Sprouts Farmers Market: High Yield and a Long Runway For Reinvestment

Image source: Sprouts Farmers Market March 2021 Investor Deck
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*Disclosure: Arch Capital Investors Fund LP (“Arch Capital”) currently has a long position in Sprouts Farmers Market stock. Arch Capital will benefit if shares of Sprouts Farmers Market increase in value, and will lose money if they decrease in value. Arch Capital may change its view on Sprouts Farmers Market at any time and is under no obligation to notify the market when it buys or sells shares in Sprouts Farmers Market. This report includes forward-looking statements, projections, and opinions about Sprouts Farmers Market’s future operating performance. Such projections may prove inaccurate and are out of the control of Arch Capital’s managers. Arch Capital makes no warranty or representation to the accuracy and completeness of the following report and expressly disclaims any liability relating to the report and other communications. Shareholders should conduct their own investigation into Sprouts Farmers Market. The report is not investment advice or a recommendation or solicitation to buy or sell any securities.*

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What is Sprouts Farmers Market?

Sprouts Farmers Market (SFM) is a health-focused grocery store based out of Phoenix, Arizona. It currently has 360 stores in 23 states focused on California, the Southwest, Texas, and the Southeast. The store layout and products are a bit different than traditional grocery stores (as the name implies, it tries to emulate a farmers market).

Locations have an open layout with produce and bulk bins in the center of the store, with the packaged goods, bakery, deli, and frozen sections wrapping around the outside. It also has a dedicated vitamins and supplements section in each store. The chain’s focus is selling healthy produce and dietary-specific items (ex. vegan, keto, gluten-free, etc.) at reasonable prices. Lastly, the company is focused on bringing a consistent amount of local, unique, and/or specialty products to its stores as a way to convert its target demographic to become repeat customers (more on this initiative later).

To sum it up, we like to think of SFM as a meeting in the middle between Whole Foods, Trader Joe’s, and Kroger. It has the organic and dietary items of Whole Foods, the uniqueness and specialty products of Trader Joe’s, and the everyday low prices of a Kroger or other standard grocery stores (this includes Wal-Mart as well).

*A map of current SFM store locations. DC=Distribution Center. Source: SFM 2021 Investor Deck.*
How We Got Here

This section will go over a brief history of SFM and developments over the last few years to give context to where the stock trades today.

In 2002, the first SFM store was opened in Chandler, Arizona. The company slowly grew its business, while also acquiring two like-minded competitors. In 2011, it merged with Henry’s (which actually was founded by the same family) and in 2012 it bought Sunflower Farmers Market. All stores have since changed to the Sprouts brand. SFM went public in 2013 and trades on the NASDAQ.

From 2015 - 2019, SFM’s store count continued to climb higher as it expanded through Texas, the Southeast, and Colorado. However, during this period, the economics of the business started deteriorating. Two-year comp-store sales growth went from an impressive 15.7% down to 3.8%, which likely contributed heavily to operating margin going from 6.37% down to 3.86%. Seeing these numbers, it is no surprise that SFM’s stock is still down 34% from its IPO price even though sales have gone up each of the last five years.
Why did the business quality deteriorate from 2015 - 2019? There was a confluence of factors, but we believe it was for two main reasons: losing customer focus and dumb expansion.

From what current management has talked about, in and around 2015, SFM started playing the coupon game with Kroger and other traditional grocers. This led to SFM acquiring low-value coupon clippers instead of the core health enthusiasts it was known for. In some consumer’s eyes, this brought SFM’s value proposition to the same level as Kroger’s, which is a game SFM is going to lose every time. It was also bringing in less valuable customers that did not become repeat customers.

With expansion, the company started pushing into new territories it wasn’t necessarily prepared for. For example, it has four stores in Washington state, but no infrastructure to support it and no other stores close by (check the map above). It also made a big push into Colorado without opening up a distribution center (DC). The nearest DC was in Arizona, which meant the delivery trucks had to constantly go over a huge mountain range to get to the Colorado stores. This was a dumb move that likely hurt product quality and profit margins in the area (it has since been fixed with a DC opened up in 2021).

