SuperValu, Inc.

SVU: NYSE

Analyst: Matthew Schilling
Sector: Consumer Staples

BUY

Price Target: $11.66

Key Statistics as of 10/09/2015

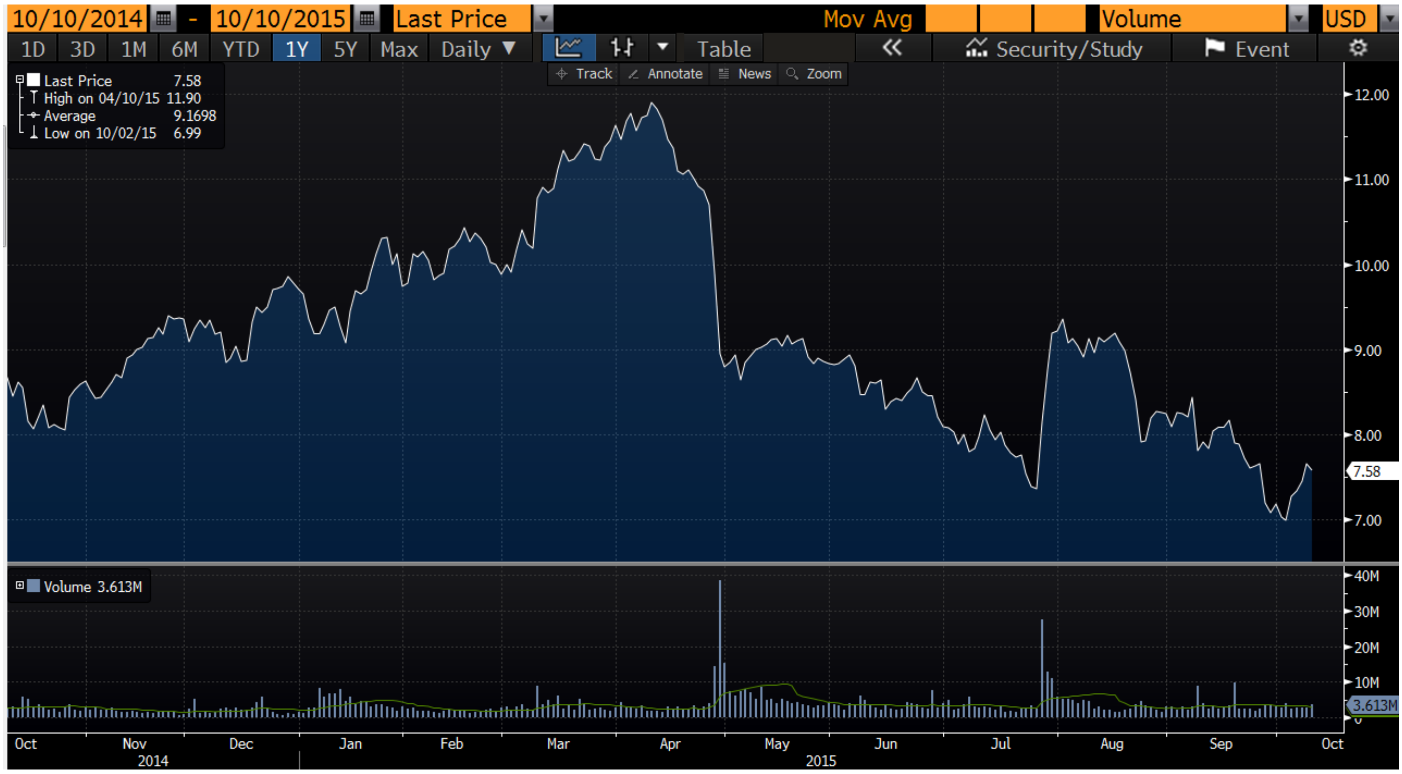
Market Price:	$7.58
Industry:	Food and Staples Retailing
Market Cap:	$2,232.87M
52-Week Range:	$6.75-$12.00
Beta:	1.16

Thesis Points:

- Current Price Indicative of Negative History, Leaving Stock Undervalued
- Smarter Growth Leading to Positive Value Creation
- CEO Retirement Announced October 2nd, More Negativity Leads Stock to be Further Undervalued

Company Description:

SuperValu Inc. is a wholesale grocery distributor and traditional discount retailer that has been in business for over a century. They offer a wide array of items, including all natural healthy food choices, baby supplies, coffee and ice cream. SuperValu operates 5 traditional retail grocery stores and a discount retail store/pharmacy that sells items at a 40% discount compared to other grocers.



