GRANT'S
INTEREST RATE OBSERVER®

Vol. 33, No. 15d Two Wall Street, New York, New York 10005 • www.grantspub.com JULY 24, 2015

Holy guacamole!

Calavo Growers (CVGW on the Nasdaq GS) came into the world only 10 years after the Federal Reserve did. "It is remarkable," marvels Lee E. Cole, 75, chairman, president and CEO of the nation's one and only major exchange-listed avocado play, "that after 90 years, the fresh avocado sector still can be considered a growth industry." As for the Calavo share price, it owes its growth as much to the super-charged times as it does to the taste and texture of the alligator pear.

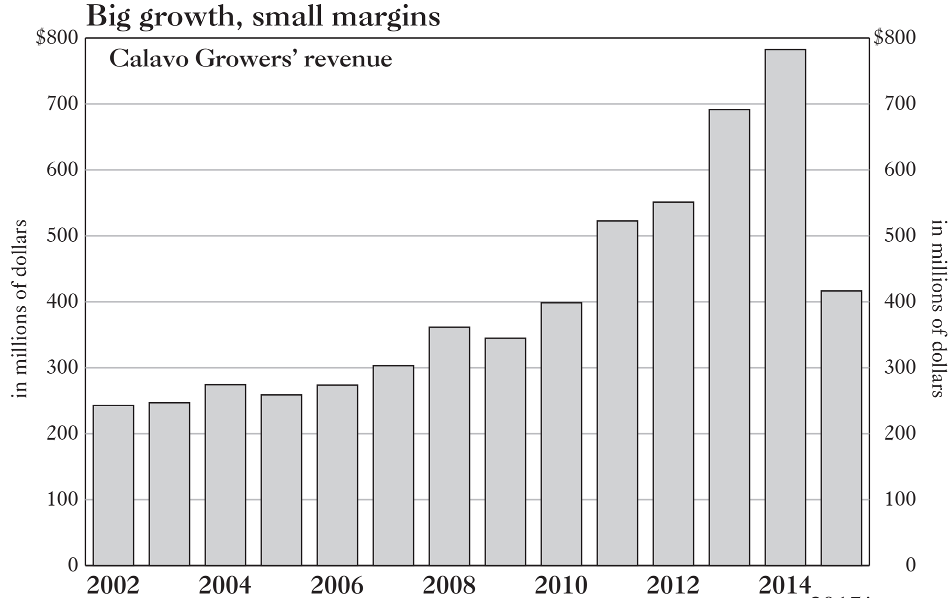
Imagine almost any biotech stock, or the inverse of any gold stock. You may now picture Calavo, a $937 million market cap, conservatively financed purveyor of all things avocado: the fruit itself; guacamole, the Super Bowl-ubiquitous avocado derivative; and—beyond avocados—a miscellany of fresh prepared packaged foods. Calavo Growers operated as a grower and member-owned cooperative from its 1924 founding until a 2001 vote to convert to for-profit status. Ten years later, following the acquisition of Renaissance Food Group, came the share price lift-off.

Google the phrase "I love avocados" and you are overwhelmed with stories of why it is right to love the fruit, and of how many others love with you. Now try "I hate avocados." You are led to suspect that you hate alone. Over the past two decades, average annual per-capita consumption of *Persea americana* in the United States has vaulted to 5 ½ pounds from 1 ½ pounds. For Cole, this is nothing less than a "perfect avocado storm," its causes traceable to health consciousness, shifting demographics and savvy promotion. As to the latter, if you do not know that avocados are cholesterol- and sodium-free, dense in fiber, vitamin B6 and antioxidants, you have somehow eluded the $50 million-per-annum, grower-financed avocado PR blitz.

Donald Trump may not like it, but Mexico figures largely in the avocado growth story. Mexican-grown fruit began making its way across the Rio Grande in 1997, not so much competing with the California-grown variety (as the California orchard keepers feared), as supplementing the indigenous crop after the close of the March-September California growing season. America's burgeoning Hispanic population—now 17% of the whole—has likewise boosted consumption. It brings tears of joy to the eyes of the bulls when they consider that per-capita avocado consumption in Mexico weighs in at 28 pounds per annum. Surely, American consumption has much, much further to go.

