The Acquisition of Sprouts Farmers Market, Inc. by Kroger Co.

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Abstract

This dissertation aims to explore the eventual acquisition of Sprouts Farmers Market by Kroger Co. The food and grocery retail sector is under a profound and disruptive transformation process. The entrance of international hard discounters and behemoth online retailers, the consumer's less propensity to cook and convenience-driven preferences, and the usage of data-intensive technologies shook the industry's future prospects. Brick-and-mortar retailers, with their profit margins crushed and stagnant growth possibilities, crave for new sources of income. As a result, M&A activity emerges as a reliable option, with Sprouts on the frontline as the optimal target. Kroger and Sprouts' intrinsic value equals 35,459 and 3,484 million USD, respectively. The transaction will be based on a friendly, all-cash approach, with a 30% premium over Sprouts' share price on July 15. The deal will be financed using Kroger's cash reserves, proceeds from the sale of assets and through the issuance of debt. It is expected that the acquisition would yield 1,141 million USD in synergy value, where 420 million USD would be captured by Kroger's shareholders.

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Keywords: Mergers and Acquisitions; Grocery Retail; Natural and Organic Grocery Retail

Resumo

Esta dissertação tem como objectivo explorar uma eventual aquisição da Sprouts Farmers Market Inc por parte da Kroger Co. O sector do retalho alimentar encontra-se num processo de enorme transformação. A entrada de novos competidores, utilização de novas tecnologias e a alteração dos hábitos dos consumidores criaram incerteza quando ao futuro dos retalhistas tradicionais. Para se manterem competitivas, estas empresas necessitam de reinventar o seu modelo de negócio e de procurar novas fontes de receita. Deste modo, M&A apresenta-se como uma importante opção, sendo a Sprouts, especialista no lucrativo retalho de produtos biológicos, o alvo de aquisição óptimo. O valor intrínseco da Kroger Co. é de 35,459 milhões de dólares e o da Sprous Farmers Market é de 3,484 milhões de dólares. A transacção basear-se-a numa aproximação amigável, com um prémio pecuniário de 30% face ao preço por acção da Sprouts a 15 de Julho, financiada utilizando uma combinação de capitais próprios, dívida e mais-valias resultantes da recente venda de activos. Espera-se que esta transacção gere sinergias no valor de 1,141 milhões de dólares, 420 milhões de dólares referentes aos accionistas da Kroger.

Palavras-chave: Fusões e Aquisições; Retalho Alimentar; Retalho de Produtos Biológicos

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List of Abbreviations

APV	Adjusted present value
CAGR	Compound annual growth rate
CAPEX	Capital expenditures
CAPM	Capital asset pricing model
CF	Cash flow
COGS	Cost of goods sold
D&A	Depreciation & amortization
DCF	Discounted cash flow model
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortization
EBT	Earnings before taxes
EV	Enterprise value
F&G	Food & Grocery
FCFE	Free cash flow for the equity
FCFF	Free cash flow for the firm
HH	Household
IPO	Initial Public Offer
KR	Kroger Co.
Kroger	Kroger Co.
LT	Long-term
LTM	Last twelve months
M&A	Mergers and acquisitions
MRP	Market risk premium
N&O	Natural & Organic
P/E	Price-Earnings ration
PP&E	Property, plant, and equipment
ROE	Return of equity
ROIC	Return on invested capital
S&P 500	Standard & Poor’s 500
SFM	Sprouts Farmers Market inc.

SG&A	Selling, general & administrative
Sprouts	Sprouts Farmers Market inc.
ST	Short-term
SWOT	Strengths, weaknesses, opportunities, and threats
WC	Working capital
YOY	Year-over-year
YTM	Yield to maturity

List of Variables and Symbols

β_L	Levered Beta
β_u	Unlevered Beta
D	Debt
E	Equity
$FCFE_t$	Free cash flow for the equity at time t
$FCFF_t$	Free cash flow for the firm at time t
g	Terminal growth rate
k_d	Cost of debt
k_e	Cost of Equity
m	Average maturity
r_f	Risk-free rate
r_M	Market risk premium
t	Tax rate

1. Introduction

Over the years, the grocery retail sector, with its consistent payout policies and continuous capital gains, was considered the holy grail for long-term investors.

Nowadays, this sector is under a deep and disruptive transformation process. The entrance of international hard discounters and behemoth online retailers, the consumer’s less propensity to cook and convenience-driven preferences, and the usage of data-intensive technologies shook the industry’s future prospects.

Brick-and-mortar retailers, with their profit margins crushed and stagnant growth possibilities, crave for new sources of income. As a result, M&A activity emerges as a reliable option.

Hence, in the aftermath of the announcement of the poor results of its turnaround program, the acquisition of a market niche specialized retail chain would foster Kroger’s revenue growth, attract outstanding profit margins, improve brand awareness and, more importantly, regain investors’ confidence. While, perhaps, create added value for the firm’s shareholders.

Therefore, the dissertation's main research question is the following: *Should Kroger Co. acquire Sprouts Farmers Market Inc. on the 15th of July 2019?*

Henceforth, to assemble a complete and reliable outcome, it is crucial to assess each firm’s operational and financial condition, as well as its future prospects. Therefore, another crucial question rises: *What is Kroger Co. and Sprouts Farmers Market Inc.'s intrinsic value on the 15th of July 2019?*

This dissertation is structured as the following: section 2 describes relevant academic literature from past researchers; section 3 plots the food and grocery retail sector and natural and organic food retail current states and future projections, as well the disruption factors encompassing the industry; section 4 introduces Kroger Co and Sprouts Farmers Market Inc operational activities, historical performance, and financial analysis; section 5 leans over the transaction rationale; section 6 assesses the intrinsic value of each stand-alone firm; section 7 valuates the value creation encompassing the transaction; section 8 exploits several transaction topics encircling the acquisition; section 9 exhibits the transaction’s post-merger integration risks; section 10 names several alternative acquisition targets; section 11 references this dissertation’s main conclusions.

2. Literature Review

2.1. Mergers and Acquisitions Overview

M&A transactions enable the transference of resources between agents and also the removal of underperforming managers (DePamphilis, 2011). Moreover, M&A activity is a prompt route that firms have to move to new markets and obtain new capabilities (Rappaport & Sirower, 1999).

Mergers and acquisitions can be classified using different criteria. When two or more of the merged firms operate in a similar industry, the transaction is rated as a horizontal merger. While a vertical merger takes place between two firms within the same supply chain (DePamphilis, 2011). Lastly, when merged firms operate in different industries, they are denominated as conglomerate mergers, which, commonly, given the diversification effect created, lead to a reduction of the combined risk (Amihud & Lev, 1981).

Finally, takeovers can be denominated as friendly takeover or hostile takeover. The first occurs when the acquirer firm takes control of the target with the approval of its management team. Whether hostile takeovers ensue when the transfer of ownership goes against the will of the target's management team. Usually, hostile takeovers encompass a high acquisition premium paid by the acquirer firm (DePamphilis, 2011) and demand cash-based payment methods (Fishman, 1989).

2.2. Motivations for M&A

Berkovitch & Narayanan, (1993) suggest three significant motives for takeovers: agency, hubris, and synergy.

The agency approach assumes that takeovers are principally motivated by management self-interest (Berkovitch & Narayanan, 1993). Therefore, managers might focus on increasing the diversification of the managerial portfolio (Amihud & Lev, 1981), foster firm's size and, as a result, their power and compensation (Jensen, 1984) or increase the firm's dependence on the expertise of the management team (Shleifer & Vishny, 1989).

Additionally, risk-averse managers might engage in conglomerate mergers to diversify their employment risk (Berkovitch & Narayanan, 1993).

According to Berkovitch & Narayanan (1993), agency driven transactions induce a wealth transfer from shareholders to managers, consisting of the primary motive of takeovers with negative total gains.

As regarding hubris, this approach assumes that managers make mistakes when evaluating the synergies generated by the M&A transaction, leading to transactions that otherwise would not occur (Berkovitch & Narayanan, 1993). The hubris hypothesis presumes that, by having outstanding good expectations on the success of the transactions, managers incur in non-rational bids (Trautwein, 1990). Indeed, firms influenced by hubris tend to overvalue their targets (Roll, 1986).

Relating to the synergy motive, it stands as the primary motivation for M&A transactions (Mukherjee, Kiymaz, & Baker, 2004) The synergy approach relies on the assumption that both managers strive to maximize shareholder value, only engaging in M&A activity resulting in gains for both parties (Trautwein, 1990). Takeovers with positive total benefits are empirically connected with synergy considerations (Berkovitch & Narayanan, 1993).

Damodaran (2005) defines synergy as the value increment achieved with the combination of two or more firms, building opportunities that would not be accessible if these firms operated autonomously. Synergies might be sorted into two different categories, operating synergies and financial synergies (Damodaran, 2005). Operating synergies are linked to an intensification of the firm's operating income from current assets, while financial synergies are predominantly materialized through a reduction of the firm's cost of capital (Damodaran, 2005).

2.3. Value creation

There is controversy about whether M&A activity creates shareholder value.

Transactions failure might be linked to an exaggeration of its potential benefits, overextending the synergy materialization or easy replication of the synergy benefits by competitors (Rappaport & Sirower, 1999).

However, there is a tendency to exaggerate the degree of failure of M&A transactions (Bruner, 2004). Contaminating events, overvalued stock, exogenous shocks, and size discrepancies between corporations might lead to the erroneous conclusion that M&A activity does not create value (Bruner, 2004).

In fact, at the macroeconomic level, M&A transactions do create value (Sirower & Sahni, 2006). Nevertheless, there is an uneven distribution of the returns. Typically, target's shareholders earn substantial returns with the transaction, whereas the acquirer's shareholders, usually, yield around the required rate of return (Bruner, 2004).

Finally, by focusing on innovative operating strategies, seeking managerial talent, offering cash-flow linked incentives to top-level managers and fostering the speed of the integration process, acquirers can harvest shareholder value (Anslinger & Copeland, 1996).

2.4. Payment methods

An essential factor to take into consideration is the payment methods encompassing the transaction, which can be all-cash, all-stock, or a mixture of both. When companies engage in all-cash deals, its shareholders detain the totality of the value and risks of the transaction, whereas, in an all-stock transaction, synergy value and risks are shared by both parties (Rappaport & Sirower, 1999). Indeed, stock-for-stock financing obliges target's shareholders to share the overpaying risk, (Martin, 1996) according to their ownership of the combined firm (Rappaport & Sirower, 1999).

Typically, equity-financed transactions tend to create less value for the acquirer shareholders (Bruner, 2004) and yield an inferior long-term performance than all-cash deals (Agrawal, Jaffe, & Mandelker, 1992).

Additionally, the payment method also has a signaling effect (Travlos, 1987), since when a company engages in a stock-for-stock transaction, investors will believe that its shares are overvalued (Rappaport & Sirower, 1999).

Stock financing is more likely to be used in large transactions, friendly takeovers, acquirer's diminished cash reserves, overvalued acquirer's share price, and dispersed ownership (Bruner, 2004). Whereas cash financing is more commonly used on tender offers, due to regulatory reasons (Martin, 1996) and when the threat of an auction environment is real (Fishman, 1989).

2.5. Valuation techniques

Valuation has a crucial part of the acquisition analysis since both acquirer and target have to decide on a fair value before engaging in the negotiation process (Damodaran, 2012).

The firms' value estimates are intrinsically connected with the corporation's resource allocation (Luehrman, 1997a). Generally, when estimating the value of an asset, most companies use a mix of valuation approaches (Luehrman, 1997a).

Therefore, literature review will emphasize the Discounted Cash Flow (DCF), Adjusted Present Value (APV), and Comparable approaches. There is little empirical evidence proving which of the methods provides better estimates, although, the combination of DCF and comparable methods leads to more reliable results (Kaplan & Ruback, 1996).

2.5.1. Discounted Cash Flow (DCF)

The primary purpose of the Discounted Cash Flow analysis is to estimate the intrinsic value of an asset based on its fundamentals (Damodaran, 2012). According to this approach, the value of an asset equals the expected cash flows generated by it, discounted to the present value at the weighted–average cost of capital (WACC).

The majority of acquirer firms rely on the DCF model to assess the value of target firms (Mukherjee, Kiymaz, & Baker, 2004). Indeed, despite its obsoletely, the DCF valuation method still maintains its importance, (Luehrman, 1997a) since the market value of the target is deepen connected to the discounted value of the cash flows generated (Kaplan & Ruback, 1996).

Kaplan & Ruback (1996) state that there are two different approaches for the FCFF estimation: the net income (NI) approach and the earnings before interest and taxes (EBIT) approach. Additionally, (Damodaran, 2012) computes FCFF starting with the FCFE. Table 1 represents the different approaches to compute the FCFF:

Net Income	EBIT	FCFE
+ Depreciation & amortization	- Corporate taxes	+ Interest expenses (1- tax rate)
- Change in net working capital	+ Depreciation & amortization	+ Principal repayments
+ Interest expense	- Change in net working capital	- New debt issues
- Capital expenditures (CAPEX)	- Capital expenditures (CAPEX)	+ Preferred dividends
+ After-taxes asset sales	+ After-taxes asset sales	
= FCFF	= FCFF	= FCFF

Table 1 – FCFF computation

Henceforth, the value of the firm can then be computed by summing up the future cash flows of the firm during the explicit forecast period and then adding the terminal value (McKinsey & Company, 2005).

The terminal value approach assumes that the organization is going to grow perpetually and that capital expenditures should at least equal the depreciation and amortization (Kaplan & Ruback, 1996).

Thus, the enterprise value and terminal value can be computed according to Equations 1 and 2, respectively.

$$\text{Enterprise Value} = \sum_{t=1}^{t=n} \frac{\text{FCFF}_t}{(1+\text{WACC})^t} + \frac{Terminal\ Value_n}{(1+WACC)^n}$$

Where:

n: life of the asset (number of periods);

$FCFF_t$: free cash flow for the firm in period t;

WACC: weighted average cost of capital;

g: perpetual growth rate of the cash flows.

Equation 1 – Enterprise Value computation

$$\text{Terminal Value}_t = \frac{\frac{FCFF_{n+1}}{(WACC-g_n)}}{(1+WACC)^n}$$

Where:

n: life of the asset (number of periods);

$FCFF_t$: free cash flow for the firm in period t;

WACC: weighted average cost of capital;

g: perpetual growth rate of the cash flows.

Equation 2 – Terminal Value computation

2.5.1.1 Weighted average capital cost

WACC translates the opportunity cost that investors are willing to bear when investing in one particular business as an alternative to other projects with the same risk (McKinsey & Company, 2005).

Therefore, Equation 3 enables the calculation of the discount rate.

$$WACC = \frac{D}{D+E} K_d (1-t) + \frac{E}{D+E} K_e$$

Where:

$\frac{D}{D+E}$: target level of debt to enterprise value using market-based values;

$\frac{E}{D+E}$: target level of equity to enterprise value using market-based values;

K_d : cost of debt;

t: income tax rate;

K_e: to the cost of equity.

Equation 3 – WACC computation

2.5.1.2. Cost of Equity (R_e)

The cost of equity is computed using the Capital Asset Pricing Model (CAPM). This model, primarily introduced by (Sharpe, 1964), (Lintner, 1965) and (Mossin, 1966), assumes that each asset's risk will be measured relatively to the market portfolio (Damodaran, 2012), which can be computed according to Equation 4.

$$K_e = R_f + \beta\ (R_m - R_f)$$

Where,

R_f: risk-free rate;

β: firm's beta;

$(R_m - R_f)$: for the market risk premium.

Equation 4 – Cost of equity computation

2.5.1.3. Risk-Free Rate (R_f)

As regards the previous formula components, R_f stands for the return of the lowest risk asset available. An asset might be considered risk free if there is no default risk and the reinvestment risk should be zero (Damodaran, 2012). Thus, a long-term zero-coupon treasury bond would be a good proxy for the risk-free asset (Kaplan & Ruback, 1996).

