



Sprouts Farmers Market Inc.

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Sprouts Farmers Market Recommendation Summary



BUY

1 Year Target Price: \$33.25
Current Trading Price: \$28.20 (17.9% Upside)

Recommendation Summary

Sprouts Farmers Market (SFM)
 Current Trading Price (04-08-2016) \$ 28.20

Recommendation **BUY**
 Target Price \$ 33.25
 Upside Potential 17.9%

Valuation Summary

Method	Price	Weight
Discounted Cash Flow		
Perpetuity Growth Method	\$ 34.86	65%
Exit Multiple Method	\$ 37.61	20%
Comparable Company Analysis		
P/E	\$ 21.74	5%
EV/EBITDA	\$ 18.31	5%
EV/Revenue	\$ 21.45	5%
Target Price	\$ 33.25	

3 Trends Driving Valuation

Aggressive New
Store Growth

Increasing
Organic Food
Adoption

Increasing
Private Label
Popularity

Industry Definition

- The supermarket industry consists of companies retailing food products and supplements, including fresh and prepared meats, canned and frozen foods, fresh fruits and vegetables and various dairy products.
- The organic/natural food segment of the industry represents one of the fastest growing segments in the broader supermarket industry.

Comparable Companies:



Whole Foods Market Inc. (Nasdaq: WFM)
Mkt Cap: 9.73 Billion



The Fresh Market Inc. (Nasdaq: TFM)
Mkt Cap: 1.33 Billion



Sprouts Farmers Market Inc. (Nasdaq: SFM)
Mkt Cap: 4.28 Billion

Target Company:

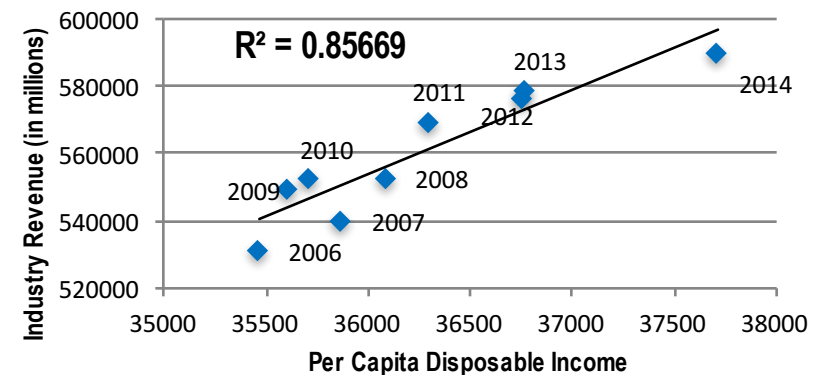
Why the Supermarket Industry?

- The aggregate supermarket industry is very mature and stable
 - Even after the recession in 2008, industry revenue only decreased by .65%
- Most public companies in this industry have stocks with a beta under .9
 - In line with the fund's risk tolerance
- **Within the industry, the organic foods segment represents one of the fastest growing segments**
 - From 2006-2014, the organic foods segment grew at a CAGR of about 11%
 - The supermarket industry as a whole only grew at a CAGR of about 1.3% from 2006-2014
- Growing Per Capita Disposable Income will contribute to aggregate industry growth

Aggregate Supermarket Data

Year	Revenue (in millions)	% Change
2006	531,046.9	
2007	537,621.3	1.24%
2008	552,803.3	2.82%
2009	549,188.7	-0.65%
2010	552,893.2	0.67%
2011	569,575.2	3.02%
2012	576,316.6	1.18%
2013	578,792.2	0.43%
2014	586,385.6	1.31%

Supermarket Industry Revenue vs. Per Capita Disposable Income (2006-2014)



Sprouts Farmers Market Background

- Sprouts is an American chain of specialty grocery stores in the United States. Sprouts stores are smaller than a typical supermarket, focusing on fresh foods, produce, healthy foods and vitamins/supplements.
- Sprouts currently operates 227 stores across 13 states



Value Proposition: “Healthy Living for Less”

