

Short: Vital Farms (VITL) - \$26.40

Vital Farms is a branded egg distributor, focusing on supplying pasture-raised eggs to meet the growing trend of ethical food consumption. At its core, Vital is selling a commodity and what moat the company does have is eroding. A combination of unsustainable trends have caused the outlook of the company to be severely overstated, with multiple catalysts for a realization of a more realistic valuation.

Current Price: \$26.40

Target Price: \$13

Downside: 50%

Thesis Summary

Vital Farms went public in July 2020. COVID-related demand from stockpiling and home-cooking as well as growth in distribution has shrouded the true operating nature of the company. At 80x 2021 EV/EBITDA, VITL is a short with multiple pathways for realizing a more realistic valuation.

1. YoY comps: COVID has disrupted the growing trend of eating out in favor of home-cooking. Stockpiling has also caused shortages of eggs in some locations. As we return to normalcy, Vital Farms will show worsening financial results. In their S-1, they attributed half of growth and 280 bps of margin to stockpiling. Further, their biggest revenue source, Whole Foods, began to compete against them at the peak of the craze. As demand dies down, the effects will shine through Vital Farms' financials.
2. Saturation of distribution: During the demand craze of this year, new store growth has fallen to 5% QoQ. Prime locations for distribution are likely to have already been picked up and new additions are less accretive, driving down revenue/store compared to sellside assumptions.
3. Competition: Currently, brand power and differentiation between conventional eggs allow for a \$1-\$2 markup. Vital Farms relies on mainstream (Walmart, Albertsons) and natural (Whole Foods, Sprouts) stores. In no location was Vital Farms the cheapest, losing to competing brands in the mainstream locations and store-brands in the natural locations, each

offering identical pasture-raised eggs. Now that the market has been proven, big players are also beginning to enter it.

4. Regulation: 7 states with 23% of US population have enacted regulation moving away from conventional methods into cage-free and above. As suppliers are forced to comply, the cage-free method will become normative, eroding the ethical moat of Vital Farms that relies on the comparison of pasture-raised to typical methods of keeping hens and inviting conventional suppliers into their market.
5. Valuation: Their closest competitor Cal-Maine trades at 1.1x 2021 revenue and 13x 2021 EV/EBITDA vs 3.6x and 82x for Vital Farms. We will see why the growth premium is unwarranted even in the best-case scenario, implying ~50% downside.

Catalyst Summary

In 2021 the company's results will have to answer competition on the part of their largest customer undercutting them by over \$1 in almost all major metropolitan areas, a sharp decrease in egg demand as COVID's effects dissipate, and slowing new store growth. Beyond 2021 they will face the transition of the US egg supply to cage-free and how they plan to maintain market share in such an environment with growing competition.

Business

Vital Farms operates in the growing trend of ethical food consumption. Consumers show a sizable interest in understanding where their food comes from, with more than 75% attributing some weight to sustainable practice in purchasing decisions.¹

Eggs are a ~\$10Bn business in the USA. 1/3 of that goes to egg products - meaning that they aren't sold as shelled eggs but rather in liquid or solid form for use in egg-based foods. The rest of the production is split between conventional, cage-free, free-range, pasture-raised, and a few other varied labels. Conventional eggs are the largest market since they are the cheapest, both in the retail

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<https://sustainablebrands.com/read/stakeholder-trends-and-insights/77-of-americans-say-sustainability-factors-into-food-purchasing-decisions>