2.5.1.4. Beta (β)

Beta refers to the stock's co-movement with the stock market and emphasis the stock's capability to further diversify the market portfolio (McKinsey & Company, 2005).

In theory, the beta estimation should measure the risk added by the investment to the market portfolio (Damodaran, 2012). Hence, since the market portfolio encompasses all the existing assets, to reliably estimate the risk premium, one must focus on the historical premium earned by stocks over the default-free asset over long periods (Damodaran, 2012).

Additionally, based on the principle that companies in the same industry face analogous operating risks, industry level betas improve the exactness of beta estimation (McKinsey & Company, 2005). Indeed, after testing several measures of beta computation, Kaplan & Ruback, (1996) concluded that industry and market-based betas consistently outperform the firm-based beta. Henceforward, since a company's beta is also a function of its financial risk, after computing the unleveraged beta for the industry, the firm's capital structure must be incorporated according to Equation 5 (Damodaran, 1999).

$$\beta_L = \frac{\beta_u}{1+(1\text{-}t)\left(\frac{D}{E}\right)}$$

Where,

β_L: firm's leveraged beta

β_u: firm's unleveraged beta

t: corporate tax rate

$\frac{D}{E}$: debt of equity ratio

Equation 5 – Beta leverage computation

Subsequently, after the incorporation of each corporation's capital structure, following the observation that company betas tend to the mean of all betas (Blume, 1975), the consequent adjustment must be performed:

$$\beta_L = \frac{2}{3}\beta_u + \frac{1}{3}$$

Where,

β_L: firm's leveraged beta

β_u: firm's unleveraged beta

Equation 6 – Adjusted beta leverage computation

2.5.1.5. Market Risk Premium (R_m - R_f)

The risk premium should measure what investors, on average, demand as an extra return for investing in this portfolio relative to the risk-free asset (Damodaran, 2012).

Based on the assumption that the level of investor's risk aversion remains constant over time, historical excess returns consist of a reliable proxy for future returns (McKinsey & Company, 2005). Therefore, the risk premium can be estimated by computing the historical premium earned by stocks over default-free securities during long periods (Damodaran, 2012).

2.5.1.6. Cost of debt (R_d)

In the case that the firm has traded bonds, the yield to maturity of liquid long-term option-free bonds is a suitable proxy (McKinsey & Company, 2005). Otherwise, the nominal cost of debt can be computed using the bond rating of the company given by rating agencies. Subsequently, since interest payments yield tax shield savings, one must compute the after-tax cost of debt, illustrated by Equation 5.

$$\text{After-tax Cost of Debt} = \text{Cost of Debt} * (1 - t_n)$$

Where,

t_n: tax rate in period n

Equation 7 – Cost of debt computation

2.5.1.7. Market Value of Debt

The market value of debt should, in principle, translate the investors' wiliness to buy the firm's debt (Damodaran, 1999). In the case of traded debt, the market value of bonds outstanding is given by the giving equation:

$$\text{Market Value of Traded Debt} = \text{Number of Bonds Issued} * \text{Bond's Market Value}$$

Equation 8 – Market value of debt computation

However, since many firms do not have traded debt, one needs to transform the debt present on the balance sheets into market valuated debt. Hence, Damodaran (2012) suggest that book value must be incorporated into one coupon bond, with the coupon corresponding to the current interest expenses and the maturity established as equal to the weighted average maturity of the face value debt, estimated as follows:

$$\text{Market Value of Debt} = \text{Interest Expense} * \left\{\frac{1-\frac{1}{(1+r_d)^m}}{r_d}\right\} + \frac{FV}{(1+r_d)^m}$$

Where:

r_d: current cost of debt

m : weighted average maturity

FV: face value of debt

Equation 9 – Computation of the market value of non-traded debt

2.5.2. Relative Evaluation

Relative valuation methodologies rely on the use of transactions or market multiples to evaluate a corporation. In these methods, a ratio or multiple value relative to a performance measure is calculated for a set of guideline or comparable firms (Damodaran, 2012).

The relative valuation assumes that the comparable companies have the same expected future cash flows as the company in analysis and that the company's value is intrinsically linked to the performance measure (Kaplan & Ruback, 1996).

Damodaran (2012) states that it is tough to spot similar firms since it is doubtful that two firms in the same industry are in the same position towards risk, growth potential, and cash flows. In fact, comparable firms should cumulatively match the company in terms of the industry, risk profile, and growth perspectives (Alford, 1992).

Regarding multiple accuracy, Liu, Nissin, & Thomas (2002) found that across all industries and sample years, forward earnings are the most accurate multiple. This ranking is followed by historical earnings, cash flow, book value of equity, and sales.

2.5.3. Adjusted Present Value (APV)

The APV approach relies on the principle of value additivity, meaning that the value of a project corresponds to the sum of its cash flow generating parts (Luehrman, 1997a). The APV method values the firm as the sum of two pieces: the all equity-firm and later the value added by the firm's choice of capital structure (Kaplan & Ruback, 1996). Its computation implies the estimation of the present value of unlevered firm's cash flows discounted at the unlevered cost of capital and, also, the present value of the interest tax shield discounted at the appropriate rate (Kaplan & Ruback, 1996).

Besides, by segregating the sources of value creation of the firm, managers can assess not only the asset's intrinsic value but also the origin of value creation (Luehrman, 1997a).

3.1. Industry analysis – Food & Grocery Retail

Kroger and Sprouts operate in the U.S. F&G retail market. This sector includes the sales of food products (packed and unpackaged), beverages (alcoholic and non-alcoholic), tobacco and household products (MarketLine, 2018a).

3.1.1. Category Segmentation

In 2017, the U.S. F&G retail market size amounted to $1,215 billion, which represented 14.4% of the global food and grocery retail market value. Within this sector, food and drinks have a market value of $847 billion and $228 billion, representing 69,7% and 18,7% of the market value of the industry, respectively (MarketLine, 2018a). In contrast, tobacco and household products account for 8,6% and 3% of the whole market.

3.1.2. Market Value and forecasts

As displayed in Figure 1, currently, this sector has seen stable, moderate growth, amounting total revenues of $1,215 billion in 2017. In the 2013-2017 period, this industry achieved a CAGR of 3,1%. The growth tendency has been supported by an intensification in consumer spending on household food and groceries.

Rendering on MarketLine (2018a), it is expected that the F&G retail sector maintain its actual growth tendency, achieving 1,419 billion USD by 2022. In the 2017-2022 period, this industry's CAGR should equal 3,1%, consisting in a 16,8% increase when compared with the market value registered in 2017 (MarketLine, 2018a).

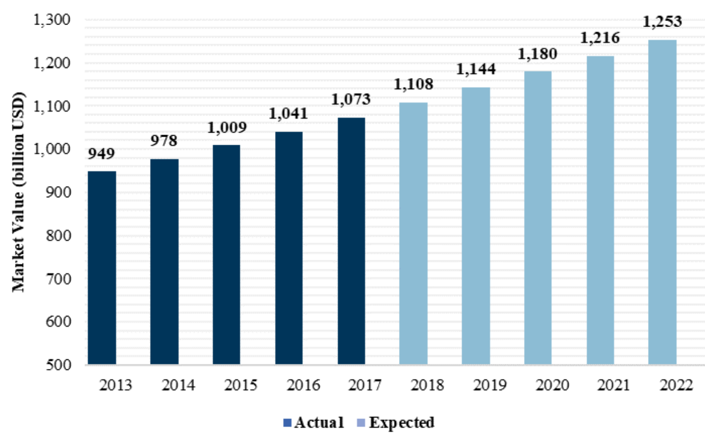

Figure 1 – U.S. F&G retail (excluding tobacco and HH products) market value forecasts

3.1.3. Market Distribution

In 2017, the U.S. F&G retail sector's main distribution channels were hypermarkets, supermarkets, and hard-discounters, who serve 61,3% of the market size, followed by convenience stores and gas stations which represent 13,6%. (Figure 2)

However, this sector is dominated by a limited number of players such as Walmart, Target, Costco, Kroger, and Whole Foods (Amazon). These incumbers are large-scale, national-based, and benefit from economies of scale (MarketLine, 2018a). Among this group, Walmart currently represents roughly one-quarter of the market share (MarketLine, 2018a).

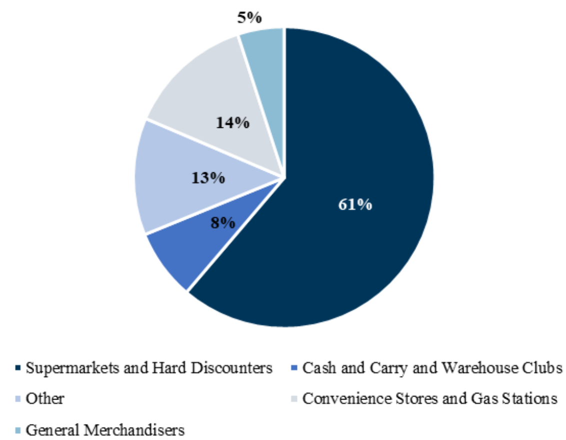

Figure 2 – U.S. F&G retail market distribution

3.1.4. Drivers and Five Porter Analysis

The F&G retail market key growth drivers are economic indicators like Gross Domestic Product (GDP) growth, consumer confidence, unemployment rate, and, most importantly, disposable income. Furthermore, the current favorable economy condition fostered the adoption of healthier consumer habits, stimulated this sector growth. Figure 3 displays the sector's Porter's Five Forces analysis, which is explained in detail in Appendix 1.

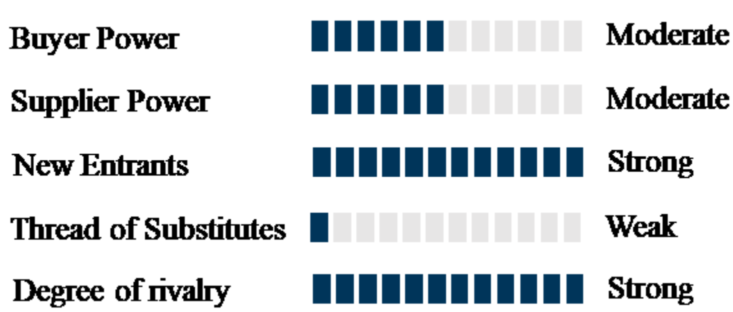

Figure 3 – Porter's Five Forces analysis of the U.S. F&G retail industry

3.2. Industry analysis – Natural and Organic Food Retail Sector

Sprouts Farmers Market, due to its expertise in organic offerings, mainly operates in the natural and organic food retail sub-sector.

3.2.1 Category segmentation

In 2017, the largest sub-sector included in the U.S. N&O food retail was the fruit and vegetables sub-sector, encompassing 49.5% of the market size. This segment was followed by dairy (17.1%), prepared food (12.0%), beverages (9.8%) bread & grains (8.3%) and meat, fish, poultry (3.4%) (MarketLine, 2018b).

3.2.2. Market Value and forecasts

Fostered by the grown awareness of the benefits of organic food when compared to non-organic, this sector has been growing at pace, totaling a revenue value of $51,233 Million in 2017, achieving a CAGR of 15.3% during the 2013-2017 period. (Figure 4) This tendency was also supported by an increase in consumer disposable income, which increased the consumers' aptitude to afford these premium products, and the uprising of healthier lifestyles.

In the near future, it is forecasted that N&O food retail would maintain its attractive growth rates, with an anticipated growth rate of 8.6%, amounting nearly $77,534 Million in 2022 (MarketLine, 2018b).

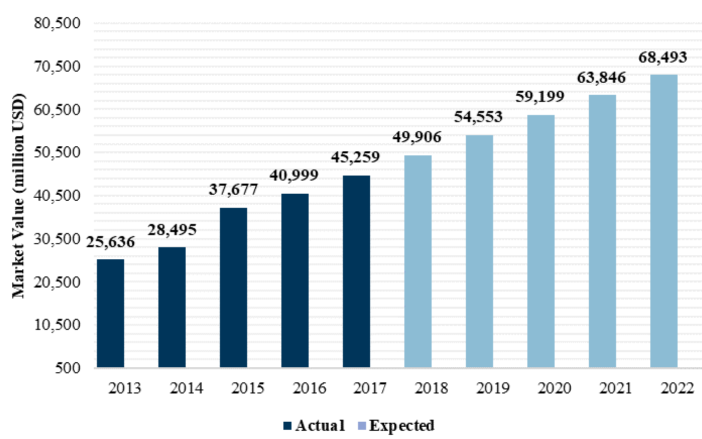

Figure 4 – United States N&O food retail market value forecasts

3.2.3. Market Distribution

Direct sales from producers to consumers are intrinsically associated with organic food concept, although conventional and N&O food supermarkets are responsible for 93% of sales (Organic Trade Association, 2019).

Several N&O supermarket chains such as Whole Foods (Amazon), Sprouts Farmers Market, Weis Market, and Vitamin Cottage Natural Food Markets operate in the sector. Additionally, conventional retailers, such as Walmart, Costco, and Kroger, already adapted to this new trend by increasing their product offerings and creating their organic labels (MarketLine, 2018b).

3.2.4. Drivers and Five Porter Analysis

The N&O food retail sector is heavily impacted by the same key economic indicators as the F&G retail industry. However, disposable income reinforces its importance in this sub-sector. Consumers expect to pay a premium for organic products during expansion cycles, though, during depressions or financial instability periods, consumers may opt by cheaper non-organic substitutes (MarketLine, 2018b). Figure 5 displays this sector's Porter's Five Forces analysis, which is explained in detail in Appendix 2.

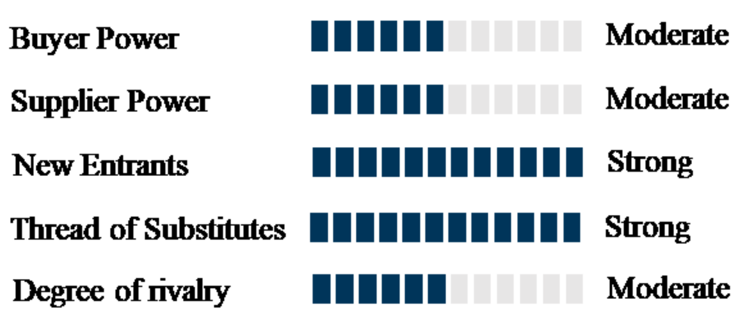

Figure 5 – Porter's Five Forces analysis of the U.S. natural and organic food retail sector.

3.3. Disruption of the industry

According to McKinsey's (2018) report *Reviving Grocery Retail: Six Imperatives*, the sector is – and, for some time, has been - going through a profound transformation, in which it is currently being impacted by, intensifying competition, consumers' changing habits and preferences, and new technologies.

3.3.1 Increasing competition in the traditional market

The increasing competition in the traditional in-store food market is deeply tied to the emergence and rise of hard-discounters. These types of supermarket chains, and especially foreign companies such as Lidl and Aldi, pose a significant threat to the long-run profitability of conventional retailers, mostly for two reasons: lower price offerings and an efficient supply chain, in which they control their own suppliers and brand selections (typically selling for lower prices than recognizable or premium brands) (Steenkamp & Kumar, 2009).

Stenkamp & Kumar (2009) define hard-discount stores as minimally decorated outlets that sell a small assortment of foodstuffs and household goods. International players in this field, such as German chains Aldi and Lidl, are increasing their investments in the United States. Aldi currently operates more than 1900 stores and plans to reach 2200 stores by 2022, whereas Lidl, who entered the US market in 2017, currently owns nearly 100 stores and aims to grow its locations to nearly 500 by 2022. The discount retail sector is expected to grow by 8% to 10% annually until 2020 (Bain & Company, 2018).