- Sprouts offers high quality organic and natural food products at significantly lower prices compared to its competitors
- Sprouts carries healthy alternatives to popular products found in conventional supermarkets
- Small Box Format (avg. 29,000 Sq. ft.) with a farmers market feel
- Sprouts is committed to customer engagement
 - Highly trained staff to educate and engage with customers

Sprouts Snapshot FY2015		TFM & WFM FY2015 Average
Revenue	3.59 Billion	N/A
3 Yr Revenue CAGR	26%	10%
Gross Margin Ratio	29.30%	34.45%
EBITDA Margin	8.30%	9.65%
Net Income Margin	3.60%	3.45%
EPS	0.83	1.42
P/E	34.76	19.55

Trends

Aggressive New Store
Growth

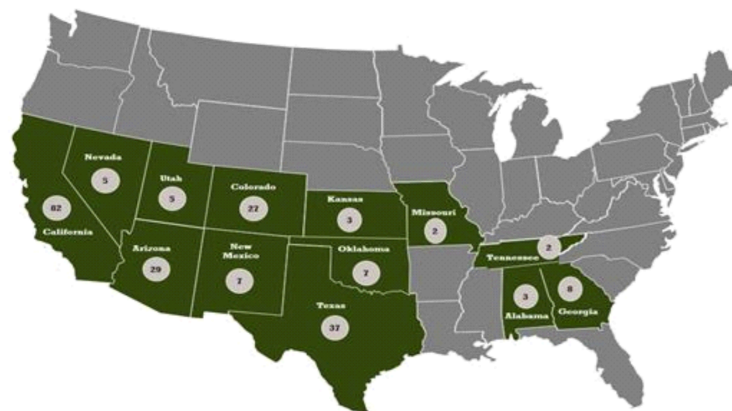
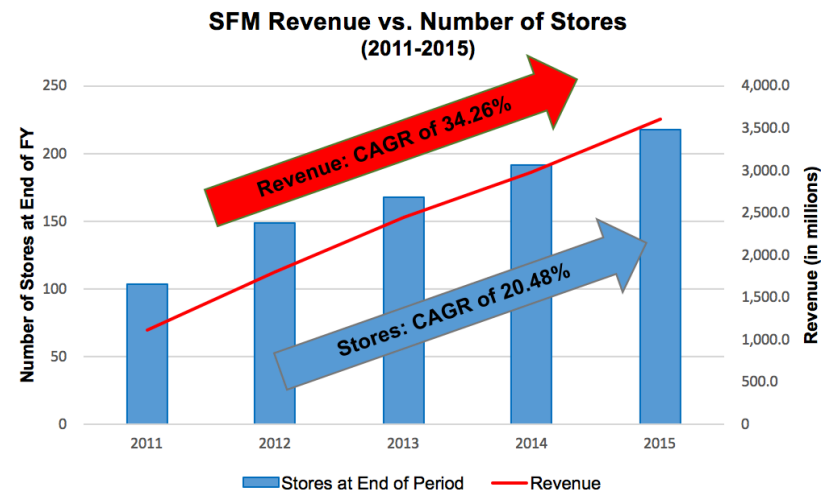
Increasing Organic Food
Adoption

Increasing Private Label
Popularity

1. Aggressive New Store Growth Leading to Strong Top Line Growth

Strong historical and projected new store growth has contributed to strong revenue growth

- Over the next 5+ years Sprouts is projecting a new store CAGR of 14%
 - 36 planned stores in 2016
- Through a growing interest in health and a focus on value, Sprouts believes it can sustain approx. 1200 stores with its current business model
 - 400 of these potential stores are within current markets (13 States)
 - Sprouts utilizes operating leases for its properties
- Sprouts targets sales of \$12-14 million in the first year for new stores
 - Avg. cash investment: \$3.1 million
- Sprouts is strategically expanding by minimizing cannibalization of sales from existing stores
 - For 35 consecutive quarters (through the recession), Sprouts has posted positive comps



Trends



Aggressive New Store
Growth

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2. Organic Food Adoption Driving Comps

