SPROUTS FARMERS MARKET, INC.

November 29th, 2020

Sprouts Farmers Market, Inc. is a food retailer operating in the United States with 341 stores across 22 states, primarily in the south-west, a majority of which are located in California, Texas, Colorado and Arizona. Sprouts focuses on offering a range of natural & organic food, differentiating themselves from their competition.

INVESTMENT SUMMARY:

- Sprouts have seen strong growth since their IPO in 2013, boasting a 5-year revenue CAGR of 9.42% and healthy cash flows.
- Sprouts maintain a price advantage over their closest competitors Whole Foods.
- Maintenance of healthy net margins by comparison to the industry as a whole.
- Furthermore, there is additional upside potential should Sprouts exceed store growth expectations which we have set to a conservative rate of 24 additional stores per year over the next 5 years, giving a 5-year CAGR of 5.46%, well above the forecasted industry 5-year CAGR of 1.7%.

Matthew Keane

matthew.keane@ucdconnect.ie

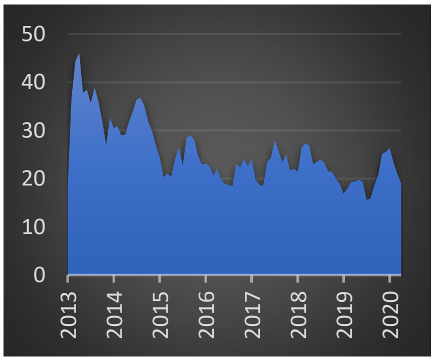
Miah Rohan

jeremiah.rohan@ucdconnect.ie

RECOMMENDATION: BUY

Ticker:	SFM (NASD)
Market Price:	$20.59
Price Target:	$29.38
Upside:	43%
52w Range:	$13.00 - 28.00
EPS (2019):	1.25

PERFORMANCE HISTORY



COMPANY INFORMATION

Revenue (2019):	$5,635m
Employees:	30,000
Fiscal Year End:	December
Headquarters:	Arizona

www.sprouts.com

GROWTH

Sprouts Farmers Market made their Initial Public Offering in 2013, thus providing 7 years' worth of store growth data (figure 1), we can observe that sprouts store growth has been declining steadily since 2013. In order to forecast future growth, data was gathered from Whole Foods to serve as a proxy due to similarities in their business model and in their rate of growth. Figure 2 shows trends for Whole Foods over a 17-year period, Sprouts and Sprouts' expected store growth for the coming 5 years. Following an acquisition of 55 stores in 2009, whole foods expanded at a rate of 24 new stores per year, which we see being a realistic & attainable goal for Sprouts.

Year	Sprouts Stores	% Growth
2013	170	
2014	198	16.5%
2015	224	13.1%
2016	256	14.3%
2017	289	12.9%
2018	318	10.0%
2019	341	7.2%

Figure 1

Figure 2 – Data source: Whole Foods Market INC, 2017

Figure 3 shows average sales per store growth, which has been increasing marginally each year, albeit at a declining rate which we forecast to plateau in 2022 at an average of $16.82m per store.

Year	Average Sales Per Store ($ million)
2013	14.34
2014	14.99
2015	16.04
2016	15.81
2017	16.14
2018	16.38
2019	16.52
2020e	16.67
2021e	16.77
2022e	16.82

Figure 3

In a previous report we identified square footage growth as a key metric to drive revenue, in this case Sprouts do not disclose such data in their annual reports, however the majority of their stores average 28,000-30,000 square feet with a consistent store design (figure 4) leaving little room for size variation, thus we to use average sales per store as the efficiency metric with which to calculate future revenues.

Figure 4 - Source: Sprouts Farmers Market, INC, 2020

Figure 5 illustrates the resulting continuation of Sprouts' strong revenue growth following the spike and levelling off in 2020 & 2021. Having grown at over 100% in 2011, Sprouts 'growth has been declining. However, they have still maintained healthy margins in recent years despite having grown so rapidly. As a result of our calculations in figures 6 & 7 we forecast YoY growth of 14.89% and 1.14% for years 2020 and 2021 respectively.