Thesis

SuperValu Inc. used to be a premium dividend paying stock that traded around $47 per share. They became highly leverage from poor acquisitions and trying to sustain dividend payouts which eventually led to the company's downfall when the 2009 financial crisis hit. SuperValu, under new management, downsized operations and honed in on projects that create value. The new style of operation is generating significantly higher returns on invested capital while managing to keep their costs of capital low. The new demonstration of value creation has not been enough to change the minds of investors due to their past history, thus making the stock significantly undervalued. In addition the CEO, Sam Duncan, recently announced that he will retire in February of 2016 leading the stock price to decrease to an even lower value leaving a significant margin for return on this investment.

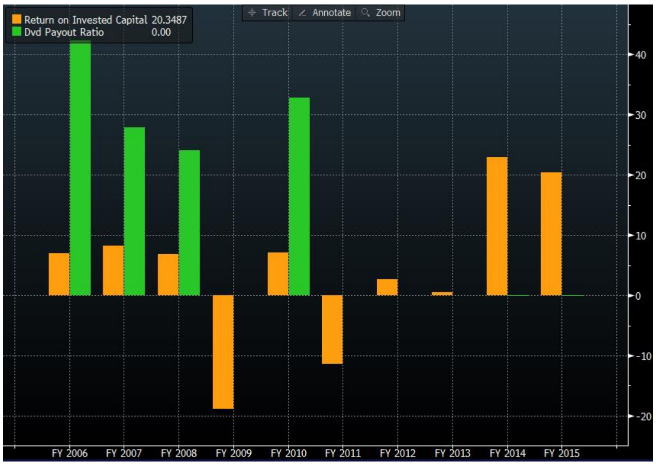
Negative History

SuperValu Inc. was a powerhouse grocery wholesaler and retailer that, at its peak, traded shares at $47 per share. In the early 2000's, the company really started to flourish as EBITDA and net income were rapidly increasing. All of their profitability margins, such as ROIC, were also getting better. The combination of their increasing profitability and a positive economic outlook sparked management to expand. In 2006, SuperValu Inc. completed a massive 9.7 billion dollar deal to acquire Albertsons, Inc. The deal included 11 different retail brands that totaled 2,150 stores. The deal dramatically increased revenue growth as it nearly doubled between 2006 and 2007. Their bottom line net income more than doubled over the same time period and the deal looked to be successful however, the deal left SuperValu in a highly leveraged position. In addition, the company had a reputation of paying high dividends exerting further pressure on them to perform. When the 2007-2009 recession hit, the consumer staples sector took a beating as a whole. Between 2008 and 2009 the XLP (United States consumer staples index fund) dropped from $285.30 to $218.77, the most significant one year decrease the index has ever experienced. The recession hit SuperValu even harder due to their highly leveraged position causing them to incur net income losses in 2009 of $2.854 billion. This loss was due to a huge impairment of intangible assets charge of $3.3 billion. The company had about $8 billion in debt at the time of the recession and the economic pressure caused their stock price to collapse.

Between 2007 and 2009 SuperValu's stock price decreased by 72% and they were quickly forced to make adjustments. The company has constantly been making changes to downsize including selling off major brands like Albertsons, Jewel-Osco and Shaw's. There was also an initiative to get rid of salaries and wages that were deemed unnecessary by laying off workers. The current CEO, Sam Duncan, has changed the mindset of SuperValu. Rather than focusing on large top line growth, he is focusing on increasing profitability metrics and creating value for the company. In the eyes of the market SuperValu Inc. was formerly a flourishing company that still has not made a recovery. That is not a fair assumption, SuperValu Inc. is a new company with an old name. Their new style of operation and the potential of the stock is lost in the market due to their previous disappointments.