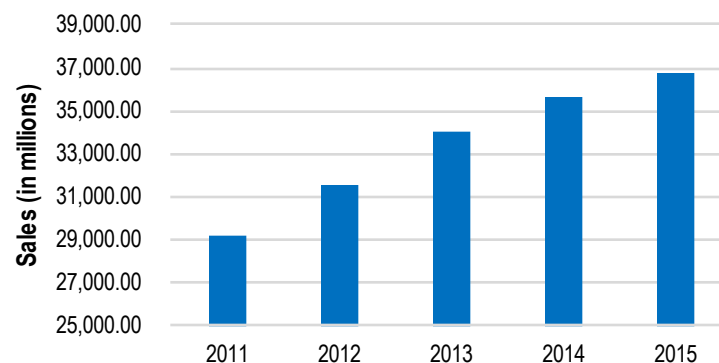
Sprouts is well positioned to capitalize on the organic food trend with their competitive pricing

- The organic/natural food segment is one of the fastest growing segments in the supermarket industry
 - Conventional supermarket share has dropped from 73% in 2005 to 65% in 2014
- According to SPINS, a leading provider of retail analytics, sales of natural and organic products are **projected to grow at annual growth rate of over 9% from 2015-2019**
- Organic foods are sourced at similar prices to non-organic foods but sold at a premium
 - Premiums on organic fruits and vegetables can range from **30.0% to over 100.0%**
- **Sprouts' products are priced significantly lower than its peers**

Year	SFM Comparable Store Sales Growth
2011	5.10%
2012	9.70%
2013	10.70%
2014	9.90%
2015	5.80%

*2015 comps beat estimates despite food produce being deflationary for 6 mo.

U.S. Organic Food Sales (in Millions)



Trends



Aggressive New Store
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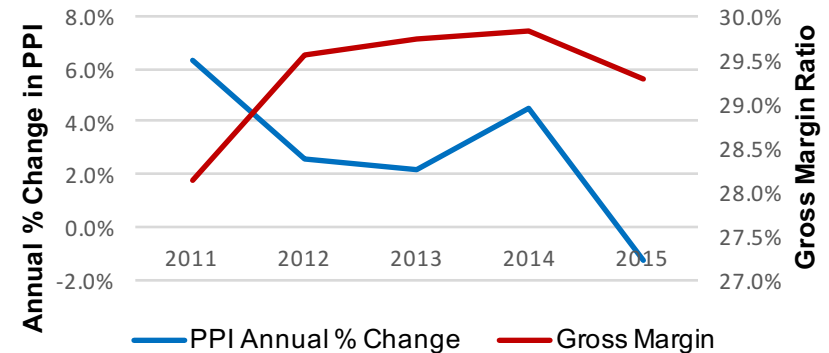
Increasing Private Label
Popularity

3. Private Label Popularity Stabilizing Margins

Sprouts' private label products with higher GM's give Sprouts the flexibility to focus on top line growth

- Sprouts offers private label produce products and private label vitamins/supplements
 - Higher margins, more value for customers, and higher brand image and customer loyalty
- Sprouts' portfolio of branded products has grown at a **CAGR of 17.6% from 2011-2016** (1,800 items today)
- In FY2015, private label products represented **9% of Sprouts revenue** (\$323.37 million)
- In a study of thousands of customers, customers highlighted the quality and taste of Sprouts' private label
- Private label products act as revenue shield during economic downturns

PPI Annual Change vs SFM Gross Margin (2011-2015)



PPI= Producer Price Index for finished consumer foods

- **Sprouts is a top line and traffic driven company**
 - They strategically utilize product inflation/deflation to competitively price their products
- **The higher margins of private label products gives Sprouts the flexibility to achieve this strategy without significantly impacting their gross margin**

Comparable Companies Valuation

Comparable Company Analysis

LTM data (04-15-2016)

Company	Ticker	EV	Market Cap	P/E	P/E/G	EV/EBITDA	EV/Revenue
Sprouts Farmers Market	SFM	4,269.7	4,245.8	32.9x	2.0x	13.8x	1.2x
Whole Foods	WFM	10,072.2	9,826.2	18.7x	3.6x	7.2x	0.6x
The Fresh Market	TFM	1,306.3	1,334.9	20.4x	4.4x	6.8x	0.7x
				High	4.4x	13.8x	1.2x
				Mean	3.4x	9.3x	0.8x
				Median	3.6x	7.2x	0.7x
				Low	2.0x	6.8x	0.6x

