

Blue Buffalo Stock Pitch

Recommendation:

We predict strong growth from Blue Buffalo Pet Products in the coming years supported by dependable in-house manufacturing, an upward trend in high-end pet food sales, and high margins for the industry that they are in.

What is Blue Buffalo?

Blue Buffalo Pet Products, Inc. (NASDAQ: BUFF) is the fastest-growing major pet food company in the United States that was founded in 2002 and incorporated in 2012. BUFF develops, produces, markets, and sells dog and cat food made with natural ingredients such as whole meats, fruits, and vegetables. BUFF is based in Wilton, Connecticut, and at the end of 2015 it had a total of 5 properties in the United States for manufacturing, distributing, warehousing, and administering its products. It currently operates in the United States, Canada, Japan, and Mexico but over 95% of net sales are from the United States. At the end of 2015, BUFF had approximately 6% of the U.S. pet food market (a \$24 billion dollar market) and fed 2-3% of the 164 million pets in the United States.

State of the Pet Food Industry

In the United States, 95% of pet owners consider pets part of the family and the number of pets has consistently increased every year for the past 10 years except for in 2010. Spending on pet food has increased substantially and in 2015 the US pet industry market expenditures were US \$60.28 billion and the pet food market revenue was US \$23.05 billion. Pet "humanization" is the biggest driver for the desire of premium and healthy pet food. In the last 10 years, the premium category of pet food has grown twice as fast as pet food sales overall. Mars PetCare Inc, Nestlé Purina PetCare, Big Heart Pet Brands, Hill's Pet Nutrition, and Diamond Pet Foods are the top 5 biggest pet food companies based on their annual revenue and all of them have at least one specialty product to appeal to this market. BUFF is 6th in revenue but expects to continue to capture market share with an aggressive advertisement campaign that its competitors don't plan on running.

Jack Friedberg : jackfriedberg@tamu.edu

Avery Fowler: averyfowler@tamu.edu

Mason Fugger: mfugger@tamu.edu>

Pablo Ayon Mont: pablo2696@tamu.edu

CALL: BUY

CURRENT PRICE: \$24.62

PRICE TARGET: \$34

P/E : 44.11

52 Week Range: \$15:12-\$27.50

52 Week Change: 24.24%

Market Cap: 4.86 B

ROA (ttm): 29.65%

ROE (ttm): 424.72%

The Case for an Undervalued Blue Buffalo

5-year Bullish Target Price: \$34

The Highlights

- Increased interest in healthy pet food and the “humanization of pets” will lead to higher interest in Blue Buffalo’s products and raise sales numbers.
- Blue Buffalo will increase their gross margins as a percent of sales because of favorable sales patterns and the opening of a new plant.

The current price of BUFF is representative of investor’s hesitation to take a chance on the new healthy pet food trend. Assuming sales remain relatively linear and BUFF continues to streamline its manufacturing process, BUFF will be perfectly positioned to capture an increased market share in the pet food industry. Market leaders like Big Heart (JM Smuckers), Iams (Mars), and Nestle Purina recognize the trend towards healthy pet food and the number of competitive brands has started to consolidate. Blue Buffalo has shown impressive resistance to these larger companies and will continue to increase their profitability by expanding in-house manufacturing capacity.

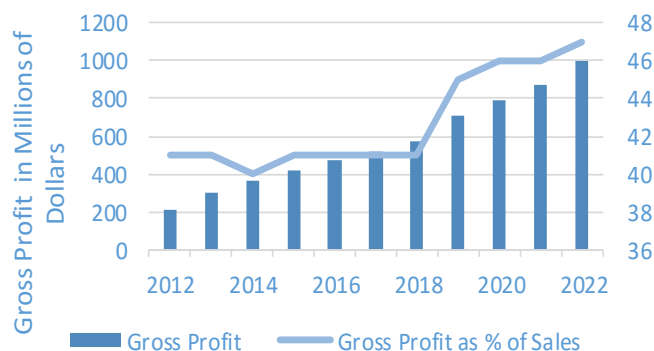
Increased Popularity of Wet Food Sales and Internal Manufacturing Capability to Drive Higher Margins

Wet food is a higher margin product that has grown in popularity with the healthy pet food trend. This, combined with moving from co-packers to in-house manufacturing will drive higher margins. This will take effect starting in 2019 when the new plant will open.

