William Blair

Equity Research

Teavana Holdings, Inc.

Consumer | Specialty Coffee and Tea

September 6, 2011
Basic Report (11-104)

Initiating Coverage With Outperform Rating

Premium retailer in rapidly growing tea market. With an inviting mall-based format and broad selection of more than 100 premium loose-leaf teas and merchandise, Teavana has achieved first-mover advantage in the fragmented U.S. specialty tea retail landscape. The domestic tea market has been growing rapidly, up more than 60% since 2004, and Teavana has experienced accelerating same-store sales gains over the past three years (2.9% in 2008, 6.9% in 2009, and 8.7% in 2010), with only one quarter of negative same-store sales in the last four years (-1.6% in fourth quarter 2008).

Impressive sales productivity yields robust unit economics. Teavana's consumer appeal is illustrated by extraordinary sales productivity of $994 per square foot (among the highest of all mall-based retailers), with consistent performance across geographies. Reflecting strong sales productivity, Teavana's stores generate healthy returns, with management targeting first-year cash-on-cash returns of about 75% and a payback period of roughly 18 months.

Plenty of room to expand store base. From about 180 company-owned stores today, we believe that Teavana has the opportunity to nearly triple its domestic mall-based presence to 500 stores, with management expecting to achieve that goal by 2015. We believe potential exists over the longer term to expand Teavana's retail presence outside malls, while also growing a more meaningful e-commerce business (about 7% of sales currently), pursuing more aggressive international retail expansion, and exploring opportunities in the premium grocery channel.

Expect 30% annual EPS growth over next three to five years. We expect 25%-plus unit expansion and same-store sales gains of 3% to 4% per year to yield annual revenue growth in the high-20% range. We anticipate consistent operating margin improvement beginning in calendar 2012 and more so in calendar 2013 given a favorable mix shift toward higher-margin loose-leaf tea as stores mature as well as leverage on fixed costs, although infrastructure investments to support growth will likely constrain margins in 2011.

Aggressive expansion is main risk. We believe that Teavana's main investment risk is its plan for aggressive store expansion, including 50 new company-owned stores this year (up 34%) and 60 new company-owned stores in 2012 (up 31%). While we believe that Teavana is well positioned to execute on its expansion plans, we view the company's ability to successfully open new stores as critical to the stock's performance.

Stock Rating:	**Outperform**
Company Profile:	**Aggressive Growth**
Symbol:	TEA (NYSE)
Price:	$25.98 (52-Wk.: $17-$29)
Market Value (mil.):	$1,010
Fiscal Year End:	January
Long-Term EPS Growth Rate:	30%
Dividend Yield:	None

Estimates (CY)	2010A	2011E	2012E
EPS	$0.32	$0.44	$0.59
Revenue (mil.)	$124.7	$164.4	$209.1
Valuation			
P/E	81.2x	58.9x	43.9x

Trading Data	
Shares Outstanding (mil.)	38.8
Inside Ownership	78%

Financial Data	
Net Debt/Total Capital (7/11)	7%
Book Value Per Share (7/11)	$1.19
Enterprise Value (mil.)	$1,012
CY 2012E EBITDA (mil.)	$47.5
Enterprise Value/CY12E EBITDA	21.3x
Return on Equity (CY11E)	30%
ROIC (CY11E)	18%

Sharon M. Zackfia, CFA
+1 312 364 5386
szackfia@williamblair.com

Tania Anderson, CFA
+1 312 364 8942
tanderson@williamblair.com

Matthew Curtis, CFA
+1 312 364 8384
mcurtis@williamblair.com

William Blair & Company, L.L.C.
222 West Adams Street
Chicago, Illinois 60606
+1 312 236 1600
www.williamblair.com

Teavana is a rapidly growing mall-based specialty tea retailer, specializing in premium loose-leaf teas, tea-related merchandise, and prepared beverages.

Summary and Investment Thesis

Founded in 1997 by current Chairman and CEO Andrew Mack and his wife, Nancy, Teavana is a rapidly growing specialty tea retailer, with about 180 domestic mall-based stores across 36 states (including 2 franchised locations) and 17 franchised stores in Mexico. Featuring a large selection of loose-leaf premium teas as well as tea-related merchandise, Teavana offers a differentiated and compelling mall-based experience with its inviting store format and highly trained staff.

Teavana's store base has more than tripled in the past four years, and sales have grown at a compound annual rate of 38% over the same time frame, inclusive of growth of 38% in 2010 to nearly $125 million. Loose-leaf tea accounts for 56% of sales; tea-related merchandise, 40%; and prepared beverages, 4%. Teavana's average ticket is $36 in its stores ($46 excluding beverages) and $55 online, with the company generating about 7% of sales through its e-commerce channel.

Compelling Premium Tea Retailer With Impressive Sales Productivity

Teavana's consumer appeal is illustrated by the company's strong sales productivity of $944 per square foot in 2010, with consistent performance across geographies. Moreover, Teavana has experienced positive same-store sales in each of the past five years, with only one quarter of negative comps (-1.6% in fourth quarter 2008), pointing to the resiliency of consumer demand for Teavana's products. Given the long shelf life of its products and low markdown levels, Teavana's gross margin was a healthy 62.9% in 2010, and Teavana's operating margin increased from 7.5% in 2008 to 18.8% in 2010.

Table 1
Teavana Holdings, Inc.
Domestic Retail Sales Productivity
(Fiscal year closest to calendar 2010)

	Sales Per Square Foot	U.S. Stores
Free People	$1,760	42
lululemon	1,270	82
Teavana	**994**	**146**
Anthropologie	950	147
Urban Outfitters	690	144
Victoria's Secret	660	1,028
lucy	650	64
Chico's	640	660
Aeropostale	630	906
J.Crew[a]	600	219
Title Nine	570	18
Hot Topic	560	657
Banana Republic	460	576
bebe[b]	450	213
Buckle	430	420
American Eagle Outfitters[c]	420	994
Abercrombie & Fitch	420	325
Zumiez	400	400
Joseph A. Bank	390	506
Express	350	591
Williams-Sonoma[d]	350	260
Cache/Cache Luxe	340	282
Gap	340	1,111
Ann Taylor	330	266
New York & Co.	330	555
Mall average	$300-$400	

[a] J.Crew sales per square foot include crewcuts, Madewell, and factory stores.
[b] Bebe sales per square foot include PH8 and 2b bebe.
[c] American Eagle Outfitters sales per square foot include aerie.
[d] Williams-Sonoma sales per square foot include Pottery Barn and West Elm.

Sources: Company documents and William Blair & Company, L.L.C. estimates

Teavana's stores feature a "Wall of Tea" (roughly 100 tins of premium loose-leaf tea), a wide array of tea-related accessories and items, and highly trained store associates who educate consumers about Teavana's products and the tea-making process. With premium loose-leaf teas ranging from $3 to $40 for two ounces (the minimum amount sold), Teavana offers an affordable yet premium healthy lifestyle indulgence, with two ounces yielding an average of 20 to 25 cups of tea—translating to less than $1.80 per cup at the highest price point.

The U.S. tea market has experienced robust growth, reaching $5.2 billion in sales in 2009, according to market research firm Mintel, with a compound annual growth rate of roughly 11% from 2004 through 2009. We believe the U.S. market for tea still has plenty of room to grow, as the United States represented only about 9% of total worldwide tea sales of $56.6 billion in 2009, with per capita tea consumption well behind many other nations. Encouragingly, Mintel expects the tea market in the United States to continue to post steady growth, projecting an approximate 6% compound annual growth rate through 2014.

Excellent Store Productivity Yields Consistently Robust Store-Level Returns
Teavana averaged sales per store of $844,000 in 2010 (up nearly 6% year-over-year), with all classes of stores (by age) experiencing gains. Moreover, Teavana's merchandise mix becomes increasingly more profitable as stores mature, as the mix naturally shifts toward high-margin loose-leaf tea as a store ages (also indicative of strong customer loyalty).

Encouragingly, Teavana's performance has been remarkably similar across all regions of the country, including the West, Central, Northeast, and Southeast, with each region consisting of roughly 25% of locations and contributing roughly 25% of sales. Teavana's average four-wall cash contribution margin was 30% in 2010, with all stores profitable.

New-store sales productivity is targeted at $600,000 to $700,000 per year (although the company has easily exceeded that target each of the past two years) on a net cash investment of $200,000 to $250,000 per store, as a greater proportion of non-A malls are expected to account for future growth. New stores are anticipated to generate 25% cash contribution margins and cash-on-cash returns of about 75%, with a payback period of roughly 18 months.