*all numbers in millions where applicable

P/E	
2016 EPS Estimate	\$ 0.98
Implied Price Target	\$21.7422
Upside (Downside) %	-22.9%

EV/EBITDA	
2016 EBITDA Estimate	\$ 337.16
Implied Price Target	\$18.3129
Upside (Downside) %	-35.1%

EV/Revenue	
2016 Revenue Estimate	\$ 4,198.08
Implied Price Target	\$21.4503
Upside (Downside) %	-23.9%

- Average of Mean and Median used for all 3 multiples
- SFM appears to be overvalued but P/E/G demonstrates that SFM's price is justified because of high growth
- P/E, EV/EBITDA, EV/Revenue each weighted 5%
 - Represent downside in valuation

Discounted Cash Flow Valuation

Key Statistics:

Current Trading Price (04-08-2016)	\$	28.20
Market Cap	\$	4,245.79
Net Debt	\$	23.93
Beta		0.82
Shares Outstanding		150.56
Marginal Tax Rate		35.03%

Perpetuity Growth Method

Growth Rate		2.75%
Undiscounted TEV	\$	6,434.84
Discounted TEV	\$	4,263.55
DCF Value	\$	5,272.12
Equity Value	\$	5,248.19
Share Price	\$	34.86
Implied Exit Multiple		8.47x

WACC Calculation:

Cost of Debt	1.60%
% Weight	4%
Cost of Equity	8.84%
% Weight	96%
WACC	8.58%

Exit Multiple Method

EBITDA Multiple	9.30x
Undiscounted TEV	\$ 7,059.66
Discounted TEV	\$ 4,677.54
DCF Value	\$ 5,686.11
Equity Value	\$ 5,662.18
Share Price	\$ 37.61
Implied Growth Rate	3.24%

Key Assumptions:

- Cost of Debt: 1.60%
- Cost of Equity: 8.84%
- WACC: 8.58%
- Terminal Growth Rate: 2.75%
- New store growth subsides
- FY2019 & 2020 Gross margin improves by ~100 basis points as economies of scale increase

CAPEX Schedule

<i>(#'s in millions where applicable)</i>	2016	2017	2018	2019	2020
Number of Stores at end of FY	247	282	310	335	362
Y/Y Growth %	14%	14%	10%	8%	8%
Stores Added in FY	30	35	28	25	27
New Store CAPEX (\$3.5 mil/store)	106	121	99	87	94
Non-New Store Capex	44	55	65	72	77
Total Capex	150	176	163	159	171

Historical Non-New Store Capex % of Revenue	1%
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Risk Factors

Competition in the organic space strengthens

- Sprouts' store growth plans and revenue growth would be negatively impacted
- Risk of not generating enough FCF to pay operating lease payments
- Wholesale players like Costco could become larger players in the organic space

Changes in minimum wage & employee unions

- None of Sprouts' employees are currently unionized
- Sprouts believes that its wages are currently high enough that minimum wage increases would have little effect on margins

Increased consolidation in the industry

- Apollo Global Management recently bought The Fresh Market at a high premium
- Rumors of Apollo planning more acquisitions to consolidate the organic supermarket industry
- Assuming Sprouts isn't acquired, the company will have a tougher time expanding in a more consolidated industry

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Q1 Earnings to be
released 5/5/16

APPENDIX

FCF Projections

2016-2017: Historical Data

2018-2020: Forecasted

2016-2017: Historical Data

2018-2020: Forecasted

	<u>Forecasted</u>									
	2016		2017		2018		2019		2020	
EBIT	\$	310.40	\$	397.52	\$	476.64	\$	608.19	\$	643.25
- Taxes		-108.7		-139.2		-166.9		-213.0		-225.3
	\$	201.68	\$	258.28	\$	309.69	\$	395.16	\$	417.94
+ D&A		74.9		86.6		95.5		102.9		110.8
- CAPEX		(150.00)		(176.00)		(163.00)		(159.00)		(170.00)
- Δ in NWC		45.29		14.63		14.61		11.39		6.43
Unlevered FCF	\$	171.83	\$	183.52	\$	256.80	\$	350.43	\$	365.16
Net Present Value		\$1,008.57								