As matters stand today, just 15% of the nation's avocado intake is sourced from drought-stricken California. Mexico stumps up 60%, Peru 8%. "It's come to this: California avocados are becoming a boutique, specialty-type crop that you'll only find in Whole Foods or other high-end grocery stores," colleague David Peligal observes. "Not so long ago, you'd paid $1 per avocado, no matter where it was from; nowadays, it's more like $2. While 'fad' isn't exactly the word for the avocado phenomenon—it's hard to argue with a 20-year improv-

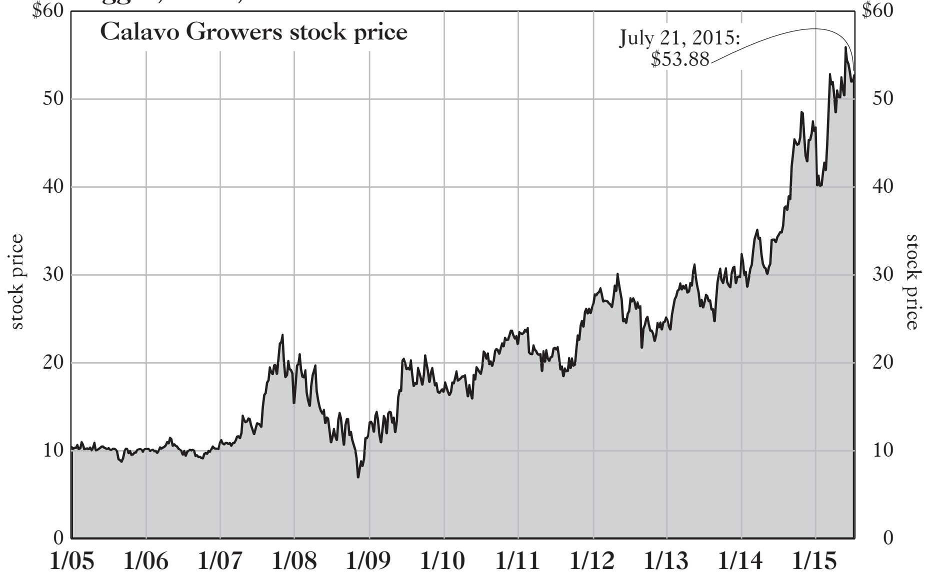
Big growth, small margins



*through first six months
source: company filings

ing market—I do wonder whether the growth rates the stock market might be dreaming of can realistically continue. 'Have You Eaten Your Last Avocado?' posed the April 20 edition of *New York* magazine. Came the answer: 'Avocados are having a moment, in the way that, in the ascendant, hashtag-friendly foodie culture of the early-21st century, certain food items can, like pop stars or catch phrases or hem lengths or hairstyles, have a moment. The avocado has emerged unexpectedly as the J.K. Simmons of the fruit basket: admiringly versatile, long underappreciated, suddenly celebrated, and unexpectedly on the verge of being priced out of your budget.' Well, *New York* magazine may or may not have the call on tomorrow's avocado prices, but it seems fair to assume that avocado demand is price elastic to a degree. Some will gladly pay $2 or $3 to add avocado to their salad at Chop't, and some (perhaps many) will not."

Bigger, even, than kale



source: The Bloomberg

In the first half of fiscal year 2015, ended April 30, Calavo Growers generated $416.4 million of sales, up 14.7% from the year before. "Fresh products," its No. 1 business division, accounted for 60% of the top line. It's the unit that "grades, sizes, packs, cools, and ripens (if desired) avocados for delivery to our customers," the company relates. To handle the domestic trade, Calavo operates two packinghouses and three operating and distributing facilities. It handles not quite a quarter of the California crop and roughly one-fifth of Mexican avocados exported to the United States. Aiming for a bigger share of the Mexican trade, the company is expanding into a new growing region outside Guadalajara. All this concentrated avocado effort, at home and abroad, yields a gross margin of all of 7.9%.

While the avocado businesses garner the attention, it's the Renaissance Food Group segment that drives the growth. Calavo: "Our RFG business produces, markets and distributes nationally a portfolio of healthy, high-quality lifestyle products for consumers via the retail channel. RFG products range from fresh-cut fruit, ready-to-eat vegetables, recipe-ready vegetables and deli meat products. RFG sells under the popular labels of Garden Highway Fresh Cut, Garden Highway, and Garden Highway Chef Essentials to a wide range of customers." In the service of generating one-third of the top line in the six months through April, RFG was only slightly more profitable than the not very profitable avocado business; it posted an 8.7% gross margin.

Growth was—and is—what makes RFG an intra-company star. The fresh refrigerated packaged goods line—i.e., RFG's line—is outgrowing the overall grocery business by 2:1. With revenues swelling at the annual rate of more than 20%, RFG is doing twice or three times as well as the average of its peers. On the June 2 earnings release, CEO Cole predicted more of the same: "From an operations standpoint and, more broadly, indicative of the growth potential in the refrigerated fresh packaged-foods segment, we have invested in facilities and capacity expansion at RFG, which we expect will continue to drive top- and bottom-line growth in the quarters and years to come."

What are the odds on continued 20% rates of expansion in RFG's revenue? Low, we judge. One reason, apart from the improbability of sustaining 20% growth in anything, is that RFG's customers—Safeway and Kroger among them—might choose to do for themselves what their fast-expanding vendor is currently doing for them. Kroger seemed to take a step in that fateful direction a few months ago when it unveiled its own "Fresh Kitchens" business. For Calavo, it might have seemed the sincerest form of flattery.

