



Yale SCHOOL OF  
MANAGEMENT



UCD Michael Smurfit  
Graduate Business School

## INGLES MARKETS, INC.

December 8th, 2020

Ingles Markets Inc is a supermarket retailer operating in the United States. The company operates 197 stores nationwide including 73 stores in North Carolina, 66 in Georgia, 35 in South Carolina, 21 in Tennessee and 1 in both Virginia and Alabama.

### INVESTMENT SUMMARY:

- Ingles Markets experienced sluggish growth over the previous 5 years, growing at a CAGR of 1.84%, notably below the industry average of approximately 2.5%.
- Stagnant growth is largely attributable to near non-existent square footage growth. A 10-year CAGR of 0.4% condemns revenue figures to grow in line with inflation rather than outpacing it.
- Face twin external pressures
  - Struggling to compete on price with rapidly expanding discount retailers such as Aldi.
  - Don't have the scale to be competitive with multiline retailers in the e-grocery landscape.

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## RECOMMENDATION: SELL

Ticker:	IMKTA (NASD)
Market Price:	\$41.77
Price Target:	\$27.58
Downside:	34%
52w Range:	\$32.21 – 49.14
EPS:	8.82

## PERFORMANCE HISTORY



## COMPANY INFORMATION

Revenue (2020):	\$4,611m
Employees:	9,880
Fiscal Year End:	September
Headquarters:	Asheville, NC

[www.ingles-markets.com](http://www.ingles-markets.com)

## GROWTH DRIVERS

Ingles Markets has seen relatively sluggish growth in the past 5 years by comparison with its peers, growing at a CAGR of 1.84%. Figure 1 shows a comparison with companies of a similar size that operate in the same industry, as Ingles have been growing at approximately the same pace as Weis Markets.

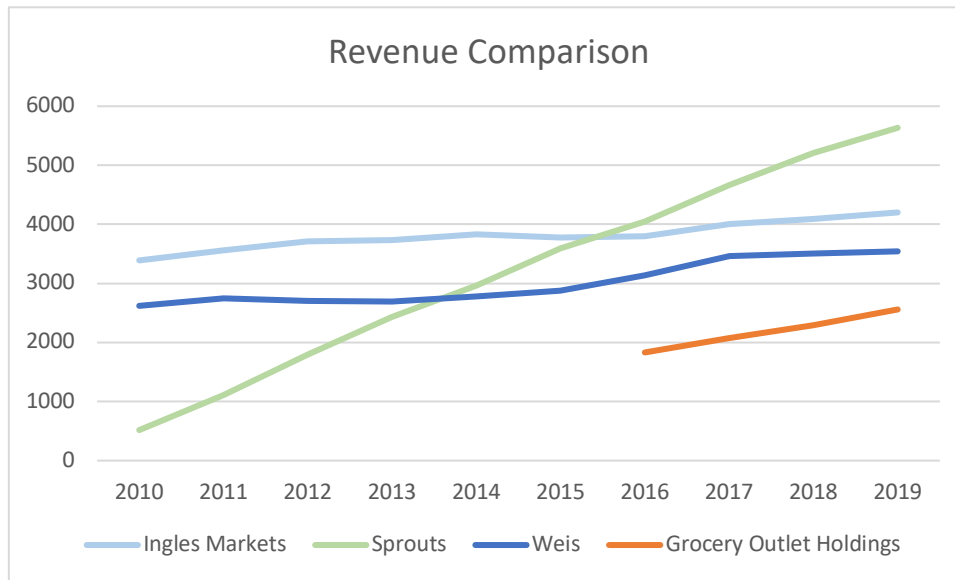


Figure 1

Figure 3 shows that revenue growth over the previous 10 years can be largely attributed to inflation, using the Consumer Price Index as a means to discount revenue figures.

Year	Consumer Price Index	% Change YoY	Revenue	CPI Adjusted Revenue
2009	214.54			
2010	218.06	1.64%	3390	3390
2011	224.94	3.16%	3560	3451
2012	229.59	2.07%	3709	3523
2013	232.96	1.46%	3739	3499
2014	236.74	1.62%	3836	3533
2015	237.02	0.12%	3779	3476
2016	240.01	1.26%	3795	3448
2017	245.12	2.13%	4003	3561
2018	251.11	2.44%	4093	3554
2019	255.66	1.81%	4202	3584

Figure 2 – Source: U.S. Bureau Of Labor Statistics (2020)

Furthermore, Ingles Markets’ inability to regularly outpace inflation is a result of their near non-existent expansion, with total square footage growing at a 10-year CAGR of 0.40% and 5-year CAGR of 0.37%. We don’t expect Ingles to improve on these rates due to fierce competition which is discussed later in the report.

