GRANT'S
INTEREST RATE OBSERVER®
Vol. 31, No. 22c Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 15, 2013

All you can eat

"Yes, food retailing is more competitive than ever," John Mackey, co-founder and co-CEO of Whole Foods Market, said during the conference call last week that followed release of satisfactory fiscal 2013 results (but of worrying 2014 guidance). "And with the growing demand for fresh, healthy foods, it seems like everyone is adding to or expanding their offering of natural and organic products."

Enter here, Sprouts Farmers Market (SFM on the Nasdaq), the multiple-sprouting specialty retailer of natural and organic food and charter member of the *Grant's* Story Stock Index. Today, there are 167 Sprouts stores. Over the next two decades, if all goes according to plan, there will be 1,200. Nodding his assent, Mr. Market has assigned the stock an 80 multiple on the 2014 sell-side earnings estimate and an equity capitalization of $7.1 billion. *Grant's* is bearish on it.

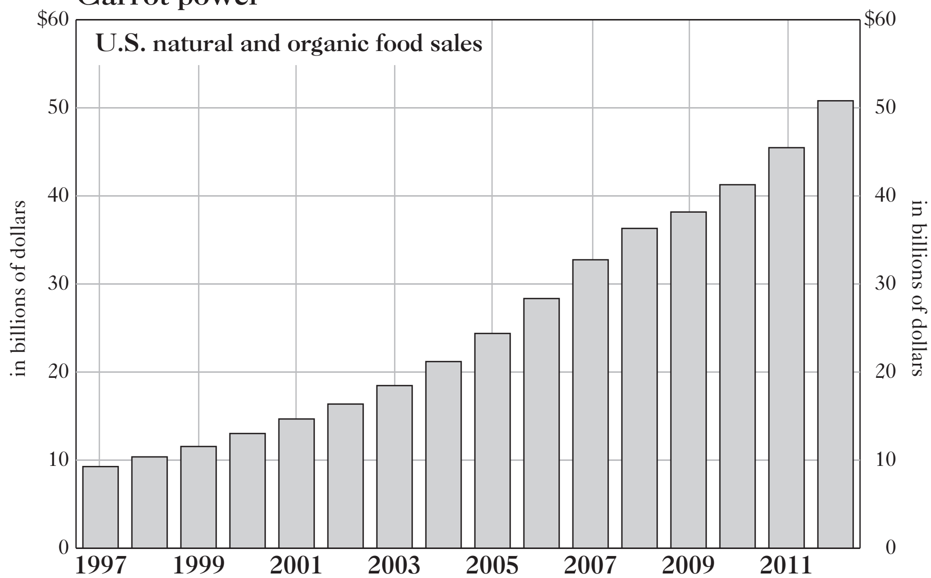
The Sprouts family tree looks like something out of the Book of Genesis. The company is the product of a succession of mergers. It's relevant for this analysis that, in 2007, Whole Foods purchased Wild Oats and sold Henry's Farmers Market (then a part of Wild Oats) to Apollo Management. In April 2011, Sprouts, which now had 63 stores, entered into a transaction with Apollo, and the private equity firm created the subject of this essay by combining Sprouts with Henry's. "Reading the company's prospectus," relates colleague David Peligal, "you're hard-pressed to truly understand the historical financials since three companies—Sprouts, Henry's and Sunflower Farmers Market—were rolled up and put together. Everything is pro-forma."

Anyway, Sprouts, which is based in Phoenix and operates in the $600 billion American supermarket industry, is eating the lunch of conventional food retailers. "According to the *Nutrition Business Journal*," the company's prospectus reads, "spending on natural and organic food experienced a compound annual growth rate of 12% from 1997 to 2011, reaching $43 billion in the United States [revisions raise that figure to $45.5 billion], and is expected to continue to grow at a CAGR of 10% through 2020."

Doug Sanders, Sprouts' president and CEO, brought the gospel of growth to a Goldman Sachs-sponsored September investor conference. "If you think about where growth is in retail grocery," said he, "traditional grocery is growing with inflation, 2%, 2.5%. Natural and organic sector is growing at 10% plus, and this is where the growth is. And the health and wellness trend, as it is gaining traction across the country, is driving that growth."

