Organic Food: Fad or Trend

In this white paper we are going to discuss the food business, more specifically, the organic/natural food category.

During the past couple of years we have seen the steady creep of the organic food business into our daily lives. There are now restaurants that are serving healthy food exclusively. There are grocery stores such as **Whole Foods**, that sell organic and natural foods. Many old line grocery stores have organic and natural food sections. There are companies that grow organic produce and meats and distribute them to restaurants and grocery stores throughout the world.

Before we discuss the individual companies in this business we need to talk about whether organic is a trend or a fad. We will begin the discussion with my daughter. We have a 21-year-old that I think is like most 21-year-olds. She doesn't use her phone as a phone but as a texting machine and she eats fast food just like any other kid.

I texted her the other day, because that's the way she likes to communicate, to ask her what fast food restaurants she goes to from time to time. Her response was revealing. She never goes to McDonald's, she never goes to Wendy's, but goes to Burger King every once in a great while. But where she goes regularly is **Chipotles**. For those of you who have never been to a **Chipotles,** they are a fast food organic/natural restaurant. For baby boomers, the only fast food restaurants in existence were burger and fried chicken restaurants when they were growing up. We have seen quite a change in the past few years.

U.S. sales of natural and organic foods and beverages projected to exceed $78 billion by 2015 *according to the 2012 Natural Foods Merchandiser's Market Overview / Natural and Organic Foods and Beverages in the U.S., 3rd Edition by Packaged Facts*

According to the recently published report by TechSci Research. ***It has been forecasted in the report that United States' organic food market revenues will grow at the CAGR*** *(compound annual growth rate)* ***of around 14% during 2013-18.***

Also according to TechSci Research. ***"The organic food market contributed about 4% to the country's overall food market in terms of revenues during 2010.*** There is a lot of room for growth.

From all the evidence that we have seen, kids are moving away from the old line fast food restaurants like McDonald's. As a matter of fact, McDonald's and Burger King's sales are falling, while Chipotles on the other hand, are rising substantially. We think that this isn't a one off. We believe that organic/natural food restaurants will continue to grow while the old line fast food restaurants will either struggle or have to remake themselves and offer this kind of food across the menu rather than selling a couple of different salads.

Now let's spend a little time talking about the grocery stores. Many of you have heard of or been in a **Whole Foods** or **Sprouts**. If you have, it becomes obvious quickly that it's all about organic and natural and fresh. Some years ago **Whole Foods** had a couple of stores but now has grown to about $14 billion in sales. Natural/organic foods are a trend not a fad.

My wife and I have been going on dates to Costco for years. We have noticed over the past few years that more and more of the food that Costco sells is organic. That includes fresh items as well as canned. Unlike some of Costco's food items that come and go with the season or the fad, organic foods seem to be taking up more and more space.

A trip to your local grocery store will reveal much the same thing. Go through the fresh vegetable section and you will notice there is an area displaying organic vegetables. Then walk over to the refrigerated dairy section and you will notice the same thing. Organic eggs and organic milk now take up significant space when a few years ago there was none. Now wander over to the canned vegetable area and you will see the same thing again.

If you have a chance, visit Trader Joe's. It seems as though, that Trader Joe's sells nothing but organic/natural foods whether it's packaged or in the fresh vegetable section. Trader Joe's has been around for a long time but over the past few years it has experienced substantial growth

This anecdotal evidence as well as extensive research has shown us that the organic/natural food business is not a fad but a trend that will be with us for many years. As we go through the analysis that will follow we will talk not only about the growth in the business but we will also discuss what might be some of the downside risks. By the end of this paper, we think that you will agree with us that investment can be made in this area that might be very lucrative in the coming years.

After spending a great deal of time researching this business we have concluded that there are four areas that we needed to investigate. They are; producers/distributors, restaurants, grocery stores and producers. Below you will see a chart describing the companies we found and the sectors they are in.

We will now discuss each of these sectors. along with companies we have identified that might make good investments. As always, we want to caution the reader that any of the stocks mentioned should only be purchased after careful consideration as to how they may fit into an overall portfolio allocation and risk tolerance.

