



Rating  
**Hold**

North America  
United States

Consumer  
Retailing / Food & Drug  
Chains

Company  
**Smart & Final**

Reuters  
SFS.N

Bloomberg  
SFS US

Exchange  
NYS

Ticker  
SFS

Date  
9 October 2018

Recommendation  
**Change**

Price at 4 Oct 2018 (USD)	5.51
Price Target	6.00
52-week range	9.70 - 4.50

**Wait & See; Move to Hold**

We are downgrading shares of SFS to Hold (from Buy) with a \$6 PT as: 1) omnichannel and e-commerce investments could further dilute EBIT margins with incremental investments a necessity in the current grocery environment; 2) very tough compares are ahead with lagging inflation and no clear catalyst to drive the top-line; and 3) we expect valuation to remain discounted in the difficult promotional and investment cycle. That said, we still believe the company maintains a high-quality offering with convenient locations at the S&F banner and a strong Foodservice business that is benefitting from food away from home trends, but think near-term and long-term pressures and a high degree of execution risk overshadow the solid foundation.

#### Long-Term Margin Pressure and Lack of Growth

We think management is making the correct strategic decision to invest in omnichannel capabilities including in house grocery delivery (20% of online sales at S&F), partnering with Instacart (80% of sales), and click & carry that will position the company to be a convenience player in the industry. However, we also believe the grocery space is going to be further split with companies able to bear the elevated capital needs winning the day (see our concurrent FITT Report - "Food Fight: Convenience & Digital Grocery at Tipping Point"). The company produced EBIT margins of 2.6% in 2014 and 2.5% in 2015, but declined to 1.3% in 2016 driven by both SG&A deleverage and GPM contraction, specifically at the S&F banner. We see SFS e-commerce investments diluting near-term EBIT margins (2018E 1.1%), and don't expect equal margin (2019 EBIT margin estimate 1.2%; 2020E at 1.1%) or top-line gains long-term as larger players create more efficient and convenient supply chains and omnichannel experiences.

#### No Near-Term Catalysts in the Face of Tough Compares

The company has shown improvement in 1H18 as the S&F banner posted a 0.8% SSS in 2Q equating to a 2.0% 2-year stack (improving from -2.5% 2-year stack in 1Q), while the Foodservice banner produced SSS of 3.3% (5.1% 2-year stack vs. 3.4% 2-year stack in 1Q). While we commend the company for improvement on the top-line, we fear there are no near-term catalysts in 2H18 that will allow the company to continue to post strong SSS in the face of tough compares, increased promotional activity (in which SFS doesn't want to participate), and lack of an inflation tailwind. We have lowered our 2018 S&F banner SSS estimate slightly to 0.5% from 0.7% and Foodservice to 3.3% from 3.5%, resulting in overall SSS at 1.1% (prior 1.3%; guidance 1%-2%).

#### Likeable Concept, But We Are Taking a Step Back

#### Valuation & Risks

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#### Key changes

TP	9.00 to 6.00	↓	-33.3%
Rating	Buy to Hold	↓	
EPS (USD)	0.43 to 0.42	↓	-0.5%
Revenue (USDm)	4,757 to 4,749	↓	-0.2%

Source: Deutsche Bank

#### Price/price relative



Performance (%)	1m	3m	12m
Absolute	-20.1	-1.6	-29.8
S&P 500 INDEX	0.2	6.9	14.3

Source: Deutsche Bank

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SFS is a value-oriented food and staples retailer that serves household and business customers in California, Washington, Oregon, Arizona, Nevada, and Idaho. SFS consists of two banners including the S&F banner (78% of sales) which averages 6%-12% lower prices than conventional grocery, and provides high quality products with a focus on a private label program that has prices up to 30% less expensive than national brand equivalents. The other banner, Foodservice (22% of sales; 33% of EBITDA), focuses more on business customers including restaurants, caterers, and more and provides SFS with a unique offering and growth strategy compared to traditional grocers. While we had presumed the company could generate HSD adj. EBITDA growth and ~20% adj. EPS growth over the long-term on MSD-HSD top-line growth and modest margin expansion, we now question the viability of this algorithm.