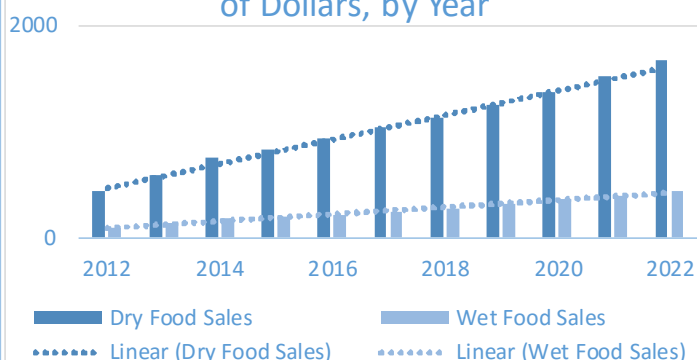
Attractive Sales Numbers and a Modern Customer Acquisition Strategy

Steadily increasing sales numbers driven by online outreach and a large investment in advertising campaign drive brand recognition

Gross Profit and Gross Margins



Dry and Wet Food Sales in millions of Dollars, by Year



Expanding Internal Manufacturing Capability and Moving Away from Outsourced Production

Recently BUFF announced that it would be expanding its in-house manufacturing capacities in order to move away from using foreign co-packers. This move was meant to address two separate issues. BUFF wants more control over the manufacturing process after the recent litigation by Nestle over meat by-products being in their meat-free food. They also are looking to increase their gross profit margin by streamlining the manufacturing process. Currently, BUFF’s gross profit margin sits at approximately 41%, but we estimate that profit margins could reach upwards of 45%. This will lead to higher annual revenue for BUFF. Indiana is also offering corporate tax credits to BUFF for opening a new manufacturing plant in their state.

Risks of Going Long

The Lowlights

5-year Bearish Target Price:
\$14

- Healthy pet food could be a “fad” and sales will slow down or flat-line.
- Increased competition from well-funded competitors who are willing to fight protracted legal battles for market share.
- Mismanagement of the new production plant being built leading to gross margins not increasing over time.

Loss of Customer Trust: Damage to Blue Buffalo's reputation could negatively impact their sales. Blue Buffalo recently settled in a lawsuit filed by Nestle for false advertisement. The lawsuit alleged that Blue Buffalo's products had certain meat by-products that went against their statement of “natural” ingredients. In the health-food market, the reputation of a product is key, and if Blue Buffalo continues to be sued for not properly labeling or producing its products, consumers may turn to other brands of dog food, forcing blue buffalo to lower prices or go out of business. This would mean that BUFF was severely over-valued and could lead to a price crash.

Increased Competition: The humanization of pets has driven a renaissance in pet food. This was quickly picked up on by major pet food producers like Mars and Nestle, who have acquired competing healthy pet food brands. These large corporations already have the facilities and managerial capacity to quickly adapt and could even price Blue Buffalo out of the market if they felt threatened.

Acquisition Premium: Failure to be acquired could have adverse affects on BUFF's stock price. Blue Buffalo is a high growth company in a high growth market. The company could be an acquisition target, as many large conglomerates like JM Smuckers and Mars are buying up the competition. As such, we believe that there is a slight buy-out premium that has already been priced into the stock. As the company matures or fails to hit their earnings projections, they could become a less attractive acquisition, causing a drop in stock price.

Failing to Meet Projected Margin Increases: Blue Buffalo is expected to turn higher margins due to an expansion in their capacity to manufacture their pet food in-house and a fast growing market for wet foods (which are a higher margin product). If the transition to fully in-house manufacturing is not timed correctly or the trend towards wet food stalls out, the valuation of the company by many major stockholders will be judged as too high and could lead to a large sell off of the stock.