		Market Value ($M)	Revenue TTM ($M)	Revenue 1-Year GR%	Revenue 3-Year GR%	EPS 1-year GR%	EPS 3-Year GR%
	Restaurants:						
CMG	Chipotle Mexican Grill Inc	20,998.30	3,625.30	23.20	21.10	19.60	21.90
PNRA	Panera Bread Co.	4,123.50	2,470.60	9.70	13.90	4.80	16.40
LOCO	El Pollo Loco Holdings Inc - Com	1,174.37	314.73	7.19	7.59		
NDLS	Noodles & Co.	649.60	369.40	13.50	15.70		
ZOES	Zoe's Kitchen Inc	585.40	133.60	50.20			
	Grocery Stores:						
WFM	Whole Foods Market, Inc.	13,982.10	13,914.00	8.30	12.20	5.00	17.90
TFM	Fresh Market, Inc.	1,587.80	1,643.50	16.30	42.90	-2.10	
SFM	Sprouts Farmers Market Inc	4,543.20	2,708.30	21.20	49.40		
NGVC	Natural Grocers By Vitamin Cottage Inc	427.70	500.10	23.40	25.20	36.60	
	Producers:						
WWAV	WhiteWave Foods Co.	5,973.80	2,986.00	24.00	13.80	38.30	
HAIN	Hain Celestial Group Inc	4,745.70	2,153.60	24.20	24.00	17.60	36.40
BDBD	Boulder Brands Inc	795.70	461.34	24.80	22.70	44.60	15.90
CVGW	Calavo Growers, Inc.	589.90	748.70	24.70	20.10	28.10	14.80
BNNY	Annie's Inc	510.50	208.20	19.10	21.20	-13.30	
LMNR	Limoneira Co.	321.20	94.90	18.40	21.30	28.30	95.30
LWAY	Lifeway Foods, Inc.	220.80	108.80	22.40	20.30		
	Producers/Distributors:						
UNFI	United Natural Foods Inc.	3,177.10	6,672.20	15.70	15.20	18.20	14.60

The analysis below is not meant to be an in-depth analysis of these companies but is meant to give the reader a thumbnail description of these companies, why we like or don't like them. We will leave the in-depth discussion to those of you that would like to have it on a one-on-one basis.

Let's begin our discussion with the restaurant sector. We think many of us can agree that restaurant food, when taken as a whole, is generally not very good for you. In years past the only way to eat healthy at a restaurant was to order a salad. If all you're going to have is a salad why bother going to a restaurant. In the last few years we began to notice a change. McDonald's started adding healthier foods as did many other fast food restaurants. What became more noticeable is that new kinds of restaurant chains emerged. These new restaurants were billed as being better for you but also very tasty. They have included **Chipotle Mexican Grill** and **Panera Bread**, also known as Paradise Bakery in Phoenix. There are also newer entries to the sector which includes **Zoes Kitchen** and **El Pollo Loco**. Please look at the table below.

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The list above represents five stocks that we felt might warrant an investment. After much research we have decided three are investable at reasonable prices.

Let's begin with **Panera Bread Company**.

It is basically an organic/natural food restaurant serving by and large healthy foods. They have lunches that begin at about 500 calories are low in fat and are good for you. Their biggest problem has been not being able to serve food quickly.

When a customer walks into a **Panera Bread Company** restaurant during lunch or other busy times they find out rather quickly it takes long time to actually order, pay, find a place to sit, and finally to receive the order. This has been hampering the growth of the number of customers **it** can serve. They have recently rolled out what they call Panera 2.0. It is a system that speeds up the customer experience rather significantly. As a matter of fact, a customer can enter the restaurant completely skip the line and get his foot immediately. He can do this in a number of ways. He can order from his desktop computer before he leaves the office or home or order from a mobile device. Customers are also going to be able to come into the store order from and pay on an iPad. They also just announced they will be accepting Apple Pay that Apple just introduced.