One could almost say that if Sprouts didn't exist, Wall Street would have to invent it. "Just look at the form 8-K that went along with the Goldman presentation," Peligal notes. "Why is the company a compelling investment? (A) Authentic natural and organic food offering at great value—check; (B) Fast-growing segment of the U.S. supermarket industry with strong macro tailwinds—check; (C) Significant new store growth opportunity supported by broad demographic appeal—check; (D) Proven and replicable store model with compelling unit

Carrot power



source: *Nutrition Business Journal*

economics—check. As to the last point, bulls contend, the Sprouts concept is unique; you don't need huge, conventional grocers' volumes to succeed. A good store is a $15 million revenue store; it's profitable. And it's cheap to build: you can put up 25,000 square feet for a net cash investment of $2.8 million. Pre-tax, cash-on-cash returns duly follow—Sprouts targets 35% to 40% within four years. Expect growth to 300 stores in existing markets, expansion within the southeastern United States by the middle of 2014, management says."

Not that Sprouts has the fresh and healthy field to itself (we wonder about opportunities in the stale and unhealthy field). Grocers big and small are homing in on it. Thus, Cincinnati-based Kroger Co. (KR on the Big Board), with its $21.8 billion market cap and resurgent share price, owns the Fry's brand in Arizona and the King Soopers brand in Colorado; both play to the Sprouts customer. Publix Super Markets, Safeway, Trader Joe's, Whole Foods, Fresh Market, Wal-Mart Stores, WinCo Foods, Natural Grocers by Vitamin Cottage, AmazonFresh etc., have their eye on the same health-conscious shopper.

It's perhaps a sign of the supercharged times that Chris Sherrell, former CEO of Sunflower Farmers Market, chose to found Fresh Thyme Farmers Market last year rather than go to work for Sprouts. Why settle for a salary when Mr. Market pays so much better?

"To get a better feel for the competitive landscape, I visited some grocery stores this week in Phoenix and Scottsdale," Peligal reports. "First stop was the Sprouts store on E. Indian School Road in Phoenix. It's situated in a shopping center with an Edward Jones office, a Papa John's Pizza and an Edible Arrangements store. I asked a woman outside why she came to this Sprouts and not Trader Joe's or Whole Foods. Carrying a small bag full of groceries, she remarked, 'I actually go to all three. It just so happens my chiropractor is located in this shopping center.' Two guys in the parking lot mentioned they came to this store for 'reasonably priced produce.' There were maybe 30 or 40 people inside the Sprouts store at around 2:15 p.m. One of the employees told me the store looks nicer now; this particular one got remodeled about six months ago. Sitting at the delicatessen counter chomping on a turkey sandwich with avocado ($2.99 plus 50 cents for the avocado), I watched people casually check out some of the bulk goods. For example: bulgur wheat for $0.99/pound, dried cranberries for $4.99/pound, and walnuts for $8.99/pound.

"Next, I stopped by a shopping center on 20th Street and Camelback Rd. in the Biltmore area of Phoenix," Peligal's dispatch continues. "It was less than a five-minute drive from my first stop. No Sprouts here. But there is a Trader Joe's and a brand-new Whole Foods, gleaming and well-stocked, complete with a juice bar, an espresso bar and another kind of bar with more than 36 craft beers on tap. I asked an ordinary Sprouts employee about the competitive situation. 'Our competition is Trader Joe's,' came the reply. 'The Whole Foods customer is the Whole Foods customer. That customer is going to Whole Foods and they're not going anywhere else. The Sprouts customer? The Sprouts customer goes to Fry's, they go to Fresh & Easy, that's our customer. We consider ourselves a transitional store, in that we appeal to the customers who would probably never go to a Whole Foods because they would never pay that kind of price.' Perhaps this is true, but as Whole Foods looks to combat its 'Whole Paycheck' reputation, management has promised to engage in 'more aggressive price matching against select competitors.'

"The Sprouts store on Shea Blvd. in Scottsdale, which was renovated earlier this year with new flooring and new freezers, was by far the most impressive of the ones I visited," Peligal's travelogue concludes. "Bulls will argue that many of the new stores Sprouts is building will be built with this format. More than the other Sprouts stores I visited—there were three, altogether—the Shea Blvd. store seemed to draw well-heeled shoppers that weren't exclusively over 60 years old. But here's the problem: the competition isn't going away. Less than a mile away, there were two Fry's stores right off Highway 101—Fry's Marketplace and Fry's Signature. The Fry's Signature store, in particular, was probably three times the size of the Sprouts' store on Shea Blvd. and had an impressive selection of organic foods."