Income Statement

	Historical					Forecasted				
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	1,105.9	1,794.8	2,437.9	2,967.4	3,593.0	4,491.3	5,479.4	6,465.7	7,241.5	7,676.0
% growth		62.3%	35.8%	21.7%	21.1%	25.0%	22.0%	18.0%	12.0%	6.0%
COGS (excl. D&A)	(794.9)	(1,264.5)	(1,712.6)	(2,082.2)	(2,541.4)	(3,175.2)	(3,860.8)	(4,555.8)	(5,032.9)	(5,334.8)
% of Revenue	71.88%	70.45%	70.25%	70.17%	70.73%	70.70%	70.46%	70.46%	69.50%	69.50%
Gross Profit	311.0	530.3	725.3	885.2	1,051.6	1,316.1	1,618.6	1,909.8	2,208.7	2,341.2
% Margin	28.1%	29.5%	29.7%	29.8%	29.3%	29.3%	29.5%	29.5%	30.5%	30.5%
SG&A	-58.528	-86.364	-81.795	-85.397	-106.412	-138.7	(169.2)	(199.7)	(223.6)	(237.1)
% of Revenue	5.29%	4.81%	3.36%	3.21%	2.96%	3.09%	3.09%	3.09%	3.09%	3.09%
Direct Store Expense	(183.6)	(310.4)	(449.0)	(521.3)	(636.9)	-786.882	-959.996	-1132.795	-1268.731	-1344.855
% of Revenue	17%	17%	18%	18%	18%	18%	18%	18%	18%	18%
EBITDA	68.8	133.6	194.5	268.5	308.3	390.5	489.4	577.4	716.3	759.3
% Margin	6.2%	7.4%	8.0%	9.0%	8.6%	8.7%	8.9%	8.9%	9.9%	9.9%
Depreciation	(54.6)	(35.8)	(47.2)	(60.4)	(69.2)	(74.9)	(86.6)	(95.5)	(102.9)	(110.8)
Amort. of Intangibles	(32.2)	-	-	-	-	-	-	-	-	-
Total D&A	(86.8)	(35.8)	(47.2)	(60.4)	(69.2)	(74.9)	(86.6)	(95.5)	(102.9)	(110.8)
Other Operating Expenses	(1.3)	(2.8)	(5.7)	(7.7)	(8.6)	(5.2)	(5.2)	(5.2)	(5.2)	(5.2)
Total Operating Expenses	(330.3)	(435.3)	(583.7)	(684.8)	(821.1)	(1,005.7)	(1,221.1)	(1,433.2)	(1,600.5)	(1,697.9)
Operating Income (EBIT)	(19.3)	95.0	141.6	200.4	230.6	310.4	397.5	476.6	608.2	643.2
% Margin	-1.7%	5.3%	5.8%	6.8%	6.4%	6.9%	7.3%	7.4%	8.4%	8.4%
Interest Expense	(19.8)	(35.5)	(37.2)	(25.1)	(17.7)	(3.9)	(3.9)	(3.9)	(3.9)	(3.9)
Interest Income	-	-	-	-	-	-	-	-	-	-
Net Interest Inc. (Exp)	(19.8)	(35.5)	(37.2)	(25.1)	(17.7)	(3.9)	(3.9)	(3.9)	(3.9)	(3.9)
Other Non-Operating Income	0.4	0.6	0.5	0.6	0.4	-	-	-	-	-
EBT Excl. Unusual Items	(38.8)	60.1	104.8	175.9	213.3	306.5	393.6	472.7	604.2	639.3
% Margin	-3.5%	3.3%	4.3%	5.9%	5.9%	6.8%	7.2%	7.3%	8.3%	8.3%
Unusual Items	(6.4)	(25.4)	(20.8)	(1.8)	(7.3)	(12.3)	(12.3)	(12.3)	(12.3)	(12.3)
EBT Incl. Unusual Items	(45.2)	34.7	84.0	174.1	206.0	294.1	381.2	460.4	591.9	627.0
Income Tax Expense	17.7	(15.3)	(32.7)	(66.4)	(77.0)	-107.3	(137.9)	(165.6)	(211.6)	(223.9)
Earnings from Cont. Ops	(27.5)	19.4	51.3	107.7	129.0	186.8	243.4	294.8	380.3	403.0
Earnings from Discounted Ops.	-	-	-	-	-	-	-	-	-	-
Extraord Item & Acct. Change	-	-	-	-	-	-	-	-	-	-
Net Income to Company	(27.5)	19.4	51.3	107.7	129.0	186.8	243.4	294.8	380.3	403.0
Minority Int. in Earnings	-	-	-	-	-	0	0	0	0	0
Net Income	(27.5)	19.4	51.3	107.7	129.0	186.8	243.4	294.8	380.3	403.0
% Margin	-2.5%	1.1%	2.1%	3.6%	3.6%	4.2%	4.4%	4.6%	5.3%	5.3%

