute and relative valuation of GNC become more attractive.

|  |
| --- |
| Figure  GNC Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  GNC Price Target Valuation |  | Figure  GNC Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  GNC Free Cash Flow |
|  |  |
| Source: Barclays Research |

1. Industry fundamentals remain challenging

After an impressive run from 2009 through 2012, comps at GNC slowed substantially in 2013 and its retail sales per store peaked that same year.

|  |  |  |
| --- | --- | --- |
| Figure  GNC Comps Excluding E-Commerce |  | Figure  GNC Retail Sales per Average Store |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

The challenges at GNC are not unique. VSI has also experienced weakening sales.

|  |  |
| --- | --- |
|  | Figure  Total Company Comps – VSI & GNC |
|  |  |
| Source: Company reports and Barclays Research |

Many industry data sources suggest that the overall Vitamins, Minerals, and Supplements (VMS) industry is growing at a mid single-digit pace. Below we show data that captures the year over year growth rate of VMS products at essentially all retail channels except specialty. The data suggests that specialty retailers are losing share to conventional channels. We also believe internet retailers are taking share.

|  |  |
| --- | --- |
|  | Figure  Y/Y Growth of Vitamins & Supplements |
|  |  |
| Note: Includes Food, Drug, Mass, Walmart, Club (not Costco), Dollar, military commissaries and c-stores.  Source: Nielsen |

Google Trends suggests that after a long decline, interest in VMS products is picking up. Google Trends looks at search term interest relative to its highest point in the past. The charts below have the year-over-year change in search interest for vitamins and supplements. Interest in both accelerated in 2011—this also coincides with strong comps. Interest in the search terms have waned after this period but began to increase year-over-year early in 2016 for vitamins and more recently for supplements.

|  |  |  |
| --- | --- | --- |
| Figure  Google Trends – Y/Y Growth in “Vitamins” |  | Figure  Google Trends – Y/Y Growth in “Supplements” |
|  |  |  |
| Note: All categories in the United States Source: Google Trends and Barclays Research |  | Note: All categories in the United States Source: Google Trends and Barclays Research |

Interest in sports nutrition has been far weaker than both vitamins and supplements. In fact, search interest has essentially been in continuous decline, although there was resurgence in 2011 and 2012. We believe among the reasons for the spike was consumers stockpiling products containing DMAA – a stimulant used in bodybuilding, weight-loss supplements, and as a pre-workout energy booster. Eventually retailers pulled the product from their shelves given the negative publicity and perceived risks.

|  |  |
| --- | --- |
|  | Figure  Google Trends – Y/Y Growth in “Sports Nutrition” |
|  |  |
| Note: All categories in the United States Source: Google Trends and Barclays Research |

As can be seen in the chart below, sports nutrition is the largest category as a percent of sales at GNC. As such, less interest in this category has been a substantial pressure on GNC and likely helps explains why the category has been so promotional.

|  |  |
| --- | --- |
|  | Figure  GNC US Retail Product Categories as a Percent of Sales |
|  |  |
| Source: Company reports and Barclays Research |

1. Retail business profitability may not be sustainable

As can be seen in the chart below, EBIT per company-owned store increased substantially from 2008-2012. Profits more than doubled per location. The data is biased upward somewhat due to the inclusion of e-commerce but we do not believe this to be overly material to the trend.

|  |  |
| --- | --- |
|  | Figure  GNC EBIT per Company-Owned Store |
|  |  |
| Source: Company reports and Barclays Research |

The boost in EBIT per retail store was due to both stronger sales as well as improvement in the operating margin driven by leverage on fixed costs. Sales benefit from substantial comp gains as the company drove increases in ticket and basket size from 2010-2012 as it introduced new premium products to stores; traffic was not a driver of comps during these years. Operating leverage on the strong comps led to sizable margin gains.

|  |  |  |
| --- | --- | --- |
| Figure  GNC Retail Segment Sales per Average Store |  | Figure  Retail Segment Operating Margin |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Looking forward, we question whether the current level of profitability can be maintained. As discussed in the first section above, trends at specialty VMS retailers have lagged conventional channels. Also interest in sports nutrition products seems to be waning, and this is a key category for GNC.

Meanwhile, we don’t see company generated innovation being much of a driver as GNC does not spent much on R&D given its size. In the past seven years GNC spent less than $1 million per year on average.

|  |  |
| --- | --- |
|  | Figure  Research and Development Spending |
|  |  |
| Source: Company reports and Barclays Research |

Meanwhile, customers seem to be buying less of the company’s private label products. If this trend continues, it will pressure the gross and operating margins since these products have a higher mark-up than branded products. The downward trend in private label would be less worrisome if there was new industry innovation that was driving growth in brand sales, but we don’t believe this to be the case. It may be that customers are losing their appetite for GNC brands.

|  |  |  |
| --- | --- | --- |
| Figure  Private Label as a % of Sports Nutrition Products Sales |  | Figure  Proprietary brands as a % of VMHS Sales |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

1. GNC’s domestic store base may be saturated

GNC expanded its store base at a 3.9% CAGR from 2006-2015. As can be seen below, this was primarily driven by Rite Aid stores within stores at a 7.4% CAGR and domestic-company owned stores at 3.3%, while franchised domestic stores have been essentially unchanged.

|  |  |
| --- | --- |
|  | Figure  GNC Domestic Store Base |
|  |  |
| Source: Company reports and Barclays Research |

GNC had nearly 7,100 domestic locations in the US including Rite Aid stores within stores. Of these, about 66% are company-owned or franchised GNC locations. The GNC store count vastly exceeds the store count of other specialty vitamin retailers and is closer to companies that sell a wide variety of consumables products, such as 7-Eleven, Family Dollar, and Walgreens. Given the pressures on the industry and its extensive store base, we think it will be difficult to expand the store base much further.

|  |  |
| --- | --- |
|  | Figure  Number of Domestic Units by Retailer – 2015 |
|  |  |
| Source: Progressive Grocer, company reports, and Barclays Research |

1. Re-franchising plan unlikely to be successful given current business trends

Prior to suspending guidance on July 28, 2016, GNC had been targeting selling 1,000 company-owned stores to franchisees over the following three to four years. The company demonstrated some progress as it refranchised 90 company-owned stores in the six months ended June 30, 2016. We do not think this run rate will accelerate, however, and it may even slow. In the last few quarters, company-owned store comps deteriorated materially, going from +0.8% in 4Q15 to -3.7% in 2Q16. At the same time, franchisee comps also deteriorated significantly from down low single-digits to down mid single-digits. We think potential buyers will be less interested in the stores given the instability; valuations will also likely be low.

|  |  |
| --- | --- |
|  | Figure  Franchise Comps |
|  |  |
| Source: Company reports and Barclays Research |

1. Stock is valued at a premium relative to other retail turnarounds

GNC’s valuation has compressed as its comps and profit growth have slowed. The stock’s high valuation occurred when comps were in the mid to high single digit range, profit margins were expanding, and EBITDA was growing at a double digit pace. Our projections for the next three years include a slight decline in comps at ~1.4% annually and sustained margin pressure, resulting in annual EBITDA declines.

|  |  |  |
| --- | --- | --- |
| Figure  GNC NTM EV/EBITDA |  | Figure  GNC NTM P/E |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Below we contrast the valuation of GNC vs. a basket of retail turnarounds in softlines, electronics and home products, department stores, gaming, and office supplies. As a group, these companies have a slightly lower ROIC and less EBITDA pressure than GNC. GNC currently trades at a premium to this group for a variety of factors, in our view. GNC has a slightly different asset base, with ~25-30% of operating profit coming from its domestic and international franchise businesses; franchise businesses tend to have higher multiples given their low capital intensity and smooth profit streams. Also, GNC is undergoing a review of financial and strategic alternatives to increase shareholder value, and this likely supports the stock to some degree. If GNC is not able to refranchise its company-owned stores, and therefore improve its ROIC, we would then expect ROIC to decline and the multiple to slowly converge with this group of turnarounds over time.

|  |
| --- |
| Figure  Selected Metrics and Valuation for “Retail Turnaround Basket” and VSI vs. GNC |
|  |
| Note: Comp average includes ANF, BBBY, BBY, BKE, DDS, EXPR, GME, GPS, KSS, M, ODP, and SPLS. \*FY15. \*\*FY16 and FY17 average. ROIC based on tangible invested capital. Source: Company reports and Thomson Reuters. |

Valuation and Conclusion

Our price target values GNC at 8x our FY17 EBITDA. If comps were to weaken and margins were to contract, we see downside to $17 (18%) – or 6.4x our FY17 EBITDA. We place a 60% probability on this scenario. If the competitive landscape improves, comps and margins stabilize, the company is able to re-franchise a large number of stores, and the company’s valuation expands, we see upside to $27 – or 8.0x our CY17 EBITDA – with a 40% probability. The weighted average gets us to our $21 price target. We would re-evaluate our rating if traffic were to improve, comps accelerate, and/or both the absolute and relative valuation of GNC become more attractive.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Vitamin Shoppe Inc (VSI)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=VSI) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 26.66 | | Price Target | USD 29.00 | | **Why Equal Weight?** Reflects: 1) a difficult competitive landscape, 2) a slight improvement in interest in supplements from consumers, 3) a moderation in market shares loss to other channels, 4) the company has moderate store growth, and 5) the company trades at a slight premium to other turnaround names given the opporunities it has to cut costs and better leverage its assets. | | |  | | | Upside case | USD 33.00 | | Reflects: 1) a moderation in the competitive landscape, 2) innovative new products drive traffic, 3) moderation in market share loss to other channels, 4) it is not necessary to reinvest cost savings into business to drive traffic, 5) new store openings, and 6) multiple expansion. | | |  | | | Downside case | USD 21.00 | | Reflects: 1) a heightened competitive landscape, 2) lack of new product introductions, 3) consumers substitute "healthy eating" for supplements, 4) market shares loss to other channels, 5) unit growth stalls, and 6) multiples contraction. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 1,267 | 1,306 | 1,311 | 1,349 | 2.1% |  |
| EBITDA (adj) | 137 | 137 | 141 | 145 | 1.8% |  |
| EBIT (adj) | 99 | 97 | 101 | 104 | 1.7% |  |
| Pre-tax income (adj) | 97 | 87 | 91 | 94 | -1.1% |  |
| Net income (adj) | 60 | 53 | 55 | 57 | -1.5% |  |
| EPS (adj) ($) | 2.04 | 2.21 | 2.39 | 2.58 | 8.0% |  |
| Diluted shares (mn) | 29.2 | 24.1 | 23.1 | 22.2 | -8.8% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 10.8 | 10.5 | 10.8 | 10.7 | 10.7 |  |
| EBIT (adj) margin (%) | 7.8 | 7.4 | 7.7 | 7.7 | 7.6 |  |
| Pre-tax (adj) margin (%) | N/A | N/A | N/A | N/A | N/A |  |
| Net (adj) margin (%) | 4.7 | 4.1 | 4.2 | 4.2 | 4.3 |  |
| ROIC (%) | 11.1 | 10.7 | 10.7 | 10.9 | 10.9 |  |
| ROE (%) | 11.6 | 11.3 | 11.4 | 10.7 | 11.3 |  |
| ROA (lease adjusted) (%) | 7.9 | 7.8 | 7.7 | 9.5 | 8.2 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 140 | 138 | 136 | 136 | -1.1% |  |
| Intangible fixed assets | 331 | 330 | 330 | 330 | -0.1% |  |
| Cash and equivalents | 15 | 31 | 69 | 131 | 105.6% |  |
| Total assets | 749 | 760 | 797 | 863 | 4.8% |  |
| Short and long-term debt | 123 | 133 | 133 | 133 | 2.5% |  |
| Total liabilities | 273 | 293 | 295 | 299 | 3.1% |  |
| Net debt/(funds) | 108 | 102 | 64 | 2 | -74.6% |  |
| Shareholders' equity | 475 | 468 | 501 | 563 | 5.8% |  |
| Change in working capital | -34 | 15 | 2 | 0 | N/A |  |
| Cash flow from operations | 61 | 116 | 103 | 103 | 19.2% |  |
| Capital expenditure | -39 | -40 | -39 | -40 | N/A |  |
| Free cash flow | 98 | 45 | 61 | 65 | -12.9% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 13.0 | 12.0 | 11.1 | 10.3 | 11.6 |  |
| EV/EBITDA (adj) (x) | 5.4 | 5.4 | 5.0 | 4.4 | 5.1 |  |
| Equity FCF yield (%) | 12.7 | 7.0 | 10.0 | 11.0 | 10.2 |  |
| P/Sales (x) | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |  |
| P/BV (x) | 1.6 | 1.4 | 1.2 | 1.0 | 1.3 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 4.1 | 4.3 | 4.2 | 4.0 | 4.1 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | -0.0 | -0.1 | 1.1 | 1.8 | 0.7 |  |
| Square footage growth (%) | 5.7 | 3.0 | 2.3 | 2.9 | 3.5 |  |
| Inventory growth (%) | 21.3 | 0.0 | -0.2 | 0.1 | 5.3 |  |
| Capex/sales (%) | 3.1 | 3.1 | 3.0 | 3.0 | 3.0 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

vitamin shoppe

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Vitamin Shoppe Inc(VSI): Quarterly and Annual EPS (USD)   |  | | --- | | VSI | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 29.00 | | Price (19-Sep-2016) | | USD 26.66 | | Potential Upside/Downside | | +8.8% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.63A | N/A | 0.67A | 0.67A | N/A | N/A | 0.72E | 6% | N/A |
| Q2 | 0.56A | N/A | 0.55A | 0.55A | N/A | N/A | 0.60E | -2% | N/A |
| Q3 | 0.48A | N/A | 0.52E | 0.50E | N/A | N/A | 0.56E | 8% | N/A |
| Q4 | 0.34A | N/A | 0.47E | 0.45E | N/A | N/A | 0.46E | 38% | N/A |
| Year | 2.04A | N/A | 2.21E | 2.17E | N/A | 2.39E | 2.35E | 8% | 8% |
| P/E | 13.0 |  | 12.0 |  |  | 11.1 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Running to Stand Still

Initiatives in place to stabilize business but secular headwinds may offset any progress; initiate at Equal Weight with a $29 price target

After spending many years as a Growth Star, and then as a company In Transition, we view VSI as a company Attempting to Reinvent itself. Significant competitive intrusions have led to weak comps, unit growth has moderated, ROIC is declining, and its lease adjusted balance sheet is moderately levered. We are encouraged by recent actions to engage customers and upgrade the customer experience. Also, we view recent steps taken by the company to improve its cost structure positively, but it may be necessary to reinvest a large portion of these savings back into the business to drive better traffic.

Eventually, we think there is a path for the company to become a Stable Staple, which would warrant a higher multiple, as we believe VSI’s prime real estate and go-to-market strategy give it a competitive moat. That said, we think it’s unlikely VSI finds its way back to being a Growth Star.

We rate the company Equal Weight and take the following into consideration:

1. Industry fundamentals have been challenging.
2. Reinvention plan and additional in house manufacturing of private label products should protect or boost margins.
3. The company’s convenient store locations, depth of offering, knowledgeable staff, and large loyalty database are a unique and valuable combination of assets.
4. We believe there is an opportunity to better leverage VSI’s assets.
5. Stock is valued at a slight premium relative to other retail turnarounds.

Equal Weight rating based on upside/downside scenario analysis

Our price target values VSI at 5.3x our FY17 EBITDA. If comps were to weaken or margins contract, we see downside to $21 (21%) – or 4.0x our FY17 EBITDA. We place a 30% probability on this scenario. If the competitive landscape improves, comps and margins improve, and the company’s valuation expands, we see upside to $33 – or 6.0x our CY17 EBITDA – with a 70% probability. The weighted average gets us to our $29 price target. We would re-evaluate our rating if traffic were to improve, comps accelerated, and/or both the absolute and relative valuation of VSI became more attractive.

|  |
| --- |
| Figure  VSI Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  VSI Price Target Valuation |  | Figure  VSI Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  VSI Free Cash Flow |
|  |  |
| Source: Barclays Research |

1. Industry fundamentals have been challenging

Comps at VSI started slowing in 2013 and its retail sales per store peaked in 2013. We forecast that comps will decline slightly this year after being flat in 2015. Quarter-to-date comps at the start of 3Q16 were negative and management expects flat to slightly negative comps for FY16.

|  |  |  |
| --- | --- | --- |
| Figure  VSI Comps Excluding E-Commerce |  | Figure  VSI Retail Sales per Average Store |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

The retail operating margin declined to 18% in 2015 from 21% in 2012. Year-to-date, the retail operating margin is lower vs. last year. The margin is still well above the 15-16% level from 2006 through 2009. The combination of lower sales per store and margin compression has led to a decline in the company’s retail store profitability.

|  |  |  |
| --- | --- | --- |
| Figure  VSI Retail Operating Margin |  | Figure  VSI Retail EBIT per Average Store |
|  |  |  |
| Source: Company reports and Barclays Research |  | Note: 1H16 is annualized YTD Source: Company reports and Barclays Research |

The challenges at VSI are not unique. GNC has also experienced weakening sales and profitability trends for its retail business in recent years.

|  |  |  |
| --- | --- | --- |
| Figure  Total Company Comps – VSI & GNC |  | Figure  GNC Retail EBIT per Average Store |
|  |  |  |
| Note: VSI comps include e-commerce starting in 2013 Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Many industry data sources suggest that the overall Vitamins, Minerals, and Supplements (VMS) industry is growing at a mid single-digit pace. Below we show data that captures the year over year growth rate of VMS products at essentially all retail channels except specialty. The data suggests that specialty retailers are losing share to conventional channels. We also believe internet retailers are taking share.

|  |  |
| --- | --- |
|  | Figure  Y/Y Growth of Vitamins & Supplements |
|  |  |
| Note: Includes Food, Drug, Mass, Walmart, Club (not Costco), Dollar, military commissaries and c-stores.  Source: Nielsen xAOC Incl Conv |

Google Trends suggests that after a long decline, interest in VMS products is picking up. Google Trends looks at search term interest relative to its highest point in the past. The charts below have the year-over-year change in search interest for vitamins and supplements. Interest in both accelerated in 2011—this also coincides with strong comps. Interest in the search terms have waned after this period but began to increase year-over-year early in 2016 for vitamins and more recently for supplements

|  |  |  |
| --- | --- | --- |
| Figure  Google Trends – Y/Y Growth in “Vitamins” |  | Figure  Google Trends – Y/Y Growth in “Supplements” |
|  |  |  |
| Note: All categories in the United States Source: Google Trends and Barclays Research |  | Note: All categories in the United States Source: Google Trends and Barclays Research |

Interest in sports nutrition has been far weaker than both vitamins and supplements. In fact, search interest has essentially been in continuous decline, although there was resurgence in 2011 and 2012. We believe among the reasons for the spike was consumers stockpiling products containing DMAA – a stimulant used in bodybuilding, weight-loss supplements, and as a pre-workout energy booster. Eventually retailers pulled the product from shelves given some negative publicity and perceived risks.

|  |  |
| --- | --- |
|  | Figure  Google Trends – Y/Y Growth in “Sports Nutrition” |
|  |  |
| Note: All categories in the United States Source: Google Trends and Barclays Research |

As can be seen in the chart below, sports nutrition is the largest category as a percent of sales at VSI. Less interest in this category has been a pressure on VSI, and it likely helps explain the intense level of competition in the category.

|  |  |
| --- | --- |
|  | Figure  VSI Product Categories as a Percent of Sales |
|  |  |
| Source: Company reports and Barclays Research |

1. Reinvention plan and further in house manufacturing of private label products should protect or boost margins

More than $22 million in gross cost savings targeted by 2018

VSI expects to realize $17.5 million in gross cost savings in 2017 and $22.5 million in 2018. The company plans to achieve a $9.5 million run rate in 2016, with much of this already achieved through a reduction in overhead (started in 2015), the closure of its Seattle Distribution center and Canadian operations, as well as other identified costs. An offset to the total gross savings is some increased spending in various areas including private brands, digital, and category management. These are expected in the $10 million range in FY16, with $6 million expected to be ongoing. In June 2016 the company hired Jason Reiser as COO to lead the company’s reinvention strategy, including vendor negotiations, and finding procurement opportunities.

Transition of private label manufacturing in-house is margin accretive

VSI purchased manufacturer Nutri-Force in 2Q14 to vertically integrate its business. This is expected to ultimately boost the operating margin as private brand manufacturing continues to migrate in-house. Private brands accounted for ~20% of sales at the end of 2015. In house manufacturing supplied 30-35% of VSI’s private label. Management believes that it should be able to transition at least half of its business over to Nutri-Force, and each one percentage point increase in private brand penetration contributes between 20-25 basis points to product margin.

|  |  |
| --- | --- |
|  | Figure  Private Brand Sales as a Percent of Total Sales |
|  |  |
| Source: Company reports and Barclays Research |

1. The company’s convenient store locations, depth of offering, knowledgeable staff, and large loyalty database are a unique and valuable combination of assets

Convenient real estate locations

VSI’s stores tend to be located in heavily trafficked, dense suburban areas, and tend to be in locations with high visibility and easy access for shoppers. Because of this real estate strategy, we believe the majority of customers become aware of a new store by driving past it and seeing the sign. As the company evolves its strategy and tries to capture increased traffic from new and lapsed customers, we believe the convenient store locations will help its recovery.

Deep product offering relative to competition

We believe VSI has the most extensive selection of VMS products available at brick and mortar. Stores carry ~7,400 SKUs vs. Vitamin World at 3,900 and GNC at 2,000+. This compares to 350-700 at most traditional food, drug, and mass formats, although we believe this SKU count is growing. Given the large assortment at VSI, customers know that they can likely find what they are looking for at a VSI store no matter how obscure a product may be. This is also important for capturing and maintaining customers as VSI may be the only retailer that offers a particular VMS product in a convenient location.

|  |  |
| --- | --- |
|  | Figure  Number of SKUs by Company/Format |
|  |  |
| Source: Company reports and Barclays Research estimates. |

Well educated staff provide a high level of service

To meet the needs of customers wanting service and information, VSI identifies potential store associates that are themselves “health enthusiasts.” All store associates are required to pass a range of courses at Vitamin Shoppe University, the company’s online learning website. Also, the company has daily training classes to make sure associates are aware of the latest products and developments in the industry. Through proper hiring and training, store associates can be helpful if a customer has a question on a product or just has a general question on which products may be best for them.

Tablet computers are expected to roll out across the chain and this will elevate the level of service even further. Store associates with a tablet will be able to see a significant amount of information on the devices including customer profile information, purchase history for both retail and online, as well as product knowledge for all SKUs and categories.

Healthy Awards

The company’s Healthy Awards loyalty program was established over 15+ years ago and had 5.9 million members at the end of last year. These customers accounted for nearly 90% of the company’s net sales, excluding Super Supplements and Nutri-Force. The company rolled out a major overhaul to the program earlier this year with loyalty members earning redemption certificates quarterly compared to annually in the past. In the most recent quarter, this program provided over a 1.5% boost to comps. There will be less outreach to market the quarterly redemption change going forward and so the comp boost is expected to moderate from this level. We believe the change in redemption interval will reengage core customers and help drive better traffic.

|  |  |
| --- | --- |
|  | Figure  Healthy Awards Members (in millions) |
|  |  |
| Source: Company reports |

1. We believe VSI can better leverage its assets; early indications suggest the company is moving in the right direction

Digital engagement

The company’s website received an improvement in basic navigation in the spring of 2015 but it remains less streamlined than it should be, in our view, to effectively merchandise the ~20,000 SKUs that are available online. The company knows that the site needs to have a more responsive design to make it easier to navigate. Also, the VSI team is working to better utilize historical customer purchase history.

Meanwhile VSI will have a mobile app later in 2016 or early 2017. Given the importance of this medium to many consumers we think the company is late to get this to market. That said, the app will be important in maintaining relevancy with younger consumers and those loyal to the brand but with an increasing set of options for purchasing VMS products.

Health Awards

As discussed above, the company has a substantial number of Healthy Rewards loyalty members that contribute nearly 90% of the company’s net sales, excluding Super Supplements and Nutri-Force. In our view, VSI has not fully utilized its large database to enhance personalization and outreach. Also, we note below that there is a high amount of churn among Healthy Awards members. More proactive and personalized engagement may be able to improve these statistics.

|  |  |
| --- | --- |
|  | Figure  Healthy Awards Members Churn |
|  |  |
| Note: Calculated as newly enrolled Healthy Awards members divided by total Healthy Awards members.  Source: Company reports. |

1. Stock is valued at a slight premium relative to other retail turnarounds

VSI’s valuation has contracted considerably in recent years as its comps and profit growth have slowed. The stock’s high valuation occurred when the company was opening units ~10% annually, comps were in the mid to high single digit range, and the company’s profit margins were expanding, yielding 20%+ annual EBITDA growth. Our projections for the next three years are for low single digit unit growth, ~1.0% comps, and low single-digit annual EBITDA growth.

|  |  |  |
| --- | --- | --- |
| Figure  VSI NTM EV/EBITDA |  | Figure  VSI NTM P/E |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Below we contrast the valuation of VSI vs. a basket of retail turnarounds in softlines, electronics and home products, department stores, gaming, and office supplies. As a group, these companies have a slightly higher ROIC than VSI but profits are expected to decline vs. slight growth at VSI. In our view, VSI should trade at a slight premium to this group given the opportunities it has to improve its cost structure and margins or to invest in growth.

GNC trades at a premium to both groups. We think this is due to its different asset base, with ~25-30% of operating profit coming from its domestic and international franchise business; franchise businesses tend to have strong multiples given their low capital intensity and smooth profit streams. Lastly, the company is undergoing a review of financial and strategic alternatives to increase shareholder value, and this likely supports the stock to some degree.

|  |
| --- |
| Figure  Selected Metrics and Valuation for “Retail Turnaround Basket” and GNC vs. VSI |
|  |
| Note: Comp average includes ANF, BBBY, BBY, BKE, DDS, EXPR, GME, GPS, KSS, M, ODP, and SPLS. \*FY15. \*\*FY16 and FY17 average. ROIC based on tangible invested capital. Source: Company reports and Thomson Reuters. |

Valuation and Conclusion

Our price target values VSI at 5.3x our FY17 EBITDA. If comps were to weaken or margins contract, we see downside to $21 (21%) – or 4.0x our FY17 EBITDA. We place a 30% probability on this scenario. If the competitive landscape improves, comps and margins improve, and the company’s valuation expands, we see upside to $33 – or 6.0x our CY17 EBITDA – with a 70% probability. The weighted average gets us to our $29 price target. We would re-evaluate our rating if traffic were to improve, comps accelerate, and/or both the absolute and relative valuation of VSI become more attractive.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Chefs' Warehouse Inc (CHEF)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=CHEF) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 11.83 | | Price Target | USD 12.00 | | **Why Equal Weight?** Our price target multiple reflects CHEF's significant top-line opportunity, but it is a discount to the historical average of ~12x due to recent execution challenges that have resulted in significant margin contraction and ROIC degradation. | | |  | | | Upside case | USD 15.00 | | Reflects: 1) MSD-HSD organic top-line growth, 2) significant gross margin recovery in FY17; 3) CHEF not making new acquisitions so that margins, ROIC and leverage improve. | | |  | | | Downside case | USD 8.00 | | Reflects: 1) LSD organic top-line growth; 2) continued gross margin pressure from the protein business; 3) the announcement of a new acquisition that distracts CHEF from improving execution at the protein business, increases leverage and depresses ROIC. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 1,056 | 1,174 | 1,255 | 1,349 | 8.5% |  |
| EBITDA (adj) | 62 | 53 | 62 | 71 | 4.3% |  |
| EBIT (adj) | 47 | 35 | 43 | 50 | 2.2% |  |
| Pre-tax income (adj) | 34 | 17 | 21 | 29 | -5.7% |  |
| Net income (adj) | 20 | 10 | 13 | 17 | -4.9% |  |
| EPS (adj) ($) | 0.75 | 0.38 | 0.45 | 0.60 | -7.3% |  |
| Diluted shares (mn) | 26.5 | 27.2 | 28.0 | 28.6 | 2.6% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 5.9 | 4.5 | 5.0 | 5.3 | 5.2 |  |
| EBIT (adj) margin (%) | 4.5 | 3.0 | 3.4 | 3.7 | 3.6 |  |
| Pre-tax (adj) margin (%) | 3.2 | 1.5 | 1.7 | 2.1 | 2.1 |  |
| Net (adj) margin (%) | 1.9 | 0.9 | 1.0 | 1.3 | 1.3 |  |
| ROIC (%) | 8.1 | 6.0 | 6.7 | 7.3 | 7.0 |  |
| ROE (%) | 11.9 | 5.4 | 6.2 | 7.8 | 7.8 |  |
| ROA (lease adjusted) (%) | 6.9 | 5.1 | 5.7 | 6.1 | 6.0 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 54 | 50 | 46 | 44 | -6.5% |  |
| Intangible fixed assets | 288 | 288 | 288 | 288 | 0.0% |  |
| Cash and equivalents | 2 | 13 | 19 | 28 | 124.2% |  |
| Total assets | 586 | 593 | 608 | 627 | 2.3% |  |
| Short and long-term debt | 275 | 275 | 275 | 275 | 0.0% |  |
| Total liabilities | 398 | 395 | 397 | 399 | 0.1% |  |
| Net debt/(funds) | 272 | 280 | 274 | 265 | -0.9% |  |
| Shareholders' equity | 188 | 198 | 211 | 228 | 6.7% |  |
| Change in working capital | -2 | -3 | -12 | -10 | N/A |  |
| Cash flow from operations | 38 | 25 | 20 | 28 | -9.5% |  |
| Capital expenditure | -22 | -14 | -15 | -19 | N/A |  |
| Free cash flow | -88 | -7 | 5 | 9 | N/A |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 15.7 | 31.0 | 26.3 | 19.7 | 23.2 |  |
| EV/EBITDA (adj) (x) | 9.5 | 11.4 | 9.6 | 8.3 | 9.7 |  |
| Equity FCF yield (%) | -29.0 | -2.3 | 1.6 | 2.8 | -6.7 |  |
| P/Sales (x) | 0.3 | 0.3 | 0.3 | 0.2 | 0.3 |  |
| P/BV (x) | 1.7 | 1.6 | 1.6 | 1.5 | 1.6 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 4.5 | 5.2 | 4.6 | 4.1 | 4.6 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Inventory growth (%) | 22.8 | 2.2 | 9.3 | 7.2 | 10.4 |  |
| Capex/sales (%) | 2.1 | 1.2 | 1.2 | 1.4 | 1.5 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Dec | | | | | | | |

chefs warehouse

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Chefs' Warehouse Inc(CHEF): Quarterly and Annual EPS (USD)   |  | | --- | | CHEF | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 12.00 | | Price (19-Sep-2016) | | USD 11.83 | | Potential Upside/Downside | | +1.4% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Dec | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.07A | N/A | 0.05A | 0.05A | N/A | N/A | 0.03E | -29% | N/A |
| Q2 | 0.21A | N/A | 0.15A | 0.15A | N/A | N/A | 0.16E | -29% | N/A |
| Q3 | 0.21A | N/A | 0.08E | 0.09E | N/A | N/A | 0.15E | -62% | N/A |
| Q4 | 0.26A | N/A | 0.11E | 0.14E | N/A | N/A | 0.20E | -58% | N/A |
| Year | 0.75A | N/A | 0.38E | 0.42E | N/A | 0.45E | 0.54E | -49% | 18% |
| P/E | 15.7 |  | 31.0 |  |  | 26.3 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Chew What You Have First

Significant top-line and margin opportunities, but execution challenges, declining ROIC, and high leverage limit upside in the near term; initiate with an Equal Weight rating and $12 price target

We are initiating coverage with an Equal Weight rating and $12 price target. Our price target values Chefs’ Warehouse (CHEF) on a CY17 EV/EBITDA of ~9.6x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $8, or 8.0x CY17 EV/EBITDA (~40% probability), while our upside scenario is $15, or 11.0x CY17 EV/EBITDA (~60% probability).