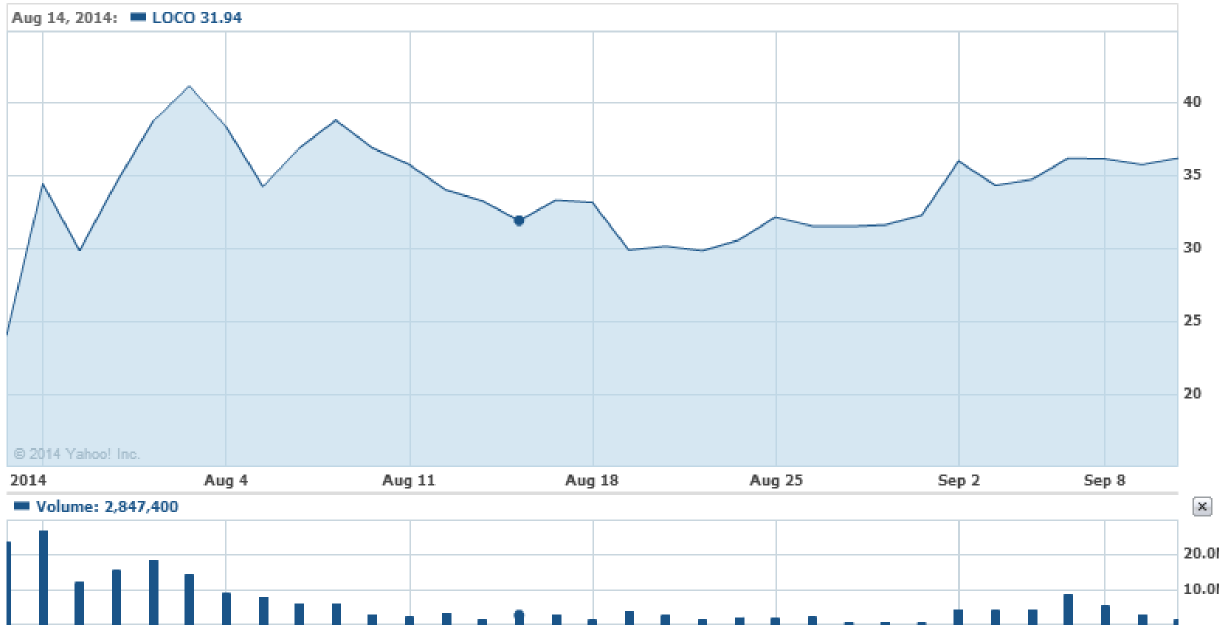
Because they have so many stores it is going to take them a year or more to roll out Panera 2.0 across the company. As a result, we believe that is going to take some time for sales to increase. Because of that, the stock has not performed well during the past year and is down about 25% off its high. We think that this may represent a good buying opportunity.

Another stock that warrants consideration is **Zoe's Kitchen**. It serves natural/organic foods as well as other healthy choices. This company has not been public for very long so there is not much of a public track record. They currently have 110 stores open and plan to open 15 to 20 more in 2015. Unlike some other restaurants, this particular company does a significant amount of business in the catering area which takes 1 to 2 years to fully implement after the store is open. This could mean that as the company matures and as additional stores are opened there could be significant comparable sales growth in the future.

They just announced earnings the other day. Total revenues increased by about 54% and comparable restaurant sales increased by 7.5%. This means that on average each restaurant did 7.5% better this quarter versus the same quarter last year. This is a very small company that has revenues of much less than $1 billion and has a market valuation of only $585 million.

Because it is a small company, it carries substantial risk. They only have 110 stores and plan to grow substantially. If they don't, or can't or competition hurts them the stock will not perform and may go down substantially. We believe though, because of the niche they fill, they have a very good chance of being successful. That does not mean that the stock will go up a lot or at all for that matter. However, because we believe they are in a subsector of the restaurant industry that we think is poised for growth that the stock warrants investment.

Now let's turn to **El Pollo Loco**, one of my personal favorites for fast food.



It is a fast food restaurant that serves grilled marinated chicken and other items that is considerably healthier than a restaurant such as, Kentucky Fried Chicken. Although the company has been in business for many years it just became publicly traded a few weeks ago. It's performance since the IPO has been stellar.

It is a small company with lots of growth potential. They think that they could grow from somewhere around 110 to 130 stores to eventually 2300. This year they will grow by about 15 stores including opening up the market of Houston, Texas. They believe that their system growth rate will be in the 8 to 10% range with long-term comparable store sales of somewhere between 2 ½ to 3 ½%. They have also told investors that when they complete the remodel of older stores by 2018 sales should go up by about 3% in each store.

We think this company should be watched and possibly purchased should the stock come down in price. However, as with many growth stories the stock may seem to be overpriced when compared to financial results. This is generally a significant risk with high growth companies. Earnings and revenue can often lag the stock price. As long as the growth continues, the stock may continually go higher but still may warrant investment.

