



QUO VADIS
CAPITAL

Proprietary Structural Analysis & Forecasting

Evaluating Quality &
Market Growth
Expectations Using Unit
Economics

Sprouts Farmers Market,
Inc. (SFM) LONG

VALUEx Klosters 2020

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**January 29-Feb 1,
2020**



Previous ideas from Value Investment Conferences

CALL	COMPANY	SYMBOL	EVENT	DATE	PRICE	1 YEAR LATER	PRICE	12M % CHANGE
SHORT	SHAKE SHACK	SHAK	CYPRUS	9/23/2019	\$ 102.89	1/29/2020	\$ 68.10	-34%
LONG	YUM CHINA	YUMC	VAIL	6/14/2019	\$ 41.16	1/29/2020	\$ 45.01	7%
LONG	BRINKER	EAT	KLOSTERS	1/29/2019	\$ 42.36	1/29/2020	\$ 44.57	4%
LONG	DOLLAR TREE	DLTR	CYPRUS	10/4/2018	\$ 81.11	10/4/2019	\$ 115.73	43%
LONG	STARBUCKS	SBUX	VAIL	6/28/2018	\$ 48.54	6/28/2019	\$ 83.83	80%
LONG	DSW, INC.	DSW	CYPRUS	10/3/2017	\$ 21.32	10/3/2018	\$ 33.30	61%

*Source: FactSet, Includes dividends; % Change is since date of presentation for ideas less than 12 months old

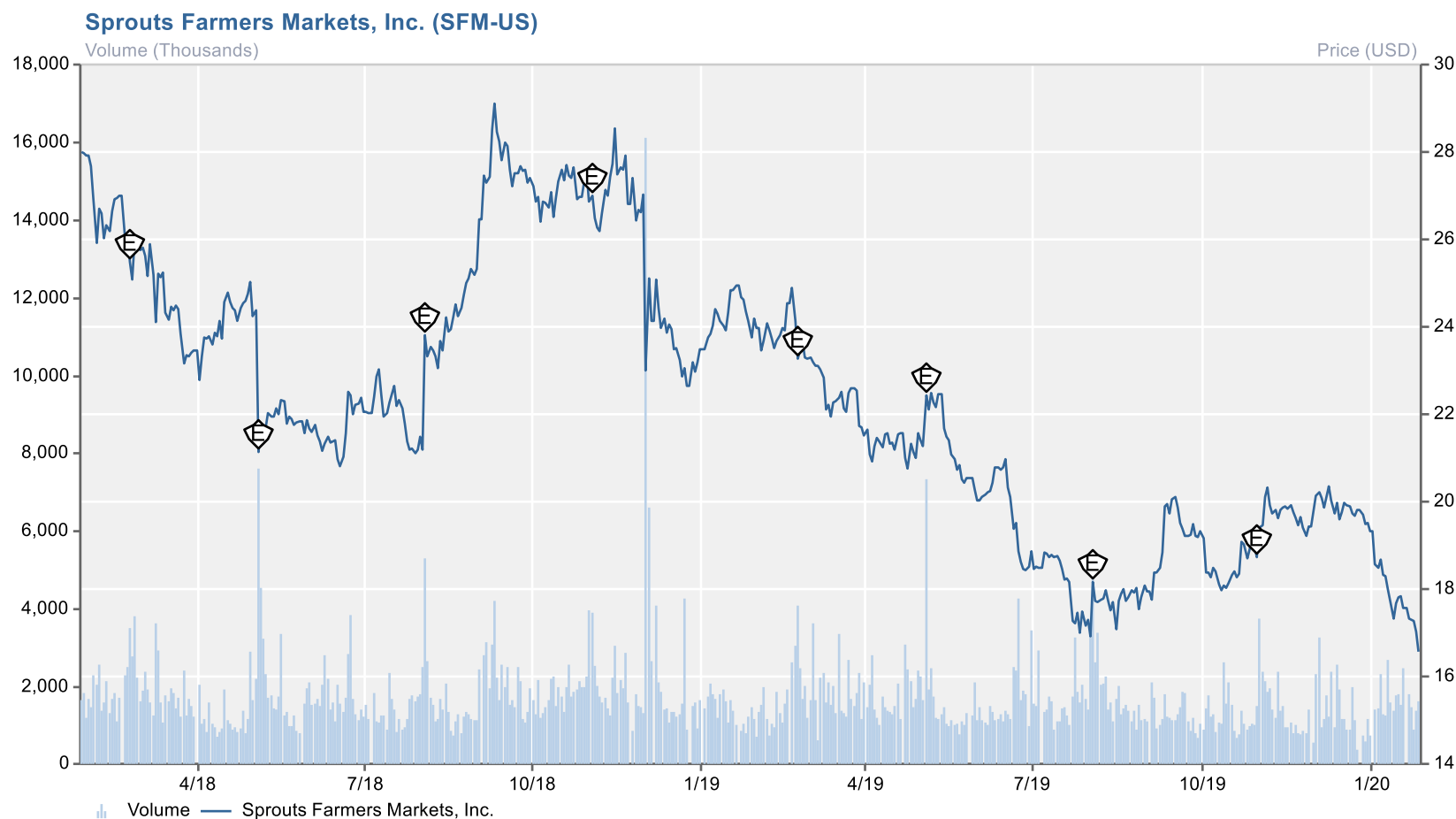
Decks from these presentations are available at
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Investment Case Summary