In our view, recent execution challenges combined with an outlook for slowing organic growth have caused this former Growth Star to become a company In Transition. Since CHEF became a public company in FY11, it has seemed at times that it has bitten off more than it can chew. Lease-adjusted ROIC has declined from 21.9% in FY11 to 6.5% in 2Q16, primarily driven by lower EBITDA margins (down from 7.5% in FY11 to 5.4% in the LTM) and the acquisition of eight companies. In addition, net debt to EBITDA leverage has increased from 1.5x (FY11) to 4.8x (LTM). In our view, upside is limited in the near-term given: 1) ongoing execution challenges, especially in the protein business; and 2) organic growth should remain pressured (consistent with a more challenging restaurant environment called out by CHEF and Sysco in August and the potential for election debates to keep diners at home).

However, unlike many of its In Transition peers, CHEF could become a Growth Star again, in our view, with +MSD organic sales growth, expanding EBITDA margins and increasing ROIC. CHEF still has a tremendous long-term growth opportunity to roll-up the specialty foodservice distribution industry and to expand to a national footprint. In addition, the company has opportunities to cross-sell with recent acquisitions (CHEF is in the early stages of cross-selling with the protein business), expand into new product categories (i.e., produce), and increase sales force productivity with the roll-out of e-commerce ordering. In addition, we believe CHEF will continue to gain share in its existing markets because it is the only pure-play specialty foodservice distributor with scale. Separately, the company’s margin opportunities include improving execution at the protein business and leveraging prior G&A investments. So, given the company’s significant opportunities combined with -29.1% YTD performance (vs. S&P 500’s +4.7%), we believe downside is also limited.

Equal Weight rating based on upside/downside scenario analysis

Given our near-term concerns regarding execution, a slowing top-line and high leverage, we would prefer to wait for a better entry point. If organic growth remains LSD beyond the near-term, the company is unable to recapture gross margin and/or CHEF makes a new acquisition, we see downside to $8 (-31%), or 8.0x FY17 EV/EBITDA. We assign a 40% probability of this scenario playing out. If, however, organic growth accelerates to +MSD, execution in the protein business improves, gross margins begin to recover, and the company makes no new acquisitions, then we see upside to $15 (+27%), or 11.0x FY17 EV/EBITDA. We believe there is a 60% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $12 price target and Equal Weight rating. The following figure captures our view on the upside and downside for CHEF.

|  |
| --- |
| Figure  CHEF Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We believe CHEF has significant top-line and margin opportunities, but execution challenges, declining ROIC and high leverage limit upside in the near-term. Our thesis contemplates the following:

What concerns us:

1. Big appetite for acquisitions has not improved fundamentals. Since the end of FY11, CHEF has completed eight acquisitions. While these acquisitions have led to robust sales growth, EBITDA and EPS growth have diverged – our FY16 estimates reflect a +12% annual increase in EBITDA since 2011, a -13.2% decline in EPS and a +24% increase in sales. In addition, EBITDA margins have declined from 7.5% in FY11 to 5.4% LTM and lease-adjusted ROIC has similarly declined from 21.9% (FY11) to 6.5% (LTM). The company has mostly used leverage to finance these deals so net debt to EBITDA has increased from 1.5x (FY11) to 4.8x (LTM). While CHEF is confident that it can return gross margins to 26%, “center of the plate” categories, including lower gross-margin-percent beef, were 20-25% of sales the last time gross margins were 26%, and it may be structurally harder to get gross margins back to 26% now that center of the plate categories are ~50% of sales. We would prefer that CHEF focuses on improving EBITDA margins and ROIC while reducing leverage instead of pursuing new acquisitions.
2. Slowing restaurant sales should limit organic growth in near-term. CHEF has a long-track record of generating best-in-class organic growth of 9.1% since 1Q10. However, organic sales slowed to +2.3% in 2Q due to a softening restaurant environment and deflation. We believe 3Q and 4Q could see a further slowing of organic growth due to extended deflation and election debates which could keep diners home. Given the slowing organic sales trends, execution challenges and heightened leverage, the stock is down -29.1% vs. S&P500 +4.7%.
3. CHEF compares unfavourably on ROIC and free cash flow vs. other distribution peers. Relative to SYY, USFD, PFGC and UNFI: CHEF has better sales and case growth and better margins, but worse lease-adjusted ROIC and free cash flow yield.

What we like:

1. Significant top-line and margin opportunities. Beyond the near-term, we believe CHEF has a significant long-term sales growth opportunity, which includes rolling-up the specialty foodservice distribution industry and expanding to a national footprint. In addition, the company has opportunities to cross-sell with the recently acquired companies (CHEF is in the early stages of cross-selling with the protein businesses), expand into new product categories (i.e., produce), and increase sales force productivity with the roll-out of e-commerce ordering. In addition, we believe CHEF will continue to gain share in its existing markets because it is the only pure-play specialty foodservice distributor with scale. Separately, the company’s margin opportunities include improving execution at the protein business and leveraging prior G&A investments.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are slightly below consensus on sales, EBITDA and EPS. Our sales estimate reflects decelerating organic sales trends in 2H16 due to extended deflation and a softening restaurant environment. In addition, our interest expense reflects the ~100 bps higher rate for the recent term loan amendment.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Company reports, Barclays Research |

The following figures show our price target valuation and CHEF’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  Price Target Valuation |  | Figure  Current Valuation |
|  |  |  |
| Source: Company Estimates, Barclays Research |  | Source: Company Estimates, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY16-FY18. We assume capex as a percentage of sales is unchanged over the next few years. In addition, we also assume that working capital is a net neutral impact vs. ~$2M drag in FY15. The increase in free cash flow in FY17-FY18 is primarily driven by expected improvements in EBITDA.

|  |  |
| --- | --- |
|  | Figure  CHEF Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) Big appetite for acquisitions has not improved fundamentals

Since the end of FY11, CHEF has completed eight acquisitions. The figure below contains the acquisitions that CHEF has completed since the end of FY11.

|  |  |
| --- | --- |
|  | Figure  Acquisitions Since End of FY11 |
|  |  |
| Source: Company Reports, Barclays Research |

While these acquisitions have led to robust sales growth, EBITDA and EPS growth have not matched – our FY16 estimates assume EBITDA is up +12.0% annually and EPS is down -13.2% annually since FY11 vs. sales increasing +24.0% annually. The next figure shows sales trends since FY11.

|  |  |
| --- | --- |
|  | Figure  CHEF Revenues: Up +24% Annually Between FY11-FY16E |
|  |  |
| Source: Company Reports, Barclays Research |

The next two figures show EBITDA dollars and margin trends since FY11. EBITDA has increased at a +12.0% CAGR, but obviously at the expense of margin as margins have declined from 7.5% in FY11 to 5.4% LTM.

|  |  |  |
| --- | --- | --- |
| Figure  CHEF EBITDA: Up +12.0% Annually Between FY11-FY16E |  | Figure  CHEF EBITDA Margins: Down Significantly |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lower gross margins are significant drivers of the EBITDA margin decline.

|  |  |
| --- | --- |
|  | Figure  CHEF Gross Margins: Down Significantly |
|  |  |
| Source: Company Reports, Barclays Research |

While CHEF is confident that it can return gross margins to 26%, center of the plate categories, including lower gross-margin-percent beef, were 20-25% of sales the last time gross margins were 26%, and it may be structurally harder to get gross margins back to 26% now that center of the plate categories are ~50% of sales.

Figure   
CHEF Sales Mix: Lower Margin Beef’s Greater Mix Creates Structural GPM Headwind



Source: Company Reports, Barclays Research

We estimate EPS of $0.38 in FY16E, which is lower than EPS of $0.77 in FY11. The implied CAGR is -13.2%, but most of the decline is due to the ~49% drop in FY16. Note that higher D&A, mostly from the acquisitions, has also been a headwind to EPS. D&A has increased +56% annually since 2011 and now represents 1.5% of sales vs. 0.5% in 2011.

|  |  |
| --- | --- |
|  | Figure  CHEF EPS: Down Significantly in FY16 |
|  |  |
| Source: Company Reports, Barclays Research |

In addition, lease-adjusted ROIC has similarly declined from 21.9% (FY11) to 6.5% (LTM). Note that the correlation between lease-adjusted ROIC and the stock price is -4.7%.

|  |  |
| --- | --- |
|  | Figure  CHEF Lease-Adjusted ROIC: Down Significantly Since FY11 |
|  |  |
| Source: Company Reports, Barclays Research |

The company has mostly used leverage to finance these deals so net debt to EBITDA has increased from 1.5x (FY11) to 4.8x (LTM).

|  |  |
| --- | --- |
|  | Figure  CHEF Leverage: Up Significantly Since FY11 |
|  |  |
| Source: Company Reports, Barclays Research |

Going forward, we would prefer that CHEF focus on improving EBITDA margins and ROIC while reducing leverage instead of pursuing new acquisitions.

2) Slowing restaurant sales should limit organic growth in the near term

CHEF has a long-track record of generating best-in-class organic growth of +9.1% since 1Q10. However, organic sales slowed to +2.3% in 2Q due to a softening restaurant environment and deflation. We believe 3Q and 4Q could see a further slowing of organic growth due to extended deflation and election debates which could keep diners home. (Our 4Q organic sales growth estimate excludes the benefit of the extra week).

|  |  |
| --- | --- |
|  | Figure  CHEF Organic Sales Growth Trends: Best-in-Class, But Slowed Recently |
|  |  |
| Source: Company Reports, Barclays Research |

CHEF’s organic top-line has recently been hurt by deflation, which we expect to continue throughout the remainder of FY16. In addition, both CHEF and SYY called out a softening restaurant environment in August.

Specifically, CHEF said:

* “During the quarter, we started to see some softening in the industry.” – CEO (8/2/2016)
* “There was some softening, and i think just given the trends we are seeing and outlook for the rest of the year...kind of anticipate that probably staying.” – CFO (8/2/2016)

SYY said:

* “Market environment...is experiencing uneven trends and appears to have softened somewhat of late. While consumer confidence and unemployment data points remain relatively favourable compared to a few years ago, the current sentiment for customer spending on meals away from home seems to be trending downward.” – CEO (8/15/2016)
* “The restaurant environment appears to be softening, and as a result, we anticipate modest case volume growth for the next quarter or two.” – CFO (8/15/2016)

In addition, we believe the election will create transient headwinds. Specifically, we took a look at the last election cycle and found several instances of restaurants calling out the election as a reason for sales slowing in October. In addition, several companies indicated this summer that they will pull back on media spend this Fall to avoid competing with the campaigns for media space.

* Cheesecake Factory called out 15-20 bps impact on comps in their 4Q12 comp because of poor traffic on debate days (“big down days for most people in the restaurant business”) (Feb 2013).
* Kona Grill said “sales trends in October and early November were choppy as political debates and the Presidential Election kept guests at home” (Feb 2013).
* Kona also said that debate and convention days were “double digit negatives” (Nov 2013).
* BJ’s restaurants said “Much like the political conventions, we continue to see negative or softer comparable restaurant sales on the nights at the presidential and vice presidential debate and I would expect that we will see negative comparable restaurant sales on the upcoming election night.” (Oct 2012).
* BJ’s also said that the Vice President and Presidential debate were “negative days” except for one night that coincided with Monday Night Football (Oct 2012).

As a result, we believe organic growth will remain pressured in the near-term. We are estimating organic growth of +1.0% in 3Q and -1.0% in 4Q (excluding the extra week).

Given the slowing organic sales trends, execution challenges and heightened leverage, the stock is down -29.1% vs. S&P500 +4.7%.

|  |  |
| --- | --- |
|  | Figure  CHEF Stock Performance |
|  |  |
| Source: Thomson |

3) CHEF compares unfavourably on ROIC and free cash flow vs. other distribution peers.

Relative to SYY, USFD, PFGC and UNFI: CHEF has better sales and case growth and better margins, but worse lease-adjusted ROIC and free cash flow yield. The following figure contains our distributor comparison table.

|  |
| --- |
| Figure  Distributor Operating Metric Comp Table |
|  |
| Source: Company Reports, Barclays Research |

4) Significant top-line and margin opportunities.

Beyond the near term, we believe CHEF has a significant long-term sales growth opportunity, which includes rolling up the specialty foodservice distribution industry and expanding to a national footprint. In addition, the company has opportunities to cross-sell with the recently acquired companies (CHEF is in the early stages of cross-selling with the protein businesses), expand into new product categories (i.e., produce), and increase sales force productivity with the roll-out of e-commerce ordering. We believe CHEF will continue to gain share in its existing markets because it is the only pure-play specialty foodservice distributor with scale. Separately, the company’s margin opportunities include improving execution at the protein business and leveraging prior G&A investments.

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating based on our upside/downside scenario analysis. If organic growth remains LSD beyond the near-term, the company is unable to recapture gross margin and/or CHEF makes a new acquisition, we see downside to $8 (-31%), or 8.0x FY17 EV/EBITDA – with an EBITDA of $62 million. We assign a 40% probability of this scenario playing out. If, however, organic growth accelerates to +MSD, execution in the protein business improves and gross margins begin to recover, and the company makes no new acquisitions, then we see upside to $15 (+27%), or 11.0x FY17 EV/EBITDA. We believe there is a 60% probability of this scenario occurring. The weighted average of these two scenarios gets us to our $12 price target and Equal Weight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Performance Food Group Co (PFGC)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=PFGC) | | | | | | | Stock Rating: OVERWEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2016A | 2017E | 2018E | 2019E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 24.13 | | Price Target | USD 28.00 | | **Why Overweight?** Our Price Target values PFGC more in line with other foodservice distributors (Sysco) and Stable Staple peers – albeit at a slight discount given the lower ROIC and lack of a dividend. | | |  | | | Upside case | USD 31.00 | | Reflects: 1) A continuation of strong Independent case volume growth, 2) a narrowing of the discount relative to the closest peer as well as some of the other names we consider "Stable Staples", 3) Improving ROIC, 4) Continued deleverage, and 5) The potential for a dividend. | | |  | | | Downside case | USD 23.00 | | Reflects: 1) A meaningful slowdown in Independent case growth, 2) A reversal of recent CPI/PPI trends - which could cause gross margin and gross profit dollar pressure, and 3) a slowdown in EBITDA and EPS Growth due to either slowing independent sales or CPI/PPI reversal. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 16,105 | 16,720 | 17,808 | 18,849 | 5.4% |  |
| EBITDA (adj) | 352 | 376 | 406 | 433 | 7.1% |  |
| EBIT (adj) | 235 | 258 | 285 | 305 | 9.1% |  |
| Pre-tax income (adj) | 152 | 203 | 230 | 250 | 18.0% |  |
| Net income (adj) | 91 | 122 | 138 | 150 | 18.1% |  |
| EPS (adj) ($) | 0.93 | 1.20 | 1.34 | 1.44 | 15.7% |  |
| Diluted shares (mn) | 97.8 | 102.0 | 103.0 | 104.0 | 2.1% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 2.2 | 2.3 | 2.3 | 2.3 | 2.3 |  |
| EBIT (adj) margin (%) | 1.5 | 1.5 | 1.6 | 1.6 | 1.6 |  |
| Pre-tax (adj) margin (%) | 0.9 | 1.2 | 1.3 | 1.3 | 1.2 |  |
| Net (adj) margin (%) | 0.6 | 0.7 | 0.8 | 0.8 | 0.7 |  |
| ROIC (%) | 9.6 | 10.1 | 10.9 | 11.6 | 10.6 |  |
| ROE (%) | 14.1 | 14.1 | 13.9 | 13.2 | 13.8 |  |
| ROA (lease adjusted) (%) | 5.9 | 6.1 | 6.2 | 6.1 | 6.1 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 637 | 669 | 676 | 676 | 2.0% |  |
| Intangible fixed assets | 823 | 823 | 823 | 823 | 0.0% |  |
| Cash and equivalents | 11 | 127 | 276 | 427 | 239.7% |  |
| Total assets | 3,455 | 3,623 | 3,888 | 4,122 | 6.1% |  |
| Short and long-term debt | 1,146 | 1,146 | 1,121 | 1,096 | -1.5% |  |
| Total liabilities | 2,653 | 2,698 | 2,823 | 2,905 | 3.1% |  |
| Net debt/(funds) | 1,135 | 1,018 | 857 | 675 | -15.9% |  |
| Shareholders' equity | 803 | 925 | 1,065 | 1,217 | 14.9% |  |
| Change in working capital | -2 | 26 | 42 | 24 | N/A |  |
| Cash flow from operations | 235 | 266 | 297 | 299 | 8.4% |  |
| Capital expenditure | -120 | -150 | -125 | -125 | N/A |  |
| Free cash flow | 92 | 116 | 161 | 182 | 25.6% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 25.9 | 20.2 | 18.0 | 16.7 | 20.2 |  |
| EV/EBITDA (adj) (x) | 10.2 | 9.2 | 8.1 | 7.2 | 8.7 |  |
| Equity FCF yield (%) | 3.9 | 4.7 | 6.5 | 7.3 | 5.6 |  |
| P/Sales (x) | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |  |
| P/BV (x) | 2.9 | 2.7 | 2.3 | 2.0 | 2.5 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 3.6 | 3.2 | 2.7 | 2.2 | 2.9 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Inventory growth (%) | 4.2 | 1.8 | 6.5 | 4.0 | 4.1 |  |
| Capex/sales (%) | 0.7 | 0.9 | 0.7 | 0.7 | 0.8 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jun | | | | | | | |

performance food group

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Performance Food Group Co.(PFGC): Quarterly and Annual EPS (USD)   |  | | --- | | PFGC | | Stock Rating | | OVERWEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 28.00 | | Price (19-Sep-2016) | | USD 24.13 | | Potential Upside/Downside | | +16.0% | | | | | | | | | | |
|  | 2016 | 2017 | | | 2018 | | | Change y/y | |
| FY Jun | Actual | Old | New | Cons | Old | New | Cons | 2017 | 2018 |
| Q1 | 0.20A | N/A | 0.22E | 0.23E | N/A | N/A | 0.29E | 10% | N/A |
| Q2 | 0.26A | N/A | 0.31E | 0.33E | N/A | N/A | 0.37E | 19% | N/A |
| Q3 | 0.13A | N/A | 0.23E | 0.24E | N/A | N/A | 0.28E | 77% | N/A |
| Q4 | 0.35A | N/A | 0.44E | 0.47E | N/A | N/A | 0.53E | 26% | N/A |
| Year | 0.93A | N/A | 1.20E | 1.27E | N/A | 1.34E | 1.48E | 29% | 12% |
| P/E | 25.9 |  | 20.2 |  |  | 18.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

A Faster Growth ‘Stable Staple’

Strong top-line, improving returns, and growing free cash flow warrant a comparison to more expensive staples peers. Initiate at Overweight with a $28 price target.

We are initiating coverage with an Overweight rating and $28 price target. Our price target values Performance Food Group (PFGC) on a CY17 EV/EBITDA of 9.7x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $23, or 8.4x CY17 EV/EBITDA (~30% probability), while our upside scenario is $31, or 10.5x CY17 EV/EBITDA (~70% probability).

In PFGC’s brief second life as a public company, shares are up 25.7% since the IPO (vs. the S&P500’s +11.2%) and +4.3% YTD (vs. the S&P’s +4.7%). In our view, performance has been a function of strong top line, improving returns, growing free cash flow, reasonable leverage, and transparency for new and existing shareholders, which cannot be underestimated as a critical success factor for newly public companies.

PFGC initially traded at a NTM EV/EBITDA of ~9.5x following its IPO, later increasing to as high as ~10.5x, but valuation has since returned to about ~9x. As a result, PFGC trades at a sizeable discount to SYY (at 10.8x) and other consumer staples peers despite exhibiting many metrics that are in-line with this peer group. We do believe PFGC should trade at a slight discount to these consumer staples peers given the lower ROIC, lack of a dividend, and shorter operating history as a public company – but, we believe the magnitude of the discount is unwarranted, so we are initiating with an Overweight rating and $28 price target. Our price target assumes a CY17 EV/EBITDA of 9.7x.

Overweight rating based on upside/downside scenario analysis

Our Overweight rating is based on a consideration of our upside and downside scenarios. Our upside scenario values PFGC at $31 (+28% upside), which we believe materializes if PFGC maintains strong momentum with independent customers, continues to deliver on its EBITDA growth goals, continues to improve ROIC and de-levers the balance sheet. In addition, with growing free cash flow, the company will have increasing balance sheet optionality. Our upside valuation reflects a CY17 EV/EBITDA of 10.5x – still a slight discount vs. Sysco and other consumer staples peers, which we believe is appropriate given PFGC’s lower ROIC, lack of a dividend and shorter operating history as a public company. We assign a 70% probability to our upside scenario.

We see downside to $23 (-5% downside) if independent case growth and EBITDA slow meaningfully. Our downside scenario reflects a CY17 EV/EBITDA of 8.4x, which is more or less in-line with Sysco’s valuation before Fall 2013 – prior to announcing the US Foods deal. The weighted average of these scenarios gets us to our $28 price target and Overweight rating.

The following figure captures our view on the upside and downside for PFGC.

|  |
| --- |
| Figure  PFGC Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We believe PFGC’s strong top-line, improving returns, and growing free cash flow warrant a multiple that is closer to its more expensive staples peers. Our thesis reflects the following:

1. Fundamentals have strong momentum. PFGC has a long-track record of gaining share in a mature industry. PFGC has increased case volumes with the more profitable independent customers by 6-10% for 28 consecutive quarters (and +9% last quarter), which is truly best-in-class. In addition, sales growth at the company’s Vistar business has also been strong (+9.1% excluding the extra week in FY16). Beyond the top line, the company expanded EBITDA margins and increased ROIC. Going forward, we expect PFGC to deliver on its top line and EBITDA growth goals (+5-7% and +7-10%, respectively), continue increasing ROIC, and continue growing free cash flow.
2. Magnitude of valuation discount vs. other staples is unwarranted. Relative to Sysco and other consumer staples peers, we expect PFGC to grow sales and EPS faster over the next three years. In addition, the company has a similar free cash flow yield. As a result, we believe the ~2x discount vs. SYY and the ~4.5x discount vs. other consumer staples peers is unwarranted, especially given the opportunities to increase cash flow, de-lever the balance sheet and grow ROIC.
3. Growing free cash flow increases optionality. We estimate that PFGC’s FY18 free cash flow yield is 6.5% (based on current valuation). Given the increasing free cash flow, we suggest that PFGC reduce debt slightly and consider implementing a dividend. A stronger balance sheet and a respectable dividend yield (e.g., 1%-2%) would solidify PFGC’s position as a faster growth Stable Staple and would warrant a further narrowing of the valuation gap vs. Sysco and other consumer staples peers.

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, our adjusted EBITDA is below PFGC’s definition and consensus because we do not add back stock compensation expense. However, the table below does show our estimates using the company’s definition (e.g., “Company-Defined EBITDA”). We are relatively in-line with consensus in FY17 (using the company’s definition), but we are below consensus in FY18 and FY19 due to our lower revenue estimates.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, ConsensusMetrix |

The following figures show our price target valuation and PFGC’s current valuation using our definition of EBITDA

|  |  |  |
| --- | --- | --- |
| Figure  PFGC Price Target Valuation |  | Figure  PFGC Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY17-FY19. Note that we assume capex (before acquisitions) is 0.9% of sales in FY17 (in-line with Guidance) and 0.7% of sales in FY18-FY19, which is consistent with FY16. Note that FY17 capex is higher than FY16 because of the timing of certain projects (e.g., automated pick and pack facility).

|  |  |
| --- | --- |
|  | Figure  PFGC Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) Fundamentals have strong momentum.

PFGC has a long-track record of gaining share in a mature industry. As a result, we believe the company is well positioned to deliver on its long-term sales and EBITDA growth goals of +5-7% and +7-10%, respectively.

As the following figure shows, PFGC has consistently increased sales in the MSD range over the last six years (FY16 was on the lighter side of MSD due to deflation and planned exits at PFG Customized).

|  |  |
| --- | --- |
|  | Figure  PFGC’s Revenue Growth Rates Reflect Share Gains in Mature Industry |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows sales mix by segment. PFS is the largest segment (60% of sales) followed by Customized (23%) and then Vistar (17%).

|  |  |
| --- | --- |
|  | Figure  Sales Mix by Segment |
|  |  |
| Source: Company Reports |

Next, we examine sales trends by segment. Starting with PFGC’s largest segment, Performance Foodservice, sales grew at a robust 12.1% pace in FY15 and increased +3.8% in FY16 (adjusted for the extra week). Sales slowed in FY16 primarily due to deflation. In general, sales growth in this segment is driven by sales to independent customers. PFGC has grown independent cases by 6-10% for 28 consecutive quarters (and +9% last quarter), which is truly best-in-class. PFGC’s success with independent customers can partially be explained by a very productive sales force. We estimate the revenues/sales person is $7.9M at PFGC vs. $6.8M and $5.7M at Sysco and US Foods, respectively. The business mix skews some of these numbers, but we believe PFGC has a motivated sales force that helps drive industry-best top line growth.

|  |  |
| --- | --- |
|  | Figure  Performance Foodservice Sales Growth |
|  |  |
| Source: Company Reports, Barclays Research |

The following chart shows the percentage of sales that independent (street) customers have represented at PFGC over the last six years. Note that the percentage of sales that independent customers represent has steadily increased over time, but we believe it is still about ~600 bps below Sysco’s penetration. As a result, we believe PFGC has an opportunity to further increase its independent customer penetration.

|  |  |
| --- | --- |
|  | Figure  Independent (Street) Sales as % of Broadline Sales |
|  |  |
| Source: |

Vistar is a leading distributor of candy, snacks, beverages and other single serve impulse items. The company is the largest distributor in the confectionary industry, and the only one with national scale. Vistar recently won a new geography with an existing dollar store customer, which should help support growth in FY17. Vistar is unique to PFGC – no other public distributor participates in this channel. The business is high margin and stable, and accounted for ~25% of EBITDA in FY16. In general we view Vistar a point of differentiation vs. the other large distributors because it gives PFGC exposure to a faster growing channel.

|  |  |
| --- | --- |
|  | Figure  Vistar Sales Growth |
|  |  |
| Source: Company Reports, Barclays Research |

Sales growth has been lumpier at PFG Customized, which is PFGC’s systems business. In FY16, sales were negatively impacted by planned customer exits ahead of the Red Lobster win and lower sales to certain customers in the casual dining channel. Red Lobster, once fully onboarded, will generate $500 million of incremental revenues, net of planned customer exits to free up capacity. PFGC began supplying Red Lobster in August 2016, but will not fully onboard them until November 2016.