One more thing. A new restaurant concept is now being launched that is not yet investable. Better for you pizza, much tastier (in my opinion), fast food style. The style of pizza is Neapolitan. This pizza is not about loading on as much cheese and meat but instead focusing on a very tasty dough and natural and organic ingredients that are not used excessively. There are several companies that can serve a made to order pizza in about three minutes. We have heard that the founders of California Pizza Kitchen are exploring this concept and will open stores soon.

We think this is something to pay attention to.

Let's move on to grocery stores. Below you will find the chart of companies we have looked at in the sector.

	Market Value ($M)	Revenue TTM ($M)	Revenue 1-Year GR%	Revenue 3-Year GR%	EPS 1-year GR%	EPS 3-Year GR%
Grocery Stores:						
Whole Foods Market, Inc.	13,982.10	13,914.00	8.30	12.20	5.00	17.90
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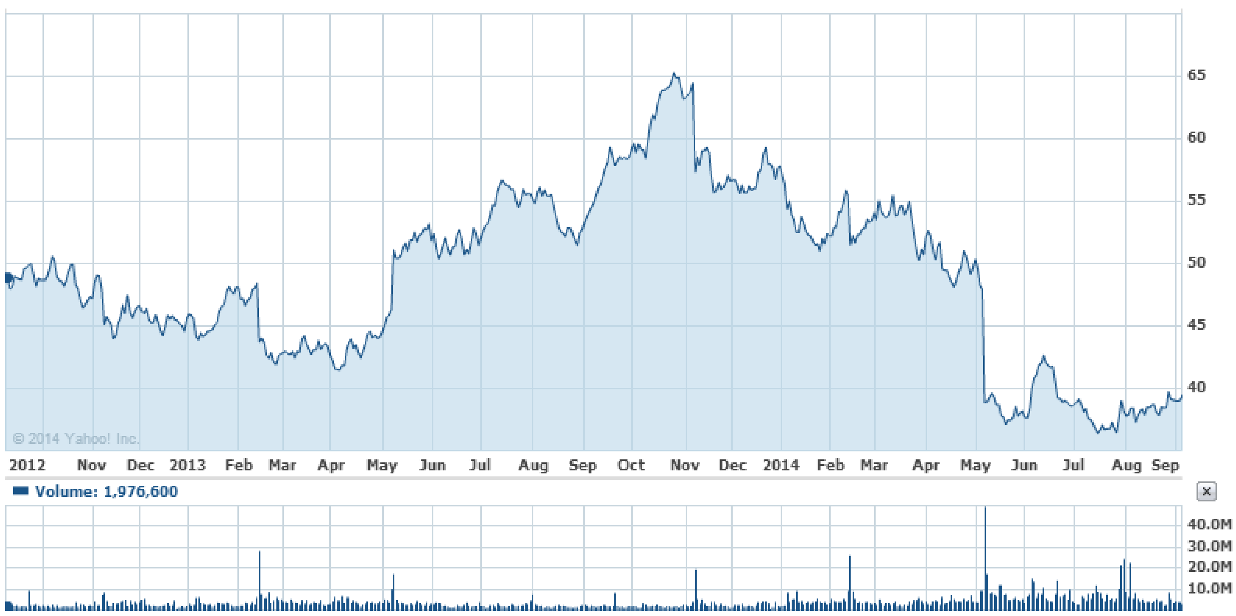
Sprouts Farmers Market Inc	4,543.20	2,708.30	21.20	49.40		
Natural Grocers By Vitamin Cottage Inc	427.70	500.10	23.40	25.20	36.60	

Let's begin with **Whole Foods Market**. This is the company that may have invented the organic/natural food craze in America. They've grown from zero to about $14 billion in revenues. In our opinion, because of its size revenue growth is beginning to slow and earnings growth is also beginning to slow. When they have as many stores as they do there are very few growth opportunities and therefore, they must grow from within. This means they need to grow sales at each store, a much more difficult task than simply opening another store.

Below you will see a two-year chart of **Whole Foods**.



Over the past two years the stock is down about 38% from its high. As a company this large reaches maturity often times this is what will happen to the stock. So it is very important when a decision to buy is made. An investor must be careful, we think, not to pay too much.