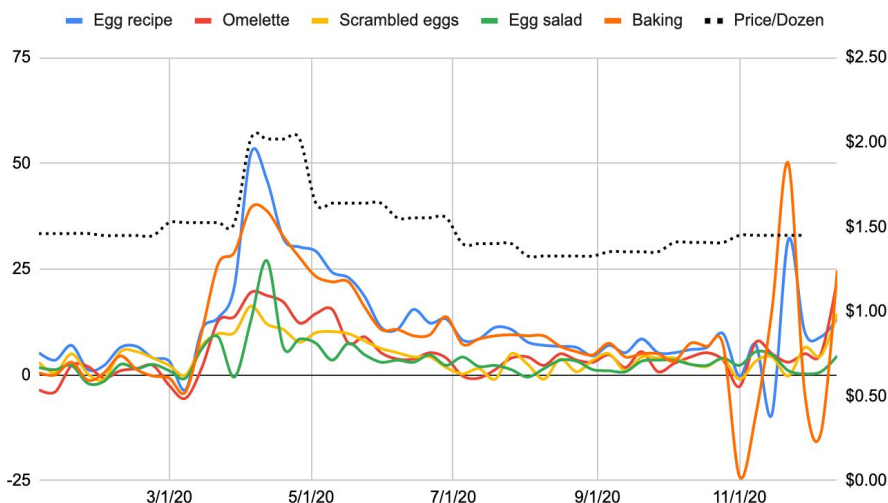
and food service segments. This market is shrinking in favor of labels with less implied cruelty due to demand and regulation. The shell egg market as a whole has seen constant but slow growth over time. Segments within the shelled egg market, like pasture-raised, are gaining market share at much higher rates.

As an egg distributor, Vital Farms partners with “family farms” to sell Pasture-Raised eggs. They sign contracts with these farm owners that guarantee purchase of the eggs at a given rate while farms are responsible for all of the working capital needed to produce them. When signing these contracts, Vital Farms ensures that the conditions for the hens are enough to meet the Certified Humane definition of 108 sq ft per bird and are then able to market the eggs as such (not regulated by the USDA). Once they purchase the eggs, they send them to their processing location where they are weighed, sorted, and packaged. They have one location in Springfield, MO which they are working to double the capacity of. From there, it is shipped to retail locations around the US, sold under their brand-name.

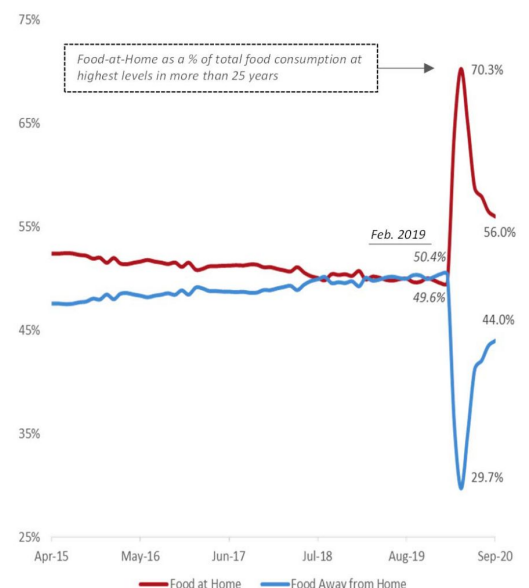
COVID

For a company that IPO'd in July, it is nice to have the best year egg demand has ever seen in your marketing materials. 2020 revenue is set to be 50% higher than the previous year, and the company is only growing still. During the first phase of lockdowns, the price of eggs doubled. This

Difference in Google Search Trends (2020 vs Average of 2016-2019) & Price of Eggs



Monthly U.S. Food Expenditures (%)



seems to be doubly due to the mania caused by the virus as well as a genuine interest in home cooking.²

Not only is this trend temporary, but it is actually worsening. 2019 was the first year that eating out was more popular (in \$\$) than eating at home - a long term trend. COVID temporarily flipped that, dropping away-from-home expenditure to 29.7%. Eggs themselves are still equally, if not more, important in the food being made due to perceived health benefits, but restaurants will seldom spring for the price differential since they're not selling the brand. Foodservice was just 1% of total revenue vs 6% for Cal-Maine.

Egg consumption per capita has historically grown at a rate of about 0.7% per year since 1999. From 2015-2019, the rate increased to 3.5%.³ 2020 has been a true aberration, with half of revenue growth and 280 bps of margin improvement attributed to price and volume resulting from lockdowns.⁴

Competition



What is the order of operations in choosing here? I'd argue 1. What price am I willing to pay? 2. How many do I want? 3. Should I buy a sustainable brand? And then, using the narrowed down options, maximize ethics while minimizing price. But how long are you willing to spend on this? How long does it take to find Vital Farms?