Separately, Ruby Tuesdays recently closed 95 stores. We believe these closures will negatively impact PFGC Customized revenues by ~$100M – so while Red Lobster will result in net incremental revenues of $500 million, Ruby Tuesday’s closures will negatively impact PFG Customized by $100 million. In a perfect world, PFG Customized would have preferred to offset Red Lobster incremental footprint and capacity requirements with Ruby Tuesday’s closed footprint in order to optimize the network. However the nuances of serving both banners from a capacity and route density perspective did not make this possible. As a result, PFGC’s Customized revenues will increase $400 million when factoring in both the Red Lobster gain and Ruby Tuesday loss.

In FY17, we expect sales growth to accelerate due to the Red Lobster win. PFGC will not cycle the new business until 2Q18. Red Lobster will be accretive to both EBITDA and EPS in FY17. Sales growth should be modest excluding new customer wins given the challenging environment in the casual dining channel and the Ruby Tuesday closures. However, it is clear that PFG Customized is gaining share in this segment as the segment’s growth rates are above Sysco’s SYGMA unit (Sysco’s SYGMA sales have declined -0.5% and -1.6% for the last two fiscal years, on a 52wk-to-52wk basis).

|  |  |
| --- | --- |
|  | Figure  PFG Customized Sales Growth |
|  |  |
| Source: Company Reports, Barclays Research |

PFGC has also consistently increased EBITDA each year by at least a MSD percentage.

|  |  |
| --- | --- |
|  | Figure  PFGC EBITDA Growth Rates (Adjusted for Extra Week in 2016) |
|  |  |
| Source: Company Reports, Barclays Research |

The next figure shows the percentage of EBITDA that each segment represents.

|  |  |
| --- | --- |
|  | Figure  EBITDA Mix by Segment |
|  |  |
| Source: Company Reports |

The following chart shows reported (not-adjusted) EBITDA growth by segment. The Performance Foodservice and Vistar divisions are driving EBITDA growth, while PFG Customized EBITDA is a slight drag – reflecting a challenging casual dining environment – but also recent customer exits ahead of the Red Lobster onboarding.

|  |  |
| --- | --- |
|  | Figure  Reported EBITDA Growth by Segment |
|  |  |
| Source: Company Reports, Barclays Research |

PFGC has also consistently increased EBITDA margins since 2010. EBITDA margins are up ~30 bps between FY10 and FY16.

|  |  |
| --- | --- |
|  | Figure  PFGC EBITDA Margins |
|  |  |
| Source: Company Reports, Barclays Research |

The following chart shows reported EBITDA margins by segment. Margins increased at both Performance Foodservice and Vistar last year, largely a function of each segments’ increase in top line. Separately, in addition to being the fastest growing segment, Vistar also has the highest margins, which should support margin expansion going forward as the segment occupies a greater share of the mix.

|  |  |
| --- | --- |
|  | Figure  EBITDA Margins by Segment |
|  |  |
| Source: Company Reports, Barclays Research |

Opportunities to Expand Margin

1. Growing private label sales should also help margins. PFGC has grown private label sales 100-400 bps faster than independent sales for the last 28 quarters, which has helped increase its private label penetration from 37.2% in FY10 to 42.6% in FY16. Note that we believe Sysco’s private label penetration is still ~200 bps higher than PFGC’s. As a result, we believe PFGC still has an opportunity to increase its private label penetration.
2. The Winning Together program represents another margin opportunity. The program spans all of PFGC, but is predominantly focused in Performance Foodservice. The program’s goal is to find cost savings and productivity improvements in order to offset inflation in wages and benefits. The program focuses on procurement opportunities (e.g., structured supplier negotiations, lower cost of in-bound logistics, e-sourcing, enhanced marketing) and operations opportunities (e.g., leveraging best practices, technology, indirect costs).
3. Acquisitions are an underappreciated opportunity. Our estimates do not reflect a top-line benefit from any meaningful acquisitions. However, PFGC has a very strong track record with acquisitions and realizing synergies. We believe only one out of the last 15 acquisitions have not met PFGC’s internal goals. PFGC’s acquisition priorities are focused on standalone broadline operating companies, fold-ins, and specialty companies (i.e., for Vistar).

Improving sales and EBITDA margins has led to higher lease-adjusted ROIC, and we believe ROIC will continue to improve given the significant opportunities detailed above. The following figure shows ROIC trends at PFGC for the last several quarters.

|  |  |
| --- | --- |
|  | Figure  Steadily Improving Lease-Adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Research |

Risk to P&L: fuel prices are set to increase in 2017

After two years of declines, gasoline and diesel prices are both set to increase going forward according to the U.S. Energy Information Administration (EIA). The EIA predicts that gasoline prices will be up y/y beginning in January 2017 and that diesel prices will be up y/y starting in December 2016. If this plays out, gasoline would be a headwind to consumer spending and diesel would be a headwind to operating costs. PFGC is somewhat mitigated by rising fuel costs through its use of costless collars. PFGC uses costless collars to hedge ~1/3 of their fuel usage in Performance Foodservice and Vistar (customers in the PFG Customized segment take on the fuel price risk). In addition, the company uses fuel surcharges with contract customers that would also help mitigate the increase of fuel costs.

|  |  |  |
| --- | --- | --- |
| Figure  US Gasoline Prices (All Grades Retail Price Including Taxes) |  | Figure  US Diesel Prices (Including Taxes) |
|  |  |  |
| Source: EIA Short-Term Energy Outlook |  | Source: EIA Short-Term Energy Outlook |

2) Magnitude of valuation discount vs. other staples is unwarranted.

Relative to Sysco and other consumer staples peers, we expect PFGC to grow sales and EPS faster over the next three years. In addition, PFGC has a similar free cash flow yield. Despite these superior or in-line metrics, PFGC’s CY17 EV/EBITDA multiple is ~2x lower than Sysco and ~4.5x lower than the consumer staples peer group’s average. While PFGC deserves to trade at some discount to these companies given the lower ROIC, lack of a dividend, and shorter operating history as a public company, we believe the magnitude of the discount is unwarranted – especially given the opportunities to increase cash flow, de-lever the balance sheet and grow ROIC. The following figure compares PFGC vs. its large foodservice distribution peers and other best-in-class consumer staples companies.

In addition, broadening the comparison to include other publicly traded food distributors on a wider range of metrics yields the same results. The company more or less has a faster top-line growth profile, but lower margins than the other large broadline distributors. PFGC has the strongest local case growth among all distributors for the last quarter reported. The company’s margins, in general, are lower than the other distributors because of its customer mix. We believe margins should continue to improve given: 1) PFGC’s long-term track record of gaining share with higher-margin independent customers; 2) PFGC’s track record of growing private label sales 100-400 bps faster than overall independent sales for each of the last 28 quarters, which should improve sales penetration, which is about ~400 bps less than Sysco; and 3) Vistar is a higher margin business that continues to be the fastest growing segment at PFGC.

|  |
| --- |
| Figure  Staples Comp Sheet |
|  |
| Source: Barclays Research, Company Reports, ConsensusMetrix |

The next figure compares PFGC’s growth algorithm vs. SYY and USFD.

|  |  |
| --- | --- |
|  | Figure  PFGC, SYY and USFD Growth Algorithms |
|  |  |
| Source: Company Reports |

The table below compares PFGC vs. other public food distributors. In general, PFGC compares favorably on the top-line and less favorably on margins. PFGC has the fastest local case growth vs. the entire group and the highest overall case growth vs. SYY and USFD. In addition, the company has lower than average margins, which is primarily driven by its business mix.

Figure   
Distributor Operating Metric Comp Table



Source: Company Reports, Barclays Research

Valuation unchanged since IPO despite shares significantly outperforming S&P 500

Since the IPO, PFGC is up +25.7% vs. the S&P 500 +11.2%. However, NTM EV/EBITDA is roughly the same now as it was when the company first went public. The next figure compares PFGC’s stock performance vs. the S&P 500 since the IPO.

|  |  |
| --- | --- |
|  | Figure  PFGC Stock Performance Since IPO |
|  |  |
| Source: Thomson Reuters |

The next figure shows PFGC’s historical NTM EV/EBITDA valuation since its IPO. Note that valuation has returned to levels seen at the time of the IPO.

|  |  |
| --- | --- |
|  | Figure  PFGC Forward NTM EV/EBITDA Valuation Since IPO |
|  |  |
| Source: Company Reports, Barclays Research |

3) Growing free cash flow increases optionality.

Similar to other Stable Staples companies, PFGC generates a healthy amount of free cash flow. By our calculation, PFGC generated $91.8 million in FY16. We estimate PFGC will generate $116.1M in FY17 (4.1% yield on our price target) and $161.5M in FY18 (5.6% yield on our price target). The following figure highlights PFGC’s free cash flow generation.

|  |  |
| --- | --- |
|  | Figure  PFGC Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

PFGC has reduced net debt to EBITDA leverage by ~0.5x since the IPO. We suggest that PFGC allocate some of its free cash flow to debt reduction. This would warrant a higher multiple. The following exhibit shows PFGC’s leverage ratio improvement since the IPO.

|  |  |
| --- | --- |
|  | Figure  PFGC Net Debt/EBITDA Improved by ~0.5x Since IPO |
|  |  |
| Source: Company Reports, Barclays Research |

In addition, we believe PFGC should consider implementing a dividend after strengthening the balance sheet. In our view, a stronger balance sheet and a respectable dividend yield (1%-2%) would solidify PFGC’s position as one of the higher growth names within the Stable Staple universe and would narrow the valuation gap vs. Sysco and other consumer staples peers. The next figure shows potential dividends and their implied yields under four different payout scenarios (20%-50%). As indicated in the exhibit, it would only take a 20% payout ratio in order to pay a dividend with a ~1% yield at current prices.

Figure   
Potential Dividend Yields



Source: Company Reports, Barclays Research

Valuation and Conclusion

We are initiating with an Overweight rating based on upside/downside scenario analysis. Our upside scenario values PFGC at $31 (+28% upside), which we believe materializes if PFGC maintains strong momentum with independent customers, continues to deliver on its EBITDA growth goals, continues to improve ROIC and de-levers the balance sheet. In addition, with growing free cash flow, the company will have increasing balance sheet optionality. Our upside valuation reflects a CY17 EV/EBITDA of 10.5x – on our EBITDA of $391 million – still a slight discount vs. Sysco and other consumer staples peers, which we believe is appropriate given PFGC’s lower ROIC, lack of a dividend and shorter operating history as a public company. We assign a 70% probability to our upside scenario. We see downside to $23 (-5% downside) if independent case growth and EBITDA slow meaningfully. Our downside scenario reflects a CY17 EV/EBITDA of 8.4x, which is more or less in-line with Sysco’s valuation before Fall 2013 – prior to announcing the US Foods deal. The weighted average of these scenarios gets us to our $28 price target and Overweight rating.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [SYSCO Corp. (SYY)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=SYY) | | | | | | | Stock Rating: UNDERWEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2016A | 2017E | 2018E | 2019E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 49.25 | | Price Target | USD 48.00 | | **Why Underweight?** Our Price Target reflects: 1) there are few catalysts to re-rate the stock higher going fwd; 2) several tailwinds that have complemented execution could abate or reverse going forward; 3) a discount vs. other staple peers given the near-term risk associated with abating/reversing tailwinds. | | |  | | | Upside case | USD 56.00 | | Reflects: 1) SYY is able to maintain its EBIT growth, potentially despite abating/reversing trends; so 2) the sustainability of sales, EBITDA and EPS growth is confirmed; and 3) valuation approaches other best-in-class staples based on a comparison of ROIC, dividend yield, and FCF. | | |  | | | Downside case | USD 45.00 | | Reflects: Abating or reversing of recent tailwinds such as low fuel prices, favorable CPI-PPI spread, or strong food away from home trends. In addition, UK exposure post-Brexit is a risk. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 50,367 | 54,405 | 56,102 | 58,082 | 4.9% |  |
| EBITDA (adj) | 2,598 | 3,013 | 3,195 | 3,345 | 8.8% |  |
| EBIT (adj) | 2,009 | 2,255 | 2,414 | 2,537 | 8.1% |  |
| Pre-tax income (adj) | 1,863 | 1,980 | 2,133 | 2,256 | 6.6% |  |
| Net income (adj) | 1,214 | 1,277 | 1,376 | 1,455 | 6.2% |  |
| EPS (adj) ($) | 2.10 | 2.32 | 2.59 | 2.78 | 9.8% |  |
| Diluted shares (mn) | 577.4 | 550.3 | 530.3 | 522.8 | -3.3% |  |
| DPS ($) | 1.23 | 1.27 | 1.32 | 1.37 | 3.5% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 5.2 | 5.5 | 5.7 | 5.8 | 5.5 |  |
| EBIT (adj) margin (%) | 4.0 | 4.1 | 4.3 | 4.4 | 4.2 |  |
| Pre-tax (adj) margin (%) | 3.7 | 3.6 | 3.8 | 3.9 | 3.8 |  |
| Net (adj) margin (%) | 2.4 | 2.3 | 2.5 | 2.5 | 2.4 |  |
| ROIC (%) | 15.3 | 14.7 | 14.0 | 15.0 | 14.7 |  |
| ROE (%) | 27.7 | 33.9 | 31.3 | 28.5 | 30.3 |  |
| ROA (lease adjusted) (%) | 7.7 | 8.6 | 8.8 | 8.8 | 8.5 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 3,880 | 6,767 | 6,547 | 6,320 | 17.7% |  |
| Intangible fixed assets | 2,329 | 2,329 | 2,329 | 2,329 | 0.0% |  |
| Cash and equivalents | 3,919 | 1,812 | 2,854 | 3,847 | -0.6% |  |
| Total assets | 16,722 | 17,589 | 18,449 | 19,404 | 5.1% |  |
| Short and long-term debt | 7,435 | 7,435 | 7,435 | 7,435 | 0.0% |  |
| Total liabilities | 13,167 | 13,458 | 13,642 | 13,856 | 1.7% |  |
| Net debt/(funds) | 3,516 | 7,156 | 6,723 | 6,063 | 19.9% |  |
| Shareholders' equity | 3,480 | 4,055 | 4,732 | 5,473 | 16.3% |  |
| Change in working capital | 102 | 94 | 99 | -30 | N/A |  |
| Cash flow from operations | 1,933 | 2,239 | 2,302 | 2,288 | 5.8% |  |
| Capital expenditure | -527 | -544 | -561 | -581 | N/A |  |
| Free cash flow | 1,340 | -1,438 | 1,633 | 1,624 | 6.6% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 23.4 | 21.2 | 19.0 | 17.7 | 20.3 |  |
| EV/EBITDA (adj) (x) | 12.1 | 11.2 | 10.2 | 9.4 | 10.7 |  |
| Equity FCF yield (%) | 4.7 | -5.3 | 6.3 | 6.3 | 3.0 |  |
| P/Sales (x) | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 |  |
| P/BV (x) | 8.2 | 6.7 | 5.5 | 4.7 | 6.3 |  |
| Dividend yield (%) | 2.5 | 2.6 | 2.7 | 2.8 | 2.6 |  |
| Adj debt/EBITDAR (x) | 1.5 | 2.5 | 2.2 | 1.9 | 2.0 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Inventory growth (%) | -2.0 | 0.0 | 0.9 | 1.8 | 0.2 |  |
| Capex/sales (%) | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jun | | | | | | | |

sysco

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| SYSCO Corp.(SYY): Quarterly and Annual EPS (USD)   |  | | --- | | SYY | | Stock Rating | | UNDERWEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 48.00 | | Price (19-Sep-2016) | | USD 49.25 | | Potential Upside/Downside | | -2.5% | | | | | | | | | | |
|  | 2016 | 2017 | | | 2018 | | | Change y/y | |
| FY Jun | Actual | Old | New | Cons | Old | New | Cons | 2017 | 2018 |
| Q1 | 0.52A | N/A | 0.57E | 0.59E | N/A | N/A | 0.68E | 10% | N/A |
| Q2 | 0.48A | N/A | 0.52E | 0.50E | N/A | N/A | 0.58E | 8% | N/A |
| Q3 | 0.46A | N/A | 0.51E | 0.52E | N/A | N/A | 0.63E | 11% | N/A |
| Q4 | 0.64A | N/A | 0.71E | 0.69E | N/A | N/A | 0.80E | 11% | N/A |
| Year | 2.10A | N/A | 2.32E | 2.30E | N/A | 2.59E | 2.58E | 10% | 12% |
| P/E | 23.4 |  | 21.2 |  |  | 19.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Perfect Operating Environments Don’t Last Forever

Comparisons get harder as powerful tailwinds abate or reverse – few positive catalysts remain; initiate at Underweight with a $48 price target

We are initiating coverage with an Underweight rating and $48 price target. Our price target values Sysco (SYY) on a CY17 EV/EBITDA of 10.6x, which is based on a weighted average of our downside and upside scenarios. Our downside scenario is $45, or 10.1x CY17 EV/EBITDA (~70% probability), while our upside scenario is $56, or 12.0x CY17 EV/EBITDA (~30% probability).

The last ~15 months have been eventful for Sysco: The US Foods deal was terminated, an activist investor took a 7.1% stake (later increasing it to its current 7.9%) with two board seats, a $1.5 billion accelerated share repurchase was completed, the SAP conversions were abandoned in favour of a more agile and less expensive SUS ERP rollout, and a comprehensive three-year plan to improve operating profit, working capital and ROIC (which has a 89% correlation to the stock since 1Q14) was introduced, revised upward and executed on so far.

As a result, SYY is up +36.8% since 7/1/2015 (vs. the S&P 500’s +3.0%), operating profit is up +9.6% (excluding the 53rd week), and lease-adjusted ROIC (by our measure) increased ~210 bps to 15.3%. During the same time, forward EV/EBITDA valuation has increased from ~9x to ~11.2x, while the forward P/E multiple increased from 18.2x to 20.8x. Calendar YTD, SYY is up +20.1% (vs. the S&P500’s +4.7%), and the stock is currently trading at a CY2017 EV/EBITDA 10.8x.

Given this appreciation, valuation is now starting to approach multiples for other consumer staple peers. As such, we applaud the many achievements to date on adhering to the roadmap. We also approve of Sysco’s ROIC-focused compensation plan and of the capital deployment. In summary, the 15.3% ROIC, the 2.4% dividend yield and ~6% free cash flow yield (excluding the Brakes Group acquisition) warrant a position in the “Stable Staples” group.

However, we believe there are few catalysts to re-rate the stock higher going forward. In fact, many of the tailwinds that have complemented the company’s strong execution, such as low fuel prices, an extremely favourable spread between CPI and PPI prices, and relatively strong food away from home trends are likely to abate or even reverse going forward. In addition, the gap between food retail prices (-LSD deflationary) and restaurant prices (+LSD inflationary) has materially widened over the last five quarters – and, we are concerned this gap could pressure restaurant sales going forward as consumers take notice of the price differential. Lastly, the increased exposure to the United Kingdom post-Brexit could create noise and uncertainty in the near-term.

Underweight rating based on upside/downside scenario analysis

As a result, we are initiating on SYY with an Underweight rating and a $48 price target. In contrast with the average upside of +17.9% that we look for in our Overweight ratings and the average upside of +4.9% among our Equal Weight ratings, we are looking for -2.5% downside for Sysco, and we therefore believe an Underweight rating is appropriate.

|  |  |
| --- | --- |
|  | Figure  Our Food & Staples Retailing Universe Average Upside/Downside by Rating |
|  |  |
| Source: Barclays Research |

If the tailwinds listed above reverse and growth slows, we see downside to $45 (-9% downside), or 10.1x CY2017 EV/EBITDA, and we assign a ~70% probability to this scenario. If we are wrong, and SYY is able to continue its pace of EBIT growth, we see upside to $56 (+14% upside), or 12.0x CY2017 EV/EBITDA and we place a ~30% probability on our upside scenario. The weighted average of these two outcomes gets us to our price target of $48 – 3% downside - a CY2017 EV/EBITDA multiple of 10.6x. The following figure captures our view on the upside and downside for Sysco.

|  |
| --- |
| Figure  SYY Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

We applaud Sysco’s execution and improvement in fundamentals. However, we believe high valuation combined with the potential for several powerful tailwinds to abate or reverse in the near term creates greater risk to the downside for shares. Our thesis contemplates the following:

1. Better execution and favourable environment drive valuation to high levels. Sysco’s valuation has rightfully increased along with the improvement in fundamentals (EBIT increased +9.6% excluding the extra week in FY16 and ROIC was up +210 bps to 15.3%) and shareholder-friendly capital deployment ($1.5 billion ASR was completed in FY16). As a result, SYY is up +36.8% since 7/1/2015 (vs. the S&P’s +3.0%). Given this appreciation, valuation is now approaching other consumer staple peers. Sysco’s NTM EV/EBITDA has climbed from ~9x to ~11.2x currently (in one year).
2. Few catalysts remain to re-rate the stock higher. SYY’s strong execution has been complemented by several, powerful tailwinds, including: lower fuel prices, an extremely favourable spread between CPI and PPI prices, and relatively strong food away from home trends. In addition, the gap between food retail prices (-LSD deflationary) and restaurant prices (+LSD inflationary) has materially widened over the last five quarters – and, we are concerned that this gap could pressure restaurant sales going forward as consumers take notice of the price differential.
3. Brexit could create noise and uncertainty in the near term. Following the close of the Brakes Group acquisition, Sysco now has a meaningful presence in the United Kingdom. We estimate ~2/3 of Brakes Group’s £4.4B in revenues is generated in the United Kingdom (or ~5.5% of total sales), and Barclays economists expect the British economy to be flat y/y in 2017 (estimates published on Sept. 16, 2016).

Summary of Financials & Valuation

Below we highlight our estimates vs. consensus. In general, we are relatively in-line with consensus on EPS through FY18 despite having lower sales estimates (we expect Brakes to contribute less than $5 billion in sales due to FX rates; it is unclear what the consensus assumption is for Brakes) and slightly higher margins than consensus.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, ConsensusMetrix |

The following figures show our price target valuation and SYY’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  SYY Price Target Valuation |  | Figure  SYY Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

Lastly, the next exhibit contains our free cash flow estimates for FY17-FY19. Note that we assume capex (before acquisitions) is 1.0% of sales in each period. In addition, our estimates estimate $3.1B of acquisitions in FY17 (Brakes Group), and $140M in FY18 and FY19 (the 10-year average cash spent on acquisitions). We expect working capital to continue to improve through FY18 given management’s goals to improve working capital by four days based on initiatives in accounts receivable, inventory and payables.

|  |  |
| --- | --- |
|  | Figure  SYY Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

1) Better execution and favourable environment drive valuation to high levels

Following the termination of the US Foods deal in June 2015, Sysco introduced a 3-year plan at its September 2015 Analyst Day to generate $400 million of incremental operating profit, improve working capital by four days and improve ROIC to 15%. In late February 2016, the company increased the incremental operating profit goal to $500 million (including the extra week in FY16), and in August 2016 beat its target of generating $100-$150M in year 1 by generating $217M of incremental operating profit (including the extra week). The following figure shows annual operating profit growth.

|  |  |
| --- | --- |
|  | Figure  Sysco Operating Profit Growth Accelerating after Years of Languishing |
|  |  |
| Source: Company Reports, Barclays Research |

In addition, lease-adjusted ROIC also improved in FY16: it was up ~210 bps to 15.3% in FY16 (including the extra week) vs. 13.2% in FY15. ROIC is now up 300 bps vs. its low of 12.2% in 2Q14.

|  |  |
| --- | --- |
|  | Figure  SYY LTM Lease-Adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Research |

Historically, SYY shares and lease-adjusted ROIC have not had a strong correlation. However, the correlation has improved since 1Q14, albeit with a small sample size. Correlation is +89% since 1Q14 vs. -42% prior to 1Q14.

|  |  |
| --- | --- |
|  | Figure  SYY Stock Price vs. Lease-Adjusted ROIC |
|  |  |
| Source: Company Reports, Barclays Estimates |

In conjunction with improving operating profit growth and lease-adjusted ROIC, Sysco also had an activist investor take a 7.1%-7.9% stake (with two board seats) and completed a $1.5 billion accelerated share repurchase. As a result of the improving fundamentals, activist investor stake and ASR, the stock is up +36.8% since 7/1/2015 (vs. the S&P500’s +3.0%). Calendar YTD, SYY is up +20.5% (vs. the S&P500’s +4.7%). The next exhibit shows Sysco’s stock price over the last two years with major events highlighted.

|  |
| --- |
| Figure  SYY Annotated Stock Chart |
|  |
| Source: Thomson Reuters DataStream, |

Valuation multiples increased 2-3x since the USFD deal’s termination in June 2015. As the following two charts show, SYY’s forward EV/EBITDA valuation increased from ~9x to ~11.2x and the forward P/E ratio increased from 18.2x to 21.0x.

|  |  |  |
| --- | --- | --- |
| Figure  Historical Forward EV/EBITDA Valuation |  | Figure  Historical Forward P/E Valuation |
|  |  |  |
| Source: Bloomberg |  | Source: Bloomberg |

SYY’s valuation ratios are now approaching consumer staple peers given the stock’s performance over the last 15 months. The following figure compares Sysco vs. a broad selection of consumer staples companies. Sysco compares favorably vs. the staples companies on sales, EBITDA and EPS growth rates, lease-adjusted ROIC and free cash flow yield.

|  |
| --- |
| Figure  Staples Comp Table |
|  |
| Source: Company Reports, Barclays Research, ConsensusMetrix |

The next figure compares Sysco vs. other food distributors. Sysco trades at a premium to other companies as measured by CY2017 EV/EBITDA. On operating fundamentals, SYY’s sales growth (including with independent restaurants) and EBITDA growth are slower, while its margins, ROIC and free cash flow yield are higher.

|  |
| --- |
| Figure  Distributor Operating Metric Comp Table |
|  |
| Source: Company Reports, Barclays Estimates |

2) Few catalysts remain to re-rate the stock higher

Sysco’s strong execution has been complemented by several, powerful tailwinds, including: lower fuel prices, an extremely favorable spread between CPI and PPI, and relatively strong food away from home trends. In addition, the gap between food retail prices (-LSD deflationary) and restaurant prices (+LSD inflationary) has materially widened over the last five quarters and we are concerned that this gap could pressure restaurant sales and therefore independent case growth going forward as consumers take notice of the ever widening price gap.

Fuel prices are set to increase in 2017 which could pressure the P&L.

After two years of declines, gasoline and diesel prices are both set to increase going forward according to the U.S. Energy Information Administration (EIA). The EIA predicts that gasoline prices will be up y/y beginning in January 2017 and that diesel prices will be up y/y starting in December 2016. If this plays out, gasoline would be a headwind to consumer spending and diesel would be a headwind to operating costs at Sysco. Sysco mitigates increasing diesel prices with forward buys (about 2/3 of their needs are bought ~12 months in advance) and fuel surcharges; but, the company will still be exposed to rising fuel costs. At a minimum, the $0.04-$0.05 operating cost per case tailwind that the company has benefitted recently from will abate, and could reverse.

|  |  |  |
| --- | --- | --- |
| Figure  US Gasoline Prices (All Grades Retail Price Including Taxes) |  | Figure  US Diesel Prices (Including Taxes) |
|  |  |  |
| Source: EIA Short-Term Energy Outlook |  | Source: EIA Short-Term Energy Outlook |

The spread between CPI and PPI that has benefitted gross margins is narrowing.