Historically, the main target of discounters has been low-income households. Nowadays, however, customers who shop at these places do not differ from traditional grocery shoppers in terms of income and education (BCG, 2017a). Indeed, rises in preference for these stores are prevalent among wealthy and high-educated households, a phenomenon rated as "smart-shopping" (Steenkamp & Kumar, 2009).

Millennials' decline in confidence in some traditional brands and their eagerness to try unconventional products, especially when pushed by accurate in-store experiences, adds to the surge in popularity of hard-discount stores (BCG, 2017a).

Discounters offer a concentrated assortment of products to their customers, meaning that they are able to purchase high volumes of Stock Keeping Unit (SKU) which lowers the cost per unit of the goods sold when comparing to traditional retailers. Due to this competitive advantage, hard discounters can offer their products at nearly half the price of conventional brands (Steenkamp & Sloot, 2018) .

Besides, by focusing on their labels, hard discounters are able to implement a smooth, reliable, and cost-efficient supply chain, fostering their pricing advantage over competitors (BCG, 2017a). Private labels are typically priced at 50% below other manufacturers' brands and normally yield a higher margin than branded products (Steenkamp & Kumar, 2009).

Furthermore, apart from the high value-for-money offered by hard discounters, they strengthen consumer engagement by offering a convenient and easy-to-shop experience, given the low degree of complexity and strong quality standards (Steenkamp & Sloot, 2018)

Moreover, in the last decade, discounters reinvented their approach by offering superior-quality goods, a broader assortment, and enhanced shopping experience (BCG, 2017a)

In conclusion, the change in the shopping habits of consumers, the deployment of their low-price strategy, cost efficiency, and improved shopping experience, are cementing the position of discounters' in the F&G retail sector.

3.3.2. Change in consumers' preferences

The change in consumers' preferences is intrinsically linked to the establishment of Millennials as the largest U.S. demographic group. While also seeking lower prices and favorable deals, this consumer group expects to buy nearly everything everywhere, whenever they please (McKinsey & Company, 2018). Furthermore, Millennials also care about the origin of their groceries and are more willing to adopt healthy lifestyles, increasing the penetration of healthier and organic diets (Tetra Pack, 2018).

Besides, due to their low predisposition to cook, nowadays consumers are tending to opt by food service, easy to cook dishes, or already made meals in replacement of traditional food-at-home (McKinsey & Company, 2018). This tendency is fostering the growth of meal kit subscription services[1], a market that, in the U.S., is worth nearly 5 Billion USD (Tetra Pack, 2018).

3.3.3. New technologies

Furthermore, traditional retailers also face the threat of new technologies and the rise of online grocery shopping. The sale of food and groceries in the U.S through online channels, fostered by Amazon's acquisition of Whole Foods[2], is expected to grow above 53 billion USD until 2022 (MarketLine, 2018a). The mixing between Amazon's digital and operational capabilities with Whole Foods' brick-and-mortar stores forms an enormous distribution channel (McKinsey & Company, 2018). This transaction aimed at establishing a network of delivery facilities closer to consumers, enabling a steadfast delivery of the groceries (Tetra Pack, 2018).

[1] A subscription-based home delivery service of pre-measured ingredients along with their respective recipe (Tetra Pack, 2018).
[2] On August 2017, Amazon bought Whole Foods in a 13.7 Billion USD deal.

The main driver of online grocery shopping is convenience, yet, costumers also expect attractive prices and a smooth all-in-one shopping experience. Besides, by implementing cutting-edge technologies such as advanced analytics, artificial intelligence, robotics and the internet of things, online competitors have increased their price advantage and consumer engagement over traditional retailers (McKinsey & Company, 2018).

These technologies can be divided into two different categories, revenue enhancement, and cost reductions. Through advanced analytics and artificial intelligence, e-retailers can retain customers by offering a personalized shopping experience via subscription services or dash buttons[3] (Tetra Pack, 2018) Whereas, with the usage of robotics and high-tech facilities, e-retailers can improve their logistics and supply chain efficiency (Tetra Pack, 2018).

Hence, it is expected that, worldwide, by 2026, 200-700 billion USD in revenues switch from traditional retailers to other formats and channels, namely, online retailers, painfully impacting traditional retailers' profitability and creating space overcapacity (McKinsey & Company, 2018).

4.1. Company profile - Kroger Co

Kroger Co. (KR) runs supermarkets, multi-department stores, and jewelry stores throughout the U.S. In addition, the company also manufactures and processes groceries available at its supermarkets. It started its operations as a small grocery store in 1893 and it is listed on the NASDAQ stock exchange since January 1928.

4.1.1. Stores and Operations

The company operates 2,782 supermarkets under a range of local banner names[4], of which 1,489 included fuel centers and 2,268 had pharmacies. As regards of Kroger's food production plants, it owns 37 food production plants. Kroger serves its customers through a combination of four different store formats (supermarket, multi-department, marketplace, and price-impact warehouses) under 21 different banners.

Moreover, Kroger operates in 42 states, with a high concentration of stores in California, Ohio, and Texas, as displayed in Figure 6.

In addition to its brick-and-mortar operations, Kroger also serves 92% of its customers through online channels via pick-up and home delivery options (The Kroger Company, 2018a).

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[3] A device that orders a particular pre-defined set of products through the press of a button (Tetra Pack, 2018).

[4] After an acquisition, Kroger typically maintains the acquired name and brand image of the acquired firm.

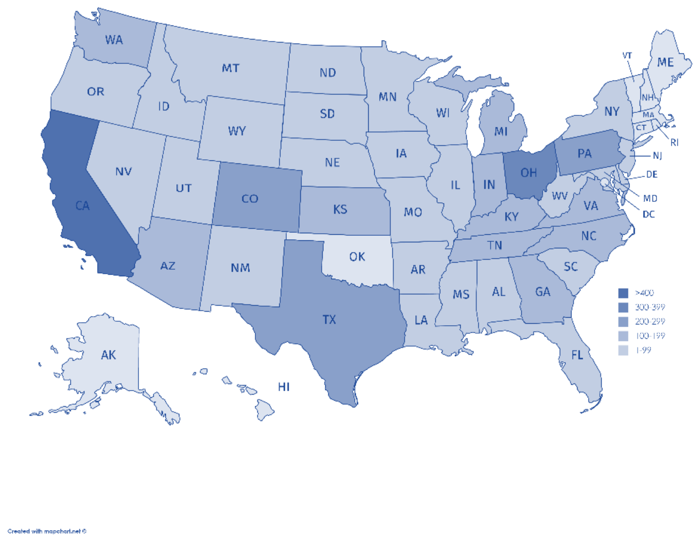

Figure 6 – Geographic distribution of Kroger's stores

4.1.3. Product offering

Regarding Kroger’s revenues by product line, exhibited in Figure 7, the firm is highly specialized in the sale of groceries (74.1% of all revenues), especially, in the non-perishable segment, which accounts for 50.1% of all revenues standalone (The Kroger Company, 2019a).

Moreover, the whole group offers more than 15,000 private label items, representing nearly one-quarter of all sales. Kroger’s owned facilities currently produce approximately 33% of all private label brands, a number that rises to 44% in the specific case of groceries (The Kroger Company, 2019a).

Besides, to adapt to customer’s needs, Kroger also expanded its product line to food service and meal kits, available both in-store and through home delivery.

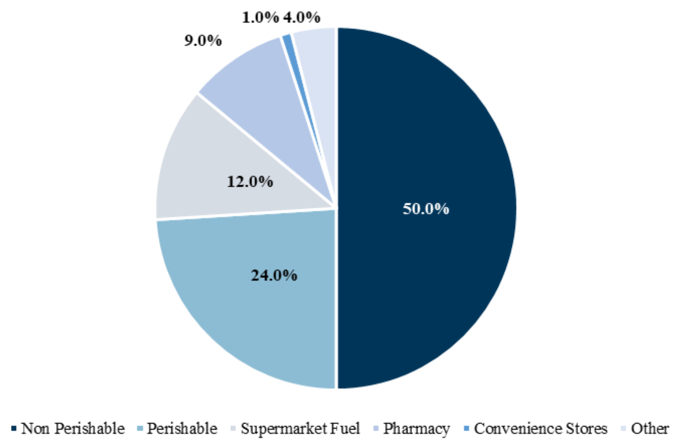

Figure 7 – Kroger's 2018 disaggregated revenues by type of product

4.1.3.1 Organic Food Division

Kroger has been fostering its position within the O&N food sector. Indeed, in 2018, this segment's revenues correspond to 17.6 billion USD (14.5% total revenues) (The Kroger Company, 2019c). Launched in 2013, Kroger's organic private label – *Simple Truth*, totals 2.3 billion USD of sales, (1.9% of the total revenues) and rapidly became the largest N&O brand in the U.S. and the second major brand sold in the firm's stores (The Kroger Company, 2019c). This private label encompasses more than 1550 products and has been growing at pace with outstanding double-digit sales growth rates (The Kroger Company, 2019a). Besides, in the near future, the company aims to strengthen *Simple Truth* position within its specific market niche (The Kroger Company, 2018a).

4.1.4. SWOT Analysis

To assess the firm's position within the industry, it is imperative to perform a SWOT analysis. This analysis takes into consideration the internal and external factors that directly impact the firm's performance. Therefore, Figure 8 plots Kroger's SWOT analysis.

Strengths	Weakness
Vast store network	High debt levels
Efficient supply chain management	Shrink profit margins
Extensive product mix	Low liquidity
Vertical integration of production plants	
Operations under different banners	

Opportunity	Threats
Online retailing	Fierce competition
Natural and organic products	Change in consumer's habits and preferences
Meal kits and food service	

Figure 8 – Kroger's SWOT analysis

4.1.5. Market Performance

As of July 15, 2019, Kroger's share price was $22.09, which was close to the firms' six-year minimum ($17.69 on February 3, 2014). By contrast, Kroger's maximum price in the same period was $42.64 - recorded on December 29, 2015. Besides, for the past six years, Kroger's stock price had a CAGR of 0.85%.

Furthermore, a glance at Figure 9, tells us that, after July 2017, Kroger's stock returns pale in comparison with the ones of the benchmark index. This reversal on the firm's cumulative returns coincided with Amazon's acquisition of Whole Foods[5], displaying investors' reservations and apprehensiveness about the disruptive impact this move could have on the industry.

Relative to last year's performance, Kroger's stock value plunged by 21.11% LTM, with its daily returns having a standard deviation of 29.38%. (Table 2) This trend was fostered by the considerable depletion of share value since the beginning of the year, as exhibited in Figure 10. Indeed, Kroger's poor performance in the stock market could be attributed to an aggressive competition environment and to the firm's inability to achieve the results expected by analysts and investors alike. Unsurprisingly, the most accentuated price drops coincided with two of the latest

[5] On June 16, 2017.

earnings announcements: first, the 2018 annual report[6], and later, the 2019's first-quarter earnings release[7]. Both of these demonstrated Kroger's unsatisfying same-store growth rates and the prevalence of the harmful impact of turnaround measures[8] on profit margins.

Figure 9 – Kroger's cumulative daily returns vs. S&P500 index since August 1, 2013[9]

Kroger		S&P 500	
CAGR (6 Years)	0.85%	CAGR (6 Years)	9.91%
Last-Year Standard Deviation	29.38%	Last-Year Standard Deviation	15.31%
Last-Year Price Change (%)	(21.11%)	Last-Year Price Change (%)	7.71%

Table 2 – Kroger's performance indicators vs. S&P500

[6] On March 8, 2019.
[7] On June 20, 2019.
[8] Turnaround measures included in the Kroger Restock Program discussed on the transaction rationale section.
[9] To compare both firms, the first of august 2013 was chosen as initial date, which corresponds to Sprouts' initial public offering.

Figure 10 – Kroger's 1-year daily share price

4.1.6. Financial Analysis

To perform the historical operating and financial analysis, metrics regarding profitability, solvency, and liquidity were used, taking into consideration the period 2014-2018. In addition, Appendixes 3, 4, and 5 display the firms' income statement, balance sheet, and cash flow statement, respectively.

Profitability indicators are intrinsically linked to the firm's revenues. Hence, as displayed in Table 3 (Thomson Reuters 2019), Kroger's revenues unveil a moderate grown rate, with 2.8% CAGR since 2014. Between 2017 and 2018's fiscal periods, Kroger announced a YoY negative growth rate of 1.2%, however, when adjusting for the 2017 extra week, Kroger's sales growth represents a 0.6% sales increase in the same period[10] (The Kroger Company, 2019a). Furthermore, it is vital to state that 2018's revenue growth already reflects the negative impact on revenues of the sale of the convenience store unit[11] Additionally, this transaction contributed to a notable increase of the firm's 2018 operation income and net income.

[10] Appendix 6 plots the 2018 adjustments to sales.

[11] Kroger sold its convenience store unit to EG Group on February 5, 2018, in a 2.15 billion USD transaction.

	2014	2015	2016	2017	2018	CAGR
Revenues	108,465	109,830	115,337	122,662	121,162	2.8%
YoY %	-	*1.3%*	*5.0%*	*6.4%*	*(1.2%)*	
Gross Profit	22,953	24,334	25,835	27,000	26,268	3.4%
YoY %	-	*6.0%*	*6.2%*	*4.5%*	*(2.7%)*	
EBITDA	5,085	5,665	5,792	5,048	5,079	(0.0%)
YoY %	-	*11.4%*	*2.2%*	*(12.8%)*	*0.6%*	
Operation Income	3,137	3,576	3,436	2,085	4,598	10.0%
YoY %	-	*14.0%*	*(3.9%)*	*(39.3%)*	*120.5%*	
Net income	1,747	2,049	1,957	1,889	3,078	15.2%
YoY %	-	*17.3%*	*(4.5%)*	*(3.5%)*	*62.9%*	

Table 3 – Kroger's income statement overview between 2014 and 2018

Furthermore, when analyzing the firm's profitability ratios, exhibited in Table 4, it is accessed that the firm is being overwhelmed by its competitors[12]. All ratios, in exception to the outliers[13] Net Income and ROE, are inferior to its peers'. Indeed, the competitive environment of the industry has shrunken the firm's profit margins over the time-span.

In terms of solvency, the company has been improving its financial situation, which is proven by the enhancement of its Assets/Equity, Debt/Equity, and Net Debt/EBITDA ratios. In fact, Kroger's management team is highly committed to reducing the company's debt levels in the near future (The Kroger Company, 2018a). Although, these indicators evidence that the firm's addresses substantial solvency risks.

Finally, in terms of liquidity, Kroger's quick and current ratios tend to remain stable over the years. However, these indicators are below the industry's median.

Concluding, given the firm's key figures, Kroger displays a delicate financial condition.

[12] All firms operating in the food retail & distribution sector (Thomson Reuters 2019).

[13] These indicators are highly correlated with the firm's leverage ratio and proceeds from the sale of the convenience store unit in 2018.

	2014	2015	2016	2017	2018	Industry Median
Profitability						
Gross Margin	21.2%	22.2%	22.4%	22.0%	21.7%	20.9%
EBITDA Margin	4.7%	5.2%	5.0%	4.2%	4.2%	5.5%
Operating Margin	2.9%	3.3%	3.0%	2.1%	3.6%	3.4%
Net Margin	1.6%	1.9%	1.7%	0.8%	2.5%	1.8%
ROE	32.0%	33.3%	29.2%	14.5%	42.0%	13.6%
Solvency						
Assets/Equity	5.64	4.97	5.45	5.37	4.83	2.84
Debt/Equity	2.14	1.77	2.10	2.25	1.93	0.82
Net Debt/EBITDA	2.17	2.03	2.20	2.83	2.93	2.17
Liquidity						
Quick Ratio	0.28	0.29	0.29	0.32	0.28	0.70
Current Ratio	0.78	0.76	0.80	0.78	0.76	1.23

Table 4 – Kroger's profitability, solvency, and liquidity indicators between 2014 and 2018

4.2. Company profile - Sprouts Farmers Market

Sprouts Farmers Market (SFM.O) is a natural and organic specialized U.S. food retailer. Following the belief that healthy food should be affordable, the company focusses on offering fresh, natural, and organic products at prices that appeal to everyday grocery shoppers (Sprouts Farmers Market, 2019). It was founded in 2002 and it is listed on the NASDAQ stock exchange since August 2013.