- Sprouts (SFM) Shares recently hit an all-time low
- Unit level analysis reveals that **SFM's economic model is not broken**. Stores generate well above average unit level ROIC and CF -- although metrics have been under pressure
- By one measure, **the market is paying nothing for SFM's future unit growth**. Alternatively the market is pricing in further profit losses at the core business
- **We have positive experience with recently announced new CEO Jack Sinclair (formerly ran WMT grocery)**. New CFO added last month; **believe new team is catalyst for improved performance**. Meanwhile the market is giving little credit to the potential for improvement.
- Full turnaround plan not yet announced we like what we've heard so far including 1) slowing growth, 2) reducing promotions and 3) focusing on more efficient, smaller stores while 4) layering on delivery/ e-commerce and 5) shifting ad spend to digital

Sprouts Farmers Market (SFM): LONG idea

Two Year Chart: Basically This Stock Has Only Lost Money for Investors



Source: FactSet Prices

Sprouts Farmers Market, Inc. (SFM) Overview

Sprouts Farmers Market is a small box **growth grocery retailer** with an emphasis on organic and natural products.

- 339 total locations
- 2019 annual revenues are forecasted at \$5.6B
- EBITDA margin: 5.8% in 2019E
- FY19E Capex ~\$160M (2.8% of sales)
- Capital Structure: \$530M LT debt, \$553M Shareholders' equity (3.6x lease adj. debt to EBITDAR)
- 2019E Free cash flow estimated at \$139M (~\$1.16/ share);
- Recent price \$16.50 on the U.S. exchange, current market cap: \$1.9B

SFM is a simple business and easy-to-understand, the company sells a focused selection of primarily organic groceries at value prices in small stores.

Sprouts Farmers Market, Inc. (SFM) Overview #2

Why Has SFM underperformed? Competitive Space got more competitive:

- Conventional grocers encroached on the organic space
- E-commerce encroached on all of retail (notably Amazon's purchase of Whole Foods)
- Pressure on P&L from rising labor and distribution costs as well as the need to invest in e-commerce and incremental fulfillment options
- Comps decelerated
- FY20E EBITDA margins forecasted around 5.5%, *down nearly 300 bps* from peak levels five years ago

As a result, top management recently turned over with the longtime CEO leaving in November 2018. Jack Sinclair was named new CEO in June 2019. New CFO was announced in January 2019.

