

Sprouts Farmers Market NASDAQ: SFM

Sprouts Farmers SFM stock price overview

SFM stock has been in a downward trend since its IPO in 2013.



SFM stock price historical chart

Despite the negative stock performance since the IPO, Sprouts Farmers has more than doubled revenues (1), quintupled net income (2), lowered the number of shares outstanding (3) from 154 million to the current 118 million by returning \$958 million through buybacks since the IPO and the current fundamentals look interesting compared to the market capitalization of \$2.3 billion. The market capitalization was \$7.3 billion when the stock peaked in 2013.

Financials

Export Ascending

	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	2016-12	2017-12	2018-12	2019-12	TTM
1 Revenue USD Mil	517	1,106	1,795	2,438	2,967	3,593	4,046	4,665	5,207	5,635	6,232
Gross Margin %	29.0	28.1	29.5	29.7	29.8	29.3	29.2	28.9	33.6	33.6	36.3
Operating Income USD Mil	9	-19	73	142	200	231	213	227	235	225	349
Operating Margin %	1.7	-1.7	4.1	5.8	6.8	6.4	5.3	4.9	4.5	4.0	5.6
2 Net Income USD Mil	5	-27	20	51	108	129	124	158	159	150	251
Earnings Per Share USD	0.04	-0.19	0.14	0.37	0.70	0.83	0.83	1.15	1.22	1.25	2.12
Dividends USD	—	—	—	—	—	—	—	—	—	—	—
Payout Ratio % *	—	—	—	—	—	—	—	—	—	—	—
3 Shares Mil	137	144	144	140	154	156	150	138	130	120	118
Book Value Per Share * USD	—	—	—	3.29	4.28	5.32	5.34	4.64	5.13	4.76	6.85
Operating Cash Flow USD Mil	22	52	84	161	181	240	254	310	294	355	442
Cap Spending USD Mil	-17	-28	-46	-87	-127	-131	-182	-199	-177	-183	-133
Free Cash Flow USD Mil	5	25	38	73	54	109	73	111	117	172	310
Free Cash Flow Per Share * USD	—	—	—	0.36	0.42	0.52	0.53	0.86	0.74	1.70	—
Working Capital USD Mil	—	13	66	56	113	115	5	—	24	-29	—

* Indicates calendar year-end data information

SFM stock analysis – fundamentals – Source: [Morningstar](#)

SFM went public when organic/natural food stores were dominating the environment regarding growth. You probably remember the buzz around Whole Foods and Amazon consequently acquiring it. But, like it often happens with growth sectors, it is hard to define who has a moat, the profitability and growth opportunity leads to a high level of competition with consequently narrowing margins. This explains the market's sentiment regarding SFM's stock, but another thing with SFM is that gross margins actually expanded over the years, operating margins declined. On the other hand, most analysts fear how SFM will not be able to compete as mainstream retailers like Kroger, Wal-Mart, Target and others introduce more and more of SFM's like products, from organic to specialty, into their stores.

The key to watch with SFM's stock is the investing opportunity that often arises when a stock transitions from an exuberant growth stock into a boring value investment. Given the metrics to watch are different, growth investors capitulate and create downward price pressure while value investors are not yet around to pick up what is left. Plus, it is also important to watch whether the analysts' fears become reality because analysts usually paint a whole sector with the same brush.