In FY16, Sysco’s consolidated gross margins increased 40 bps to 17.9% and US Broadline gross margins were up ~50 bps to 18.9%. As a result, gross profit growth exceeded sales growth for the first time in 5+ years. Gross margins also benefitted from category management, a mix shift towards higher margin independent customers, higher private label penetration and deflation.

|  |  |
| --- | --- |
|  | Figure  Gross Profit Growth Exceeded Sales Growth for First Time in 5+ Years |
|  |  |
| Source: Company Reports |

Regarding deflation, the CPI-PPI spread (the spread between Sysco’s sales prices and input costs) has significantly helped gross margins. As the following two charts illustrate, while the CPI-PPI spread does not entirely explain the direction of Sysco’s gross margins, it clearly has a significant influence as the two variables have a +0.50 correlation, R^2 of 0.25 and a P value of 0.01. Basically, 25% of the variation in y/y gross margin change is explained by the CPI-PPI spread, and there is a 99% probability (P value of 1%) that the CPI-PPI spread is having some effect. In addition, the relationship is stronger if we lag gross margin by three quarters (i.e., the spread today explains gross margins three quarters from now). The correlation increases to +0.72, R^2 is 0.52 and the P value declines to 0.0002. So, 52% of the variation in y/y gross margin change is explained by the CPI-PPI spread, and there is a 99.98% probability that the CPI-PPI spread is having some influence.

The first of the two next charts compares SYY’s y/y consolidated gross margin change vs. the CPI-PPI spread (defined as the difference between CPI Food-at-Home prices and a weighted average of Farm Products and Processed Foods PPI prices).

|  |  |
| --- | --- |
|  | Figure  Sysco’s Y/Y Gross Margin Change vs. CPI-PPI Spread |
|  |  |
| Source: Company Reports, BLS |

The second chart compares the same variables but lags gross margin by three quarters. The relationship between the two variables is stronger with the lag as correlation and R^2 increase and the P value declines.

|  |  |
| --- | --- |
|  | Figure  Sysco’s Y/Y Gross Margin Change vs. CPI-PPI Spread (GPM Lagged 3 Quarters) |
|  |  |
| Source: Company Reports, BLS |

Going forward, the spread is set to narrow. The average spread was 650 bps during SYY’s FY16, but it has declined to 470 bps over the last three months. Sysco clearly deserves credit for expanding its gross margins through category management, growing private label penetration and increasing sales to independent customers. Going forward, revenue management (fully deployed in 4Q16) should also help gross margins. But, gross margins have also benefitted from the spread between CPI-PPI. As such, if the spread continues to narrow, this significant tailwind is likely to abate or even reverse.

Food away from home trends could be slowing.

On SYY’s 4Q15 earnings call, management indicated that restaurant trends are uneven and that the environment is softening. SYY mentioned that their growth trajectory has slowed relative to recent quarters. Going forward, we believe the environment could soften for two reasons: 1) food at home spend taking back some share from food away from home as the gap in prices between the two has materially widened; and 2) in the near-term, restaurant sales could temporarily slow in October due to the “CNN effect” (uncertainty) of the elections and consumers staying home to watch debates.

Historically, food away from home has consistently gained share from food at home. Sysco, and other foodservice distributors, have benefitted from this long-term trend as it has supported restaurant sales. The next chart below shows the percentage of sales that food away from home and food at home represent as a total of food sales – consumers have consistently dined out more every year.

|  |  |
| --- | --- |
|  | Figure  % of Food Sales: Away from Home Gaining from At Home |
|  |  |
| Source: USDA Economic Research Service |

However, we believe this trend could pause in the near-term as food at home prices become more attractive vs. food away from home. Over the last five quarters, the gap between food retail prices and restaurant prices has materially widened as restaurants are forced to take price to cover cost increases (e.g., labor) irrespective of declining commodity prices. The chart below shows the y/y change in food retail prices (food at home) and restaurant prices (food away from home). Food away from home prices have consistently stayed in the +~2.5% range while food at home prices turned deflationary.

|  |  |
| --- | --- |
|  | Figure  However, Food At Home Prices Becoming More Attractive |
|  |  |
| Source: USDA Economic Research Service |

Aside from these broader headwinds – we do believe the election will create transient headwinds. Specifically, we took a look at the last election cycle and found several instances of restaurants calling out the election as a reason for sales slowing in October. In addition, several companies indicated this summer that they will pull back on media spend this Fall to avoid competing with the campaigns for media space.

* Cheesecake Factory called out 15-20 bps impact on comps in their 4Q12 comp because of poor traffic on debate days (“big down days for most people in the restaurant business”) (Feb 2013).
* Kona Grill said “sales trends in October and early November were choppy as political debates and the Presidential Election kept guests at home” (Feb 2013).
* Kona also said that debate and convention days were “double digit negatives” (Nov 2013).
* BJ’s restaurants said “Much like the political conventions, we continue to see negative or softer comparable restaurant sales on the nights at the presidential and vice presidential debate and I would expect that we will see negative comparable restaurant sales on the upcoming election night.” (Oct 2012).
* BJ’s also said that the Vice President and Presidential debate were “negative days” except for one night that coincided with Monday Night Football (Oct 2012).

3) Brexit could create noise and uncertainty in the near-term.

Following the close of the Brakes acquisition in July, Sysco now has a major presence in the United Kingdom. We estimate ~2/3 of Brakes Group’s £4.4B in revenues are generated in the United Kingdom, or ~5.5% of sales. Going forward, the Brakes business could be pressured if the UK economy falls into a recession. Currently, Barclays economists forecast the UK economy to be flat y/y in 2017, which could pressure the P&L (estimates published on 9/16/2016 in “[‘Slow fuse’ recession](https://live.barcap.com/go/publications/content?contentPubID=FC2260552)” report). The following figure shows real GDP changes in the UK and Euro area.

|  |  |
| --- | --- |
|  | Figure  Y/Y Real GDP Change – Brakes Group Exposed to Slowing Economies |
|  |  |
| Source: Barclays Research |

In addition, we note the following comments made by management companies with exposure to the UK economy recently:

* “And in UK, they are seeing declining retail spend…due to the slowing economy, etc., and the impact of Brexit” – Truworths International (8/19/2016).
* “The impact of the vote [Brexit] is expected to weigh on the UK economy in the near-term” – William Hill plc (8/5/2016).
* “A slow growth European economy, Brexit, a weakened British pound, and ongoing security concerns throughout the region have contributed to consumer uncertainty throughout Europe” – Starbucks (7/21/2016).

Valuation and Conclusion

Based on the above, we are initiating with an Underweight rating and a $48 price target. Our price target factors in our upside/downside scenario analysis. In contrast with the average upside of +17.9% that we look for in our Overweight ratings and the average upside of +4.9% among our Equal Weight ratings, we are looking for -2.5% downside for Sysco, and we therefore believe an Underweight rating is appropriate. If the tailwinds listed above reverse and growth slows, we see downside to $45 (-9% downside), or 10.1x CY2017 EV/EBITDA of $3.1 billion, and we assign a ~70% probability to this scenario. If we are wrong, and SYY is able to continue its pace of EBIT growth, we see upside to $56 (+14% upside), or 12.0x CY2017 EV/EBITDA and we place a ~30% probability on our upside scenario. The weighted average of these two outcomes gets us to our price target of $48 – 3% downside – a CY2017 EV/EBITDA multiple of 10.6x.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [United Natural Foods Inc (UNFI)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=UNFI) | | | | | | | Stock Rating: UNDERWEIGHT |
|  | | | | | | | |
| Income statement ($k) | 2016A | 2017E | 2018E | 2019E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 39.31 | | Price Target | USD 40.00 | | **Why Underweight?** Our Price Target reflects some ongoing challenges on the top line, deteriorating ROIC, weaker than industry trends in Independents and ongoing challenges at WFM. | | |  | | | Upside case | USD 60.00 | | Reflects: 1) The competitive landscape normalizes, 2) A resurgence of dominance with the true Independent natural/organic retailers; 3) share gains by UNFI; 4) accretive acquisitions. | | |  | | | Downside case | USD 35.00 | | Reflects: 1) Conventional distributors take share in natural and organic distribution, 2) WFM's growth rate remains anemic, 3) Independents continue to struggle, 4) UNFI continues to make dilutive acquisitions; 5) ROIC remains pressured. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 8,470,286 | 9,479,615 | 9,947,358 | 10,442,171 | 7.2% |  |
| EBITDA (adj) | 302,881 | 327,804 | 344,062 | 357,586 | 5.7% |  |
| EBIT (adj) | 231,875 | 235,804 | 247,523 | 256,244 | 3.4% |  |
| Pre-tax income (adj) | 215,988 | 217,910 | 229,628 | 238,350 | 3.3% |  |
| Net income (adj) | 130,724 | 130,964 | 137,777 | 143,010 | 3.0% |  |
| EPS (adj) ($) | 2.59 | 2.58 | 2.71 | 2.80 | 2.5% |  |
| Diluted shares (k) | 50,399.0 | 50,718.1 | 50,920.9 | 51,124.6 | 0.5% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 3.6 | 3.5 | 3.5 | 3.4 | 3.5 |  |
| EBIT (adj) margin (%) | 2.7 | 2.5 | 2.5 | 2.5 | 2.5 |  |
| Pre-tax (adj) margin (%) | 2.5 | 2.3 | 2.3 | 2.3 | 2.4 |  |
| Net (adj) margin (%) | 1.5 | 1.4 | 1.4 | 1.4 | 1.4 |  |
| ROIC (%) | 7.5 | 7.0 | 7.1 | 7.2 | 7.2 |  |
| ROE (%) | 9.0 | 8.3 | 8.0 | 7.7 | 8.2 |  |
| ROA (lease adjusted) (%) | 4.5 | 4.2 | 4.2 | 4.1 | 4.3 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($k) | | | | | CAGR |  |
| Tangible fixed assets | 616,605 | 592,105 | 565,197 | 536,951 | -4.5% |  |
| Intangible fixed assets | 588,482 | 588,482 | 588,482 | 588,482 | 0.0% |  |
| Cash and equivalents | 18,593 | -18,845 | 87,227 | 196,458 | 119.4% |  |
| Total assets | 2,852,155 | 3,030,691 | 3,201,085 | 3,378,611 | 5.8% |  |
| Short and long-term debt | 600,112 | 600,112 | 600,112 | 600,112 | 0.0% |  |
| Total liabilities | 1,332,651 | 1,380,223 | 1,412,840 | 1,447,357 | 2.8% |  |
| Net debt/(funds) | 582 | 445 | 273 | 94 | -45.4% |  |
| Shareholders' equity | 1,519,504 | 1,650,468 | 1,788,245 | 1,931,255 | 8.3% |  |
| Change in working capital | 64,430 | -192,902 | -58,612 | -62,025 | N/A |  |
| Cash flow from operations | 296,609 | 30,062 | 175,704 | 182,326 | -15.0% |  |
| Capital expenditure | -41,375 | -67,500 | -69,632 | -73,095 | N/A |  |
| Free cash flow ($mn) | -49 | 137 | 172 | 179 | N/A |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 15.2 | 15.2 | 14.5 | 14.1 | 14.8 |  |
| EV/EBITDA (adj) (x) | 8.5 | 7.9 | 7.3 | 6.7 | 7.6 |  |
| Equity FCF yield (%) | -2.5 | 6.8 | 8.6 | 8.9 | 5.5 |  |
| P/Sales (x) | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |  |
| P/BV (x) | 1.3 | 1.2 | 1.1 | 1.0 | 1.2 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 2.6 | 2.1 | 1.6 | 1.2 | 1.9 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Square footage growth (%) | N/A | N/A | N/A | N/A | N/A |  |
| Inventory growth (%) | 4.0 | 10.2 | 5.0 | 5.0 | 6.0 |  |
| Capex/sales (%) | 0.5 | 0.7 | 0.7 | 0.7 | 0.7 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jul | | | | | | | |

united natural foods

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| United Natural Foods, Inc.(UNFI): Quarterly and Annual EPS (USD)   |  | | --- | | UNFI | | Stock Rating | | UNDERWEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 40.00 | | Price (19-Sep-2016) | | USD 39.31 | | Potential Upside/Downside | | +1.8% | | | | | | | | | | |
|  | 2016 | 2017 | | | 2018 | | | Change y/y | |
| FY Jul | Actual | Old | New | Cons | Old | New | Cons | 2017 | 2018 |
| Q1 | 0.63A | N/A | 0.62E | 0.66E | N/A | N/A | 0.67E | -2% | N/A |
| Q2 | 0.49A | N/A | 0.50E | 0.56E | N/A | N/A | 0.50E | 2% | N/A |
| Q3 | 0.77A | N/A | 0.78E | 0.79E | N/A | N/A | 0.83E | 1% | N/A |
| Q4 | 0.70A | N/A | 0.67E | 0.66E | N/A | N/A | 0.70E | -4% | N/A |
| Year | 2.59A | N/A | 2.58E | 2.69E | N/A | 2.71E | 2.89E | -0.39% | 5% |
| P/E | 15.2 |  | 15.2 |  |  | 14.5 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Transitions Take Time and Usually Involve Risk

Competitive and secular headwinds likely to persist – diversifying takes time and comes with earnings risk; initiate at Underweight

UNFI was once a Growth Star, but more recently, ~67% of sales have become increasingly ubiquitous and commoditized, which has contributed to slowing sales growth. As a result, UNFI is rapidly trying to diversify its revenue stream and customer base to the faster growing fresh, ethnic and gourmet categories in order to once again reclaim its status as a Growth Star.

As we see it, UNFI has two choices:

1. **Stay the course in an effort to reclaim Growth Star status**: Since we believe the competitive landscape for distributing UNFI’s core natural and organic grocery SKUs only continues to deteriorate, the pivot to fresh/ethnic/gourmet is likely essential for longer-term survival even if it increases risk for shareholders in the near- and intermediate-term.
2. **Stop making acquisitions and become a cash generator – or a Stable Staple**.

Neither solution is ideal. In our view, making acquisitions is necessary for longer term survival but will likely not help UNFI reclaim Growth Star status. In the meantime – these acquisitions are pressuring ROIC and free cash flow generation. Alternatively, becoming a compelling free cash flow story for now is short-sighted and likely only weakens longer-term strategic positioning.

Underweight rating based on upside/downside scenario analysis

As a result, we are initiating on UNFI with an Underweight rating and $40 price target. Our rating is based on the following: 1) We are looking for just +1.8% upside on UNFI compared with an average upside of +17.9% for our Overweight ratings and +4.9% for our Equal Weight ratings, and we do not anticipate a positive catalyst for a valuation re-rating, 2) we believe competitive and secular headwinds will persist, and 3) we believe acquisition multiples will remain high and accretion on future transactions will remain elusive.

|  |  |
| --- | --- |
|  | Figure  Our Food & Staples Retailing Universe Average Upside/Downside by Rating |
|  |  |
| Source: Barclays Research |

If our thesis plays out, we see downside to $35 (-11% downside), or 6.4x CY2017 EV/EBITDA, and we assign an 80% probability to this scenario. If we are wrong, and UNFI’s organic top-line re-accelerates, we see upside to $60 (+51% upside), or 10.1x CY2017 EV/EBITDA and we place an 20% probability on our downside scenario.

The weighted average of these two outcomes gets us to our price target of $40 – +2% upside – a CY2017 EV/EBITDA multiple of 7.1x.

In addition, UNFI’s -0.1% YTD performance (vs. the S&P500’s +4.7%) when many of our companies have significantly underperformed YTD (SFM -22.9%, SFS -30.9%, WFM -14.7%, KR -26.4%) despite the many headwinds facing the Food and Staples Retailing universe further supports our rating. The following figure captures our view on the upside and downside for UNFI.

|  |
| --- |
| Figure  UNFI Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Our view in greater detail

In the intermediate term, while we believe UNFI has no choice but to diversify its revenue stream, our concerns with UNFI are six-fold:

1. Acquisition multiples are greater than UNFI’s valuation. Specialty and ethnic distributors are high growth businesses, and, as a result, they command higher acquisition multiples. UNFI’s multiple has recovered recently, but we believe the multiples UNFI is paying for its recent acquisitions are greater than UNFI’s current valuation – so, it is unclear if these acquisitions will be accretive.
2. Velocity in center store categories will continue to increase as SKUs become more commoditized. As a result, competition with conventional distributors or retailers using alternate supply sources will only continue to intensify.
3. Independent customers will remain challenged. The natural and organic landscape remains intensely competitive, and while independents (~30% of sales) have historically risen to the challenge, history is not always relevant – and, we are not convinced they will persevere this time around. They will not be able to compete on price vs. larger retailers on the commoditized/ubiquitous grocery categories, and we believe merchandising and knowledge at more conventional players is improving – narrowing the gap further with true independents.
4. Factoring in acquisitions in “capex”, UNFI continues to generate very little free cash flow. As discussed later in this section, free cash flow generation is very respectable if we exclude acquisitions – so if acquisition activity declined – this could potentially warrant a higher multiple in the short term – but we do not see this as a sustainable solution for the longer term success of UNFI’s business model.
5. Lease-Adjusted ROIC will likely remain pressured. Lease-adjusted ROIC has decreased from 10.1% in FY07 to 7.5% in FY16 – a ~260 bps deterioration. So far, acquisitions have not proven to be positive catalysts for ROIC, so it seems likely that UNFI’s recent acquisitions could weigh on ROIC going forward, which could in turn weigh on the stock since UNFI’s lease-adjusted ROIC and stock have a +66% correlation. Executive compensation contemplates ROIC targets (8.7%-9.1% in FY15), but they were below FY14’s actual ROIC of 9.4% by UNFI’s calculation. We would prefer to see more aggressive ROIC targets, with a greater weight on ROIC within the compensation matrix.
6. UNFI compares unfavorably to its publicly-traded, pure-play food distribution peers. Relative to SYY, USFD, PFGC, and CHEF, UNFI has compares unfavourably on case growth, margins, and EBITDA growth.

Summary of Financials & Valuation

Below we highlight our estimates vs. Consensus. In general, we are below Consensus because we believe organic growth rates will remain subdued and margins will be pressured throughout FY2017.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Research, ConsensusMetrix |

The following figures show our price target valuation and UNFI’s current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  UNFI Price Target Valuation |  | Figure  UNFI Current Valuation |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

The next exhibit contains our free cash flow estimates for FY17-FY19. Note that our estimates assume only ~$30M of acquisitions in FY17 and no acquisitions in FY18-FY19. As evidenced below – in the absence of meaningful acquisition expenditures within capex, UNFI generates a very respectable free cash flow. We assume a limited working capital drain on cash flow, which is a significant improvement vs. trends prior to FY16, but a deterioration vs. FY16’s $64M source of cash flow. Significant acquisitions and or deterioration in working capital management would lower our FCF estimates.

|  |
| --- |
| Figure  UNFI Free Cash Flow |
|  |
| Source: Company Reports, Barclays Research |

I. Stay the course in an effort to reclaim Growth Star status

1) UNFI’s acquisition multiples are greater than its own valuation

Valuation is lower vs. historical average, but has improved throughout CY2016 despite worsening competitive environment.

UNFI’s slowing organic growth and declining ROIC have resulted in significant multiple contraction. UNFI’s forward NTM EV/EBITDA multiple of 7.5x is ~3.5x below its 10-year average multiple of 10.8x and almost ~7x below its 14.6x 2Q15 peak. The following figure illustrates UNFI’s NTM forward EV/EBITDA multiples for the last 10 years.

|  |  |
| --- | --- |
|  | Figure  UNFI Historical EV/EBITDA Valuation |
|  |  |
| Source: Company Reports, Barclays Research |

Although UNFI’s current valuation is significantly less than its 10-year average and recent peak, it has actually recovered meaningfully since it pre-announced 2Q16 results and significantly lowered FY16 EPS guidance by ~16% at the mid-point on 2/29/2016. On the day of the pre-announcement, the stock declined -21.4%, and at the time was trading at an EV/EBITDA of ~7x. The stock has since recovered – flat vs. the day before the pre-announcement (vs. +9.8% for the S&P500) and UNFI is now trading at an EV/EBITDA of ~7.5x. The following figure shows UNFI’s YTD stock performance and its performance since the 2Q16 pre-announcement and 3Q16 earnings. Surprisingly, the stock has held in despite worsening fundamentals, which suggests to us that valuation has not priced in the significant amount of earnings risk created by UNFI’s transition.

|  |  |
| --- | --- |
|  | Figure  UNFI Stock Performance |
|  |  |
| Source: Thomson Reuters |

Recent acquisitions may not be accretive given the prices paid.

Since the start of CY2016, UNFI has made the following acquisitions in an effort to diversify into fresh/ethnic/gourmet:

1. Global Organic/Specialty Source: a specialty perishable distributor in Florida for $20.6M (closed 3Q16).
2. Nor-Cal Produce: conventional/organic produce distributor in Northern California for $68.6M (closed 3Q16).
3. Haddon House: specialty ethnic/gourmet distributor that supplies the Eastern half of the US for $217.5M (closed 4Q16).
4. Gourmet Guru: a gourmet distributor in the Northeast for an unknown price (closed 1Q17).

Of the acquisitions, UNFI disclosed **both** the purchase prices **and** revenues for Nor-Cal Produce and Haddon House. Therefore, we are able to estimate EV/sales multiples of 0.4x-0.5x for both deals. UNFI is currently trading at an EV/sales of ~0.3x. Conceptually, it makes sense that these acquisitions would be priced above where UNFI is trading given that they are faster growth businesses. In addition, it is unlikely that target valuations will decline going forward given conventional distributors’ increasing interest in the category (discussed in more detail in the next section). We believe C&S Wholesale (the #1 grocery wholesaler in the US) is looking to expand further into natural/organic. As a result, it will be difficult for these and future deals to be accretive without significant synergies given the difference in multiples (and we note that synergies could be harder to obtain because they are not fold-in acquisitions).

Our analysis could be wrong if the acquired companies’ operating margin structures are significantly higher than UNFI’s. However, we do not believe this is the case. The following two figures compare UNFI’s EV/sales multiple to its recent acquisitions and list the EV/sales multiples for all deals where UNFI has disclosed the data.

|  |  |  |
| --- | --- | --- |
| Figure  UNFI EV/Sales Multiple vs. 2016 Acquisitions |  | Figure  UNFI Historical Acquisition Multiples |
|  |  |  |
| Source: Company Reports, Barclays Research |  | Source: Company Reports, Barclays Research |

2) Velocity in center store categories will continue to increase as SKUs become more commoditized.

As the following figure illustrates, a significant percentage of UNFI’s sales are in the commoditized grocery/general merchandise and frozen foods categories. These categories are commoditized because UNFI is no longer the scale distributor of these products given their increasing velocity. These products now turn fast enough that they have attracted the interest of conventional distributors (e.g., C&S Wholesale) and retailers that self-distribute – and these alternate supply sources can often distribute at a lower cost to the customer than UNFI. In general, UNFI’s competitive advantage is negatively correlated with how fast a SKU turns.

Note – on a recent conference call, management indicated “fresh” now accounts for 15% of sales but it is unclear how “fresh” is defined. “Fresh” would most likely be allocated to “produce/perishables” – at 20% of sales, but until we gain a greater understanding of how this category is growing, it is impossible to know if UNFI is making any progress at diversifying away from the more commoditized, center store categories. Absent more concrete data, we assume the percentage of sales that these commoditized categories represent has probably decreased following the recent acquisitions, but these categories most likely still represent a large majority of sales.

|  |
| --- |
| Figure  Product Categories – The Commoditized Grocery & Frozen Categories Represent 2/3 of Business |
|  |
| Source: Company Reports |

Competitive environment to get worse before it gets better

Looking ahead, as long as natural/organic grocery and frozen SKUs continue to generate growth in a low-growth environment, the competitive environment will only continue to intensify. As an example, we believe C&S Wholesale is pursuing natural/organic more aggressively because it sees it as a faster growth and higher margin opportunity, and because its customers are looking to expand into these SKUs more. In addition, conventional distributors will also begin to compete with UNFI on acquisitions, which could further drive up multiples.

Below, we provide select comments from UNFI management and from other companies that highlight the competitiveness of the industry.

UNFI comments that highlight competitiveness of industry

* “When you look year over year, the thing that pops first is the competitive pricing pressure. That's something that while the competitive dynamics may change a little bit, I think that pressure is probably still going to be a force as we move forward.” (CFO 6/14/16)
* “If you think about our segments in the supermarket channel, that's probably where the competitiveness is the most intense and some of the traditional conventional distributors there, obviously they see this space as an attractive space, the natural-organic space. And they're picking up SKUs to try to better service that business” (CFO 6/14/2016)
* “As a result, the competitive nature of our industry at retail, wholesale, and supply is evolving, and at UNFI we continue to build upon our new distribution opportunities outside of our core natural channel.” (CEO 2/29/16)
* “It's the competitive pressure at retail which are driving down comps. So when your existing customer base across our entire natural channel, if they are getting competitive pressure from other retailers, their comps are compressed. Those comp compressions translate directly to us and so I would say that is driver number one. Number two is suppliers, and this is a gross generalization, but suppliers generally promote where they are getting the growth. And so when you take the growth out of the channel you see a significant reduction in the amount of promotional activity. Promotional activity is a significant source of margin from UNFI, so if the suppliers divert the promotional activity to other channels, we're going to feel the pain.” (CEO 2/29/16)

HAIN comments highlight fast growth at customers not supplied by UNFI

In addition, Hain Celestial (HAIN) has indicated recently on conference calls and at investor presentations that Costco, Trader Joe’s and Sprouts have been large drivers of their growth – all of whom are not supplied by UNFI. In our view – the highest growth retailers in general (with the exception of Whole Foods) are not supplied by UNFI.

3) UNFI’s independent customers will remain challenged.

UNFI’s independent customers are challenged by the same competitive dynamics described above: natural/organic SKUs are mainstream enough now that independent natural/organic stores (along with a few larger natural/organic retailers) are no longer the primary destination for these SKUs. Independent natural/organic retailers are facing an existential threat from the increasing participation in natural/organic by large retailers with greater scale (e.g., Costco, Kroger) because they cannot compete on price. Independent retailers will need to reinvent themselves in order to survive by adding less commoditized SKUs (e.g., fresh/ethnic/gourmet), and while they have historically risen to the challenge, history is not always relevant – and we are not convinced they will persevere this time around. As a result, independent customers (~30% of sales at UNFI) could be a drag on UNFI’s top-line for years to come. The following figure illustrates how UNFI’s sales to independent customers has fallen below the industry average growth rate recently, which shows that independent customers are losing share.

|  |  |
| --- | --- |
|  | Figure  UNFI’s Independent Channel Sales Growth (Excluding Acquisitions) |
|  |  |
| Source: Company Reports, Natural Foods Merchandiser, SPINs |

4) Lease-adjusted ROIC will likely remain pressured.

Acquisitions have been depressing ROIC

Lease-adjusted ROIC at UNFI has decreased from 10.1% in 4Q07 to 7.5% in FY16, which represents a 260 bps deterioration. So far, acquisitions have not proven to be positive catalysts for ROIC as demonstrated in the following figure. As a result, it seems likely that ROIC will remain pressured going forward given the recent acquisitions at relatively high multiples, combined with the weak fundamentals in the core business.

|  |  |
| --- | --- |
|  | Figure  UNFI Lease-Adjusted ROIC Show Dampening Effect from Acquisitions in Near-Term |
|  |  |
| Source: Company Reports, Barclays Research |

Upside to shares likely limited while ROIC is pressured

UNFI’s lease-adjusted ROIC and stock have a positive correlation at +56%. So, a weaker ROIC in the near-term could limit the stock’s upside.

|  |  |
| --- | --- |
|  | Figure  UNFI Lease-Adjusted ROIC vs. Stock Price |
|  |  |
| Source: Company Reports, Barclays Research, Thomson Reuters |

Management is compensated on ROIC, but we would prefer more aggressive goals

While executive compensation does contemplate minimum ROIC, we would prefer to see more aggressive ROIC hurdles that consider ROIC expansion. UNFI’s FY15 compensation had a target ROICs of 8.7%-9.1%, but UNFI generated ROIC of 9.4% in FY14 based on their calculation (the primary difference between UNFI’s ROIC calculation and ours is that ours is lease-adjusted and theirs is not). So, management’s target ROIC metrics contemplated an ROIC deterioration. We would prefer management be compensated if ROIC expands given the positive correlation between ROIC and the stock price.