4.2.1. Stores and Operations

Sprouts operates in 19 states through its 313 stores (Sprouts Farmers Market, 2019). As displayed in Figure 11, there is an intense concentration of Sprouts' stores in highly-populated states such as California, Arizona, and Texas. In fact, 36% of the company's supermarkets are located in California (Sprouts Farmers Market, 2019).

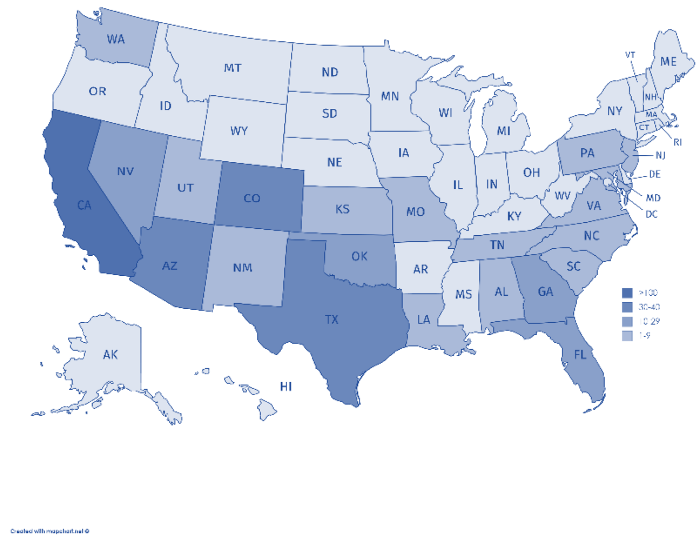

Figure 11 – Geographic distribution of Sprouts' stores

Regarding store format, Sprouts emphasis on smaller stores than its competitors, with a higher area assigned to produce and a small box shape that fosters quick in-and-out service (Sprouts Farmers Market, 2019). Stores are mainly located in mid-sized and extensive shopping centers, lifestyle centers and often in, independent single-unit, stand-alone developments.

4.2.3. Product Offering

Sprouts focuses on delivering an assortment of fresh, natural, and organic food to its customers. However, in order to offer the full grocery shopping experience, Sprouts complements its shelves with additional departments.

Thus, as displayed in Figure 12, 57.5% of the company's revenues refer to perishable products, while the remaining 42.5% correspond to non-perishable goods.

Besides, Sprouts delivers more than 2400 private label products which account for 13% of the revenues of the company (Sprouts Farmers Market, 2019). These products enhance the company's brand awareness while delivering substantially higher margins than branded products (Sprouts Farmers Market, 2019).

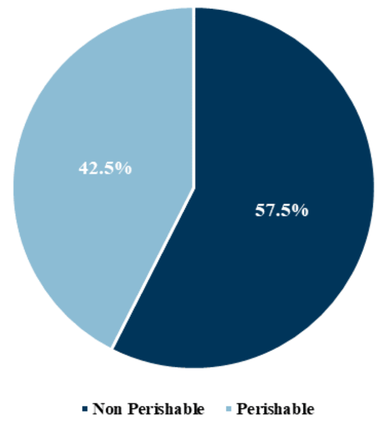

Figure 12 – Sprouts' 2018 disaggregated revenues by type of product

4.2.4. Sourcing and Distribution

Sprouts sources, warehouses and distributes almost all of the produce available on its stores while other goods are distributed by third parties (Sprouts Farmers Market, 2019). Apart from the leading supplier, which accounts for 34% of the total purchases, Sprouts has a very diverse range of suppliers (Sprouts Farmers Market, 2019).

Finally, to increase consumer engagement, Sprouts has been smoothing exploring mobile and digital opportunities by offering home deliveries operated through strategic partners (Sprouts Farmers Market, 2019). Indeed, through the partnership with Instacart[14], Sprouts offers same-day deliveries to its consumers.

4.2.5. SWOT Analysis

To summarize the firm's competitiveness within the industry, a SWOT analysis was performed as displayed in Figure 13.

[14] On January 9, 2018, Sprouts' partnership with Instacart replaced the firm's Amazon Prime online distribution channel.

Strengths	Weakness
Considerable profit margins	Reliance on third-party suppliers
Vast expertise in organic retailing	Stores highly concentrated in a few states
	Lack of liquidity

Opportunity	Threats
Online retailing	Fierce competition
Expansion across other states	Counterfeit products
Meal kits and food service	

Figure 13 – Sprouts' SWOT analysis

4.2.6. Market Performance

Sprouts' share price as of July 15th, 2019 was $18.67, which sits close to its all-time minimum ($17.63 on March 7, 2017). Its all-time maximum price was $49.11 on October 21, 2013. During the six years prior to July 15, 2019, Sprouts' stock price had a CAGR of (-11.79%).

The firm's daily cumulative returns compared with the benchmark index (S&P 500), displayed in Figure 14, exposes the negative performance of Sprouts stock returns when compared with the said index. These outcomes lead to a hypothesis that, at the IPO moment, investors overestimated the firm's future performance, especially regarding Sprouts' capability of expanding to new markets.

Relative to last year's market performance, since July 15, 2018, share price has decreased by 16.91%, with its standard deviation equaling 32.24% (Table 5). As shown in Figure 15, Sprouts went through an unusually rapid depletion of share value over the last three months.

Amongst other factors, the increasingly competitive nature of the industry might be deeply connected with the downward trend in investors' expectations. Moreover, the recent offset of revenue growth proceeds by the increase of the SG&A margin and uncertainty regarding the firms' CEO's replacement[15] also produced a harmful impact on investors' prospects[16] (Sprouts Farmers Market, 2019).

[15] Sprouts' former CEO, resigned on December 30, 2018, whereas its replacement was announced on June 20, 2019.
[16] Further discussed in the Financial Analysis section.

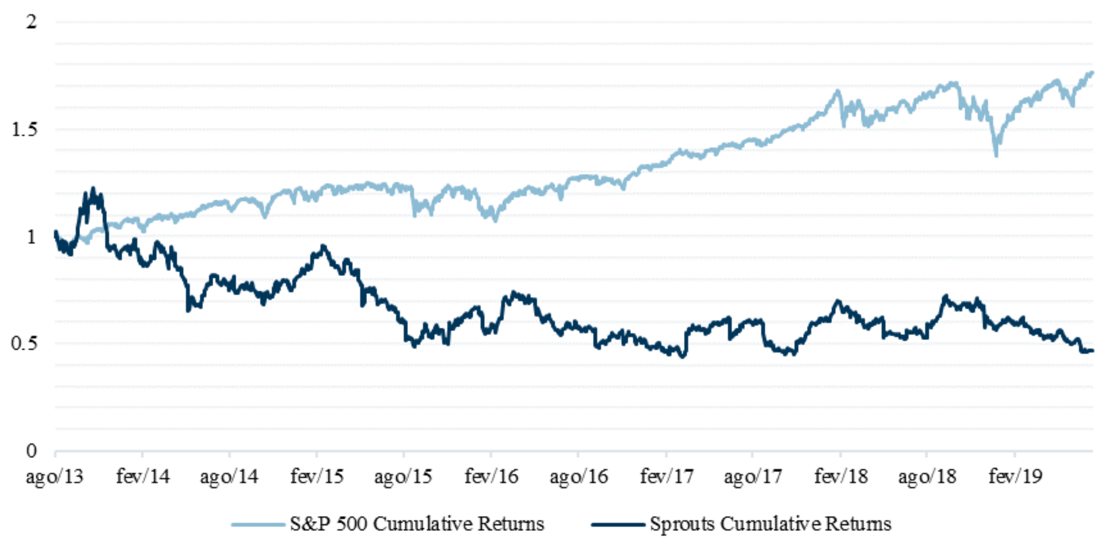

Figure 14 – Sprouts' daily cumulative returns vs. S&P500 index since August 1, 2013[17]

Sprouts		S&P 500	
CAGR (6 Years)	(11.97%)	CAGR (6 Years)	9.91%
Last-Year Standard Deviation	32.24%	Last-Year Standard Deviation	15.31%
Last-Year Price Change (%)	(16.91%)	Last-Year Price Change (%)	7.71%

Table 5 – Sprouts' performance indicators vs. S&P 500

Figure 15 – Sprouts' 1-year daily share price

[17] To compare both firms, the first of august 2014 was chosen as initial date, which corresponds to Sprouts' initial public offering

4.2.7. Financial Analysis

Following the methodology applied to Kroger's financial analysis, metrics regarding profitability, solvency, and liquidity were employed. Additionally, Appendixes 8, 9, and 10 display the firm's income statement, balance sheet, and cash flow statement, respectively.

Revenues are the fundamentals of a firm's profitability. Therefore, as exhibited in Table 6, Sprouts revenues have been growing at pace since 2014, achieving a remarkable CAGR of 15.1%. The last period growth rate was mostly driven by the strong performance of the newest thirty stores opened (Sprouts Farmers Market, 2019). The firm's reported gross income has increased, on average, 18.5% a year, yet this effect was not remarkably intense in the other indicators encompassing the income statement.

	2014	**2015**	**2016**	**2017**	**2018**	**CAGR**
Revenues	2,967	3,593	4,046	4,665	5,207	15.1%
YoY %	-	*21.1%*	*12.6%*	*15.3%*	*11.6%*	
Gross Profit	885	1,052	1,363	1,567	1,747	18.5%
YoY %	-	*18.8%*	*29.7%*	*14.9%*	*11.5%*	
EBITDA	200	229	291	320	331	13.5%
YoY %	-	*14.5%*	*27.3%*	*10.0%*	*3.3%*	
Operating Income	200	229	213	226	223	2.8%
YoY %	-	*14.5%*	*(6.9%)*	*6.2%*	*(1.4%)*	
Net income	108	129	124	158	159	10.2%
YoY %	-	*19.8%*	*(3.6%)*	*27.5%*	*0.1%*	

Table 6 - Kroger's income statement overview between 2014 and 2018

Moreover, to legitimate assess the firm's profitability, solvency, and liquidity position, one should compare its key ratios with the industry[18]. Hence, entrusting Table 7 (Thomson Reuters 2019), Sprouts' position in the organic retail market niche maintains solid and consistent profit margins above the industry median. Nevertheless, since 2014, EBITDA, operating and net income margins denote a contraction trend as a result of higher compensation, store expansion and investments aiming to enhance the firm's future performance (Sprouts Farmers Market, 2019).

[18] Industry encompasses all firms operating in the food retail & distribution (Thomson Reuters 2019).

In terms of solvency, Sprouts evidence a stable and sustainable situation, with assets/equity, net debt/equity, and net debt/EBITDA enhancing the low leverage of the firm in comparison to the industry's median.

Finally, relating to Sprouts' liquidity levels, the firm's ambitious organic growth strategies led to prevalent short liquidity levels. Indeed, since 2015, the retailer's quick and current ratios have deteriorated considerably, especially the quick ratio, which declined from 0.87 in 2014 to 0.22 in the 2018 fiscal year,

In conclusion, considering the firm's key indicators, Sprouts bear reduced profitability and solvency risk, however, its illiquid condition may be harmful.

	2014	2015	2016	2017	2018	Industry Median
Profitability						
Gross Margin	29.8%	29.3%	33.7%	33.6%	33.6%	20.9%
EBITDA Margin	8.8%	8.3%	7.3%	6.9%	6.4%	5.5%
Operating Margin	6.7%	6.2%	5.3%	4.8%	4.3%	3.4%
Net Margin	3.6%	3.6%	3.1%	3.0%	3.0%	1.8%
ROE	18.0%	17.1%	16.6%	21.1%	25.6%	13.6%
Solvency						
Assets/Equity	2.0	1.7	2.1	2.4	2.8	2.84
Net Debt/Equity	0.6	0.4	0.6	0.7	1.0	0.82
Net Debt/EBITDA	1.2	0.7	0.9	1.3	1.6	2.17
Liquidity						
Quick Ratio	0.87	0.78	0.23	0.23	0.22	0.70
Current Ratio	1.51	1.50	1.02	1.00	1.08	1.23

Table 7 – Sprouts' profitability, solvency, and liquidity indicators between 2014 and 2018

5. Transaction Rationale

To offset the new challenges for the grocery retail industry described in the *Disruption of the Industry* section, in the final quarter of 2017, Kroger launched its Restock Kroger Program. This program is aiming to improve the firm's performance and shareholders' compensation, by investing in advanced analytics, home delivery services, and the fulfillment of new consumer needs.

Through the partnership with Ocado[19] and acquisition of Home Chef, Kroger adapts to new consumer trends, by extending its vast product offering of meal kits and complementing brick-and-mortar shopping with online and home delivery possibilities[20] (The Kroger Company, 2018a). Also, to counter online competitors, the firm is committed to redefining consumer experiences (The Kroger Company, 2018a) by transforming physical stores into social hubs, generating notable experiences that will retain consumers and that cannot be replicated online (Tetra Pack, 2018).

Likewise, the company is fostering growth in its steadiest growing segment, the N&O segment. This segment has been growing double-digit in the past five years (The Kroger Company, 2018a) mostly due to its private-label (*Simple Truth*) who covers this market niche.

Thus, to increase market share, intensify access to reliable organic food suppliers[21], gain brand awareness and assure its solid position as a healthy grocer, Kroger should engage, once again, in an M&A process by acquiring the organic & natural specialized grocery chain, Sprouts Farmers Market.

Sprouts has a seamless supply chain of organic products and is renowned for its expertise in high-quality product- and perishable-offerings. Sprouts' capabilities along with its privilege position within the organic retail sector, would perfectly complement Kroger's national reach and yield large economies of scale.

Moreover, this acquisition would foster Kroger's position in the O&N sector not only by capturing consumers who are fully dedicated to healthy grocery shopping but also by empowering cross-sells. Merging the two companies would enable the expansion of Sprouts' products through the Kroger's national level store network and also benefit from the inclusion of Kroger's *Simple Truth* products to Sprouts' shelves. Besides, this acquisition would intensify Kroger's presence in highly-populated states such as California, Texas, and Arizona as well as launching operations in the Oklahoma state.

Furthermore, the outstanding track record of Kroger's integration of past acquisitions[22] and current depreciation of Sprouts' share value[23] would intensify the value caption and, subsequently, increase shareholder value.

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[19] Kroger acquired a minimal stake on Ocado's equity and signed an exclusive partnership use Ocado's unique technology to boost online sales and foster supply chain efficiency.

[20] Through Ocado, Kroger offers its customers click-and-pick, instant delivery and shipment options.

[21] Due to the increasing demand on this market niche retailers harden in stablishing stable and reliable relations with organic suppliers.

[22] Appendix 11 exibits Kroger's recent acquisitions.

[23] Sprouts' share value depleted 16.9% LTM .

6. Valuation of Standalone Firms

6.1. Kroger Co.

6.1.1. Discounted Cash Flow Model (DCF)

The DCF was accomplished by forecasting all the firm's statements and athwart the creation of three distinct scenarios. Each scenario includes different revenue growth rates, which may be accessed in Appendix 12. Besides, in subsequence chapters, all results refer to the base case scenario.