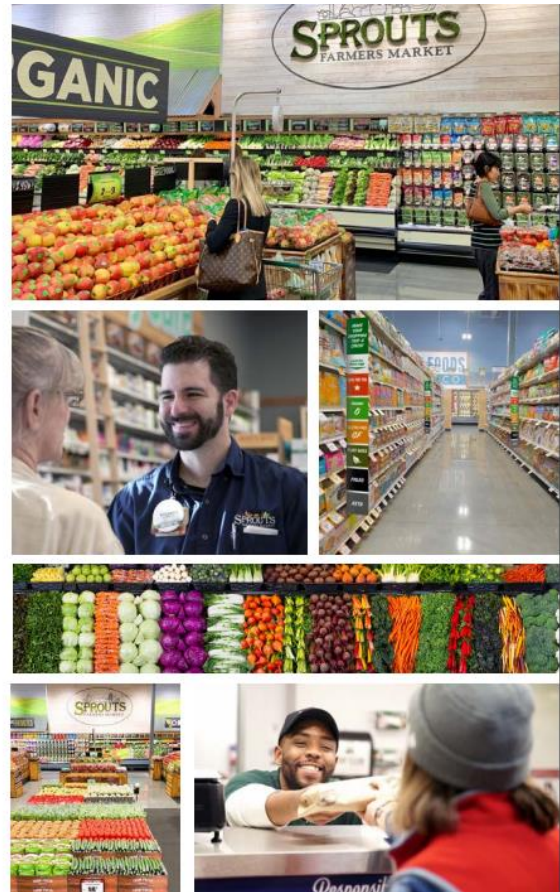
Let's discuss the business outlook, the fundamentals and the investing outlook through a value stock analysis model.

Sprouts Farmers Stock Analysis – Business Overview

If you are not familiar with SFM, it is something like the cheaper version of Whole Foods, offering premium, healthy, organic and specialty foods to customers. The management calls the company a specialty differentiated retailer.

WHAT DEFINES SPROUTS AND WHAT MAKES US DIFFERENT

- A farmers market experience – open layout of fresh produce at the heart of the store, community feel, treasure hunt for unique products
- A place with happy, helpful team members
- Intentional curation of responsibly and locally sourced products
- The right assortment of healthy alternatives and good-for-you options
- Making the highest quality fresh foods accessible to all



Sprouts Farmers Market stock analysis – business overview – Source: [SFM investor presentation](#)

The main idea is that produce is in the centre of the store surrounded by premium products.



Sprouts' Stores are Filled with a Curation of Differentiated Good-For-You Products



Thousands of Responsibly Sourced Products Made with Simple Clean Ingredients with Certifications and Attributes like USDA Organic, Fair Trade, and Humane Certified

Sprouts Farmers Market stock analysis – business overview – Source: [SFM investor presentation](#)

Given the narrowing margins over the last years, there has been a management transition at Sprouts Farmers Market and the new growth strategy is to have smaller stores for higher profitability, more growth in existing markets rather than pure geographical expansion where it is hard to scale and reach cost benefits.



Deliver a Unique, Friendly Experience with Healthy, Innovative Products in a Smaller Box with Higher Returns

From...



**30K
Enhanced
Layout**

square foot box

To...



**21K-25K
Small Market
Layout**

square foot box

Format to Stay True to our Fresh-focused Farmers Market Heritage

Prioritize Categories For Growth Potential

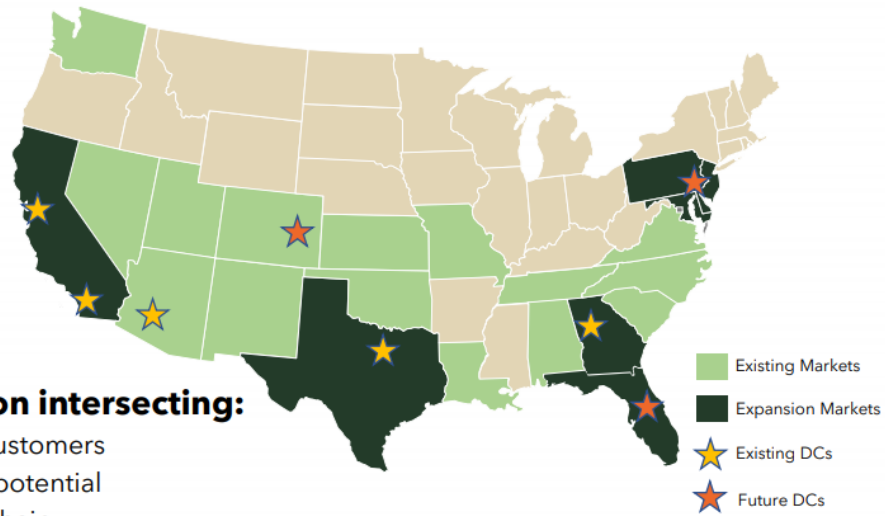
Continue to Offer all Categories

Sprouts Farmers Market stock analysis – business overview – Source: [SFM investor presentation](#)