Ample Opportunity for Store Expansion
From about 180 company-owned stores today, we believe that Teavana has the opportunity to nearly triple its U.S. store base, in keeping with management's goal of reaching 500 domestic stores by 2015. Should Teavana meet its objectives, it would be one of the fastest-growing publicly traded retailers, with 50 new company-owned stores expected in 2011 (up 34%) and 60 new stores in 2012 (up 31%).

While Teavana's growth plans are aggressive, we believe they may also be necessary to cement the concept's first-mover advantage, particularly as others are likely to notice Teavana's highly profitable model now that the company is publicly traded. We believe there are 500 high-quality domestic malls that meet Teavana's requirements, and we see the potential for the company to augment its mall-based locations with strategically placed street locations in the future. Teavana also has 17 franchised stores in Mexico, and we expect the company to explore additional international expansion opportunities in coming years through company-owned development and/or franchised agreements. To this point, Teavana recently announced a 10-year development agreement in the Middle East with Alshaya, a leading franchise operator of other concepts such as Starbucks, P.F. Chang's, and The Cheesecake Factory.

Over the longer term, we believe the Holy Grail would be for Teavana to evolve from a retailer into a market-defining brand, similar to what Starbucks has achieved over the past 20 years. While such stories are rare, we see parallels in Teavana bringing its European-style specialty tea retail experience to the United States to the way Starbucks introduced Americans to Italian-based espresso beverages. If Teavana can define the tea market in the way that Starbucks has dominated specialty coffee, we see the potential for meaningful brand extension opportunities in the premium grocery and foodservice channels (Starbucks's consumer packaged goods business accounted for 17% of its operating profits in fiscal 2010).

We Expect 30% Annual EPS Growth Over the Next Three to Five Years

We expect 25%-plus unit expansion and same-store sales gains of 3% to 4% per year will yield annual revenue growth in the high-20% range over the next three to five years. We expect a modest contraction in operating margin in 2011 given incremental infrastructure expenses associated with the company's new store support center, expansion of the company's distribution center, and the buildout of systems and marketing functions. In addition, we see the potential for a mix shift toward lower-margin merchandise over the holidays this year, a category that management believes underperformed in 2010 (merchandise seasonally peaks as a percent of sales during the holidays).

Despite the potential for infrastructure investments to constrain margins over the near term, we expect consistent operating margin improvement beginning in calendar 2012 and more so in calendar 2013 given a favorable mix shift toward higher-margin loose-leaf tea as stores mature, the benefits of increased scale with suppliers, and leverage on fixed costs. Over the longer term, we believe operating margins in the low-20% range are achievable, versus 18.8% in 2010.

Primarily reflecting strong sales growth, we project EPS of $0.44 this year (up 39%), $0.59 in 2012 (up 34%), and $0.77 in 2013 (up 30%).

Table 2
Teavana Holdings, Inc.
Summary Operating Statistics
($ in millions, except earnings per share)

Fiscal year ending January	**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Company-owned	87	108	146	196	256	326
Franchised	15	15	15	19	20	22
Ending stores	102	123	161	215	276	348
% change	37.8%	20.6%	30.9%	33.5%	28.4%	26.1%
Same-store sales	**2.9%**	**6.9%**	**8.7%**	**4.5%**	**3.8%**	**4.0%**
Revenues	**$63.9**	**$90.3**	**$124.7**	**$164.4**	**$209.1**	**$267.8**
% change	35.4%	41.3%	38.2%	31.9%	27.1%	28.1%
Gross profit	$36.7	$53.8	$78.4	$105.1	$134.6	$173.0
Gross margin	57.4%	59.6%	62.9%	63.9%	64.4%	64.6%
Selling, general, and administrative	$29.2	$38.1	$50.6	$68.7	$87.8	$111.7
% of sales	45.8%	42.3%	40.6%	41.8%	42.0%	41.7%
Depreciation and amortization	$2.7	$3.5	$4.4	$6.0	$7.9	$10.5
% of sales	4.2%	3.9%	3.5%	3.7%	3.8%	3.9%
Operating income	$4.8	$12.2	$23.5	$30.4	$38.9	$50.8
Operating margin	7.5%	13.5%	18.8%	18.5%	18.6%	19.0%
Tax rate	54.9%	45.8%	42.6%	40.8%	39.8%	39.8%
Net income	$1.2	$5.3	$12.0	$16.9	$23.2	$30.4
% change	227.0%	328.1%	126.9%	40.9%	37.2%	30.9%
EPS	**$0.03**	**$0.14**	**$0.32**	**$0.44**	**$0.59**	**$0.77**
% change	223.9%	325.5%	124.4%	38.7%	34.2%	30.1%

Sources: Company documents and William Blair & Company, L.L.C. estimates

Premium Stock Valuation Appears Fair Given Growth Prospects

Teavana's stock valuation of 44 times our calendar 2012 EPS estimate reflects a premium to its peer group average of roughly 22 times, which includes specialty beverage retailers such as Starbucks, Caribou Coffee, and Peet's, as well as other retailers that cater to higher-income consumers, such as Williams-Sonoma, Coach, Whole Foods Market, and lululemon athletica. However, Teavana's long-term EPS growth rate of 30% eclipses even its fastest-growing peer (lululemon at 25%) and easily surpasses the peer group average of 18%. As a result, although Teavana's PEG ratio of 1.5 times exceeds its peer group average of 1.2 times, its premium is in keeping with high-quality, resilient premium retailers such as Whole Foods, lululemon, Peet's, and The Fresh Market (all with PEG ratios of 1.4 to 1.8 times).

While we would not call for multiple expansion from current levels, we believe that Teavana's premium valuation is justified given its strong growth prospects and historically resilient sales trends, and we expect investors to be rewarded with healthy 30% annual EPS growth with the potential for upside. We are initiating coverage with an Outperform rating and Aggressive Growth company profile.

Investment Risks

Rate of Store Growth Could Strain Operations

Teavana's plan to expand its domestic company-owned store base from about 180 stores today to 500 stores over the next five years is ambitious and could strain the company's human resources while potentially damaging its distinctive culture based on extensive training and superior customer service. In the near term, Teavana plans to open 50 stores in 2011 (up 34%) and 60 stores in 2012 (up 31%), and we project 70 new stores in 2013 (up 27%). While we believe that Teavana is well positioned to execute on its plans for new stores, we view the company's ability to successfully open high-volume new stores as critical to the stock's performance.

New Stores May Not Be as Productive as Existing Store Base

Teavana has achieved sales productivity that is among the highest in mall-based retail. However, as the company grows, its proportion of "A" malls will decrease as Teavana enters a wider array of less productive malls, which could result in average unit volumes declining from current levels. Management is already handicapping for this potential outcome, modeling new store volumes at $600,000 to $700,000. Importantly, even at lower volumes, unit-level returns remain healthy, as stores within this sales bandwidth achieved cash contribution margins of 25% to 30% in 2010.

Reliance on Single Product Category

Teavana's business is concentrated on a single product—premium loose-leaf tea—and its related merchandise. Teavana's sales would likely be penalized by any negative news related to the quality or safety of tea or tea-related products.

Exposure to Mall-Based Traffic Trends and Seasonality of Earnings

Teavana's mall-based real estate strategy renders it susceptible to mall traffic trends. In addition, Teavana earns the bulk of its earnings in its fiscal fourth quarter of the year, which typically has roughly twice the revenue of any other quarter and contributes the vast majority of full-year earnings (75% in 2010). As a result, the company is particularly vulnerable to events that hinder consumer spending or mall traffic during the holidays. The first quarter is the second-most-profitable quarter for Teavana, with the second and third quarters only slightly profitable.

Limited Float Post-Deal

Teavana has a limited float following the company's IPO, as founder and CEO Andrew Mack still holds 57% of shares and private-equity investor Parallel Investment Partners holds 19%.

Distinctive Premium Loose-Leaf Tea Retailer

Teavana was founded in 1997 by CEO Andrew Mack and his wife, Nancy, as a channel for their passion for tea that they acquired through their worldwide travels. Teavana's first store opened in Atlanta that year, followed by a second store in Atlanta in 1998 and a third in 2000. In 2001, the couple expanded Teavana's geographic presence with an opening in Minneapolis's Mall of America, followed by openings in 2002 in Las Vegas; Tysons Corner, Virginia; and Jacksonville, Florida. By 2003, Teavana had grown to 11 mall-based stores.