I have been to **Whole Foods** many times and I am continually amazed at how expensive it is. I think, as an organic food buyer one understands that he will pay a premium. **Whole Foods** is no exception. However, the store that I frequent gives an overall impression that it is an expensive place to shop and it is confirmed as you walk through the store. The stores are beautiful with amazing food items at, in my opinion a very large premium. There are many people will pay a large premium but others that may shop elsewhere. This brings me to **Sprouts Farmers Market**.

The ambience at **Sprouts** is entirely different than **Whole Foods**. When you enter the store you get the feeling they are doing what they can to keep prices low. At least on my visits, it seems to be a lower price alternative.

Sprouts is another company that has not been public for very long. If you look at the chart above you will notice its 1 and 3 year revenue growth but nothing on earnings-per-share from one in three years because it was not public then. If you look at the table you will notice a couple of things. Revenues are about a third of **Whole Foods** and **Sprout's** growth rate is 2 to 3 times theirs. The growth rate is higher for **Sprouts** for a couple reasons. First, it's a much smaller company so when they add a store it represents a larger share of total revenue. Secondly, once again because it's a much smaller company as they add stores earnings grow faster. Once **Sprouts** has reached the size it would like to be, the growth will fall dramatically as it does with all mature businesses.

Sprouts can be considered for purchase but, once again, investors need to be careful of the price they pay. They also need to understand that it is a more speculative than **Whole Foods**. Whereas **Whole Foods** is already a mature company **Sprouts** is not.

Although we list two more companies in the grocery store sector at this time we have elected to not comment on them at this time. If they warrant discussion in the future we will write about them.

Now let's focus on, what I think, is the most exciting and could be the most profitable sector in this industry, the **Producers/Distributors**.
These are the companies that manufacture and/or distribute organic and natural products to retail stores and restaurants all over the world. If organic is a real trend and not a fad many companies in this list are going to participate and a few of them will participate in a big way. It is this sector that we think warrants a serious look at and an investment that we think should not be insignificant.

		Market Value ($M)	Revenue TTM ($M)	Revenue 1-Year GR%	Revenue 3-Year GR%	EPS 1-year GR%	EPS 3-Year GR%
	Producers:						
WWAV	WhiteWave Foods Co.	5,973.80	2,986.00	24.00	13.80	38.30	
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UNFI	United Natural Foods Inc.	3,177.10	6,672.20	15.70	15.20	18.20	14.60

Once again, we are not going to talk about all of the companies in this list but those that we think at this time warrant consideration. Before we talk specifically about individual companies want to give the reader an overview of why this sector could be ready for substantial growth.

If organic is a trend it's going to be with us for a very long time, it's going to have to start with these companies. Products have to be made, crops need to be grown, and items need to be distributed to retailers and restaurants. So if the retailers and the restaurants are going to be successful by definition one or more of these companies will have to be successful as well.

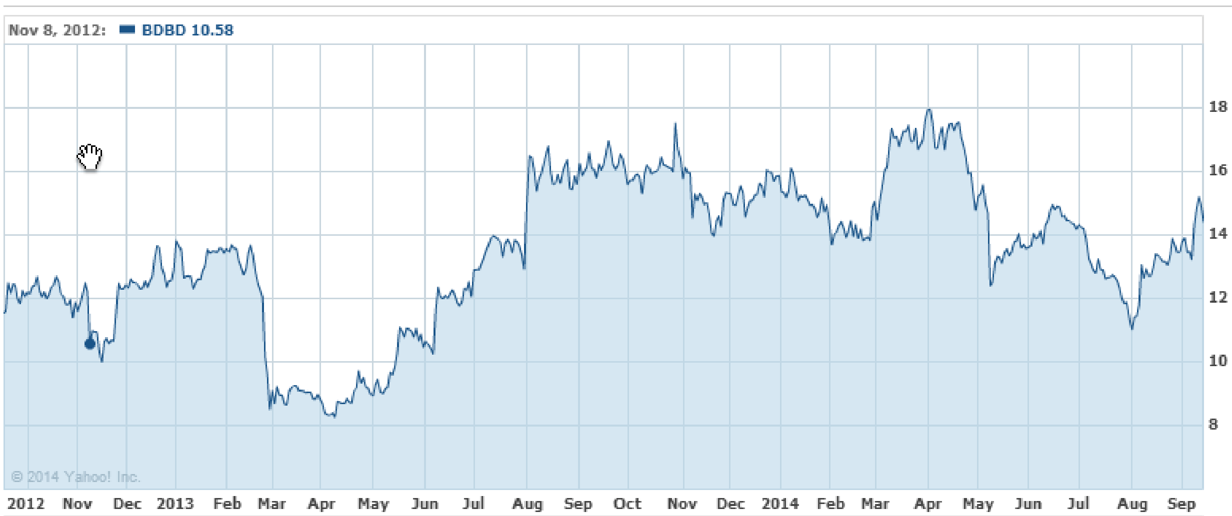
As is often the case, it is not the large corporations in America that innovate. Small companies sometimes are better innovators than large ones and some of them become large because of it. If we look at the larger food manufacturing companies in America such as General Mills and Kellogg's, I think we will notice that organic is a very small part of what they do. They have been late to the party and have noticed that these organic manufacturers are doing things that they are not.