² https://calmainefoods.com/media/1173/investor_presentation_nov-2020.pdf

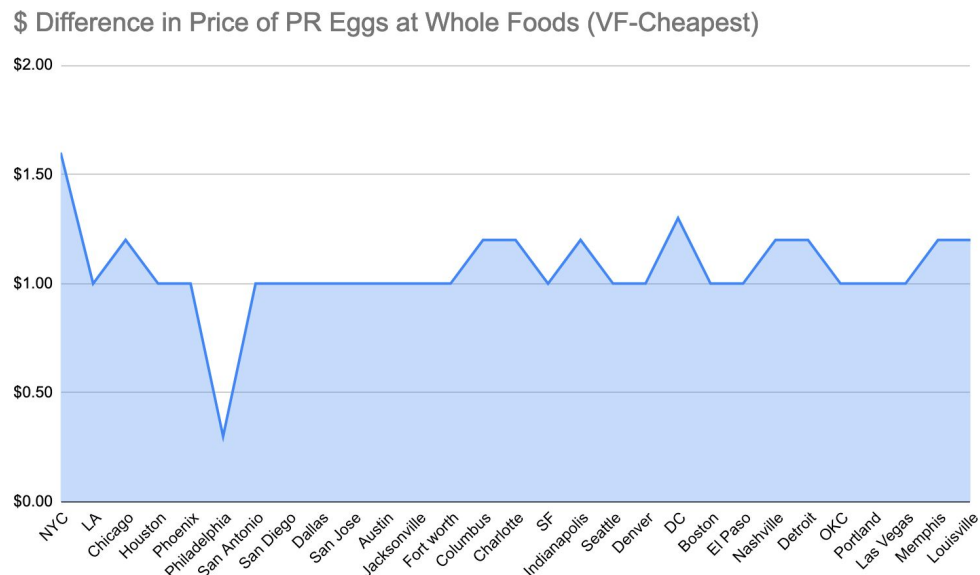
³ <https://unitedegg.com/facts-stats/>

⁴ <https://investors.vitalfarms.com/static-files/5ce98856-66b2-4b85-b30c-79823bb66a9c>

Vital farms claims in their earnings report to be the #2 Overall Egg Brand and #1 Pasture-Raised Egg Brand in the US with 80% market share.⁵ This couldn't be farther from reality as they exclude private labels in their calculation, even as private labels like those of Sprouts and Whole Foods carry the same ethos of the store in being natural.

In reality, assuming their supply has grown with their demand, they are not even in the top-50 egg producers. Compared to Cal-Maine's 44m hens, Vital Farms likely has closer to 3m.⁶

They also lose on price. Vital Farms sells their Pasture-Raised eggs for \$5.99 and Organic Pasture-Raised eggs for \$6.99. Whole Foods accounts for over 30% of their revenue and has undercut them on price in the Pasture-Raised category in all of the top-30 cities by population in the US according to my research. Based the earliest online reviews for Whole Foods' product, this was launched in April 2020 so results have yet to normalize the impact. Sprouts similarly carries their brand at \$1 cheaper (seems to have launched in late 2019) but I have also found Organic Pasture-Raised eggs by a local (Bay Area) brand (Red Hill) for \$3.99 - \$2 cheaper.



Further, in their S-1 they claim “the U.S. pasture-raised retail egg market in 2019 accounted for approximately \$177.0 million in retail sales and has grown at a CAGR of 31.7% between 2017

⁵ <https://investors.vitalfarms.com/static-files/6de2cdce-b67f-4f05-a314-126927d47d5a>

⁶ https://www.itpnews.com/uploads/2018/02/watt_eggi_201802.pdf?direct_access_media=1

and 2019”.⁷ Using this, we are able to back-out their market share to see that, even before Amazon and Sprouts entered their market, they were losing share despite their growth.

Pasture Raised Eggs	2017		2018		2019
VF Revenue	\$	66,600	\$	98,967	\$ 128,579
PR Market Size	\$	77,880	\$	134,396.36	\$ 177,000
VF Market Share		86%		74%	73%

These competitors have better distribution at lower costs, the same, if not better, access to Vital Farms customers, and pricing power over the company itself, given the high reliance on these concentrated revenue streams.