In 2004, the company obtained equity capital through a minority investment from Parallel Investment Partners to fund future growth. In 2005, with the help of Parallel, Teavana filled out its executive management team, hiring Daniel P. Glennon as CFO; Peter M. Luckhurst as vice president of stores (subsequently executive vice president of operations); and Robert A. Shapiro as vice president of real estate. With a solid executive team in place, Teavana entered a period of rapid growth, opening nearly 130 stores from 2005 through 2010 with no incremental equity capital.

Since its founding 14 years ago, Teavana has emerged as the leading retailer of premium loose-leaf tea in the United States, with no other comparable retailer having more than four locations. Teavana's stores offer a broad selection of more than 100 premium loose-leaf teas from around the world, composed of roughly 20% single-estate teas and 80% blended and herbal teas (85% of which are proprietary) within seven categories (white, green, oolong, black, rooibos-based blends, maté-based blends, and other herbal-based blends). Merchandise margins are consistent across Teavana's tea categories.

Stores are located in high-traffic locations within malls and lifestyle centers, each featuring a sample cart at its entrance to entice customers to try featured teas, as shown in figure 1. The overall retail experience is inviting, with blond wood fixtures, ceramic tiled floors, soft lighting, and Asian-inspired music. Each store features a "Wall of Tea" behind the sales counter, with the seven categories of tea distinguished by bright, color-coded canisters. Given the importance of newness to its customers, Teavana refreshes approximately 10% to 20% of its Wall of Tea offerings annually.

Figure 1
Teavana Holdings, Inc.
Inviting Retail Presence

Sources: Company website and Google Images

Teavana also offers an appealing selection of tea-related merchandise (more than half of which is exclusive to Teavana), including teapots, teacups, tea makers, decorative tins, gift sets, and other tea-related accessories and items. Overall, loose-leaf tea represented 56% of sales in 2010 (roughly 150 SKUs), followed by tea-related merchandise at 40% (375 SKUs at price points from $4 to $250) and prepared beverages at just 4% of sales (7 options at approximately $5 per cup).

Table 3
Teavana Holdings, Inc.
Product Mix and Depth

	% of Total Sales	SKUs	Price Range
Tea and tea blends	56%	150	$3-$40
Tea-related merchandise	40%	375	$4-$250
Prepared beverages	4%	7	$5

Sources: Company documents

Teavana's loose-leaf teas range in price from $3 to $40 for two ounces (the minimum amount sold), with single-estate teas generally the most expensive and rooibos-based blends, maté-based blends, and herbal-based blends the least expensive. Teavana does not typically raise prices on its existing tea offerings, instead introducing new teas at higher price points with its annual changes to the Wall of Tea. With 2 ounces yielding about 20 to 25 cups of tea on average (depending on strength preference), Teavana provides an affordable indulgence for as little as $0.13 per cup to as much as $1.80 per cup at the highest price point.

Figure 2
Teavana Holdings, Inc.
Merchandise Mix Features Wide Array of Tea and Tea-Related Products

Wall of Tea

Tea-Related Merchandise

Sources: Company website and Google Images

Talent Development Bolsters Reputation as Premium Tea Retailer

Given the highly interactive nature of engaging and educating customers on tea, Teavana provides extensive training for all store-level employees. Each "teaologist" (i.e., staff associate) receives three weeks of in-store and classroom training, during which time the associate is educated on the different types of tea, the tea-making process, and methods of engaging and informing customers about Teavana's premium tea offerings and related merchandise, with a culmination of three "tea tests" that must be passed. Assistant managers and general managers receive an additional four weeks of training at the company's store support center.

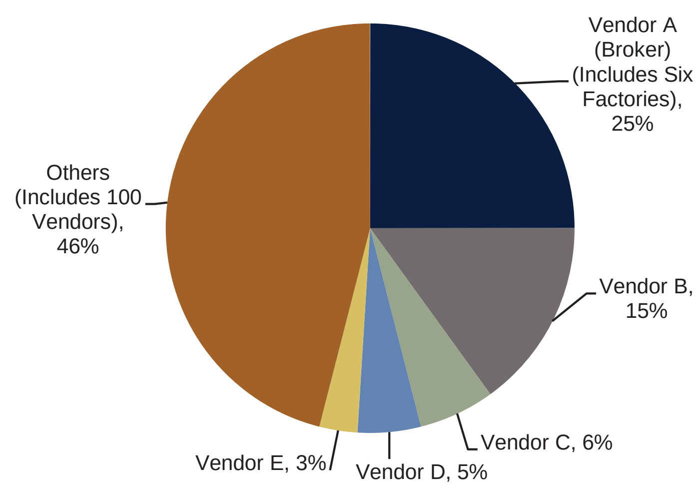
Each store is led by a general manager, an assistant manager, and 2 team leaders who typically oversee 8 to 10 store associates. To ensure strong new store openings, general managers are hired four months in advance of an opening, and team members are hired four weeks in advance, and new-store team members receive on-site training from specialized new-store trainers. Area managers are responsible for roughly 10 stores, while regional directors oversee about 8 area managers (or about 80 stores).

Teavana's philosophy of promoting from within has yielded strong employee retention as well as a pipeline of new talent that bodes well for future store development. In 2010, 87% of general manager positions were filled with internal candidates who were promoted, up from 39% in 2009 and 15% in 2008, and virtually all general manager positions in 2011 are expected to be filled internally. Moreover, employee turnover has been on a downward trend over the past few years, with general manager turnover at 18% last year versus 28% in 2008, assistant general manager turnover at 34% versus 58%, and full-time team member turnover at 48% versus 64%, while zero turnover has occurred in area manager or regional director positions.

In addition, Teavana actively tracks and rewards performance to identify and incentivize top performers. All positions, including part-time store associates, are eligible for individualized performance-based incentive compensation, while managers are incentivized on store performance versus sales and payroll targets.

Supply Chain and Distribution
Teavana sources its wide array of loose-leaf tea and tea-related merchandise from more than 100 vendors worldwide, with its 2 largest vendors representing 25% and 15% of inventory purchases in 2010. Tea is sourced directly from tea gardens, blenders, and brokers in 10 countries, while most tea-related merchandise comes from Asia. Teavana does not have any long-term contracts with vendors related to supply, price, or exclusivity of its tea, although the company works with suppliers to create Teavana-branded merchandise for its stores. However, premium loose-leaf tea is a very fragmented commodity with multiple harvest seasons and prices that vary greatly depending on the specific type of tea, which tempers the likelihood of inflation.

Figure 3
Teavana Holdings, Inc.
2010 Inventory Purchased by Vendor



Sources: Company documents

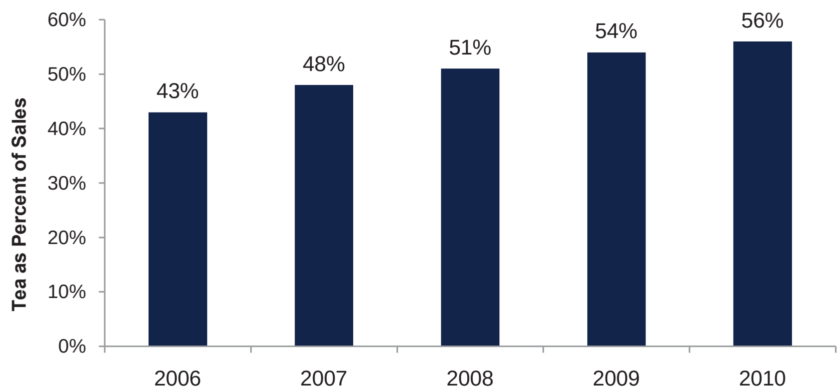
Teavana's distribution system for both its retail and e-commerce channels consists of a single 80,000-square-foot facility in Stratford, Connecticut, which should be adequate to support growth through first quarter 2013 following the completion of an ongoing three-phase expansion. The first two phases have already been completed, with 19,000 square feet (up 24%) added in April 2011 and an additional 10,000 square feet (up 12%) added in July 2011. The final phase is expected to be completed in July 2012, adding 12,900 square feet. While the company's lease runs through 2016 (and 2020 for some portions of the facility), management has commissioned a study to determine long-term distribution needs, including a further expansion of its existing distribution center or the construction of an additional facility, potentially on the West Coast.