Management

Shareholder	Percentage (%) outstanding	Key executives at BUFF include President William Bishop Jr., CEO Kurt Schmidt, and Chairman of the board William Bishop. They are among the company's 11 insiders that are also share holders. The management team, key executives and board of directors, hold an average of 4.98 years in their current positions. Roughly the same amount of time that BUFF has been a public company. CEO Schmidt has been working at BUFF since 2012, and has worked in the food industry for over 14 years. Chairman Bishop and President Bishop Jr. have been in the company since its founding. The rest of the board members belong to Invus Financial Advisors LLC, Invus Group, Harvard Business School, and Artal Group S.A: an investment company, a financial services company, a top ranked education institution, and BUFF's major share holder, respectively.
Artal Group SA	44.51	
Bishop Family LP	6.18	
Vanguard Group	2.70	
Goldman Sachs Group Inc.	2.44	
Hitchwood Capital Management LP	1.83	
Waddel & Reed Financial Inc.	1.59	
Capital Group Companies Inc.	1.48	
Nueberger Berman Group LLC	1.32	
Lord Abbett &Co LLC	1.25	
Citadel Advisors LLC	1.24	

Source: Bloomberg

Bullish Case Discounted Cash Flow Valuation

Free cash flow was calculated using projected annual revenues found on the next page. Depreciation and amortization sees a bit of a spike starting in 2018 due to the opening of their new factory and the costs associated with it. Capital expenditures also spiked in 2016 and into 2017 during the construction period of the new plant. Our WACC value was calculated using a beta of 0.75. BUFF's actual beta is .29 but because it is such a new company we used the industry average to get a more accurate valuation. The bullish DCF uses an EBIT that reflects marginal growth from 41% to 47% over the 5 year period. We used a 10x multiple of our final year's free cash flow to arrive at our terminal value.

WACC Calculation

Market Value of Equity	85780
Market Value of Debt	385000
Interest Paid (Annual)	15091
Equity + Debt	470780
Beta	0.75
10 yr Treasury Bond (Risk Free)	0.0162
Market Risk Premium	0.0491
E/V (% of financing that's equity)	0.18220825
Re (Cost of Equity)	0.040875
D/V (% of financing that's debt)	0.81779175
Rd (Cost of Debt)	0.039197403
(1-Tc) (Tc = corporate tax rate)	0.77
WACC	0.032130353

$$WACC = r_d(1 - T_c)(D/V) + r_e (E/V)$$

	2016	2017	2018	2019	2020	2021	2022	Terminal
EBIT	241	268	294	397	452	516	610	
Interest Paid	16	16	16	16	16	16	16	
Taxes	56	63	78	88	100	113	128	
Tax Adjusted EBT	169	189	200	293	336	387	466	
D&A	11	14	18	21	25	28	32	
Capital Expenditures	65	65	20	20	20	20	20	
Change in NWC	2	2	2	2	2	2	2	
Free Cash Flow	113	136	196	292	339	393	476	
Terminal Value								4998*
WACC	3.21%							
(1+WACC)^n	1.032100	1.06523	1.099424	1.134716	1.17114	1.208734	1.247534	
Discounted Free Cash Flow	109.4855	127.6719	178.2751	257.3332	289.4615	325.1336	381.5527	4998
Implied Value	6666.913							
Outstanding Shares	196.43							
Stock Price	\$33.94							

*Terminal Value calculated with 10.5x the FCF of last projected year

Projected Annual Income Statement (USD m)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Dry Foods	434	592	746	833	936	1035	1126	1249	1374	1511	1662
Wet Foods, Treats, Other	89	128	172	194	215	240	275	314	352	394	433
Net Sales	523	720	918	1027	1151	1275	1401	1563	1726	1905	2095
Cost of Goods Sold	311	422	551	609	679	752	827	855	940	1030	1100
Gross Profit	212	298	367	418	472	523	574	708	786	875	995
Advertising	33	58	81	84	92	102	112	125	130	135	140
R&D	2	5	8	10	12	13	14	14	14	14	14
Non-Strategic SG&A	60	76	92	115	127	140	154	172	190	210	231
Total Ongoing SG&A	95	139	181	209	231	255	280	311	334	359	385
Operating Profit	117	158	178	158	241	268	294	397	452	516	610
Non-Recurring Items	0	1	8	51	0	0	0	0	0	0	0
Adjusted Operating Profit	117	159	186	209	241	268	294	397	452	516	610
Net Interest Expense	10	37	14	15	16	16	16	16	16	16	16
Other Expense	0	0	0	0	0	0	0	0	0	0	0
Pre-Tax Income	107	121	164	143	225	252	278	381	436	500	594
Income Tax	43	44	63	56	85	98	109	140	160	185	220
GAAP Net Income	64	77	101	87	140	154	169	241	276	315	374
Interest	10	37	14	15	16	16	16	16	16	16	16
Taxes	43	44	63	56	85	98	109	140	160	185	220
D&A	1	1	5	8	11	14	18	21	25	28	32
EBITDA	118	159	183	166	252	282	312	418	477	544	642
CAPEX	23	64	33	10	65	65	20	20	20	20	20