Unit Level Economics Analysis: Evaluating Quality

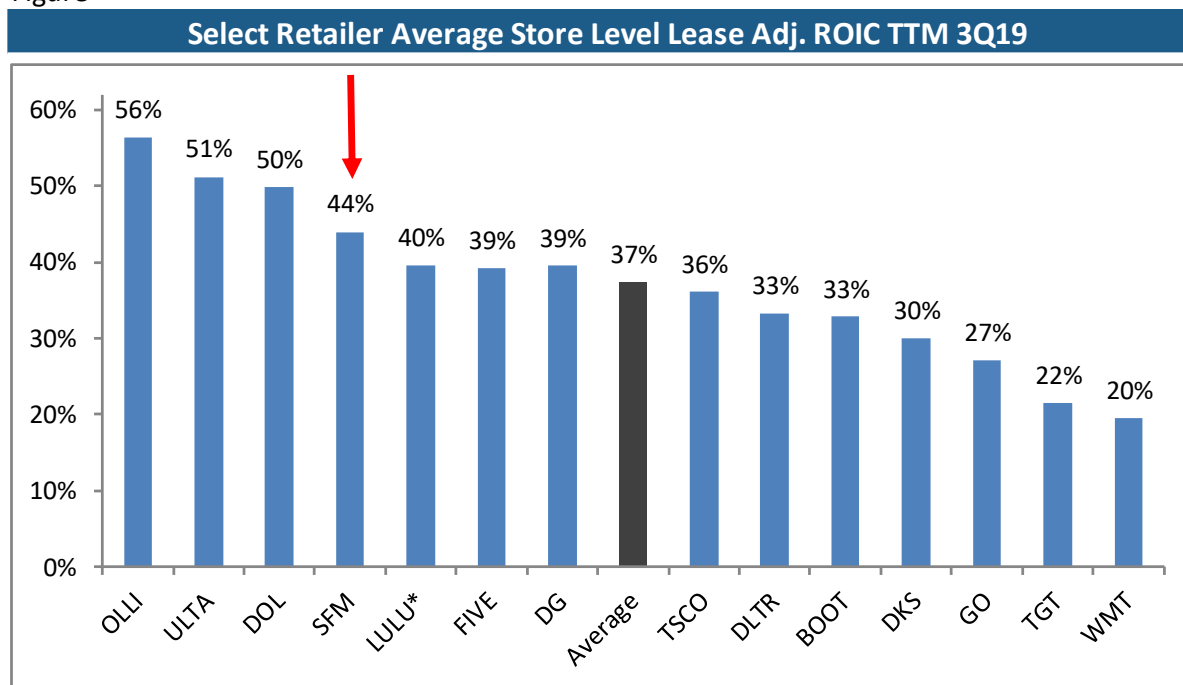
*Our Process for evaluating retailers, restaurants and other companies involves **breaking out and evaluating unit level ROIC** vs. a peer group, understanding the component parts that drive the ROIC profile and identifying any trends or inflection points in returns.*

We want to own high ROIC businesses with a sustainable return profile or improving ROIIC, and sell those that have poor returns or negative inflections in ROIC or ROIIC

Unit Economic Analysis: Step 1 Peer Compare

Why care about SFM? Why get involved with this out-of-favor stock in a difficult industry that is experiencing margin compression? Our work shows Sprouts at the store level ***generates above average and very attractive returns:***

Figure



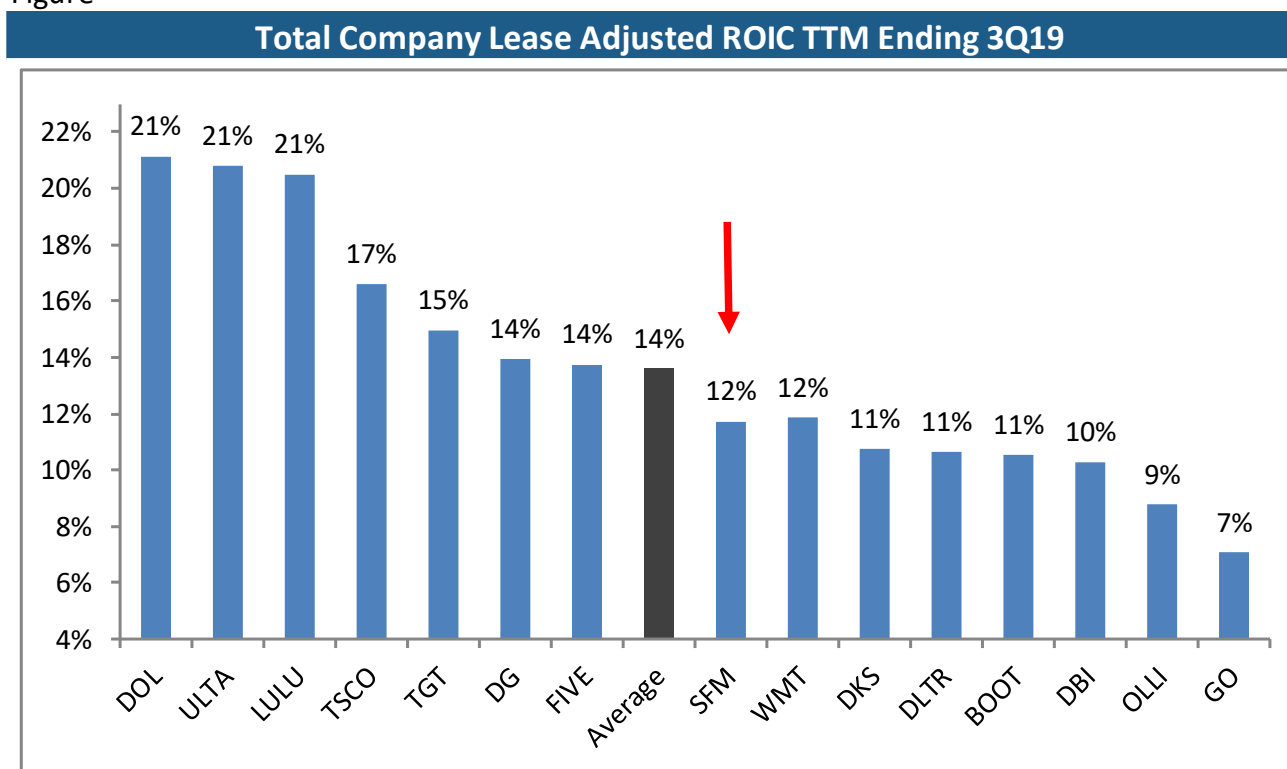
Source: Co. Reports & Quo Vadis Capital, Inc. ests; TSCO, SFM & BOOT use Cal Qtrs *Ex ecom