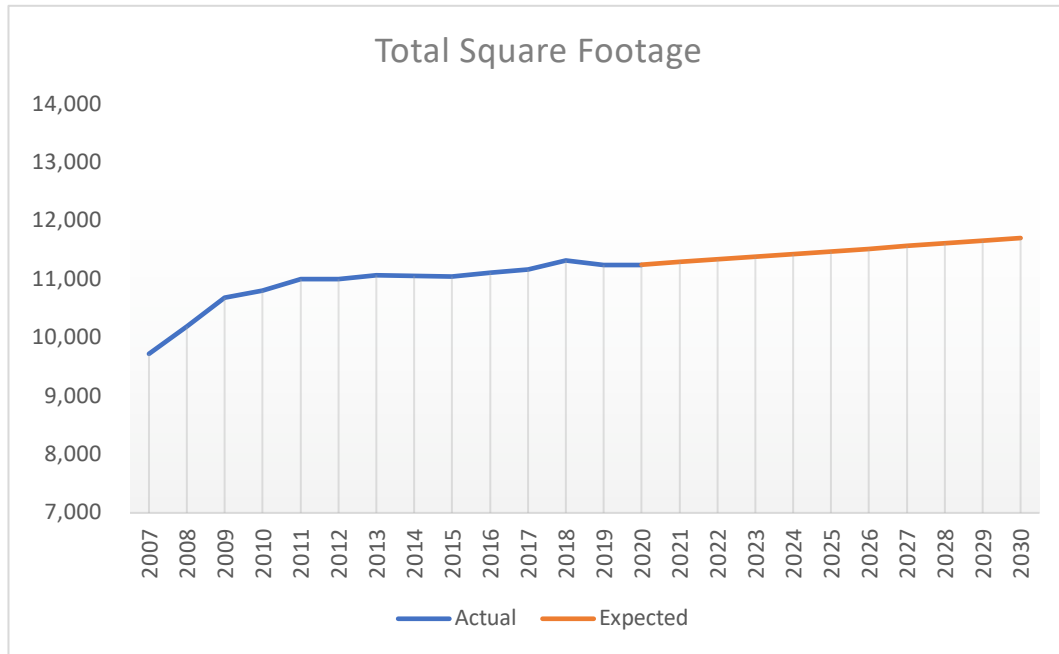


Figure 3 - Source: Ingles Markets Inc. (2020)

Previously we had used sales per store or sales per square foot as a metric with which to forecast revenue. Ingles provide “Sales Per Square Foot of Selling Space” as a more accurate and applicable metric in their 10-K reports, whereby they estimate approximately 70% of the average store’s square footage can be classified as “selling space”. Figure 4 shows that on an aggregate basis this metric has been increasing since 2007. However, when adjusting for inflation using similar methodology as in fig. 3, we find that Sales Per Square Foot of Selling Space has also remained stagnant since 2012. Figure 10 in this report demonstrates that COGS/Revenue and SG&A/Revenue remains at a consistent level over time, further to the argument that selling prices & costs are increasing in line with inflation.

Year	Weighted Average Sales per Square Foot of Selling Space	CPI Adjusted Weighted Average of Sales Per Square Foot of Selling Space
2007	405	405
2008	448	431
2009	425	411
2010	434	413
2011	437	403
2012	464	419
2013	465	414
2014	476	417
2015	470	411
2016	471	407
2017	494	418
2018	502	414
2019	516	418
2020e	568	
2021e	546	
2022e	542	
2023e	551	
2024e	560	
2025e	569	
2026e	579	
2027e	588	
2028e	598	
2029e	608	
2030e	618	

Figure 4 – Source: Ingles Markets Inc. (2020)