Despite the bad stock performance, SFM is still focused on growth and executing on it.



300-400 New Stores in Expansion Markets - Minimum
10% Unit Growth Beyond 2021



Site selection intersecting:

- Target customers
- Growth potential
- Supply chain

Drive growth in existing markets with support of Distribution Centers (DC)
California & Texas – More opportunity to fill in where we are strong
Build out Mid-Atlantic and Florida

Sprouts Farmers Market stock analysis – business overview – Source: [SFM investor presentation](#)

The concentration should lower logistics costs and give more pricing bargaining power, increase the efficiency of ads and allow for better margins.



Create an Advantaged Fresh Supply Chain

Current	Future
<ul style="list-style-type: none">• DCs are located within <u>500</u> or more miles of the stores• 5 DCs serving 345 stores (Atlanta serving southern Florida)• Multiple deliveries to the stores daily	<ul style="list-style-type: none">• Aspire DC to be within <u>250</u> miles of the majority of stores• Additional Florida & Colorado DCs in 2021• Mid-Atlantic DC 2022• Leverage existing DC space to reduce overall costs; cross-docking more products• Drive efficiencies and simplicity in store & DC replenishment process

Deliver on Fresh Commitment

Sprouts Farmers Market stock analysis – business overview – Source: [SFM investor presentation](#)

I've followed a few of the last conference calls and there is a clear COVID boost with sales up 9.5%, comps 4.2% and online sales up 337% (Q3 2020). Apart from that, there are interesting business developments like:

- Going online for advertising (smart – there are SFM's customers)
- Working on private label (Vegan Matcha Latte Protein Powder)
- Their target is to double in size – *“With a \$6 billion grocer in a \$1.2 trillion market, we only need a small portion of market share to double in size.”*
- Of the 400 basis points gross margin increase, they estimate 250 related to COVID and 150 to improvements

But, the key thing on a conference call are the questions because those give you an indication of the issues and what the analysts/market are thinking:

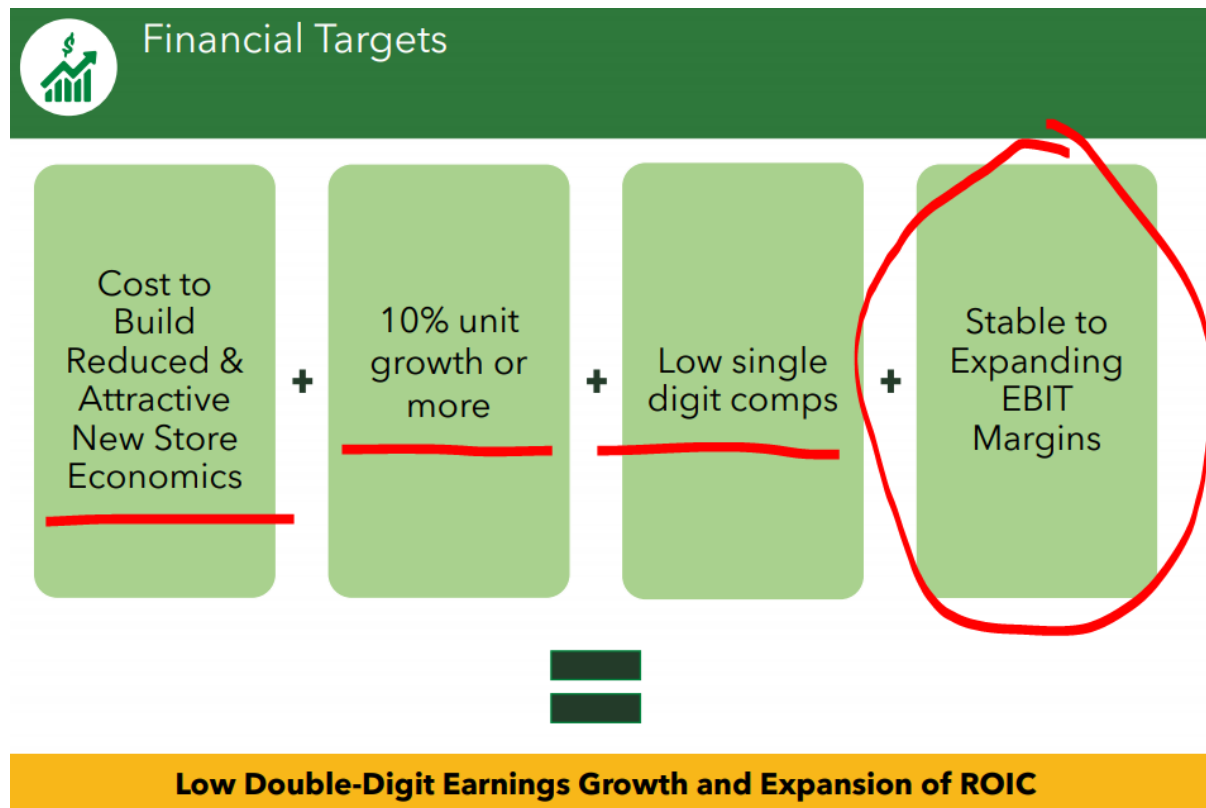
- SFM had lower comps than the competition – Answer: focusing on the niche and not selling large consumables like others.
- More questions about comparable sales in relation to the market – that is the focus on the market – not the fundamentals, but the benchmark.
- Another similar question topic: *“so the traffic and the sales get more in line with the industry”*
- E-commerce is margin dilutive, so they will not be able to reach the EBITDA margin of 8.4% reached last in 2014. – Answer: the organic market is so much bigger than back in 2014, no need to grow faster than the market.

- 3 questions on no loyalty cards and not keeping core customers.

So, SFM is definitely not doing things as analysts would want them to do things. In the meantime free cash flows are increasing, revenues too and the company is better and better positioned albeit with declining operating margins and not expanding margins at the same rate as the competition did in 2020.

SFM stock analysis - financials

If they can grow at 10%, lower costs, increase comparable sales in stores, then margins will expand, so will profits and consequently the stock too.



Sprouts Farmers Market stock analysis – financial targets – Source: [SFM investor presentation](#)

The key is to watch whether margins will start expanding or keep narrowing as analysts fear, and as has been the case with operating margins over the past years, excluding the COVID-19 positive impact. The narrowing of operating margins is what created the pressure on the stock, alongside the fear of increasing competition from Amazon through Whole Foods and online, To Wal-Mart, Kroger and others having more and more specialty and organic offerings to hard discounters doing the same.

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Dividends USD	—	—	—	—	—	—	—	—	—	—	—
Payout Ratio % *	—	—	—	—	—	—	—	—	—	—	—
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SFM stock analysis – margins – Source: [Morningstar](#)

2020 has been really good with operating cash flows of \$410 million for the 3 reported quarters, investments of \$76 million and the remaining cash has been used to pay down \$176 million of outstanding debt.

The forecasted earnings in 2021 before interest and taxes are expected to be in the range of \$285 million to \$305 million. With \$100 million in depreciation, excluding capitalized leases, we get to approximately \$400 million in EBITDA which means the company could be attractive for buyers at 7 times EV/EBITDA.