Year to Year Growth

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Dry Foods	N/A	36%	26%	12%	12%	11%	9%	11%	10%	10%	10%
Wet Foods, Treats, etc	N/A	44%	34%	13%	11%	12%	15%	14%	12%	12%	10%
Net Sales	N/A	38%	28%	12%	12%	11%	10%	12%	10%	10%	10%
Gross Profit	N/A	41%	23%	14%	13%	11%	10%	12%	10%	10%	10%
Operating Profit	N/A	35%	13%	-11%	53%	11%	10%	12%	13%	13%	12%
Pretax Income	N/A	13%	36%	-13%	57%	12%	10%	13%	14%	13%	13%
Net Income	N/A	20%	31%	-14%	61%	10%	10%	13%	14%	13%	13%

As a Percent of Sales

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross Margin	41%	41%	40%	41%	41%	41%	41%	45%	46%	46%	47%
R&D	0%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
Advertising	6%	8%	9%	8%	8%	8%	8%	8%	8%	7%	7%
SG&A	18%	19%	20%	20%	20%	20%	20%	20%	19%	19%	18%
Less: Non-Recurring	0%	0%	1%	5%	0%	0%	0%	0%	0%	0%	0%
Adjusted SG&A	18%	19%	21%	25%	20%	20%	20%	20%	19%	19%	18%
Total Operating Expenses	18%	19%	20%	20%	20%	20%	20%	20%	19%	19%	18%
Operating Margin	22%	22%	19%	15%	21%	21%	21%	25%	26%	27%	29%
Adjusted Operating Margin	22%	22%	20%	20%	21%	21%	21%	25%	26%	27%	29%
PreTax Margin	20%	17%	18%	14%	20%	20%	20%	24%	25%	26%	28%
Effective Tax Rate	40%	36%	38%	39%	38%	39%	39%	37%	37%	37%	37%
Net Margin	12%	11%	11%	8%	12%	12%	12%	15%	16%	17%	18%

Bearish Case Discounted Cash Flow Valuation

Free cash flow was calculated using projected annual revenues found on the next page. Depreciation and amortization sees a bit of a spike starting in 2018 due to the opening of their new factory and the costs associated with it. Capital expenditures also spiked in 2016 and into 2017 during the construction period of the new plant. Our WACC value was calculated using a beta of 0.75. The bearish DCF uses an EBIT that reflects no marginal growth due to the possibility of mismanagement of the new manufacturing plant. We used a 3.2x multiple of our final year's free cash flow (the historical rate of growth for companies in the S&P 500) to arrive at our terminal value

WACC Calculation

Market Value of Equity	85780
Market Value of Debt	385000
Interest Paid (Annual)	15091
Equity + Debt	470780
Beta	0.75
10 yr Treasury Bond (Risk Free)	0.0162
Market Risk Premium	0.0491
E/V (% of financing that's equity)	0.18220825
Re (Cost of Equity)	0.040875
D/V (% of financing that's debt)	0.81779175
Rd (Cost of Debt)	0.039197403
(1-Tc) (Tc = corporate tax rate)	0.77
WACC	0.032130353

$$WACC = r_d(1 - T_c)(D/V) + r_e (E/V)$$

	2016	2017	2018	2019	2020	2021	2022	Terminal
EBIT	241	268	294	330	374	422	474	
Interest Paid	16	16	16	16	16	16	16	
Taxes	56	63	70	79	90	102	115	
Tax Adjusted EBT	169	189	208	235	268	304	343	
D&A	11	14	18	21	25	28	32	
Capital Expenditures	65	65	20	20	20	20	20	
Change in NWC	2	2	2	2	2	2	2	
Free Cash Flow	113	136	204	234	271	310	353	
Terminal Value								1341*
WACC	3.21%							
(1+WACC)^n	1.032100	1.06523	1.099424	1.134716	1.17114	1.208734	1.247534	
Discounted Free Cash Flow	109.4855	127.6719	185.5517	206.2190	231.3984	256.4667	282.9582	1341
Implied Value	2740.751							
Outstanding Shares	196.43							
Stock Price	\$13.95							