6.1.1.1 Income Statement

To estimate the intrinsic value of a firm, one must start by forecasting the income statement, in which, most of its items are driven from revenues.[24]

During 2019, Kroger's revenues should evolve according to the corporation's estimates (2.0%) (The Kroger Company, 2018a). Hereafter, sales should smoothly approach the MarketLine estimates for the industry until 2022. Subsequently, it is expected that the revenue growth rate slowly decays over time, tending to the perpetual growth rate. (Figure 16)

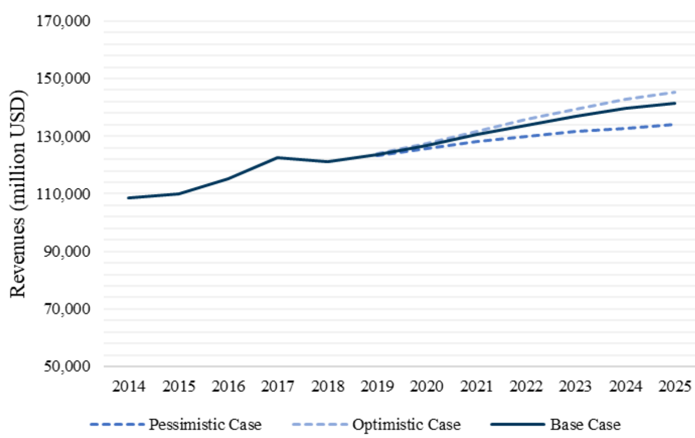

Figure 16 – Kroger's revenue growth estimates

Since Kroger's COGS as a percentage of revenue have been consistent in the past, it is assumed that it will remain to represent 78% of the total revenue. As for the remaining operating expenses estimates, namely SG&A and Rent expenses, due to their stable pattern, it is estimated that the

[24] Appendix 13 plots the firm's forecasted income statement.

company will maintain the 2018 proportion of revenues. Thus, SG&A and Rent expenses would preserve their 17% and 1% ratios, respectively.

Relating to the company's sponsored pension plan costs, due to their high volatility in the previous years, the simple average of the past periods would be a reliable estimation.

For the interest expenses, it is presumed that Kroger's interest rate would be constant equaling 3.45% since it matches the weighted average yield to maturity of tradable bonds outstanding at the data collection date.

As regards to the other non-recurrent items encompassing the income statement, due to their unpredictability matter, they were assumed to be zero in the future.

Finally, during the forecasted period, tax provisions were computed using a constant tax rate (27%), which equals future expectations (KPMG, 2019).

6.1.1.2 Balance Sheet

Following the estimation of the Income Statement, one should proceed to the forecast of the balance sheet.[25]

Working capital items are driven by revenue straight-line forecasting. These items' connection with revenues are assumed to remain constant over time.

As for depreciation, this item is estimated as a percentage of revenues. In the future, the company's D&A would represent 2.0% of the revenues, whereas CAPEX should represent 2.4%. This assumption goes in line with the Kroger Restock Program, which expects that CAPEX expenditures will amount to 9,000 million USD during the 2018-2020 period.

Hence, the PP&E driven from the subsequent formula:

$$PP\&E_t = PP\&E_{t-1} + CAPEX_t - \text{Depreciation Expenses}_t - \text{Asset Sales}_t$$

Equation 10 – PP&E computation

As for the amortization of intangibles, due to the company's past acquisition policy, a reliable estimate is difficult to obtain. However, it is presumed that amortization would represent 0.0004% of the revenues. This value is driven from the 2017 amortization expense, which corresponds to the only period when intangibles denoted a net decrease.

[25] Appendix 14 plots the firm's forecasted balance sheet.

$$\text{Intangibles}_t = \text{Intangibles}_{t-1} + \text{Purchases}_t - \text{Amortization Expenses}_t$$

Equation 11 – Intangibles computation

No impairment measures will be taken in the future, consequently, goodwill is expected to remain constant. Finally, due to lack of guidance, assets held for sale are anticipated to be liquidated at par value in the upcoming period and that they will seize to exist afterward.

As regards to debt obligations and lease contracts, the company will continue the deleveraging process started in 2018[26]. Accordingly, during the forecasted period, the company's amortization of outstanding debt will remain constant and equal to 2018 values. Besides, it is anticipated that, due to the current investment grade of the firm, it will be capable of refinancing all its debt as current obligations reach maturity.

Deferred income taxes and pension and postretirement obligations, due to lack of guidance are assumed that will remain constant during the forecasted period.

Finally, in the statement of shareholder's equity, shares at par value and additional paid-in capital are assumed to remain constant during the explicit period. Dividends payments would keep representing 14.1% of Net Income. Whereas, due to the extraordinary deleveraging measures, share buybacks will be reduced and amount 500 million USD each year. Moreover, retained earnings will continue to grow following Kroger's results as translated in the following formula:

$$\text{Retained Earnings}_t = \text{Retained Earnings}_{t-1} + \text{Net Income}_t - \text{Dividends}_t$$

Equation 12 – Retained earnings computation

6.1.1.3. Cash Flow Statement

Given the assumptions stated beforehand, Kroger will be capable of fulfilling all its operations, investment, and financing obligations, as well as its ambitious shareholder's compensation program, while continuously increasing its cash balance.[27]

6.1.1.4. Discount Rate

To compute Kroger's discount rate, one must start by selecting a reliable proxy for the risk-free rate. Therefore, the fifteen of July 10-year zero-coupon U.S. Treasury bond was chosen (2.09%).

26 Kroger's management aims to achieve a Net Total Debt / EBITDA ratio between the 2.3-2.5 range. (The Kroger Company, 2018b).
27 Appendix 15 plots the firm's forecasted cash flow statement.

Henceforth, the corporate tax rate and market risk premium used were 27% and 5.75%, respectively, under the KPMG's recommendation for 2019 on (KPMG, 2019).
Hereafter, the company's beta was computed through a bottom-up approach. This methodology calculates the company's beta by regressing each competitors' 5-years monthly returns on the S&P 500 index[28]. Subsequently, the industry unlevered beta was adjusted to Kroger's capital structure and smooth using the methodology suggested by McKinsey & Company (2005) and Blume, (1975).
Thus, Kroger's Beta equals to 0.977.[29] Henceforth, applying Equation 4, Kroger's cost of equity equals to 7.66%.
As regards the cost of debt estimation, most of the debt outstanding is tradable, consequently the weighted average of the Kroger's bonds was used as a proxy. Thereby, the cost of debt of 3.45% was later renewed into an after-tax cost of debt of 2.52%.
Finally, with the incorporation of Kroger's target capital structure, which, due to lack of guidance, it is assumed to equal the current capital structure in market values[30], the WACC equals to 5.32%.

6.1.1.5. Free Cash Flow for the Firm

Based on the abovementioned assumptions, the FCFF estimations were computed, which can be accessed in Table 8.
Hereafter, applying Equation 1 on a mid-year approach, the firm's PV was computed, leading to a valuation of 35,459 million USD. In order to calculate Kroger's terminal value, it was assumed that the company would reach steady state in 2025 and that, given the firm's mature stage, its terminal growth rate would equal 1%.
Furthermore, the market value of debt was subtracted to the enterprise value, which divided by the current number of shares would lead to an intrinsic value of $25.02 per share, representing a potential upside of 13.33% regarding the actual share price ($22.08).

[28] For Kroger's beta calculation, non-U.S. peers were excluded - Tesco PLC, RWE AG.
[29] Detailed Beta computation present in Appendix 16.
[30] Appendix 17 explains in detail the computation of the firm's capital structure.

FCFF	2019E	2020E	2021E	2022E	2023E	2024E	2025E
EBIT	2,613	2,678	2,761	2,830	2,894	2,952	2,989
Taxes	(705)	(723)	(746)	(764)	(781)	(797)	(807)
NOPLAT	**1,907**	**1,955**	**2,016**	**2,066**	**2,113**	**2,155**	**2,182**
D&A	2,568	2,632	2,713	2,781	2,844	2,901	2,937
ΔWC	17	22	28	23	21	19	12
CAPEX	(3,026)	(3,102)	(3,198)	(3,278)	(3,352)	(3,419)	(3,462)
FCFF	**1,466**	**1,507**	**1,559**	**1,592**	**1,626**	**1,656**	**1,670**

Table 8 – Kroger's FCFF forecasts

6.1.1.6. Sensitivity Analysis

		WACC				
	Share Price	4.92%	5.12%	5.32%	5.52%	6.72%
Terminal Growth Rate	0.5%	25.15	23.19	21.43	19.74	12.08
	0.8%	27.22	25.06	23.13	21.28	13.00
	1.0%	29.57	27.16	25.02	22.99	14.00
	1.3%	32.23	29.53	27.15	24.90	15.10
	1.5%	35.28	32.23	29.56	27.05	16.30

Table 9 – Kroger's DCF sensitivity analysis

6.1.2. Relative Valuation

Kroger's relative valuation was based on the firm's competitors (The Kroger Company, 2019a) P/E and EV/EBITDA historic ratios[31]. However, since the peer group defined by the management team denoted several discrepancies, a k-cluster analysis was performed. Following this methodology, it was possible to aggregate the firm's competitors into several homogenous groups.[32]

Thus, based on the firm's cluster indicators, Kroger's share price is within the $28.33-$44.77 price range.

[31] Ratios evidenced at each firm's 2018 annual earnings release date.

[32] Appendix 18 explains, in detail, how the k-cluster analysis was performed.

6.1.3. Valuation Summary

Figure 17 compares Kroger's valuation results with the 52-week high-low price range and current share price.

Due to the usage of historic ratios used and recent underperformance of the firm when compared to its peers, relative valuation methodologies lose accuracy, leading to an overestimation of the firm's share value.

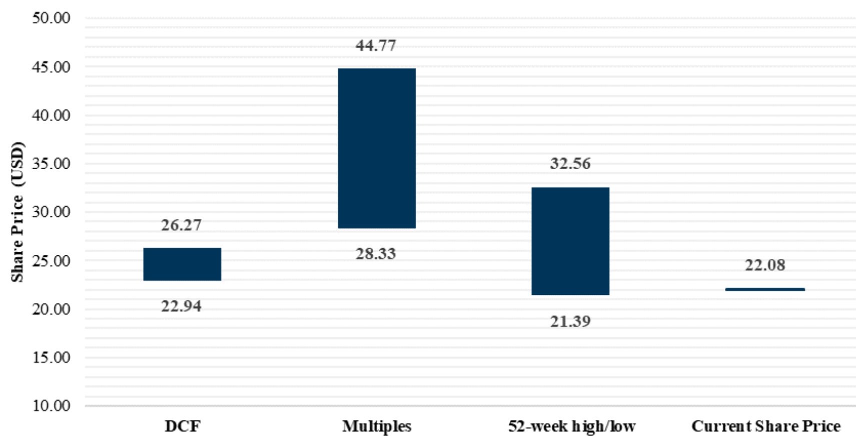

Figure 17 – Kroger's valuation summary

6.2. Sprouts Farmers Market

6.2.1. Discounted Cash Flow Model

The DCF was performed estimating all the firm's statements and through the creation of three distinct scenarios. Each scenario encompasses diverse revenue growth rates, which may be accessed in Appendix 19. In subsequence chapters, all outcomes refer to the base case scenario.

6.1.2.1. Income Statement

To accurately estimate the income statement items, several items are driven by revenue straight-line forecasting.[33]

Therefore, one must start by predicting future revenue growth. Therefore, Sprouts' revenues should vary in following the MarketLine estimates for the industry until 2022. After this period, the revenue growth rate is likely to decay over time slowly.

[33] Appendix 20 plots the firm's forecasted income statement.

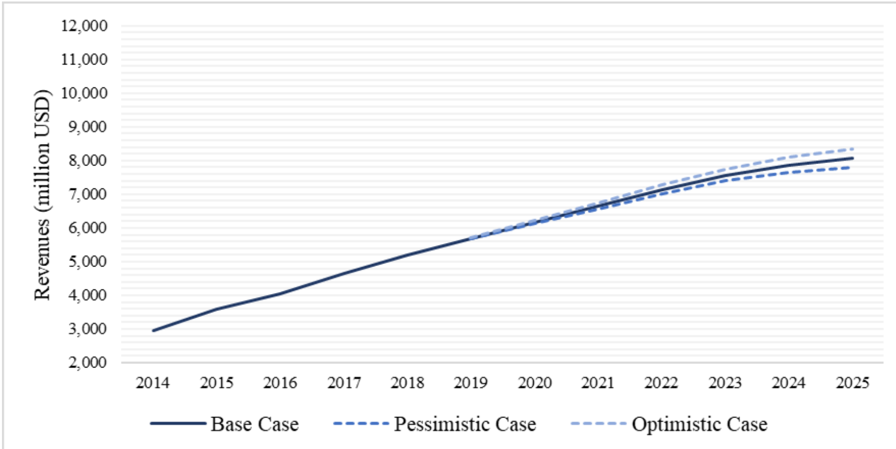

Figure 18 – Sprouts' revenue growth forecasts

Hence, since Sprouts' COGS as a percentage of revenue denote a consistent pattern in the past, it is assumed that this item will continue to represent 66.44% of the total revenue. As for the remaining operating expenses estimates, namely SG&A and store closure and other costs, due to their steady outline, it is estimated that the company will maintain the 2018 ratios, 27.00%, and 0.23%, respectively.

Further, interest expense estimates, due to the inexistence of traded debt which could be used as a proxy, it was considered that the current interest rate[34] (4.73%) would remain constant during the forecasted period.

Other non-recurrent items encompassing the income statement, due to their unpredictability matter, were assumed to be inexistent in the future.

Lastly, due to the lack of guidance and past volatility, tax provisions were computed using a constant tax rate (27%), which equals future expectations (KPMG, 2019).

6.1.2.2. Balance Sheet

After forecasting the income statement, one should advance to the balance sheet estimation.

Working capital items are driven by revenue straight-line forecasting.[35] These items' ratios are assumed to remain constant over time.

As for PP&E estimation, this value is intrinsically correlated with the firm's D&A and CAPEX policies. These items were estimated as a percentage of revenues and taking into consideration the

[34] Driven from dividing interest expenses by the sum of debt and leases outstanding.
[35] Appendix 21 plots the firm's forecasted balance sheet.

most recent values. Thus D&A and CAPEX will represent 2.93% and 1.90% of revenues, respectively.

Intangible assets are expected to continue their straight-line amortization scheme initiated in 2015 (Sprouts Farmers Market, 2019).

As for goodwill resulting from the past acquisition processes, since no goodwill impairment measures were taken in the past, it is reasonable to assume that this item will remain constant in the future.

It is presumed that the company will not fluctuate its current debt levels and, since Sprouts is rated as an investment-grade firm, the firm will be capable of refinancing all its debt as current obligations reach maturity.

Deferred income tax liabilities, due to limited information are assumed that will remain constant during the forecasted period.

Finally, in the statement of shareholder's equity, preferred shares and common shares at par value, and additional paid-in capital are assumed to remain constant during the explicit period. The firm will maintain its non-dividend distribution policy, while distributing, via share repurchases, the excess cash generated. Moreover, Sprouts' retained earnings will continue to vary under the future performance of the firm.

6.1.1.3. Cash Flow Statement

Given the inputs detailed beforehand, Sprouts will be able to fulfill all its operations, investment, and financing obligations while maintaining its shareholder's compensation and cash balance increase.[36]

6.1.1.4. Discount Rate

For the discount rate computation, the fifteen of July 10-year zero-coupon US Treasury bond was chosen (2.09%) as the risk-free rate. Whereas the corporate tax rate and market risk premium used were 27% and 5.75%, respectively (KPMG, 2019).

Hereafter, the company's beta was computed through a bottom-up approach. To do so, one must first regress the median[37] of each competitors' 5-years monthly returns on the S&P 500 index.

[36] Appendix 22 plots the firm's forecasted cash flow statement

[37] Median was chosen in order to reduce outliers

Subsequently, the industry unlevered beta was adjusted to Sprouts' capital structure and smooth using the methodology suggested by McKinsey & Company (2005) and Blume (1975).

Thus, Sprouts' beta equals 0.745.[38] Henceforth, applying Equation 4, the firm's cost of equity equals 8.37%.

As regards the cost of debt estimation, since the firm only possesses non-traded debt, the last period effective interest rate was used as a proxy[39]. Therefore, the cost of debt of 4.73% was later renewed into an after-tax cost of debt of 3.45%.