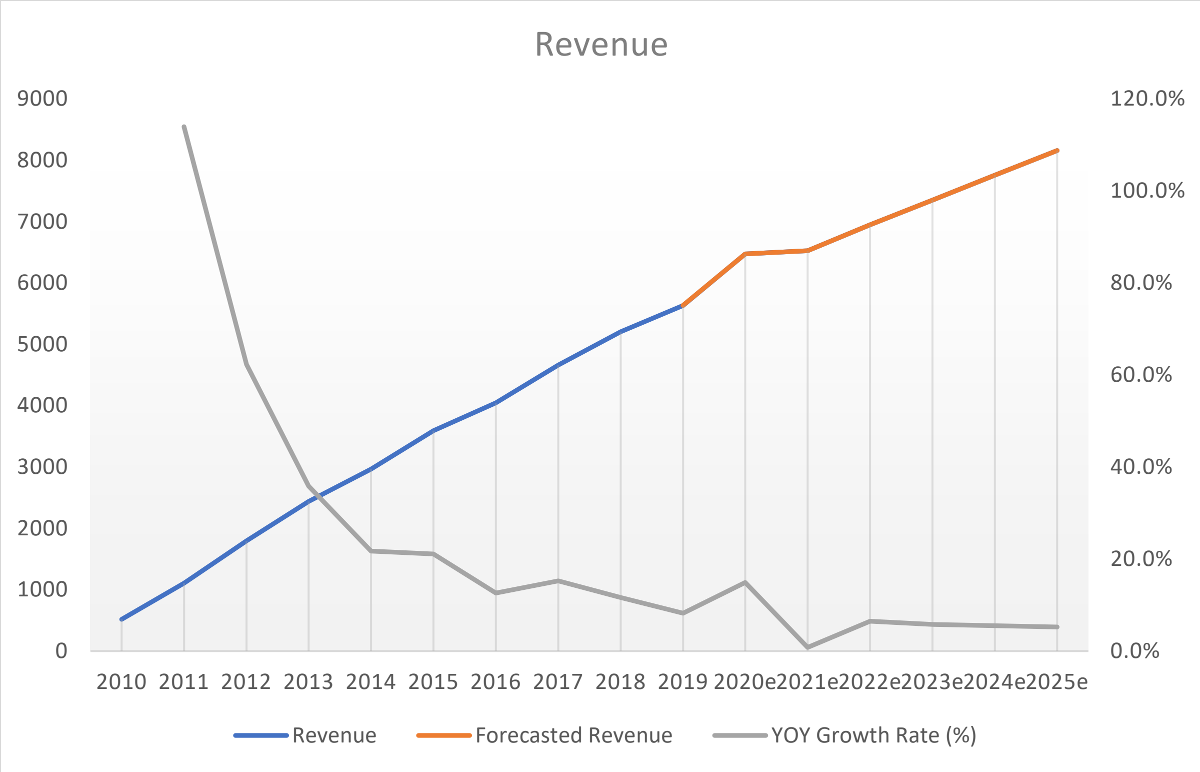


Figure 5

2020 Q4 AND 2021 REVENUE PROJECTION

As previously mentioned, COVID has had a significant impact on the grocery industry which ultimately led to inflated revenue figures in 2020 as a result of movement and economic restrictions in various states. We believe these figures and their subsequent inflated growth rates are unsustainable and in order to quantify to what extent revenues were inflated, we compared expected 2020 revenue to actual 2020 revenue.

2020e = (# stores in 2020 * average sales per store) = (362*16.67) = $6,086m

Resulting revenue indicates 7.17% growth on 2019 figures for the year 2020, which is broken down by quarter in figure 6.

	Q1	Q2	Q3	Q4	
2019	1414	1416	1440	1365	
Expected Growth	8.00%	8.00%	8.00%	8.00%	
2020e	1,527.06	1,529.06	1,555.48	1,474.25	
2020 Actual	1,646.54	1,642.79	1,577.60	1,607.00	6,473.92
Actual Growth	16.5%	16.0%	9.5%	9.0%	
Artificial (COVID) Growth	8.5%	8.0%	1.5%	1.0%	

Figure 6

As figure 6 shows, COVID growth declined in Q2 and declined dramatically in Q3, further to our argument that these revenue figures are inflated and unsustainable. The observed growth from "2020e" to "2020 Actual" is the sum of expected growth and artificial growth attributable to COVID. COVID Growth is quantified by the formula:

COVID Growth = Actual Growth – Expected Growth

We use the same methodology in figure 7 to quantify expected 2021 revenue, taking into account the prevailing COVID growth until it dissipates in Q3.