Balance Sheet

	Historical					Forecasted				
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Cash And Equivalents	14.5	67.2	77.7	130.5	136.1	261.0	397.6	607.5	911.0	1,228.3
Accounts Receivable	2.5	5.6	5.2	8.2	11.6	12.7	15.4	18.2	20.4	21.6
Other Receivables	4.7	2.8	5.8	11.9	14.6	(10.3)	(12.5)	(14.8)	(16.3)	(17.3)
Total Receivables	7.2	8.4	11.0	20.1	26.3	2.3	2.9	3.4	4.1	4.3
Inventory	63.6	98.4	118.3	142.8	165.4	229.0	278.4	328.5	362.9	384.7
Prepaid Exp.	1.2	2.5	6.2	4.8	17.0	13.3	16.2	19.1	21.1	22.4
Other Current Assets	1.0	2.1	0.4	0.4	0.5	2.2	2.7	3.2	3.6	3.8
Total Current Assets	87.6	178.5	213.5	298.5	345.2	507.9	697.8	961.8	1,302.7	1,643.5
Gross Property, Plant & Equipment	270.4	387.2	476.2	637.5	731.6	881.6	1,057.6	1,220.6	1,379.6	1,550.6
Accumulated Depreciation	(49.0)	(84.0)	(127.4)	(182.7)	(237.5)	(312.4)	(399.0)	(494.5)	(597.3)	(708.1)
Net Property, Plant & Equipment	221.4	303.2	348.8	454.8	494.1	569.2	658.6	726.1	782.3	842.5
Long-term Investments	-	-	-	-	-	-	-	-	-	-
Goodwill	199.4	368.1	368.1	368.1	368.1	368.1	368.1	368.1	368.1	368.1
Other Intangibles	190.4	196.8	195.5	194.2	198.6	198.6	198.6	198.6	198.6	198.6
Deferred Tax Assets, Current & LT	59.1	47.2	33.4	35.6	1.4	1.4	1.4	1.4	1.4	1.4
Deferred Charges, LT	2.2	-	-	-	-	-	-	-	-	-
Other Long-Term Assets	1.6	9.5	13.1	17.8	19.0	19.0	19.0	19.0	19.0	19.0
Total Assets	761.7	1,103.3	1,172.4	1,369.0	1,426.4	1,664.2	1,943.5	2,275.0	2,672.0	3,073.0
Accounts Payable	53.9	82.7	111.2	112.9	134.5	193.885	235.75	278.19	307.32	325.76
Accrued Exp.	27.1	40.9	44.5	57.4	64.3	74.5	90.9	107.3	120.2	127.4
Curr. Income Taxes Payable	-	-	-	-	-	-	-	-	-	-
ST Debt	-	-	-	-	-	-	-	-	-	-
Other Current Liabilities	9.6	13.2	19.9	50.6	31.7	45.0	54.8	64.6	71.4	75.7
Total Current Liabilities	90.6	136.8	175.6	220.8	230.4	313.5	381.4	450.1	498.9	528.8
Long Term Debt	294.2	424.8	305.4	248.6	160.0	160.0	160.0	160.0	160.0	160.0
Capital Leases & Current Portion	73.2	104.3	116.2	121.6	115.5	115.5	115.5	115.5	115.5	115.5
Unearned Revenue, Non-Current	-	-	-	-	-	-	-	-	-	-
Def. Tax Liability, Non-Curr.	-	-	-	18.6	-	-	-	-	-	-
Other Non-Current Liabilities	36.2	50.6	61.4	74.1	97.5	97.5	97.5	97.5	97.5	97.5
Total Liabilities	494.2	716.5	658.6	683.7	603.4	686.4	754.4	823.1	871.8	901.8
Common Stock	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Additional Paid In Capital	295.7	395.5	479.1	543.0	577.4	577.4	577.4	577.4	577.4	577.4
Retained Earnings	(28.4)	(8.9)	34.5	142.2	245.4	400.2	611.6	874.4	1,222.7	1,593.7
Treasury Stock	-	-	-	-	-	-	-	-	-	-
Comprehensive Inc. and Other	-	-	-	-	-	-	-	-	-	-
Total Common Equity	267.4	386.7	513.8	685.4	823.0	977.8	1,189.2	1,452.0	1,800.2	2,171.3
Minority Interest	-	-	-	-	-	-	-	-	-	-
Total Equity	267.4	386.7	513.8	685.4	823.0	977.8	1,189.2	1,452.0	1,800.2	2,171.3
Total Liabilities and Equity	761.6	1,103.2	1,172.4	1,369.1	1,426.4	1,664.2	1,943.5	2,275.0	2,672.0	3,073.0