*Terminal Value calculated with 3.2x the FCF of last projected year, the historical growth rate for companies in the S&P 500

Projected Annual Income Statement (USD m)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Dry Foods	434	592	746	833	936	1035	1126	1249	1374	1511	1662
Wet Foods, Treats, etc	89	128	172	194	215	240	275	314	352	394	433
Net Sales	523	720	918	1027	1151	1275	1401	1563	1726	1905	2095
Cost of Goods Sold	311	422	551	609	679	752	827	922	1018	1124	1236
Gross Profit	212	298	367	418	472	523	574	641	708	781	859
Advertising	33	58	81	84	92	102	112	125	130	135	140
R&D	2	5	8	10	12	13	14	14	14	14	14
Non-Strategic SG&A	60	76	92	115	127	140	154	172	190	210	231
Total Ongoing SG&A	95	139	181	209	231	255	280	311	334	359	385
Operating Profit	117	158	178	158	241	268	294	330	374	422	474
Non-Recurring Items	0	1	8	51	0	0	0	0	0	0	0
Adjusted Operating Profit	117	159	186	209	241	268	294	330	374	422	474
Net Interest Expense	10	37	14	15	16	16	16	16	16	16	16
Other Expense	0	0	0	0	0	0	0	0	0	0	0
Pre-Tax Income	107	121	164	143	225	252	278	314	358	406	458
Income Tax	43	44	63	56	85	98	109	123	140	159	179
GAAP Net Income	64	77	101	87	140	154	169	191	218	247	279
Interest	10	37	14	15	16	16	16	16	16	16	16
Taxes	43	44	63	56	85	98	109	123	140	159	179
D&A	1	1	5	8	11	14	18	21	25	28	32
EBITDA	118	159	183	166	252	282	312	351	399	450	506
CapEX	23	64	33	10	65	65	20	20	20	20	20

Year to Year Growth

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Dry Foods	N/A	36%	26%	12%	12%	11%	9%	11%	10%	10%	10%
Wet Foods, Treats, etc	N/A	44%	34%	13%	11%	12%	15%	14%	12%	12%	10%
Net Sales	N/A	38%	28%	12%	12%	11%	10%	12%	10%	10%	10%
Gross Profit	N/A	41%	23%	14%	13%	11%	10%	12%	10%	10%	10%
Operating Profit	N/A	35%	13%	-11%	53%	11%	10%	12%	13%	13%	12%
Pretax Income	N/A	13%	36%	-13%	57%	12%	10%	13%	14%	13%	13%
Net Income	N/A	20%	31%	-14%	61%	10%	10%	13%	14%	13%	13%

As a Percent of Sales

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Gross Margin	41%	41%	40%	41%	41%	41%	41%	41%	41%	41%	41%
R&D	0%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
Advertising	6%	8%	9%	8%	8%	8%	8%	8%	8%	7%	7%
SG&A	11%	11%	10%	11%	11%	11%	11%	11%	11%	11%	11%
Less: Non-Recurring	0%	0%	1%	5%	0%	0%	0%	0%	0%	0%	0%
Adjusted SG&A	11%	10%	9%	6%	11%	11%	11%	11%	11%	11%	11%
Total Operating Expenses	18%	19%	20%	20%	20%	20%	20%	20%	19%	19%	18%
Operating Margin	22%	22%	19%	15%	21%	21%	21%	21%	22%	22%	23%
Adjusted Operating Margin	22%	22%	20%	20%	21%	21%	21%	21%	22%	22%	23%
PreTax Margin	20%	17%	18%	14%	20%	20%	20%	20%	21%	21%	22%
Effective Tax Rate	40%	36%	38%	39%	38%	39%	39%	39%	39%	39%	39%
Net Margin	12%	11%	11%	8%	12%	12%	12%	12%	13%	13%	13%