2021e = (# stores in 2021 * average sales per store) = (389*16.77) = $6,525m

A full breakdown of 2020, 2021 and 2022 projected revenue figures can be found in the appendix of this report. We contend that COVID growth will continue to decline and dissipate by mid 2021 (figure 7).

	Q1	Q2	Q3	Q4	
2020e	1,527.06	1,529.06	1,555.48	1,474.25	
Expected Growth	7.21%	7.21%	7.21%	7.21%	
Artificial Growth	1.00%	0.50%	0.00%	0.00%	
Actual Growth	8.21%	7.71%	7.21%	7.21%	
2021e	1,652.50	1,647.02	1,667.70	1,580.61	6,547.83

Figure 7

SPROUTS PRICING EDGE V WHOLE FOODS

Increased focus on profitability and a targeted promotional strategy that has helped expand gross margin in the past few quarters -- even before the surge in demand from the pandemic -- haven't dulled Sprouts' price advantage over Amazon's Whole Foods. In a recent analysis carried out by Bloomberg they found prices at Sprouts were 4.8% cheaper by comparison for a basket of 143 similar items (including promotions). This could be the key to ensuring same-store sales growth, as the grocer attempts to expand its bottom line without alienating value-seeking consumers.

What makes this more impressive is that since acquiring Whole Foods in 2017, Amazon has worked hard on being more price competitive to shake the reputation of Whole Foods being overpriced in order to try reignite sales growth. However, even after this effort, Sprouts still retains its pricing edge. This demonstrates that Sprouts are able to compete with the larger retailers in the industry on price, which will be a driver in winning market share going forward.

Pricing Study Sprouts V Whole Foods	2020		2019	
	Whole Foods	Sprouts	Whole Foods	Sprouts
Total Items priced	143	143	211	211
Total items on sale	8	72	20	109
% of items on sale	5.59%	50.35%	9.48%	51.66%
Average discount	22.94%	19.27%	25.91%	19.12%
# Lowest Price Items - Regular Items	72	43	86	74
# Lowest Price Items - Sale Items	39	71	51	114
Total regular price basket cost (all brand items) ex promos	$650.57	$676.20	$943.75	$955.58
Total lowest basket cost (all brand items) including promos	$641.01	$611.64	$910.49	$845.83
% Difference Regular Price Basket		3.79%		1.24%
% Difference Sale Price Basket (all brand items)		-4.80%		-7.64%

Figure 8 - Source: Bloomberg

COGS & SG&A

As you can see from the graphs below, COGS and SG&A have remained relatively stable since Sprouts had an accounting change in 2016, which reapportioned some of the COGS expenses to SG&A expenses.