Finally, with the incorporation of Sprouts Farmers Market target capital structure, which is assumed to equal the current capital structure in market values[40], the WACC equals to 5.71%.

6.1.1.5. Free Cash Flow for the Firm

Hence, the FCFF forecasts were computed, present in Table 10.

Hereafter, applying Equation 1 on a mid-year approach, the firm's PV of FCFF was computed, leading to a valuation of 3,484 million. For the terminal value computation, by convention, it is anticipated the company would reach steady state in 2025 and that, given the firm's current maturity stage, its terminal growth rate would equal 1%.

Afterward, the market value of debt was subtracted to the enterprise value, which divided by the current number of shares would lead to an intrinsic value of 23.44 per share, representing a potential upside of 25.5% regarding the actual share price (18.67).

[38] Detailed Beta computation present in Appendix 16.

[39] Driven from dividing interest expenses by the sum of debt and leases outstanding.

[40] Appendix 17 explains in detail the computation of the firm's capital structure.

FCFF	2019E	2020E	2021E	2022E	2023E	2024E	2025E
EBIT	252	273	295	316	336	349	358
Taxes	(68)	(74)	(80)	(85)	(91)	(94)	(97)
NOPLAT	**184**	**200**	**215**	**231**	**245**	**255**	**261**
D&A	110	119	128	138	146	151	155
ΔWC	10	10	10	10	9	6	4
CAPEX	(167)	(181)	(195)	(209)	(222)	(231)	(237)
FCFF	**137**	**148**	**159**	**170**	**178**	**182**	**184**

Table 10 – Sprouts' FCFF forecasts

6.1.1.6. Sensitivity Analysis

		WACC				
	Share Price	5.3%	5.5%	5.71%	5.9%	6.1%
Terminal Growth Rate	0.5%	23.59	22.43	21.35	20.36	19.43
	0.8%	24.79	23.52	22.34	21.26	20.27
	1.0%	26.13	24.73	23.44	22.26	21.18
	1.3%	27.63	26.08	24.66	23.37	22.19
	1.5%	29.33	27.60	26.02	24.61	23.30

Table 11 – Sprout's DCF valuation sensitivity analysis

6.2.2. Relative Valuation

Since the company does not disclose its competitors, all firms encompassing the Food Retail & Distribution sector with a market cap greater than 1 billion USD were taken into consideration[41]. From this primary group, through a k-cluster analysis, a homogeneous cluster was formed which lead to a relative share price based on the EV/EBITDA and P/E historic ratios[42], within the $30.45-$30.78 price range.

[41] Appendix 18 explains, in detail, how the k-cluster analysis was performed.
[42] Ratios evidenced at the 2018 annual earnings date.

6.2.3. Valuation Summary

Figure 19 compares Sprouts' valuation outcomes with the 52-week high-low share price range and current share price.

The usage of historic ratios, recent depletion of profit margins, and low similarity degree of the peers jeopardize the relative valuation results. In fact, the scarcity of listed firms with both comparable size and operations in the same market niche as Sprouts leads to a low degree of reliability when estimating the firm's intrinsic value using multiples.

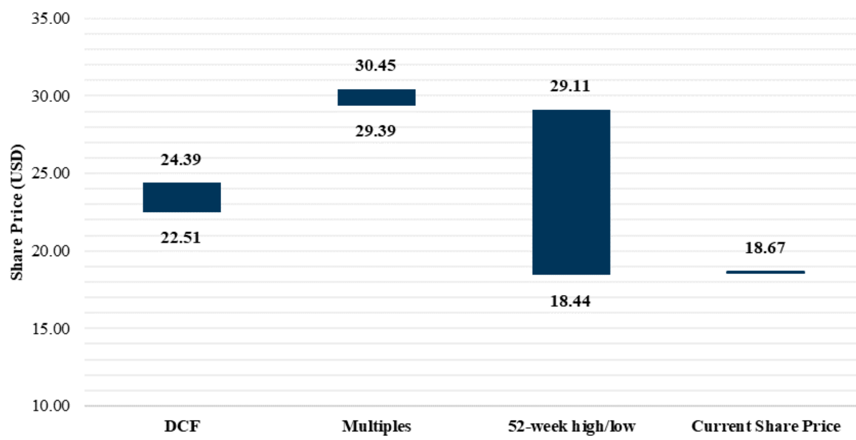

Figure 19 – Sprouts' valuation summary

7. Valuation of the Combined Firm

7.1.1. Synergies

Synergies are the primary motive for acquisition processes with positive total benefits (Berkovitch & Narayanan, 1993). Therefore, to properly evaluate the reasonability of the transaction, one must measure the value created by combining both firms, and later compare it with fees waged and transaction premium paid to Sprouts' investors.

Besides, it is imperative to assess that the integration of the two firms is an ongoing process, consequently, synergies hardly ever appear instantly (Damodaran, 2005). Hence, for each scenario[43], it was assumed that the transaction would harvest no synergies in 2019, moderate synergies in 2020 and achieve its full potential later on.

Cost savings are the central argument in most of the transactions (BCG, 2018). In this particular transaction, economies of scale, intensification of bargaining power and enhanced supply chain efficiency yield powerful cost savings synergies. Furthermore, the elimination of duplicate staff and unused facilities would also contribute to a reduction of Sprouts' COGS in percentage of sales in 10 basis points[44].

Moreover, in accordance with Deloitte (2017)[45], gains from applying the best management practices, centralization of corporate facilities, elimination of duplicate non-operational divisions and marketing campaign savings, are expected to decrease Sprouts' SG&A in percentage of sales by 250 basis points.[46]

As for revenue enhancements, due to the size difference between the merged firms, it was imperative to segregate the value creation across both standalone firms. Consequently, through cross-sells, Kroger will boost its sales growth rate by 1 basis point. Whereas, Sprouts will benefit from Kroger's established market position, brand awareness, and online presence, leading to an increase of Sprouts' revenues growth rate by 50 basis points.[47]

Regarding financing synergies, given the size dissimilarities between the two firms and financing tools used, it is unlikely that the borrowing capacity of the merged firm will suffer substantial alterations. Moreover, concerning tax benefits, since both firms operate within the U.S. tax jurisdiction, tax benefits, if existent, are most likely negligible. Figure 20 plots the relative distribution of synergies according to its category.

[43] Three different scenarios were computed: Base case, Pessimistic Case and Optimistic Case; values present in the text refer to the base case scenario; Appendix 23 exhibits detailed information about each scenario assumptions.

[44] The high degree of competitiveness in the food and grocery retail sector has shrunk gross margins, decreasing the likelihood of this kind of synergies.

[45] Synergies typically vary between 1% and 5% of the target's combined costs (Deloitte, 2017).

[46] Due to the size differences between both firms, no cost savings synergies were forecasted for Kroger's operations.

[47] According to (Deloitte, 2017), normally, revenue enhancements amount 1-5% of the target's revenues, however, given the already outstanding growth rates of the firm, it is unlikely that they would further increase .

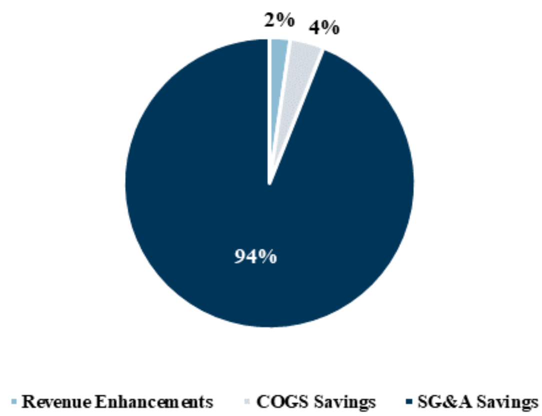

Figure 20 – Synergy's source disaggregation

However, the increasing leverage has an impact on the merged firm's beta which slightly increased the WACC by 0.9 basis points[48], leading to a post-transaction WACC of 5.35%.[49]
Therefore, following the scenario analysis, the PV of synergies, in million USD, is within the 442-1,841 million USD range. Albeit, for further analysis, only the base case scenario will be considered, which establishes the PV of synergies in 1,141 million USD.

7.1.2. Control Premium

Thus, given the market underperformance of Sprouts' stock, it is reasonable to assume that a friendly takeover would occur, with an estimated control premium slightly lower than the median of past transactions within the F&G retail industry.[50] Therefore, it is forecasted that Sprouts shareholders would accept to trade their positions for a 30% increment on their actual price. ($24.71 per share) Hence, Sprouts transaction price equals 2,795 million USD.

7.1.3. Transaction and Integration Fees

Besides the control premium demanded by the acquired shareholders, one must estimate the transaction and integration fees encompassing the transaction. Due to the size similarity, the investment banking fees paid on Kroger's past acquisition of Harris Teeter Supermarket Inc. were used as a proxy.[51] Thus, transaction fees equal 40 million USD.

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[48] When comparing with the weighted average WACC of the two firms standalone.
[49] Appendix 24 plots the post-transaction WACC computation.
[50] As displayed in Appendix 25, the median premium paid on past transaction equals 34% .
[51] On July 9, 2013 Kroger announced the acquisition of Harris Teeter Supermarkets Inc on a 2,544 Billion USD deal, whose transaction fees encompassed 1.42% of the deal value (Thomson Reuters 2019).

Moreover, it is expected the integration fees to reach 1.5% of Sprouts' enterprise value, totaling a PV of 36 million USD. However, since the integration of both firms is an ongoing process, integration costs, such as regulatory filings, staff relocation/layoff and facility closing (M&A Leadership Council, 2014) would occur in the next three years.[52]

7.1.4. Financing

Given the size discrepancies between both firms, Kroger will buy Sprouts in an all-cash deal. Exceptionally, due to the commitment of Kroger's management team in maintaining its investment-grade rating of the firm (Baa1[53]), part of the transaction will be financed the firm's excess cash reserves[54] and with the after-taxes proceeds from announced sales of You Technology Brand SVCS Inc[55] and Turkey Hill Dairy[56] divisions. Whereas, the remaining amount will be financed through the issuance of new debt. Figure 22 plots the financing options employed in the acquisition of Sprouts[57].

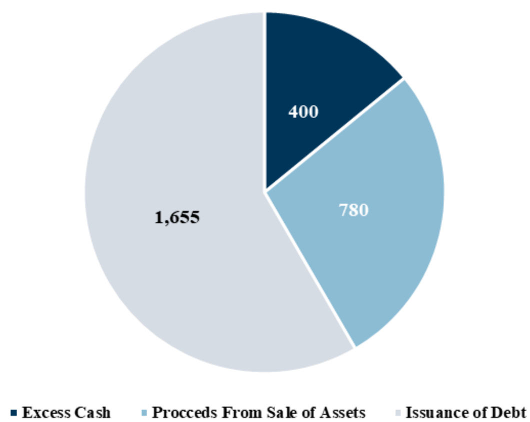

Figure 21 – Financing options employed (millions USD)

[52] Appendix 26 displays in detail the integration costs and its dispersion through time.
[53] According to Moody's on 12 June 2019.
[54] Excess cash equals to the cash outstanding minus the minimum cash requirements; Minimum cash requirements assumed - 30 million USD.
[55] On March 13, 2019, Kroger Co. settle with Inmar Inc. the sale of You Technology Brand SVCS Inc for 565 million USD.
[56] On March 19, 2019, Kroger Co. agreed to sell Turkey Hill Dairy to Peak Rock Capital LLC for 215 million USD.
[57] Including transaction fees.

7.1.5. Valuation Summary

Hence, the FCFF forecasts of the combined firm was computed, present in Table 12. Appendixes 27, 28, and 29 exhibit the post-transaction income statement, balance sheet, and cash flow statement, respectively.

Hereafter, the firm's PV of FCFF was calculated, leading to a valuation of 41,739 million USD, as displayed in Figure 23.

FCFF	2019E	2020E	2021E	2022E	2023E	2024E	2025E
EBIT	2,864	2,984	3,201	3,342	3,438	3,519	3,571
Taxes	(773)	(806)	(864)	(902)	(928)	(950)	(964)
NOPLAT	**2,091**	**2,178**	**2,337**	**2,440**	**2,510**	**2,569**	**2,607**
D&A	2,678	2,752	2,845	2,923	2,996	3,060	3,101
ΔWC	28	32	38	34	31	26	17
CAPEX	(3,193)	(3,283)	(3,394)	(3,490)	(3,578)	(3,655)	(3,705)
FCFF	**1,603**	**1,680**	**1,825**	**1,907**	**1,959**	**2,000**	**2,020**

Table 12 – Merged corporation's FCFF forecasts

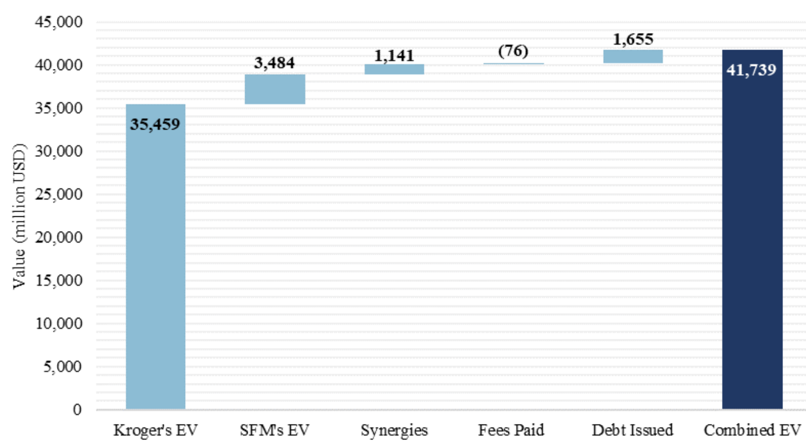

Figure 22 – Valuation summary - merged corporation

Henceforth, given the control premium paid to Sprouts' shareholders of 645 million USD, Kroger's shareholders will capture 420 million USD, which after the payment of the transaction and integration fees represents 37% of the value creation of the transaction, as displayed in Figure 24.

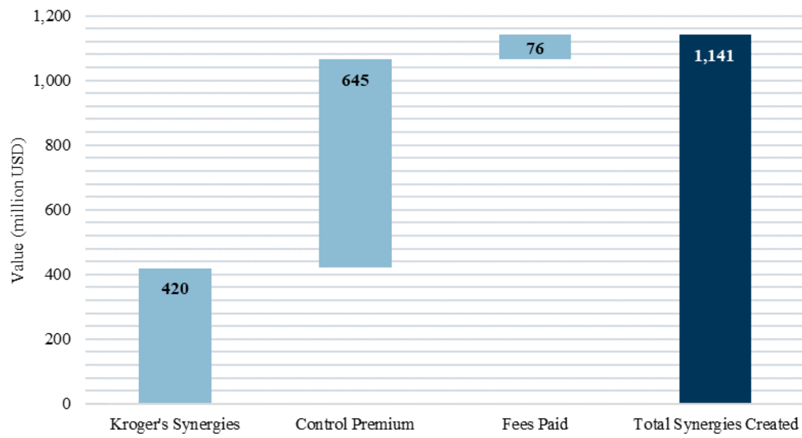

Figure 23 – Synergies' capture

8. Transaction Topics

After analyzing the transaction rationale and valuating the deal's added value, one must focus on the several issues comprising the transaction.

8.1. The Threat of an Auction Environment

The high level of consolidation within the industry leads to a scarce number of suitable mid-sized acquisition targets. Therefore, the possibility that Kroger's competitors, such as Costco, Walmart, Target, Albertsons, or Amazon, attracted by the flourished synergies of Sprouts, might enter into the negotiation. Indeed, in 2017, after Amazon's acquisition of Whole Foods, Target and Albertsons showed interest in the integration of Sprouts in their portfolio.