Impressive Store-Level Returns With Plenty of Room to Expand

Teavana's stores generate impressive sales productivity, with average sales per store reaching $844,000 in 2010 (up nearly 6% year-over-year) and sales per square foot of $994 (versus $935 in 2009), among the best of all mall-based retailers. Encouragingly, Teavana's consumer appeal has proved similar across geographic regions, with sales per store fairly consistent across the West, Central, Northeast, and Southeast, with each region consisting of approximately 25% of locations and contributing roughly 25% of sales. California is Teavana's most important state, contributing 14% of sales, followed by Florida at 8%; no other state contributes more than 5% of sales.

From a store age perspective, each store class from 2004 through 2009 experienced year-over-year improvements in average sales per store in 2010, as even older stores continued to post comp gains. Moreover, Teavana's merchandise mix actually becomes increasingly more profitable as stores mature, as high-margin tea grows as a percent of sales by 8 to 10 percentage points. As shown in figure 4, loose-leaf tea grew from 43% of sales in 2006 to 56% last year, with all classes of stores selling an increased percentage of loose-leaf tea (tea as a percent of sales at Teavana's oldest stores is in the low-60% range).

Figure 4
Teavana Holdings, Inc.
High-Margin Tea Growing as Percent of Sales Mix



Sources: Company documents

New store sales productivity is targeted at $600,000 to $700,000 per year (although the company has easily exceeded that target each of the past two years) on a net cash investment of $200,000 to $250,000 per store, as a greater proportion of non-A malls are anticipated to account for future growth. New stores are expected to generate 25% cash contribution margins and cash-on-cash returns of roughly 75%, with a payback period of about 18 months. On a fully capitalized basis (capitalizing operating leases at eight times), we estimate unit-level after-tax returns of more than 25%. Notably, stores within the $700,000 to $800,000 sales bandwidth achieved cash contribution margins of 25% to 30% in 2010.

Table 4
Teavana Holdings, Inc.
Impressive Unit Economics
($ in thousands)

	Existing Locations	Model for New Units
Cash investment	$225	
Capitalized operating leases*	76	
Fully capitalized investment	$301	
Average store size (square feet)	888	950
Sales	**$844**	**$650**
Sales per square foot	*$994*	*$684*
Unit-level cash contribution	$253	$163
Depreciation	34	34
Operating income	**$219**	**$129**
Cash contribution margin	30%	25%
Operating margin	26%	20%
Cash-on-cash return on investment	**113%**	**72%**
After-tax return on fully capitalized investment	**44%**	**26%**

*Capitalized at 8 times annual rent

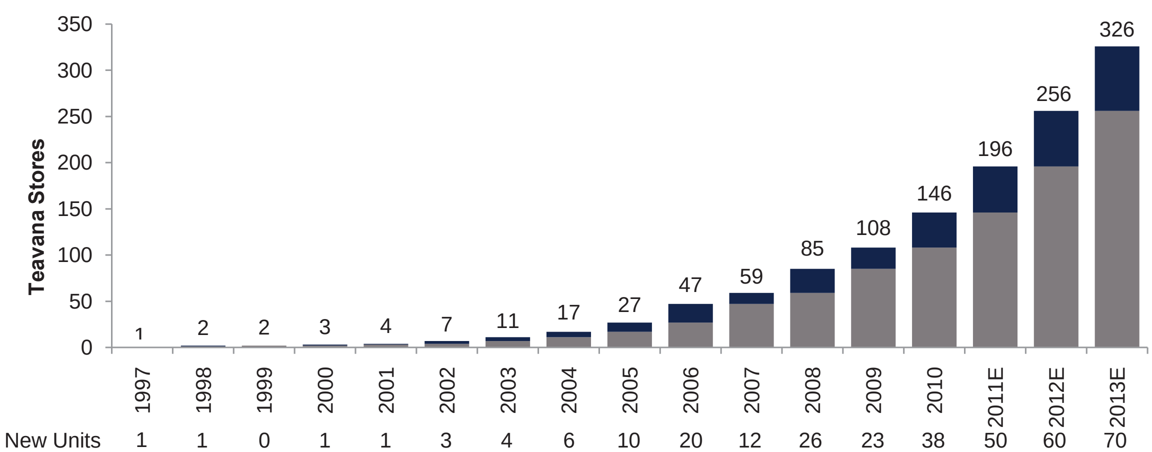
Sources: Company documents and William Blair & Company, L.L.C. estimates

Plenty of Room to Expand Store Base

From about 180 company-owned stores across 36 states, management's goal of 500 domestic stores appears reasonable, in our opinion. Still, the planned pace of expansion is aggressive, with the goal of reaching the 500 store target within five years, including 50 new company-owned stores this year (up 34%) and 60 new stores in 2012 (up 31%).

Teavana's stores are located in high-traffic areas of malls and lifestyle centers, with A and B malls viewed as the strongest opportunity given the demographics of the brand ($60,000 to $100,000 household incomes). The real estate team typically looks for an average household income of more than $50,000, good population density inclusive of owner-occupied housing within 10 miles, a strong daytime work population within 5 miles, and co-tenants such as Williams-Sonoma, Ann Taylor, and Coach; new stores are targeted at 900 square feet to 1,000 square feet (although the company has had success with a range of store sizes). Teavana also has two franchised locations in the United States, although the company has no plans to expand franchised development domestically.

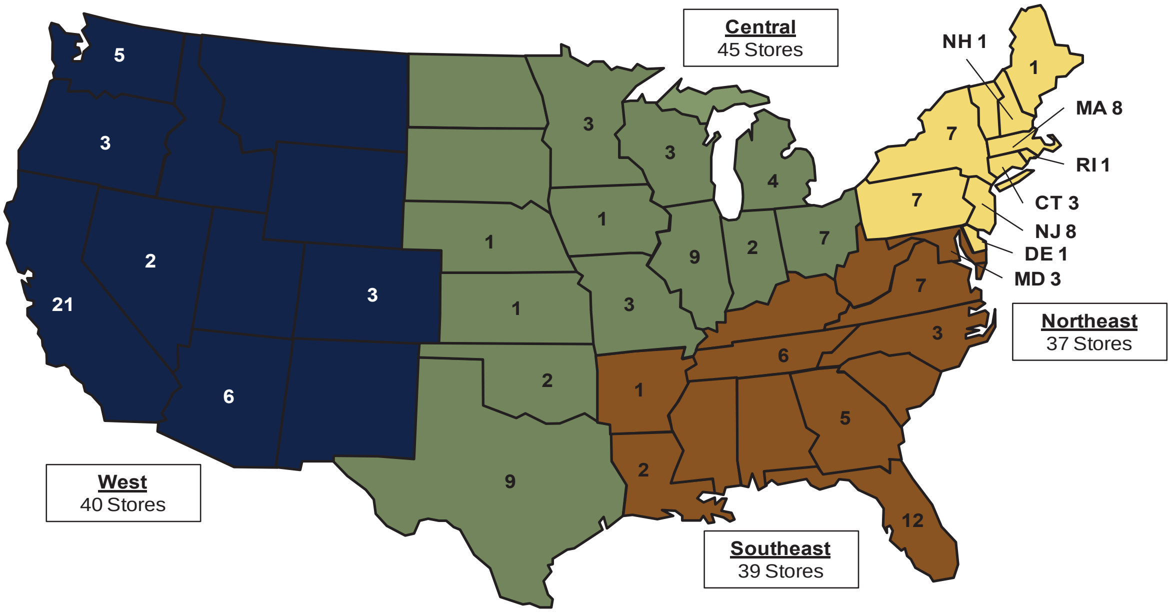
Figure 5
Teavana Holdings, Inc.
Robust Company-Owned Unit Expansion



Sources: Company documents and William Blair & Company, L.L.C. estimates

Teavana has 17 franchised stores in Mexico through an international development agreement with Casa Internacional del Te, S.A. de C.V., and the company recently announced a 10-year development agreement in the Middle East with Alshaya (a leading franchise operator of other concepts such as Starbucks, P.F. Chang's, and The Cheesecake Factory). We expect Teavana to further explore additional international expansion opportunities via partnerships with franchise operators, although management may choose to open company-owned stores in markets such as Canada.