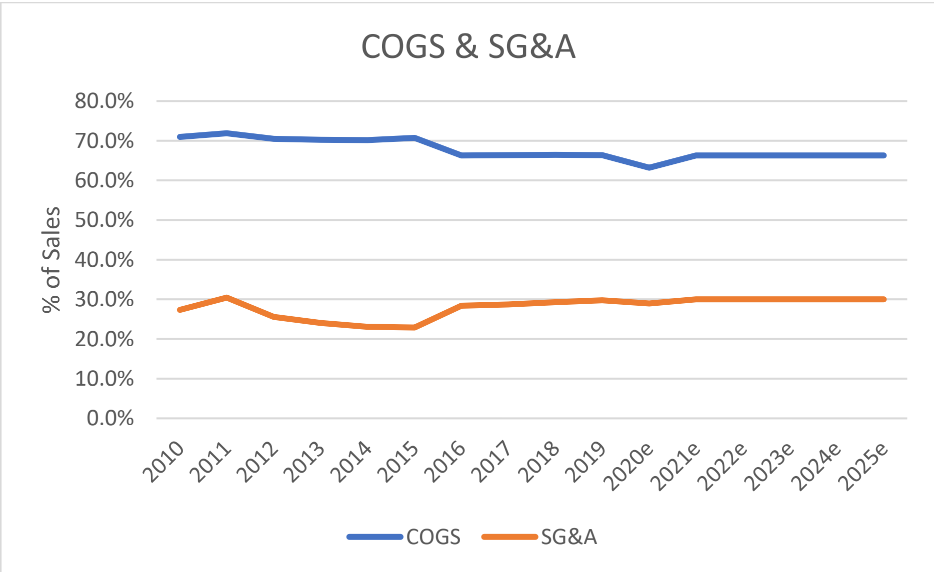


Figure 9

COGS: We projected that COGS would remain constant at 66.4% of sales, given that it has been constant at this level for the last four years. Sprouts cost of sales and gross profit are highly correlated to sales volumes. However, the positive leverage in 2020 was driven by more balanced promotions and gains arising from shrink benefits due to customer stockpiling. We did not see any reason that Sprouts would improve their gross margins significantly from their historic levels.

SG&A: This has risen 110bps in the previous two years, which coincides with Sprouts teaming up with Instacart to offer curb side pick-up and offer home delivery. This is a worrying trend for the company, who elect to use their own employees to fulfil customer orders rather than let Instacart shoppers do it. This increases the cost of online sales, evidence of which has been display in 2020, as leverage from increased sales have been completely offset by higher wage costs and incremental ecommerce fees. The company is also facing continued pressure from higher health care, labour and occupancy costs.

D&A AND CAPEX

Depreciation and Amortization: As the company expands and build new stores we see the rate of depreciation slightly increasing as a percentage of sales, converging with CAPEX at 2.6% of sales in 2025

Capital Expenditures: As a result of their rapid growth trajectory, Capex for Sprouts is driven mainly by store growth. While they have consistently built 20-30 new stores every year, Capex as a percentage of sales has fallen since 2016. We project Sprouts to add 24 stores a year which is consistent with what they have done in the past and is a conservative estimate on what they plan to build in the future. As a result of these projections, Capex will continue to fall as a percentage of sales and converge with depreciation at 2.6% in the terminal year.

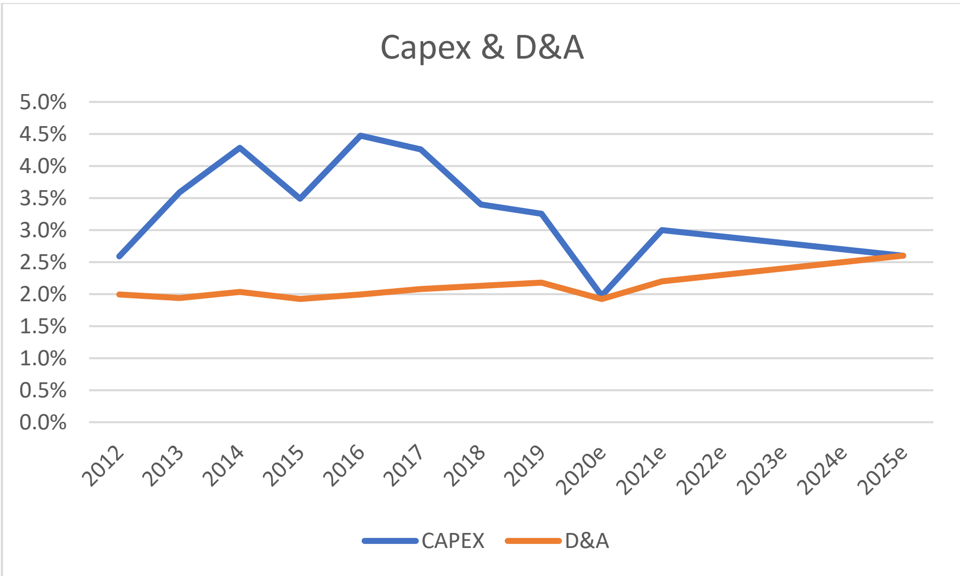


Figure 10

OTHER ITEMS

Non-operating Loss: Since 2015, this has been relatively stable for the company at 0.4% of sales. We have no reason to believe that Sprouts will make any investments in the future that will increase this number, so we forecasted it at 0.4% of sales until 2025

Tax Rate: The Company’s tax rate has been decreasing as a result of changes at the federal level in the US. Last year the company’s effective tax rate was 23.7%. We have no reason to believe that the company’s tax rate will rise or fall substantially in the near future so we are keeping the tax rate constant.