Ingles’ weighted average sales per square foot of selling space sees a spike in 2020 as a consequence of the revenue spike induced by COVID-19 and restrictive measures being placed on competitors in the food service industry. In order to forecast how this metric will improve in the future we omitted the 2020 estimation and found that over the previous 5 years (2015-2019) the weighted average sales per square foot of selling space had been growing at 1.65% per year, which we used as our YoY growth rate from 2022 onwards. As figure 4 will show, revenue in 2020 & 2021 are inflated to an unsustainable degree and don’t serve as a good foundation to forecast expected sales per square foot of selling space from 2022 onwards. We instead calculated 2022’s average as:

$$\begin{aligned}
 &= 2019 \text{ average} * (1 + \text{Growth})^3 \\
 &= 516 * (1+1.63\%)^3 \\
 &= 542
 \end{aligned}$$

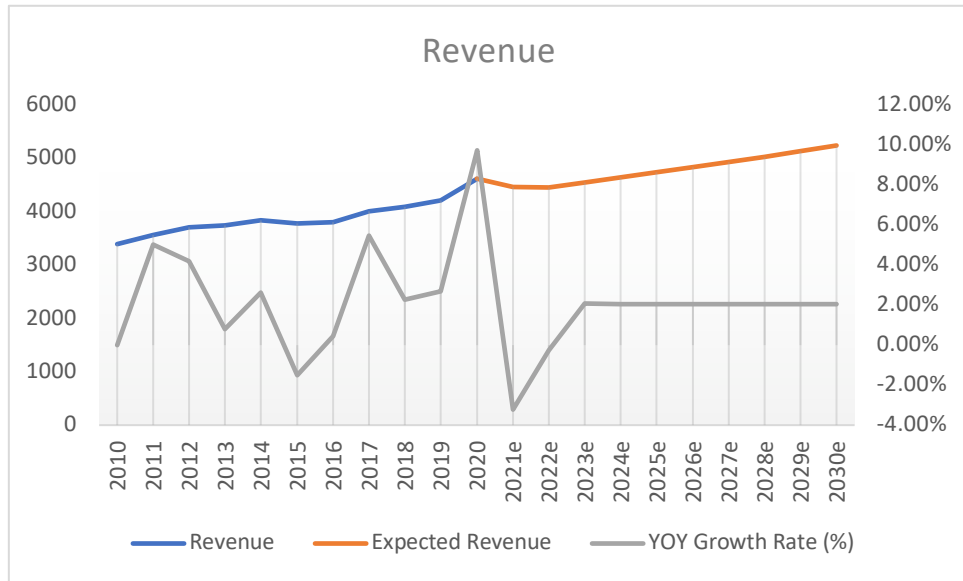


Figure 5

Figure 5 illustrates our revenue forecast based on Ingles' store growth & projected growth of sales per square foot of selling space. The formula we used to compute these figures (except for 2021) is:

$$(\text{Total Square Footage})_t * (\text{Average \% of Selling Space per Store})_t * (\text{Weighted Average Sales Per Square Foot of Selling Space})_t = \text{Revenue}_t$$

As per Ingles Markets 10-K reports, they approximate selling space as 70% of total square footage, however when reverse engineering their average selling space by using the formula:

$$\text{Revenue}_t / (\text{Total Square Footage}_t * \text{Weighted Average of Sales Per Square Foot of Selling Space}_t) = \text{Average Selling Space}_t (\%)$$

We found that on average selling space accounted for 72.37% of square footage, which we used to calculate revenue. Figure 6 shows the resulting expected revenue growth rates from 2021-2024.

Year	2020	2021	2022	2023	2024
Revenue	4611	4462	4451	4542	4636
Revenue Growth	9.72%	-3.23%	-0.26%	2.06%	2.06%

Figure 6

## 2020 Q4 AND 2021 REVENUE PROJECTION

As previously mentioned, COVID has had a significant impact on the grocery industry which ultimately led to inflated & unsustainable revenue figures in 2020 as a result of movement and economic restrictions in various states. Ingles Markets' fiscal year ends in 2020, giving us data for the full year to analyse whether this additional "COVID" growth has dissipated or will persist into 2021. In order to quantify to what extent revenues were inflated in 2020, we compared expected 2020 quarterly revenue to actual 2020 quarterly revenue (figure 7). For example, Q1 2020e was calculated as:

$$= 2019 \text{ Q1 Revenue} * \text{Expected 2020 Growth (\%)}$$

Where:

$$\text{Expected 2020 Growth (\%)} =$$

$$[(\text{Sq. Footage in 2020} * \text{Avg Sales per sq. foot of selling space} * 72.37\%) / \text{Revenue}_{2019}] - 1$$

$$= [(11,256 * 525 * 72.37\%) / 4,202] - 1$$

$$= 4,273 / 4,202 - 1$$

$$= 1.68\%$$

Using 1.68% as our expected growth rate, we quantify COVID's effect on revenue in figure 7, which validates our methodology as we predict 2020 Q1 (Oct – Dec 2019) with an accuracy of 99.85% where there were COVID had no effect on revenue.

	Q1	Q2	Q3	Q4	Total
2019	1062	1002	1062	1076	4202
Expected Growth	1.68%	1.68%	1.68%	1.68%	
2020e	1,080	1,019	1,080	1,094	
2020 Actual	1,078	1,145	1,190	1,197	4,611
Actual Growth	1.6%	14.3%	12.0%	11.3%	
Artificial (COVID) Growth	-0.1%	12.7%	10.3%	9.57%	

Figure 7

### Explanation:

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:

$$\text{COVID Growth} = \text{Actual Growth} - \text{Expected Growth}$$

To forecast total 2021 revenue, we used 2020 expected revenue as a foundation and forecasting actual expected growth

$$2021 \text{ Q1e} = 2020 \text{ Q1e} * (1 + \text{Actual Expected Growth})$$

Where:

$$\text{Total Expected Growth} = (\text{Expected Growth} + \text{COVID Growth})$$

We calculate these figures under the assumption that COVID growth will decline with linearity and dissipate by mid 2021 (figure 8).

	Q1	Q2	Q3	Q4	Total
2020e	1,080	1,019	1,080	1,094	4,273
Expected Growth	2.06%	2.06%	2.06%	2.06%	
Artificial (COVID) Growth	6.38%	3.19%	0.00%	0.00%	
Total Expected Growth	8.44%	5.25%	2.06%	2.06%	
2021e	1,171	1,072	1,102	1,117	4,462

Figure 8

## COMPETITION FROM ALL ANGLES

### Discount Retailers

As you can see from figure 9 below, Georgia and North Carolina make up 73% of Ingles' store locations.

	Number of Supermarkets at Fiscal Year Ended September			Percentage of Total Net Sales for Fiscal Year Ended September		
	2020	2019	2018	2020	2019	2018
North Carolina	73	73	72	41%	41%	42%
South Carolina	35	36	36	19%	19%	18%
Georgia	66	66	69	32%	32%	32%
Tennessee	21	21	21	8%	8%	8%
Virginia	1	1	1	—	—	—
Alabama	1	1	1	—	—	—
	197	198	200	100%	100%	100%

Figure 9 – Source: Ingles Markets Inc (2020)

The threat of discount retailers in these regions is looming large for Ingles. Aldi now has 67 stores in Georgia, surpassing Ingles following its aggressive growth strategy in the past few years. Lidl also has nine locations in the state but has plans for a lot more. There is a similar story developing in North Carolina, with both discount retailers growing rapidly in the state.

As mentioned in our industry report, groceries are considered a staple purchase, rather than a discretionary one, which suggests if Aldi is growing sales, some other competitor has to be losing out. Aldi is a prime example of this, positioning its stores next to the competition, recognising that even though they want them to shop exclusively at Aldi, consumers are going to go to more than one store.

### The Shift to Online Grocery Sales.

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.

Traditional grocers simply don't have the massive capital-expenditures budgets and talent pool of their larger competitors that could help them deliver digital sales. In this way, the rise of online grocery shopping will help strengthen the retailers already in the winner's circle and may accelerate the demise of others.

These combined threats have meant Ingles have had approximately zero store growth over the past ten years, and that the prospect of adding more stores in the future is becoming increasingly unlikely.

