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Stock Rating
Equal-weight

Industry View
In-Line

April 16, 2012

Teavana Holdings, Inc.

Quick Comment: TEA Spills Into Canada

We are positive on Teavana's recently announced \$26.9M acquisition of Teaopia. We believe Teaopia offers a low risk path to expand Teavana's Canadian store footprint given its international aspirations. Teaopia's 46 stores generate CAD \$17M in revenue and management expects the acquisition to be EPS neutral (or \$0.04–\$0.05 dilutive from transaction expenses) in 2012 and accretive by \$0.03–\$0.04 in 2013.

Teaopia's lower store productivity offers opportunity for revenue and EPS upside. Teaopia currently generates \$435K in revenue per store vs. Teavana's average \$913K per store. Teavana expects to close this revenue productivity gap over time.

Teaopia's similarities to Teavana should make the transition easy. Teaopia offers a similar product mix in a similar footprint (~900 sqft) and store layout (including a wall of tea). TEA expects minimal capital requirements and estimates spending ~\$25K per store to rebrand them under the Teavana moniker compared to Teavana's typical \$200–\$250K new store investment.

Our analysis demonstrates the Teaopia acquisition has more EPS upside than if the company had bought back shares. We conducted an alternative use-of-cash analysis (share buyback) to benchmark the Teaopia acquisition. We found that the acquisition compares favorably with 3c–4c of 2013 accretion vs. 3c for \$26.9M in share buybacks. Increasing the store base by ~30% should also give Teavana additional leverage on infrastructure costs and allow the company to benefit from further scale as it makes additional system investments like CRM.

We believe shares are currently appropriately priced and maintain our Equal-weight. 3c–4c 2013 accretion from the acquisition at the current 22.7x P/E on our 2013 numbers suggests \$0.68–\$0.91 of share appreciation over Friday's \$19.20 close.

Key Ratios and Statistics

Reuters: TEA.N Bloomberg: TEA US
Retail, Softlines / United States of America

Shr price, close (Apr 16, 2012)	\$19.76
Mkt cap, curr (mm)	\$779
52-Week Range	\$29.35–14.28

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Teaopia stores are largely similar to Teavana both in concept, product and characteristics. In terms of appearance, store size, and product mix, Teaopia stores have a similar positioning to Teavana. Primary differences are in Teaopia's in-store experience and resulting store productivity. Management commented that Teaopia does not invest as much in service and experience as Teavana does, leading to sales per store roughly half of Teavana's average. Teavana hopes to improve Teaopia's store productivity by putting Teaopia employees through Teavana's training program and introducing Teavana's exclusive product into Teaopia stores to improve performance.

Exhibit 1

Store Layouts Are Virtually Identical



Source: Company Data, Morgan Stanley Research

Exhibit 2

Teaopia and Teavana Have Similar Store Profiles

	Teaopia	Teavana
Number of stores	46	200
Average sales per store	~\$435,000	\$913,000
Avg store size (sqft)	~900	920
Occupancy cost per store (\$)	~100% of TEA	N/A
Loose-leaf tea as % of revenue	~50%	55%
Mall avg SSF (existing locations)*	~\$500	~\$500

*Indicates average SSF of the malls where Teavana and Teaopia stores are located. Source: Company Data, Morgan Stanley Research

Similarities should facilitate transition and reduce up-front integration costs. TEA estimates spending ~\$25K per store to rebrand them under the Teavana moniker compared to the typical \$200–\$250K (net of tenant allowances, inventory and cash pre-openings costs) for a new store.

Alternative use-of-cash analysis suggests that the Teaopia transaction has more upside than a \$26.9M share repurchase. We estimate that if Teavana used the purchase proceeds to buyback stock, the transaction would be 3c accretive to 2013 EPS, which is the low end of the guided range of 3-4c of accretion from the Teaopia transaction.

Exhibit 3

A Theoretical \$26.9M Share Repurchase Would Yield +3c in 2013 vs. +3-4c from the Teaopia Acquisition

Alternative Use of Cash	
Acquisition Cost	\$26.9 M
Share price (4/13/2012)	\$19.20
Potential Shares Repurchased	1.4 M
2013E	
Current Net Income	\$33.7
FD Shares Outstanding	39.8
Pro Forma FD Shares Outstanding	38.4
Current EPS estimate	\$0.85
Pro Forma EPS estimate	\$0.88
Accretion/Dilution	+\$0.03

Source: Company Data, Morgan Stanley Research

Teaopia gives Teavana a fully built out store network in Canada. Assuming that Teavana is able to optimize the Teaopia store network, we believe that a fully integrated Teaopia could contribute up to 15c in EPS. We assume TEA's average \$913K revenue per store and a 19% segment operating margin (vs. 18.3% TEA operating margin in 2012e and 20.3% in 2013e). We believe Teaopia could take some

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time to transition and is not likely to reach parity with Teavana stores until 2015 or beyond.