Figure 6
Teavana Holdings, Inc.
Company-Owned Store Locations*



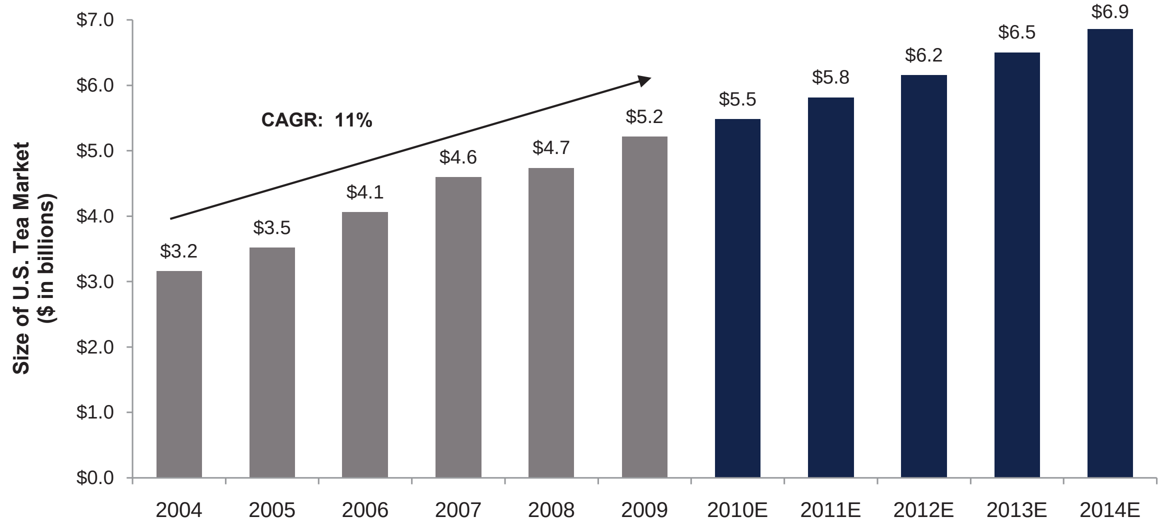
*As of May 1, 2011
Sources: Company documents

Rapidly Growing Domestic Tea Market

The U.S. tea market has experienced robust growth, reaching $5.2 billion in sales in 2009, according to Mintel, with a compound annual growth rate of roughly 11% from 2004 through 2009. We believe that the U.S. market for tea still has plenty of room to grow, as the United States represented only about 9% of total worldwide tea sales of $56.6 billion in 2009, with per capita tea consumption well behind many other nations. Encouragingly, Mintel expects the tea market in the United States to continue posting steady growth, projecting an approximate 6% compound annual growth rate through 2014.

The United States lags all other regions of the world in per capita tea consumption (with the exception of Latin America), although per capita consumption in the United States has grown faster than almost every other region over the past five years with a compound annual rate of 2% (according to Euromonitor International)—second only to Eastern Europe (which grew at an approximate 4% compound annual rate over the same time frame). The growth in U.S. tea consumption may be reflective of an increasing appreciation of the healthful qualities of tea, which is virtually calorie-free and has multiple potential health benefits (antioxidants to reduce the risk of cancer and polyphenols to inhibit the absorption of cholesterol).

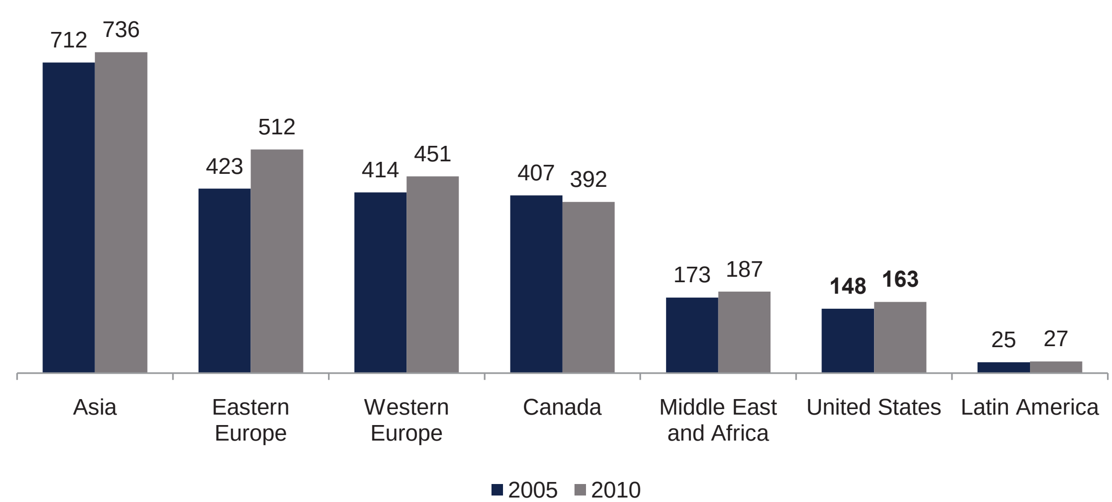
Figure 7
Teavana Holdings, Inc.
Healthy Growth Expected in U.S. Tea Market*



*Includes ready-to-drink
Source: Mintel International

Not surprisingly, Asia has the highest per capita consumption at 736 cups—4.5 times that of the United States, and consumption in Western and Eastern Europe is roughly 3 times higher than that in the United States. Even Canada's tea consumption per capita is more than twice that of the United States, while the Middle East and Africa also have slightly higher consumption patterns than the United States.

Figure 8
Teavana Holdings, Inc.
United States Lags Other Regions in Per Capita Tea Consumption
(number of cups)



Source: Euromonitor International

Competitive Environment

Although Teavana is the leader in the fragmented specialty tea retail market, the company competes in the broader tea market against consumer packaged goods companies and specialty beverage companies, such as Starbucks, Peet's, and Caribou Coffee. While Teavana has established a first-mover advantage in the United States with no comparable competitor having more than four stores, companies such as Starbucks could become more aggressive in tea in coming years with its Tazo Tea brand (tea is Starbucks's fastest-growing beverage category), although we believe it is unlikely that Starbucks will replicate the broad selection and customer service interaction available at Teavana. In addition, Argo Tea has roughly 20 stores across 3 states, catering to tea drinkers with a prepared-beverage focus, although it also offers premium loose-leaf tea as well as tea-related merchandise.

Table 5
Teavana Holdings, Inc.
Fragmented Retail Competition

Domestic Competition	Stores	States
Starbucks	10,930	50
Caribou Coffee	464	20
Peet's Coffee & Tea	193	6
Teavana	163	34
Argo Tea	20	3
Lupicia Fresh Tea	4	2
Chado Tea	3	1
Adagio Teas	2	1
Amanzi Tea	2	2
Tealuxe	2	2
TeaGschwendner	2	2
TeaSource	2	1
Kusmi Tea	1	1

International Competition	Stores	Countries
Starbucks	5,933	More than 50 countries
TeaGschwendner	138	Germany (120), Middle East (12), Brazil (3), Austria (1), Luxembourg (1), Switzerland (1)
Lupicia Fresh Tea	131	Japan (129), Taiwan (1), Australia (1)
Caribou Coffee	80	Middle East (75), South Korea (2)
Whittard of Chelsea	75	United Kingdom
DavidsTea	47	Canada
Teaopia	37	Canada
Teavana	17	Mexico
Kusmi Tea	9	France (8), Canada (1)

Sources: Company documents and websites

Internationally, Teavana faces tougher competition given more developed tea cultures, as evidenced by much higher levels of per capita consumption and already-established competition. Germany-based TeaGschwendner has more than 130 stores, most of which are in Germany, while Lupicia Fresh Tea leads the Japanese market with nearly 130 stores. In addition, Whittard of Chelsea has roughly 70 stores in the United Kingdom, and the Canadian market has two established players: DavidsTea, with nearly 50 locations, and Teaopia, with nearly 40 stores.

Management Team in Place to Lead Growth

Following a minority investment by Parallel Investment Partners in 2005, Teavana deepened its management team with the addition of a new CFO, vice president of stores, and vice president of real estate, with no senior management turnover since that time.

Andrew T. Mack, along with his wife, Nancy, founded Teavana in 1997 and serves as chairman and CEO. Before founding Teavana, Mr. Mack held a variety of management positions in the restaurant industry, including at Darden.

Daniel P. Glennon joined Teavana as CFO in 2005. Previously, Mr. Glennon was a manager at Marakon Associates, a management consulting firm, and an auditor at Arthur Andersen LLP. He also served as CFO or vice president of finance for three small or early-stage corporations.