Smarter Growth and Value Creation

After the recession, SuperValu faced many difficult management decisions, as they knew the severity of the financial position they were in. In the past the company was very loose with investment decisions, focusing solely on how the investments affect their revenues and income. This style of investment generated higher income for the company, for a given period of time, but ended up hurting the value of the company. Management neglected to evaluate their return on invested capital in comparison to their cost of capital. In 2006, when they completed the large deal for Albertsons they generated huge increases in revenue and net income but they destroyed value in the company. In 2006, ROIC was just 4.64 and with a WACC of 8.29, the company had an economic value added spread of -3.65, meaning the project was actually losing value for SuperValu Inc. The problem was amplified when they were hit with the $3.3 billion dollar impairment charge in 2009, as their economic value added spread plummeted to -27.90. When Sam Duncan was hired as CEO the ROIC for SuperValu was 0.54, currently ROIC is 20.35. He was able to do this by divesting 5 of its largest retail brands, laying off workers and consolidating positions within the company. There was an increased focus on efficiency and cutting any expense that was not absolutely necessary. One major expense that management dealt with was the payment of dividends. They were paying approximately 60 cents per share up until 2011 when it decreased to 35 cents per share and then was eventually discontinued in 2014. When a company decreases their dividend payouts it is a clear sign of financial distress, which they were clearly experiencing.



(Green represents div. payout ratio, Yellow represents ROIC)

However, management took the capital they would have given out as a dividend and used it to make their operations more efficient. By the end of all the budget cuts the company was generating revenues that were less than half of what they were in previous years but their profitability ratios and margins increased significantly. This new style of management has changed the company entirely and setup a nice framework for the company to begin growing.

The Retirement of CEO, Sam Duncan

On October 2nd, 2015 Sam Duncan announced that he would retire in February of 2016 causing the stock price of SuperValu to fall to its 52 week low making it the perfect time to buy stock in SVU. With the retirement announcement it was also announced that Bruce Besanko would take over for Duncan. Besanko has his MBA in finance from the University of Chicago and has numerous years of financial leadership experience. He has held CFO positions in several companies such as Yankee Candle, Circuit City and OfficeMax. He and Duncan worked together at OfficeMax and held key leadership positions until they were acquired by Office Depot. Duncan brought him aboard at SuperValu and together they rebuilt the framework of the company. With Duncan leaving, Besanko will be able to continue focusing on value creation and steadily growing the company. Therefore the announcement of Duncan's retirement further undervalues the stock making it a perfect time to act.

Conclusion

I am recommending a buy on SuperValu, Inc. The company's past struggles are too heavily weighted in the current valuation of the stock. They now have a solid framework for growth as it is focused more on value creation than revenue generation. Increasing profitability margins and ratios show the company has made the proper steps in becoming more efficient. The stock price is undervalued and now is the perfect time to buy.

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SUPERVALU Inc.	SVU	Analyst Matthew Schilling	Current Price $7.58	Intrinsic Value $9.10	Target Value $11.66	Divident Yield 0%	1-y Return: 53.87%	BULLISH

General Info

Sector	Consumer Staples
Industry	Food and Staples Retailing
Last Guidance	July 28, 2015
Next earnings date	October 16, 2015

Market Data

Enterprise value	$4,592.99
Market Capitalization	$629,466.45
Daily volume	40.21
Shares outstanding	264.91
Diluted shares outstanding	265.50
% shares held by institutions	60.72%
% shares held by insiders	0.56%
Short interest	5.24%
Days to cover short interest	3.51
52 week high	$12.00
52-week low	$6.75
5y Beta	1.78
6-month volatility	38.88%

Peers	Market Cap.
Whole Foods Market, Inc.	$12,222.24
The Kroger Co.	$37,019.71
The Fresh Market, Inc.	$1,219.99
United Natural Foods, Inc.	$2,776.59
Sprouts Farmers Market, Inc.	$3,615.26
Casey's General Stores, Inc.	$4,177.20
Empire Company Limited	$7,577.03
Safeway Inc.	
Smart & Final Stores, Inc.	$1,254.69
Roundy's, Inc.	$135.33

Current Capital Structure

Total debt/Common Equity (LTM)	-2.49
Cost of Borrowing (LTM)	8.73%
Estimated Cost of new Borrowing	7.81%
Altman's Z	3.73
Estimated Debt Rating	C
Current levered Beta	1.12
LTM WACC	3.11%