Imagine that you are running one of these large companies and have begun to understand that the organic/natural food business is going to be around for years. What do you do to participate? Do you start from scratch and build a brand knowing that it takes years? Or might you consider buying a company that is already doing it and has an established brand that you might be able to expand because of your reach into the retailers and restaurants?
We have discussed this at length and have decided that buying a smaller company would be an attractive way for a large food company to participate. Today, we have learned we were right. General Mills, a very large food company, announced that they are buying organic food

manufacturer Annie's at about a 40% premium to yesterday's stock price. Personally, I am not surprised that they are buying an organic company but I am surprised that they are buying one so small.

We think that there could be more buyouts in the sector. As we said previously, it is much easier to buy a well-known brand rather than starting from scratch. We will discuss later, companies that we think could either be a buyer or be bought.

We previously mentioned that Annie's was purchased by General Mills just this week. One of its competitor is **Boulder Brands**.

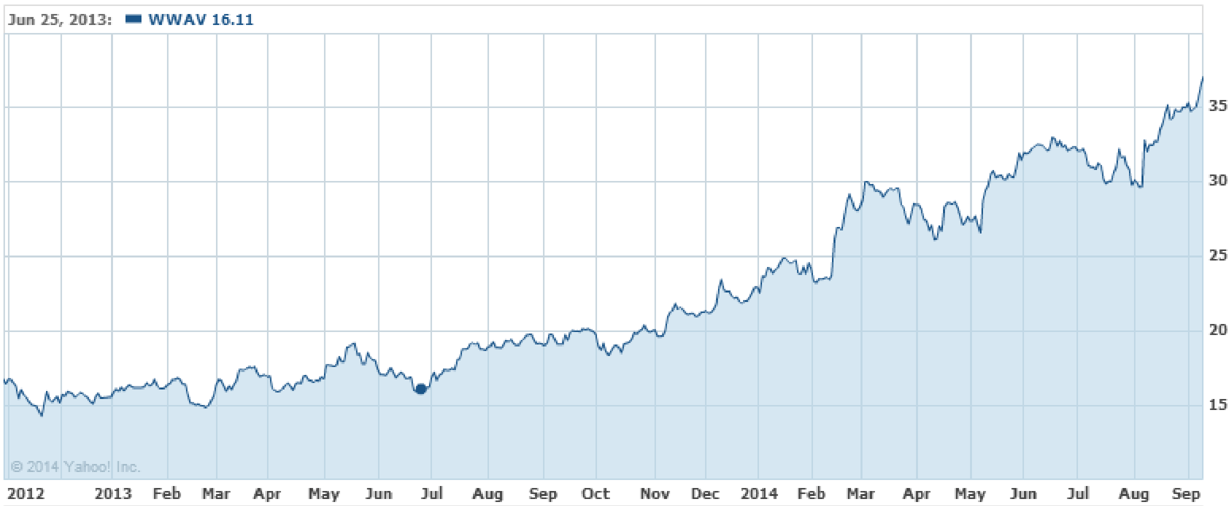


They both sell very similar products at similar prices and grocery stores throughout the United States. Revenues are a little higher at **Boulder Brands** but growth rates are similar. The food products they make are either organic or healthy for you. One of the brands you may have heard of is Smart Balance spreads. This alternative to butter is claimed to be good for your heart. It is a staple at many grocery stores.

Boulder Brands focuses on something a little bit different than some of the others. They are focusing on gluten-free products which some think are healthier than products made with gluten which is wheat flour. Many people are allergic to gluten and try to do their best to find substitutes, such as gluten-free bread, baked goods and flour. However, many researchers think gluten free diets can cure many conditions such as ADD and others. We know of no research that shows a gluten free diet cures as many ailments, as some claim. We know that people with celiac disease cannot eat gluten-based products however, these products are becoming more mainstream everyday.