#### Stock option liquidity data

Market Cap (USD)	406.9
Shares outstanding (m)	73.8
Free float (%)	100
Volume (4 Oct 2018)	71,861
Option volume (und. shrs., 1M avg.)	–

Source: Deutsche Bank

#### Valuation Unlikely to Expand

Our PT goes to \$6 (from \$9) based on 6.0x (from 7.5x) applied to our adjusted 2019E EBITDA of \$187M (prior \$196M; Street \$189M). The stock is currently trading at a historically cheap valuation at 5.2x EV/EBITDA compared to a 3-year average of 7.0x, 3-year minimum of 5.0x, and a maximum of 9.2x. We think our new multiple balances the strong SSS growth in the Foodservice banner with the incremental investments needed and inflation headwinds seen across the business and specifically in the S&F banner. Upside risks include a return of food inflation, online initiatives gaining traction (especially the in house offering), better than expected SSS, and lessening promotional activity. Downside risks include a slowing macro environment impacting consumer spending, persistent competitive activity, continued food deflationary pressures, or difficulty in securing suitable real estate at reasonable rates.

#### Forecasts and ratios

Year End Dec 31	2017A	2018E	2019E	2020E
1Q EPS	-0.02	-0.04A	-0.04	–
2Q EPS	0.14	0.16A	0.18	–
3Q EPS	0.18	0.19	0.18	–
4Q EPS	0.14	0.12	0.12	–
FY EPS (USD)	0.44	0.42	0.44	0.46
OLD FY EPS (USD)	0.44	0.43	0.48	0.55
% Change	0.0%	-0.5%	-8.2%	-17.3%
P/E (x)	23.1	13.0	12.6	12.0

Source: Deutsche Bank estimates, company data

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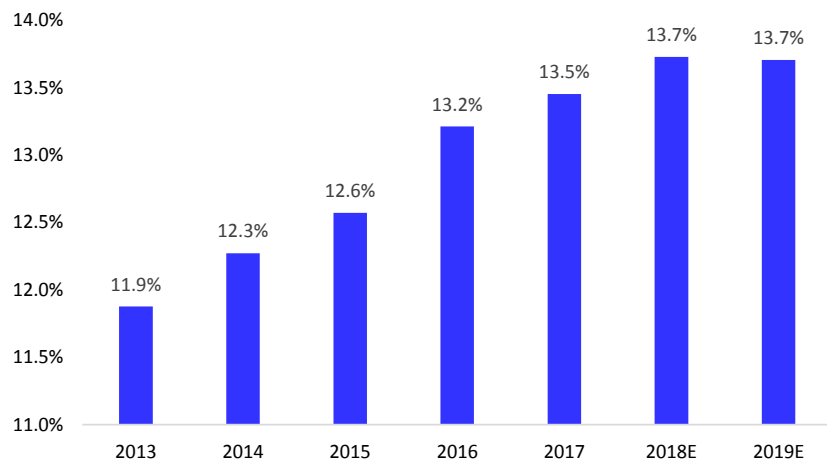
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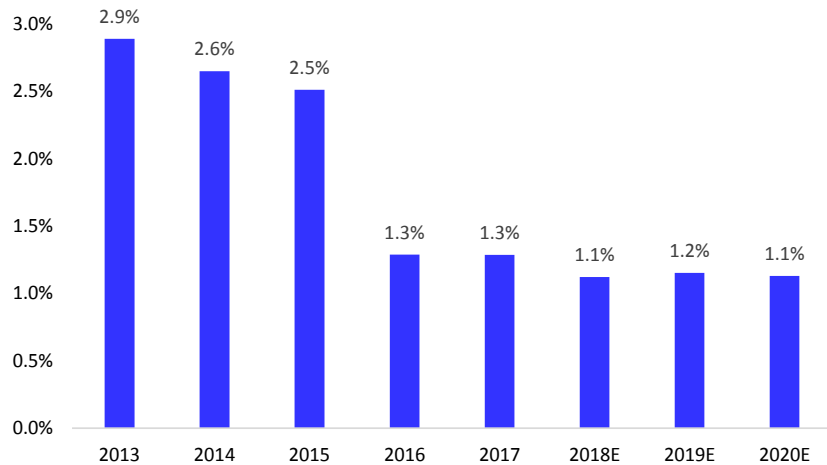
# Downgrade to Hold