ONLINE GROCERY SALES PLACING PRESSURE ON THE BOTTOM LINE

COVID has been a catalyst for online sales, with online grocery sales on track to account for 10% of a $1 trillion market, up from 3.4% last year. Struggling to mobilize their own delivery service, all the major players in the industry have teamed up with Instacart and Shipt for online delivery and curb side pick-up. This trend has been accelerated by COVID as grocery stores were required to increase delivery and pick-up capacity in a short space of time.

SPROUTS ONLINE MODEL

Sprouts has partnered up with Instacart in 2018 who charge $10 per delivery, or an annual subscription fee of $100. On top of that there is a service fee, and a mark-up on store price depending on the nature of the partnership between the grocery store and delivery company. As a result, usually the majority of the added expense falls on the customer as opposed to the retailer.

However, unlike other grocery stores, Sprouts has elected to use its own staff (not Instacart shoppers) to do the picking when fulfilling online orders. While this may improve the ambiance in store, it increases wages as outlined earlier when referencing SG&A. As a result, we believe this will continue to put pressure on their margins once conditions normalise post COVID and we have forecasted net income margin of 2.6% going forward, which is well below the five-year average of 3.4%.

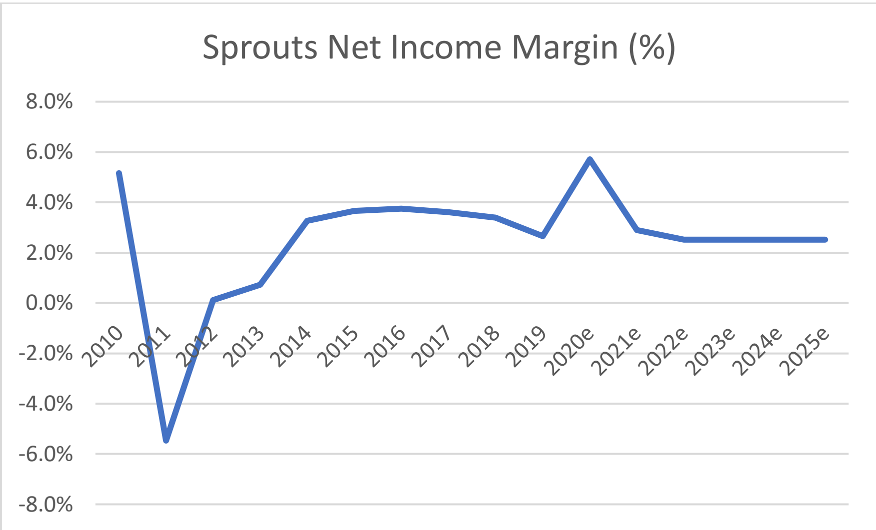


Figure 11

As can be seen in figure 12, Sprouts is not the only company whose margins are coming under pressure over the last few years. This reflects a broader trend in the industry of heavy spending on ecommerce and the weak profitability of online sales.