The figure below shows the metrics that the CEO, CFO (at the time) and COO were compensated on during FY15. Note during FY16, they made some changes related to payout percentages, but there was no change to the performance metrics used.

|  |  |
| --- | --- |
|  | Figure  Cash Based Incentive Compensation Performance Metrics |
|  |  |
| Source: Company Reports |

The following exhibit shows the different ROIC compensation thresholds for FY15. The FY15 ROIC targets (8.7%-9.1%) were all below FY14’s actual ROIC. FY15’s lease-adjusted ROIC ended up below the easier targets (vs. FY14).

|  |  |
| --- | --- |
|  | Figure  UNFI’s ROIC Performance Compensation Targets for FY2015 |
|  |  |
| Source: Company Reports |

5) UNFI compares unfavourably vs. other publicly-traded food distribution peers

Relative to the average, UNFI compares unfavorably on top-line growth, margins and EBITDA growth. In fact, UNFI is the only one of the group that has declining y/y EBITDA. The following figure contains our distributor comp table.

|  |
| --- |
| Figure  Distributor Comp Table |
|  |
| Source: Company Reports, Barclays Research |

II. Stop making acquisitions and become a cash generator – or a Stable Staple

UNFI continues to generate very little free cash flow when we include acquisitions in capex

Historically, UNFI has not generated much free cash flow. Between FY11 and FY16, UNFI generated negative free cash flow of -$415.1M, which was primarily driven by a working capital drag of -$537.6M and acquisitions of -$559.8M. In FY16, UNFI improved its working capital management with working capital adding $64.4M to cash flow. However, free cash flow was still negative at -$49.2M as acquisitions of $306.7M offset the lower y/y capex spend. Note we believe acquisitions should be counted against free cash flow since UNFI would otherwise have to invest in the infrastructure through capex to enter into these new product categories.

|  |  |
| --- | --- |
|  | Figure  Historical Free Cash Flow |
|  |  |
| Source: Company Reports, Barclays Research |

For illustrative purposes only, we detail a scenario where UNFI stops making acquisitions and becomes a slower growth free cash flow story. While we believe this strategy would be shortsighted – the exercise does illustrate potential optionality when and if the environment stabilizes. Assuming only $30M in acquisitions in FY17 (versus $306.7M in FY16) and beyond, we estimate UNFI would generate $136.5M in free cash flow (6.7% yield on our $40 PT). Our estimate assumes a limited working capital drag of -$5M (vs. working capital being a $64.4M source of cash in FY16). In addition, our estimate assumes capex is 0.7% of sales vs. 0.5% in FY16.

|  |  |
| --- | --- |
|  | Figure  FY16 Free Cash Flow: With and Without Acquisitions |
|  |  |
| Source: Company Reports, Barclays Research |

As the following figure clearly shows, UNFI screens very favorably on free cash yield in our minimal acquisition scenario versus other staple peers.

|  |
| --- |
| Figure  CY2017: UNFI Free Cash Flow Yield vs. Staples Peers |
|  |
| Source: Company Reports, Barclays Research |

Greater free cash flow would allow UNFI to start paying a dividend.

In this scenario, UNFI would have ample cash flow to begin paying a dividend. Below, we highlight the different potential dividends and yields under various payout ratio scenarios.

While we do not recommend this course of action today – it is worth contemplating should the environment stabilize in the future.

|  |  |
| --- | --- |
|  | Figure  Potential Dividend Yields |
|  |  |
| Source: Barclays Research |

Valuation and Conclusion

Based on our concerns, we are initiating with an Underweight rating and a $40 price target. Our price target factors in our upside/downside scenario analysis. Our rating is also based on the following: 1) On our Overweight ratings, we are looking for an average upside of +17.9%, on our Equal Weight ratings, we are looking for an average upside of +4.9%, and we are looking for a +1.8% for UNFI. Based on Barclays methodology – and the fact that we do not anticipate seeing a positive catalyst for a valuation re-rating – we believe an Underweight rating is appropriate, 2) we believe competitive and secular headwinds will persist, 3) we believe acquisition multiples will remain high and accretion on future transactions will remain elusive. If our thesis plays out, we see downside to $35 (-11% downside), or 6.4x CY2017 EV/EBITDA of $336 million, and we assign an 80% probability to this scenario. If we are wrong, and UNFI’s organic top-line re-accelerates, we see upside to $60 (+51% upside), or 10.1x CY2017 EV/EBITDA and we place a 20% probability on our upside scenario. The weighted average of these two outcomes gets us to our price target of $40 – +2% upside – a CY2017 EV/EBITDA multiple of 7.1x.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Big Lots, Inc. (BIG)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=BIG) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 47.00 | | Price Target | USD 51.00 | | **Why Equal Weight?** Reflects: 1) steady comps helped by recent initiatives, 2) slight margin improvement, 3) moderate square footage contraction, 4) slight improvement in ROIC, 5) a below average EV/EBITDA multiple - as the multiple returns closer to its historical relative valuation to peers - but a P/E multiple that is in line with its historical average. | | |  | | | Upside case | USD 59.00 | | Reflects: 1) continued steady comp growth boosted by recent initiatives, 2) margin improvement, 3) flat to slightly increasing unit growth, 4) improvement in ROIC, 5) a less competitive retail environment, and 6) slightly above average P/E and EV/EBITDA multiples. | | |  | | | Downside case | USD 40.00 | | Reflects: 1) negative volatility in comps due to increased competition and stalling furniture/soft home business, 2) margin pressure, 3) square footage contraction, 4) deteriorating ROIC, and 5) below average multiples. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 5,191 | 5,222 | 5,272 | 5,334 | 0.9% |  |
| EBITDA (adj) | 372 | 385 | 391 | 407 | 3.0% |  |
| EBIT (adj) | 249 | 264 | 269 | 283 | 4.3% |  |
| Pre-tax income (adj) | 241 | 260 | 264 | 278 | 5.0% |  |
| Net income (adj) | 151 | 160 | 163 | 172 | 4.3% |  |
| EPS (adj) ($) | 2.97 | 3.52 | 3.89 | 4.32 | 13.3% |  |
| Diluted shares (mn) | 51.0 | 45.5 | 41.9 | 39.7 | -8.0% |  |
| DPS ($) | 0.78 | 0.86 | 0.94 | 1.03 | 9.9% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 7.2 | 7.4 | 7.4 | 7.6 | 7.4 |  |
| EBIT (adj) margin (%) | 4.8 | 5.1 | 5.1 | 5.3 | 5.1 |  |
| Pre-tax (adj) margin (%) | 4.6 | 5.0 | 5.0 | 5.2 | 5.0 |  |
| Net (adj) margin (%) | 2.9 | 3.1 | 3.1 | 3.2 | 3.1 |  |
| ROIC (%) | 10.2 | 10.4 | 10.6 | 11.0 | 10.6 |  |
| ROE (%) | 20.0 | 23.9 | 27.4 | 30.9 | 25.6 |  |
| ROA (lease adjusted) (%) | 8.5 | 8.5 | 8.7 | 8.9 | 8.7 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 1,640 | 1,664 | 1,624 | 1,604 | -0.7% |  |
| Intangible fixed assets | 0 | 0 | 0 | 0 | N/A |  |
| Cash and equivalents | 54 | 97 | 94 | 106 | 25.2% |  |
| Total assets | 1,640 | 1,664 | 1,624 | 1,604 | -0.7% |  |
| Short and long-term debt | 62 | 183 | 183 | 183 | 43.2% |  |
| Total liabilities | 920 | 1,046 | 1,054 | 1,064 | 5.0% |  |
| Net debt/(funds) | 8 | 86 | 89 | 77 | 111.1% |  |
| Shareholders' equity | 720 | 618 | 570 | 541 | -9.1% |  |
| Change in working capital | 79 | 19 | -2 | -2 | N/A |  |
| Cash flow from operations | 342 | 293 | 277 | 283 | -6.1% |  |
| Capital expenditure | -126 | -95 | -75 | -80 | N/A |  |
| Free cash flow | 253 | 214 | 218 | 223 | -4.1% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 15.8 | 13.4 | 12.1 | 10.9 | 13.1 |  |
| EV/EBITDA (adj) (x) | 5.7 | 5.7 | 5.6 | 5.4 | 5.6 |  |
| Equity FCF yield (%) | 10.6 | 10.0 | 11.1 | 12.0 | 10.9 |  |
| P/Sales (x) | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |  |
| P/BV (x) | 3.3 | 3.5 | 3.5 | 3.4 | 3.4 |  |
| Dividend yield (%) | 1.7 | 1.8 | 2.0 | 2.2 | 1.9 |  |
| Adj debt/EBITDAR (x) | 3.7 | 3.7 | 3.7 | 3.6 | 3.7 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 1.8 | 1.3 | 1.5 | 1.6 | 1.6 |  |
| Square footage growth (%) | -0.6 | -1.1 | -0.9 | -0.7 | -0.8 |  |
| Inventory growth (%) | -0.2 | 0.6 | 0.9 | 8.0 | 2.3 |  |
| Capex/sales (%) | 2.4 | 1.8 | 1.5 | 1.5 | 1.8 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

big lots

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Big Lots, Inc.(BIG): Quarterly and Annual EPS (USD)   |  | | --- | | BIG | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 51.00 | | Price (19-Sep-2016) | | USD 47.00 | | Potential Upside/Downside | | +8.5% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.60A | N/A | 0.82A | 0.82A | N/A | N/A | 0.91E | 37% | N/A |
| Q2 | 0.40A | N/A | 0.52A | 0.52A | N/A | N/A | 0.56E | 30% | N/A |
| Q3 | -0.01A | N/A | -0.02E | -0.01E | N/A | N/A | 0.01E | -100% | N/A |
| Q4 | 2.00A | N/A | 2.21E | 2.21E | N/A | N/A | 2.45E | 10% | N/A |
| Year | 2.97A | N/A | 3.52E | 3.53E | N/A | 3.89E | 3.92E | 19% | 11% |
| P/E | 15.8 |  | 13.4 |  |  | 12.1 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Taking the Right Path

Improved merchandising driving more consistent results, but traffic is weak and units are contracting; initiate at Equal Weight with a $51 price target

For many years, Big Lots had inconsistent financial performance, and during this period we viewed BIG as a company Attempting to Reinvent itself. We believe much of this was due to the company’s business model, which in the past was very closeout driven. As the company grew larger in size, we believe it became harder to find large quantities of true closeout product. This improved during the recession and the years shortly thereafter as branded product was available at attractive prices and some large retailers filed bankruptcy and liquidated their inventory. In an effort to continue to drive comps, the company went after new merchandise categories, including electronics and hard home, but customers had a mixed reaction to the product and stores became cluttered and difficult to shop.

Now the company is in a very different place than just a few years ago and we view the company as In Transition. Comps have been positive for ten consecutive quarters and EBITDA has grown year-over-year for each of the last eight quarters – a result of a change in go-to-market strategy and merchandising. Stores now showcase a more cohesive product offering and inventory is no longer purchased based on mark-up, as was done in the past, and it now reflects a better balance between fashion, price, and value. Meanwhile, we expect various initiatives will boost comps, including the introduction of a store credit card, growth in the use of furniture financing, and continued improvements in merchandising. Lastly, we appreciate that management’s variable compensation is tied to ROIC.

Despite the improvements to the business and our favorable view of management’s turnaround plan and incentives, BIG still suffers from negative traffic trends, a lack of unit growth opportunities, and its valuation is above where it has historically traded relative to comparable companies. We are initiating at an Equal Weight rating and factor the following in to our recommendation:

1. Changes in strategy have led to steadier comps.
2. Traffic declines and store closures will pressure profit growth.
3. ROIC will begin to improve as the company cycles various investments.
4. Management’s variable compensation is tied to ROIC.
5. Despite a moderate absolute valuation, BIG’s valuation relative to comparable companies suggests the stock is not yet attractive.

Equal Weight rating based on upside/downside scenario analysis

We think that BIG is doing everything that it should be doing given its opportunity set and the environment. Our price target values BIG at 5.6x our FY17 EBITDA. If comps were to weaken and the company was forced to close more stores, we see downside to $40 (15%) – or 4.5x our FY17 EBITDA. We place a 40% probability on this scenario. If recent business momentum accelerates and the company’s valuation expands, we see upside to $59 – or 6.5x our CY17 EBITDA – with a 60% probability. The weighted average gets us to our $51 price target. We would re-evaluate our rating if traffic were to improve, comps accelerated, and/or both the absolute and relative valuation of BIG became more attractive.

|  |
| --- |
| Figure  BIG Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  BIG Price Target Valuation |  | Figure  BIG Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  BIG Free Cash Flow |
|  |  |
| Source: Barclays Research |

1. Changes in strategy have led to an improvement in comps

Historically comps at BIG were inconsistent given the business was very closeout driven. As the company grew larger in size, we believe it became harder to find large quantities of true closeout product. This improved during the recession and the years shortly thereafter as branded product was available at attractive prices and some large retailers filed bankruptcy and liquidated their inventory. In an effort to continue to drive comps the company went after new merchandise categories including electronics and hard home but customers had a mixed reaction to the product and stores became cluttered and difficult to shop.

|  |  |
| --- | --- |
|  | Figure  BIG Historical Comps |
|  |  |
| Note: Approximate timing for Edit to Amplify Source: Company reports and Barclays Research |

More recently, comps have been steady. We believe this is due to merchandising and operating changes since David Campisi became CEO in May 2013. These changes included its “edit to amplify” strategy and improved merchandising. Edit to amplify reduced high margin but slow turning SKUs where the company didn’t have a competitive advantage. For example, the company exited automotive, paint, plumbing and other items throughout 2013 and 2014, creating space for other categories with stronger trends. A key focus was getting merchants and store associates to get in the habit of making decisions on how best to serve “Jennifer,” the company’s prototypical customer.

|  |  |
| --- | --- |
|  | Figure  BIG Historical Merchandise Mix |
|  |  |
| Note: This segment reporting was not available in 2012. Source: Company reports and Barclays Research |

Prior to 2013, product placement made stores difficult to navigate. In fact, the store was previously organized based on how product was purchased, rather than how consumers shop. This resulted in similar product in different regions of the store. This has since been changed. With regard to product selection, buyers no longer focus on mark-up percentage and have been instructed to widen their focus to include quality, brand, and fashion in their purchasing decisions. Silos have been broken and cross merchandising has improved. A notable example is the coordination between soft home and furniture – for example, rugs are now showcased alongside sofas. We think the company will continue to benefit from these changes as current and lapsed customers increase their share of wallet with the company. Over time, this may also result in better traffic from new customers as they learn about the improved shopping experience at the retailer.

Perhaps the greatest opportunity going forward will be growing the company’s furniture sales. Furniture financing (management describes this as “Easy Leasing”) offered through a third party was rolled out in mid-2014 and employee sales training was completed in all stores by the end of 3Q15. While the financing carries a high interest rate, it can be less expensive than renting furniture or financing options available at other retailers. Also, store associates in this department had never received training in the past. The training has resulted in a higher conversion of traffic into purchases and also a higher ticket as associates educate customers on the Easy Leasing program. We expect a further boost to the furniture business given the launch of its private label credit card in May 2016. The card will create a financing alternative for individuals that have a better credit history than those needing to use the Easy Leasing program. As with Easy Leasing, BIG will not assume the credit risk as this will be absorbed by its partner. Importantly, there was little to no impact on the success of the leasing program when the credit card was tested in stores.

1. Traffic declines and store closures will pressure profit growth

Competitive environment is intensifying and traffic remains weak

Despite many positive initiatives at BIG, traffic has remained negative. The company believes it is faring better than other retailers but it doesn’t necessarily expect traffic will turn positive in the near term, and so it continues to do what it can to grow its basket size. We think this is an appropriate strategy for the company. In the near term, traffic may deteriorate further as some consumables retailers have indicated they are experiencing traffic pressure – such as Dollar General – and they have started to invest in price. Meanwhile, as discussed earlier, Walmart US has made significant changes to its business practices and is now also investing in price. These actions have been recognized by consumers, leading to gains in its traffic and comps. We note that BIG is insulated from these actions, to some extent, given food and consumables are only ~35% of its merchandise mix. That said, these competing retailers may now be “top of mind” when it comes to seasonal, furniture, and other more discretionary purchases. As can be seen in the chart below, we expect comps will moderate from in FY16, but then slowly improve over the next two years.

|  |  |
| --- | --- |
|  | Figure  BIG Comps |
|  |  |
| Source: Company reports and Barclays Research estimates |

We forecast square footage contraction over the next few years

BIG has experienced net square footage contraction in recent years as the company closes or relocates underperforming stores and we expect this will continue. As can been seen in the chart below, home goods companies rapidly grew capacity in the early to late 2000s. Since then, the industry has been absorbing this capacity and dealing with disruption.

|  |  |  |
| --- | --- | --- |
| Figure  Average Annual Unit Growth for Selected Comps |  | Figure  BIG Annual Unit Growth |
|  |  |  |
| Note: Includes HVT, PIR, BBBY, and Pottery Barn  Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Meanwhile, rents are projected to rise at an accelerating pace and we believe the company’s stores have a wide range in profitability. As such, given that leases are expiring for 57% of its store base from 2016-2018, we expect BIG will use this as an opportunity to close or relocate underperforming stores.

|  |  |
| --- | --- |
|  | Figure  Shopping Center National Asking Rent per Square Foot and Vacancy Rates |
|  |  |
| Note: Community and neighborhood shopping centers. Source: Reis and Barclays Research |

While we don’t expect the company will return to net square footage growth in the near term, we do believe that BIG has the opportunity to relocate stores to more productive areas. If store productivity and profitability continue to improve, the company may return to unit growth longer-term.

|  |  |
| --- | --- |
|  | Figure  BIG Selling Square Footage |
|  |  |
| Source: Company reports and Barclays Research estimates |

We expect modest EBITDA growth as strategy changes offset headwinds

As discussed above, the company’s strategies are driving better performance. This will translate to moderate levels of EBITDA growth over the next three years, in our view, given our expectation for negative traffic and net store closures.

|  |  |
| --- | --- |
|  | Figure  Historical and Projected EBITDA Dollars and Growth |
|  |  |
| Source: Company reports and Barclays Research estimates |

1. ROIC should begin to improve as BIG cycles various investments

Capex as a percent of sales has averaged slightly over 2% in recent years but we expect this rate will decrease going forward. In FY12, BIG grew square footage at a 3.5% annual rate and we estimate that new store capex at this time was ~$600,000 to ~$700,000. Net store growth stopped in FY13 but capex remained relatively high as the company opened 55 stores, invested in IT systems, tested a remodel program, and spent on various projects related to the acquisition of Liquidation World in Canada. In FY14 BIG had moderate new store openings (net closures) and it invested in freezers and coolers, new POS systems, and minor e-commerce investments. Capex as a percentage of sales spiked in FY15 as the company completed the rollout of freezers and coolers and the new POS systems, and also invested in e-commerce.

|  |  |
| --- | --- |
|  | Figure  Historical and Projected Capex as a Percent of Sales |
|  |  |
| Source: Barclays Research estimates |

We foresee lower capex as a percent of sales going forward unless the company accelerates new store growth. The scatter plot below suggests that capex as a percent of sales could be close to 1.5% with no change in square footage growth. In the past, maintenance capex was ~$40 million (0.8% of sales) although this figure is likely higher now given the company’s investments in freezers and coolers and e-commerce. We expect that capex as a percent of sales will continue to moderate.

|  |  |
| --- | --- |
|  | Figure  Y/Y Change in Square Footage Growth vs. Capex/Revenue – 2001to 2015 |
|  |  |
| Source: Barclays Research estimates |

With capex moderating and the company’s underlying profitability improving, we expect lease adjusted ROIC to improve over the next few years as the company harvests its prior spending.

|  |  |
| --- | --- |
|  | Figure  Historical and Projected Lease Adjusted ROIC |
|  |  |
| Source: Barclays Research |

1. Management’s variable compensation is tied to ROIC

In response to feedback received throughout shareholder outreach efforts in 2013, the company significantly changed its executive compensation program starting in FY14. Executive officers now receive 60% of their equity awards in the form of performance share unit (PSU) awards. The awards vest after the completion of a three-year performance period, weighted 50% to EPS and 50% to average ROIC performance. In 2015, PSUs were nearly 40% of the CEO’s compensation and almost 30% of the compensation for other executive officers. In our view, this compensation structure creates the appropriate incentives for the creation of long-term shareholder value.

1. Despite a moderate absolute valuation, valuation relative to comparable companies suggest stock is not yet attractive

Relative EV/EBITDA and P/E valuations suggests that stock is not yet attractive

BIG has typically traded at a lower multiple than comparable companies. This discount has been ~1x based on EV/EBITDA. Historically, the stock has been relatively “expensive” when it traded near parity with these comparable companies and relatively “cheap” when at a 2x discount or greater. Currently, BIG is trading at a premium, an indication that the stock is relatively expensive relative to the other companies in this comp set.

|  |  |  |
| --- | --- | --- |
| Figure  Forward EV/EBITDA Ratio – BIG vs. Comparable Average |  | Figure  BIG EV/EBITDA Relative Valuation - Discount/Premium |
|  |  |  |
| Note: Comparable average includes BBBY, DG, HVT, KIRK, PIR, and WSM Source: Thomson Reuters and Barclays Research |  | Note: Comparable average includes BBBY, DG, HVT, KIRK, PIR, and WSM  Source: Thomson Reuters and Barclays Research |

As can be seen in the table below, our comp set has a higher ROIC than BIG and essentially the same EBITDA growth. Given this, it is not surprising to see BIG trading at a slight discount to the group.

|  |  |
| --- | --- |
|  | Figure  ROIC, Expected EBITDA Growth, and CY17 EV/EBITDA |
|  |  |
| Note: \*FY15 lease adjusted ROIC excluding goodwill. \*\*Average expected EBITDA growth for CY16 and CY17. Expected EBITDA growth is the consensus estimate for all companies except BIG, which is a Barclays Research estimate.  Source: Thomson Reuters and Barclays Research |

BIG is also trading above its average P/E discount to comparable companies. This discount has been ~2.5x historically. Currently, BIG is trading near parity relative to the comp set, an indication that the stock is expensive relative to these companies.

|  |  |  |
| --- | --- | --- |
| Figure  Forward P/E Ratio – BIG vs. Comparable Average |  | Figure  BIG P/E Relative Valuation - Discount/Premium |
|  |  |  |
| Note: Comparable average includes BBBY, DG, KIRK, PIR, and WSM Source: Thomson Reuters and Barclays Research |  | Note: Comparable average includes BBBY, DG, KIRK, PIR, and WSM  Source: Thomson Reuters and Barclays Research |

As can be seen in the table below, we expect that BIG will be able to drive EPS growth well in excess of comparable companies over the next couple of years. This is due to our expectation for continued large share repurchases.

|  |  |
| --- | --- |
|  | Figure  ROIC, Expected EBITDA Growth, and CY17 EV/EBITDA |
|  |  |
| Note: \*FY15 lease adjusted ROIC excluding goodwill. \*\*Averaged expected EPS growth for CY16 and CY17. Expected EBITDA growth is the consensus estimate for all companies except BIG, which is Barclays Research estimate.  Source: Thomson Reuters and Barclays Research |

Free cash flow yield slightly above long-term average

At ~10.0% BIG’s forward free cash flow yield is slightly above its long-term average of 8.7%. The free cash flow yield may improve in FY17 and FY18 if EBITDA continues to grow and capital expenditures moderate; this would make the stock more attractive.

|  |  |
| --- | --- |
|  | Figure  BIG Forward Free Cash Flow Yield |
|  |  |
| Source: Barclays Research |

P/E and EV/EBITDA multiples at slight discounts to long-term averages

As can be seen in the charts below, BIG’s forward P/E and EV/EBITDA multiples are slightly below their long-term averages.

|  |  |  |
| --- | --- | --- |
| Figure  BIG Forward NTM P/E Ratio |  | Figure  BIG Forward NTM EV/EBITDA |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating and a $51 price target. Our price target factors in our upside/downside scenario analysis. We think that BIG is doing everything that it should be doing given its opportunity set and the environment. Our price target values BIG at 5.6x our FY17 EBITDA of $591 million. If comps weaken and the company is forced to close more stores, we see downside to $40 (15%) – or 4.5x our FY17 EBITDA. We place a 40% probability on this scenario. If recent business momentum accelerates and the company’s valuation expands, we see upside to $59 – or 6.5x our CY17 EBITDA – with a 60% probability. The weighted average gets us to our $51 price target. We would re-evaluate our rating if traffic improves, comps accelerate, and/or both the absolute and relative valuation of BIG became more attractive.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Dollar Tree Inc (DLTR)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=DLTR) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 80.22 | | Price Target | USD 88.00 | | **Why Equal Weight?** We have some degree of skepticism related to the success of the Family Dollar acquisition given our view that: 1) FDO's store base will never achieve productivity levels seen at DG, 2) ROIC will be permanently lower given FDO's drag on combined company ROIC, and 3) synergies may have to be reinvested into the business. | | |  | | | Upside case | USD 105.00 | | Reflects: 1) Upside to synergy estimates, 2) flawless execution on integration, 3) no changes to the competitive landscape from Mass, Dollar Stores and Hardline retailers, and 4) unchanged ROIC. | | |  | | | Downside case | USD 80.00 | | Reflects: Valuation more in line with average EV/EBITDA multiples given: 1) Our view that recent, high multiples were unwarranted, 2) ROIC declines, 3) the landscape will become more competitive, and 4) problems with integrating Family Dollar. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 15,498 | 20,733 | 21,875 | 23,783 | 15.3% |  |
| EBITDA (adj) | 1,630 | 2,338 | 2,632 | 2,934 | 21.6% |  |
| EBIT (adj) | 1,142 | 1,703 | 1,981 | 2,251 | 25.4% |  |
| Pre-tax income (adj) | 901 | 1,353 | 1,647 | 1,947 | 29.3% |  |
| Net income (adj) | 554 | 897 | 1,041 | 1,236 | 30.6% |  |
| EPS (adj) ($) | 2.48 | 3.79 | 4.46 | 5.38 | 29.5% |  |
| Diluted shares (mn) | 223.5 | 236.4 | 233.4 | 229.6 | 0.9% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 10.5 | 11.3 | 12.0 | 12.3 | 11.5 |  |
| EBIT (adj) margin (%) | 7.4 | 8.2 | 9.1 | 9.5 | 8.5 |  |
| Pre-tax (adj) margin (%) | 5.8 | 6.5 | 7.5 | 8.2 | 7.0 |  |
| Net (adj) margin (%) | 3.6 | 4.3 | 4.8 | 5.2 | 4.5 |  |
| ROIC (%) | 14.3 | 13.7 | 13.4 | 14.1 | 13.9 |  |
| ROE (%) | 17.9 | 18.5 | 19.2 | 20.8 | 19.1 |  |
| ROA (lease adjusted) (%) | 8.4 | 7.5 | 7.8 | 8.5 | 8.1 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 3,126 | 3,167 | 3,212 | 3,287 | 1.7% |  |
| Intangible fixed assets | 8,527 | 8,527 | 8,527 | 8,527 | 0.0% |  |
| Cash and equivalents | 736 | 1,394 | 658 | 517 | -11.1% |  |
| Total assets | 15,901 | 16,553 | 16,174 | 16,307 | 0.8% |  |
| Short and long-term debt | 7,346 | 7,301 | 6,551 | 5,801 | -7.6% |  |
| Total liabilities | 11,494 | 11,282 | 10,612 | 10,009 | -4.5% |  |
| Net debt/(funds) | 6,610 | 5,908 | 5,893 | 5,284 | -7.2% |  |
| Shareholders' equity | 4,407 | 5,271 | 5,562 | 6,298 | 12.6% |  |
| Change in working capital | -140 | -189 | -231 | -52 | N/A |  |
| Cash flow from operations | 781 | 1,285 | 1,461 | 1,867 | 33.7% |  |
| Capital expenditure | -481 | -660 | -696 | -757 | N/A |  |
| Free cash flow | 476 | 757 | 847 | 1,200 | 36.1% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 32.3 | 21.1 | 18.0 | 14.9 | 21.6 |  |
| EV/EBITDA (adj) (x) | 15.7 | 10.6 | 9.5 | 8.3 | 11.0 |  |
| Equity FCF yield (%) | 2.7 | 4.0 | 4.5 | 6.5 | 4.4 |  |
| P/Sales (x) | 1.2 | 0.9 | 0.9 | 0.8 | 1.0 |  |
| P/BV (x) | 4.1 | 3.6 | 3.4 | 2.9 | 3.5 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 4.7 | 4.5 | 4.3 | 3.9 | 4.4 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 2.2 | 1.6 | 2.5 | 3.0 | 2.3 |  |
| Square footage growth (%) | 133.4 | 4.0 | 4.6 | 5.4 | 36.8 |  |
| Inventory growth (%) | 178.6 | 0.0 | 9.9 | 5.0 | 48.4 |  |
| Capex/sales (%) | 3.1 | 3.2 | 3.2 | 3.2 | 3.2 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

dollar Tree

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Dollar Tree Inc(DLTR): Quarterly and Annual EPS (USD)   |  | | --- | | DLTR | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 88.00 | | Price (19-Sep-2016) | | USD 80.22 | | Potential Upside/Downside | | +9.7% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.71A | N/A | 0.98A | 0.98A | N/A | N/A | 1.10E | 38% | N/A |
| Q2 | 0.25A | N/A | 0.72A | 0.72A | N/A | N/A | 0.94E | 188% | N/A |
| Q3 | 0.49A | N/A | 0.79E | 0.78E | N/A | N/A | 0.91E | 61% | N/A |
| Q4 | 1.01A | N/A | 1.30E | 1.30E | N/A | N/A | 1.51E | 29% | N/A |
| Year | 2.48A | N/A | 3.79E | 3.79E | N/A | 4.46E | 4.54E | 53% | 18% |
| P/E | 32.3 |  | 21.1 |  |  | 18.0 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Trading ROIC for Growth May Not Lead to Value Creation

1 + 1 might not = 3. But “3” is expected. Initiating coverage at Equal Weight and an $88 price target

Prior to the Family Dollar (FDO) acquisition, we viewed DLTR as a best-in-class Growth Star given the company’s remarkably strong execution, the simplicity of the business model, consistently respectable comps, high single-digit unit growth, high single-digit EBITDA and low double-digit EPS growth, mid-teen return on lease adjusted capital, and respectable free cash flow yield. However, leading up to the acquisition of Family Dollar, some of these metrics had started to slow slightly, so while the acquisition is earnings accretive, we view DLTR as a story that is In Transition because we believe Growth Star status may not be sustainable, yet it appears growth remains the goal. As a result, we are a little less enthusiastic with the DLTR story today versus several years ago for eight reasons. Our rationale also incorporates our view that a more competitive landscape might limit upside to synergies.