## COGS & SG&A

As you can see from the graphs below, COGS and SG&A have remained relatively stable since for Ingles Markets

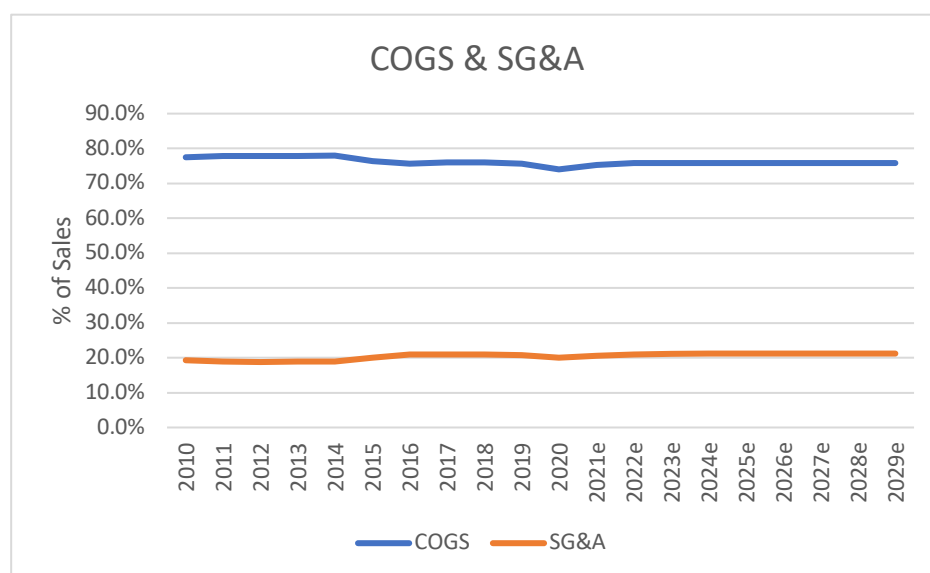


Figure 10

**COGS:** Ingles cost of sales and gross profit are highly correlated to sales volumes. However, there was positive leverage in 2020 as COGS dropped to 74% of sales. This was driven by increased same store sales and gains arising from shrink benefits due to customer stockpiling. We expect Ingles to continue to benefit from some of this positive leverage in FY2021, forecasting COGS at 75.2% of sales for the coming fiscal year. However, we did not see any reason that Ingles would improve their gross margins significantly from their historic levels. As a result, we projected COGS at 75.8% of sales in the long term, given that it had little variance from this mean in 2016-2019.

**SG&A:** This was constant at 20.9% of sales from 2016-2019. In FY2020 the company was able to gain positive leverage (90 basis points) from increased same store sales even after taking on 5,000 extra staff at the height of the pandemic. We expect some of this positive leverage to continue onto next year as the company's sales remain high due to COVID, projecting SG&A



at 20.5% of sales in FY2021. In the long-term we project SG&A to be 21.2% of sales, with the slight increase from historic levels due to the continued pressure from higher health care and labour costs, as well as the incremental costs in rolling out ecommerce. Increasing rents aren't as issue as they own the majority of their stores.

### D&A AND CAPEX

Depreciation and Amortization: As we believe the company will build less new stores, we see the trend of increasing depreciation as a percentage of sales tailing off, converging with CAPEX at 3% of sales in 2030

Capital Expenditures: Capex for Ingles is driven mainly by new stores and store refurbishments As previously mentioned we expect there store growth to continue to slow down/retract. As a result of these projections, Capex will continue to fall as a percentage of sales and converge with depreciation at 3% in the terminal year.