From that perspective SFM stock looks cheap as Apollo paid 6.9x EV/EBITDA for The Fresh Market in 2016, Onyx 7x for Save-A-Lot, Amazon 11x for Whole Foods for example. On the other hand, Goldman has just downgraded the stock on the [following](#):

- 1) a less favourable outlook for food at home,
- 2) the company's narrowing of the customer base could result in some top line headwinds before we see the intended improvements,
- 3) the possibility of increased promotions in 2020,
- 4) survey work pointing to customers still preferring one stop shopping and less shoppers going to SFM versus 2019,
- 5) Valuation work pointing to downside to our target price of \$18; 8% downside vs. 9% upside for our hardlines coverage. And,
- 6) SFM has been consistently underperforming its grocery peers even before the pandemic began and says that gap has only widened during the food-at-home tail.

Let's value the company from a risk and reward perspective alongside a possible margin of safety.

SFM stock valuation

SFM is a small but established player and it is always valuable for someone to acquire it if things don't go as planned so there is a margin of safety. Someone will buy this up fast if on

the market and if the current interest rate environment remains. Total debt is \$540 million and not much compared to cash flows.

Let's say they manage to double the business in 7 years. That would be \$400 million in FCF without improvements on operating margins. On the current market capitalization of \$2.4 billion it would give a 15% FCF yield. Even if they just keep the FCF on the pre-COVID level of \$200 million, thus they don't improve margins, they would still give an 8% FCF. If they do buybacks at lower prices – the stock could be up to the \$30s over the coming years for a good return.

In my valuation model I use the cash flows that I assume will be returned to shareholders through buybacks over the next 10 years, as it was the case in the last decade and assumed a 7% earnings growth alongside a 50% increase in buybacks in 2026 when the expansion plans slow down. With a very conservative multiple of 15 on disposable cash flows in 2030, I get to SFM being fairly valued for a 10% long-term return if they manage to keep margins stable and execute well on their plans.

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Scenario 1	Cashflow	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	Terminal Value	Growth rate
normal case	100.00	107.00	114.49	122.50	131.08	140.26	182.00	194.74	208.37	222.96	238.56	3344.37	7% next 5 years
	PV(10%)	97.27	94.62	92.04	89.53	87.09	102.73	99.93	97.21	94.56	91.98	1289.40	7% 5 to 10 years
	INTRINSIC VALUE	2236.35											10% Discount rate
	FCF PAYOUT -	50%	50%	50%	50%	50%	75%	75%	75%	75%	75%		15.0 Terminal multiple

SFM stock valuation – Source: Sven Carlin Research (downloadable template and example)

Shorter term, yes, if they can keep growing and get to a free cash flow yield of 20 on the \$200 million in free cash flows – then the stock can easily double.

SFM stock risks

The key risk and what everyone is watching are operating margins. If margins keep declining, like it has been the case since 2014, down to 4% from 8%, then the outlook will not be great.