Unit Economic Analysis; Peer Compare Continued

- Corporate level returns are closer to a peer group average but the company is nevertheless generating returns that materially exceed WACC:

Figure

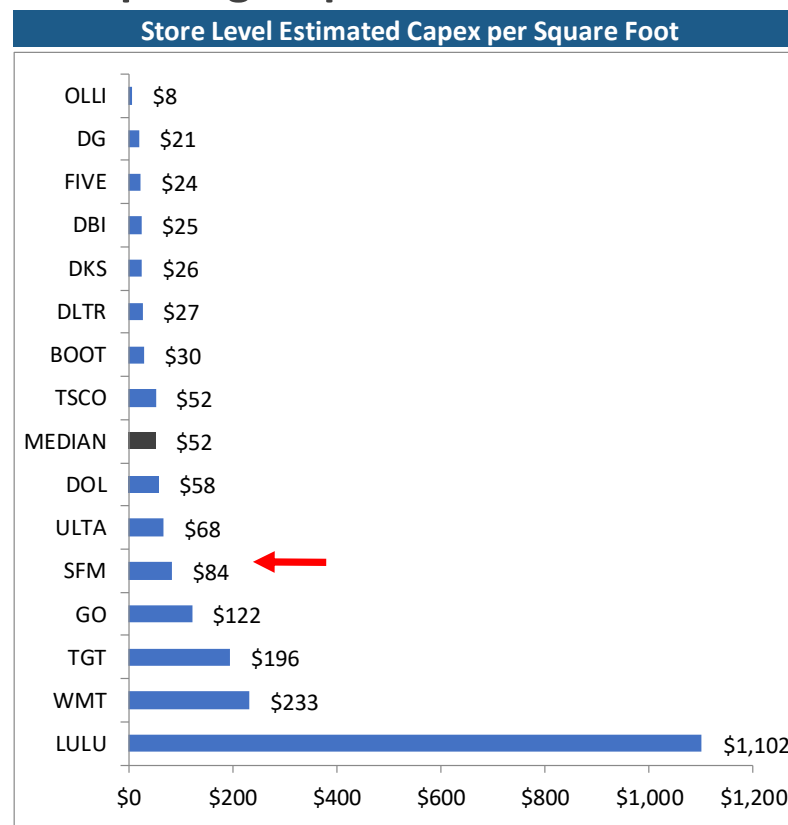
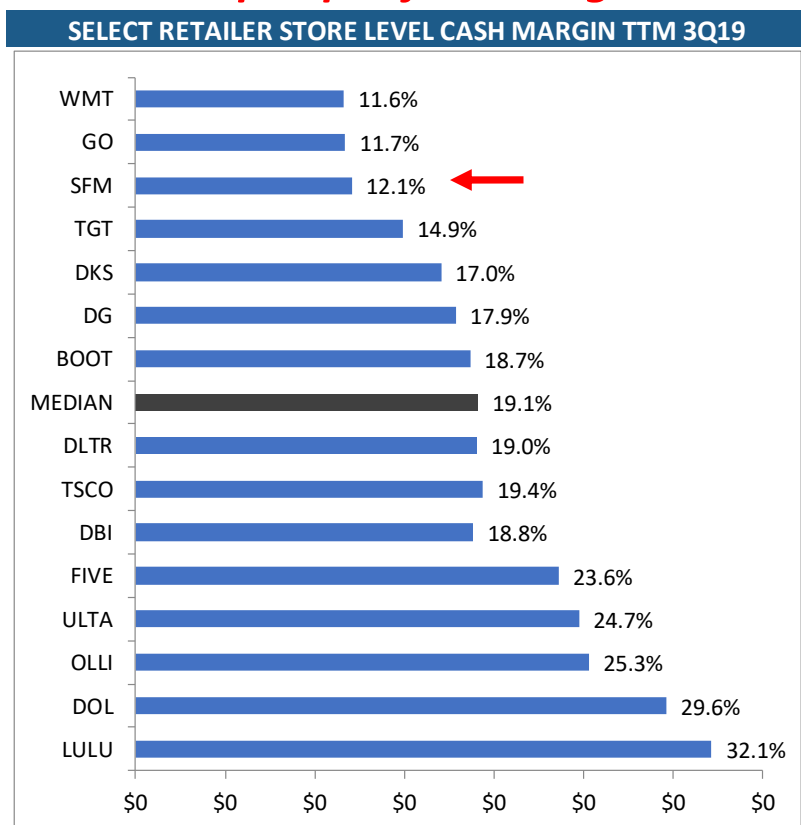