Exhibit 4

Teaopia Store Network Could Add Up to 15c to EPS

(\$ in 000s)	2011 Estimated	Potential
Total sales	\$17,000	\$47,377
Online sales	765	3,553
Online % of total sales ⁽¹⁾	4.5%	7.5%
Store-only sales	\$16,235	\$43,824

Existing Stores

Number of stores ⁽²⁾	34	48
Sales/store ⁽³⁾	\$435	\$913
Total Existing Store Revenue	\$14,790	\$43,824

New Stores

Number of new stores	12	-
Sales/new store	\$120	-
Sales Productivity	28%	NA
Total New Store Revenue	\$1,445	\$0

(in \$M)		
Operating Profit	\$0.9	\$9.0
Assumed Operating Margin ⁽⁴⁾	5.0%	19.0%
Taxes	0.3	3.2
Assumed Tax Rate ⁽⁵⁾	35%	35%
Net Income Contribution	0.6	5.9

EPS Contribution	\$0.15
Shares Outstanding	39.8

(1) Based on management commentary of "less than 5%" for Teaopia online sales. Potential online sales are based on Teavana's current percentage of online sales.

(2) 34 Teaopia stores in 2011 based on 46 stores at time of acquisition minus 12 stores opened in the last twelve months as per press release. 48 potential stores include 2 additional stores expected to open in 2012.

(3) Teaopia's \$435K in sales/store is based on Teavana presentation on 4/16/12. We assume Teavana's \$913K sales/store average as the potential for Teaopia store productivity.

(4) We assume 5% 2011 operating margin based on company guidance for neutral 2012 EPS impact excluding transaction costs. We assume Teaopia profitability is offset by interest expense and increased costs. We assume potential 19% operating margins in-line with 2011 operating margins.

(5) We assume a lower 35% tax rate for international operations compared to Teavana's current 40% tax rate.

Source: Company Data, Morgan Stanley Research

The per store economics of the acquisition are not as favorable as new stores, but still generate robust 34% cash on cash returns. The \$26.9M transaction cost translates to an \$585K acquisition cost per store. Adding \$25K per store in rebranding costs brings the total cost per store to \$610K, which does not compare favorably with \$200–\$250K net cash investments for the typical Teavana store. We assume that Teaopia stores could perform at the high end of the new store opening range of \$700K in sales per store and a 30% contribution margin. We calculate a 3-year payback period on investment. In order to achieve the 18 month payback for TEA's traditional new stores, we estimate a 50% average 4-wall contribution would be necessary given the acquisition cost per store.

Exhibit 5

We Estimate 34% Cash on Cash Return on Teaopia Stores

Teaopia Store Economics	
Acquisition Price	\$26.9 M
Teaopia Stores Acquired	46
Transaction cost/store (\$000)	\$585
Capex Improvements	25
Total cost per store	\$610
Annual Sales	\$700
4-Wall contribution (%)	30%
4-Wall contribution (\$000)	\$210
Cash on cash return	34%
Payback Period	2.9 yrs

We assume sales per store of \$700K and 30% 4-Wall contribution margin, both at the top of the range for new Teavana stores. Source: Company Data, Morgan Stanley Research

Purchase price of 1.6x 2011 sales is in line with Specialty Retail average of 1.6x. Our comparison of the Teaopia transaction against prior specialty retail M&A transactions since 2010, shows that TEA purchased Teaopia at a valuation in-line with the industry average. Over the past year, private equity firms acquired other mall-based specialty retailers like J. Crew and Gymboree at 1.6x revenue.

We estimate \$550-\$680K interest expense could weigh on acquisition benefits. With \$16 to \$18M cash on hand financing the transaction, we estimate interest expense on the remainder of the acquisition cost would be roughly \$550-\$680K per year based on a 6.25% interest rate on TEA's existing credit facility as of January 2012.

Acquisition Risks

- **Financial risk** – Teavana's use of cash balance to fund the acquisition could reduce its future financial flexibility should anything unexpected happen during the company's normal course of operations.
- **Teaopia may be overstored** - Additionally, Teaopia may be oversaturated in Canada with 46 stores. The US currently has a population of ~315M which supports approximately 200-250 Class-A malls. Canada's population of 34M (or 11% of the US) would imply the country could only support less than 30 Class-A locations.