Burt P. Flickinger III, managing director of New York-based Strategic Resource Group, a supermarket consultant, kindly contributed his take on Sprouts, as follows: "Phoenix is by far their best market. There is quite a variance between the stores my team and I checked in California, relative to Phoenix. If they can do another 1,000 stores like what you see in Phoenix, this could be a spectacular success—even at these valuations. The problem is that the cap-ex to do all the stores like Phoenix—you're running at 'catch-up' cap-ex rates of 3.5% to 5% as a percentage of sales, and for the oldest acquired stores, cap-ex of up to 7% to 8%, which is unsustainable. In Phoenix, renovations and major remodels made Sprouts look like a brand-new store. It looks like the best of Whole Foods. Whereas in California, you have a sprinkling of so many acquired chain stores—Henry's under Smart & Final or Boney's in San Diego, which was bought by Henry's. They postponed capital expenditures for a significant amount of time. It's probably not cost effective for Sprouts to completely renovate those stores but, at the same time, sections of the stores look a little older and a little more tired."

One way to think about Sprouts' valuation is to try to imagine the completed corporate work. Assume, for instance, that management builds its 1,200th store and builds it tomorrow—there, that was easy. Those 1,200 stores at a net cash investment of $2.8 million per store would require $2.9 billion of additional investment. So add $2.9 billion to the $7.1 billion market cap, and the $372 million of net debt to get an enterprise value of $10.4 billion.

Next assume the company can hit the high end of its pre-tax cash-on-cash return target of 35% to 40%. This would yield a total of $1.12 million of EBITDA per store, or $1.34 billion of EBITDA for all 1,200 stores. Ignore corporate expense, for now. The company is trading—as we imagine it—at 7.8 times enterprise value divided by EBITDA ($10.4 billion of EV over $1.34 billion of EBITDA). So ends our hypothetical exercise.

"Now then," suggests Peligal, "let's compare Sprouts as it really is to The Fresh Market (TFM on the Nasdaq), a 31-year-old specialty grocery retailer, and Fairway Group Holdings (FWM, also on the Nasdaq), a popular New York City grocer. Fresh Market, with an average store size of 20,000 square feet, operates 140 locations across 26 states. Fairway, with an average store size of about 35,000 square feet, operates 14 locations in three states. Adding the enterprise value of Fresh Market to the enterprise value of Fairway, you get $3.7 billion. It's a little less than half of the

Sprouts' enterprise value. Adding the EBITDA of Fresh Market to the EBITDA of Fairway—admittedly an imprecise calculation owing to the difference in the companies' reporting periods—you get more EBITDA than Sprouts generates. In sum: for about the same sales levels and growth rates, you're getting more EBITDA with Fresh Market and Fairway and paying about half the price. One of the knocks on shorting a company like Sprouts at this point is that shorting high-growth retailers this early in the store rollout is often a loser. It's a fair criticism and perhaps this is why the opportunity exists."

In April, Leon Black, chairman and CEO of Apollo Global Management, served notice on the bull market. "We think it's a fabulous environment to be selling," he said. "We're selling everything that's not nailed down, and if it is nailed down, we're refinancing it." It should, therefore, have come as no surprise that Apollo, owner of 45% of Sprouts, filed an S-1 on Nov. 7 to sell 22.5 million Sprouts' shares, representing about 14% of the fully diluted share count or about the same number of shares as the IPO disgorged. With the stock at 45, up from an issue price of 18, Apollo has made about 10 times its original investment. Notable is that Apollo got Goldman Sachs and Credit Suisse to waive the lock-up restrictions since Sprouts only went public three months ago.

"I would watch very carefully for issuance," the short-seller James S. Chanos advised the *Grant's* Conference last month. "We're already beginning to see a lot of it. It may take a while, but I think that some of the craziness we're seeing in the Nasdaq and the Russell 2000 and some of these high-fliers is going to bring out a lot of new stock—probably within the next six to nine months, unless I miss my guess."

And, of course, Sprouts isn't nailed down.

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