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INVESTING

The Fresh Market Follows Whole Foods

By Julian Willis
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The Food Market Institute (FMI) recently issued a 2012 study of the grocery store sector and consumer shopping behaviors. Key findings were that smaller supermarket chains were experiencing significant growth, along with a long-term shift by consumers to value-seeking behavior of “natural” products. According to the FMI:

“One of the most significant shifts in value-seeking behaviors is how customers have changed their approach to private label or store brands during the recession. Private-label brands have seen a dramatic increase in sales since 2007…along with organic products. Nearly half (47%) of consumers now believe store brands have the same quality as national brands.”

Three Smaller Supermarket Brands

With this new study in mind, three publicly traded smaller supermarket chains, under $2.5 billion in market cap, are competing for market share and consumer dollars. These are The Fresh Market (TFM), Harris Teeter Supermarkets (HTSI), and Weis Markets (WMK). Of these three, Fresh Market is showing significant top-line growth and considerable expansion of its national footprint. The company is also poised to participate in the growth witnessed by Whole Foods Market, Inc. (WFM), by focusing on the organic food vertical and private-label branding.

The Fresh Market, with a $2.2 billion market cap, is headquartered in Greensboro, N.C. and considers itself a “specialty retail grocer,” operating 130 stores across 25 states. Founded in 1981, The Fresh Market has a gross margin of 34% and an operating margin (a key metric for grocers) of 7.7%. The company has a return on equity (ROE) of approximately 39.5% and strong quarterly-revenue growth of 15.3%.

Harris Teeter, with a $2.3 billion market cap, hails from Matthews, N.C. and was formerly known as Ruddick (changing its name in 2012). Harris operates 208 supermarkets, along with 143 pharmacies located inside its grocery stores. Harris Teeter has a lesser gross margin of 30%, an operating margin of approximately 3.7%, an ROE of about 9.6% and far lesser quarterly-revenue growth of just 4.3%.

Weis Markets, with a $1.1 billion market cap, is based in Sunbury, PA. The company owns and operates 165 stores in Pennsylvania, Maryland, New Jersey, New York, and West Virginia. Weis has a lower gross margin of 28% and sports a slightly higher operating margin than Harris Teeter of 4.7%. Weis has an ROE of 10.5% and quarterly revenue growth of 3.2% as of the company's first quarter of 2013.

The Importance of Levered Free Cash Flow

While Fresh Market is clearly outperforming its two primary competitors across most business metrics, a statistic called "levered free cash flow" is where the company truly shines. According to Investopedia.com, levered free cash flow (LFCF) is "the amount of cash that is left over…after interest on company debt has been paid." LFCF can tip-off investors as to whether a company is utilizing cash to reinvest back in its own business or spending heavily on acquisitions and other corporate excesses.

As of its most recent quarter, Fresh Market has positive levered free cash flow of $31.2 million and Harris Teeter followed close behind with $23.2 million, while Weis has a whopping decline of -$17.5 million in LFCF.

The Fresh Market has definite plans for those cash balances. According to Craig Carlock, Fresh Market's CEO, the company is opening "19 to 22 new stores, with two new stores opening in the first quarter; four to six new stores opening in the second quarter; and 13 to 15 new stores opening in the second half of the year."

Harris Teeter reported second quarter 2013 earnings on May 2 and reiterated its plans to pursue some expansion opportunities in the Washington, D.C. metro area in the second half of fiscal 2013. Unfortunately for Weis Markets, expansion in 2013 will be difficult, due to its lack of LFCF and the weaker state of its balance sheet.

Following the Focus of Whole Foods

Fresh Market is expanding faster than its two competitors, but it's also closely following the path paved by Whole Foods. Headquartered in Austin, Texas, Whole Foods now has a market capitalization of $19.4 billion and operates 340 stores in the U.S., Canada, and the United Kingdom. Two keys to Whole Foods's rapid growth have been higher-priced organic products and higher-margin private-label products.

In a November 2012 article entitled "Whole Foods Sees Continued Growth from Private Label," published by research firm Store Brands Decisions, Whole Foods CEO, John Mackey, stated: "An important element to our value strategy is to continue to expand our private label offering. We are very excited about our recent launch of 70 new "365" and "Whole Foods Market" exclusive brand frozen items."

Whole Foods' house brands have continued to inch up the company's margins. On May 7, the company reported second-quarter results, and delivered record operating margin of 7.5%, gross margin of 36%, and quarterly earnings growth of 20.3%. Whole Foods has now raised guidance for the remainder of fiscal 2013 and is the leading industry in gross margin.

Fresh Market has been paying close attention and has followed Whole Foods' success with its own private-label products, which it refers to as "TFM." To date, Fresh Market's TFM line seems to be catching fire with consumers and critics alike.

Its frozen pizzas, canned vegetables, cookies, and organic jams won numerous "Private Label Buyer Packaging Awards" and its bakery line was recently awarded the "2012 GDUSA American Package Competition." Fresh Market is already posting operating and gross margins that compare closely to those of Whole Foods, while Harris Teeter and Weis are lagging well behind.

Leveraging Proven Strategies

In conclusion, The Fresh Market is early in its growth cycle, but has been smart enough to leverage proven strategies that have paid off handsomely for larger competitors. The company has also just start penetrating the Western states, such as the health-conscious markets of California, Colorado, and Oregon.

For those that missed out on Whole Food's stock appreciation from $3 per share in 1992 to nearly $105 per share today, Fresh Market may provide a second opportunity with its strong margins and reasonable valuation. The company reports first quarter 2013 earnings on May 29 and its stock is poised to move higher on strong results.

Julian Willis has no position in any stocks mentioned. The Motley Fool recommends The Fresh Market and Whole Foods Market. The Motley Fool owns shares of Whole Foods Market. The article "Fresh Market Follows Whole Foods" originally appeared on Fool.com. The Motley Fool has a disclosure policy.