The presence of several firms bidding the target would create an auction environment which, typically, raises the target's purchase price and, increases the likelihood of an overestimation of the target's value - a phenomenon known as winner's curse[58] (DePamphilis, 2011).

8.2. Takeover Approach

Kroger's approach should align interests with Sprouts' management team to incur in a friendly takeover. This process fosters cooperation among parties, which prevents auction environments, eases premerger integration planning, and diminishes the integration time spam (DePamphilis, 2011). Besides, this approach evades value-depletion takeover defense costs.

[58] The winner's purchase price is higher than the target's implicit value (DePamphilis, 2011).

8.3. Premium analysis

It is primordial to access the maximum price that Kroger is willing to offer by Sprouts' equity before the initial approach. This step is crucial in an auction environment to avoid overpaying. On the DCF's valuation, it was concluded that Sprouts was undervaluated. Therefore, it is presumable that Sprouts' shareholders would not accept the transaction for a share price lower than its intrinsic value, $23.44 (25.54% premium).

Furthermore, the maximum price that enables the creation of value to Kroger's shareholders is $25.64 per share (37.37% premium).

However, as stated in the valuation section, given the market underperformance of Sprouts' stock, it is reasonable to assume that Sprouts' shareholders would accept 30% as control premium, which is slightly lower than the median of past transactions within the F&G retail industry.[59] Henceforth, Sprouts transaction price equals $24.71 per share.

9. Post-Merger Integration Risks

Simultaneously to the negotiation process, Kroger must prepare a profound and reliable integration plan aiming to mitigate upcoming risks and increase the likelihood of synergy generation. In fact, in an M&A process, early planning maximizes the added value captured (BCG, 2016). Therefore, following Deloitte's (2010) nomenclature regarding post-merger integration risks[60], the acquirer must settle a team capable of forestall and ease post-merger integration jeopardies. Nevertheless, the firm must be aware of eventual misleading synergy estimates, cultural crashes, integration incompatibilities, self-competition, and business model incongruencies that might harmfully impact the value creation of the acquisition.

Notwithstanding, given the Kroger's exceptional integration capabilities, demonstrated by a successful past integration program, rapid and smooth incorporation of Sprouts will, most likely, occur.

[59] As displayed on Appendix 25, the median premium paid on past transaction equals 34%.

[60] A transaction, typically, bears people, synergy, structure and project risks (Deloitte, 2010).

10. Alternative Targets

Prior to the selection of Sprouts as the optimal acquisition acquired, other potential firms were considered. Therefore, Weis Markets Inc and Natural Grocers by Vitamin Cottage, Inc.[61] emerge as suitable alternatives to Sprouts. These firms are specialized in the natural and organic food retail sector, feature appealing growth potential, and attractive profit margins.

However, as displayed in Table 13, these firms are overwhelmed by Sprouts in terms of size and profitability. In Kroger's management's point of view, since the firm is craving for profitability enhancements, size is the critical variable when selecting an acquisition target due to its substantial instant impact on overall profitability.

Additionally, the considerable family ownership of Weis Markets' stock might disincentive the acquisition.

	Weis Markets	Natural Grocers	Sprouts Farmers Market
Market Cap ($M)	991	224	2,150
Same Store Sales Growth (%)	0.7%	5.8%	2.1%
Number of Stores	202	148	313
EBITDA Margin (%)	5.0%	5.2%	6.4%
Net Margin (%)	1.8%	1.0%	3.0%

Table 13 – Comparison of key operating indicators between Sprouts and alternative targets

[61] These corporations, given their low size (market cap lower than 1 billion) and unavailability of several financial ratios, were excluded from Sprouts' initial peer group.

11. Conclusions

The added value proposal of this dissertation refers to the question: Should Kroger Co. acquire Sprouts Farmers Market Inc on the 15th of July 2019?

Primarily, it was concluded that the food and grocery retail sector has been under a deep transformation process. As a result, M&A activity emerges as a reliable option for traditional brick-and-mortar retailers to fulfill their thirst for new sources of income.

Sprouts Farmers Market, with its privileged position in the natural and organic food grocery retail sector, immense growth potential, and outstanding margins, stands out as the most suitable acquisition target to overcome Kroger's recent underperformance. As a matter of fact, the firm could redirect its recent proceeds from the sale of non-core assets into completing this transaction. Based on a DCF methodology, Kroger and Sprouts' intrinsic value is estimated to be 35,459 and 3,484 million USD, respectively, consisting of an upside regarding its current share price of 13.3% and 25.5%.

The merger process would occur following a friendly approach, with a bidding price of $24.71, representing a control premium of 30% over the Sprouts' current share price. It is expected that this transaction would lead to an EV of the combined firm equaling 41,739 million USD. Regarding the issue of value creation, the present deal would yield a combined synergy value of 1,141 million USD, in which Kroger's shareholders would capture 420 million USD.

Finally, despite the potential value creation encompassing this transaction, Kroger's management team should also be concerned about a potential auction environment, which may inadvertently inflate the acquisition price, and about the post-merger integration risks, which, in turn, may hamper synergy realization over time.

Appendix

1. Five Forces Analysis – United States Grocery Retail Sector

Buyer Power

The buyers of this market consist of end-consumers. Due to the high volume of potential consumers, each individual possesses a low degree of buyer power. Nevertheless, collectively, consumers have common interests and expectations, which retailers should not disregard. In fact, as the consequence of a high concentration of the market share among a small number of players, consumer choices are often shaped by retailers, diminishing consumers' buying power (MarketLine, 2018a). Even though retailers focus on implementing strategies that increase consumers' retention such as cashback campaigns or fuel discounts, the homogeneity of the grocery products offered among retailers leads to the fact that consumers' choice is mostly impacted by two central factors: price and convenience (Tetra Pack, 2018). Albeit, the convenience culture is facing new challenges, which foster consumers ' buying power. The increasing consumer preferences towards fresh, dull, or traditionally prepared foods as well as the growing concern about healthier, organic, and more diverse products undermine the retail position of traditional retailers. (MarketLine, 2018a)

Consequently, buyer power is considered moderate.

Supplier Power

The leading suppliers of the Food and Grocery Retail sector are the producers of food and ingredients and the manufacturers of the food sold. Generally, the goods sold in this sector are commodities and homogeneous, diminishing supplier power. Leading retailers frequently maintain relationships with a vast range of suppliers, reducing switching costs, ensuring stability, and offsetting the risk of local sourcing issues and price fluctuations (MarketLine, 2018a). Besides, vertical integration is also an option, whether performed by large retailers, which build and operate their production plants and manufacturing plants (normally producing private labels), or by manufacturers who open their retail centers. Moreover, in the traditional grocery segment, large retailers often are the largest source of suppliers' revenues, fostering retailers' bargaining power.

This relation is inverted in the particular case of small retailers operating in niche sectors such as luxury or organic food, where suppliers have stronger bargaining power (MarketLine, 2018a). Nevertheless, consumer awareness regarding social and environmental issues fostered the creation of movements, such as Fairtrade and Utz Certified, which rise supplier power by exerting pressure on suppliers to enhance their behavior regarding pay, child labor, freedom of expression and environmental responsibility. (MarketLine, 2018a)
In summary, supplier power is moderate.

New Entrants

The United States Food and Grocery retail market is characterized by having several large entities, such as Walmart, Kroger, Target, Costco, which dominate the market. These players are large-scale, national-based and primarily benefit from economies of scale, which enable them to engage in aggressive price wars that harden the entrance of new retailers (MarketLine, 2018a).
However, while in the traditional retail sector, new entrants are very unlikely, niche segments offer profitable opportunities protected from pricing pressures and mainstream marketing. The organic food market, for example, has been steading growing in the past few years, resisting a CAGR of 15,3% in the 2013-2017 period. (MarketLine, 2018a) Furthermore, even though large retailers dominate the market, independent retailers still have an essential position in the market. In fact, according to the United States Department of Agriculture, in 44% of the states, at least half of the food retailers are independent (MarketLine, 2018a).
Thus, for this industry, the threat of new entrants is measured as moderate.

Threat of substitutes

There are very few substitutes for the food and grocery retail market. In fact, only food service and subsistence agriculture might be considered an alternative to this sector. However, food service, both in fast-food restaurants, takeaway or sit-down restaurants, are view more as a complement to food retail rather than a substitute (MarketLine, 2018a). As for substance agriculture, nowadays, this practice is not as common as in the past, having a negligible impact on the food and grocery retail market (MarketLine, 2018a).
In summary, consumer buying power is weak.

Degree of rivalry

This industry is mainly dominated by the supermarket/hypermarket/hard discounter channel, which aggregated 61% of the market size in 2017. (MarketLine, 2018a) Within this channel, several large retailers, due to high economies of scale, employ aggressive pricing schemes gaining a significant competitive advantage over smaller retailers. Indeed, due to low switching costs and relatively homogeneous products offered by retailers, price and convenience are mainly the critical factors in consumer's choice (MarketLine, 2018a).

Consequently, rivalry is considered strong.

2. Five Forces Analysis – United States N&O Grocery Retail Sector

Buyer Power

The buyers of this market consist of the end-consumers. Due to the high volume of potential consumers, each individual possesses a low degree of buyer power. Although the majority of consumers are small in size, a few numbers of more significant consumers are progressively emerging as companies and institutions gain awareness about the health benefits of organic diets.

Price sensitivity is highly reliant on the stage of the economic circle (MarketLine, 2018b). Consumers are willing to pay a higher premium for organic products in comparison to non-organic products, however, during recession periods, due to the depletion of income, consumers may tend to replace their organic buys by the non-organic substitute (MarketLine, 2018b). Albeit, the homogeneity of the grocery products offered among retailers, creates insignificant switching costs, fostering consumer power (MarketLine, 2018b).

Overall, buyer power is considered moderate.

Supplier Power

The strict quality and production standards imposed on suppliers, and the locally-sourced produce matter of several organic products severely limit supplier choice and highly increase retailers' dependent on suppliers (MarketLine, 2018b). Besides, to maintain high-quality standards and a reliable supply of goods, many retailers are enforced to sign long-term contracts with their crucial suppliers (MarketLine, 2018b).

However, this fact is offset by an increasing tendency among retailers of backward integration, by building and operating their supply facilities (MarketLine, 2018b). Moreover, the size discrepancy between giant retailers and small suppliers also tends to reduce supplier power.
In summary, supplier power is moderate.

New Entrants

This sector is highly dominated by large incumbents, that, due to their economies of scale and strong financial position meaningfully reduces the threat of new entrants. The acquisition of Whole Foods by Amazon created solid subscription programs, fostering consumer loyalty, toughening entry-level competition (MarketLine, 2018b). However, it is expected that the strong growth rates prevailing in this market, naturally, attract the entrance of new players, especially at a local-level competitor. Further, the recent regulation alterations ease the switch of non-organic farmers to this market niche, increasing the available opportunities for newcomers (MarketLine, 2018b).
Hence, the threat of new entrants is accessed as strong.

Threat of substitutes

Even though organic goods are marketed as more environmentally friendly and healthier than cheaper conventional products, non-organic equivalents consist of the premier substitute for organic groceries (MarketLine, 2018b). This effect, especially, occurs during harsh economic periods, where the disposable income suffers a considerable decrease, and consumers are less eager to buy organic groceries (MarketLine, 2018b).
Thus, given the presence of cheaper, non-organic equivalents, the threat from substitutes is considered strong.

Degree of rivalry

Naturally, the limited distinction between organic products and non-existing switching costs increase rivalry among retailers (MarketLine, 2018b). Albeit, even though large supermarket chains are prevalent, due to their diverse nature of revenue streams, the competition among players highly depends on their level of commitment within this sub-sector. Moreover, the strong market growth eases competition among retailers, as players might generate revenuers without invading its competitor's market share (MarketLine, 2018b).
Hence, the degree of rivalry is accessed as moderate.

4. Income Statement – Kroger

Income Statement (million USD)	2014	2015	2016	2017	2018
Sales	**108,465**	**109,830**	**115,337**	**122,662**	**121,162**
Merchandise costs	(85,512)	(85,496)	(89,502)	(95,662)	(94,894)
Gross Margin	**22,953**	**24,334**	**25,835**	**27,000**	**26,268**
Operating, general and administrative	(17,161)	(17,946)	(19,162)	(21,041)	(20,305)
Rent	(707)	(723)	(881)	(911)	(884)
EBITDA	**5,085**	**5,665**	**5,792**	**5,048**	**5,079**
Depreciation and amortization	(1,948)	(2,089)	(2,340)	(2,436)	(2,465)
EBIT	**3,137**	**3,576**	**3,452**	**2,612**	**2,614**
Company-sponsored pension plan costs	-	-	(16)	(527)	(26)
Mark to market gain on Ocado securities	-	-	-	-	228
Gain on sale of business	-	-	-	-	1,782
EBIT (including non-recurring items)	**3,137**	**3,576**	**3,436**	**2,085**	**4,598**
Interest expense	(488)	(482)	(522)	(601)	(620)
EBT	**2,649**	**3,094**	**2,914**	**1,484**	**3,978**
Income tax provision	(902)	(1,045)	(957)	405	(900)
Net Income (including noncontrolling interests)	**1,747**	**2,049**	**1,957**	**1,889**	**3,078**
Net gains from noncontrolling interests	(19)	(10)	18	18	32
Net Income attributable to The Kroger Co.	**1,728**	**2,039**	**1,975**	**1,907**	**3,110**

Table 14 – Kroger's historical income statement

5. Balance Sheet – Kroger

Consolidated Balance Sheet (million USD)	2014	2015	2016	2017	2018
Current assets					
Cash and temporary cash investments	268	277	322	347	429
Store deposits in-transit	988	923	910	1,161	1,181
Receivables	1,266	1,734	1,649	1,637	1,589
Inventory	5,688	6,168	6,561	6,533	6,846
Assets held for sale	-	-	-	604	166
Prepaid and other current assets	701	790	898	835	592
Total current assets	**8,911**	**9,892**	**10,340**	**11,117**	**10,803**
Non current assets					
Property, plant and equipment	17,912	19,619	21,016	21,071	21,635
Intangibles	757	1,053	1,153	1,100	1,258
Goodwill	2,304	2,724	3,031	2,925	3,087
Other assets	613	609	965	984	1,335
Total non current assets	**21,586**	**24,005**	**26,165**	**26,080**	**27,315**
Total assets	**30,497**	**33,897**	**36,505**	**37,197**	**38,118**
Current liabilities					
Current portion of long-term debt	1,874	2,370	2,252	3,560	3,157
Trade accounts payable	5,052	5,728	5,818	5,858	6,059
Accrued salaries and wages	1,291	1,426	1,234	1,099	1,227
Deferred income taxes	287	221	251	-	-
Liabilities held for sale	-	-	-	259	51
Other current liabilities	2,888	3,226	3,305	3,421	3,780
Total current liabilities	**11,392**	**12,971**	**12,860**	**14,197**	**14,274**
Non current liabilities					
Long-term debt	9,723	9,709	11,825	12,029	12,072
Deferred income taxes	1,209	1,752	1,927	1,568	1,562
Pension obligations	1,463	1,380	1,524	792	494
Other long-term liabilities	1,268	1,287	1,659	1,706	1,881
Total long term liabilities	**13,663**	**14,128**	**16,935**	**16,095**	**16,009**
Total liabilities	**25,055**	**27,099**	**29,795**	**30,292**	**30,283**
Shareholders equity					
Preferred shares, $100 par per share	-	-	-	-	-
Common shares, $1 par per share	1,918	1,918	1,918	1,918	1,918
Additional paid-in capital	2,748	2,980	3,070	3,161	3,245
Accumulated other comprehensive loss	(812)	(680)	(715)	(471)	(346)
Accumulated earnings	12,367	14,011	15,543	17,007	19,681
Common shares in treasury	(10,809)	(11,409)	(13,118)	(14,684)	(16,612)
Total shareholders' equity	**5,412**	**6,820**	**6,698**	**6,931**	**7,886**
Noncontrolling interests	30	(22)	12	(26)	(51)
Total equity	**5,442**	**6,798**	**6,710**	**6,905**	**7,835**
Total liabilities and equity	**30,497**	**33,897**	**36,505**	**37,197**	**38,118**