Sensitivity Analysis

DCF - Perpetuity Growth Sensitivity

		WACC							
		0.070809	7.6%	8.1%	8.6%	9.1%	9.6%	10.1%	10.6%
Terminal Growth Rate	3.8%	\$ 60.20	\$ 52.12	\$ 45.94	\$ 41.05	\$ 37.11	\$ 33.85	\$ 31.13	\$ 28.82
	3.3%	\$ 52.97	\$ 46.67	\$ 41.69	\$ 37.66	\$ 34.35	\$ 31.57	\$ 29.22	\$ 27.20
	2.8%	\$ 47.41	\$ 42.34	\$ 38.24	\$ 34.86	\$ 32.03	\$ 29.63	\$ 27.57	\$ 25.79
	2.25%	\$ 43.00	\$ 38.82	\$ 35.38	\$ 32.49	\$ 30.05	\$ 27.95	\$ 26.13	\$ 24.54
	1.75%	\$ 39.42	\$ 35.91	\$ 32.97	\$ 30.48	\$ 28.34	\$ 26.48	\$ 24.87	\$ 23.44
	1.25%	\$ 36.45	\$ 33.46	\$ 30.92	\$ 28.73	\$ 26.85	\$ 25.20	\$ 23.74	\$ 22.46

DCF - EV/EBITDA Exit Multiple Sensitivity

		#DIV/0!							
		7.1%	7.6%	8.1%	8.6%	9.1%	9.6%	10.1%	10.6%
Terminal EBITDA Multiple	11.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90
	10.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90
	9.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90
	8.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90
	7.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90
	6.3 x	\$ 39.85	\$ 39.08	\$ 38.33	\$ 37.61	\$ 36.90	\$ 36.22	\$ 35.55	\$ 34.90

WACC/CAPM

Capital Asset Pricing Model

Beta	0.82
Risk-free Rate	2.41%
Base Risk Premium	6.70%
Market Cap	\$ 4,245.79
Size Premium	0.94%
CAPM	8.84%

WACC Calculation:

Cost of Debt	1.60%
% Weight	4%
Cost of Equity	8.84%
% Weight	96%
WACC	8.58%
WACC = 1.60% * 4% + 8.84% * 96%	

Cost of Debt

You can use morningstar.com or bloomberg to find bonds and yield of companies

Notes

Debt Tranche	Type of Debt	Value	% of Total	Coupon	Yield	Maturity	Seniority	Callable	Convertible	Currency
1			160.0		100%	2.46%				
2				0%						
3				0%						
4				0%						
5				0%						

Total Value of Debt	160.0
Cost of Debt	2.46% Weighted average of the different yields