Peter M. Luckhurst has served as executive vice president of operations since 2010 and previously served as vice president for stores from 2005 through 2010. Before joining Teavana, Mr. Luckhurst served as president of HMV North America, where his career spanned 15 years.

Juergen W. Link joined Teavana as vice president of distribution in 2005. Mr. Link founded Special Teas, Inc., in 1996 and served as the company's president until 2005, when it was acquired by Teavana.

Robert A. Shapiro has been Teavana's vice president of real estate since 2005. Before joining the company, Mr. Shapiro was senior vice president of real estate and property development for Zale Corporation.

Summary of Earnings Drivers

Historical and projected income statements, balance sheets, and cash flows can be found in tables 7 and 8, on pages 19 and 20.

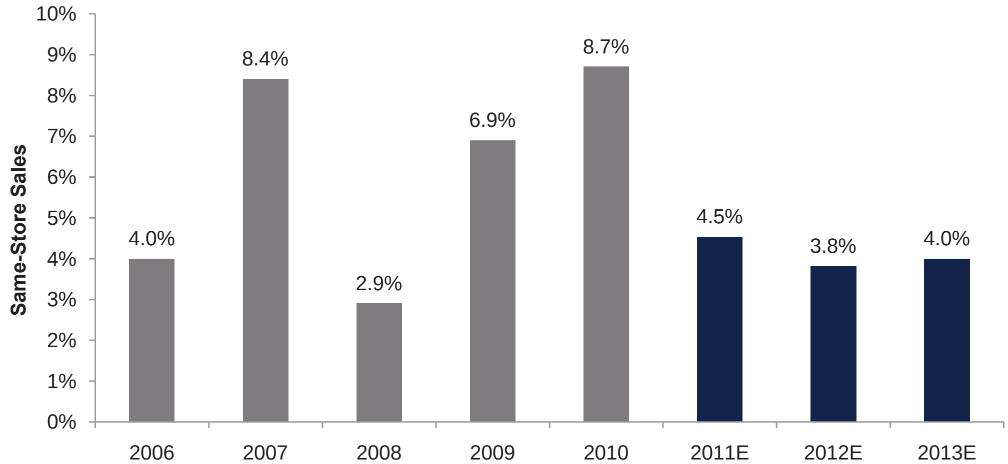
Strong Projected Sales Growth

We expect revenue growth in the high-20% range over the next three to five years, driven by rapid new unit expansion and healthy same-store sales growth in the 3% to 4% range. Domestic company-owned store expansion will be Teavana's primary source of revenue growth, and we project 50 new stores in 2011 (up 34%), 60 new stores in 2012 (up 31%), and 70 new stores in 2013 (up 27%). In addition to mall-based expansion in the United States, we believe potential exists over the longer term to expand Teavana's retail presence outside malls while also growing a more meaningful e-commerce business (about 7% of sales currently) through an increased focus on marketing and promotional initiatives and pursuing more aggressive international retail expansion and opportunities in the premium grocery channel.

Teavana experienced strong same-store sales gains over the past two years, including a 6.9% increase in 2009 and an 8.7% increase in 2010, as shown in figure 9. Teavana's healthy comp trends have continued so far in 2011, with comps up 6.0% in the first quarter and 6.9% in the second quarter (excluding e-commerce). We project 3% to 4% quarterly comp gains through the remainder of the year.

Comps over the past two years have largely been driven by average ticket gains, as transaction growth has been hampered somewhat by the de-emphasizing of prepared beverages since 2009 (now at 4% of sales, versus 8% to 10% several years ago). Looking forward, we expect comps to be driven by both the introduction of new consumers to Teavana through incremental marketing initiatives as well as the "trade-up" of existing customers, the latter of which continues to drive average ticket increases.

Figure 9
Teavana Holdings, Inc.
Historical and Projected Same-Store Sales



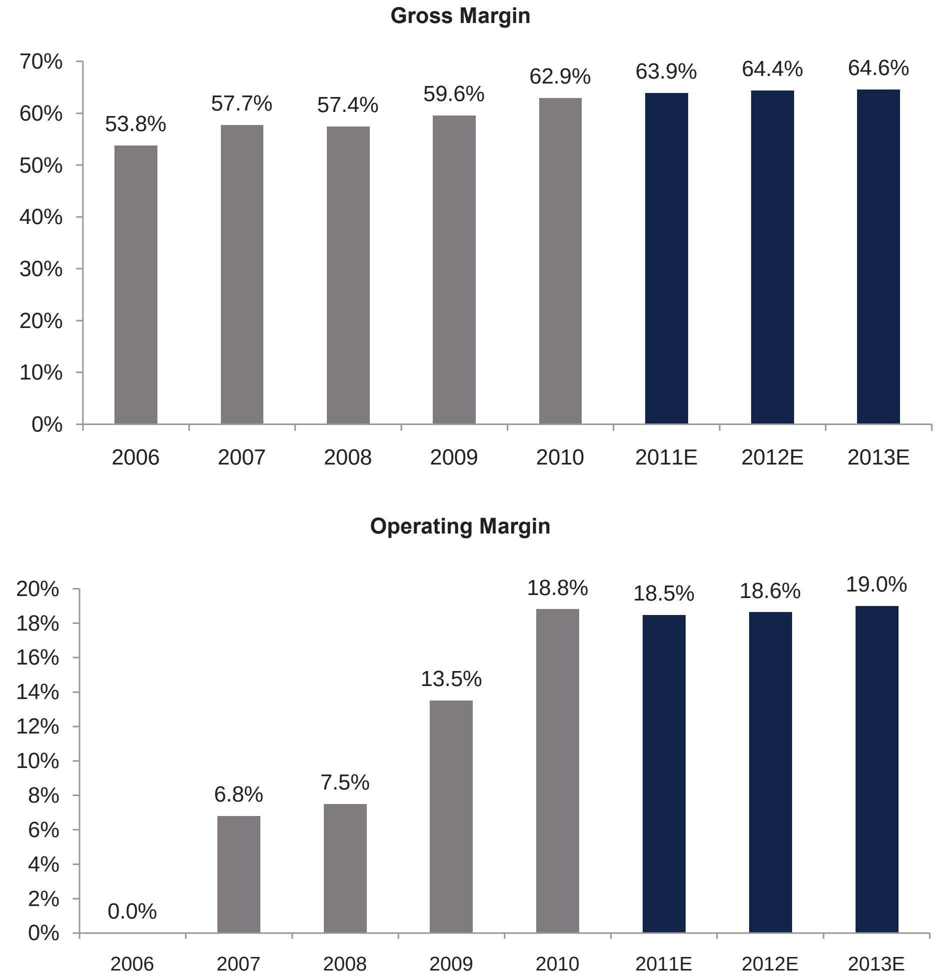
Sources: Company documents and William Blair & Company, L.L. C. estimates

Teavana's operating margin improved dramatically over the past few years, increasing from 7.5% in 2008 to 18.8% in 2010, as shown in figure 10. We expect a modest contraction in operating margin in 2011, reflecting the anniversary of gross margin expansion stemming from the company's shift to direct sourcing last year (which we estimate contributed 300 basis points to gross margin) and incremental SG&A investments associated with the company's new store support center (opened in third quarter 2010), expansion of the company's distribution center (first half of 2011), and the ongoing buildout of systems and marketing functions. In addition, we see the potential for a mix shift toward lower-margin merchandise over the holidays this year, which management believes underperformed in 2010 (merchandise seasonally peaks as a percent of sales during the holidays).

Despite the potential for infrastructure investments to constrain margins over the near term, we expect consistent operating margin improvement beginning in calendar 2012 and more so in calendar 2013 given a favorable mix shift toward higher-margin loose-leaf tea as stores mature, the benefits of increased scale with suppliers, and leverage on fixed costs. Over the longer term, we believe operating margins in the low-20% range are achievable, versus 18.8% in 2010.

Primarily reflecting strong sales growth, we project EPS of $0.44 this year (up 39%), $0.59 in 2012 (up 34%), and $0.77 in 2013 (up 30%). We expect Teavana will be able to generate sufficient cash to support its growth plans, with free cash flow (after capital expenditures) projected to grow from about $5 million this year to nearly $10 million in 2011 and nearly $15 million in 2012.