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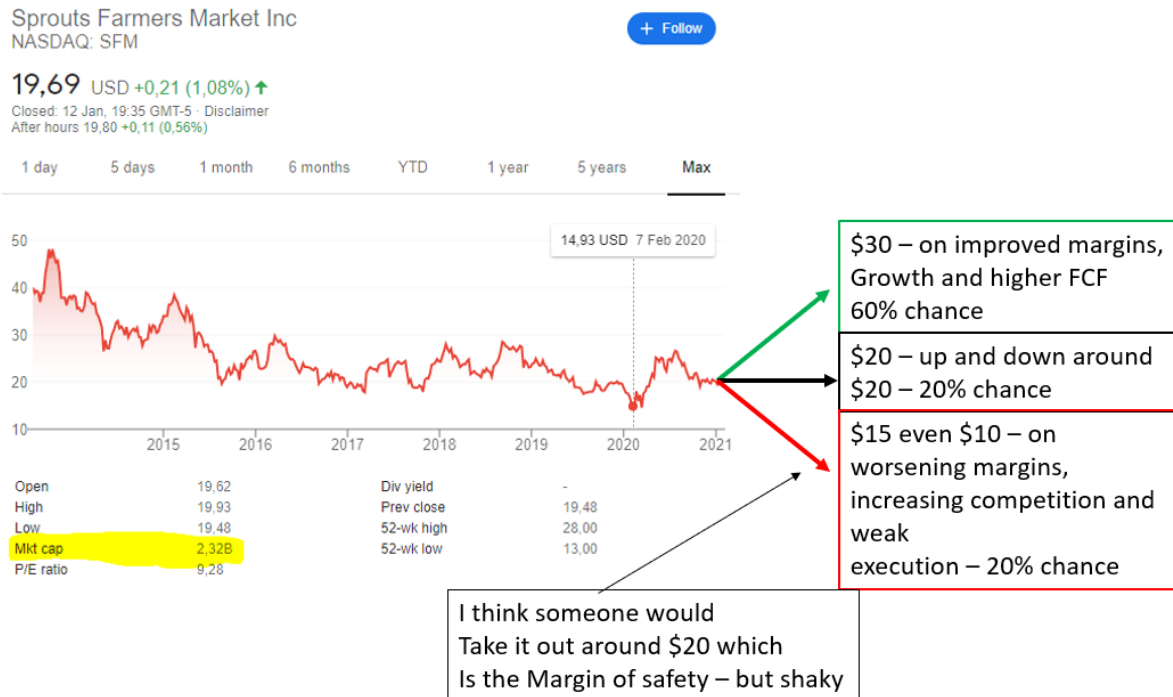
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SFM stock analysis – margins – Source: [Morningstar](#)

However, if they can stop operating margin contraction with the new initiatives, and perhaps even grow it given the gross margin expansion, things could get really interesting.

It will all depend on the environment, demand, the competition, the growth and execution with online sales that make 11% for now but are margin diluting.

All in all, we have a company trading at \$2.3 billion that makes approximately \$200 million in FCF in a normal year, is rewarding shareholders through buybacks and offers growth potential. It is in a resilient industry and the trend is still growing for organics with a 6.3% growth rate in 2019 according to [OTA](#).



SFM stock investing valuation – Source: Author’s estimations

PERSONAL OPINION – what is the moat? Retail is a cut throat business, very hard. FIND BETTER SVEN, IT IS GOOD, BUT FIND BETTER! YOU DON’T KNOW WHAT WILL HAPPEN – yes organic is growing, but by how much, how fast etc. A lot can happen, from US to other risks.

ESG Action Items
Recent Initiatives



ADUSA commitments:

- By June 2025, at least 54% of own-brand food sales will achieve 1 to 3 stars through the Guiding Stars nutrition guidance
- Starting this year, will disclose annually the percentage of food sales generated from all products that achieve 1 to 3 stars



Albert Heijn doubled its own-brand assortment of vegetarian, vegan and vegetable products in the fall



Delhaize continued to focus on healthier products with more permanent price reductions for Nutriscore A/B products; led to the launch of the SuperPlus loyalty program in October

Ahold stock analysis - Source: [Q3 2020 Investor presentation](#)

4	Kroger	KR	24.36	20.18	0.83	12-Jan-21	WATCH	USD Billions	Good business, safe industry, good return in the high single digits, great for swi
5	Sprouts F	SFM	2.38	2.19	0.92	12-Jan-21	WATCH	USD Billions	Good business, focused on growth but with declining operating margins which i
6	AHOLD	AMS:AD	26.68	20.23	0.76	14-Jan-21	WATCH	EUR Billions	Good business, BOL.COM is high growth, high cash flows, but typical retail risks

Excerpt from my watch list – SFM and Kroger look cheaper than Ahold – Source: Research Platform

The above is definitely a risk because all retailers are introducing more and more vegetarian products and thus lowering the need to go to specialty stores. My wife is all into healthy foods and these days we go less and less to specialty stores, the local organic market has a lot plus all stores have more and more specialty items.