Other Bets

Vital has also begun selling products like hard boiled eggs, butter, ghee, liquid whole eggs, and egg bites. These products are more likely to be sold at Whole Foods and Sprouts vs their mainstream distribution sources (5.7 average items including eggs vs 2.8). Based on the store penetration of 1,577 for hard boiled eggs, the most successful non-butter venture, these items have far less reach and are contributing negligible amounts to revenue compared to butter at ~10% of revenue with 12,060 stores.⁸

Butter is sold only in the 8oz quantity for \$3.99-4.99 and ranges from 2x as expensive (including 16oz adjusted prices) to 25% more expensive (8oz only) compared to other Pasture-Raised brands. Compared to conventional butter, Vital Farms was 2.5x the cost (16oz only). The butter market at large is also smaller, at \$3.3Bn with a 2.7% CAGR from 2017-2019.⁹

Branding

Their selling point to consumers and investors comes in the form of supposed brand power, attesting that people should, and are willing to, pay more for the eggs with the same certification so long as it is sold under the logo of Vital Farms. This only accounts for a small sect of loyal

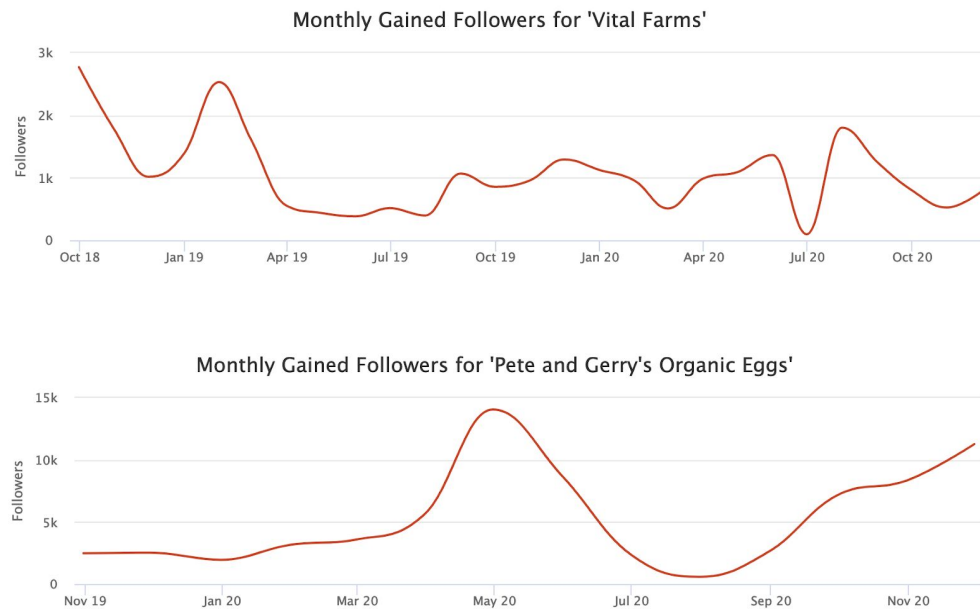
⁷ <https://investors.vitalfarms.com/static-files/c6d115bd-6bd6-4a72-ad76-7b0b3a8df27f>

⁸ <https://investors.vitalfarms.com/static-files/6de2cdce-b67f-4f05-a314-126927d47d5a>

⁹ <https://investors.vitalfarms.com/static-files/c6d115bd-6bd6-4a72-ad76-7b0b3a8df27f>

customers while many will be driven towards the competitive offerings of the private labels of grocers, who also are able to determine the real estate of the egg section.

And, for those brand-sensitive customers, Vital Farms is losing the narrative battle. With a smaller base of 89,000 Instagram followers compared to the 109,000 of Pete and Gerry's - a rival ethical egg producer - their draw is only worsening in comparison.¹⁰



This is also as brands that may be less social media savvy offer identical products at rapid rates of increased distribution like Handsome Brook Farms and Happy Egg Co. The latter is Walmart's brand of choice - cheaper by over \$1. Competitors aren't all pasture-raised but do compete for the same customer base by offering free-range and organic options. Many of the largest brands, like Cal-Maine, are currently sitting at cage-free (45% of revenue) but, as demand and regulations change, have the ability and distribution to enter higher-standard markets with force.