Figure 10
Teavana Holdings, Inc.
Historical and Projected Margins



Sources: Company documents and William Blair & Company, L.L.C. estimates

Premium Stock Valuation Appears Fair Given Growth Prospects

Teavana's stock valuation of 44 times our calendar 2012 EPS estimate reflects a premium to its peer group average of roughly 22 times, which includes specialty beverage retailers such as Starbucks, Caribou Coffee, and Peet's, as well as other retailers that cater to higher-income consumers, such as Williams-Sonoma, Coach, Whole Foods Market, and lululemon athletica. However, Teavana's long-term EPS growth rate of 30% eclipses even its fastest-growing peer (lululemon at 25%) and easily surpasses the peer group average of 18%. As a result, although Teavana's PEG ratio of 1.5 times exceeds its peer group average of 1.2 times, its premium is in keeping with high-quality, resilient premium retailers such as Whole Foods, lululemon, Peet's, and The Fresh Market (all with PEG ratios of 1.4 to 1.8 times).

While we would not call for multiple expansion from current levels, we believe that Teavana's premium valuation is justified given its strong growth prospects and historically resilient sales trends, and we expect investors to be rewarded with healthy 30% annual EPS growth with the potential for upside. We are initiating coverage with an Outperform rating and Aggressive Growth company profile.

Table 6
Teavana Holdings, Inc.
Comparative Valuation Analysis
($ in million, except per share)

Company	Stock Price 9/1/11	Stock Performance YTD	Stock Performance 2010	Market Capitalization (in millions)	2010 Operating Summary[a] Same-Store Sales Growth	Sales Growth	Gross Margin	Operating Margin	Return on Invested Capital[b]	Earnings EPS Growth CY11E	EPS Growth CY12E	Long-Term EPS Growth Rate	Valuation Price/ CY11E EPS	Price/ CY12E EPS	CY12E PEG Ratio	EV/CY EBITDA 2012E
Starbucks	$38.19	18.9%	39.3%	$29,475.0	7%	10%	58%	14%	15%	13%	19%	17%	24.0x	20.2x	1.2x	10.4x
Coach	55.38	0.1%	51.4%	16,703.7	NA	12%	73%	32%	32%	13%	18%	14%	17.7	14.9	1.1	9.0
Whole Foods	64.96	28.4%	84.3%	11,602.5	9%	12%	35%	5%	8%	25%	14%	16%	32.2	28.1	1.8	10.9
lululemon	54.53	59.4%	127.3%	7,901.9	30%	57%	55%	25%	33%	27%	25%	25%	50.7	40.7	1.6	22.9
Abercrombie & Fitch	62.65	8.7%	65.4%	5,666.1	7%	18%	64%	7%	8%	57%	46%	17%	19.5	13.3	0.8	5.4
Urban Outfitters	26.00	-27.4%	2.3%	4,179.3	9%	17%	41%	18%	19%	-4%	26%	20%	16.9	13.5	0.7	5.9
Williams-Sonoma	32.48	-9.0%	71.8%	3,481.3	10%	13%	39%	10%	15%	14%	13%	15%	14.7	13.0	0.9	5.3
Chico's	13.41	11.5%	-14.4%	2,361.7	6%	11%	56%	9%	13%	37%	18%	15%	15.0	12.8	0.8	4.6
Fresh Market (The)	37.40	-9.2%	87.3%	1,799.8	5%	16%	33%	7%	19%	24%	23%	21%	35.2	28.6	1.4	12.4
Peet's	56.30	34.9%	25.2%	761.2	NA	9%	54%	9%	11%	12%	23%	18%	37.6	30.6	1.7	13.2
Caribou Coffee	14.71	45.9%	30.6%	304.1	5%	8%	54%	4%	14%	-10%	24%	23%	36.1	29.0	1.3	8.8
Average		14.7%	51.9%	$7,657.9	10%	17%	51%	13%	17%	19%	23%	18%	27.2x	22.3x	1.2x	9.9x
S&P 500	1204.42									12%	9%	8%				
Teavana	**$25.98**	**52.8%**	**NA**	**$1,008.0**	**9%**	**38%**	**63%**	**19%**	**19%**	**39%**	**34%**	**30%**	**58.9x**	**43.9x**	**1.5x**	**21.3x**

[a]Fiscal year closest to calendar 2010
[b]Net operating profit after taxes (excluding nonrecurring items)/invested capital; operating leases capitalized at 8 times

Sources: Thomson, company documents, and William Blair & Company, L.L.C. estimates

Table 7
Teavana Holdings, Inc.
Quarterly Earnings Model
($ in millions, except per share)

Fiscal year ending January	2009	Apr-10	Jul-10	Oct-10	Jan-11	2010	Apr-11	Jul-11	Oct-11E	Jan-12E	2011E	Apr-12E	Jul-12E	Oct-12E	Jan-13E	2012E	2013E
Company-owned	108	118	128	141	146	146	161	179	188	196	196	211	221	241	256	256	326
Franchised	15	15	15	15	15	15	19	19	19	19	19	19	20	20	20	20	22
Total stores	123	133	143	156	161	161	180	198	207	215	215	230	241	261	276	276	348
% change	20.6%	24.3%	23.3%	27.9%	30.9%	30.9%	35.3%	38.5%	32.7%	33.5%	33.5%	27.8%	21.7%	26.1%	28.4%	28.4%	26.1%
Same-store sales	**6.9%**	**15.7%**	**6.9%**	**5.9%**	**7.5%**	**8.7%**	**6.0%**	**6.9%**	**4.0%**	**3.0%**	**4.5%**	**4.0%**	**3.0%**	**4.0%**	**4.0%**	**3.8%**	**4.0%**
Revenues	$90.3	$25.8	$23.0	$24.7	$51.2	$124.7	$34.9	$31.3	$32.4	$65.8	$164.4	$45.8	$38.9	$40.3	$84.0	$209.1	$267.8
Cost of sales (including occupancy)	36.4	10.0	9.5	10.2	16.6	46.3	12.5	12.2	12.8	21.9	59.3	16.1	15.1	15.8	27.5	74.5	94.8
Gross profit	$53.8	$15.8	$13.5	$14.5	$34.6	$78.4	$22.5	$19.1	$19.6	$43.9	$105.1	$29.7	$23.8	$24.5	$56.5	$134.6	$173.0
Selling, general, and administrative	38.1	10.8	10.8	12.1	16.8	50.6	14.8	15.4	16.5	22.1	68.7	19.9	19.7	20.5	27.7	87.8	111.7
Depreciation and amortization	3.5	1.0	1.1	1.1	1.2	4.4	1.3	1.4	1.6	1.7	6.0	1.8	1.9	2.0	2.2	7.9	10.5
Operating income	$12.2	$4.0	$1.7	$1.3	$16.6	$23.5	$6.5	$2.3	$1.5	$20.1	$30.4	$8.0	$2.2	$2.1	$26.6	$38.9	$50.8
Interest expense, net	2.4	0.6	0.7	0.7	0.6	2.6	0.7	0.7	0.3	0.1	1.8	0.1	0.1	0.1	0.1	0.4	0.4
Pretax income	$9.8	$3.4	$1.0	$0.6	$15.9	$20.9	$5.8	$1.6	$1.2	$20.0	$28.6	$7.9	$2.1	$2.0	$26.5	$38.5	$50.4
Tax rate	45.8%	42.6%	42.7%	42.4%	42.6%	42.6%	42.4%	35.2%	40.8%	40.8%	40.8%	39.8%	39.8%	39.8%	39.8%	39.8%	39.8%
Net income	$5.3	$1.9	$0.6	$0.3	$9.1	$12.0	$3.3	$1.0	$0.7	$11.9	$16.9	$4.8	$1.3	$1.2	$16.0	$23.2	$30.4
Diluted average shares	37.3	37.5	37.6	37.7	37.7	37.7	37.7	37.8	38.8	38.9	38.3	39.0	39.1	39.2	39.3	39.2	39.4
EPS	**$0.14**	**$0.05**	**$0.02**	**$0.01**	**$0.24**	**$0.32**	**$0.09**	**$0.03**	**$0.02**	**$0.30**	**$0.44**	**$0.12**	**$0.03**	**$0.03**	**$0.41**	**$0.59**	**$0.77**
Margins:																	
Gross margin	59.6%	61.1%	58.9%	58.6%	67.7%	62.9%	64.4%	61.1%	60.5%	66.7%	63.9%	64.9%	61.1%	60.9%	67.3%	64.4%	64.6%
Selling, general, and administrative	42.3%	41.9%	47.0%	49.0%	32.9%	40.6%	42.2%	49.1%	51.0%	33.6%	41.8%	43.5%	50.5%	50.8%	33.0%	42.0%	41.7%
Depreciation and amortization	3.9%	3.8%	4.6%	4.5%	2.4%	3.5%	3.6%	4.6%	4.9%	2.6%	3.7%	3.9%	4.9%	5.0%	2.6%	3.8%	3.9%
Operating margin	13.5%	15.4%	7.2%	5.2%	32.4%	18.8%	18.5%	7.4%	4.6%	30.5%	18.5%	17.5%	5.7%	5.1%	31.7%	18.6%	19.0%
Growth rates:																	
Revenues	41.3%	43.3%	33.1%	32.4%	41.0%	38.2%	35.6%	36.3%	30.7%	28.6%	31.9%	31.2%	24.3%	24.6%	27.6%	27.1%	28.1%
Selling, general, and administrative	30.4%	26.2%	26.1%	33.2%	41.4%	32.6%	36.6%	42.2%	36.1%	31.3%	35.9%	35.1%	27.9%	24.1%	25.3%	27.7%	27.2%
Depreciation and amortization	30.9%	21.6%	21.8%	22.0%	34.1%	25.0%	30.9%	34.7%	44.1%	39.3%	37.6%	41.3%	33.1%	25.0%	29.4%	31.6%	32.9%
Operating income	156.2%	276.4%	338.1%	100.5%	63.8%	92.6%	62.3%	40.8%	15.2%	21.2%	29.2%	24.1%	-4.6%	40.5%	32.5%	28.2%	30.6%
EPS	339.3%	686.6%	NM	NM	74.9%	124.4%	71.3%	78.1%	99.0%	25.7%	38.7%	38.6%	20.0%	69.0%	33.2%	34.2%	30.1%