In the first half of fiscal 2015, Calavo earned $13.8 million, or 79 cents per diluted share. Say—as the Street says—that next year will deliver $2.20 a share. At the currently prevailing stock price of $53, this highly commoditized business commands a forward P/E multiple of 24. Earnings data at Calavo come with an asterisk and a back story. In accounting for the 2011 acquisition of RFG, the Calavo front office erred in presenting terms of the agreed upon earn-out with the sellers. Three years of earnings were therefore restated. (The market shrugged off news in June that the 64-year-old CFO/COO, Arthur Bruno, was stepping down.)

"We view the fundamental story very favorably as it boasts a rare commodity—growth," Heather Jones, the BB&T analyst on the case, remarked after Calavo released earnings last month. "However, we believe the shares fully discount the outlook, particularly given that its sales and earnings are largely driven by relatively low-margin businesses with limited opportunity for dramatic expansion." A cheap stock Calavo certainly isn't, no matter which measurement you apply. In terms of EV to EBITDA—enterprise value to earnings before interest taxes, depreciation and amortization—it changes hands at no less than 16 times.

On the Loews Corp. earnings call in May, CEO Jim Tisch remarked that "after all these years of low interest rates and quantitative easing, what we have is markets, both fixed-income and equity markets, that are priced for perfection." He quipped that with respect to EV to EBITDA valuations in private-equity transactions, "10 times is the new six times."

A multiple of 16 times would seem to eliminate Calavo from consideration as a candidate for a going-private transaction. Then, again, in this market, it doesn't pay to dogmatize. Last month, Campbell Soup Co. bought Garden Fresh Gourmet for $231 million, or 2.31 times sales, twice the price-to-sales multiple at which Calavo is quoted. Garden Fresh Gourmet makes the No. 1 branded refrigerated salsa in the United States; Calavo makes its own salsa and, of course, guacamole, but those desirable product lines are tucked away in that tiny department of the business called Calavo Foods. A bull could retort that Calavo is the rare public equity that ticks all the hot new fresh-food boxes, Dole Food and Chiquita Brands International both having exited the public markets for private ownership. As for Fresh Del Monte Produce, it trades at a mere 10 times EV to EBITDA.

To read the CEO's exultant comments on prospects for the second half of fiscal year 2015—"We are extremely optimistic about the path ahead"—you would suppose he is buying stock. He's rather a seller. Cole, who has been a Calavo board member since 1982, sold 45,136 shares on July 15 at a price of $52.21. Between July 10 and July 13, he dumped 41,026 shares at prices ranging from $52.03 to $52.07. Between July 7 and July 8, he off-loaded 36,014 shares at prices ranging from $52.01 to $52.05. Between July 2 and July 6, he disposed of 34,408 shares at a price of $54.01 and $54.02. On July 1, he jettisoned 65,656 shares at a price of $52.47.

"And so on," Peligal reports. "All told since June 10, Cole sold 348,000 shares, and pocketed roughly $18.5 million. His remaining holdings sum to 437,195 shares. I called him twice—never a call back. So he'll have to put up with my speculating on why the person who presumably knows the company best is such an active seller. According to public records, Cole raises cattle and avocados on 4,400 acres in California, a chunk of which is located in Ventura County. Maybe he wants to buy more land on which to grow still more avocados. Or maybe he realizes that this is about as good as it gets—that he has already milked the avocado side of his business, and that he's a bit out of position for the future. Perhaps he realizes that he has no exposure in Peru, the emerging avocado producing area of the world, and if he wants to get in, it's going to cost him a whole lot of money, because he's late and doesn't have the distribution network.

"Perhaps Cole looks around at his other board members and realizes that they are not exactly spring chickens (the average age is almost 67); where are the young up-and-comers who will lead Calavo in the future? Perhaps he realizes that the company's revenue growth rate will start to slow, and if Mr. Market wants to pay a crazy multiple for his stock, so be it. And what would happen if there were a health scare in avocados similar to the E.coli O157:H7 outbreak that rocked the spinach market in 2006?"

Or perhaps the chairman and CEO of Calavo is a reasoner by analogy. Let us hypothesize that Cole has been following news of the patenting of dulse, "a new strain of a succulent red marine algae" that grows quickly, is packed full of protein, and when cooked tastes like bacon. According to the Oregon State University researchers who secured the patent (we quote from the press release), dulse is a kind of super food with twice the nutritional value of kale.

Kale is, of course, the new foodie favorite green vegetable. It has disrupted spinach, and now it appears that dulse may disrupt kale. Beware avocado stock cultists: Nothing's forever in the dynamic world we live in.

•