This business deterioration led to CEO Amin Meredia resigning in late 2018. It is unclear whether he was pushed out or decided to leave on his own, but we do not believe anyone was clamoring for him to stay with where the business was heading or where the stock traded.

**Where We Are Now**

We left out 2020 in the above analysis because like with all grocers, SFM had a positive catalyst from COVID-19. Operating margin and comp sales both rebounded nicely from the 2019 lows, a lot of which likely came from restaurant closures and the fact it was one of the few stores open throughout 2020.

Here is a summary of SFM’s 2020 financials to give a reference point for 2021 onward:

- Net sales of $6.5 billion
- Net income of $287 million
- Operating cash flow of $494 million
- Free cash flow of $372 million (OCF - capex)

At a share price of $27, SFM has a market cap of $3.19 billion, giving it an earnings yield of 9% and a FCF yield of 11.7% based on the 2020 numbers.
Now, we know what you’re thinking, we can’t just assume the 2020 financials are sustainable because of the one-time COVID-19 boost. We’ll get to that below.

We should also mention here the new CEO, Jack Sinclair. Sinclair joined the company in June of 2019. Before becoming SFM’s CEO, he was briefly the CEO of 99 Cents Only Stores. Before that, from 2007 - 2015, he was the VP of U.S. Grocery for Wal-Mart, which covered more than 4,000 stores. With 35 years of retail experience and his previous job in charge of thousands of grocery locations at Wal-Mart, we’re confident in Sinclair’s ability to lead SFM as it marches towards 1,000 locations.

**Management’s Plans for the Next Five Years**

The more you read and listen to Sinclair on conference calls and corporate events, the more you realize SFM was woefully mismanaged before he arrived. For example, no stores have self-checkout, which seems like table stakes for grocers in 2021 (the company is planning to fix this over the next few years).

Here is what Sinclair and the management team’s stated plans are and how we think they can impact the business.

**Store expansion and DCs**

The first priority for SFM is opening up new stores. In 2021, it is set to open 20 new stores, which will bring its total to 382 at year-end. After that, Sinclair says their goal is to accelerate store growth to 10% a year. This would bring store count up to 559 by 2025.
Outside of stores, management’s goal is to eventually get a DC 250 miles from every store. In 2021 it opened two new DCs, one in Colorado and one in Florida. The Colorado one is meant to right the ship in a struggling region, while the Florida DC is set to be the base for store expansion in the state.

DCs within close proximity to stores are vital to SFM’s goal of creating a differentiated customer experience. The immediate effect is a better margin structure (no more driving over mountain passes), but more importantly, the regional DCs set the baseline for its fresh supply chain. For example, with the new DC in Colorado, SFM will be able to better control the freshness of its produce/perishables and establish better relationships with local farmers. This, in turn, will improve the customer experience by offering more reliable products and more unique items to shoppers. 68% of sales at SFM come from organic or attribute-based items (vegan, keto, paleo, etc.), which highlights the importance of these DCs for SFM vs. other grocers.

If you want more detail on the DC importance, here is a 5-minute clip describing SFM’s Colorado DC and why it services as the baseline for building its brand in the region: [https://www.youtube.com/watch?v=af7HVFrwVfo&t=1s](https://www.youtube.com/watch?v=af7HVFrwVfo&t=1s)

Don’t underestimate the relationships with local farmers either. Focusing on unique products that you can market as “Only at Sprouts” or whatever the tagline is can help re-separate SFM stores from Kroger and Wal-Mart for customers. It will take years to build this brand equity, but if successful, it can help steady comp store growth and reduce marketing spend (less need to re-acquire customers), which would positively impact profit and cash flow margins over the long term.
Smaller store format

Starting this year, SFM is testing new, smaller store formats of 21k - 25k square feet that it believes will improve returns on invested capital (the legacy stores are typically around 30k sq ft). These are a lot smaller than traditional stores, but we believe the format is viable because SFM locations do not require 12 aisles for non-perishable CPG items.