1. While we appreciate the strategic rationale for the FDO acquisition, top line and ROIC trends had started to decelerate at DLTR prior to the acquisition, so in our view, the acquisition was potentially more defensive versus offensive in nature to maintain growth.
2. On a combined basis, FDO clouds visibility in what was once a very clean and simple story, even if trends were decelerating at DLTR prior to the acquisition.
3. FDO’s ROIC has always trailed DLTR’s ROIC meaningfully, and by our estimates – even if FDO’s productivity narrows with DG – FDO would still be dilutive to DLTR’s ROIC on a combined basis. Irrespective of ROIC, we are not convinced FDO as a stand-alone will ever bridge the gap on ROIC versus DLTR or DG. We base this view on our belief that FDO’s variability in real estate (exposure to strip malls versus DG and DLTR, a wide range of income demographics, a wide range of ethnicity, and locations ranging from suburban, to urban, to rural) has always meant that a “fix” for FDO was never that simple – even in the hands of an exceptionally strong (DLTR) operator. As a result, we have always been skeptical that just better, basic blocking and tackling could bridge the gap on productivity and returns versus peers. Said differently – we believe achieving much higher sales productivity and a higher margin structure may prove to be more elusive than expected. We factor ROIC and direction of ROIC in our valuation methodology, and we reflect this in our recommendation and rating.

Heightened Competitive Landscape May Limit Upside on Synergy Estimates:

1. DG’s sales have recently weakened, and in our view, DG will not cede share – especially because traffic recently turned negative. As all retailers know – once traffic turns – it is hard to regain – and our concern is that the landscape will become more irrational in the near term. Given that over 60% of FDO’s stores are in the same zip code as DG stores – we are concerned the competitive landscape with DLTR’s most direct competitor will remain challenging – and are further concerned unanticipated price investments may dampen upside to synergies.
2. We believe Walmart’s resurgence may prove to be a bigger challenge than originally contemplated. We look at a range of strain rates for FDO with WMT taking share.
3. We believe the competitive landscape in the Southeast (37% of FDO’s store base) has – for years – been fairly benign but believe this will change with the arrival of Lidl and Wegmans in the Southeast by 2018. As a result, we believe the margin structure will permanently change in a high percent of FDO’s store base – and believe this imminent change in the competitive landscape could dampen upside to synergies.
4. Given that hard discounters - such as Aldi - will play a greater role in shaping the competitive landscape going forward, we believe “fresh” will play an increasingly important role in FDO’s future success – and we do not believe this change in the landscape has been fully contemplated in the strategic plan for FDO.

Additional Macro Risks to Synergy Upside:

1. We believe several macro challenges also present risk to the upside on net synergy estimates. These include: SNAP reductions, increases in housing costs (rent) as a percent of net income, and rising healthcare costs.

Equal Weight rating based on upside/downside scenario analysis

With our concerns as a backdrop, we look at valuation on our FY18 estimates. This time frame gives DLTR credit for achieving its synergy goals and paying down debt (since we always use forward net debt and share count for our valuations). We assume no further upside to synergies given the above concerns.

Our upside scenario on DLTR’s valuation reflects: 1) a benign competitive landscape for the next two years, and 2) that the company achieves its stated synergy goals. On this basis, we value DLTR at 10x our EBITDA estimates (versus the company’s 10 year historical average of 8x). We assign a 30% probability to this upside scenario given the 8 concerns we state above. In this scenario, we value DLTR at $105.

Our downside scenario reflects the likelihood that the competitive landscape intensifies and that incremental and unanticipated price investments dampen upside to the synergy goals. Under this scenario (a 70% probability) our 8x multiple on FY18 EBITDA contemplates: 1) DLTR’s 10 year average valuation of 8x, and 2) lower consolidated ROIC. In this scenario – we see downside at the current level – at $80.

The weighted average of these two scenarios gets us to our $88 price target – 10% upside and not compelling enough to warrant an Overweight rating given our view of the risks in achieving our FY18 estimates.

|  |
| --- |
| Figure  DLTR Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  DLTR Price Target Valuation |  | Figure  DLTR Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  DLTR Free Cash Flow |
|  |  |
| Source: Barclays Research |

1. After impressive run, performance had started to slow and ROIC had started to flatten

Rapid unit growth resulted in DLTR closing in on its domestic store potential

From 2007 through 2014, the year before the Family Dollar acquisition, annual unit growth at DLTR averaged 6.6%. During this time the store base increased by nearly 2,000 units to 5,367 Dollar Tree stores, with 210 of these stores in Canada. Based on the company’s 6-7% historical unit growth rate, the company was on a trajectory to hit the concepts long-term potential of 7,000 stores in five years. We should note that the 7,000 target has not been updated in many years and so no there is reason to believe it has increased.

|  |  |
| --- | --- |
|  | Figure  DLTR Historical Unit Growth |
|  |  |
| Source: Barclays Research |

Comp boost from consumables expansion and recession has moderated

Prior to the “great recession,” the company’s comps had benefited from a mix shift towards more consumable merchandise. Then the recession resulted in an additional boost in traffic and spending as trade down customers began shopping stores and existing customers increased their spending. From 2006 to 2013, consumables expanded from 45.3% of sales to 51.4%. Among the drivers of the increase was the addition of freezers and coolers to many stores. From 2006 to 2013, the percentage of stores with freezers and coolers increased from 20% to 63%. This drove increased traffic from current customers and it also allowed the company to accept SNAP benefits as the coolers enabled the company to sell certain required products for SNAP eligibility including milk and eggs. In fact, the company indicated the addition of a cooler increased comps by 7-8% in the early stages of this initiative. Given the proliferation of options for consumers today (at other dollar formats, hard discounters, etc.), we believe this lift is meaningfully lower today.

|  |  |
| --- | --- |
|  | Figure  DLTR Historical Comp Growth |
|  |  |
| Source: Barclays Research |

EBITDA and EPS growth, while impressive, slowed in 2013 and 2014

As comps slowed in 2013 and 2014, so did the company’s growth in profits as measured by EBITDA and EPS. In addition to lower comps, the business was no longer generating operating margin expansion. From 2007 to 2012 the operating margin expanded by over 450 bp, with 70% of the gain driven by SG&A leverage. In 2013 comps began to slow and so the company began offering more value with its discretionary product to drive sales in 2014. This included re-merchandising the front-end with more seasonal products and also making changes to its stationary and party businesses.

|  |  |  |
| --- | --- | --- |
| Figure  DLTR Historical EBITDA Growth |  | Figure  DLTR Historical EPS Growth |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

ROIC seemingly peaked at ~17% between FY12-FY14

DLTR’s lease adjusted return on invested capital expanded rapidly from FY07 to FY12 as a result of its various merchandising changes in addition to the “great recession,” during which new customers were introduced to the retailer. ROIC peaked in FY12 at 16.9% and hovered near that level for the following two years.

|  |  |
| --- | --- |
|  | Figure  Dollar Tree Lease Adjusted ROIC |
|  |  |
| Source: Barclays Research |

1. Family Dollar’s ROIC is lower than Dollar Tree; it’s unlikely the business can generate returns similar to DG

Family Dollar historical lease adjusted ROIC has lagged Dollar Tree

The lease adjusted return on invested capital at Family Dollar averaged just above 14% in the years prior to its results weakening in 2013 and 2014, when ROIC deteriorated by 400 bp. ROIC at Dollar Tree has historically been above Family Dollar and was between 70-300+ bp better over comparable periods. As such, the Family Dollar acquisition has been dilutive to DLTR’s ROIC, and we expect this dilution will pressure returns for the foreseeable future.

|  |  |  |
| --- | --- | --- |
| Figure  Family Dollar Lease Adjusted ROIC |  | Figure  Lease Adjusted ROIC - Dollar Tree vs. Family Dollar |
|  |  |  |
| Note: For fiscal year ended August  Source: Barclays Research |  | Note: Excludes goodwill and intangibles related to the Family Dollar acquisition. Source: Barclays Research |

1. **Closing Family Dollar’s ROIC gap with DG will require a significant improvement in productivity, margin, and the realization of synergies**

As discussed above, the lease adjusted ROIC at Family Dollar has historically lagged that of Dollar Tree and has also been below DG’s industry leading returns at ~17%. Below we provide a hypothetical pro forma analysis of the potential ROIC for the Family Dollar business if it were to close its productivity and margin gap with DG. In our analysis we take our FY18 Family Dollar store count forecast and apply DG’s current level of sales per store ($1.66mn) and EBITDA margin (11.4%). We also assume that depreciation and amortization is 2.5% of sales (in line with both Dollar Tree and Family Dollar before the deal) and that rent expense grows at 2% annually. Our last key assumption is that invested capital per store at Family Dollar remains unchanged from FY15, just prior to the company being purchased by DLTR. This yields a lease adjusted ROIC of 15.8% for Family Dollar. This compares to our FY18 forecast at DG of 16.9% and DLTR’s FY14 ROIC at 16.8%. We forecast the combined company (Family Dollar + Dollar Tree) will have a ROIC of 14.1%, well below DG and Dollar Tree’s historical ROIC. Our combined company ROIC assumes slightly more than $300 million in run rate synergies by FYE18 (although realized synergies are slightly lower), and while we assume productivity (in both sales per square foot and operating margins) at Family Dollar improves, we do not assume Family Dollar fully closes the sales productivity or margin gap with DG. Our estimates also factor in the headwind from the amortization of lease rights.

Given the below analysis, we believe it’s unlikely DLTR will achieve ROIC metrics similar to Dollar Tree prior to its acquisition of Family Dollar even with a significant improvement in various operating metrics and stable invested capital per store at Family Dollar. A rapidly evolving competitive landscape is also likely to be a headwind and it may offset various “low hanging fruit” at Family Dollar and synergies. Also, the banner may encounter difficulties if it needs to evolve its assortment towards fresh to remain relevant with its customers. These factors are discussed in more detail below.

|  |
| --- |
| Figure  Pro Forma Analysis of Family Dollar Closing its Performance Gap With DG – 2018 Estimates |
|  |
| Note: DLTR includes an extra week. Source: Barclays Research estimates |

Risk to Upside to Synergies:

1. **We expect more intense competition between DG and Family Dollar**

DG and Family Dollar have significant store overlap in many markets. A Bloomberg analysis from 2014 noted that 65% of Family Dollar’s stores were in the same zip code as DG stores. As can be seen in the table below, both concepts have the majority of their stores concentrated in the Southeast (a market on the cusp of becoming more competitive) and both serve a customer that is on a budget seeking convenience, good values, and is satisfied with a limited assortment of products.

|  |  |
| --- | --- |
|  | Figure  Dollar Tree Store Overlap with Family Dollar and Dollar General |
|  |  |
| Source: Company Reports and Barclays Research |

As was discussed on its 2Q call, it appears DG will invest in price to regain comp and traffic momentum. Meanwhile, DLTR is improving the merchandising at Family Dollar and is reverting back towards its historical EDLP positioning. We therefore expect the two concepts may increasingly pressure each other’s results. We should note that prior to DLTR’s acquisition of the company, Family Dollar had flat to slightly negative comps for nearly two years. It also closed 5% of its store base in the summer of 2014 and new unit openings dwindled. During this time we believe the competitive intensity between the two concepts waned, to some degree, as Family Dollar struggled – one could argue it was its own worst enemy. As such, Dollar General benefited, and we have not seen the two companies simultaneously in a strong position for many years. This fact may not be fully appreciated by some investors – because Dollar General will not cede share.

|  |  |
| --- | --- |
|  | Figure  Family Dollar vs. DG Comps – 2Q13 to 1Q15 |
|  |  |
| Source: Company reports and Barclays Research |

1. **Stronger sales at Walmart may pressure Family Dollar’s comps**

As discussed in our Walmart initiation, Walmart US has made significant changes to its business practices and it is now also investing in price. These actions have been recognized by consumers, leading to gains in its traffic and comps. In recent years as Walmart’s comps have stagnated, we believe this put less pressure on Family Dollar. Even small comp gains at Walmart may put considerable pressure on Family Dollar as the two businesses serve many of the same customers and stores can be in relatively close proximity. In the table below, we estimate how a change in Walmart’s US comps may pressure Family Dollar’s comps assuming moderate strain rates.

|  |  |
| --- | --- |
|  | Figure  Estimated Impact to FDO Comps from an Increase/(Decrease) in Walmart US Comps |
|  |  |
| Source: Company Reports and Barclays Research |

1. **Expansion by Lidl and Wegmans into the southeast is a game changer**

The competitive landscape in the southeast has been fairly benign, in our view. We expect this will change in the next few years driven by the growth of Lidl and southern expansion by Wegmans. The Germany-based global discount chain Lidl has indicated that it is pursuing sites from Pennsylvania and New Jersey down to Georgia. The company has already constructed or has construction in progress on multiple regional distribution centers that will serve these markets. Lidl’s stated goal is to open its first stores in the U.S. no later than 2018. Our review of the company’s website showed 12 store management positions open throughout the Southeast, Mid-Atlantic, and into the Northeast. Similar to Aldi, the stores are known for their low prices and no frills shopping experience; however, Lidl’s stores have a higher mix of apparel and general merchandise (versus Aldi), so we believe Lidl will prove to be a formidable competitor to Family Dollar and other consumable and non-consumable retailers in its markets.

Wegmans is a very different type of retail competitor than Lidl but we rank them as one of the strongest in the food and consumables space. Press reports indicate that the company had been negotiating leases to open stores in North Carolina – specifically Cary – an indication that the company is continuing to expand south from its Northeast roots. While we don’t expect Wegmans will have a direct impact on Family Dollar, we expect the ripple effects will. Supermarkets competing with the newly opened Wegmans will experience substantial sales declines, in our view. The average Wegmans store does $85-$90 million in sales annually. When a Wegmans opens in a given geography, we expect supermarket and other food competitors will be aggressive to maintain their market share. The increase in competitive intensity, in turn, could pressure Family Dollar’s results indirectly.

**7a) Aldi expansion should not be underestimated**

European discount grocer Aldi operates small format, convenient grocery stores, with low prices due to its efficient model and extreme use of private label. The company plans to invest billions of dollars in the US and to operate nearly 2,000 stores by the end of 2018, nearly a 30% increase from today. While the format attracts shoppers from across the economic spectrum, it tends to attract lower income shoppers. Unlike dollar stores, however, customers can do a “full” food shop at Aldi whereas they can only do a “fill in” shop at the dollar stores given their limited assortment of food products; most notably, their absence of fresh meats and produce. Aldi private offering is very high in quality. In addition, Aldi offers a very credible fresh offering spanning produce, meat, and dairy. Fresh meat and produce are not available at Family Dollar and there is a limited supply of dairy products. Over time we believe Family Dollar customers will try the Aldi format and will be pleasantly surprised by the stores’ great values and convenience. As these customers do more of their food shopping at this format, this will pressure traffic and comps at Family Dollar.

|  |  |
| --- | --- |
|  | Figure  Dollar Tree and Family Dollar Store Overlap with Aldi |
|  |  |
| Source: Aggdata and Barclays Research |

**7b) Family Dollar is ill-equipped to handle growing popularity of fresh foods**

Consumers are increasingly migrating their diets towards fresh foods. This may be an obstacle for all dollar stores, given that fresh requires a different labor model and poor execution can result in lost sales and high shrink – but Family Dollar has not tested this nor does it have formats that offer fresh food. Dollar General has familiarity with fresh given its numerous formats and it is currently testing a limited selection of produce in traditional stores. Given the anticipated growth of low priced food formats like Aldi and Lidl as well as changing consumer tastes, Family Dollar may find itself in a situation where its customers abandon the brand for a competitor with a broader fresh food offering and the company may not have the expertise to win them back.

**Additional Macro Risks to Synergy Upside:**

**8 a) Fewer households receiving SNAP, and the monthly benefit is declining**

The 2009 Recovery Act suspended SNAP’s (Supplemental Nutrition Assistance Program, formerly known as food stamps) work requirement time limit for childless adults. Under this work requirement, childless adults aged 18-50 are entitled to three months of SNAP benefits in any 36-month period when they aren’t employed or in a work or training program for at least 20 hours a week. The suspension of the work requirement and more individuals qualifying for benefits led to a substantial increase in SNAP utilization starting in 2009. From 2009 to 2013, the number of households utilizing food stamps increased by ~30%. Rates began falling in 2013 as many states began reinstating work requirements for childless adults aged 18-50. Even with these reductions, ~15% of the US population and nearly 20% of households received SNAP benefits as of March 2016.

|  |  |  |
| --- | --- | --- |
| Figure  Number of Households Receiving SNAP |  | Figure  Y/Y Change in the Number of Households Receiving SNAP |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Since peaking in November 2012, the average monthly benefit per person has declined by 8% to $124.89 and the average monthly benefit per household has declined by nearly 10% to $253.98.

|  |  |  |
| --- | --- | --- |
| Figure  SNAP – Average Monthly Benefit Per Person |  | Figure  SNAP – Average Monthly Benefit Per Household |
|  |  |  |
| Source: USDA Food and Nutrition Service and Barclays Research |  | Source: USDA Food and Nutrition Service and Barclays Research |

In 2016 the time limit on work requirements was re-established in 22 states. In most of these states the time limit took effect in January 2016 and so those no longer eligible stopped receiving benefits in April (three months later). The map below identifies the relevant states. Many of the states are in the southeast, the densest market of Family Dollar’s stores. Overall, these changes will impact states comprising nearly 50% of the company’s store base.

|  |  |
| --- | --- |
|  | Figure  States Newly Implementing SNAP Time Limits In 2016 |
|  |  |
| Note: Blue states are those that had a statewide waiver of the time limit for childless adults aged 18-49 without disabilities in 2015, but are implementing the time limit in some or all of the state beginning January 2016. The other states either began implementing the time limit in 2015 or earlier, or are eligible for and will waive the entire state from the time limit in 2016. Source: Center on Budget and Policy Priorities and Barclays Research |

**8b) Housing costs may be pressuring the budget of low income earners**

The bottom 40% of income earners spends approximately 40% of their income on housing according to consumer expenditure data from the BLS. This includes mortgage or rent, utilities, and household supplies and furnishings. It should be noted that the table below shows dollars as a percentage of *expenditures* and not *income*. For consumers in this income bracket, expenditures exceed total income, on average. Spending above total income is possible as individuals borrow or rely on savings. Some may also underreport total income. Given this dynamic, even small changes in total housing costs can have a substantial impact on the welfare of these consumers. According to this survey, the percentage of expenditures spent on housing has shown an inconsistent trend in recent years but the dollars have increased meaningfully between 2013 and 2015. Data is not yet available for 2016.

|  |
| --- |
| Figure  Consumer Expenditures for Bottom 40% of Income Earners |
|  |
| Source: Consumer Expenditure Survey, BLS |

Wage increases of lower income individuals have lagged the overall rise in housing costs over the past few years according to the housing component of the Consumer Price Index (CPI). More recently, however, lower income individuals earning full time wages may have gained some ground vs. housing, while those working part time have fallen further behind. We realize the limitations of the housing CPI as a national proxy since it is for urban consumers and many Family Dollar stores (and customers) are in rural areas. Nevertheless, we think the analysis is representative enough to show what is likely a larger trend.

|  |  |  |
| --- | --- | --- |
| Figure  CPI - Housing vs. Wage Growth: 1Q11-2Q16 |  | Figure  CPI - Housing vs. Wage Growth : 1Q15-2Q16 |
|  |  |  |
| Source: BLS |  | Source: BLS |

**8c) Healthcare costs have been rising quickly in recent years**

In the figure above, it is clear that an increasing percentage of low income earners expenditures have been going towards healthcare. From 2012-2015, healthcare increased from 8.1% to 9.0% of expenditures.

It is not clear to us if the Affordable Care Act (ACA) has led to budget pressures for those on a limited income. The purchase of insurance may have resulted in lower total medical spending if the coverage was utilized but we believe many individuals qualify for Medicaid and so are not required to purchase insurance. Also, some have cited the penalty associated with not purchasing insurance as a headwind. This has likely not had a significant impact on incomes or purchasing since there is little recourse for the government to collect the penalty. The IRS can only collect for the penalty when an income tax refund is due and there are no civil or criminal penalties for not paying the fine. If an individual or household does not have a refund in a given year and chooses not to pay a fine, the fines will be collected in a subsequent year when a refund is due. Any adverse impact to low income earners stemming from the ACA is hard to determine but we do not believe it has necessarily been meaningfully negative because it seems likely that a high percentage of Family Dollar’s customer base doesn’t file a tax return – so no penalty is incurred for not having insurance. Having said that – it is possible – subconsciously – the potential for a penalty as an expense could weigh on behaviour.

The next figure explains how the Affordable Care Act impacts various income demographics.

|  |
| --- |
| Figure  The Requirement to Buy Coverage Under the Affordable Care Act 2015 and Beyond |
|  |
| Source: The Kaiser Family Foundation and Barclays Research |

DLTR is pricing in a smooth turnaround at Family Dollar and a growing realization of synergies

We forecast acceleration in comps at both banners and margin expansion

Over the next three and a half years, we forecast gradually accelerating comps at both banners. At Dollar Tree, we expect comps will improve as the company anniversaries the impact of cannibalization on its comps from the re-bannered Deal$ and Family Dollar stores in 2015 and 2016. Meanwhile, we expect the EBITDA margin will expand by over 100 bp from FY16E through FY19E through a combination of improved operations and merchandising at Family Dollar as well as the realization of synergies.

|  |  |  |
| --- | --- | --- |
| Figure  DLTR Consolidated Segment Comp Forecast |  | Figure  DLTR Consolidated EBITDA Margin Forecast |
|  |  |  |
| Source: Barclays Research estimates |  | Source: Barclays Research estimates |

Stock is trading above its average multiples

Even though the multiple has compressed recently, DLTR’s stock is trading considerably above its average forward P/E and EV/EBITDA ratios. With the stock trading at 19.5x its NTM earnings, DLTR is about three turns or 19% above its long-term average. Meanwhile, its NTM EV/EBITDA ratio is two turns or 25% above its long-term average. Our numbers contemplate the realization of synergies and improved execution at Family Dollar. The above average valuation indicates turnaround and synergy realization expectations are priced into the stock and so any stumble may result in a much lower stock price.

|  |  |  |
| --- | --- | --- |
| Figure  DLTR NTM P/E Ratio |  | Figure  DLTR NTM P/E Ratio |
|  |  |  |
| Source: Barclays Research estimates |  | Source: Barclays Research estimates |

Free cash flow yield is below average

DLTR trades at a premium to its average free cash flow yield. We note that new store growth has slowed at Family Dollar, but the capex benefit from this may be offset by IT and other projects related to synergy realization.

|  |  |
| --- | --- |
|  | Figure  DLTR Free Cash Flow Yield |
|  |  |
| Source: Barclays Research |

Return and growth characteristics impressive relative to peer set

Even with its lower ROIC due to the Family Dollar acquisition, DLTR’s high lease adjusted ROIC is in line with large market capitalization Staples and is above “staple-type” companies in our coverage. DLTR’s CY17 EV/EBITDA multiple of 9.3x is at a 30% discount to Staples but is a 4% premium to staple-type companies in our coverage. Its free cash flow yield is below both Staples and staple-type companies in our coverage at 4.5%. We expect sales and profit growth will exceed both Staples and staple-type companies in our coverage but this is not without risk; it is contingent on the company driving a turnaround at Family Dollar – while the competitive environment intensifies – as well as the realization of synergies.

|  |
| --- |
| Figure  DLTR vs. Staples and “Staple-Type” Companies in Our Coverage Comp Table |
|  |
| Source: Barclays Research estimates |

ROIC trend may again influence the stock price

DLTR’s stock price had a strong correlation with ROIC for many years but this relationship deteriorated after the Family Dollar acquisition announcement on July 28, 2014. Now that it’s been more than a year since the transaction closed (July 6, 2015), we expect the trend in ROIC will again correlate with DLTR’s stock price. In fact, we view improving the ROIC at Family Dollar one of the key investment considerations when looking at DLTR’s stock.

|  |  |
| --- | --- |
|  | Figure  DLTR Lease Adjusted Return on Invested Capital and Stock Price |
|  |  |
| Note: Excludes goodwill and intangibles related to the Family Dollar acquisition. Source: Barclays Research |

The next page has comparable statistics for a variety of retailers, including the dollar stores.

|  |
| --- |
| Figure  Comparable Statistics for Various Formats Including Dollar Stores |
|  |
| Note: (1) Data are for Walmart US where available. (2) Assumes part-time wages of $8/hr and full-time at $12/hr. Annual part-time hours worked are 1,000 and annual full-time hours worked are 2,000.  Source: Company reports and Barclays Research estimates |