Figure 1: We Expect SG&A Will Continue to Deleverage



Source: Deutsche Bank, Company Filings

Figure 2: EBIT Margin Remains Pressured



Source: Deutsche Bank, Company Filings

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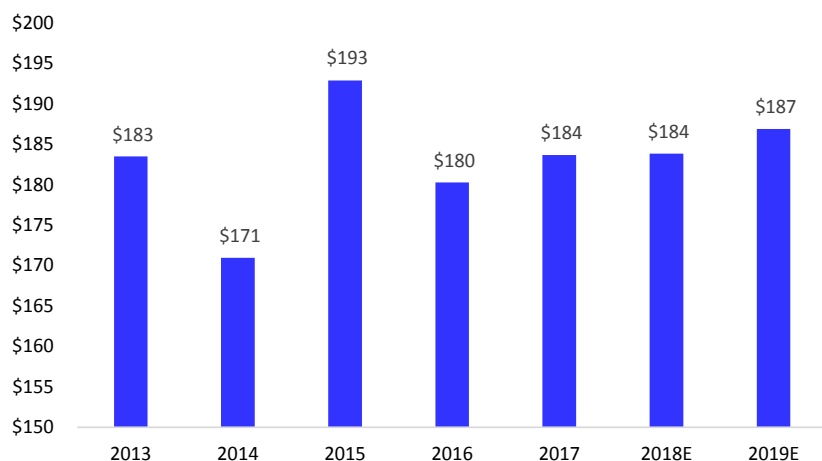
Figure 3: SFS Lapping Tough Compares in 2H18

SSS				
	2015	2016	2017	2018E
1Q	6.1%	2.0%	(2.5%)	1.2%
2Q	3.5%	(0.3%)	1.3%	1.3%
3Q	4.8%	1.3%	1.5%	1.4%
4Q	<u>3.9%</u>	<u>(2.0%)</u>	<u>3.2%</u>	<u>0.5%</u>
Annual	<b>4.4%</b>	<b>(0.5%)</b>	<b>1.0%</b>	<b>1.1%</b>

2-Year Stacked SSS				
	2015	2016	2017	2018E
1Q	10.3%	8.1%	(0.5%)	(1.3%)
2Q	9.8%	3.2%	1.0%	2.6%
3Q	11.4%	6.1%	2.8%	2.9%
4Q	<u>11.7%</u>	<u>1.9%</u>	<u>1.2%</u>	<u>3.7%</u>
Annual	<b>10.7%</b>	<b>3.9%</b>	<b>0.5%</b>	<b>2.1%</b>

Source: Deutsche Bank, Company Filings

Figure 4: SFS Company Adjusted EBITDA



Source: Deutsche Bank, Company Filings

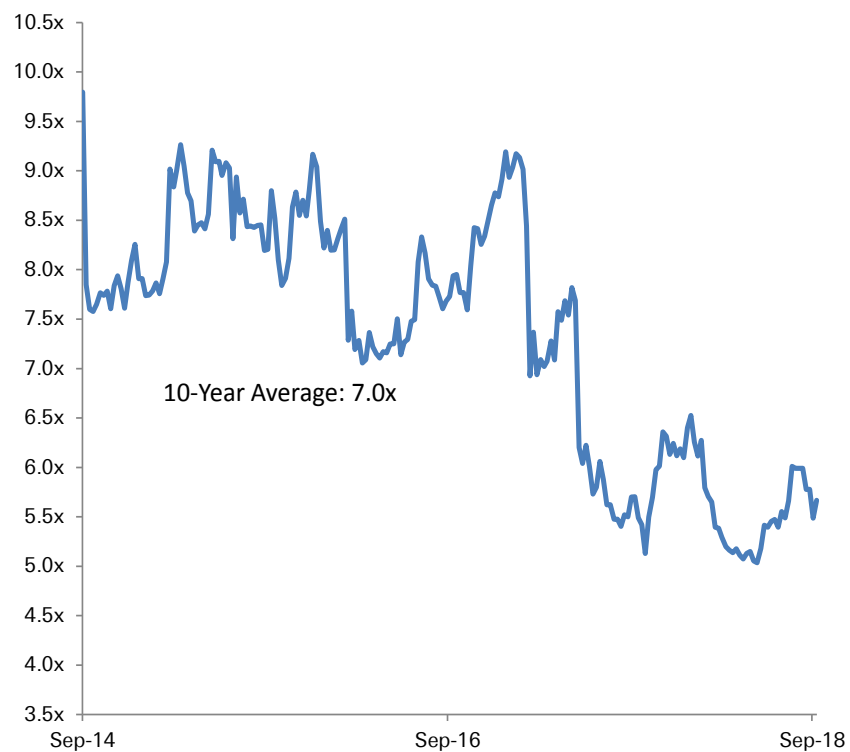
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Figure 5: We Expect EV/EBITDA Multiple to Remain Below the Historical Average