The unit economics have not been proven out, but management believes the new formats will:

- Cost $3.2 million to build
- Hit $16 million - $18 million in sales by year 4
- Hit 8% EBITDA margins in year 4 (which tracks with SFM’s historical margin profile)

The cost to build might not average $3.2 million over the long term (we estimate $4 million per store in the model below), but we believe the sales and margin profile are entirely reasonable. 8% EBITDA margins and $17 million in sales imply $1.36 million in per store EBITDA by year 4. Over the last five years, SFM has averaged $853,740 in operating income per store, which makes sense when you consider that this includes stores that haven’t reached 4-year maturity and that operating income includes D&A.

Focused market strategy

In conjunction with the refocus on a fresh supply chain and more unique products, management has narrowed its marketing strategy. It got rid of all newspaper coupons/advertising (which was directly equating it to traditional grocers in the consumer’s mind) and is instead solely focused on digital marketing and rebuilding its customer list through email. This no doubt hurt comp sales in the short run, but we believe it helped them “rip the bandaid” off from its old, unsustainable strategy and set the business back on a logical track.

The marketing team is also narrowing its focus to what it calls “health enthusiasts” and “experience seekers.” We’re not exactly sure what they mean by the experience seekers, so we just group it as people who are passionate about eating healthy or are on restrictive diets. Management estimates this demographic spends around $200 billion on at-home food annually, making it about 17% of the $1.2 trillion at-home food market in the United States. Using digital marketing and email will help SFM target this subsection of the population, which will lead to a better ROI from advertising spend.

What’s great is that the marketing and supply chain strategy work in tandem. This isn’t a special insight by Sinclair, but it will help properly align the SFM brand within the consumer’s mind over the next five years and beyond.
Pick-up and e-commerce

SFM’s e-commerce and store pick-up business grew 340% in 2020 and was around 10% of SFM’s business last year. Since it outsources delivery to Instacart, management believes e-commerce margins are similar to its in-store business. So far that has proven true, but it is something to watch for if the category grows as a percentage of SFM’s overall business.

From management’s commentary, it sounds like they will not be pushing e-commerce onto customers, but wants to make it available, either through pick-up or delivery through Instacart, for anyone that does. It also allows customers to get groceries delivered or start a pick-up order through its website and mobile app. In this scenario, delivery is still white-labeled through Instacart, similar to how Chipotle partners with DoorDash. The app is extremely average from a UI/UX perspective, and we don’t expect it to be a value driver for SFM going forward.

E-commerce is not a part of the bull thesis for SFM, but we think the segment’s performance in 2020 shows management’s ability to be flexible and perform in high-pressure situations (how much that will be needed going forward, that is unclear).

Share repurchases

With a low earnings multiple, $260 million in debt, $256 million in cash, and a business that generates hundreds of millions in cash a year, SFM is set up beautifully to repurchase stock over the next few years.

(The majority of the debt is $250 million on a March 2023 credit agreement with variable interest rates. They own interest rates swap to mitigate any rise in rates. No word from management if they plan to pay down this early.)

Management just announced a new $300 million share repurchase program, which hopefully will be exhausted over the next year or two.

And if you’re worried about buybacks not actually reducing share count, SFM’s share count has fallen at a 4% rate from Q1 2016 to Q1 2021. It stopped the buyback program in 2019 when Sinclair came in to right the ship and then was paused last year with all the extra costs associated with COVID-19 and because management decided to pay down debt, but coming out of the pandemic SFM is poised to consistently reduce share count.

<table>
<thead>
<tr>
<th>Year</th>
<th>Share Count (millions)</th>
</tr>
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10
<table>
<thead>
<tr>
<th>Year</th>
<th>Share Count</th>
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<tbody>
<tr>
<td>2021</td>
<td>118,131,886</td>
</tr>
<tr>
<td>2022</td>
<td>114,587,929</td>
</tr>
<tr>
<td>2023</td>
<td>111,150,292</td>
</tr>
<tr>
<td>2024</td>
<td>107,815,783</td>
</tr>
<tr>
<td>2025</td>
<td>104,581,309</td>
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</table>

Here is what the share count will be if SFM can reduce it by 3% from now until 2025. We think this is conservative with how much cash SFM will generate over the next five years unless the stock sees serious multiple expansion. Either scenario bodes well for shareholders though.