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating and an $88 price target. Our price target factors in our upside/downside scenario analysis. We use our FY18 estimates for valuation because this time horizon gives DLTR credit for achieving its synergy goals and paying down debt (since we always use forward net debt and share count for our valuations). We assume no further upside to synergies given the concerns we discuss. Our upside scenario on DLTR’s valuation reflects: 1) a benign competitive landscape for the next two years, and 2) that the company achieves its stated synergy goals. On this basis, we value DLTR at 10x our EBITDA estimate of $2.9 billion (versus the company’s 10 year historical average of 8x). We assign a 30% probability to this upside scenario given the 8 concerns we state. In this scenario, we value DLTR at $105. Our downside scenario reflects the likelihood that the competitive landscape intensifies and that incremental and unanticipated price investments dampen the synergy goals. Under this scenario (a 70% probability) our 8x multiple on FY18 EBITDA contemplates: 1) DLTR’s 10 year average valuation of 8x, and 2) lower consolidated ROIC. In this scenario – we see downside at the current level – at $80. The weighted average of these two scenarios gets us to our $88 price target – 10% upside and not compelling enough to warrant an Overweight rating given our view of the risks in achieving our FY18 estimates.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Dollar General Corporation (DG)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=DG) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 71.83 | | Price Target | USD 74.00 | | **Why Equal Weight?** Our price target reflects a higher than historical valuation multiple - so we assume some of the recent noise is transient, but given our belief that the competitive landscape will remain more challenging for the foreseeable future, we also believe more recent valuation multiples were too high. | | |  | | | Upside case | USD 85.00 | | Reflects: 1) a peak multiple based on historical valuation, 2) a multiple we would assign to a "Stable Staple", 3) a multiples at the high end of DG's historical ranges, 4) a normalized competitive environment, 5) improving ROIC, and 6) stronger comps. | | |  | | | Downside case | USD 66.00 | | Reflects: 1) a heightened competitive landscape, 2) recent peak multiples should not be viewed as the new "norm", 3) ROIC could decline going forward, 4) hard discounters could materially alter the competitive landscape especially for Dollar General and Family Dollar. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 20,369 | 22,074 | 23,508 | 25,445 | 7.7% |  |
| EBITDA (adj) | 2,299 | 2,480 | 2,610 | 2,812 | 7.0% |  |
| EBIT (adj) | 1,946 | 2,101 | 2,203 | 2,380 | 6.9% |  |
| Pre-tax income (adj) | 1,859 | 2,002 | 2,104 | 2,281 | 7.0% |  |
| Net income (adj) | 1,169 | 1,269 | 1,326 | 1,437 | 7.1% |  |
| EPS (adj) ($) | 3.96 | 4.50 | 4.90 | 5.55 | 11.9% |  |
| Diluted shares (mn) | 295.2 | 282.3 | 270.5 | 259.1 | -4.3% |  |
| DPS ($) | 0.88 | 1.00 | 1.08 | 1.17 | 9.8% |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 11.3 | 11.2 | 11.1 | 11.1 | 11.2 |  |
| EBIT (adj) margin (%) | 9.6 | 9.5 | 9.4 | 9.4 | 9.4 |  |
| Pre-tax (adj) margin (%) | 9.1 | 9.1 | 9.0 | 9.0 | 9.0 |  |
| Net (adj) margin (%) | 5.7 | 5.8 | 5.6 | 5.6 | 5.7 |  |
| ROIC (%) | 17.7 | 17.5 | 17.0 | 16.9 | 17.3 |  |
| ROE (%) | 21.1 | 23.2 | 23.6 | 25.0 | 23.2 |  |
| ROA (lease adjusted) (%) | 11.4 | 11.6 | 11.6 | 11.9 | 11.6 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 2,264 | 2,492 | 2,727 | 2,990 | 9.7% |  |
| Intangible fixed assets | 5,540 | 5,539 | 5,539 | 5,539 | 0.0% |  |
| Cash and equivalents | 158 | 327 | 139 | 19 | -50.5% |  |
| Total assets | 11,258 | 11,953 | 12,234 | 12,692 | 4.1% |  |
| Short and long-term debt | 2,971 | 3,218 | 3,218 | 3,218 | 2.7% |  |
| Total liabilities | 5,880 | 6,373 | 6,578 | 6,854 | 5.2% |  |
| Net debt/(funds) | 2,813 | 2,891 | 3,079 | 3,199 | 4.4% |  |
| Shareholders' equity | 5,378 | 5,580 | 5,656 | 5,837 | 2.8% |  |
| Change in working capital | -184 | -66 | -29 | -39 | N/A |  |
| Cash flow from operations | 1,378 | 1,630 | 1,746 | 1,877 | 10.9% |  |
| Capital expenditure | 505 | 603 | 642 | 695 | 11.2% |  |
| Free cash flow | 871 | 1,018 | 1,104 | 1,182 | 10.7% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 18.1 | 16.0 | 14.7 | 13.0 | 15.4 |  |
| EV/EBITDA (adj) (x) | 10.1 | 9.4 | 9.0 | 8.4 | 9.2 |  |
| Equity FCF yield (%) | 4.1 | 5.0 | 5.7 | 6.4 | 5.3 |  |
| P/Sales (x) | 1.0 | 0.9 | 0.9 | 0.8 | 0.9 |  |
| P/BV (x) | 3.9 | 3.6 | 3.4 | 3.2 | 3.6 |  |
| Dividend yield (%) | 1.2 | 1.4 | 1.5 | 1.6 | 1.4 |  |
| Adj debt/EBITDAR (x) | 3.1 | 3.0 | 3.1 | 3.1 | 3.1 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 2.8 | 1.2 | 2.0 | 2.5 | 2.1 |  |
| Square footage growth (%) | 6.0 | 7.1 | 7.7 | 7.1 | 7.0 |  |
| Inventory growth (%) | 10.5 | 9.1 | 6.5 | 8.2 | 8.6 |  |
| Capex/sales (%) | 2.5 | 2.7 | 2.7 | 2.7 | 2.7 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

dollar general

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Dollar General Corporation(DG): Quarterly and Annual EPS (USD)   |  | | --- | | DG | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 74.00 | | Price (19-Sep-2016) | | USD 71.83 | | Potential Upside/Downside | | +3.0% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.84A | N/A | 1.03A | 1.03A | N/A | N/A | 1.09E | 23% | N/A |
| Q2 | 0.95A | N/A | 1.08A | 1.08A | N/A | N/A | 1.19E | 14% | N/A |
| Q3 | 0.88A | N/A | 0.94E | 0.94E | N/A | N/A | 1.05E | 7% | N/A |
| Q4 | 1.30A | N/A | 1.46E | 1.47E | N/A | N/A | 1.58E | 12% | N/A |
| Year | 3.96A | N/A | 4.50E | 4.51E | N/A | 4.90E | 4.93E | 14% | 9% |
| P/E | 18.1 |  | 16.0 |  |  | 14.7 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

A Disruptor Experiencing Some Disruption

Challenging environment likely to persist, valuation not compelling enough to recommend; initiate with an Equal Weight and a $74 price target

Prior to the company’s 2Q results on August 25, we viewed DG as a higher growth Stable Staple – deserving of a low double-digit EV/EBITDA multiple – given its remarkable consistency in comps, positive traffic, respectable unit growth and EBITDA/EPS growth, strong ROIC (albeit declining recently), leverage, and respectable free cash flow and dividend yields. However, despite the 21.7% decline in the stock price over the last four weeks vs. the S&P 500 at -1.7% (and only 540 bp of underperformance YTD vs. the S&P), we are initiating with an Equal Weight rating and a $74 price target because we believe DG is In Transition and the next several quarters could be very challenging. We factor the following into our recommendation:

1. DG’s customer is experiencing some headwinds including

* Reduced SNAP benefits,
* Rising housing costs, and
* Increasing healthcare costs

We believe these headwinds will pressure results.

1. In addition, we believe the competitive landscape has deteriorated and the more challenging environment will persist longer than it has historically even if deflation abates. As a result, we believe comps may be slower to recover with price investments versus the trajectory (and recovery) the company has historically experienced using a similar playbook. Said differently, given that industry dynamics have only very recently changed, we believe past playbooks may not resonate as quickly as they have in the past – and may require more widespread price reductions versus historical. Heightened competition, in our view, consists of:

* The resurgence of Walmart
* A more competitive Family Dollar
* Aldi
* Lidl and Wegmans in the Southeast

1. In our view, in the near term this means: 1) comps may be lumpy and sometimes negative, 2) traffic comps could remain weak or negative for an extended period of time, 3) generating consistent EPS and EBITDA growth may also be more challenging, and lastly, 4) we believe ROIC – albeit at industry leading levels – could further deteriorate.
2. While stock performance has not had a correlation with ROIC – given the slowing top line, we believe ROIC will become a much greater determinant of stock performance going forward, and ROIC has been deteriorating recently, and we believe this trend might continue.

As such, we believe DG is in a “Transition” phase until comps recover and the competitive landscape normalizes.

Equal Weight rating based on upside/downside scenario analysis

With this in mind, given that the change in the landscape is only very recent, we think it is only prudent to stay the course on unit growth and price investments for now but since we believe competitive headwinds are likely to persist for the intermediate term, we see downside to $66 (-8%) - or 8.0x our FY17 EBITDA and we assign an 60% probability to this scenario. In the event the current environment is only transitory, we see upside to $85 (a 40% probability and 18% upside) or 10x our FY17 EBITDA. The weighted average of these two scenarios gets us to our Equal Weight rating and a $74 price target. We would re-evaluate our rating if ROIC were to stabilize and/or if comps were to re-accelerate.

|  |
| --- |
| Figure  DG Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

Summary of financials

Below we highlight our estimates vs. Consensus.

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

Price target and current valuation

Below we highlight our price target and current valuation.

|  |  |  |
| --- | --- | --- |
| Figure  DG Price Target Valuation |  | Figure  DG Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Free cash flow

We expect increasing free cash flow from FY16-FY18 driven by EBITDA gains.

|  |  |
| --- | --- |
|  | Figure  DG Free Cash Flow |
|  |  |
| Source: Barclays Research |

Stock price performance YTD

The following figures show DG’s absolute and relative YTD stock price performance. The stock is flat YTD compared to the S&P 500, which is up 4.7%. The stock fell 17.8% on August 25 (vs. the S&P 500 at -0.7%) when it reported 2Q16 results. While EPS only missed by a $0.01 and the company maintained its long-term earnings algorithm targets for 2016, investors were surprised by the weaker than expected comp and negative traffic trends. Traffic turned negative for the first time since 4Q07.

|  |  |  |
| --- | --- | --- |
| Figure  DG Stock Price |  | Figure  DG Indexed Stock Price |
|  |  |  |
| Source: Thomson Reuters, Barclays Research |  | Source: Thomson Reuters, Barclays Research |

While history is frequently irrelevant when considering future valuation, DG’s historical P/E has averaged 15.5x, while it’s EV/EBITDA has averaged 9.1x. More recently, the stock reached multiples as high as 20x and 11 on P/E and EV/EBITDA respectively. Despite the recent stock price decline and multiple contraction, we don’t believe DG’s valuation is necessarily “cheap” on EV/EBITDA – especially when we consider the headwinds we believe the company will face going forward.

|  |  |  |
| --- | --- | --- |
| Figure  DG Forward P/E Ratio |  | Figure  DG Forward EV/EBITDA |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

1. Consumers on tight budgets are facing numerous headwinds

Fewer households receiving SNAP, and the monthly benefit is declining

The 2009 Recovery Act suspended SNAP’s (Supplemental Nutrition Assistance Program, formerly known as food stamps) work requirement time limit for childless adults. Under this work requirement, childless adults aged 18-50 are entitled to three months of SNAP benefits in any 36-month period when they aren’t employed or in a work or training program for at least 20 hours a week. The suspension of the work requirement and more individuals qualifying for benefits let to a substantial increase in SNAP utilization starting in 2009. From 2009 to 2013, the number of households utilizing food stamps increased by ~30%. Rates began falling in 2013 as many states began reinstating work requirements for childless adults aged 18-50. Even with these reductions, ~15% of the US population and nearly 20% of households received SNAP benefits as of March 2016.

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| --- | --- | --- |
| Figure  Number of Households Receiving SNAP |  | Figure  Y/Y Change in the Number of Households Receiving SNAP |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

Since peaking in November 2012, the average monthly benefit per person has declined by 8% to $124.89 and the average monthly benefit per household has declined by nearly 10% to $253.98.

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| --- | --- | --- |
| Figure  SNAP – Average Monthly Benefit Per Person |  | Figure  SNAP – Average Monthly Benefit Per Household |
|  |  |  |
| Source: USDA Food and Nutrition Service and Barclays Research |  | Source: USDA Food and Nutrition Service and Barclays Research |

This year, 22 states re-imposed the time limit on work requirements for childless adults aged 18-50. , and in most of these states the time limit took effect in January 2016. The map below identifies the relevant states. Many of the states are in the southeast, the densest market of DG’s stores. Overall, these changes will impact states comprising 56% of its store base. For the states that started the time limit in January 2016, those no longer eligible stopped receiving benefits in April (three months later).

|  |  |
| --- | --- |
|  | Figure  States Newly Implementing SNAP Time Limits In 2016 |
|  |  |
| Note: Blue states are those that had a statewide waiver of the time limit for childless adults aged 18-49 without disabilities in 2015, but are implementing the time limit in some or all of the state beginning January 2016. The other states either began implementing the time limit in 2015 or earlier, or are eligible for and will waive the entire state from the time limit in 2016. Source: Center on Budget and Policy Priorities and Barclays Research |

The impact of fewer individuals receiving SNAP had a significant impact to DG in its 2Q16. CEO Todd Vasos commented on the 2Q16 earnings conference call that, “When we look at it, the headwind of SNAP for us really was a big deal.” The company estimates that this, along with deflation, was a 60-70 bp headwind to the comp in the quarter.

Housing costs may be pressuring the budget of low income earners

The bottom 40% of income earners spends approximately 40% of their income on housing according to consumer expenditure data from the BLS. This includes mortgage or rent, utilities, and household supplies and furnishings. It should be noted that the table below shows dollars as a percentage of *expenditures* and not *income*. For consumers in this income bracket, expenditures exceed total income, on average. Spending above total income is possible as individuals borrow or rely on savings. Some may also underreport total income. Given this dynamic, even small changes in total housing costs can have a substantial impact on the welfare of these consumers. According to this survey, the percentage of expenditures spent on housing has shown an inconsistent trend in recent years but the dollars have increased meaningfully between 2013 and 2015. Data is not yet available for 2016.

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| --- |
| Figure  Consumer Expenditures for Bottom 40% of Income Earners |
|  |
| Source: Consumer Expenditure Survey, BLS |

Wage increases of lower income individuals have lagged the overall rise in housing costs over the past few years according to the housing component of the Consumer Price Index (CPI). More recently, however, lower income individuals earning full time wages may have gained some ground vs. housing, while those working part time have fallen further behind. We realize the limitations of the housing CPI as a national proxy since it is for urban consumers and many DG stores (and customers) are in rural areas. Nevertheless, we think the analysis is representative enough to show what is likely a larger trend.

|  |  |  |
| --- | --- | --- |
| Figure  CPI - Housing vs. Wage Growth: 1Q11-2Q16 |  | Figure  CPI - Housing vs. Wage Growth : 1Q15-2Q16 |
|  |  |  |
| Source: BLS |  | Source: BLS |

Healthcare costs have been rising quickly in recent years

In the figure above, it is clear that an increasing percentage of low income earners expenditures have been going towards healthcare. From 2012-2015, healthcare increased from 8.1% to 9.0% of expenditures.

It is not clear to us if the Affordable Care Act (ACA) has led to budget pressures for those on a limited income. The purchase of insurance may have resulted in lower total medical spending if the coverage was utilized but we believe many individuals qualify for Medicaid and so are not required to purchase insurance. Also, some have cited the penalty associated with not purchasing insurance as a headwind. This has likely not had a significant impact on incomes or purchasing since there is little recourse for the government to collect the penalty. The IRS can only collect for the penalty when an income tax refund is due and there are no civil or criminal penalties for not paying the fine. If an individual or household does not have a refund in a given year and chooses not to pay a fine, the fines will be collected in a subsequent year when a refund is due. Any adverse impact to low income earners stemming from the ACA is hard to determine but we do not believe it has necessarily been meaningfully negative because it seems likely that a high percentage of DG’s customer base doesn’t file a tax return – so no penalty is incurred for not having insurance. Having said that – it is possible – subconsciously – the potential for a penalty as an expense could weigh on behaviour. The next figure explains how the Affordable Care Act impacts various income demographics.

|  |
| --- |
| Figure  The Requirement to Buy Coverage Under the Affordable Care Act 2015 and Beyond |
|  |
| Source: The Kaiser Family Foundation and Barclays Research |

1. Competitive landscape has deteriorated and will lead to comp pressure

Stronger sales at Walmart may pressure DG’s comps

As discussed in our Walmart initiation report, Walmart US has made significant changes to its business practices and it is now also investing in price. These actions have been recognized by consumers, leading to gains in its traffic and comps. In recent years as Walmart’s comps have stagnated, and DG likely benefited slightly. Similarly, given the size of Walmart, even small comp gains may put considerable pressure on DG as the two businesses serve many of the same customers and are often geographically close in proximity. In the table below, we estimate that Walmart’s US comps may pressure DG’s comps by 60-100+ bps assuming only moderate strain rates.

|  |  |
| --- | --- |
|  | Figure  Estimated Impact to DG Comps from an Increase/(Decrease) in Walmart US Comps |
|  |  |
| Source: Barclays Research |

Rebound at Family Dollar may also hurt DG’s results

For many years DG was competing against a weak direct competitor. Prior to its acquisition by Dollar Tree (DLTR), Family Dollar had flat to slightly negative comps for nearly two years. It also closed 5% of its store base in the summer of 2014 and new unit openings dwindled. Since the company’s acquisition by Dollar Tree (DLTR) on July 6, 2015, DLTR has focused on improving the results at the retailer, starting with better in store standards. DLTR believes that Family Dollar strayed too far from everyday low prices, and it is now in the process of evolving the price architecture at the brand. While not necessary, DLTR has the opportunity to invest into this, should it chose to, given the $300+ million in synergies that the transaction is expected to generate. Most of these synergies are from procurement and some are already being realized. In addition, there are opportunities at Family Dollar for much stronger execution and merchandising – for example, being “first of the month ready” with the right product. As can be seen in the figures below, there is considerable geographic overlap between DG and Family Dollar. We believe that growing strength at Family Dollar will ultimately pressure the results at DG.

|  |  |  |
| --- | --- | --- |
| Figure  DG Regional Store Distribution |  | Figure  Family Dollar Regional Store Distribution |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

Aldi expansion should not be underestimated

European discount grocer Aldi plans to invest billions of dollars in the US and to operate nearly 2,000 stores by the end of 2018, nearly a 30% increase from today. Aldi is a small format, convenient grocery store, with low prices due to its efficient model and extreme use of private label – nearly all products in the store are private label. While the format attracts shoppers from across the economic spectrum, it tends to attract lower income shoppers. Unlike dollar stores, however, customers can do a “full” food shop at Aldi whereas they can only do a “fill in” shop at the dollar stores given their limited assortment of food products; most notably, their absence of fresh meats and produce. Aldi has a very credible fresh offering spanning produce, meat, and dairy. Fresh meat and produce are not available at DG and there is a limited supply of dairy products. DG is currently testing a limited set of basic produce items in some of its traditional stores but it will likely never have an extensive selection nor fresh meat. As Aldi continues to open more stores and new customers are introduced to the concept, we think the price/value equation will resonate with many core dollar store customers.

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| --- | --- |
|  | Figure  Aldi Regional Store Distribution |
|  |  |
| Source: Aggdata and Barclays Research |

Lidl and Wegmans expansion in the Southeast will also pressure results

The competitive landscape in the southeast has been fairly benign, in our view. We expect this will change in the next few years driven by the growth of Lidl and southern expansion by Wegmans. The Germany based global discount chain Lidl has indicated that it is pursuing sites from Pennsylvania and New Jersey down to Georgia. The company has already constructed or has construction in progress on multiple regional distribution centers that will serve these markets. Lidl’s stated goal is to open its first stores in the U.S. no later than 2018. Our review of the company’s website indicated 12 store management positions open throughout the Southeast, Mid-Atlantic, and into the Northeast. Similar to Aldi, the stores are known for their low prices and no frills shopping experience, however, Lidl’s stores have a higher mix of apparel and general merchandise (versus Aldi), so we believe Lidl will prove to be a formidable competitor to Dollar General and other consumable and non-consumable retailers in its markets.

Wegmans is a very different type of retail competitor than Lidl but we rank them as one of the strongest in the food and consumables space. Press reports indicate that the company had been negotiating leases to open stores in North Carolina – specifically Cary - an indication that the company is continuing to expand south from its Northeast roots. While we don’t expect Wegmans to have a direct impact on Dollar General, we expect the ripple effects will. Supermarkets competing with the newly opened Wegmans will experience substantial sales declines, in our view. We note that the average Wegmans store does between $85-$90 million in sales annually. When a Wegmans opens in a given geography, we expect supermarket and other food competitors will be aggressive to maintain their market share. The increase in competitive intensity, in turn, could pressure Dollar General’s results indirectly.

1. We forecast comps to be volatile and eventually rebound but ROIC and profit growth will be pressured

Comps will likely remain weak in the near term due to various factors

DG reported comps of 0.7% for its 2Q16, well below the prior quarter at 2.2% and expectations above 2.0%. In addition, traffic turned negative for the first time since 4Q07 when the company reported total comps of +0.4% (negative traffic, slightly offset by a positive basket). The company cited a variety of factors for the weak comp including food deflation, a reduction in both SNAP participation rates and benefit levels, unseasonably mild spring weather, and a more competitive environment in regions of the country. DG sized the negative impact of deflation and SNAP at 60-70 bp. It believes that a weaker consumer was another 50-60 bp based on Nielsen panel data; this data shows that consumers feel worse today than just a few months ago. Lastly, the company sized the impact of competition on the comp at just 10 bp.

In response to the decline in SNAP participation rates and benefit levels as well as the competitive environment, the company will invest in price to maintain its comp and market share growth. DG is responding similarly to when SNAP benefits were cut in 2013 with price investments in key items of importance to its customer. This includes items in food, paper, cleaning supplies, laundry, and pet. The last time this was done, it took a few quarters for sales to strengthen and the company is currently less than two months into this process. It should be noted however, these investments were made (and customers reacted favourably) in a period when Walmart was starting to struggle (Walmart U.S. comps turned negative in 1Q14). Today, Walmart is regaining momentum and we believe the 2013 playbook might not have the same positive reaction today. It should also be noted, these investments were made in less than 20% of the store base and we believe the company is in the process of determining if the investments should be expanded to additional stores. If price investments are further expanded – we assume this would bring EPS growth down to the low end of the company’s guidance range. Consensus is currently at the high end of the range.

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| --- | --- |
|  | Figure  Barclays’ DG Comp Forecast |
|  |  |
| Source: Barclays Research |

EBITDA and EPS Projections

We expect EBITDA and EPS growth of 7.9% and 13.6%, respectively, in FY16. After adjusting an extra week this year, EBITDA growth is closer to 5.0% and EPS is at ~11.3%. We expect profit growth will slow next year, as we see the current difficult environment lasting into 2017, and the company will then also have a difficult comparison due to the extra week in 2016. If the environment normalizes, the business should grow at a more normalized rate in FY18. This is predicated on its price investments gaining traction, its new stores maturing at historical rates, moderate food inflation, and the competitive environment becoming more rational.

|  |  |  |
| --- | --- | --- |
| Figure  Barclays’ EBITDA Forecast |  | Figure  Barclays’ EPS Forecast |
|  |  |  |
| Note: Not adjusted for extra week in FY16 Source: Barclays Research |  | Note: Not adjusted for extra week in FY16 Source: Barclays Research |

ROIC will decline year-over-year in FY17 and FY18

We forecast that DG’s return on lease adjusted invested capital will decline over the next few years due to a variety of factors. Profitability will be pressured as the company invests in price in response to the recent changes to SNAP, deflation, and more aggressive competition. The company is also accelerating square footage growth in FY17, opening 100 more stores next year than in FY16. Even though stores mature quickly, we expect this will weigh on the firm’s ROIC. Lastly, the company will be adding two new distribution centers, one in Janesville, Wisconsin and another in Jackson, Georgia.

|  |  |
| --- | --- |
|  | Figure  DG Lease Adjusted Return on Invested Capital Excluding Goodwill and Amortization |
|  |  |
| Note: Excludes goodwill and amortization related to going private transaction. Source: Barclays Research |

Stock price has shown no correlation with ROIC but this may change

DG’s stock price has shown no correlation with its ROIC – this is unusual for our coverage. We believe among the reasons for this is the company’s EV/EBITDA multiple was increasing off of a low base and had been converging closer to other Staples given its ROIC and growth profile. Now that this gap has been narrowed, and top line growth is slowing, ROIC becomes more important, so we think the stock is more likely to trade in line with the trend in its ROIC.

|  |  |
| --- | --- |
|  | Figure  DG Return on Lease Adjusted Invested Capital and Stock Price |
|  |  |
| Note: ROIC excludes goodwill and amortization related to going private transaction. Source: Barclays Research |

Stock priced appropriately given our outlook

Return and growth characteristics impressive relative to peer set

DG has higher lease adjusted ROIC than both “staple-type” companies in our coverage and large market capitalization Staples. At its current CY17 EV/EBITDA multiple and FCF yield, the stock trades at a discount to both “staple-type” companies in our coverage and large market capitalization staples. The dividend yield is well below both cohorts, however.

While some may think this may make the stock attractive, we believe the stock should trade at a discount to the Stable Staples given the decline in traffic last quarter and the imminent changes to the competitive landscape. Also, as is discussed further below, we expect deteriorating ROIC in FY17 and FY18. Meanwhile, the stock is currently trading at its average NTM EV/EBITDA despite our expectation for volatility in the near-term.

|  |
| --- |
| Figure  DG vs. Staples and “Staple-Type” Companies in Our Coverage Comp Table |
|  |
| Source: Barclays Research estimates |

Valuation has risen over time despite deceleration in comps

DG’s NTM EV/EBITDA valuation expanded over time as its earnings grew and more investors looked at the company as a Stable Staple. This was despite the fact that comps had been slowing as the company lapped many merchandising initiatives, including expanding the number of freezers and coolers in stores – an initiative that still continues. DG is currently trading at a NTM EV/EBITDA of ~9.0x, in line with its average despite our expectation for comp and earnings volatility in the near-term.

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| --- | --- |
|  | Figure  DG Forward EV/EBITDA and Comps |
|  |  |
| Source: Barclays Research |

Free cash flow yield is slightly above average

DG’s current free cash flow yield is currently at ~5.0%. this is slightly above its long-term average at 4.5% but well below where it has peaked at ~6.0%.

|  |  |
| --- | --- |
|  | Figure  DG Free Cash Flow Yield |
|  |  |
| Source: Barclays Research |

The next page has comparable statistics for a variety of retailers, including the dollar stores.

|  |
| --- |
| Figure  Comparable Statistics for Various Formats Including Dollar Stores |
|  |
| Note: (1) Data are for Walmart US where available. (2) Assumes part-time wages of $8/hr and full-time at $12/hr. Annual part-time hours worked are 1,000 and annual full-time hours worked are 2,000.  Source: Company reports and Barclays Research estimates |

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating and a $74 price target. Our price target factors in our upside/downside scenario analysis. We recommendation reflects the fact that the change in the landscape is only very recent, so we believe it is only prudent to stay the course on unit growth and price investments for now but since we believe competitive headwinds are likely to persist for the intermediate term, we see downside to $66 (-8%) - or 8.0x our FY17 EBITDA of $2.6 billion and we assign an 60% probability to this scenario. In the event the current environment is only transitory, we see upside to $85 (a 40% probability and 18% upside) or 10x our FY17 EBITDA. The weighted average of these two scenarios gets us to our Equal Weight rating and a $74 price target. We would re-evaluate our rating if ROIC were to stabilize and/or if comps were to re-accelerate

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| U.S. Food & Staples Retailing | | | | | | | Industry View: NEUTRAL |
| [Five Below Inc (FIVE)](https://live.barcap.com/go/BC/composite/GER_COMPANY?ticker=FIVE) | | | | | | | Stock Rating: EQUAL WEIGHT |
|  | | | | | | | |
| Income statement ($mn) | 2015A | 2016E | 2017E | 2018E | CAGR |  | |  |  | | --- | --- | | Price (19-Sep-2016) | USD 40.38 | | Price Target | USD 42.00 | | **Why Equal Weight?** Reflects: 1) Steady comps and some benefit from the company's awareness efforts, 2) store growth maintained at ~20%, 3) 2,000 store growth target viewed as achievable, 4) business remains seasonal, and 5) ROIC is maintained. | | |  | | | Upside case | USD 49.00 | | Reflects: 1) Strong merchandising and growing customer awareness lead to acceleration in comps, 2) store growth maintained at ~20% annually, 3) belief that the company can meet or exceed its 2,000 store target, 4) less seasonality, and 5) improving ROIC. | | |  | | | Downside case | USD 35.00 | | Reflects: 1) Company doesn't execute on trends and customer awareness efforts are unsuccessful result in weak comps, 2) store growth slows materially, 3) investors do not believe the 2,000+ store target is achievable, 4) business remains seasonal, and 5) ROIC deteriorates. | | |  | | | Upside/Downside scenarios | | |  | | |
| Revenue | 832 | 1,005 | 1,222 | 1,480 | 21.2% |  |
| EBITDA (adj) | 115 | 143 | 176 | 219 | 23.9% |  |
| EBIT (adj) | 93 | 117 | 144 | 179 | 24.4% |  |
| Pre-tax income (adj) | 93 | 117 | 144 | 179 | 24.5% |  |
| Net income (adj) | 58 | 73 | 90 | 112 | 24.7% |  |
| EPS (adj) ($) | 1.05 | 1.32 | 1.60 | 1.95 | 22.9% |  |
| Diluted shares (mn) | 54.8 | 55.3 | 56.2 | 57.3 | 1.5% |  |
| DPS ($) | 0.00 | 0.00 | 0.00 | 0.00 | N/A |  |
|  | | | | | |  |
| Margin and return data | | | | | Average |  |
| EBITDA (adj) margin (%) | 13.8 | 14.3 | 14.4 | 14.8 | 14.3 |  |
| EBIT (adj) margin (%) | 11.2 | 11.6 | 11.7 | 12.1 | 11.7 |  |
| Pre-tax (adj) margin (%) | 11.1 | 11.6 | 11.7 | 12.1 | 11.6 |  |
| Net (adj) margin (%) | 6.9 | 7.2 | 7.3 | 7.6 | 7.3 |  |
| ROIC (%) | 14.6 | 14.8 | 15.5 | 15.9 | 15.2 |  |
| ROE (%) | 27.5 | 25.3 | 23.5 | 22.7 | 24.8 |  |
| ROA (lease adjusted) (%) | 12.0 | 11.7 | 11.6 | 11.5 | 11.7 |  |
|  | | | | | |  |
| Balance sheet and cash flow ($mn) | | | | | CAGR |  |
| Tangible fixed assets | 120 | 136 | 155 | 175 | 13.4% |  |
| Intangible fixed assets | 9 | 0 | 0 | 0 | -100.0% |  |
| Cash and equivalents | 53 | 147 | 223 | 321 | 82.2% |  |
| Total assets | 393 | 512 | 650 | 818 | 27.6% |  |
| Short and long-term debt | 0 | 0 | 0 | 0 | N/A |  |
| Total liabilities | 149 | 180 | 219 | 265 | 21.2% |  |
| Net debt/(funds) | -53 | -147 | -223 | -321 | N/A |  |
| Shareholders' equity | 244 | 332 | 431 | 553 | 31.3% |  |
| Change in working capital | -3 | 3 | -4 | -5 | N/A |  |
| Cash flow from operations | 88 | 114 | 128 | 157 | 21.4% |  |
| Capital expenditure | -53 | -40 | -52 | -59 | N/A |  |
| Free cash flow | 35 | 74 | 79 | 100 | 41.3% |  |
|  | | | | | |  |
| Valuation and leverage metrics | | | | | Average |  |
| P/E (adj) (x) | 38.3 | 30.6 | 25.3 | 20.7 | 28.7 |  |
| EV/EBITDA (adj) (x) | 18.9 | 14.5 | 11.3 | 8.7 | 13.3 |  |
| Equity FCF yield (%) | 1.6 | 3.3 | 3.5 | 4.3 | 3.2 |  |
| P/Sales (x) | 2.7 | 2.2 | 1.8 | 1.5 | 2.1 |  |
| P/BV (x) | 9.1 | 6.7 | 5.3 | 4.2 | 6.3 |  |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |  |
| Adj debt/EBITDAR (x) | 2.6 | 2.2 | 2.0 | 1.8 | 2.2 |  |
|  | | | | | |  |
| Selected operating metrics | | | | | Average |  |
| Same store sales growth (%) | 3.4 | 3.0 | 3.0 | 3.0 | 3.1 |  |
| Square footage growth (%) | 19.4 | 19.5 | 19.2 | 18.5 | 19.1 |  |
| Inventory growth (%) | 28.3 | 20.8 | 21.6 | 21.1 | 22.9 |  |
| Capex/sales (%) | 6.4 | 4.0 | 4.3 | 4.0 | 4.7 |  |
|  | | | | | | | |
| Source: Company data, Barclays Research Note: FY End Jan | | | | | | | |

five below

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Five Below, Inc.(FIVE): Quarterly and Annual EPS (USD)   |  | | --- | | FIVE | | Stock Rating | | EQUAL WEIGHT | | Industry View | | NEUTRAL | | Price Target | | USD 42.00 | | Price (19-Sep-2016) | | USD 40.38 | | Potential Upside/Downside | | +4.0% | | | | | | | | | | |
|  | 2015 | 2016 | | | 2017 | | | Change y/y | |
| FY Jan | Actual | Old | New | Cons | Old | New | Cons | 2016 | 2017 |
| Q1 | 0.08A | N/A | 0.12A | 0.12A | N/A | N/A | 0.15E | 50% | N/A |
| Q2 | 0.13A | N/A | 0.18A | 0.17E | N/A | N/A | 0.21E | 38% | N/A |
| Q3 | 0.08A | N/A | 0.10E | 0.10E | N/A | N/A | 0.12E | 25% | N/A |
| Q4 | 0.77A | N/A | 0.91E | 0.92E | N/A | N/A | 1.13E | 18% | N/A |
| Year | 1.05A | N/A | 1.32E | 1.31E | N/A | 1.60E | 1.61E | 26% | 21% |
| P/E | 38.3 |  | 30.6 |  |  | 25.3 |  |  |  |
| Source: Barclays Research.Consensus numbers are from Thomson Reuters | | | | | | | | | |

Bargain Merchandise but Not a Bargain Stock

Dynamic concept with robust unit growth and strong unit economics but a full valuation; initiate at Equal Weight with a $42 price target

We view FIVE as a Growth Star given its impressive ~20% annual unit expansion, even faster EBITDA growth, solid ROIC, and strong balance sheet. As the company continues to grow, we believe its product value will improve, which will boost transactions and perhaps average ticket. Given the diversity of merchandise in stores and customer’s expectations, we believe the company will always be able to find merchandise that resonates with customers in a “treasure hunt” environment. FIVE started out in the Northeast but years of rapid expansion across the country into new markets – and the success of these stores –prove the concept is portable and works in other markets.