Regulation

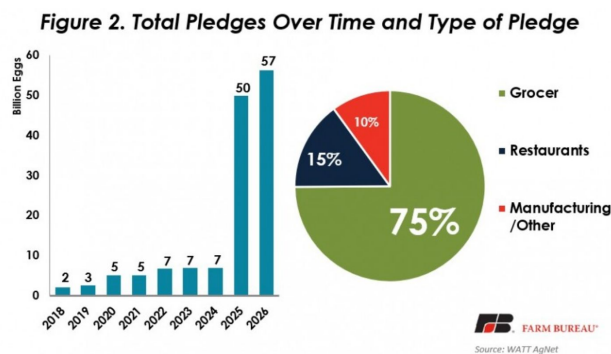
Major egg labels

- Conventional: Chickens are treated legally

¹⁰ Socialblade.com

- Cage-free: Chickens did not live in cages
- Free Range: Access was provided to the outdoors
- Pasture-Raised: Chickens spend the day outside and have indoor spaces to spend the night or winter in (up to 2 weeks)
- Organic/GMO: Describes the chicken feed

This trend of ethical consumption has gone mainstream. Both Walmart and McDonalds have pledged to only use cage-free eggs by 2025. Many states already have enacted similar laws that would require all eggs sold in the state to be cage free - amounting to over 20% of the US population. In totality, to reach these goals, over half of all eggs being produced will come from cage free sources. Cage-free is becoming a de-facto norm that eventually most producers will abide by. Some consumers will lose the ethical imperative to avoid the cheapest eggs as they are less cruel.



Producers are going to have to make this transition soon. Cal-Maine estimates that 70% of hens will need to be in cage-free facilities by 2026 and have invested over \$400m to make that a reality already.¹² Most other producers will be forced to cease operations in traditional means. This can also mean graduating beyond cage-free into higher ethical certifications - like pasture-raised. It's an economic decision. If there are profits being made supplying those eggs, they will enter the market and drive down profits for existing players. In the past, conventional producers were able to operate as normal without having to make any major investments. In the coming years, they are forced to upgrade their facilities, basically being pushed into the ethical egg market at least at the lowest level by their customers, states, and consumers. The largest portion of the \$10Bn TAM is going to be distributed into the different egg varieties, increasing competition at all levels.

¹¹ <https://www.fb.org/market-intel/cage-free-eggs-were-once-expected-to-dominate-the-egg-market>

¹² https://calmainefoods.com/media/1173/investor_presentation_nov-2020.pdf

Variant View

The biggest problem with the sellside estimates is the use of 2020 as a base year and failure to recognize the first principles of operating as an oligopoly.

On the former: estimates tout extreme CAGR figures for a market with a hard ceiling. Pasture-Raised eggs are a growing subset of a growing subset (cage free+) of a mature market growing at 1-3% a year. Irrespective of the competition that has breached the castle, it's hard to see why 2021 will be a year with more growth given the aberration that 2020 has been.

On an egg-revenue per store basis (assumes 10% of revenue from other bets) the company historically has operated in the range of \$10,000 +/- \$2,000, even in 2020. There are about 40,000 locations in the US that sell grocery items.¹³ To be in that same range of 90% of revenue from eggs and ~\$10,000 per store, they would essentially need to be in every single one of these locations by 2024 (more than doubling locations and their historical location growth rate) and cannot suffer any loss in unit economics. This is taking the projected 2024 revenue as given.

Marginal store additions are likely to continue at a slower rate since demand for higher-end commodities is not ubiquitous and the best locations are likely to be already served. All of the top-30 cities by population carry their products already.

Still, if we assume a generous growth rate, bringing them to over 22,000 stores in 2024, revenue projections are hard to comprehend. At over half of US stores served, egg-revenue assumptions imply a more than doubling of revenue per store.

Further, revenue assumptions continue to assume extreme growth in the size of the market and Vital Farm's implied share. The market for pasture-raised eggs is unsustainable since the region where hens can access the pasture year-round is limited to the south due to the suitable weather.

The model demonstrates exactly how the sell side assumptions of over \$500m in 2024 revenue, implying \$450m from eggs, are not rooted in reality. If we keep 2020's market size as even,

¹³ <https://www.foodindustry.com/articles/how-many-grocery-stores-are-there-in-the-united-states/>

or write in a small decline followed by continued strong growth, and factor in a generous 50%+ market share, we are still far from the base case.

EOY Stores Growth	10544	14,677.0 39%	16,911.4 15%	18,978.7 12%	20,729.3 9%	22,019.5 6%	22,729.5 3%	About 40,000 Grocery Stores in the USA		
S/S Scenario 1	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	Base year 2019 2020 Assumes/Implies
VF Revenue	\$ 66,600	\$ 98,967	\$ 128,579	\$ 190,921	\$ 220,776	\$ 278,178	\$ 373,500	\$ 469,800	Revenue	30% 25% 20% revenue CAGR
PR Market Size	\$ 77,880	\$ 134,396.36	\$ 177,000	\$ 265,500	\$ 336,389	\$ 409,385	\$ 477,752	\$ 533,649	Market	25% 19% PR -> half of specialty egg (cage free) market by 2024
PR Market Growth		73%	32%	50%	27%	22%	17%	12%		No loss in market share
VF Market Share	86%	74%	73%	73%	66%	68%	78%	88%		Sellside correct
Revenue/Store	\$	9,386	\$ 8,761	\$ 11,289	\$ 11,633	\$ 13,420	\$ 16,962	\$ 20,669		
S/S Scenario 2	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	Base year 2019 2020 Assumes/Implies
VF Revenue	\$ 66,600	\$ 98,967	\$ 128,579	\$ 212,134	\$ 220,776	\$ 278,178	\$ 373,500	\$ 469,800	Revenue	30% 22% 25% market CAGR
PR Market Size	\$ 77,880	\$ 134,396.36	\$ 177,000	\$ 290,595	\$ 302,432	\$ 381,066	\$ 511,644	\$ 643,562	Market	29% 22% Constrant market share
PR Market Growth		73%	32%	64%	4%	26%	34%	26%		Sellside correct
VF Market Share	86%	74%	73%	73%	73%	73%	73%	73%		
Revenue/Store	\$	9,386	\$ 8,761	\$ 12,544	\$ 11,633	\$ 13,420	\$ 16,962	\$ 20,669		
S/S Scenario 3	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	Base year 2019 2020 Assumes/Implies
VF Revenue	\$ 66,600	\$ 98,967	\$ 128,579	\$ 212,134	\$ 220,776	\$ 278,178	\$ 373,500	\$ 469,800	Revenue	30% 22% Declining market share
PR Market Size	\$ 77,880	\$ 134,396.36	\$ 177,000	\$ 309,038	\$ 341,528	\$ 458,711	\$ 659,387	\$ 892,418	Market	38% 30% 33% market CAGR - higher than last 3 years
PR Market Growth		73%	32%	75%	11%	34%	44%	35%		Sellside correct
VF Market Share	86%	74%	73%	69%	65%	61%	57%	53%		
Revenue/Store	\$	9,386	\$ 8,761	\$ 12,544	\$ 11,633	\$ 13,420	\$ 16,962	\$ 20,669		
Generous Scenario	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	Base year 2019 2020 Assumes/Implies
VF Revenue	\$ 66,600	\$ 98,967	\$ 128,579	\$ 212,134	\$ 200,511	\$ 226,664	\$ 255,259	\$ 286,224	Revenue	17% 8% Market same size in 2021. Growth slows overall
PR Market Size	\$ 77,880	\$ 134,396.36	\$ 177,000	\$ 290,595	\$ 290,595	\$ 348,714	\$ 418,457	\$ 502,148	Market	23% 15% Increased competition = declining market share
PR Market Growth		73%	32%	64%	0%	20%	20%	20%		Sellside wrong
VF Market Share	86%	74%	73%	73%	69%	65%	61%	57%		
Revenue/Store	\$	9,386	\$ 8,761	\$ 12,544	\$ 10,565	\$ 10,934	\$ 11,592	\$ 12,593		
				Revenue Difference	(20,265.2)	(51,514.2)	(118,241.4)	(183,575.6)		
Realistic Scenario	2017	2018	2019	2020	2021	2022	2023	2024	CAGR	Base year 2019 2020 Assumes/Implies
VF Revenue	\$ 66,600	\$ 98,967	\$ 128,579	\$ 212,134	\$ 180,459	\$ 203,998	\$ 220,161	\$ 236,582	Revenue	13% 3% Market same size in 2021. Growth slows as it nears saturation
PR Market Size	\$ 77,880	\$ 134,396.36	\$ 177,000	\$ 290,595	\$ 261,535	\$ 313,843	\$ 360,919	\$ 415,057	Market	19% 9% Increased competition = declining market share
PR Market Growth		73%	32%	64%	-10%	20%	15%	15%		Sellside wrong
VF Market Share	86%	74%	73%	73%	69%	65%	61%	57%		
Revenue/Store	\$	9,386	\$ 8,761	\$ 12,544	\$ 9,509	\$ 9,841	\$ 9,998	\$ 10,409		
				Revenue Difference	(40,316.2)	(74,180.6)	(153,339.4)	(233,217.6)		