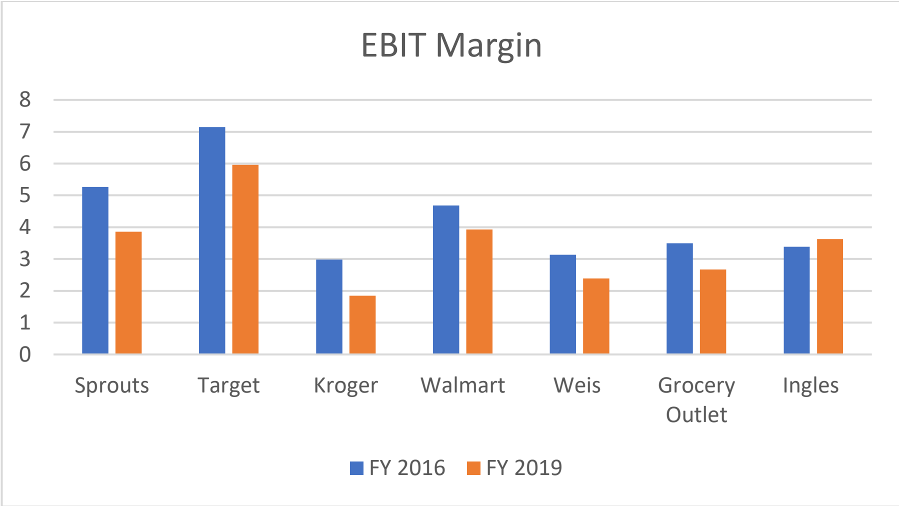


Figure 12

VALUATION

WACC v APV

We chose to use WACC rather than APV, as we believe the company intends to target a debt/equity ratio over the next number of years. From the graph below, you can see the company's debt/equity ratio was flat from 2013 to 2015; the company's equity lost value over this time period. At the same time they were deleveraging, which is typical of a company owned by private equity going public and using some of the funds raised to pay down the debt. From 2015 to 2019, debt rose consistently, while the value of the equity fell, and this is why you see a significant increase in their debt/equity ratio. Currently they are paying down some of the debt to be "prudent" during the pandemic. As a result, we believe the company has a target capital structure and believe a D/E ratio of 0.24 from Q3 2020 seems reasonable.

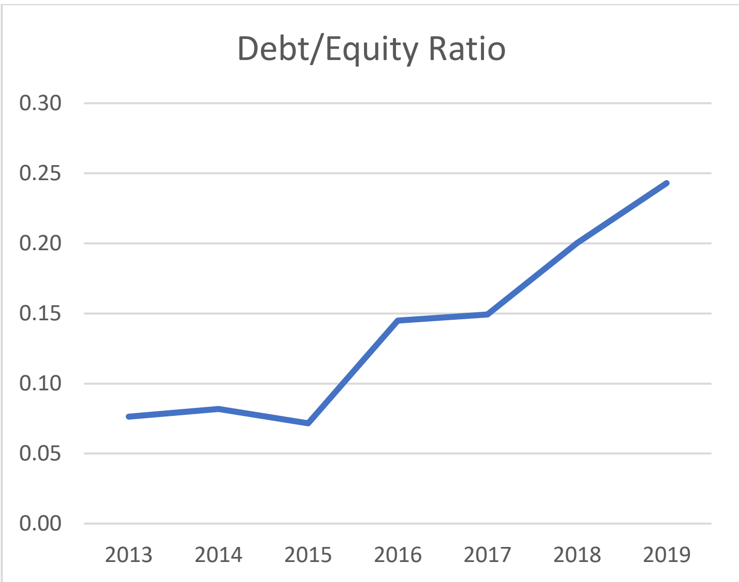


Figure 13

BETA

To estimate beta, we analysed over 8 years of return data since its IPO in 2013. We found the excess monthly returns for the last 8 years using the Wilshire 5000 as our benchmark. We then regressed our weighted monthly returns over the excess returns on the market, delivering beta estimates for the last 39 months. Our beta estimate as at 30/11/2020 was 0.27, however we felt this was artificially low and had been driven down due to the pattern of returns during COVID; when lockdowns began, the overall market fell dramatically while Sprouts' share price increased due to a surge in revenues. However, when lockdowns eased off the trend was reversed, as the general market has performed extremely well while Sprouts has seen a drop off in demand since May and its share price has fallen since then.

As a result, we felt using an estimate based off our regression would be unwarranted and decided to use our grocery industry beta of 0.66. We believe this beta is a better representation ofS Sprouts' risk profile relative to the overall market.