Financials and Valuation

*Using $27 a share, 118.13 million shares outstanding, and $3.19 billion market cap for all analysis*

Since SFM only has one business line, we have made a simple model to estimate how much excess cash the business can generate over the next five years. Here are the assumptions we made in this model, and why we chose them:

- Operating income per store (OI/store) will be the average of the 2015 - 2020 period at $853,370. We believe this is a logical estimate since the improvements management is implementing will make the store economics better than 2017 - 2019, but the business may not hit 2015 or 2020 profitability levels again. We took this number and multiplied it by the estimated store count to get annual operating income each year.
- The conversion from operating income to operating cash flow will stay around the average of the last five years, at 130%. The company will consistently have high D&A as a percentage of revenue, so we don’t expect this number to go down materially (we think
you could argue this conversion will be higher over the next few years with a reduction in interest expense, but we want to keep the model conservative)

- On average, each new store will cost $4 million to build. We took a higher number than $3.2 million because of the chance supply costs stay elevated as they have recently. New store capex is $4 million multiplied by the number of stores opened in the year.

- Non-store capex (maintenance, DCs, headquarters, e-commerce) will be 45% of new store capex each year, which is close to where it has averaged historically (assuming $4 million in per store capex in prior years). In 2021 it is 70% of new store capex with the small number of new stores opening and the two DCs opening (this is aligned with management’s guidance for overall capex in 2021)

With these inputs, we’re able to get annual free cash flow estimates through 2025 and get an estimate of excess cash generation that can be returned to shareholders or pay down debt over the next five years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating Income</th>
<th>Operating Cash Flow</th>
<th>New Stores</th>
<th>New Store Capex</th>
<th>Non-Store Opening Capex</th>
<th>Free Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021</td>
<td>$326,128,666</td>
<td>$423,967,266</td>
<td>20</td>
<td>$80,000,000</td>
<td>$56,000,000</td>
<td>$287,967,266</td>
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<tr>
<td>2022</td>
<td>$358,741,532</td>
<td>$466,363,992</td>
<td>38</td>
<td>$152,000,000</td>
<td>$68,400,000</td>
<td>$245,963,992</td>
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<td>2023</td>
<td>$394,615,686</td>
<td>$513,000,392</td>
<td>42</td>
<td>$168,000,000</td>
<td>$75,600,000</td>
<td>$269,400,392</td>
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<tr>
<td>2024</td>
<td>$434,077,254</td>
<td>$564,300,430</td>
<td>46</td>
<td>$184,000,000</td>
<td>$82,800,000</td>
<td>$297,500,430</td>
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<tr>
<td>2025</td>
<td>$477,484,980</td>
<td>$620,730,474</td>
<td>51</td>
<td>$204,000,000</td>
<td>$91,800,000</td>
<td>$324,930,474</td>
</tr>
</tbody>
</table>

| Cumulative FCF Over Next Five Years: | $1,425,762,553 |
| Market Cap: | $3,189,560,922 |
| Q1 Cash: | $256,019,000 |
| Debt & Finance Lease Liabilities: | $260,287,000 |
| Enterprise Value: | $3,193,828,922 |

As you can see, even with the high capital expenditures needed to grow this business, SFM can generate almost half its current enterprise value in cash over the next five years (and depending on where share count goes, possibly much higher than half its EV).
What’s even more beautiful is that the company can do this without the need for outside financing. In our mind, this gives SFM stock a high margin of safety on a five-year outlook, especially if management consistently repurchases shares.

Now, you might be asking, isn’t $325 million in 2025 free cash flow not that exciting? On the surface level, yes. But if you look at the growth of operating income, operating cash flow, and steadily dropping share count, investors will be owning a significantly more valuable stake in this business five years from now.

