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BJORKLUND FUND

November 4th , 2017

Hostess: TWNK

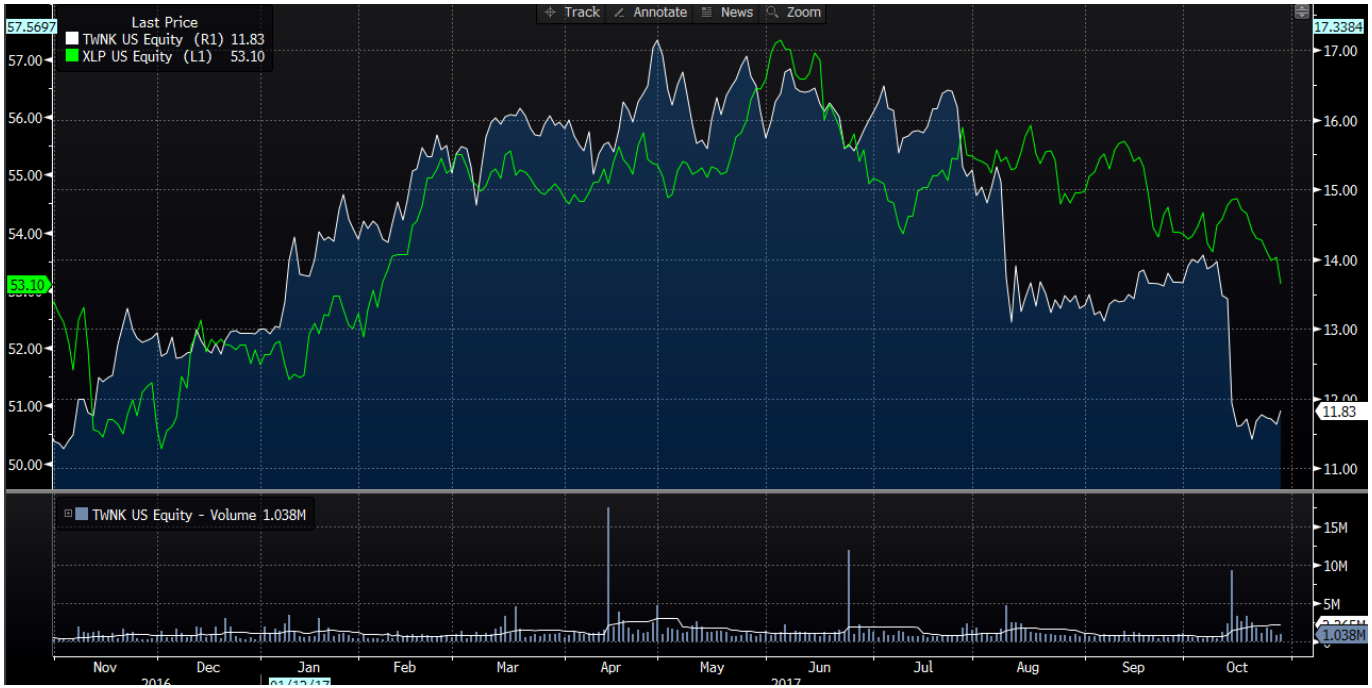
Timothy Shumsky

Sector: Consumer Staples
Industry: Packaged Foods & Meats
Current Price: $11.63
Target Price: $12.64

BUY

Current Price:	$11.63
Target Price:	$12.64
Market Cap:	1.54B
Average Volume:	1.34M
ROE:	18.05%
Ke:	9.7%

Company Description: Hostess is a sweet goods manufacturer based out of Kansas City, Mo. The company creates iconic products such as "Twinkies", "Ho-Ho's", and "Dum-Dum's".



Thesis: Hostess is currently in a market which has been heavily affected by diet trends, wage growth from collective bargaining agreements, and a

Catalysts:

- **Short Term (within the year):** The Company has been revitalized since its

slew of overleveraging. This has led to companies, such as Hostess, being beaten up on prices. The company has restructured themselves by fixing wage issues and is now in a very good position to redeem past mistakes. Hostess has done this while maintaining a brand loyalty.