In our view, the company has a formula that works and so it should stick to its core competencies and remain disciplined. It needs to actively push through old boundaries and seek new relationships in sourcing product. Meanwhile, the company must maintain discipline as it continues to expand into new markets and increases its presence in existing ones. FIVE has managed its rapid growth well but compounding at a ~20% annual growth is not sustainable long-term. That said, we believe this growth rate can be sustained for many years.

As a result, we are initiating at an Equal Weight rating and factor the following into our recommendation:

1. FIVE stores have industry leading returns.
2. Rapid unit growth drives scale and – in turn – procurement opportunities, which will lead to the company offering better values to customers.
3. FIVE is an underappreciated growth story by some, and we believe it can achieve its 2,000+ store target.
4. Breadth of “category worlds” insulates the business from changing trends but the retailer will be very seasonal for the foreseeable future.
5. The company is insulated from internet retailing competition.
6. The current valuation seems appropriate given the company’s growth and returns.

Equal Weight rating based on upside/downside scenario analysis

We think that FIVE is doing everything that it should be doing given its opportunity set and the environment. Our price target values FIVE at 12.2x our FY17 EBITDA. If comps were to weaken or store growth were to slow, we see downside to $35 (13%) – or 10.0x our FY17 EBITDA. We place a 50% probability on this scenario. If business momentum accelerates and the company’s valuation expands, we see upside to $49 – or 14.5x our CY17 EBITDA – with a 50% probability. The weighted average gets us to our $42 price target.

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| --- |
| Figure  FIVE Valuation Snapshot |
|  |
| Source: Company Reports, Barclays Research |

|  |  |
| --- | --- |
|  | Figure  Barclays Estimates vs. Consensus |
|  |  |
| Source: Barclays Estimates, ConsensusMetrix |

|  |  |  |
| --- | --- | --- |
| Figure  FIVE Price Target Valuation |  | Figure  FIVE Current Valuation |
|  |  |  |
| Source: Barclays Research |  | Source: Barclays Research |

|  |  |
| --- | --- |
|  | Figure  FIVE Free Cash Flow |
|  |  |
| Source: Barclays Research |

1. FIVE stores have industry leading returns

FIVE’s new stores generate sales of $1.9-$2.0 million in their first full year of operations and EBITDA of ~$0.5 million (~25% margin). The average cash investment is approximately $0.3 million, including store build-out net of tenant allowances, inventory net of payables, and cash pre-opening expenses. As such, the cash payback on a new store is less than one year – very compelling in our view. The low capital requirement for stores and quick payback have allowed the company to self fund its rapid 20% annual growth without needing to access the capital markets.

|  |  |
| --- | --- |
|  | Figure  FIVE Stores – 2007 to 2016E |
|  |  |
| Source: Company reports and Barclays estimates |

The company’s strong year 1 sales and EBITDA are due, in part, to the company’s store opening and clustering strategies. FIVE will open multiple stores at the same time in a new market. This helps the company leverage marketing and events around the new openings to increase awareness. Given this strategy stores in new markets hit mature levels of productivity in their first year. From a returns standpoint, this is ideal. A consequence of this is that comps don’t follow a traditional waterfall, with strong comps in a store’s early years before normalizing towards a mature level.

|  |  |
| --- | --- |
|  | Figure  New Store Productivity |
|  |  |
| Source: Company reports and Barclays Research estimates |

1. Rapid growth drives scale and procurement opportunities

Sales at FIVE have grown at a 35% CAGR from 2007-2016E. FIVE leverages its growing scale to demand better pricing or improved product quality. With sales on track to cross the ~$1 billion threshold this year, the company is now able to have discussions with more vendors that previously didn’t do business with it because of its size. Once a relationship with a vendor is established, FIVE is often in a position of strength as it’s often one of the vendor’s fastest growing retail partners. FIVE reinvests procurement savings back into its product, offering customers more value. As such, we do not expect to see an improvement in the merchandise margin despite its growing scale. That said, the operating margin may benefit if the company can generate fixed cost leverage on low to mid single-digit comps.

|  |  |
| --- | --- |
|  | Figure  FIVE Sales – 2007 to 2016E |
|  |  |
| Source: Company reports and Barclays Research estimates |

As the company has grown, not only has it become a more significant buyer but also a more sophisticated one. It now purchases more product internationally and it can get the product to the US efficiently as it consolidates its containers overseas – a process that was started in recent years. With more product coming directly from overseas and FIVE relying less on domestic sourcing agents, we believe product value has improved. A consequence of this evolution in sourcing is that inventories have been steadily rising – a common theme stated by those not constructive on the name and a source of concern to some given the stock’s 13% short interest. This is due to more freight being in transit as ownership of the product is taken overseas. We would note the company does very little pack-a-way; what it does pack-a-way are items that change very little from year to year. Given the company’s rapid unit growth, slow moving merchandise can be deployed into one of its many new stores at a bargain and can be quickly sold through.

|  |  |
| --- | --- |
|  | Figure  Product Sourced by Domestic Vendors |
|  |  |
| Source: Company reports |

1. FIVE is an underappreciated growth story by some, and we believe it can achieve its 2,000+ store target

FIVE has stated its potential is more than 2,000 stores over time. Some investors, however, do not think FIVE can get to this number. To have a view on this we investigated zip code data for each of FIVE’s 500+ stores. In Pennsylvania – the company’s second densest state in terms of store count but the market where it has had operations the longest – FIVE has 60 stores with an average population per store in a given zip code of ~28,000. This compares to 177 zip codes in the state with more than 28,000 residents. We identified more than 3,300 zip codes nationally that have populations over ~28,000 without a FIVE store. It doesn’t seem unreasonable to us that FIVE can open a store in perhaps a third of these or more, and as a new concept, we expect FIVE will continue to increase its density in Pennsylvania. Also, we should also point out that more than 20% of FIVE’s store base are in zip codes with populations of less than 20,000 people. These stores presumably pull shoppers from larger adjacent markets or are very unique in their markets. We admit there are limitations to this analysis given the varying geographic size and characteristics of adjacent markets. That said it is sufficient enough to us to suggest there is indeed a 2,000 domestic store opportunity and it may be larger.

|  |  |
| --- | --- |
|  | Figure  FIVE Domestic Store Potential |
|  |  |
| Source: Aggdata and Barclays Research |

1. Breadth of “category worlds” insulates the business from changing trends but the retailer will be very seasonal for the foreseeable future

FIVE stores have eight category worlds: Style, Room, Sports, Tech, Crafts, Party, Candy, and Now. About 50% of products are characterized as leisure products – ranging from sporting goods, games, toys, tech, books, electronic accessories, and arts and crafts. Approximately 30% is considered fashion and home, which includes items such as personal accessories, t-shirts, beauty, home goods and storage. Party and snack are the remaining 20% and these include party and seasonal goods, greeting cards, candy and other snacks, and beverages.

The breadth of category worlds allows the company to be flexible in its assortment and also smoothes volatility as some categories may be outperforming and others underperforming. This has led to positive comps over time. We believe one of the company’s core competencies is identifying and translating trends to product in its stores. Its agility is impressive. In fact, we were surprised earlier in the summer when the company had Pokemon product in at least one of its stores the week after the Pokemon Go phenomena started.

While we believe the company has sufficient flexibility to manage the merchandise mix – and the right merchants in place to make prudent decisions – the company is very seasonal and this does introduce an element of risk into the business.

|  |  |
| --- | --- |
|  | Figure  Percent of Annual Sales and EBITDA by Quarter – 2016 |
|  |  |
| Source: Company reports and Barclays Research |

Compounding the risk of seasonality is that the company has its stores concentrated in the Northeast and bad winter weather is a risk. In the past when the company has experienced poor weather in its core markets during 4Q, sales were negatively impacted but it managed the challenging environment surprisingly well. FIVE has been diversifying its store base geographically into more southern and western states and so we expect weather risk will lessen over time.

|  |  |  |
| --- | --- | --- |
| Figure  States with at Least One FIVE Store – May 2013 |  | Figure  States with at Least One FIVE Store – January 2016 |
|  |  |  |
| Source: Company reports and Barclays Research |  | Source: Company reports and Barclays Research |

1. Insulated from internet retailing competition

We believe many characteristics of FIVE’s business insulted it from competition from e-commerce. This includes its low price per item, treasure hunt offering, fun shopping experience, and broad offering. A customer walking through a store can easily observe it’s greater than 4,000 SKUs. To view the same number of items online a customer browsing the web would have to click through 40-80 pages if looking at 50-100 items per page. Plus, of course, the web customer is not able to interact with the product online. In addition, the low average item price point means many products aren’t economical to ship. E-commerce players operating in this niche have minimum shipping requirements that are well above FIVE’s average ticket. We believe shipping costs are a large barrier to purchase since e-commerce customers are accustomed to free shipping. Lastly, we note that its core teen and pre-teen customer already index highly for internet and mobile use. FIVE is not abandoning customers that want to shop over the internet, however. It successfully launched e-commerce in 2Q16 with a website that was specifically designed for smooth navigation and shopability on mobile.

1. The current valuation seems appropriate given the company’s growth and returns

Stock appropriately valued when controlling for growth and ROIC

In the scatter plot below, we show CY17 EV/EBITDA multiples for a handful of growth companies vs. an average of expected CY16 and CY17 EBITDA growth. Given there is an 80% correlation, between expected growth and forward EV/EBITDA valuation, we believe this is an appropriate and important way to frame valuation. FIVE is clearly among a few outlier companies in retail with rapid expected EBITDA growth. Only four companies have a higher valuation.

Figure   
CY17 EV/EBITDA vs. Average CY16 and CY17 EBITDA Growth



Note: All estimates are consensus estimates except FIVE, which is Barclays’ forecast. Tangible invested capital for OLLI.   
Source: Thomson Reuters and Barclays Research

As can be seen in the chart below, the market is willing to pay a premium for stocks with higher ROIC even if they have lower growth.

Figure   
CY17 EV/EBITDA vs. Lease Adjusted ROIC



Note: All estimates are consensus estimates except FIVE, which is Barclays’ forecast. Tangible invested capital for OLLI.   
Source: Thomson Reuters and Barclays Research

Below we contrast FIVE with some of the company’s with higher ROIC and growth. We believe FIVE’s current valuation is appropriate given our EBITDA growth and ROIC expectations.

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| --- | --- |
|  | Figure  ROIC, Expected EBITDA Growth, and CY17 EV/EBITDA |
|  |  |
| Note: \*FY15 lease adjusted ROIC excluding goodwill. \*\*Average expected EBITDA growth for CY16 and CY17.  Source: Thomson Reuters and Barclays Research |

Stock valuation multiples are slightly below recent averages

FIVE’ valuation has come down over the past four years as the company has doubled in size, going from 226 stores to nearly 500 at the end of the most recent quarter.

|  |  |  |
| --- | --- | --- |
| Figure  Forward NTM EV/EBITDA |  | Figure  Forward NTM P/E |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

Looked at over a shorter period of time when its multiples have been more stable, FIVE is currently trading at a slight discount to its average forward EV/EBITDA and P/E multiples.

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| --- | --- | --- |
| Figure  Forward NTM EV/EBITDA |  | Figure  Forward NTM P/E |
|  |  |  |
| Source: Company Reports and Barclays Research |  | Source: Company Reports and Barclays Research |

Valuation and Conclusion

Based on the above, we are initiating with an Equal Weight rating and a $42 price target. Our price target factors in our upside/downside scenario analysis. Our price target values FIVE at 12.2x our FY17 EBITDA of $176 million. If comps were to weaken or store growth were to slow, we see downside to $35, we see downside to $35 (13%) – or 10.0x our FY17 EBITDA. We place a 50% probability on this scenario. If business momentum accelerates and the company’s valuation expands, we see upside to $49 – or 14.5x our CY17 EBITDA – with a 50% probability. The weighted average gets us to our $42 price target.

| Valuation Methodology and Risks |
| --- |
| U.S. Food & Staples Retailing |
| Big Lots, Inc. (BIG) |
| **Valuation Methodology:** Our $51 price target is based on a 5.6x EV/EBITDA multiple and CY17 EBITDA of $391 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A further decrease in customer traffic, increased competitive pressures, disruptive winter weather given the company's business is very seasonal, customers not reacting favorably to the many changes in the business. |
| Casey's General Stores Inc (CASY) |
| **Valuation Methodology:** Our $116 price target is based on a 9.0x EV/EBITDA multiple and CY17 EBITDA of $612 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Higher gas prices that hurt gas margins, consumer spending and increase operating expenses (credit card fees and distribution costs). Other risks include significant inflation in commodity input costs used for prepared food and/or a deteriorating farm belt economy. |
| Chefs' Warehouse Inc (CHEF) |
| **Valuation Methodology:** Our $12 price target is based on a 9.6x EV/EBITDA multiple and CY17 EBITDA of $62 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Deteriorating food away from home sales, especially at full-service restaurants in CHEF's markets, significant inflation or deflation, merger integration challenges, and/or high financial leverage. |
| Costco Wholesale Corp. (COST) |
| **Valuation Methodology:** Our $158 price target is based on a 12.7x EV/EBITDA multiple and CY17 EBITDA of $5.55 billion. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Our earnings forecast and investment thesis for Costco are subject to domestic and international risks including cost of goods, consumer spending and debt levels, currency fluctuations, interest rate fluctuations, store expansion plans, variability in comparable store sales, and market saturation. |
| Dollar General Corporation (DG) |
| **Valuation Methodology:** Our $74 price target is based on a 8.9x EV/EBITDA multiple and CY17 EBITDA of $2,610 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A sudden re-acceleration of the comp, a more significant share repurchase initiative, an increase in the dividend, a further reduction in SNAP, heightened competitive behavior in light of onging deflation, a more aggressive push by hard discounters in the Southeast, a port disruption, currency fluctuations for imported markets. |
| Dollar Tree Inc (DLTR) |
| **Valuation Methodology:** Our $88 price target is based on a 8.6x EV/EBITDA multiple and CY17 EBITDA of $2,632 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Missteps in execution of the FDO integration, heightened competitive landscape, a more aggressive direct competitor aggressively protecting share, a more aggressive push by hard discount operators in the Southeast, a port disruption. |
| Five Below, Inc. (FIVE) |
| **Valuation Methodology:** Our $42 price target is based on a 12.2x EV/EBITDA multiple and CY17 EBITDA of $176 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Adverse winter weather given the company's business is very seasonal, a slow down in new store growth, and a lack of new product trends. |
| GNC Holdings Inc. (GNC) |
| **Valuation Methodology:** Our $21 price target is based on a 7.0x EV/EBITDA multiple and CY17 EBITDA of $405 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Sustained competitive pressures, lack of new product introductions, customers abandoning the specialty channel for VMS products, unit growth stalls or contracts, inability to sell company owned stores. |
| Kroger Co. (KR) |
| **Valuation Methodology:** Our $33 price target is based on a 6.9x EV/EBITDA multiple and CY17 EBITDA of $6,195 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Heightened competitive behavior in light of persistent deflation, another acquisition, volatility in gas margins, deceleration in tonnage, persistent deflation, a significant change in capex, a significant change in free cash flow allocation, the merger of two meaningful competitors. |
| Natural Grocers by Vitamin Cottage Inc (NGVC) |
| **Valuation Methodology:** Our $12 price target is based on a 6.0x EV/EBITDA multiple and CY17 EBITDA of $55 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Deteriorating economy in NGVC's Western states, natural/organic product supply shortage, increasing cannibalization,and/or increased competitive openings. |
| Performance Food Group Co. (PFGC) |
| **Valuation Methodology:** Our $28 price target is based on a 9.7x EV/EBITDA multiple and CY17 EBITDA of $391 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A widening spread of CPI vs. PPI, a significant merger of some of the more significant operators in the space, execution missteps with the Red Lobster onboarding, a weak cycle in theatre leading to soft Vistar sales. |
| Smart & Final Stores Inc (SFS) |
| **Valuation Methodology:** Our $13 price target is based on a 8.5x EV/EBITDA multiple and CY17 EBITDA of $186 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A slower than expected ramp of the Haggen stores, greater than expected cannibalization of C&C in S&F markets (and vice versa), a meaningful change in the competitive landscape in the Southeast, persistent deflation, more aggressive behavior from restaurants distributors. |
| SpartanNash Co (SPTN) |
| **Valuation Methodology:** Our $31 price target is based on a 6.6x EV/EBITDA multiple and CY17 EBITDA of $231 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Deteriorating economy in SPTN's core Midwest markets, significant deflation or inflation, significant new customer wins or losses, rising fuel prices and/or competitive openings. |
| Sprouts Farmers Market Inc (SFM) |
| **Valuation Methodology:** Our $24 price target is based on a 11.4x EV/EBITDA multiple and CY17 EBITDA of $336 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A meaningful change to mid term targets, persistent deflation in general deflation in produce, a competitive flare up in SFM concentrated markets, execution missteps in deli and prepared foods roll out. |
| SYSCO Corp. (SYY) |
| **Valuation Methodology:** Our $48 price target is based on a 10.6x EV/EBITDA multiple and CY17 EBITDA of $3,104 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** An additional increase in share repurchase activity, a widening speak of CPI vs. PPI, a significant merger of some of the more significant operators in the space. |
| United Natural Foods, Inc. (UNFI) |
| **Valuation Methodology:** Our $40 price target is based on a 7.1x EV/EBITDA multiple and CY17 EBITDA of $336 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A re-acceleration of top line, a significant new customer win, significant inflation or deflation, rising fuel prices, a take out by a conventional distributor. |
| Vitamin Shoppe Inc (VSI) |
| **Valuation Methodology:** Our $29 price target is based on a 5.3x EV/EBITDA multiple and CY17 EBITDA of $141 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** Sustained competitive pressures, lack of new product introductions, customers abandoning the specialty channel for VMS products, inability to achieve cost savings, unit growth stalls or contracts. |
| Wal-Mart Stores (WMT) |
| **Valuation Methodology:** Our $87 price target is based on a 7.8x EV/EBITDA multiple and CY17 EBITDA of $33.29 billion. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** We believe the long-term risks for Walmart include: (1) the challenges associated with managing increasingly vast and complex operations, (2) the growing contribution of the lower-margin food business to the overall merchandise mix, (3) the ability to acquire and successfully integrate assets abroad, (4) the proficiency with which the company adapts its store formats to the various economic and cultural environments in international markets, and (5) ability to profitably grow its e-commerce business. Our earnings forecast and investment thesis for Walmart are subject to such factors as cost of goods, consumer spending and debt levels, currency fluctuations, interest rate fluctuations, store expansion plans, and variability in comparable store sales. |
| Whole Foods Market Inc (WFM) |
| **Valuation Methodology:** Our $30 price target is based on a 7.7x EV/EBITDA multiple and CY17 EBITDA of $1,337 million. |
| **Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target:** A more meaningful share re-purchase initiative, a takeout or a meaningful investment by a conventional food retailer, private equity, or activist investor. |
| Source: Barclays Research. |

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| Analyst(s) Certification(s): |
| I, Karen Short, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report. |

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All authors contributing to this research report are Research Analysts unless otherwise indicated.  The publication date at the top of the report reflects the local time where the report was produced and may differ from the release date provided in GMT.  Analysts regularly conduct site visits to view the material operations of covered companies, but Barclays policy prohibits them from accepting payment or reimbursement by any covered company of their travel expenses for such visits.  In order to access Barclays Statement regarding Research Dissemination Policies and Procedures, please refer to http://publicresearch.barcap.com/static/S\_ResearchDissemination.html. In order to access Barclays Research Conflict Management Policy Statement, please refer to: http://publicresearch.barcap.com/static/S\_ConflictManagement.html.  The Investment Bank’s Research Department produces various types of research including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research product may differ from recommendations contained in other types of research, whether as a result of differing time horizons, methodologies, or otherwise.  **Primary Stocks (Ticker, Date, Price)**  **Big Lots, Inc.** (BIG, 19-Sep-2016, USD 47.00), Equal Weight/Neutral, CE/J  **Casey's General Stores Inc** (CASY, 19-Sep-2016, USD 119.72), Equal Weight/Neutral, CD/CE/J  **Chefs' Warehouse Inc** (CHEF, 19-Sep-2016, USD 11.83), Equal Weight/Neutral, J  **Costco Wholesale Corp.** (COST, 19-Sep-2016, USD 151.79), Equal Weight/Neutral, CD/CE/D/J/K/L/N  **Dollar General Corporation** (DG, 19-Sep-2016, USD 71.83), Equal Weight/Neutral, CD/CE/J/K/M  **Dollar Tree Inc** (DLTR, 19-Sep-2016, USD 80.22), Equal Weight/Neutral, CD/CE/J/K/M  **Five Below, Inc.** (FIVE, 19-Sep-2016, USD 40.38), Equal Weight/Neutral, CE/J  **GNC Holdings Inc.** (GNC, 19-Sep-2016, USD 20.72), Equal Weight/Neutral, CD/CE/E/J/L  **Kroger Co.** (KR, 19-Sep-2016, USD 30.79), Equal Weight/Neutral, CD/CE/J  **Natural Grocers by Vitamin Cottage Inc** (NGVC, 19-Sep-2016, USD 10.97), Equal Weight/Neutral, CE/J  **Performance Food Group Co.** (PFGC, 19-Sep-2016, USD 24.13), Overweight/Neutral, A/CE/D/J/K/L/M  **Smart & Final Stores Inc** (SFS, 19-Sep-2016, USD 12.58), Equal Weight/Neutral, J  **SpartanNash Co** (SPTN, 19-Sep-2016, USD 29.18), Equal Weight/Neutral, CE/J  **Sprouts Farmers Market Inc** (SFM, 19-Sep-2016, USD 20.50), Overweight/Neutral, CE/J  **SYSCO Corp.** (SYY, 19-Sep-2016, USD 49.25), Underweight/Neutral, CD/CE/D/J/K/L/N  **United Natural Foods, Inc.** (UNFI, 19-Sep-2016, USD 39.31), Underweight/Neutral, CE/J  **Vitamin Shoppe Inc** (VSI, 19-Sep-2016, USD 26.66), Equal Weight/Neutral, CD/CE/J  **Wal-Mart Stores** (WMT, 19-Sep-2016, USD 72.09), Overweight/Neutral, CD/CE/D/J/K/L/M/N  **Whole Foods Market Inc** (WFM, 19-Sep-2016, USD 28.58), Equal Weight/Neutral, CD/CE/J  Prices are sourced from Thomson Reuters as of the last available closing 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Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.  **Stock Rating**  **Overweight** - The stock is expected to outperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.  **Equal Weight** - The stock is expected to perform in line with the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.  **Underweight** - The stock is expected to underperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.  **Rating Suspended** - The rating and target price have been suspended temporarily due to market events that made coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.  **Industry View**  **Positive** - industry coverage universe fundamentals/valuations are improving.  **Neutral** - industry coverage universe fundamentals/valuations are steady, neither improving nor deteriorating.  **Negative** - industry coverage universe fundamentals/valuations are deteriorating.  Below is the list of companies that constitute the "industry coverage universe":   |  |  |  | | --- | --- | --- | | **U.S. Food & Staples Retailing** | | | | Big Lots, Inc. (BIG) | Casey's General Stores Inc (CASY) | Chefs' Warehouse Inc (CHEF) | | Costco Wholesale Corp. (COST) | Dollar General Corporation (DG) | Dollar Tree Inc (DLTR) | | Five Below, Inc. (FIVE) | GNC Holdings Inc. (GNC) | Kroger Co. (KR) | | Natural Grocers by Vitamin Cottage Inc (NGVC) | Performance Food Group Co. (PFGC) | Smart & Final Stores Inc (SFS) | | SpartanNash Co (SPTN) | Sprouts Farmers Market Inc (SFM) | SYSCO Corp. (SYY) | | United Natural Foods, Inc. (UNFI) | Vitamin Shoppe Inc (VSI) | Wal-Mart Stores (WMT) | | Whole Foods Market Inc (WFM) |  |  |   **Distribution of Ratings:**  Barclays Equity Research has 1734 companies under coverage.  40% have been assigned an Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating; 61% of companies with this rating are investment banking clients of the Firm; 79% of the issuers with this rating have received financial services from the Firm.  41% have been assigned an Equal Weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating; 50% of companies with this rating are investment banking clients of the Firm; 76% of the issuers with this rating have received financial services from the Firm.  16% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 44% of companies with this rating are investment banking clients of the Firm; 66% of the issuers with this rating have received financial services from the Firm.  **Guide to the Barclays Research Price Target:**  Each analyst has a single price target on the stocks that they cover. The price target represents that analyst's expectation of where the stock will trade in the next 12 months. Upside/downside scenarios, where provided, represent potential upside/potential downside to each analyst's price target over the same 12-month period.  **Top Picks:**  Barclays Equity Research's "Top Picks" represent the single best alpha-generating investment idea within each industry (as defined by the relevant "industry coverage universe"), taken from among the Overweight-rated stocks within that industry. Barclays Equity Research publishes "Top Picks" reports every quarter and analysts may also publish intra-quarter changes to their Top Picks, as necessary. While analysts may highlight other Overweight-rated stocks in their published research in addition to their Top Pick, there can only be one "Top Pick" for each industry. To view the current list of Top Picks, go to the Top Picks page on Barclays Live (https://live.barcap.com/go/keyword/TopPicks).  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