Like most great retail investments, SFM will require large amounts of capex to grow, which will make free cash flow look a lot lower than it can/will be at maturity. However, we think operating cash flow can steadily compound over the next five years and beyond, allowing SFM to sustainably go after this long reinvestment runway.

**Trends Working in SFM’s Favor**

Things working in SFM’s favor it can’t necessarily control. We don’t believe these trends need to continue in order for the stock to perform well, but they can be small tailwinds for the business.

**The rise of vegans/plant-based diets**

A big portion of SFM’s value proposition is catering to consumers who follow a vegan/plant-based diet. These consumers typically have trouble finding items in traditional stores. Luckily for SFM, the number of vegans in the U.S. has risen substantially over the last decade. The data comes from surveys, so it is tough to get an exact answer, but the estimates range from 2% - 6% of the population that follows a vegan diet. More importantly for SFM, 39% of people who aren’t vegan said they want to incorporate more plant-based foods into their diets. This is a tailwind that SFM can ride if they execute the strategies laid out above.

Source for this data: [https://www.plantproteins.co/vegan-plant-based-diet-statistics/](https://www.plantproteins.co/vegan-plant-based-diet-statistics/)

SFM is agnostic to its customers’ diet preferences too, it isn’t just focused on plant-based products. This allows SFM to ride the wave of whatever is trending among diet and health-focused land at any one time.

**Inflation**

If we hit moderate or high inflation over the next decade, that should help grocers, including SFM. The Kroger CEO mentioned recently that its business operates the best when inflation is 3% - 4%. We would think SFM is in the same boat.
You might argue that SFM is less equipped for inflation or an economic downturn than someone like Kroger, Wal-Mart, or Costco. But this isn’t Whole Foods. SFM’s pitch is to be the everyday grocery store for health enthusiasts, which in theory will make it easier for consumers to keep shopping there even with higher prices or less spending power.

We don’t need inflation for SFM stock to do well, but it could be a nice tailwind for the business.

**Pays workers well**

SFM employs 35,000 workers, so it is at risk of getting hurt by the current wage pressure many retailers and restaurants are facing. However, from what it looks like from the outside, SFM is in a lot better shape to handle rising wages. Why? Because in 2020 the company:

- Paid an average wage of $17.42 to in-store employees
- Sourced 72% of manager positions with internal candidates
- Paid over $100 million in pandemic-based bonuses (while still generating almost $500 million in cash from operations, we might add)

This gives us confidence that SFM can weather any wage pressure and retain employees better than most of its competitors. These aren’t eye-popping Costco-like numbers, but from a shareholder’s perspective, it looks like they take care of their employees.

**Scenario Planning**

If the above model is our base case, we think the likelihood SFM hits somewhat close to those numbers over the next five years is fairly high. We don’t want to throw a percentage on it because these are all assumptions, but the simplicity of the business makes its financials a lot more predictable than most other companies.

However, this model is not a guarantee. Here are some downside and upside scenarios we’re thinking about with SFM that could throw the stock off the trajectory we believe it is currently on.

**Here comes Amazon (downside)**

A big potential threat to SFM is Amazon. Not only does it own Whole Foods, but it is also building out its Amazon Fresh stores (28 slated to open, by the last count), integrating both with Prime, and putting in its smart checkout technology. Scary stuff. We will be tracking Amazon’s
brick-and-mortar plans to see how they are resonating with consumers. But here’s why we are not worried about Amazon vs. SFM:

- Amazon has a poor track record in physical retail, and you could argue that (so far) the Whole Foods acquisition has been underwhelming. SFM has grown sales every year since 2017. If the Whole Foods acquisition hasn’t crushed them so far, why assume it will in the future? Yes, Amazon is lowering prices at Whole Foods and doing its thing with Prime memberships, which seems like the logical thing to do if consumers acted rationally. But ask yourself: How will SFM’s target demographic react to the Prime-ification of Whole Foods? We think poorly. “What - If Anything - Is Left to Love About Whole Foods?”
  https://www.austinmonthly.com/what-if-anything-is-left-to-love-about-whole-foods/
- SFM’s target demo is not looking for efficiency, and it already offers cheap prices. If anything, Kroger and other commodity grocery stores are the ones who should be worried about Amazon.
- There are around 40,000 grocery stores in the U.S. Amazon may take some market share, but there will be plenty to go around.
- Customers don’t actually care about Amazon Fresh and the smart checkout tech if the stores have crappy food selection and quality (alright, I’ll admit, that one was personal. But I’ve been to an Amazon Fresh store and the quality turned me away for good - Brett)

Discounting all competitors because Amazon has announced that they are thinking about expanding into an industry is foolish, especially in an industry they have a poor track record in. We think there is a small chance Amazon could disrupt SFM’s growth, but it’s no reason not to buy the stock.

Amazon store plans:
  https://www.supermarketnews.com/retail-financial/report-amazon-has-28-more-amazon-fresh-stores-works

On a smaller note, Wal-Mart has made great strides in grocery the last two decades (a lot of it thanks to the man running SFM now). This could pose another competitive threat to SFM, but we think it is more of a worry for the Kroger’s of the world. These companies are not where SFM’s target customer likes to shop.

Not differentiated enough (downside)

A big pushback investors have with SFM is that the brand is not differentiated enough. It usually goes something like “people love Trader Joe’s. But what’s special about Sprouts?” A lot of
people are concerned that management might talk about being “special” but are really just viewed as a commodity in the eyes of the consumer.

At a recent investor conference, Sinclair stated that “some of our best stores are the ones that are right next door to Trader Joe’s.” Trader Joe’s isn’t a competitor to SFM, it is complementary.

Trader Joe’s, Whole Foods, or even smaller chains, are a small worry for investors. They were all around in 2015, when SFM was doing well, and were around in 2017, when SFM was doing poorly. SFM’s wounds were self-inflicted, and can be healed with the plan management has put in motion. Could they fail to execute? Sure. But competition will likely have little do with that unless the operating environment rapidly changes.

Going through these scenarios was what got us so excited to invest in SFM, because we realized no one is stopping SFM but itself. It really came down to answering these questions:

**Can the retail giants like Amazon (or Target, Wal-Mart, or Costco) crush SFM?** No, because their whole purpose is to offer a wide selection that caters to everyone. Trying to compete with SFM in its niche is not worth it because in doing so these companies would sacrifice the model they’ve built.

**Is the concept unique?** Yes. It offers a different value proposition than a traditional grocer. Trader Joe’s is complementary and not a threat. Whole Foods is the closest competitor but does not offer everyday low prices (that may change) and is managed by a company that wants to offer a wide selection of products that caters to everyone.

**Does the concept scale nationwide?** Yes. Everyone eats, and a growing subset of the population wants to eat healthy or diet-focused food. There’s no reason to think the concept can’t work in other areas, especially the pacific northwest and northeast.

**The reinvestment runway is there. All management has to do is go after it.**

**Multiple expansion (upside)**

Whatever multiple you look at, SFM is trading at a discount to the market average. Maybe it deserves to trade where it does right now. But if comp sales get back to 3% or higher (not two-year, one year), margins stay steady, and store count marches higher, we believe there is a decent chance SFM stock sees significant multiple expansion in the coming years, which would boost investor returns.
We don’t need multiple expansion to do well, and the consistent buybacks can help with returns if the multiple stays depressed. But multiple expansion is not out of the question here and should be considered as a part of the underwriting process, even if it only has a small chance of occurring.

**Summary of Why We Own the Stock**

- 10% annual store growth with a long runway for reinvestment unencumbered by competition
- Recovered margin profile and comp-store sales growth
- Smart initiatives in marketing, store formats, and supply chain
- Consistently dropping share count
- High current and forward earnings/FCF yield

With a high margin of safety due to the clean balance sheet and years of proven cash generation, we believe SFM stock has a high floor along with a high ceiling, allowing us to make this a concentrated position in our portfolio.