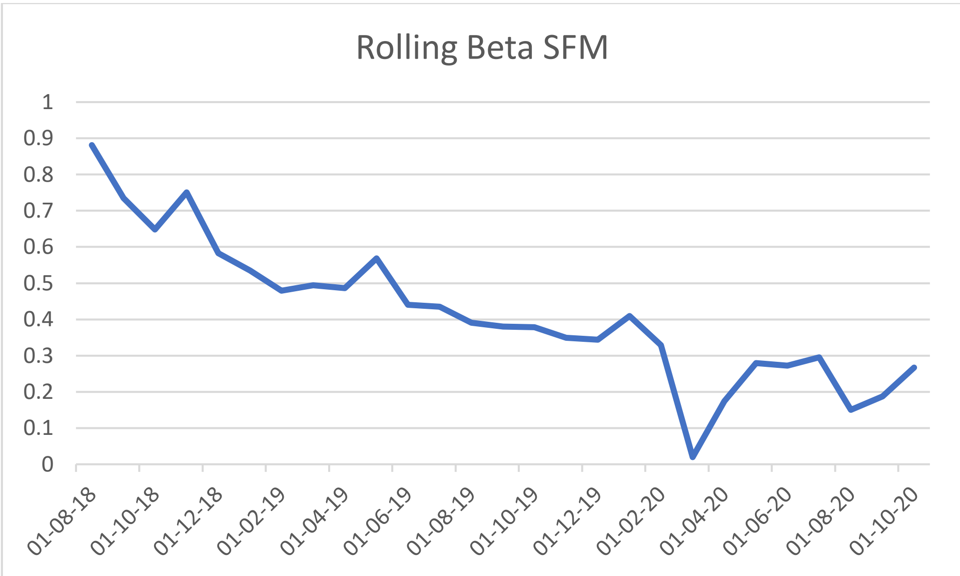


Figure 14

COST OF EQUITY

We used the 10-year treasury yield of 0.88% as our risk-free rate. Through our analysis we believe the historic market risk premium to be 7%. Using these inputs, we arrived at a cost of equity of 5.5%.

COST OF DEBT

The most recent credit rating assigned to the company's debt was Ba2, but this was back in 2015. It was later rescinded at the request of the company as they changed their financing structure, switching to a revolving credit facility. However, on further analysis we found the current corporate bond yield for Ba2 rated bonds are 3.19%, which falls in line with the expected cost of the company's current debt load. As a result, we used 3.19% as the company's cost of debt.

DCF

Using the mid-year convention, we discounted our forecasted cash flows from 2020 through to 2025 at the cost of capital (5.1%) giving us a valuation of $29.38 per share, which represents a 43% upside on the current share price of $20.59. As a result, we strongly recommend a buy on Sprouts Farmers Market.

APPENDIX

4th Quarter 2020 Estimates	Q1	Q2	Q3	Q4	Total
Revenue	1647	1643	1578	1607	6474
QOQ Growth Rate (%)		0%	-4%	2%	
COGS	1053	1030	993	1015	4091
% of sales	63.9%	62.7%	62.9%	63.2%	63.2%
Gross Profit	594	613	585	592	
Operating Expenses	436	489	475	482	1882
% of sales	26.5%	29.8%	30.1%	30.0%	29.1%
Operating Income	157.5	123.8	109.7	109	500.4
% of sales	9.6%	7.5%	7.0%	6.8%	7.7%
Non-Operating Income	4.827	3.737	3.117	4	15.7
Pretax Income	152.7	120.0	106.6	105.4	484.8
Income Taxes	36.2	28.5	25.3	25.0	115.0
Tax Rate	23.7%	23.7%	23.7%	23.7%	23.7%
Net Income	116.5	91.6	81.3	80.4	369.8
NI Margin (%)	7.1%	5.6%	5.2%	3.3%	5.7%

Table 1

	2018	**2019**	**2020**	**2021**	**2022**	**2023**
Revenue	5207	5635	6086	6525	6948	7352
Revenue Growth	11.6%	8.2%	8.0%	7.2%	6.5%	5.8%
# Stores	318	341	365	389	413	437
Store Growth	10.0%	7.2%	6.2%	6.2%	6.2%	6.2%
Sales Per Store	16.38	16.52	16.67	16.77	16.82	16.82