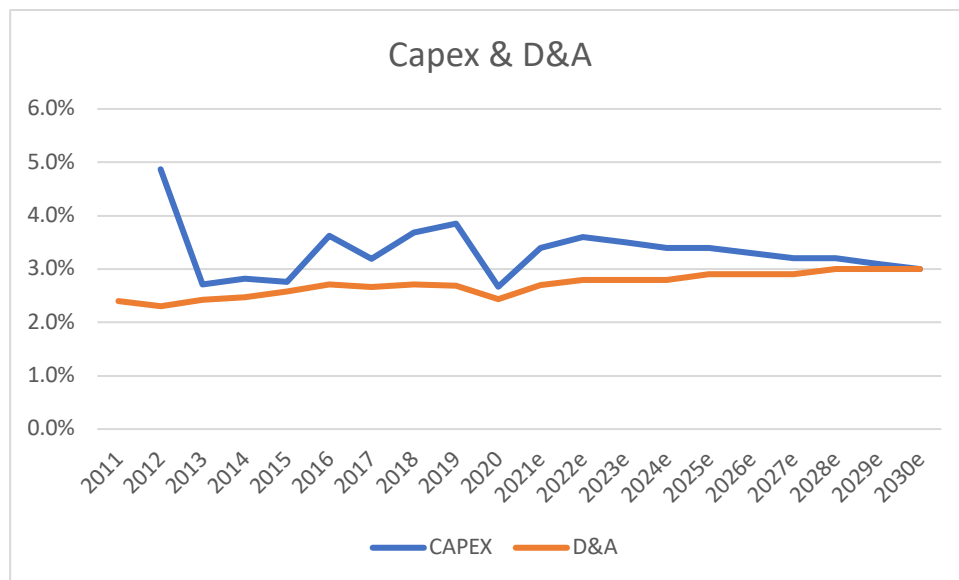


Figure 11

### OTHER ITEMS

Non-operating Loss: Since 2014, this has been relatively stable for the company at 1% of sales. We have no reason to believe that Ingles will make any investments in the future that will increase this number, so we forecasted it at 1% of sales until 2030

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 24%, which is in line with the federal corporate tax rate. 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.

## VALUATION

### WACC v APV

We chose to use APV over WACC, as the company targets a constant amount of debt. From the graph below, you can see the company's debt hovers between \$800-900 million mark from 2010-2019. The exception to this is in FY2020, where like sprouts and other grocers, Ingles have used the added cash flow from the pandemic to pay down/redeem some of their debt. Having managed to redeem over \$200m of debt with this added cash flow, we expect the Ingles to target \$627m as their constant amount of debt in the future.

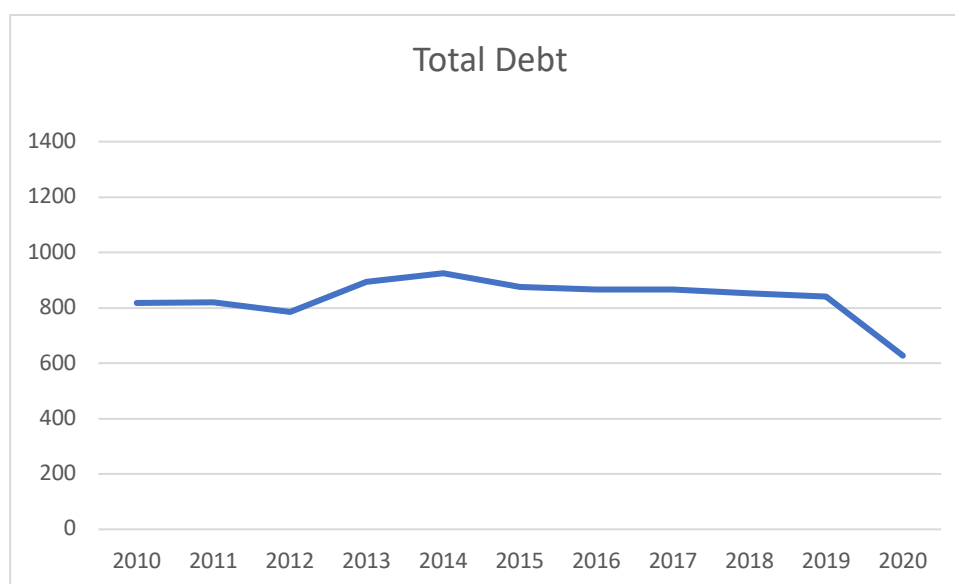


Figure 12

## BETA

To estimate beta, we analysed 10 years of return data for Ingles Market. We found the excess monthly returns for the same period 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 60 months. Our beta estimate as at 30/11/2020 was 0.60, however we felt this was low compared to the long-term average. Instead, we decided to use a five-year average of our estimates, delivering a beta of 0.76. We believe this beta is a better representation of Ingles' risk profile relative to the overall market.

