ZACKS | Our Research. Your Success. Jul 14, 2020

Grocery Outlet Holding (GO)

$39.56 (As of 07/13/20)

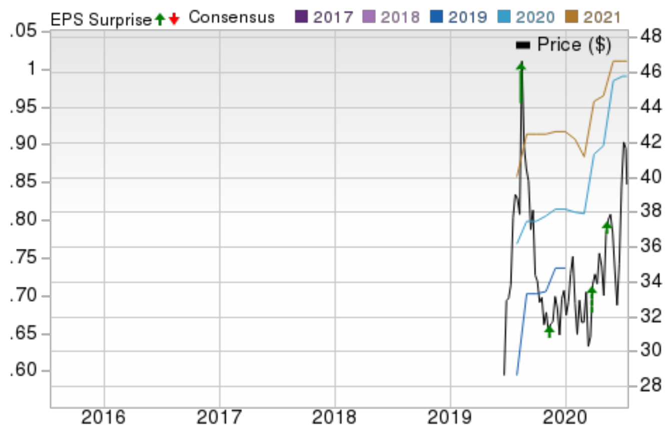
Price Target (6-12 Months): **$42.00**

Long Term: 6-12 Months	**Zacks Recommendation:** (Since: 06/08/20) Prior Recommendation: Outperform	**Neutral**
Short Term: 1-3 Months	**Zacks Rank:** (1-5) Zacks Style Scores: Value: C | Growth: A | Momentum: C	**3-Hold** VGM:B

Summary

Shares of Grocery Outlet have risen and outpaced the industry in the past three months. The stock got a boost following the company's first-quarter 2020 results, wherein both the top and the bottom line grew year over year. While earnings beat the Zacks Consensus Estimate for the fourth straight quarter, net sales came in line. Notably, the company benefited from coronavirus-led demand. Also, we note that increase in the number of customer transactions and rise in average transaction size aided comparable-store sales growth. While gross margin also expanded during the quarter, management cautioned that a number of COVID-related factors may impact the same in the near future. Also, the company expects SG&A expense, as a percentage of sales, to increase in the second quarter, thanks to incremental costs associated with the ongoing pandemic.

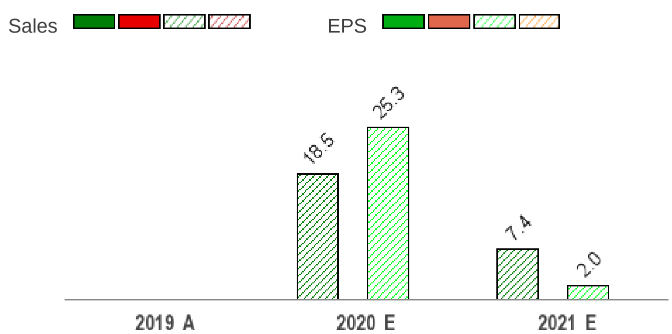
Price, Consensus & Surprise



Data Overview

52 Week High-Low	**$47.57 - $28.11**
20 Day Average Volume (sh)	**1,964,786**
Market Cap	**$3.6 B**
YTD Price Change	**21.9%**
Beta	**NA**
Dividend / Div Yld	**$0.00 / 0.0%**
Industry	**Consumer Products - Staples**
Zacks Industry Rank	**Top 14% (34 out of 251)**
Last EPS Surprise	**12.5%**
Last Sales Surprise	**0.0%**
EPS F1 Est- 4 week change	**0.0%**
Expected Report Date	**08/11/2020**
Earnings ESP	**11.6%**
P/E TTM	**40.0**
P/E F1	**40.0**
PEG F1	**3.0**
P/S TTM	**1.3**

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2021	768 E	805 E	814 E	808 E	3,260 E
2020	760 A	761 E	727 E	775 E	3,034 E
2019		645 A	653 A	656 A	2,560 A

EPS Estimates

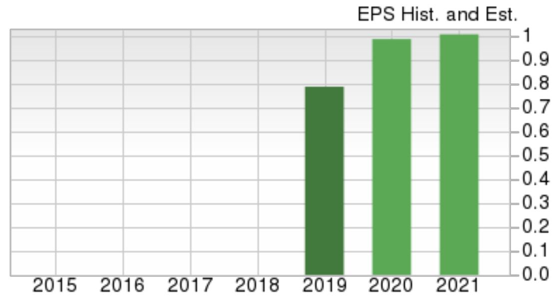
	Q1	Q2	Q3	Q4	Annual*
2021	$0.25 E	$0.26 E	$0.27 E	$0.24 E	$1.01 E
2020	$0.36 A	$0.22 E	$0.22 E	$0.22 E	$0.99 E
2019		$0.20 A	$0.22 A	$0.21 A	$0.79 A

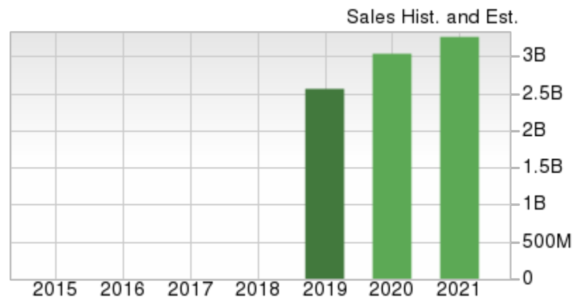
*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 07/13/2020. The reports text is as of 07/14/2020.

Overview

Founded in 1946 and headquartered in Emeryville, CA, Grocery Outlet Holding Corp. is a high-growth, extreme value retailer of quality, name-brand consumables and fresh products that are sold through a network of independently owned and operated stores. Notably, the company's stores offer a fun, treasure hunt shopping experience in an easy-to-navigate, “small-box” format of size 15,000-20,000 square feet. The company offers discounted, overstocked and closeout products from name brand and private label suppliers. Stores are operated by Entrepreneurial Independent Operators (“IOs”).





The company’s flexible buying model allows it to offer products significantly below those of conventional retailers and discounters. It acquires merchandise at considerable discounts arising from order cancellations, manufacturer overruns, packaging changes and approaching “sell-by” dates. Notably, an ever-changing assortment of “WOW!” deals, supplemented by competitively priced everyday staples attracts bargain-hunters.

As of Mar 28, 2020, the company had 355 stores in California, Washington, Oregon, Pennsylvania, Idaho and Nevada. The stores offer a curated and ever-changing assortment of approximately 5,000 SKUs. The company’s perishable departments, which comprises dairy and deli, produce and floral and fresh meat and seafood, represented about 34% of 2019 sales. Non-perishable departments including grocery, general merchandise, health and beauty care, frozen foods and beer and wine, represented roughly 66% of sales. The company also provides a wide range of Natural, Organic, Specialty and Healthy or “NOSH” products. Consumables represented approximately 90% of product sales in 2019.

In June 2019, the company completed the initial public offering.

Reasons To Buy:

> We believe that Grocery Outlet's compelling value proposition will continue to attract bargain-hunters, encourage customers to revisit stores, and increase basket sizes.

▲ **Impressive Q1 Results Boost Stock:** Grocery Outlet impressed investors with its first-quarter 2020 financial results, wherein both the top and the bottom line improved year over year. While earnings surpassed the Zacks Consensus Estimate, net sales came in line. The company gained from coronavirus-led demand. As people started dining at home and maintaining social distancing, they have been stocking essential items. The company reported adjusted earnings of 36 cents a share that comfortably beat the Zacks Consensus Estimate of 32 cents and improved significantly from 15 cents reported in the prior-year period. Higher net sales and lower interest expense contributed to the bottom line. This was the fourth straight quarter of positive earnings surprise. Net sales came in at $760.3 million, up 25.4% from year-ago quarter courtesy of comparable-store sales growth and contribution from 32 net new stores opened since the end of the first quarter last year. The company made sure to maintain both opportunistic and everyday products in high volumes. The company managed its inventory well to meet customers' burgeoning demand amid the crisis. Notably, the company's shares have surged 17.6% in the past three months against the industry's decline of 6.1%.

▲ **Differentiated Business Model:** Grocery Outlet looks well poised from a long-term perspective given its flexible sourcing and distribution model that differentiates it from traditional retailers. The company provides customers quality, name-brand consumables and fresh products at exceptional values. The company purchases merchandise at considerable discounts that arise from order cancellations, manufacturer overruns, packaging changes and nearing "sell-by" dates. We note that a typical "Grocery Outlet basket" is priced roughly 40% below than conventional grocers and approximately 20% below than leading discounters. The company's product offering is ever-changing with a constant rotation of opportunistic products, complemented by everyday staple products. Opportunistically sourced products accounts for approximately half of purchasing mix, and are referred to as "WOW!" deals. Moreover, in order to drive customers and keep them well informed about price, quality and service, the company refreshed its brand image — updated website, modernized logo and adopted new marketing campaign "Welcome to Bargain Bliss."

Notably, the company's stores are operated by Entrepreneurial Independent Operators ("IOs"). The company enters into an "Operator Agreement" with each IO, which grants it a license to operate a particular Grocery Outlet Bargain Market retail store. The agreement provides the IO with greater decision-making power, which includes merchandising, selecting about 75% of products, managing inventory, marketing locally, directly hiring, training and employing store workers and supervising operations. The company shares 50% of store-level gross profits with IOs.

▲ **Decent Comps Performance:** We believe that Grocery Outlet's compelling value proposition will continue to attract bargain-hunters, encourage customers to revisit stores, and increase basket sizes. Cumulatively, these will drive comparable-store sales growth. Notably, expanded product offerings, more "WOW!" Deals and increased customer awareness will help fuel sales. In terms of offerings, the company source on-trend products based on consumer preferences. With consumers now looking for fresh and healthy options, the company shifted its focus to Natural, Organic, Specialty and Healthy or "NOSH" products, and fresh seafood and grass-fed meat. The company's opportunistic purchasing strategy and marketing initiatives have helped it to register comparable-store sales growth for 16 straight years. In fiscal 2019, comparable store sales had risen 5.2%.

The company registered comparable-store sales growth of 17.4% during the first quarter of 2020 courtesy of increases in both the number of customer transactions and average transaction size. We note that the company's comparable-store sales rose a meager 4.2% in the prior-year period. Management notified that through the first five weeks of the second quarter, comparable-store sales growth is tracking in the mid-teens. The increase in comparable-store sales reflects rise in average basket size partly offset by lower store traffic owing to "shelter-in-place restrictions."

▲ **Store Growth Opportunity:** Grocery Outlet had earlier indicated that based on experience and in addition to research conducted by eSite Analytics, it believes that there is a room for more than 1,500 additional locations in the states in which it currently operates and neighboring ones. In the long term, the company believes that there is potential to establish 4,800 locations nationally. In fiscal 2019, the company had opened 34 new stores. During the first quarter of 2020, it inaugurated 10 new stores and closed two taking the total count to 355 stores in six states — California, Washington, Oregon, Pennsylvania, Idaho and Nevada. The company plans to open 28-30 outlets this year with no additional store closure planned. The company remains optimistic about 10% annual unit growth. Notably, the company has been making strategic investments to improve its functionality and scalability. These include enhanced point of sale, warehouse management, vendor tracking, store communications, real estate lease management, and financial planning and analysis.