Table 2

Select Income Statement Data																
											Projected Annual Forecast					
Year	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020e**	**2021e**	**2022e**	**2023e**	**2024e**	**2025e**
Revenue	517	1106	1795	2438	2967	3593	4046	4665	5207	5635	6474	6525	6948	7352	7756	8159
Forecasted Revenue										5635	6474	6525	6948	7352	7756	8159
YOY Growth Rate (%)		114.0%	62.3%	35.8%	21.7%	21.1%	12.6%	15.3%	11.6%	8.2%	14.9%	0.8%	6.5%	5.8%	5.5%	5.2%
COGS	367	795	1265	1713	2082	2541	2683	3098	3460	3740	4091	4326	4607	4874	5142	5410
% of sales	71.0%	71.9%	70.5%	70.3%	70.2%	70.7%	66.3%	66.4%	66.4%	66.4%	63.2%	66.3%	66.3%	66.3%	66.3%	66.3%
Gross Profit	150	311	530	725	885	1052	1363	1567	1747	1895	2383	2199	2342	2478	2614	2750
Gross Profit Margin	29.0%	28.1%	29.5%	29.7%	29.8%	29.3%	33.7%	33.6%	33.6%	33.6%	36.8%	33.7%	33.7%	33.7%	33.7%	33.7%
Operating Expenses	141	337	460	586	685	823	1151	1341	1525	1677	1882	1957	2084	2206	2327	2448
% of sales	27.3%	30.4%	25.6%	24.0%	23.1%	22.9%	28.4%	28.7%	29.3%	29.8%	29.0%	30.0%	30.0%	30.0%	30.0%	30.0%
Operating Income	9	-26	71	140	200	229	213	226	223	217	500	241	257	272	287	302
% of sales	1.7%	-2.3%	3.9%	5.7%	6.7%	6.4%	5.3%	4.8%	4.3%	3.9%	7.7%	3.7%	3.7%	3.7%	3.7%	3.7%
Non-Operating Loss	0.4	19.5	35.9	55.4	25.6	22.8	14.3	20.6	27.1	21.2	15.7	24.0	24.0	24.0	24.0	24.0
Pretax Income	9	-45	35	84	174	206	199	206	196	196	485	217	233	248	263	278
	0.1%	1.8%	2.0%	2.3%	0.9%	0.6%	0.4%	0.4%	0.5%	0.4%	0.2%	0.4%	0.3%	0.3%	0.3%	0.3%
Income Taxes	39	42	48	44	29	33	37	-19	19	21	115	52	55	59	62	66
Tax Rate										23.7%	23.7%	23.7%	23.7%	23.7%	23.7%	23.7%
Net Income	-30	-87	-14	40	145	173	161	225	176	176	370	166	178	189	201	212
NI Margin (%)	-5.8%	-7.9%	-0.8%	1.6%	4.9%	4.8%	4.0%	4.8%	3.4%	3.1%	5.7%	2.5%	2.6%	2.6%	2.6%	2.6%

DCF

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020e	2021e	2022e	2023e	2024e	2025e
										Projected Annual Forecast					
Sales	1,106	1,795	2,438	2,967	3,593	4,046	4,665	5,207	5,635	6,474	6,548	6,948	7,352	7,756	8,159
COGS	795	1,265	1,713	2,082	2,541	2,683	3,098	3,460	3,740	4,091	4,326	4,607	4,874	5,142	5,410
Gross Profit	311	530	725	885	1,052	1,363	1,567	1,747	1,895	2,383	2,222	2,342	2,478	2,614	2,750
SG&A	337	460	586	685	823	1,151	1,341	1,525	1,677	1,882	1,957	2,084	2,206	2,327	2,448
Net Income	-87	-14	40	145	173	161	225	176	176	370	166	178	189	201	212
(+) D&A	55	36	47	60	69	81	97	111	123	124	144	160	176	194	212
(-) Capex	0	46	87	127	125	181	199	177	183	127	180	201	206	209	212
(-) changes in NWC		53	-10	57	2	-110	-5	24	-53	26	1	7	6	6	6
(=) Free Cash Flow	-33	-78	10	21	115	171	128	86	168	341	129	129	153	179	206
% of the Free Cash Flow to be discounted										25%	100%	100%	100%	100%	100%
Period for Discount Factor (Mid-Year Convention)										0.25	1.25	2.25	3.25	4.25	5.25
Discount rate (WACC)										5.58%	5.58%	5.58%	5.58%	5.58%	5.58%
PV of FCF										336	121	114	128	142	155
Sum of present values of FCFs										**$ 996**					

Terminal Value		
Growth in perpetuity method:		
Long term growth rate		**1.0%**
WACC		**5.1%**
Free cash flow (t+1)	$	155
Terminal Value	$	3,809
Present Value of Terminal Value	**$**	**2,938**

WACC		
Cost of Debt		**3.2%**
Cost of Equity		**5.5%**
Total Debt ($)	$	557
Total Equity ($)	$	2,429
Total Capital	**$**	**2,986**
Debt Weighting		18.7%
Equity Weighting		81.3%
WACC		**5.1%**

Enterprise Value to Equity Value		
Sum of Present Values of FCFs	$	1014
Present Value of Terminal Value	$	2,938
Enterprise Value	**$**	**3,952**
Less: Net debt	$	472
Equity Value (intrinsic)	**$**	**3,480**
WASO	$	118.5
Target Price	**$**	**29.38**
Market Value	**$**	**2,429**
Share Price	**$**	**20.59**
Upside		**43%**

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