Freshpet, Inc. (FRPT)
G’day Mate - Competitive Dominance Reinforced, Growth Story Intact

FRPT remains a rare breed. FRPT’s 1Q results were fine, and the company reaffirmed its top-line guidance while trimming FY20 adjusted EBITDA plan by ~8% to account for incremental revenue growth supporting investments. Beyond the numbers, FRPT’s successful defense of their dominant competitive position and improving leverage to digital grocery disruption represent durable positives not to be overlooked from this report. Bottom line, the key pillars of this rare consumer staple growth story remain very much intact. We reiterate our Outperform rating and $90 price target.

1Q recap. Sales increased ~28% y/y to ~$70M (vs. our ~$69M estimate), though consumption growth was even stronger at +33%. Adjusted EBITDA of $5.7M (+106% y/y) comfortably exceeded our $3.9M and was in line with Street expectations. The upside vs. our model reflected stronger adjusted gross margin (49.5% vs. our 48.2%), which benefited from a mix shift to rolls.

Underlying demand trends remain robust. Consumption growth was tracking +29% prior to the surge in March (+42%). While take-away slowed in April (+10%), FRPT’s market share continued to build, and trends have been improving since the lull. Importantly, household penetration continues to grow rapidly (total/core dog +28%/+33% to 2.58%/2.00%).

Dominant competitive position reinforced. While COVID-19 disruptions to certain retail partners will limit new store placement growth to ~1,000 net adds this year (prior plan 1,400+), the exit of Australia’s Real Pet Food from the U.S. market has provided an opportunity for FRPT to acquire second fridges in ~500 pet specialty doors. With RPF representing FRPT’s only real “fresh” competitor, their inability to make it work in the U.S. (despite being the pioneer of fresh pet food in Australia) simply reinforces the significant competitive moat that surrounds FRPT’s business.

Capitalizing on the digital grocery surge. Consumer trial of online grocery has surged during the pandemic. With six direct-to-home delivery platform options (Instacart, Amazon Fresh, Prime Now, Fresh Direct, Peapod, Shipt), four “click and collect” retail partnerships (Walmart, Kroger, PetSmart, Petco), a new "SOS" ordering option launching next week, and additional direct partnerships on tap, FRPT is well positioned to benefit from this structural change in consumer shopping behavior in the years ahead.

2020 outlook. FRPT continues to target 2020 revenue of >$310M (+26%) as incremental investments in advertising, retail, and digital efforts help offset lower new store placements. That said, these costs are expected to pressure adjusted EBITDA by ~$4M, resulting in new guidance of >$44M. Importantly, key capacity expansion plans remain largely intact with FRPT’s Kitchens 2.0 project’s completion date only delayed a month (now targeting October launch). Our 2020/2021 revenue estimates are effectively unchanged, but we have reduced FRPT-defined adjusted EBITDA to $44.5M/$64.6M (from $48.2M/$65.9M).

Reiterate Outperform rating. With a large TAM, proven customer acquisition formula, and competitive/first-mover advantages, FRPT remains a rare breed. Price target remains $90.

Freshpet pioneered the concept of “fresh food” for pets in North America and provides fresh/refrigerated pet foods/treats across over ~21,000 retail outlets.

Peter S. Benedict
Sr. Research Analyst
pbenedict@rwbaird.com
203.353.1049

Justin E. Kleber, CFA
Sr. Research Associate
jkleber@rwbaird.com
314.445.6517

Alex A. Vasti
Research Analyst
avasti@rwbaird.com
414.298.2480
Details

1Q recap. Sales increased ~28% y/y to $70M (above our ~$69M estimate), though consumption growth was even stronger (Nielsen Mega-Channel +33%). Adjusted EBITDA more than doubled to $5.7M (+106% y/y) – comfortably exceeding our $3.9M and in line with Street expectations. The upside vs. our model was driven by stronger adjusted gross margin (49.5% vs. our 48.2%E), which benefited from a mix shift to rolls as FRPT was capacity constrained on bags in 1Q.

Underlying demand trends remain robust. Consumption growth increased 29% prior to the surge in March (consumption accelerated to +42% for the 4-weeks ended 3/28). While take-away slowed in April (+10% for the 4-weeks ended 4/25), FRPT’s market share continued to build, and trends have been improving since the post-surge lull even as FRPT shifted advertising spend into May and August (due to the lack of capacity/supply). Total household penetration increased to 2.58% in 1Q20 (+28% y/y), with growth in core dog even stronger (+33% to 2.00%). While buying rate was effectively flat at ~$113, this is not all that surprising given the significant influx of new users added to the franchise (new users spend less). Bottom line: we remain encouraged by the continued growth in key customer acquisition metrics.
Dominant competitive position reinforced. While COVID-19 disruptions to certain retail partners will limit new store placement growth to ~1,000 net adds this year (prior plan 1,400+), the exit of Australia's Real Pet Food from the U.S. market has provided an opportunity for FRPT to acquire second fridges in ~500 pet specialty doors. With RPF representing FRPT's only real "fresh" competitor, their inability to make it work in the U.S. (despite being the pioneer of fresh pet food in Australia) simply reinforces the significant competitive moat that surrounds FRPT's business.

Capitalizing on the digital grocery surge. Consumer trial of online grocery has surged during the pandemic. With six direct-to-home delivery platform options (Instacart, Amazon Fresh, Prime Now, Fresh Direct, Peapod, Shipt), four "click and collect" retail partnerships (Walmart, Kroger, PetSmart, Petco), a new "SOS" ordering option launching next week, and additional direct partnerships on tap, FRPT is well positioned to benefit from this structural change in consumer shopping behavior in the years ahead.

Key capacity expansion plans remain largely intact. FRPT has experienced some delays related to the construction of Kitchens 2.0, so current plans call for operations to commence in October (instead of September). In order to help catch up to demand in 2Q, FRPT is adding a second shift to Kitchens South by June. While capacity of FRPT's Fresh From the Kitchen product could get tight in 3Q (resulting in shipments moving into 4Q), all other bags will have adequate capacity.

2020 outlook. FRPT continues to target 2020 revenue of >$310M (+26%) as incremental investments in advertising (taking advantage of low cost media and investing behind proven campaigns), retail (placing double fridges in >1,000 outlets; incremental retail coverage to help with re-stocking/out-of-stocks), and digital efforts (media-driven curbside pickup partnerships, "SOS" ordering option) help offset lower new store placements. That said, these costs are expected to pressure adjusted EBITDA by ~$4M, resulting in new guidance of >$44M. Of note, management's revenue guidance assumes retailers resume fridge placements and new item distribution in 3Q. From an adjusted EBITDA standpoint, guidance excludes ~$4M of COVID-19 related costs, most of which should prove transitory (related to additional compensation and increased absenteeism).

Estimates. Our 2020/2021 revenue estimates are effectively unchanged, but we have reduced our FRPT-defined adjusted EBITDA to $44.5M/$64.6M (from $48.2M/$65.9M).
Investment Thesis

Freshpet is a true “category creator” disrupting the North American pet food industry. Founded in 2006, FRPT is pioneering the concept of “fresh food for pets” in North America and currently provides fresh, all-natural, refrigerated pet foods and treats across a number of retail channels (mass/grocery, club, natural, pet specialty, online) in the $30B-plus North American pet food market. As such, FRPT is a true “category creator,” one that is disrupting the industry with a unique and innovative offering that holds powerful appeal for consumers, retailers, and (in our view) investors alike. With company-owned coolers in over ~21k retail locations and the only coast-to-coast refrigerated distribution network in pet, FRPT enjoys significant “first mover” competitive advantages and stands on the cusp of a multi-year cycle of robust top- and bottom-line growth.

Living at the intersection of two powerful secular trends. Big picture, we continue to believe FRPT is uniquely positioned to benefit from two powerful secular trends in CPG – the humanization of pets and the desire for fresh, all-natural foods. When combined with rising Millennial/Gen Z pet ownership, the business is also poised to enjoy a natural demographic tailwind as FRPT over-indexes to these cohorts.

The path to $1B in revenue by 2025. Based on the aforementioned secular and demographic trends, management believes the addressable household opportunity for the brand currently stands at 20M "Prime Prospects" – nearly triple the 7.5M TAM identified in 2016. Management has utilized several approaches to assessing the businesses longer-term opportunity. The results all point to a similar conclusion – a market opportunity >$1.7B at retail by 2025 (or ~$1B in wholesale revenue). Management's $1B revenue target is predicated on adding 5M U.S. households to the franchise (vs. ~3M today). While media investments will remain a key driver of customer acquisition (leveraging proven strategies plus new tests), FRPT is also focused on converting "aware, non-user" households through ongoing product innovation and expanding accessibility/availability (via multi-fridge stores, ecommerce/digital).

Capacity expansion plans ramping. Kitchens 2.0 is on track for 3Q20 production and the planning process for Kitchens 3.0 (which will be located in Ennis, TX) is already kicking into gear. Expected to start production sometime in 2022, phase 1 of this new facility will cost ~$300M for ~400k sqft and bring ~$300M in production capacity. We estimate phase 2 could cost another ~$160M for ~200k sqft and ~$400M of additional capacity (assumes more efficient lines). All told, K3.0 should bring an incremental ~$700M of production capacity to FRPT by 2025.

Significant profitability growth on tap. Despite increased media spend and some expense pull-forward related to future capacity, G&A leverage is expected to result in 2020 adjusted EBITDA growth >50% (well ahead of >26% sales growth). Looking to 2025, while structural improvements in adjusted gross margin will largely be offset by mix, G&A leverage is expected to result in ~25% adjusted EBITDA margins (vs. 2020E’s ~14%).

Price target rationale. Our $90 price target reflects a blended NTM multiple of ~5x/~22.5x on FY25E sales/EBITDA discounted back at ~10%. Given FRPT’s potential to deliver outsized sales and profit growth, we believe these target multiples are justified given BUFF’s takeout multiples of ~6x/25x TTM sales/EBITDA.

Risks & Caveats

Managing rapid growth. Freshpet’s growth strategy must be carefully managed (e.g., ensuring retail partner buy-in, launching effective/successful new products, driving customer adoption and purchase velocity, containing fridge opening/production operating costs) in order to achieve sales/margin targets
and appropriate returns on capital. Ongoing fridge growth and new product launches could also cannibalize existing sales and damage the company’s overall operating results.

- **Concentration of retail customer base.** A significant portion of Freshpet’s sales currently come from several key retail accounts, including Walmart, Kroger, and Target. As a result, FRPT’s operations are more susceptible to the pet category management actions and purchase behaviors across these key retailers than the operations of more diversified pet food manufacturer competition.

- **Key person risk.** CEO Billy Cyr, COO/President Scott Morris, and the broader FRPT senior leadership team have been and will continue to be instrumental to FRPT’s growth, continued financial performance, retail relationships, and expansion strategy. Any departures from or disruption to this management team could adversely impact the company’s strategy and growth prospects.

- **Vendor/supply chain risk.** FRPT’s ability to manage commodity/input costs (most notably chicken, but also beef) and produce/deliver pet food products at the highest levels of quality (e.g., close to human-grade, free from bacterial contamination) remains a significant driver of FRPT’s success (as well as key risk) longer term.

- **Increased competition.** Expansion of large players (Mars Petcare, Nestle Purina Pet, Hill’s, Blue Buffalo, etc.) into the fresh/refrigerated/raw/frozen pet food category, as well as efforts on the part of small/upstart pet food competitors in growing market share, launching innovative products and/or increasing promotional pricing, could adversely impact Freshpet’s sales and/or margins.

- **Changes in U.S. consumer spending and pet ownership trends.** Any abrupt change in U.S. consumer spending or pet-related trends (e.g., pet ownership rates, pet food purchase tastes, etc.) could have a material impact on Freshpet’s ability to deliver sales and margin growth.

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**Company Description**

Founded in 2006, Freshpet pioneered the concept of “fresh food” for pets in North America and currently provides fresh, all-natural, refrigerated pet foods and treats across a number of retail channels (mass/grocery, club, natural, pet specialty, online). As such, Freshpet is a true “category creator,” one that is disrupting the $30B-plus North American pet food industry with an innovative/differentiated offering that is positioned at the intersection of two key secular trends — growing pet humanization and increased consumer focus on health and wellness. The company’s first-mover status, in-house “know-how,” and unique retail distribution model (products available in >21k company-owned refrigerators across all major retail channels) represent significant competitive advantages and barriers to entry, which should provide a solid foundation for profitable growth over the next several years.
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