Management

Professional	Title	Comp. FY2013	Comp. FY2014	Comp. FY2015
Duncan, Sammy	Chief Executive Officer, President and Directc	$2,713,299	$4,946,608	$6,917,850
Besanko, Bruce	Chief Operating Officer and Executive Vice Pi	$0	$5,166,576	$2,414,821
Burdick, Randy	Chief Information Officer and Executive Vice	$0	$2,247,341	$1,510,526
Haugarth, Janel	Executive Vice President and President of Inc	$1,607,424	$2,437,913	$3,598,587
Sales, Wayne	Executive Director	$5,776,806	$4,548,664	$200,000
Casteel, Ritchie	Chief Executive Officer of Save-A-Lot and Pr	$0	$0	$1,824,176

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	0.39%	5.87%	15.00%	4.26%
Last Quarter-1	-0.49%	4.88%	14.29%	4.32%
Last Quarter -2	2.57%	10.40%	28.57%	7.70%
Last Quarter -3	1.61%	-1.63%	-8.33%	2.93%
Last Quarter -4	0.95%	-2.41%	5.88%	2.41%
Standard error	0.5%	2.4%	6.1%	2.32%
Standard Error of Revenues prediction	0.5%			
Imputed Standard Error of Op. Cost predictio	2.4%			
Imputed Standard Error of Op. Cost predictio	5.6%			

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 9 years

General Assumptions

Money market rate (as of today)	0.27%
Risk-Free rate (long term estimate)	2.82%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	5.5%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$17,963.00
FY2016	0.5%	$18,059.62
FY2017	2.4%	$18,496.31
FY2018	2.8%	$19,005.98
FY2019	4.7%	$19,896.90
FY2020	3.8%	$20,661.70
FY2021	3.4%	$21,368.72
FY2022	3.2%	$22,054.86
FY2023	3.1%	$22,739.76
FY2024	3.1%	$23,433.95
FY2025	3.0%	$24,143.15
Continuing Period	3.0%	$24,867.44

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Sub-industry)	Adjustment per year
Operating Cash/Rev.	0.00%	1.40%	0.2%
NWV/Rev.	0.51%	0.54%	0.0%
NPPE/Rev.	7.98%	20.68%	1.4%
Dpr/NPPE	18.91%	11.66%	-0.8%
NOPAT MARGIN	2.04%	3.06%	0.1%
Op. Exp./Rev.	95.46%	94.08%	-0.2%
SBC/Rev.	0.13%	0.21%	0.0%
Rent Exp./Rev.	0.70%	0.00%	-0.1%
R&D/Rev.	0.00%	0.00%	0.0%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	12.18%	18.73%	0.7%
ROIC	12%	10.87%	-0.09%
EV/Rev.	0.27x	0.58x	0.03x
EV/EBITA	8.60x	11.91x	0.37x
Debt/Equity	-249%	129%	42.0%
Unlevered beta	-2.01	0.54	0.28
Cost of Borrowing	2%	6%	0.5%
Dividends/REV	0%	1%	0.1%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Money market rate
Other claims on the firm's assets	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.335%, 5.5%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.78
1-year target price σ(ε)	$0.39

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Enterprise Value	Net Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	11.7%	3.1%	$3,089.06	$8,867.78	$4,704.64	264.91	$10.93
FY2016	12.2%	3.5%	$2,977.04	$8,818.06	$4,395.56	264.91	$12.59
FY2017	12.9%	3.9%	$3,053.22	$8,842.48	$4,253.81	264.91	$13.39
FY2018	13.0%	4.6%	$3,214.77	$8,991.76	$4,260.44	264.91	$14.06
FY2019	13.0%	5.4%	$3,483.59	$9,306.00	$4,375.80	264.91	$14.65
FY2020	12.7%	6.3%	$3,760.03	$9,689.01	$4,499.53	264.91	$15.39
FY2021	12.4%	7.2%	$4,045.74	$10,161.95	$4,635.14	264.91	$16.36
FY2022	12.3%	8.1%	$4,342.48	$10,742.31	$4,790.00	264.91	$17.61
FY2023	12.2%	9.1%	$4,651.70	$11,449.99	$4,952.34	264.91	$19.24
FY2024	12.2%	10.1%	$4,974.56	$12,308.82	$5,118.47	264.91	$20.74
FY2025	11.7%	9.8%	$5,124.56	$13,069.63	$5,097.55	264.91	$22.91
Continuing Period	10.9%	6.8%	$6,995.56				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $9.1; the 3σ(ε)-adjusted target price is $11.66; and the analysts' median target price is $10.61

Sensitivity Analysis

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance