

Introduction

Vitamin Shoppe, Inc. is a leading global retailer and manufacturer of nutritional products. Vitamin Shoppe manufactures and brands its own products, in addition to also manufacturing a variety of white-label products for third-parties. Its proprietary brands include BodyTech, True Athlete, and ProBioCare. Coupled with its e-commerce store, Vitamin Shoppe has approximately 750 physical stores spread across its two brands, Vitamin Shoppe, and Super Supplements.



THE VITAMIN SHOPPE®

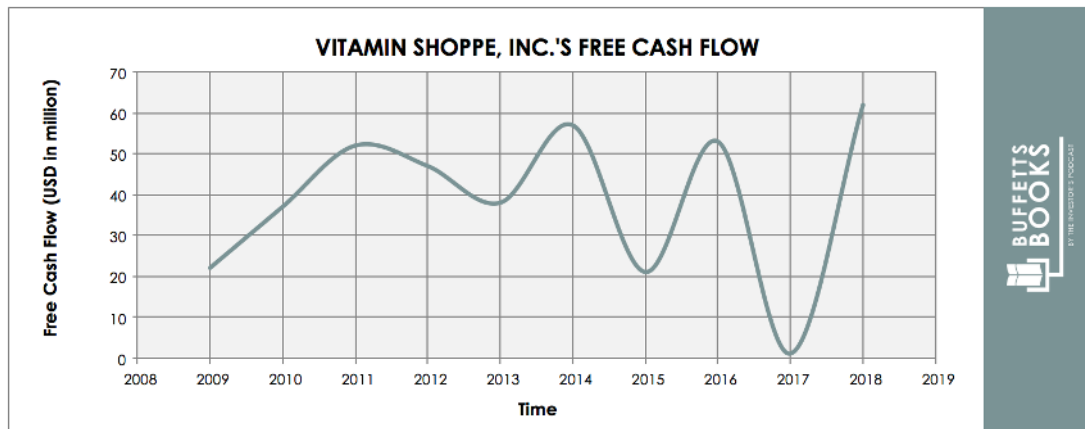
At the time of this writing, Vitamin Shoppe, Inc.'s market capitalization is about \$94 million, which has been cut from nearly \$2 billion as recently as early-2013. Its revenue and cash flows for the 2018 fiscal year were \$1.1 billion and \$62 million, respectively. Its stock has hit a 52-week low of \$3.32 and a 52-week high of \$13.95. At today's price of \$4.34, is the stock undervalued?



Source: Google Finance

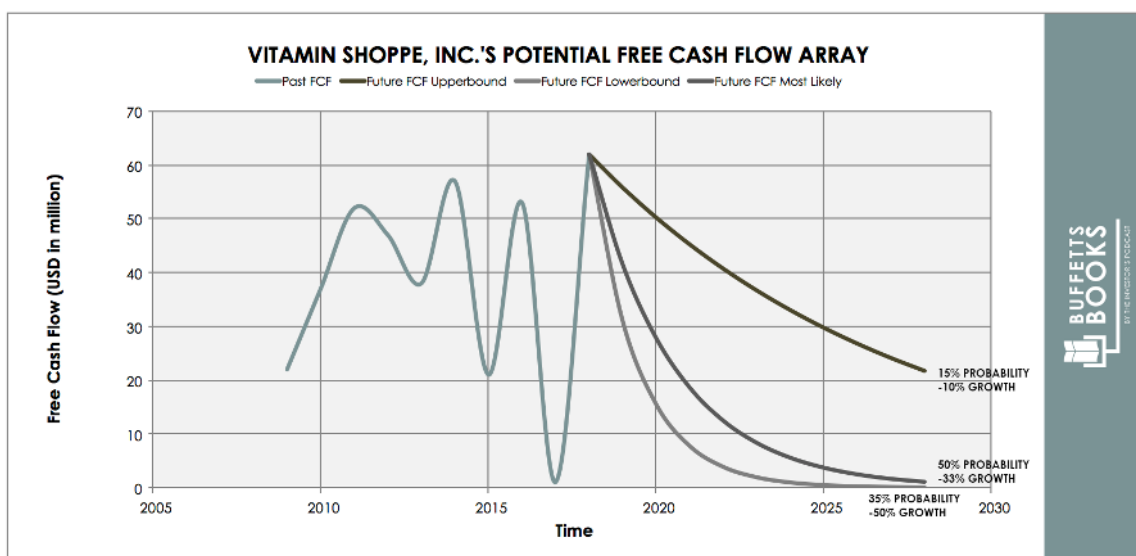
The Intrinsic Value of Vitamin Shoppe, Inc.

With net income being easily manipulated and not a true representation of the cash available to a company's owners, we prefer to use free cash flow to value a company's stock. Using free cash flow instead of net income allows investors to value the company based on the actual cash it generated for its owners. Below is a chart of VSI's free cash flow for the past ten years.



From its 2009 level of \$22 million, Vitamin Shoppe, Inc. was able to grow its free cash flow to over \$60 million in 2018, a compounded annual growth rate (CAGR) of 11%. However, this growth was not linear. Vitamin Shoppe, Inc.'s free cash flow generation was volatile without much of a dependable trend. Had 2018 not been its strongest year in over a decade, Vitamin Shoppe, Inc.'s cash flow would have contracted since 2009. The various risks discussed in detail in the 'Risks' section below may illustrate some of the causes of Vitamin Shoppe, Inc.'s volatile free cash flow generation, as well as potential issues it may face into the future.

To value Vitamin Shoppe, Inc.'s stock, its future free cash flows must be estimated. To do this, the array model below has been developed to account for three potential outcomes of Vitamin Shoppe, Inc.'s future free cash flows.



The upper-bound line (red) illustrates a -10% contraction rate with a 15% probability of occurrence. The middle line (blue) represents a -33% contraction with a 50% probability of occurrence. Finally, the lower-bound (green) line illustrates a -50% contraction with a 35% probability of occurrence. The contraction in Vitamin Shoppe, Inc.'s free cash flow generation is assuming that competitors and online retailers continue to disrupt the retail industry, Vitamin Shoppe, Inc.'s management fails in its strategies to expand its physical store footprint, its agreement with the US Navy isn't material, and the United States economy enters into a recessionary period over the next one to three years, resulting in a significant slowdown in consumer spending.

Looking at these growth rates and probabilities, you will notice there is a drastic skew towards negative growth/contraction over the next decade. This may seem quite pessimistic, which it is, but it also allows for a conservative valuation and to consider the potential downside risk. While protecting downside risk is almost always important when investing, I see it as even more important in a situation like with Vitamin Shoppe, Inc. The stock may appear undervalued on a quantitative basis, which we will visit in the next part of this article, but there are two important considerations that must be addressed when analyzing Vitamin Shoppe, Inc.'s stock: 1) The base off which the future free cash flow growth is calculated, and 2) the momentum of the stock, before arriving at an "undervalued" conclusion.

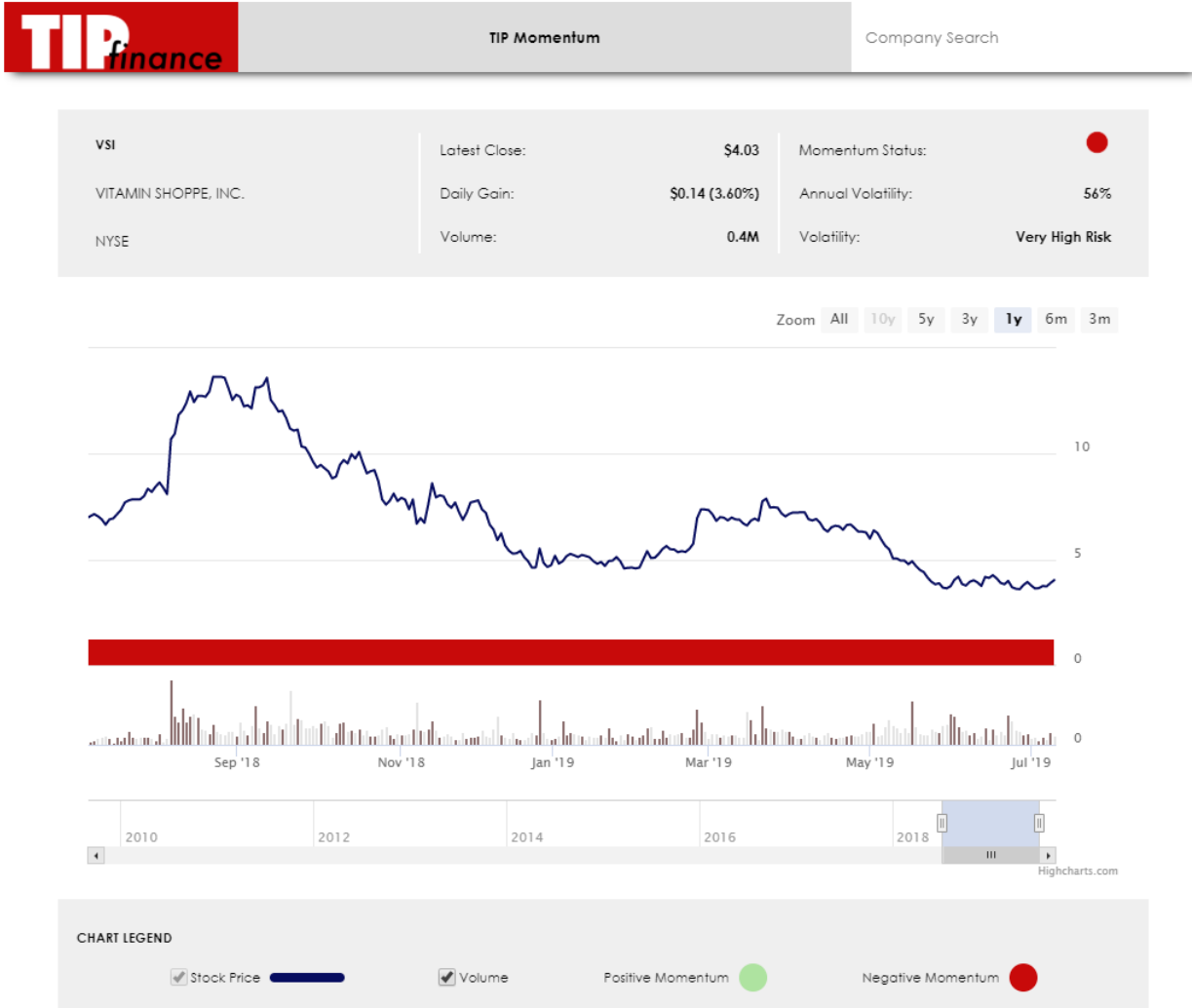
When looking at our estimates for Vitamin Shoppe, Inc.'s future free cash flow generation, it is being estimated off of the most current year's levels (2018). The reason this can potentially be an issue if overlooked is because this free cash flow figure is much higher than 2017, and is the highest in the last decade. This means that 2019 is being estimated off of a high base and subsequent years are continuing to be estimated off of this potentially misleading figure. If 2018 levels had been more in line with previous years, the estimate for 2019 and subsequent years would be significantly less, which would reduce Vitamin Shoppe, Inc.'s value. While this does not necessarily indicate that Vitamin Shoppe, Inc.'s stock is overvalued, it is an important consideration that needs to be thought about when completing a quantitative analysis, as we did.

Second, it is also important to consider the current momentum of the stock. Even if a stock may appear to be undervalued on a quantitative basis, it can continue in a downtrend for a significant period of time if it is showing negative momentum, resulting in a test on an investor's emotions and psychology. In the TIP Finance chart below, you can see that Vitamin Shoppe, Inc.'s stock is currently in a negative momentum trend, which furthers my concern regarding it being a potential "falling knife" or "value trap."

When creating a valuation model, one must consider the economic environment in which their investment would be made. In today's environment, it is likely wise to estimate growth rates very conservatively with a margin of safety. Any outperformance of the conservative growth rates would provide investors with additional returns above and beyond what was expected.

It is also important to recognize that the above-estimated contraction rates are *not* expected to be exact each and every year over the next decade. In fact, that is very unlikely. Vitamin Shoppe, Inc.'s results will likely fluctuate from year-to-year. We do not attempt to estimate results on a yearly basis. Rather, we look to estimate accurate growth/contraction rates annualized over five to ten years.

Assuming the estimated outcomes discussed above prove accurate, Vitamin Shoppe, Inc.'s stock may be priced at a 13.7% annual return at today's price of \$4.34.



Source: [TIP Finance](#)

The Competitive Advantage of Vitamin Shoppe, Inc.

VSI's competitive advantages will be discussed in detail below:

- **Brand.** While VSI does face significant competition with many of its products, it does have a very strong brand. VSI's products are very well known across the world and are known for being high-quality. It will be able to leverage its strong brand as the company continues to expand and compete with other retailers.
- **Diversified Business.** Its diversified business model provides various avenues for potential growth, while also providing a hedge against competitive pressures. As the health and wellness industry continues to grow, VSI can take advantage of this buy, increasing its focus on manufacturing and white-labeling products to third-party companies. If its in-house brands continue to feel pressure, it can be offset by increasing its focus on white-label manufacturing.

Risk Factors

Let's look at the potential risks that can offset Vitamin Shoppe, Inc.'s competitive advantages discussed above:

- **Relatively Weak Balance Sheet.** Its balance sheet is heading in the right direction – management has paid off all of its short-term debt, and it is paying down its long-term debt. However, it has very little cash on its balance sheet, and a significant portion of its assets are tied up in “Other long-term assets” and “Property, Plant & Equipment.”
- **Severe Competition.** With the strong growth in the popularity of the health and wellness industry over the last five to seven years, there has been a massive influx of competition into the industry. Not only is it facing competition from other traditional players, but it is facing increased competition from independent providers and influencers. Influencers have been able to disrupt markets by using their following and marketplaces like Alibaba and AliExpress to source products. If you combine the significant growth in new and strengthening competitors with the issues being faced by physical retailers (due to Amazon), Vitamin Shoppe, Inc. is faced with competitive pressures it may not be able to overcome.
- **Economy.** Many of Vitamin Shoppe, Inc.'s products are discretionary and premium. This means that if/when the economy enters tough times, Vitamin Shoppe, Inc. is going to have weaker demand for its products in two-fold because, 1) consumers do not *need* its products, and 2) its products are expensive. When consumers have less disposable income, they will cut their spending on supplements, or transition away from the premium brands towards more affordable products.

Opportunity Costs

Although opportunity costs will not appear in your brokerage statements, it is a very real cost to investors that must be considered. When making an investment, an investor makes the conscious decision to forego other investment opportunities for the one chosen. Despite having a positive real result, an investment could actually be negative when considering opportunity costs if capital is not allocated to its most efficient use. Vitamin Shoppe, Inc. is currently priced to return better results than the 10-year treasury and the S&P 500 over the next decade, but it may not offer the best risk-adjusted return in comparison to other individual companies.

Macro Factors

Attempting to time the market is rarely a recipe for success when investing, but it would likely be unwise to not at least consider the overall macro environment. Specifically, with brick-and-mortar retailers like Vitamin Shoppe, Inc., economic conditions play a pivot role in their success. During a recessionary period, consumer spending is significantly reduced, and retailers see their sales plummet. Unemployment is currently at, or near, 50-year lows, and U.S. private debt levels have exceeded previous major financial crisis. With various economic indicators pointing to a potential peak, an investor should consider protecting oneself from an economic downturn.

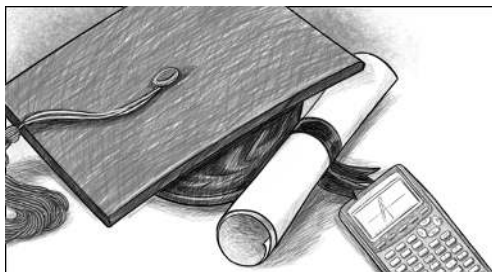
Summary

On a quantitative basis, Vitamin Shoppe, Inc. appears to fall well into Benjamin Graham's “cigar-butt” category or potentially a Warren Buffett value-investment. However, the negative momentum trend illustrated by the TIP Finance tool raises concern and may point to a value-trap more than a value-opportunity.

Vitamin Shoppe, Inc. provides a great example for investors of when they must look past the numbers and consider the qualitative side of the business. Purely quantitatively speaking, Vitamin Shoppe, Inc. would be a buy, but when you consider its negative momentum, the headwinds it faces, and the risks involved, an investor must carefully weigh the risk-reward opportunity presented. If you decide, based on your risk tolerance and holding period, that Vitamin Shoppe, Inc. provides a value-opportunity rather a value-trap, with more

potential upside than downside, it is recommended you consider your portfolio allocation strongly when initiating your position. Given the assumptions outlined in this analysis, a return of approximately 13.7% can be expected at today's prices.

Disclaimer: The author does not currently hold any ownership in Vitamin Shoppe, Inc. (VSI) and has no intentions of initiating a position over the next 72 hours.



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