▲ **Financial Flexibility:** Grocery Outlet's ended first-quarter 2020 with cash and cash equivalents of $160.9 million compared with $28.1 million at the end of the preceding quarter and $19.6 million at the end of the year-ago period. Total debt, including the $90 million drawn on the revolving credit facility of First Lien Credit Agreement, was $550.2 million at the end of the quarter under review, compared with $873.7 million at the end of the prior-year period. The decline in total debt was due to the prepayment of debt in conjunction with initial public offering in June 2019 and an additional voluntary prepayment of debt in October 2019. Net cash provided by operations during the quarter was $67.8 million, which reflects a considerable increase from $22.2 million in the year-ago period. Moreover, at the end of the quarter under review, the company's debt-to-capitalization ratio was a respectable 0.63 compared with 0.75 for the industry. Also, the company's "times interest earned" ratio of 1.6 has improved on a sequential basis — 1.4 at the end of the fourth quarter of 2019 — and stands better than the industry's ratio of 1.3. The times-interest-earned ratio is very important for some companies, as it measures a company's ability to meet its debt obligations based on its current income.

Reasons To Sell:

- **Near Term Headwinds:** Industry experts believe that continued volatility given the uncertainty regarding consumer demand, changes in shelter-in-place orders, the impact of economic stimulus, and potential for large scale liquidation sales may have a bearing on sales results. Grocery Outlet also cautioned that gross margin might be impacted in the near term due to a number of COVID-related factors, such as higher distribution and supply chain costs, short-term product mix shifts and potential increases in commodity prices.

> Grocery Outlet cautioned that gross margin might be impacted due to a number of COVID-related factors, such as higher distribution and supply chain costs, short-term product mix shifts and potential increases in commodity prices.

- **Higher Operating Expenses a Concern:** We note that overall operating expenses jumped 33.1% to $220.2 million during the first quarter of 2020, thanks to higher SG&A expenses that rose 22.3%. We note that as a percentage of net sales, operating expenses increased 170 basis points to 29%. Grocery Outlet anticipates incremental operating expenses related to the coronavirus outbreak during the second quarter. These include cleaning and safety costs, corporate and distribution center personnel expenditures, costs for protective equipment, and supply chain expenses. Management believe that the impact of these expenses may extend to future quarter as well, if the pandemic is not contained.

- **Stock Looks Little Stretched:** Considering price-to-earnings (P/E) ratio, Grocery Outlet looks pretty overvalued when compared with the industry as well as the S&P 500. The stock has a forward 12-month P/E ratio of 39.53, which is below the median level of 41.15 and the high level of 68.32 scaled in the past one year. On the contrary, the forward 12-month P/E ratio for the industry and the S&P 500 is 19.62 and 22.69, respectively.

- **Stiff Competition:** Grocery Outlet competes with both conventional grocery stores and discounters. The company faces stiff competition from a diverse group of retailers, including discount, conventional grocery, department, drug, convenience, hardware, variety, online and other specialty stores. The company views discount retailers of consumable products, such as Walmart, WinCo, Aldi and Lidl, as major competitors, as these provide wide range of products at relatively low prices, when compared with conventional grocery stores. While the company has embraced online and digital marketing, it has thus far not pursued e-commerce. The company also competes against a fragmented landscape of opportunistic purchasers, such as Big Lots and 99 Cents Only.

- **Dip in Consumer Sentiment May Impact Sales:** Any dip in consumer confidence — a key determinant of the economy's health — may have serious bearing on spending. The company's customers remain sensitive to macroeconomic factors including interest rate hikes, increase in fuel and energy costs, credit availability, unemployment levels, and high household debt levels, which may negatively impact their sentiment. This may adversely impact its growth and profitability.

Last Earnings Report

Grocery Outlet Q1 Earnings Beat Estimates, Increase Y/Y

Quarter Ending	03/2020
Report Date	May 11, 2020
Sales Surprise	0.00%
EPS Surprise	12.50%
Quarterly EPS	0.36
Annual EPS (TTM)	0.99

Grocery Outlet Holding Corp. recently came out with its first-quarter 2020 financial results, wherein both the top and the bottom line improved year over year. While earnings surpassed the Zacks Consensus Estimate, net sales came in line. The company gained from coronavirus-led demand. As people started dining at home and maintaining social distancing, they have been stocking essential items.

Let's Take an Insight

The owner and operator of grocery store chains reported adjusted earnings of 36 cents a share that comfortably beat the Zacks Consensus Estimate of 32 cents and improved significantly from 15 cents in the prior-year period. Higher net sales and lower interest expense contributed to the bottom line. This was the fourth straight quarter of positive earnings surprise.

Net sales came in at $760.3 million, up 25.4% from year-ago quarter courtesy of comparable-store sales growth and contribution from 32 net new stores opened since the end of the first quarter last year. Management in its first-quarter preliminary results had highlighted that the company registered "the wave of customer pantry-loading" in the month of March. Grocery Outlet made sure to maintain both opportunistic and everyday products in high volumes. The company managed its inventory well to meet customers' burgeoning demand amid the crisis.

Notably, the company registered comparable-store sales growth of 17.4% during the quarter under review on account of increases in both the number of customer transactions and average transaction size. We note that the company's comparable-store sales rose a meager 4.2% in the prior-year period.

Management notified that through the first five weeks of the second quarter, comparable-store sales growth is tracking in the mid-teens. The increase in comparable-store sales reflects rise in average basket size partly offset by lower store traffic owing to "shelter-in-place restrictions."

Margins & Costs

We note that gross profit increased 26.7% year over year to $237 million on account of new store growth and rise in comparable store sales. Notably, adjusted EBITDA surged 45.8% to $57 million, while adjusted EBITDA margin increased 100 basis points to 7.5%.

Although SG&A expenses surged 22.3% to $186.9 million, as a percentage of net sales the same contracted 60 basis points to 24.6%. The increase in SG&A expenses led to a jump of 33.1% in overall operating expenses of $220.2 million. As a percentage of net sales, operating expenses increased 170 basis points to 29%.

Grocery Outlet anticipates incremental operating expenses related to the coronavirus outbreak during the second quarter. These include cleaning and safety costs, corporate and distribution center personnel expenditures, costs for protective equipment, and supply chain expenses.

Store Update

During the quarter under review, Grocery Outlet opened 10 new stores and closed two taking the total count to 355 stores in six states. The company plans to open 28-30 outlets this year with no additional store closure planned. The company remains optimistic about 10% annual unit growth.

Other Financial Aspects

Grocery Outlet ended first-quarter 2020 with cash and cash equivalents of $160.9 million compared with $19.6 million at the end of the same period in fiscal 2019.

Total debt, including the $90 million drawn on the revolving credit facility of First Lien Credit Agreement, was $550.2 million at the end of the quarter under review, compared with $873.7 million at the end of the prior-year period. The decline in total debt was due to the prepayment of debt in conjunction with initial public offering in June 2019 and an additional voluntary prepayment of debt in October 2019.

Net cash provided by operations during the quarter was $67.8 million, which reflects a considerable increase from $22.2 million in the year-ago period. The company incurred capital expenditures (excluding the impact of landlord allowances) of $28.2 million during the quarter under review. Management envisions capital expenditures between $90 million and $100 million for the full year.

Valuation

Grocery Outlet shares are up 21.9% in the year-to-date period and nearly 11.8% in the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Consumer Staples sector are down 7.2% and 11.9%, respectively, in the year-to-date period. Over the past year, the sub-industry and the sector are down 10.4% and 20.1%, respectively.

The S&P 500 index is down 0.8% in the year-to-date period but up 6.5% in the past year.

The stock is currently trading at 39.53X forward 12-month earnings, which compares to 19.62X for the Zacks sub-industry, 19.48X for the Zacks sector and 22.69X for the S&P 500 index.

Our Neutral recommendation indicates that the stock will perform in line with the market. Our $42 price target reflects 41.9X forward 12-month earnings.

Industry Analysis **Zacks Industry Rank:** Top 14% (34 out of 251)

Top Peers

Company (Ticker)	Rec	Rank
Big Lots, Inc. **(BIG)**	Outperform	1
Dollar General Corporation **(DG)**	Outperform	1
Ollies Bargain Outlet Holdings, Inc. **(OLLI)**	Outperform	1
Sprouts Farmers Market, Inc. **(SFM)**	Outperform	1
Caseys General Stores, Inc. **(CASY)**	Neutral	2
Dollar Tree, Inc. **(DLTR)**	Neutral	3
Target Corporation **(TGT)**	Neutral	3
Walmart Inc. **(WMT)**	Neutral	3

Industry Comparison Industry: Consumer Products - Staples

	GO	X Industry	S&P 500	BIG	OLLI	WMT
				Industry Peers		
Zacks Recommendation (Long Term)	Neutral	-	-	Outperform	Outperform	Neutral
Zacks Rank (Short Term)	3	-	-	1	1	3
VGM Score	B	-	-	A	D	A
Market Cap	3.59 B	3.46 B	21.41 B	1.47 B	6.01 B	367.02 B
# of Analysts	6	5	14	6	7	14
Dividend Yield	0.00%	0.00%	1.92%	3.21%	0.00%	1.67%
Value Score	C	-	-	A	F	B
Cash/Price	0.04	0.05	0.07	0.20	0.02	0.04
EV/EBITDA	41.27	14.27	12.70	5.61	32.61	12.32
PEG Ratio	2.96	2.96	2.87	0.87	2.13	4.95
Price/Book (P/B)	4.54	3.91	3.02	1.66	5.49	4.95
Price/Cash Flow (P/CF)	29.89	14.77	11.61	5.20	40.78	14.63
P/E (F1)	39.90	19.81	21.07	6.12	40.80	26.26
Price/Sales (P/S)	1.32	1.64	2.23	0.27	4.19	0.69
Earnings Yield	2.50%	4.26%	4.47%	16.33%	2.45%	3.81%
Debt/Equity	1.69	0.76	0.76	1.68	0.27	0.85
Cash Flow ($/share)	1.32	1.82	6.94	7.18	2.31	8.85
Growth Score	A	-	-	A	B	A
Hist. EPS Growth (3-5 yrs)	NA%	2.13%	10.85%	7.48%	31.17%	1.81%
Proj. EPS Growth (F1/F0)	25.32%	5.31%	-9.37%	66.21%	17.71%	0.06%
Curr. Cash Flow Growth	75.51%	5.95%	5.51%	0.18%	8.58%	-0.12%
Hist. Cash Flow Growth (3-5 yrs)	NA%	5.06%	8.55%	2.93%	30.96%	-0.31%
Current Ratio	1.94	1.43	1.30	1.48	2.48	0.77
Debt/Capital	62.86%	53.86%	44.46%	62.66%	21.48%	46.01%
Net Margin	0.89%	1.26%	10.59%	5.05%	9.48%	2.81%
Return on Equity	9.78%	13.96%	15.75%	19.99%	12.56%	18.33%
Sales/Assets	1.24	1.21	0.55	1.67	0.91	2.27
Proj. Sales Growth (F1/F0)	18.53%	2.91%	-2.54%	10.94%	12.58%	4.16%
Momentum Score	C	-	-	A	C	C
Daily Price Chg	-4.93%	-0.94%	-0.19%	-7.55%	-6.10%	-0.89%
1 Week Price Chg	-0.90%	0.01%	-0.41%	0.07%	7.46%	9.62%
4 Week Price Chg	19.34%	3.88%	-0.91%	7.42%	1.43%	9.69%
12 Week Price Chg	13.22%	19.59%	10.22%	90.56%	59.53%	-0.25%
52 Week Price Chg	11.81%	10.57%	-7.40%	57.60%	8.87%	12.65%
20 Day Average Volume	1,964,786	750,215	2,267,087	2,297,864	1,320,015	9,863,774
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	37.34%	2.93%	0.00%
(F1) EPS Est 12 week change	-9.32%	-1.85%	-6.60%	103.67%	24.81%	-3.44%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	229.38%	0.00%	0.00%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	A
Momentum Score	C
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

Disclosures

This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock.The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment.This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time.ZIR is not a broker-dealer.ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients.Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.