Source: Deutsche Bank, FactSet

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# Appendix 1

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\*Other information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Smart & Final	SFS.N	5.20 (USD) 5 Oct 2018	7

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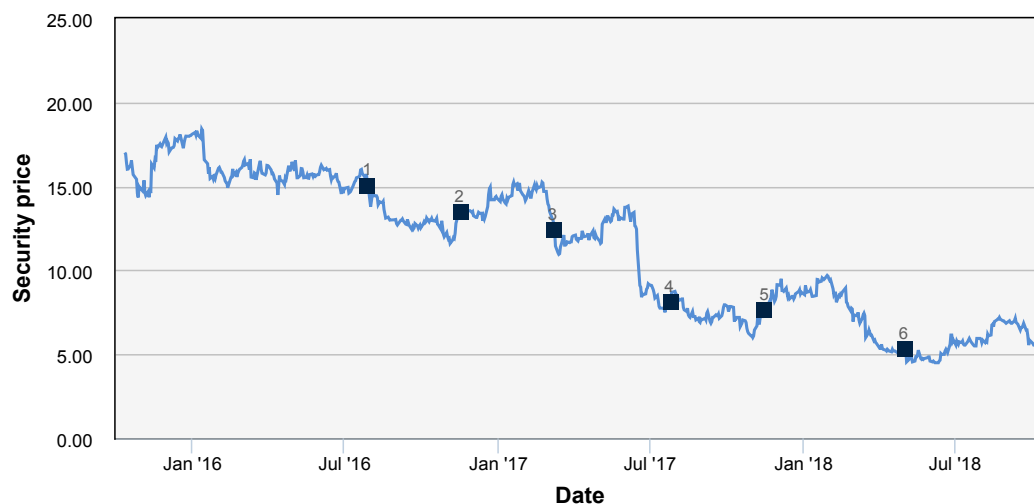
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## Historical recommendations and target price. Smart & Final (SFS.N)

(as of 10/05/2018)



### Current Recommendations

Buy  
Hold  
Sell  
Not Rated  
Suspended Rating

\*\* Analyst is no longer at Deutsche Bank

1.	07/29/2016	Buy, Target Price Change USD 17.00 Shane Higgins**	4.	07/26/2017	Buy, Target Price Change USD 12.00 Shane Higgins**
2.	11/17/2016	Buy, Target Price Change USD 15.00 Shane Higgins**	5.	11/16/2017	Buy, Target Price Change USD 10.00 Shane Higgins**
3.	03/09/2017	Buy, Target Price Change USD 14.00 Shane Higgins**	6.	05/03/2018	Buy, Target Price Change USD 9.00 Paul Trussell

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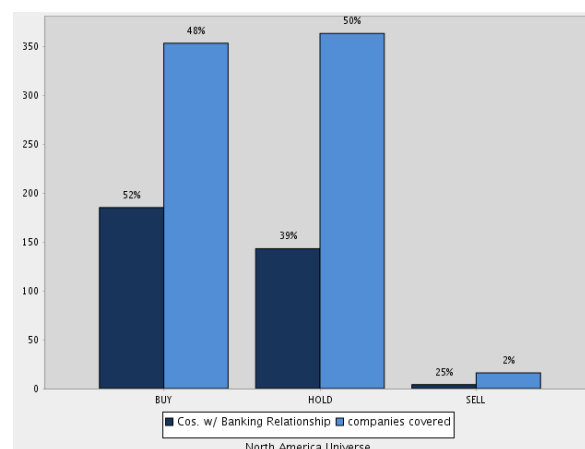
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**Hold:** We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

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