Sources: Company documents and William Blair & Company, L.L.C. estimates

Table 8
Teavana Holdings, Inc.
Summary of Cash Flows and Balance Sheet
($ in millions, except per share)

Fiscal year ending January	2009	2010	2011E	2012E	2013E
CASH FLOWS					
Net Income	$5.3	$12.0	$16.9	$23.2	$30.4
Depreciation and amortization	3.5	4.4	6.0	7.9	10.5
Other	2.5	2.2	6.4	3.5	3.5
Stock-based and noncash compensation	0.2	0.2	2.0	4.0	5.0
Change in working capital	(0.3)	0.7	(9.3)	(9.3)	(10.9)
Cash from operations	**$11.1**	**$19.4**	**$22.0**	**$29.3**	**$38.4**
Capital expenditures	(6.6)	(12.6)	(16.4)	(20.0)	(24.0)
Free cash flow	**$4.4**	**$6.8**	**$5.6**	**$9.3**	**$14.4**
Change in equity	0.0	0.0	14.0	0.0	0.0
Change in debt	(4.3)	(0.3)	0.0	0.0	0.0
Net change in cash	**$0.1**	**$6.6**	**$19.6**	**$9.3**	**$14.4**
BALANCE SHEET					
Cash and cash equivalents	$1.3	$7.9	$27.5	$36.8	$51.2
Accounts receivable	0.3	0.3	0.3	0.3	0.3
Inventories	11.6	16.9	21.9	27.5	35.1
Prepaid expenses and other	2.8	5.1	11.6	17.5	23.5
Current assets	$16.0	$30.2	$61.4	$82.1	$110.1
Property and equipment, net	22.5	31.0	41.4	53.5	67.0
Other assets	3.2	2.9	2.0	2.0	2.0
Total assets	**$41.8**	**$64.1**	**$104.8**	**$137.7**	**$179.1**
Accounts payable	2.6	3.6	4.6	5.8	7.4
Income taxes payable	4.0	4.8	6.0	7.0	8.0
Other current liabilities	4.7	6.9	6.9	6.9	6.9
Current liabilities	$11.3	$15.3	$17.5	$19.7	$22.3
Long-term debt	1.0	1.0	1.0	1.0	1.0
Deferred rent	3.9	7.5	11.0	14.5	18.0
Other long-term liabilities	0.6	0.9	3.0	3.0	3.0
Shareholders' equity	25.0	39.3	72.2	99.4	134.8
Total liabilities and shareholders' equity	**$41.8**	**$64.1**	**$104.8**	**$137.7**	**$179.1**
Book value per share	$0.67	$1.04	$1.89	$2.54	$3.42
Net debt to total capitalization	-1.2%	-17.1%	-36.2%	-35.6%	-37.0%
Return on invested capital	13.7%	17.7%	17.6%	15.1%	15.2%
Return on equity	24.7%	37.3%	30.3%	27.0%	25.9%

Sources: Company documents and William Blair & Company, L.L.C. estimates

Additional information is available upon request.

This report is available in electronic form to registered users via R*Docs™ at www.rdocs.com or www.williamblair.com.

Please contact us at +1 800 621 0687 or consult http://www.williamblair.com/pages/eqresearch_coverage.asp for all disclosures.

DJIA:	11493.57
S&P 500:	1204.42
NASDAQ:	2546.04

The prices of the common stock of other public companies mentioned in this report follow:

Caribou Coffee Company, Inc.	$14.71
Cheesecake Factory Incorporated (The)	$27.04
Darden Restaurants, Inc.	$47.50
lululemon athletica inc.	$54.53
P.F. Chang's China Bistro, Inc.	$29.58
Starbucks Corporation	$38.19
Whole Foods Market, Inc.	$64.96
Williams-Sonoma, Inc.	$32.48
Zale Corporation	$3.96

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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
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Market Perform (Hold)	31%	Market Perform (Hold)	2%
Underperform (Sell)	1%	Underperform (Sell)	0%

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Equity Research Directory

Bob Newman, CFA, Principal   Manager and Director of Research   +1 312 364 8783
Kyle Harris, CFA, Principal   Operations Manager   +1 312 364 8230

CONSUMER

Sharon Zackfia, CFA, Principal   +1 312 364 5386
Group Head–Consumer
Apparel, Leisure, Restaurants

Jon Andersen, CFA, Principal   +1 312 364 8697
Consumer Products

Daniel Hofkin   +1 312 364 8965
Broad Assortment and Hardlines, Health, Beauty, and Convenience

Mark Miller, CFA, Principal   +1 312 364 8498
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FINANCIAL SERVICES

Adam Klauber, CFA   +1 312 364 8232
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GLOBAL INDUSTRIAL INFRASTRUCTURE

Nick Heymann   +1 212 237 2740
Co-Group Head–Global Industrial Infrastructure
Multi-industry

Larry De Maria, CFA   +1 212 237 2753
Co-Group Head–Global Industrial Infrastructure
Capital Goods

Nate Brochmann, CFA   +1 312 364 5385
Commercial Services, Logistics/Transportation

Brian Drab, CFA   +1 312 364 8280
Filtration and Water Management, Industrial Technology

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Industrial Components

Chase Jacobson   +1 212 237 2748
Engineering and Construction

Ryan Merkel, CFA   +1 312 364 8603
Commercial Services, Industrial Distribution

GLOBAL SERVICES

Brandon Dobell, Principal   +1 312 364 8773
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Educational Services, Real Estate Services

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Group Head–Healthcare
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Healthcare Information Technology, Healthcare Services

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Distribution, Outsourcing, Pharmacy Benefit Management

Tim Lugo   +1 415 248 2870
Therapeutics

Amanda Murphy, CFA   +1 312 364 8951
Diagnostic Services, Life Sciences, Pharmacy Benefit Management

Matthew O'Brien   +1 312 364 8582
Medical Devices

John Sonnier, Principal   +1 312 364 8224
Biotechnology

Brian Weinstein, CFA   +1 312 364 8170
Diagnostic Products

Y. Katherine Xu, Ph.D.   +1 212 237 2758
Biotechnology

TECHNOLOGY

Jason Ader, CFA, Principal   +1 617 235 7519
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Co-Group Head–Technology
Business Software & Services, IT Services, Software as a Service

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Electronic Components, Semiconductors, Wireless Communications

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Cybersecurity, Security Technology

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Business Software & Services, IT Services

CHINA

Liping Cai, CFA   +86 21 2327 2260
China-Based Companies

EDITORIAL

Steve Goldsmith, Head Editor   +1 312 364 8540
Maria Erdmann   +1 312 364 8925
Beth Pekol   +44 20 7868 4516
Kelsey Swanekamp   +1 312 364 8174
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