This isn't technology. It's hard to see why the demand shifts of home-cooking and stockpiling should continue as we return to normalcy at the rate that these estimates assume. The basic problem is that projections ignore the reality faced by the company in the grocery store. Even without 2020 - the company was facing an inflection point in their ability to sustain their growth. Remember - half of their 2020 growth is due to COVID. Their multiple is going to be harder to justify when topline growth falls dramatically.

Valuation

As a result, to reach the price target of \$13, I have modeled in some more very generous assumptions. At an 8% EBITDA margin, higher than they have ever achieved, and a 30x multiple, higher than Facebook, they are worth 40-50+% less - even using sellside estimates. Other companies that trade at more than twice their market multiple may continue to put up big numbers, growing to their valuation. For Vital Farms, 2021 and beyond should be years of reckoning for the reasons

mentioned earlier. The valuation in the model is accommodating to protect from unexpected developments. It would be reasonable to expect downside below \$12 absent any saving graces.

EV 12/21/2020

\$	976,710	EBITDA Margin	2021 EV/EBITDA	2022 EV/EBITDA	2023 EV/EBITDA	2024 EV/EBITDA
S/S		8%	55.3	43.9	32.7	26.0
Generous		8%	60.9	53.9	47.8	42.7
Realistic		8%	67.7	59.8	55.5	51.6

	2021	Margin	2021 Multiple	Implied Price	Downside
S/S		8%	30.0	\$ 14.30	-46%
Generous		8%	30.0	\$ 12.99	-51%
Realistic		8%	30.0	\$ 11.69	-56%
	2022	Margin	2022 Multiple	Implied Price	Downside
S/S		8%	30.0	\$ 14.30	-46%
Generous		8%	30.0	\$ 12.99	-51%
Realistic		8%	30.0	\$ 11.69	-56%

It's also worth noting that the company seems prone to tail risk. The avian influenza outbreak in 2016 reduced Cal-Maine sales by 44%. In 2019, Vital was subject to a recall in hard boiled eggs due to listeria. Vital farms has a concentrated production base and only one distribution center that they are expanding capacity on located in Springfield, MO.

Risks

- State laws making cage-free eggs the norm can be deemed unconstitutional as it regulates interstate commerce. This has been denied by district courts and the Supreme Court refused to hear the case.
- Butter and other products can bridge the gap in projected revenue.
- There may be some permanence in lockdown trends. If people continue to cook at home it would help sustain some of the growth the egg market has seen but would still likely equate to a YoY decline.
- Possibility of a buyout by Cal-Maine sized producer. This would kill the brand ethos and is unlikely at this valuation. They are already investing in expansion for cage-free eggs and have a history of acquiring farms making them more likely to compete on contracts with farmers vs buying Vital Farms outright.

- International expansion. This would increase the number of potential customers but there are not many candidate markets that don't already have their demand met. Additionally, it would be a significant downward force on margins.
- Growth in egg consumption accelerates. If this were a concern it would be possible to turn this into a pair trade by going long Cal-Maine (CALM).