Source: Co. Reports & Quo Vadis Capital, Inc. estimates; TSCO, SFM & BOOT use Cal Quarters



Unit Economic Analysis; Step 2 Component Breakdown

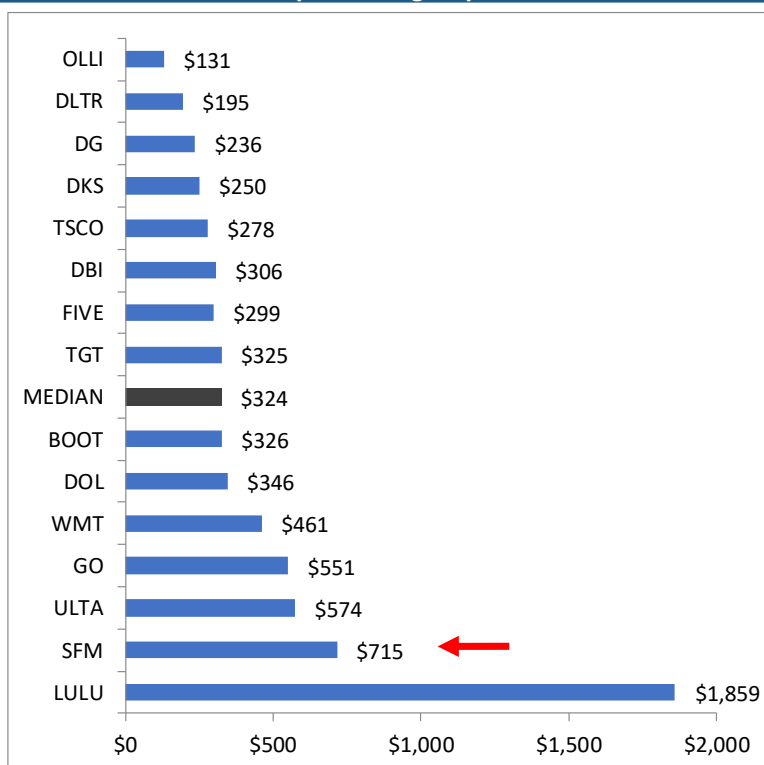
➤ Digging into the components of unit level returns shows *margins are low and capex per foot is high* relative to the peer group



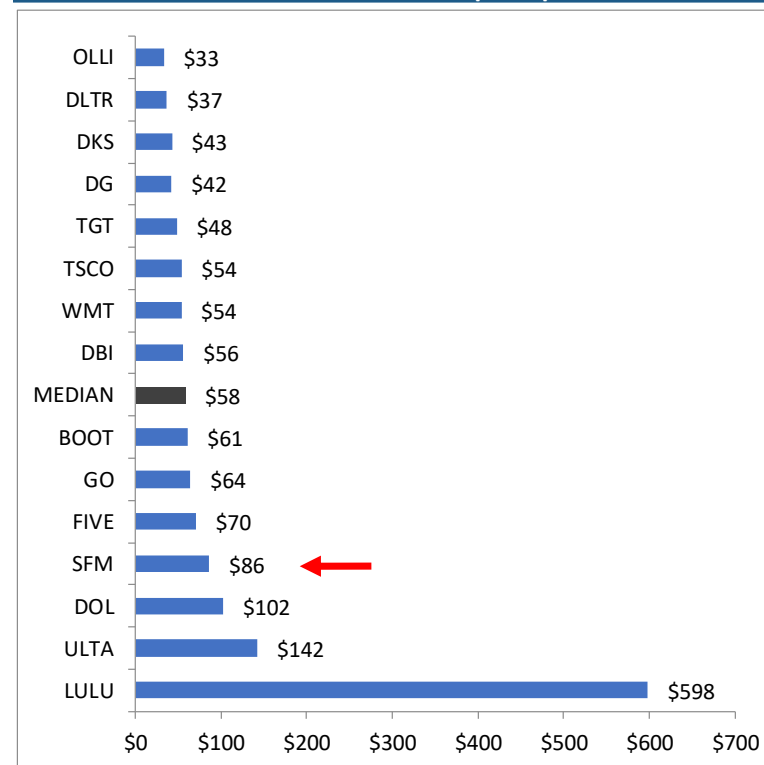
Unit Economic Analysis; Breakdown Continued