The question for us is whether the widespread use of gluten-free products is a trend or a fad. If it is a trend, **Boulder Brands** will be successful, if it is a fad, growth will wane. So we think that investors should wait and look elsewhere for investments in this category, at least for now.

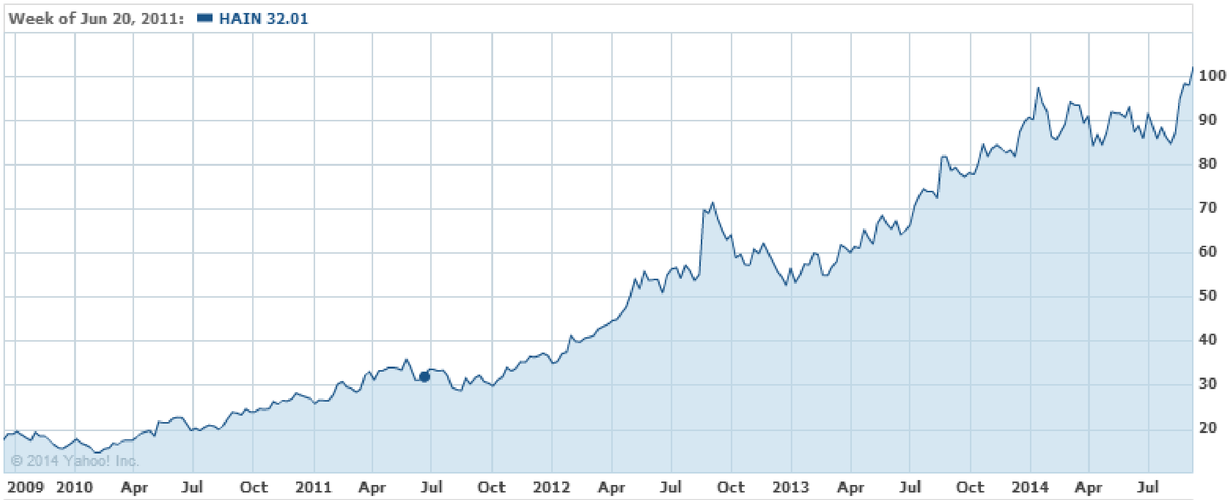
Let's move on to **White Wave Foods**.



You may know them better as Horizon Organic Milk, Silk, and Land O Lakes products. Everything they sell is plant-based and are generally healthy. Look at the table on the previous page and you will notice the growth in revenue and earnings is pretty substantial. They do a significant amount of business in the United States are growing in Europe, just beginning in South America and have just inked a deal with a partner in China. Growth could be substantial for a number of years.

We believe they may be a likely takeover candidate because of their brands, management and substantial revenues. If **White Wave** was purchased at the same multiple to revenues as Annies, the price would be about $70 per share. We have no special knowledge that anyone is considering it but it just makes sense to us. They have the brands, they have the revenues and they are profitable. It seems to us that if an old line food company were to spend the same amount of money building a brand versus buying a brand it would take them many years versus what could be done overnight.

The last company we will discuss is **Hain Celestial** Group.



This company has about the same amount revenues as **White Wave**. They have about 40 different brands all-natural or organic. Revenues are still growing substantially as well as earnings. They are growing in the United States as well as in Europe. The company consistently beats Street revenue and earnings estimates and its stock price rise reflects it.