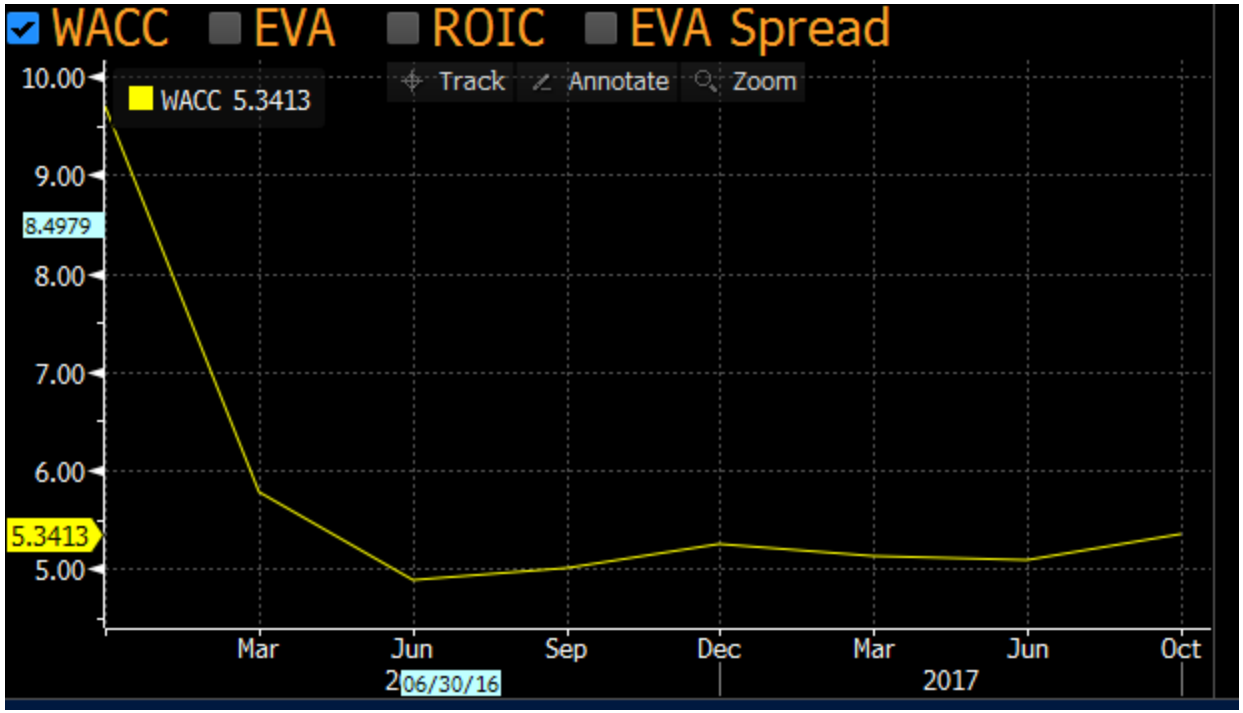
11/30/2015 re-entrance into the market. The company has engaged in cost cutting initiatives by cutting unionized employees, this trend should continue.

- **Mid Term (1-2 years):** The Company is trying to re-enter convenience store markets. This is an area Hostess can excel once they regain shelf-space.
- **Long Term (3+):** Hostess is currently operating below ROE and below ROIC of the market with gross and operating margins far above market; this means financing costs are destroying net income. Once the debts of past financing are covered, all ratio based investor will gain interest.

The Rebirth of the Twinkie:

Hostess was originally birthed in 1919 as a confections retailer that had only one product, the "Hostess Cupcake". This company slowly transformed into a multi-product business that has sold many notable creations. This success all came crashing down when in 2012 the company became over levered to the point they went bankrupt. At this time, the majority of the company's employees were protected under a collective bargaining agreement; these employees were not satisfied with the terms of their employment and were under strike causing a deficiency of cash inflows and an inability to pay back debtors. The company was purchased out of bankruptcy in 2014 and was taken public again in November of 2015. The company has made a few fundamental changes. The first fundamental change the company made was that it has phased employment out of collective bargaining agreements; of its 1300 employees only 400 are currently protected. This is a far cry from the companies once 8000 employees, of the 8000 employees approximately 6000 were under a collective bargaining agreement at the time of bankruptcy. The cost cutting initiatives of employees have also extended into its transportation costs. The

company has taken its transportation and distribution costs from 34% of revenue down to 16%. The company has also become much more efficient in its production of the products themselves. The company is opting to mechanize as many processes as possible, and close extraneous locations. Although the company is still debt heavy it has taken steps to improve processes and has recently refinanced, taking its WACC from 9.6% down to 5.3% in the last year showing a step in improving value building processes.



Floundering Market:

The confections market has exhibited no growth in recent years. In the years the company was not active, due to bankruptcy, the "Sweet Baked Goods" segment contracted 8%. The contraction happened during a time of growth within the economy which shows just how poorly the segment has performed. Since the companies reintroduction into the market they have contributed 72% of the growth to the sweet baked goods category between July 31, 2013 and December 31, 2016; according to their 10K. They also claim to account for 100.5% of this year's growth, claiming the rest of the market contributed (.5%) growth in their 10K. The floundering of this

market provides a positive outlook because it will lead to elimination of competition. The elimination of competition will either come from bankruptcy or acquisition, this has showcased itself already in a failed, but attempted, acquisition of Mondelez attempting to acquire Hershey. Since Hostess has both a recognizable brand and industry leading margins, the company lends itself to being an acquisition target. The other alternative is that the company functions with an industry that becomes consolidated as companies begin to die, this may lead to larger margins and more profitability.

Financial Analysis:

Hostess currently holds 993 Million dollars' worth of long term debt, this is a lot for a company who has a market cap of 1.54 billion. The company currently holds a debt to equity ratio of 2.22. A debt to equity ratio such as this tells investors that the company is highly leveraged. A highly levered company often has a hard time creating a large ROE or ROIC as the financing cost essentially kill the net income. Many times, invested capital is very high initially to lay the groundwork for the infrastructure of the company; but because invested capital is so high, any return in the numerator of ROIC is highly diluted. In order to look at companies ROIC capital for a highly levered company it is sometimes better to look at NOPAT/IC. In this instance I have taken the NOPAT for this year of 96.56; and the cash adjusted invested capital for the year prior of 555.49. The reason I have used the year prior because this invested capital should realize its investment in the next year. The number results in a return of 17.38%. For a company, similar to hostess, it is important to look at free cash flow and recognize if the company is cash flow positive (put in FCF number), which it is. Another important note to look at is the fact that for a company who is so highly levered and has a history of bankruptcy their WACC is not overly expensive, the company recently refinanced their debt and took their WACC from 9.6% down to 5.3%. The refinancing effect should trickle its way down into net income by the next quarter through reducing their finance costs. With a positive net income the company will become much easy to value through ratios, thus appearing more often in a

simpler screening process. With the added value and ratio based investors the company will have upward pressure on price.

Aggressive Growth Model:

If there is one thing that Hostess has made clear, it is the fact that they are interested in continued expansion. The company has been building up product lines. The company has reintroduced old favorites such as Twinkies, Snoballs, Donettes, Coffeecakes, etc. and also been slowly introduced new and innovative products. Hostess has introduced a fried Twinkie. Fried Twinkies have long been a staple of summer camp grill outs and by introducing a prepackaged fried Twinkie Hostess has made this favorite available at any time. The company has also introduced ice creams. Ice creams are important to not as they must be shelved in the refrigerated goods department. Refrigerated goods is notoriously a hard place to get shelving space and signals that the company is not shying away from this competition. Adding to the idea of aggressive growth, the company has also made clear

that they will not shy away from the idea of acquisitions if they feel as though the company will gain. Management has proven they are looking out for investor's best interests when in investor relation slides the company explicit

addresses that they look for companies that will increase EPS. The investor slides also have given reassurance that this company is not solely dependent on one distributor. Brick and mortar stores have struggled recently, giving way to more accessible ecommerce stores. Hostess has entered the ecommerce segment which shows they are taking part in growing ecommerce sales and also attempting to diversify the possibility of brick and mortar failures.

Multiple Valuation:

In the most recent earnings the company reported earnings in-line with expectations. Although the company did not miss its earnings it still has high financing costs which distort ROE and ROIC. The P/E multiple is also widely distorted for Hostess. When looking at multiples many investors use the trailing P/E that averages the last four-quarter's earnings, the price is then divided by these earnings. Hostess reported a (.25) EPS in its first quarter traded. The next two quarters were followed by .15 EPS and .18 EPS. Since the company reported this negative earnings call, its P/E is severely inflated and difficult to accurately use. Instead of using the distorted numbers there are three multiples that can be looked at to try to value the company. The first multiple to look at would be EV/EBITDA. EV/EBITDA is un-skewed by the financing costs the company is experiencing from reopening and re-vamping its entire production facility. The company beats all competitors in this category indicating it is a market leader here. Next, investors could look at price/book. P/B is an important ratio as the company just upgraded a lot of their production facility; a lot of this funding has come from the debt that destroys figure such as net income because of finance expense. Again, the company is an industry leader with the closest competitor being 67% more expensive as a percentage of their book value. The final multiple the company can look at is FCF/basic shares. The company currently has $1.30 per basic share. Other than Hershey, whose basic share price is 9.11x more expensive, this is industry leading. All three of these multiples indicate that the company is either industry leading or undervalued.

	Name	Mkt Cap (USD)	P/E	ROE	ROIC LF	BEst EV/BEst EBITDA	P/B	FCF/Basic Sh↓ T12M
	Median	2.28B	21.09	12.14%	8.28%	13.03	3.20	1.13
100)	HOSTESS BRANDS INC	1.51B	47.04	6.60%	3.31%	11.20	1.61	1.30
101)	HERSHEY CO/THE	22.35B	21.09	125.26%	19.66%	13.03	27.15	4.40
102)	TOOTSIE ROLL INDS	2.28B	34.46	9.35%	8.28%	--	3.20	1.13
103)	MONDELEZ INTERNATION...	62.35B	19.81	12.14%	5.98%	14.87	2.40	0.95
104)	ROCKY MOUNTAIN CHOC ...	67.89M	19.41	18.42%	15.15%	--	3.48	0.81

Margin Growth:

Although the company has a very recognizable brand which has allowed it to re-enter the market with little effort Hostess has one true competitive advantage, margins. Margins have come to this come through becoming much more efficient in their product. Hostess has done away with the majority of their unionized workers who were very expensive. Of its 1300 employees only 400 are currently protected, this is a far cry from when nearly all employees were unionized. Hostess has also reduced its transportation costs down to nearly have of what it was as a percentage of revenue. Currently the company is looking at gross margins for their "sweet goods" segment of 45.1% and 29.9% within their other segment. Although their "sweet goods" segment is very promising in its dominance on margins the "other" segment is equally as impressive. The "other" segment is a new segment having been reintroduced since relaunch. The new other segment holds a stark contrast to the "sweet goods" segment which holds some products that have been in production for longer than 75 years. The age of the production means that the company has room to grow in this segment from setting up infrastructure, finding distribution chains of raw materials, how to distribute the product, and how to produce it efficiently. This room to grow gives great promise. Another reason to have faith in the margins of the "other"

Other	
Revenue	20.4
Gross Profit	6.1
Sweet baked goods	
Revenue	182.7
Gross Profit	82.4

segment is because Hostess has added ice cream to their line-up. Since ice cream must be refrigerated it does not hold as high of margins. These margins are usually around 30% which is exactly where Hostess is at; this company has entered a brand-new market and already commands the same margins more seasoned companies hold. When looking at a company like Unilever though, you see they have 43.1% gross margin with the company explicitly stating that this was pushed by the improved margins of ice cream. The Unilever example shows that the company can still grow this segment and become even more margin dominant. All of these margins are very competitive, if not the best, within this respective market. These margins may be deceiving though because they have been calculated using GAAP accounting methods. When these margins are looked at on a cash-basis the company's margins are: EBITDA margin is 26.35%, Operating margin is 27.74%, and Gross margin is 32.48%. All of these numbers have been calculated from the 6/30/2017 release. Even using the cash-basis the company is beating the market in two of the three margin bases; even when compared to GAAP figures.

	Name	Mkt Cap (USD)	OPM LF	GM:Q	EBITDA to Net Sales:Q
	Median	2.28B	18.16%	43.53%	22.07%
100)	HOSTESS BRANDS INC	1.51B	24.51%	43.53%	28.99%
101)	HERSHEY CO/THE	22.35B	21.59%	45.31%	24.65%
102)	TOOTSIE ROLL INDS	2.28B	13.10%	38.08%	17.47%
103)	MONDELEZ INTERNATION...	62.35B	18.09%	39.46%	21.29%
104)	ROCKY MOUNTAIN CHOC ...	67.89M	18.16%	53.40%	22.07%

Acquisition:

This company currently falls in a market where there is attempt consolidation. Two large examples of failed, but attempted, acquisitions was that Mondelez tried to acquire Hershey. Recently, Nestlé's U.S. division has been rumored to have been offered up to $3 billion dollars to be bought out. In an industry that is no longer growing

at a fast pace because of health-consciousness. The market has actually fallen 1.6% in sales from 01/28/2016 through 12/31/2016. Since the industry isn't performing well companies no longer have the luxury of worrying about how they will increase revenues. The companies in this industry now must focus on how they will cut costs to increase profits with the current market share they have. Since Hostess is an industry leader in operating margin and Ebitda to net sales it is very likely that this company will become a target for acquisition. Hostess holds expertise in both efficient production and how to systematically lay off deadweight employees. If the rumored Nestle deal is true the $3 billion dollar price tag is 3.25x revenues for the company. Assuming Hostess gets a more conservative 3x revenue for a similar acquisition, 3 times last year's revenues imputes an acquisition price of $2.183 billion dollars. If the hypothetical acquisition price for Hostess is divided by the current number of diluted shares outstanding, this imputes a share price of $20.36 per share; this would be a 75% return from the current stock price.

Conclusion:

Hostess has been able to restructure itself in a matter of years. The company is set to create disruption in a market that has not seen much disruption in recent years. Hostess has management that has experience in the field and in implementing cost cutting initiatives. The fact that this management is in place should be reassuring to investors and proof of their expertise is already on display. Hostess has gone from someone incapable of covering costs to a company with market leading margins in their primary segment, and are well on their way to duplicating this success in their new segments. Hostess has also begun to encroach on companies shelve space. The shelve space they are encroaching on has also created disruption within a stagnate market. I believe there is two outcomes for this company. The first outcome is that this company continues to expand on its goods and specialty segment; creating economies of scale and further improving margins and revenue base. The second

outcome is that with added competition within the space, larger companies feel the disruption and race to acquire Hostess. Both of these outcomes result in investors making money which is why I am suggesting a buy for Hostess.

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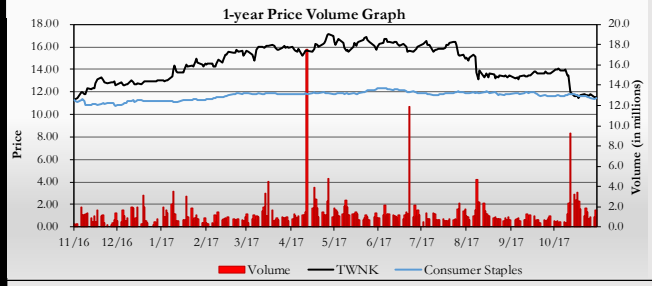
Hostess Brands, Inc. (TWNK)

CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by TIMMMMMY!	Current Price:	$11.63	Intrinsic Value	$10.27	Target 1 year Return: 12.14%
11/2/2017	Divident Yield:	1.7%	Target Price	$12.84	Probability of Price Increase: 80%

1-year Price Volume Graph



Description

Hostess Brands, Inc., a packaged food company, focuses on developing, manufacturing, marketing, selling, and distributing fresh sweet baked goods in the United States.

General Information

Sector	Consumer Staples
Industry	Food Products
Last Guidance	November 3, 2015
Next earnings date	November 8, 2017
Estimated Country Risk Premium	6.42%
Effective Tax rate	24%
Effective Operating Tax rate	24%

Market Data

Market Capitalization	$1,135.91
Daily volume (mil)	0.75
Shares outstanding (mil)	99.99
Diluted shares outstanding (mil)	141.58
% shares held by institutions	116%
% shares held by investments Managers	80%
% shares held by hedge funds	10%
% shares held by insiders	1.84%
Short interest	12.65%
Days to cover short interest	9.45
52 week high	$17.18
52-week low	$11.19
Volatility	0.00%

Past Earning Surprises

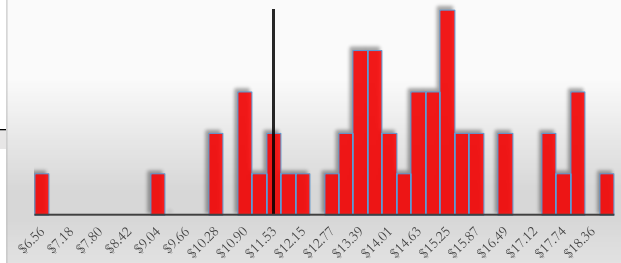
Quarter ending	Revenue	EBITDA
6/30/2016	N/A	N/A
9/30/2016	N/A	N/A
12/31/2016	321.79%	300.01%
3/31/2017	0.90%	0.81%
6/30/2017	-1.20%	-6.99%
Mean	107.16%	97.94%
Standard error	107.3%	101.1%

Peers

Snyder's-Lance, Inc.
Lancaster Colony Corporation
John B. Sanfilippo & Son, Inc.
Amplify Snack Brands, Inc.
Tootsie Roll Industries, Inc.
The Hain Celestial Group, Inc.
Pinnacle Foods Inc.
B&G Foods, Inc.

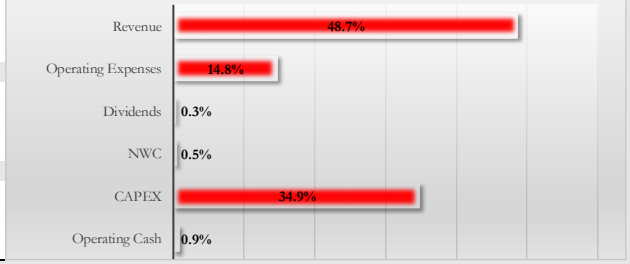
Management	Position	Total compensations growth	Total return to shareholders
Metropoulos, C.	Executive Chairman	N/M	0% per annum over 0y
Toler, William	President, CEO & Director	N/M	0% per annum over 0y
Jacobs, Andrew	Executive VP & Chief Commerc	N/M	0% per annum over 0y
Peterson, Thomas	Executive VP & CFO	N/M	N/M
Cramer, Michael	Executive VP & Chief Adminis	N/M	N/M
Sebree, Jolyn	Senior VP, General Counsel &	N/M	N/M

Intrinsic Value Distribution--Probability (Upside)=80%

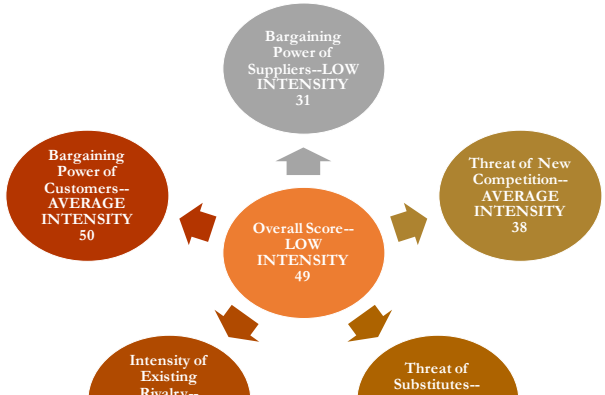


Profitability	TWNK (LTM)	TWNK (2 years historical average)	Peers' Median (LTM)
Return on Capital (GAAP)	20.0%	6.93%	9.19%
Operating Margin	12%	14.19%	5.29%
Revenue/Capital (GAAP)	1.64	0.49	1.74
ROE (GAAP)	-3.0%	9.0%	24.7%
Net margin	5.0%	10.5%	5.0%
Revenue/Book Value (GAAP)	-0.59	0.85	4.98
Invested Funds	**TWNK (LTM)**	**TWNK (2 years historical average)**	**Peers' Median (LTM)**
Cash/Capital	-86.7%	27.5%	12.7%
NWC/Capital	2.8%	4.4%	15.8%
Operating Assets/Capital	100.6%	66.4%	51.3%
Goodwill/Capital	83.4%	1.7%	20.2%
Capital Structure	**TWNK (LTM)**	**TWNK (2 years historical average)**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	1.44	0.37	0.40
Cost of Existing Debt	4.6%	4.6%	4.8%
CGFS Rating (F-score, Z-score, and default Probability)	BB	CC	BBB
WACC	4.1%	9.0%	9.3%

Sensitivity Attribution Analysis



Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue Growth Forecast	NOPAT Margin Forecast	Revenue to Capital Forecast
Base Year	23%	23.6%	1.22
6/30/2018	6%	-1.2%	0.38
6/30/2019	4%	-0.2%	0.39
6/30/2020	6%	2.7%	0.43
6/30/2021	6%	6.0%	0.46
6/30/2022	0%	7.0%	0.46
6/30/2023	-2%	5.6%	0.46
6/30/2024	1%	5.1%	0.48
6/30/2025	2%	4.5%	0.50
6/30/2026	2%	4.0%	0.53
6/30/2027	2%	26.0%	0.58
Continuing Period	2%	26.0%	0.56

Period	Return on Capital Forecast	WACC Forecast	Price per share Forecast
Base Year	28.9%	4.1%	$10.36
6/30/2018	-0.5%	9.4%	$13.56
6/30/2019	-0.1%	9.2%	$15.40
6/30/2020	1.1%	9.2%	$17.12
6/30/2021	2.8%	9.2%	$18.88
6/30/2022	3.2%	9.5%	$20.63
6/30/2023	2.6%	9.3%	$22.24