- However, *sales productivity is very high and profit per square foot is well above average.* This is the basis for SFM's attractive ROIC profile

Select Retailer Sales per Average Square Foot TTM 3Q19



Estimated Store-Level Profit per Square Foot

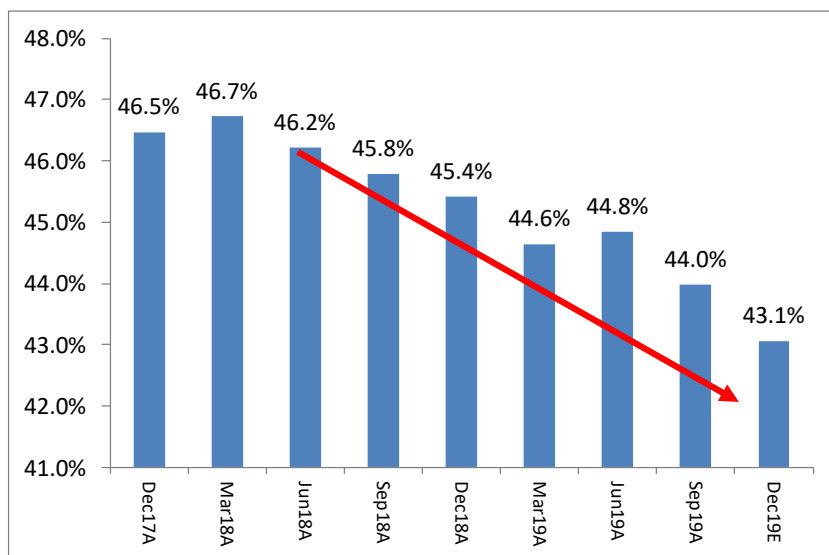


Source: Company Reports & Quo Vadis Capital, Inc. estimates; BOOT, TSCO, SFM & GO use CAL Qtrs; DOL in \$CAD

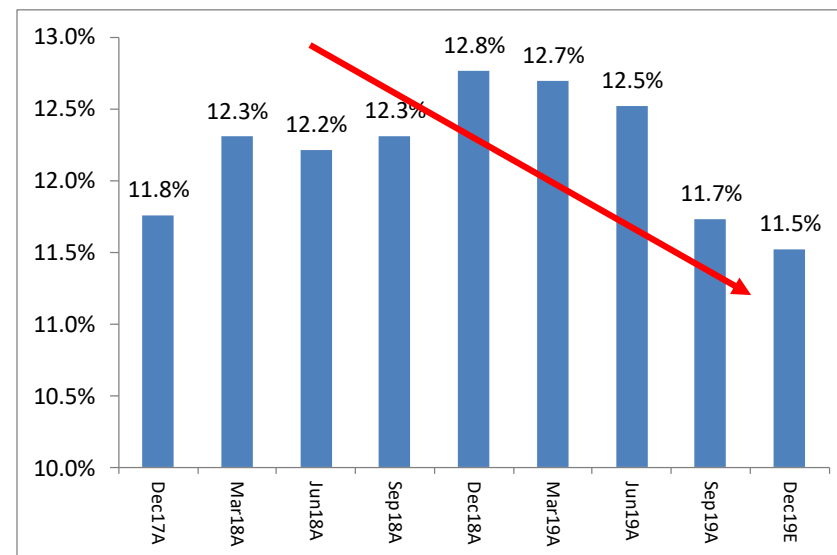
Unit Economic Analysis; Step 3. Trend Work

- **Unit level ROIC is in long-term downtrend** and corporate level ROIC appears to be rolling over and heading lower:

Lease-adj. Store-Level Estimated Average Store TTM ROIC



Lease-adj. Corp-Level TTM ROIC

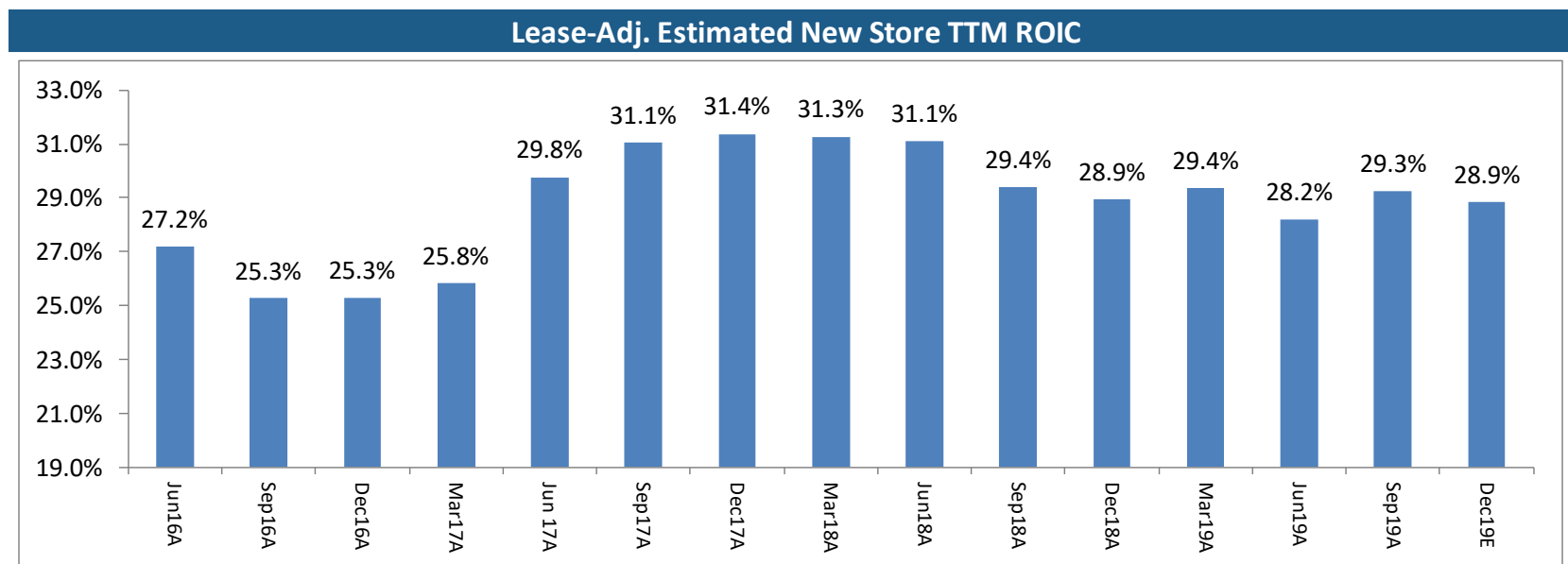


Source: Quo Vadis Capital, Inc. estimates and company reports



Unit Economic Analysis; Trend Work Continued

- The profile of new unit ROIC which we consider to *be return on incremental invested capital (ROIIC) is modestly deteriorating from recent peak levels*



Source: Company reports and Quo Vadis Capital, Inc. estimates

Unit Level Economics Analysis *Conclusion*

Sprouts' stores unit economic model is not broken. Stores generate very attractive financial returns due to high levels of sales productivity and despite meager grocery-industry margins. However, return metrics are under pressure and sustainability of the company's return profile is in question.

We need a reason to believe return metrics can stabilize or positively inflect to justify getting involved

Unit Level Valuation Tool **(NEW!!)**

*This tool 1) breaks out an **estimated value for a company's existing business**, and calculates what the market is paying for **the growth component***

2) We next independently estimate the value of future stores using a unit-level DCF calculation

Finally we quantify:

3) What the market may be over- or under-paying for the future cash flows from the yet-to-be-built component of the business

Unit Level Valuation Tool for Growth Companies

- First Part: Estimate cash generation from existing business & what the market is paying for the growth component

Stock	CF/ share from existing business	Market Multiple (8% CF yield)	Estimated value of existing biz	Market EV (\$M)**	Implied market value of growth option	% of current market value related to growth	
CMG	\$14.51	12.0x	\$4,944	\$23,701	\$18,757	79%	For these companies, our screen suggests a majority of the market value is for growth or reflects expectations for improvement in the core
GO	\$0.77	12.0x	\$863	\$3,583	\$2,719	76%	
SHAK	\$1.53	12.0x	\$704	\$2,467	\$1,763	71%	
FIVE	\$3.43	12.0x	\$2,307	\$6,122	\$3,815	62%	
OLLI	\$1.72	12.0x	\$1,355	\$3,456	\$2,101	61%	
BOOT	\$1.83	12.0x	\$640	\$1,354	\$713	53%	
DG	\$7.32	12.0x	\$22,622	\$42,479	\$19,857	47%	
SBUX	\$4.83	12.0x	\$69,917	\$113,412	\$43,495	38%	
ULTA	\$13.89	12.0x	\$9,627	\$15,325	\$5,698	37%	
TXRH	\$3.27	12.0x	\$2,741	\$4,219	\$1,478	35%	
TSCO	\$5.70	12.0x	\$8,211	\$11,688	\$3,477	30%	Our screen suggests the market is paying NEXT TO NOTHING for SFM's ability to grow
DOL-TSE	\$2.73	12.0x	\$10,395	\$14,750	\$4,356	30%	
DLTR	\$6.61	12.0x	\$18,845	\$23,987	\$5,142	21%	
YUMC	\$2.62	12.0x	\$12,212	\$13,895	\$1,683	12%	
CHUY	\$1.85	12.0x	\$369	\$400	\$31	8%	
★ SFM	\$1.87	12.0x	\$2,645	\$2,447	(\$198)	-8%	
PLAY	\$6.14	12.0x	\$2,321	\$2,090	(\$231)	-11%	
BJRI	\$4.18	12.0x	\$1,026	\$811	(\$216)	-27%	

Source: FactSet, Quo Vadis Capital, Inc. and Company reports ** does not include leases

Unit Level Valuation Tool for Growth Companies

- Second part: Calculate estimated value of new units (DCF driven) & compare to embedded market expectations:

Stock	Current Number of stores	# of new stores (5 yrs.)	Discounted Value of after tax CF from to-be opened stores	Implied market value of the growth component	Premium or Discount to Estimated Value of Growth
CMG	2625	725	\$ 1,559	\$18,757	11.0x
SBUX	33320	5307	\$ 7,267	\$43,495	5.0x
GO	346	211	\$ 612	\$2,719	3.4x
BOOT	257	120	\$ 177	\$713	3.0x
DG	16094	3962	\$ 4,972	\$19,857	3.0x
DOL-TSE	1291	396	\$ 1,148	\$4,356	2.8x
ULTA	1241	420	\$ 2,182	\$5,698	1.6x
TXRH	498	138	\$ 570	\$1,478	1.6x
SHAK	151	310	\$ 732	\$1,763	1.4x
FIVE	894	904	\$ 2,378	\$3,815	0.6x
DLTR	15338	2443	\$ 3,587	\$5,142	0.4x
OLLI	345	319	\$ 1,604	\$2,101	0.3x
TSCO	1990	550	\$ 1,405	\$3,477	0.1x
YUMC	7171	4000	\$ 3,989	\$1,683	(0.6x)
CHUY	103	25	\$ 58	\$31	(0.5x)
★ SFM	335	135	\$ 1,168	(\$198)	(1.2x)
PLAY	136	68	\$ 808	(\$231)	(1.3x)
BJRI	209	33	\$ 162	(\$216)	(2.3x)

For these names, our estimate of the value of new units suggests **investors are either overpaying for unit growth** or assuming improvements in the core business

Meanwhile, using our unit economic forecasts **we estimate significant cash flow and value from SFM's future units which is avail at a discount**

Source: FactSet, Quo Vadis Capital, Inc. and Company reports ** does not include leases



Unit Level Valuation Tool *Conclusion*

*Our work reinforces our view that **the market ascribes little or no value for SFM's future stores**. Alternatively, our work suggests the market believes profits from the existing business will decline over time.*

*If SFM can grow or maintain profitability of its existing business, then **investors are essentially able to buy the cash flows of its future stores for free***

Investment Recap:

- **\$2B Growth Food Retailer with \$5.6B in revenues and strong FCF**
- **Shares have underperformed for multiple years & sentiment is terrible** due to decelerating same-store sales and contracting EBIT margins
- Unit level analysis reveals **very strong economic model** with well above average unit level ROIC & history of FCF and capital return
- Valuation work suggests **growth potential is not factored into the stock price** or that market expects further profit losses at the core business
- **Recently announced new CEO Jack Sinclair (formerly ran WMT grocery) & Announced new CFO this past month; believe new team is catalyst for improved performance**
- Full turnaround plan not yet announced but co. is 1) slowing growth, 2) reducing promotions and 3) focusing on more efficient, smaller stores while 4) layering on delivery/ e-commerce and 5) shifting ad spend to digital

Risks & Other Considerations:

- The company competes in the difficult grocery segment
- Deflation is a risk to pricing and comps
- E-commerce and delivery efforts may lose money or dilute margins
- New management may fail to generate improvements we forecast
- Rising labor and other costs

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