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(as of March 31, 2012)

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Not-Rated/Hold	101	3%	26	2%	26%
Underweight/Sell	478	16%	126	12%	26%
Total	2,926		1088		

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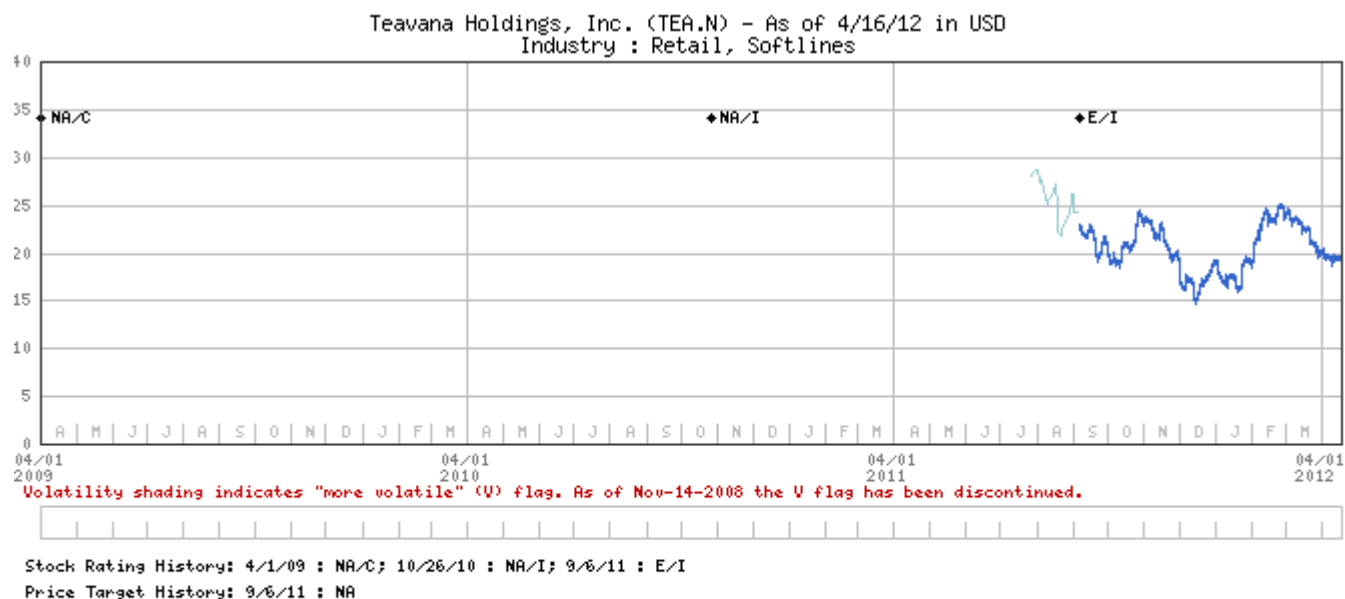
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April 16, 2012
Teavana Holdings, Inc.



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Industry Coverage: Retail, Softlines

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Abercrombie & Fitch Co. (ANF.N)	E (10/26/2010)	\$46.78
Aeropostale Inc (ARO.N)	U (10/26/2010)	\$21.09
American Eagle Outfitters, Inc. (AEO.N)	E (12/05/2011)	\$17.22
Chico's FAS Inc. (CHS.N)	E (10/26/2010)	\$15.07
Children's Place Retail Stores Inc. (PLCE.O)	E (10/26/2010)	\$48.12
Coach Inc (COH.N)	E (11/04/2011)	\$73.84
Express, Inc. (EXPR.N)	O (01/31/2011)	\$23.91
Gap Inc (GPS.N)	E (10/26/2010)	\$26.43
Limited Brands Inc (LTD.N)	O (10/26/2010)	\$47.91
Lululemon Athletica Inc. (LULU.O)	E (01/20/2010)	\$73.4
Michael Kors Holdings Ltd (KORS.N)	O (01/24/2012)	\$42.1
Ross Stores Inc. (ROST.O)	E (10/26/2010)	\$59.22
Skullcandy Inc (SKUL.O)	O (08/29/2011)	\$17.29
TJX Companies Inc. (TJX.N)	E (10/26/2010)	\$40.19
Teavana Holdings, Inc. (TEA.N)	E (09/06/2011)	\$19.76
Tiffany & Co. (TIF.N)	E (11/04/2011)	\$66.66
Urban Outfitters Inc. (URBN.O)	O (07/07/2011)	\$28.48

Stock Ratings are subject to change. Please see latest research for each company.
* Historical prices are not split adjusted.