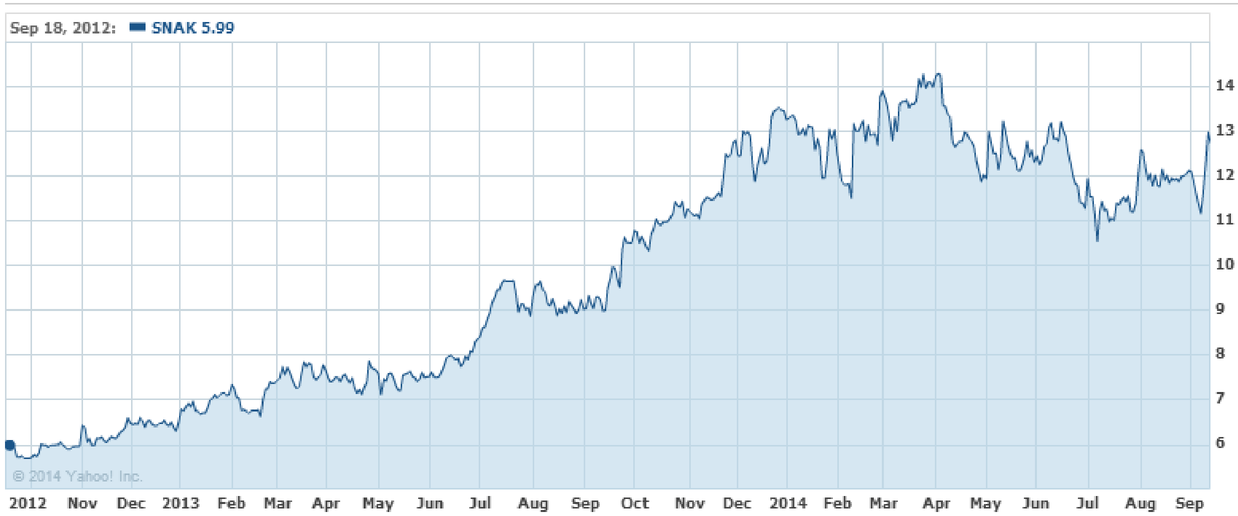
It's trailing PE is about 36 versus **White Wave's** at about 55. So from a valuation point of view **Hain Celestial Group** is a cheaper stock. From a financial perspective this company is performing very well. The question of course, as with all the stocks we have mentioned is the organic/natural food category a trend or fad and is the stock price rich, cheap or something in between? We think that **Hain Celestial Group** represents a good investment for a couple of reasons. First, as we mentioned previously we think the organic food category is here to stay. Secondly, as we mentioned with **White Wave** that **Hain Celestial** could be a takeover candidate for a much larger mainline food company. This company could also be an acquirer. It has done it in the past and could continue.

To sum it all up we think the organic/natural food category will be with us for a very long time. This food category is just beginning to been mainstreamed into grocery stores and restaurants. We believe we are in the first, second or third inning of the growth in this area. Therefore, we think investments can be made now for a 3 to 5 year time horizon. Some of these stocks are speculative and are subject wild price swings while others are a bit more mature and are not so volatile.

As always, we think it is important for investors to be careful what they buy and the price they pay. He should buy the stocks with the idea of holding them for 3 to 5 years and pay little attention to the volatility swings in the meantime.

As always, should any of our readers have any questions please do not hesitate to give one of us a call.

As we were finishing this report we discovered another company that we need to discuss. **Inventure Foods**, Inc. (SNAK), better known as Poore Brothers Potato Chips in Arizona.



		Market Value ($M)	Revenue TTM($M)	Revenue 1-Year GR%	Revenue 3-Year GR%	Revenue 5-Year GR	EPS 1-Year GR$	EPS 3-Year GR%
SNAK	Inventure Foods Inc.	248.6	252.7	31.4	19.5	15.9	53	21.6

Over the past 24 to 36 months **Inventure Foods** has reinvented itself. It used to be a bad for you, way too much fat, salty snack food company that sold potato chips and other snacks. Today 82% of their revenues are generated by organic/natural products.

They sell healthier for you, salty snacks, frozen fruit and smoothie mix and frozen vegetables. If you look at the table above you will see that revenues are growing substantially as well as earnings per share. We just listened to their last quarterly conference call and got the impression that the last half of this year will witness continued growth. They also mentioned that they will get more involved in the East Coast in 2015 which might provide additional revenue growth. They also said they will continue to look for acquisitions and make a purchase when it makes sense.

If you take a look at the market value of this company versus its revenues you will notice that the company is selling for approximately 1 times revenue. If you look at the table at the very beginning of this paper you will notice, on the whole, these companies are trading at two times revenue or higher. It also looks like that it is selling for 19 times next year's earnings, which is a low multiple as compared with other companies in this space.

It appears to us that the market may not fully understand that this company has turned itself into an organic/natural food company. If that is the case, we might expect substantial price improvement over the next year. We think that a purchase can be made here with the understanding that this is a speculative buy and the stock could be very volatile.

Source: All charts finance.yahoo.com
Source: All tables Intrinsic research