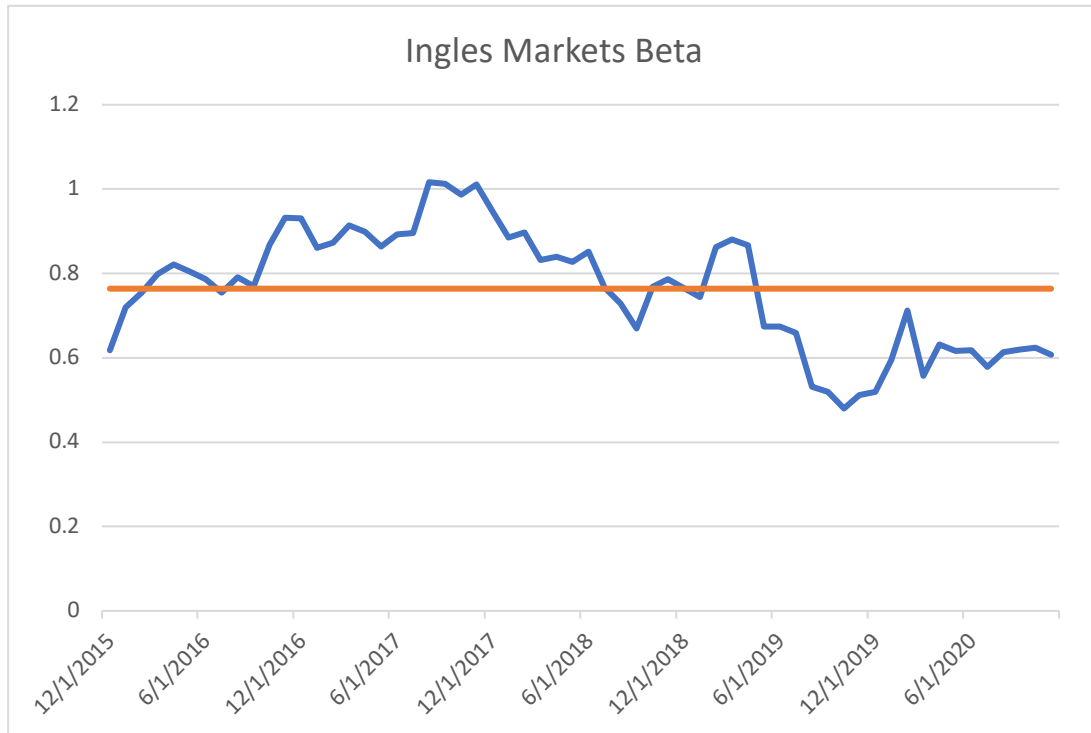


Figure 13

## COST OF EQUITY

We used the 10-year treasury yield of 0.92% 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 6.27%.

## COST OF DEBT

The company's credit rating was upgraded to Ba2 earlier in the year by Moody's, because of its improved cash flow and reduced debt burden. The 5 year probability of default for a BB bond is 6.92%, and the company's tax rate is 24%, giving us a cost of debt of 3.96%.

## VALUATION

Given the stable nature of Ingles cash flows we projected 10 years forward. As a result of this stability, we found that a lot of the line items on the financial statements had been a relatively consistent portion of sales over the last 10 years. Therefore, we were able to forecast items on the Income Statement, Balance Sheet and Cash Flow Statements based on these ratios and adjust them where we identified drivers which could lead to a material change in the future. Using APV, we got the PV of these cash flows using the cost of equity and added this to the PV of the debt tax shield giving us a valuation of \$560 million, or \$27.63 per share. This represents a 34% downside on the market price of \$41.77.

As a result, we strongly recommend a **sell** on Ingles Markets.

## APPENDIX

<b>PV(ALL Equity Cash Flows)</b>	
Unlevered cost of capital	6.3%
<b>Value of unlevered project</b>	<b>\$336</b>
<b>PV(Debt Tax Shield)</b>	
Debt amount	<b>\$627</b>
Cost of debt	4.0%
Interest rate	5.6%
Tax rate	24.0%
<b>PV of debt financing</b>	<b>\$223</b>
<b>APV</b>	<b>\$559</b>
<b>Enterprise Value to Equity Value</b>	
<b>Equity Value (intrinsic)</b>	<b>\$559</b>
WASO	20.26
<b>Target Price</b>	<b>\$27.58</b>
<b>Market Value</b>	\$846.25
<b>Share Price</b>	<b>\$41.77</b>
<b>Upside</b>	<b>-34%</b>

Balance Sheet																				
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e
Revenue	3560	3709	3739	3836	3779	3795	4003	4093	4202	4611	4462	4451	4542	4636	4731	4828	4927	5028	5131	5236
Cash and Equivalents	12	5	17	9	8	6	24	11	42	7	9	13	14	14	14	14	15	15	15	16
% of sales	0.3%	0.1%	0.5%	0.2%	0.2%	0.1%	0.6%	0.3%	1.0%	0.1%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Accounts Receivable	57	62	60	61	66	62	66	70	72	81	76	76	77	79	80	82	84	85	87	89
% of sales	1.6%	1.7%	1.6%	1.6%	1.8%	1.6%	1.7%	1.7%	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%
Inventories	303	330	330	330	339	344	349	372	374	367	379	392	409	417	426	435	443	453	462	471
% of sales	8.5%	8.9%	8.8%	8.6%	9.0%	9.1%	8.7%	9.1%	8.9%	8.0%	8.5%	8.8%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Other ST Assets	17	30	28	15	11	7	6	44	9	15	13	13	14	14	14	14	15	15	15	16
% of sales	0.5%	0.8%	0.8%	0.4%	0.3%	0.2%	0.2%	1.1%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Total Current Assets	389	426	435	414	424	418	446	497	497	470	477	494	513	524	535	546	557	568	580	592
PPE Net	1133	1197	1212	1219	1211	1248	1265	1303	1344	1401	1432	1468	1500	1528	1551	1570	1585	1595	1600	1600
% of sales	31.8%	32.3%	32.4%	31.8%	32.1%	32.9%	31.6%	31.8%	32.0%	30.4%	32.1%	33.0%	33.0%	33.0%	32.8%	32.5%	32.2%	31.7%	31.2%	30.6%
Other LT Assets	96	19	23	24	20	20	22	25	26	28	27	27	27	28	28	29	30	30	31	31
% of sales	2.7%	0.5%	0.6%	0.6%	0.5%	0.5%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%
Total Noncurrent Assets	1229	1216	1235	1243	1231	1268	1287	1328	1370	1429	1459	1495	1527	1555	1580	1599	1615	1626	1631	1632
Total Assets	1618	1642	1669	1657	1655	1686	1733	1825	1867	1899	1937	1989	2040	2079	2114	2145	2172	2194	2211	2224
Payables & Accruals	256	256	232	238	241	232	233	247	235	296	277	267	273	278	284	290	296	302	308	314
% of sales	7.2%	6.9%	6.2%	6.2%	6.4%	6.1%	5.8%	6.0%	5.6%	6.4%	6.2%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
ST Debt	34	50	19	12	11	10	12	13	13	28	28	28	28	28	28	28	28	28	28	28
Total Current Liabilities	290	306	251	251	252	242	246	260	248	324	304	295	300	306	312	317	323	329	336	342
LT Debt	821	785	894	925	875	866	866	853	840	627	627	627	627	627	627	627	627	627	627	627
Other LT Liabilities	75	93	114	99	99	108	111	117	117	129	125	125	127	130	132	135	138	141	144	147
% of sales	2.1%	2.5%	3.0%	2.6%	2.6%	2.9%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%
Total Noncurrent Liabilities	896	879	1007	1024	974	975	977	969	957	756	752	752	754	757	760	762	765	768	771	774
Total Liabilities	1186	1185	1259	1274	1226	1216	1222	1229	1205	1080	1056	1047	1055	1063	1071	1080	1088	1097	1106	1116
Total Equity	432	457	411	383	429	470	511	595	663	819	860	942	986	1016	1043	1065	1083	1096	1105	1106
Total Liabilities and Equity	1618	1642	1669	1657	1655	1686	1733	1825	1867	1899	1937	1989	2040	2079	2114	2145	2172	2194	2211	2224



	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e
Net Income	39	43	21	51	59	54	54	97	82	179	115	74	72	70	72	73	75	76	78	80
(+)D&A	85	91	95	98	103	107	111	113	113	100	120	125	127	130	137	140	143	151	154	157
(-)Capex	98	181	101	108	104	138	128	150	162	123	152	160	159	158	161	159	158	161	159	157
(-) changes in NWC	-5	21	63	-20	9	5	23	36	13	-103	27	26	14	5	5	5	5	5	5	6
(=) Free Cash Flow	32	-73	-53	58	44	14	9	21	20	259	57	13	27	38	43	49	55	61	67	74

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