Table 15 – Kroger's historical balance sheet

6. Cash Flow Statement – Kroger

Cash Flow Statement (million USD)	2014	2015	2016	2017	2018
Cash flows from operating activities:					
Net earnings including noncontrolling interests	1,747	2,049	1,957	1,889	3,078
Depreciation and amortization	1,948	2,089	2,340	2,436	2,465
Asset impairment charge	37	46	26	0	0
LIFO (credit) charge	147	28	19	(8)	29
Stock-based employee compensation	155	165	141	151	154
Expense for company-sponsored pension plans	55	103	94	591	76
Goodwill impairment charge	-	-	-	110	-
Deferred income taxes	73	317	201	(694)	(45)
Gain on sale of business	-	-	-	-	(1,782)
Mark to market gain on Ocado securities	-	-	-	-	(228)
Other	72	54	(28)	79	116
Store deposits in-transit	(27)	95	13	(265)	(20)
Receivables	(141)	(59)	(110)	61	(208)
Inventories	(147)	(184)	(382)	(23)	(354)
Prepaid and other current assets	2	(28)	(172)	41	244
Trade accounts payable	135	440	16	158	213
Accrued expenses	249	275	(118)	(40)	416
Income taxes receivable and payable	(68)	(359)	261	(96)	289
Company-sponsored pension plans	-	(5)	-	(1,000)	(185)
Other	(22)	(109)	14	23	(94)
Net cash provided by operating activities	**4,215**	**4,917**	**4,272**	**3,413**	**4,164**
Cash flows from investing activities:					
Payments for PP&E	(2,831)	(3,349)	(3,699)	(2,809)	(2,967)
Proceeds from sale of assets	37	45	132	138	85
Proceeds on settlement of financial instrument	-	-	-	-	235
Payments for acquisitions, net of cash acquired	(252)	(168)	(401)	(16)	(197)
Purchases of stores	-	-	-	-	(44)
Net proceeds from sale of business	-	-	-	-	2,169
Purchases of Ocado securities	-	-	-	-	(392)
Other	(14)	(98)	93	(20)	(75)
Net cash used by investing activities	**(3,060)**	**(3,570)**	**(3,875)**	**(2,707)**	**(1,186)**
Cash flows from financing activities:					
Proceeds from issuance of long-term debt	576	1,181	2,781	1,523	2,236
Payments on long-term debt	(375)	(1,245)	(1,355)	(788)	(1,372)
Payments borrowings on commercial paper	25	(285)	435	696	(1,321)
Dividends paid	(338)	(385)	(429)	(443)	(437)
Excess tax benefits on stock-based awards	52	97	-	-	-
Proceeds from issuance of capital stock	110	120	68	51	65
Treasury stock purchases	(1,283)	(703)	(1,766)	(1,633)	(2,010)
Investment in equity of noncontrolling interest	-	(26)	-	-	-
Other	(55)	(92)	(86)	(87)	(57)
Net cash used by financing activities	**(1,288)**	**(1,338)**	**(352)**	**(681)**	**(2,896)**
Beginning of year	401	268	277	322	347
Net change in cash	(133)	9	45	25	82
End of year	**268**	**277**	**322**	**347**	**429**

Table 16 – Kroger's historical cash flow statement

7. Adjustments to Revenues – Kroger

Sales Adjustment	2017	2017 (adjusted)	*%YoY*	2018
Total Sales (excluding fuel)	104,207	102,290	*2%*	104,486
Supermaket Fuel Sales	13,177	12,906	*16%*	14,903
Convenience Stores	4,515	4,434	*(79%)*	944
Other Sales	763	753	*10%*	829
Total Revenues	**122,662**	**120,383**	***(51%)***	**121,162**

Table 17 – Kroger's 2018 revenues adjustments

8. Income Statement – Sprouts Farmers Market

Income Statement (million USD)	2014	2015	2016	2017	2018
Sales	**2,967**	**3,593**	**4,046**	**4,665**	**5,207**
Cost of sales	(2,082)	(2,541)	(2,683)	(3,098)	(3,460)
Gross profit	**885**	**1,052**	**1,363**	**1,567**	**1,747**
Selling, general and administrative expenses	(95)	(106)	(1,072)	(1,246)	(1,404)
Direct store expenses	(582)	(706)	-	-	-
Store pre-opening costs	(8)	(9)	-	-	-
Store closure and other costs	(1)	(2)	(0)	(1)	(12)
EBITDA	**200**	**229**	**291**	**320**	**331**
Depreciation and amortization	0	0	(78)	(94)	(108)
Income from operations	**200**	**229**	**213**	**226**	**223**
Other income	1	0	0	1	0
Loss on extinguishment of debt	(1)	(5)	-	-	-
EBIT	**199**	**224**	**213**	**227**	**223**
Interest expense	(25)	(18)	(15)	(21)	(27)
Income before income taxes	**174**	**206**	**199**	**206**	**196**
Income tax provision	(66)	(77)	(74)	(47)	(37)
Net income	**108**	**129**	**124**	**158**	**159**

Table 18 – Sprouts historical income statement

9. Balance Sheet - Sprouts Farmers Market

Balance Sheet (million USD)	2014	2015	2016	2017	2018
Current assets:					
Cash and cash equivalents	131	136	12	19	2
Accounts receivable	14	20	25	26	41
Inventories	143	165	204	230	264
Prepaid expenses and other current assets	11	23	22	25	27
Deferred income tax asset	36	-	-	-	-
Total current assets	**334**	**345**	**264**	**300**	**334**
Non-current assets					
Property and equipment	455	494	605	713	766
Intangible assets	194	199	198	196	195
Goodwill	368	368	368	368	368
Other assets	18	19	6	5	12
Deferred income tax asset	-	1	-	-	-
Total Non Current Assets	**1,035**	**1,081**	**1,176**	**1,282**	**1,342**
Total Assets	**1,369**	**1,426**	**1,440**	**1,582**	**1,676**
Current liabilities:					
Accounts payable and other accrued liabilities	154	185	214	245	254
Accrued salaries and benefits	30	31	33	46	49
Current portion of capital and financing leases	29	15	12	9	7
Current portion of long-term debt	8	-	-	-	-
Total current liabilities	**221**	**230**	**259**	**300**	**310**
Long-term capital and financing lease obligations	122	116	117	125	120
Long-term debt	249	160	255	348	453
Other long-term liabilities	74	97	116	131	153
Deferred income tax liability	19	-	19	27	50
Total non current liabilities	**463**	**373**	**508**	**631**	**776**
Total liabilities	**684**	**603**	**767**	**931**	**1,086**
Shareholders equity:					
Undesignated preferred stock; $0.001 par value;	-	-	-	-	-
Common stock, $0.001 par value	0	0	0	0	0
Additional paid-in capital	543	577	597	621	657
Accumulated other comprehensive income	-	-	-	(1)	1
Retained earnings	142	245	76	31	(69)
Total equity	**685**	**823**	**673**	**651**	**589**
Total liabilities and equity	**1,369**	**1,426**	**1,440**	**1,582**	**1,676**

Table 19 – Sprouts' historical balance sheet

10. Cash Flow Statement - Sprouts Farmers Market

Cash Flow Statement (million USD)	2014	2016	2017	2017	2018
Cash flows from operating activities					
Net income	108	129	124	158	159
Adjustments to reconcile net income:					
Depreciation and amortization expense	60	69	81	97	111
Accretion of asset retirement obligation	1	0	-	-	-
Amortization of financing fees	1	1	0	0	1
Loss on disposal of property and equipment	1	2	0	2	1
Gain on sale of intangible assets	(0)	-	-	-	-
Store closure and other costs	-	-	-	-	4
Loss on extinguishment of debt	1	5	-	-	-
Share-based compensation	5	8	13	14	15
Deferred income taxes	16	16	21	8	23
Changes in working capital:					
Accounts receivable	(4)	(6)	(5)	(5)	(8)
Inventories	(25)	(23)	(39)	(25)	(35)
Prepaid expenses and other current assets	(3)	(12)	1	(3)	(3)
Other assets	(5)	(0)	13	(0)	(5)
Accounts payable and other accrued liabilities	4	27	22	39	4
Accrued salaries and benefits	7	1	2	13	3
Other long-term liabilities	13	23	19	11	25
Cash flows from operating activities	**181**	**240**	**254**	**310**	**294**
Cash flows from investing activities					
Purchases of property and equipment	(127)	(125)	(181)	(199)	(177)
Proceeds from sale of property and equipment	0	3	1	-	-
Proceeds from sale of intangible assets	0	-	-	-	-
Purchase of leasehold interests	-	(6)	(0)	-	-
Cash flows used in investing activities	**(127)**	**(128)**	**(181)**	**(199)**	**(177)**
Cash flows from financing activities					
Payments on term loan	(57)	(261)	-	-	-
Proceeds from revolving credit facilities	-	260	105	153	233
Payments on revolving credit facilities	-	(100)	(10)	(60)	(128)
Payments on lease obligations	(4)	(4)	(4)	(4)	(5)
Payments of deferred financing costs	0	(2)	-	-	(2)
Proceeds from lease obligations	1	0	-	1	4
Repurchase of common stock	-	(26)	(294)	(203)	(258)
Proceeds from exercise of stock options	11	7	3	9	22
Excess tax benefit for exercise of stock options	47	20	4	-	-
Other	-	-	-	-	(0)
Cash flows used in financing activities	**(2)**	**(106)**	**(197)**	**(104)**	**(135)**
Cash and temporary cash investments:					
Beginning of the year	78	130	136	12	19
Net increase in cash	53	6	(124)	7	(17)
Adjustments for Balance Sheet[62]	-	0	0	0	(1)
Cash at the end of the period	**130**	**136**	**12**	**19**	**2**

Table 20 – Sprouts' historical cash flow statement

[62] Adjustments performed due to different statement's report dates

11. Kroger's Past Mergers and Acquisitions

Year	Acquired	Sector	Number of Stores
2018	Ocado Group Plc	Online retailing	-
2018	Home Chef	Meal kits	-
2018	ShopKo Inc	Pharmacy	-
2017	Marsh Supermarkets	Grocery Stores	11
2017	Murray's Cheese	Cheese producer	-
2015	Roundy's.	Grocery Stores	151
2014	Harris Teeter Supermarkets Inc.	Grocery Stores	212
2014	Vitacost.com, Inc	Online retailing	-
2014	Youtechnology Brand Services Inc.	Online retailing	-
2012	Axien Pharmacy Holdings Inc.	Pharmacy	-

Table 21 – Kroger's past acquisitions (Marketline, 2018c)

12. Scenario Assumptions – Kroger

Revenues' growth rates	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Pessimistic Case	1.80%	2.00%	1.75%	1.50%	1.25%	1.00%	1.00%
Base Case	2.00%	2.50%	3.10%	2.50%	2.25%	2.00%	1.25%
Optimistic Case	2.20%	3.00%	3.30%	3.00%	2.75%	2.50%	1.75%

Table 22 – Kroger's scenario assumptions

13. Income Statement Forecasted – Kroger

Income Statement (million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Sales	**123,585**	**126,675**	**130,602**	**133,867**	**136,879**	**139,616**	**141,362**
Cost of sales	(96,792)	(99,212)	(102,287)	(104,844)	(107,203)	(109,347)	(110,714)
Gross Margin	**26,793**	**27,463**	**28,315**	**29,022**	**29,675**	**30,269**	**30,647**
Operating, general and administrative	(20,711)	(21,229)	(21,887)	(22,434)	(22,939)	(23,398)	(23,690)
Rent	(902)	(924)	(953)	(977)	(999)	(1,019)	(1,031)
EBITDA	**5,181**	**5,310**	**5,475**	**5,612**	**5,738**	**5,853**	**5,926**
Depreciation and amortization	(2,568)	(2,632)	(2,713)	(2,781)	(2,844)	(2,901)	(2,937)
EBIT	**2,613**	**2,678**	**2,761**	**2,830**	**2,894**	**2,952**	**2,989**
Sponsored pension plan costs	-	-	-	-	-	-	-
Gain on Ocado securities	-	-	-	-	-	-	-
Gain on sale of business	-	-	-	-	-	-	-
EBIT (including non-recurring items)	**2,613**	**2,678**	**2,761**	**2,830**	**2,894**	**2,952**	**2,989**
Interest expense	(513)	(500)	(488)	(476)	(463)	(451)	(438)
EBT	**2,100**	**2,178**	**2,273**	**2,355**	**2,431**	**2,501**	**2,550**
Income tax provision	(567)	(588)	(614)	(636)	(656)	(675)	(689)
Net Income	**1,533**	**1,590**	**1,659**	**1,719**	**1,774**	**1,826**	**1,862**
Gains from noncontrolling interests	-	-	-	-	-	-	-
Net Income attributable	**1,533**	**1,590**	**1,659**	**1,719**	**1,774**	**1,826**	**1,862**

Table 23 – Kroger's forecasted income statement

14. Balance Sheet Forecasts – Kroger

Balance Sheet (million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Current assets:							
Cash and temporary cash investments	611	669	779	923	1,101	1,312	1,540
Store deposits in-transit	1,205	1,235	1,273	1,305	1,334	1,361	1,378
Receivables	1,621	1,661	1,713	1,756	1,795	1,831	1,854
Inventory	6,983	7,157	7,379	7,564	7,734	7,889	7,987
Assets held for sale	-	-	-	-	-	-	-
Prepaid and other current assets	604	619	638	654	669	682	691
Total current assets	**11,023**	**11,342**	**11,782**	**12,201**	**12,633**	**13,074**	**13,449**
Non current assets:							
Property, plant and equipment	22,147	22,672	23,213	23,768	24,335	24,913	25,499
Intangibles	1,205	1,150	1,093	1,036	976	916	855
Goodwill	3,087	3,087	3,087	3,087	3,087	3,087	3,087
Other assets	1,335	1,335	1,335	1,335	1,335	1,335	1,335
Total non current assets	**27,774**	**28,244**	**28,728**	**29,225**	**29,733**	**30,251**	**30,776**
Total assets	**38,797**	**39,586**	**40,511**	**41,426**	**42,366**	**43,326**	**44,225**
Current liabilities:							
Current portion of long-term debt	3,082	3,008	2,933	2,858	2,784	2,709	2,635
Trade accounts payable	6,180	6,335	6,531	6,694	6,845	6,982	7,069
Accrued salaries and wages	1,252	1,283	1,323	1,356	1,386	1,414	1,432
Deferred income taxes	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Liabilities held for sale	51.00	51.00	51.00	51.00	51.00	51.00	51.00
Other current liabilities	3,856	3,952	4,075	4,176	4,270	4,356	4,410
Total current liabilities	**14,421**	**14,628**	**14,912**	**15,136**	**15,336**	**15,512**	**15,596**
Non current liabilities:							
Long-term debt	11,787	11,501	11,216	10,931	10,645	10,360	10,074
Deferred income taxes	1,562	1,562	1,562	1,562	1,562	1,562	1,562
Pension obligations	494	494	494	494	494	494	494
Other long-term liabilities	1,881	1,881	1,881	1,881	1,881	1,881	1,881
Total long term liabilities	**15,724**	**15,438**	**15,153**	**14,868**	**14,582**	**14,297**	**14,011**
Total liabilities	**30,144**	**30,067**	**30,065**	**30,003**	**29,918**	**29,808**	**29,608**
Shareholders equity:							
Preferred shares, $100 par per share	-	-	-	-	-	-	-
Common shares, $1 par per share	1,918	1,918	1,918	1,918	1,918	1,918	1,918
Additional paid-in capital	3,245	3,245	3,245	3,245	3,245	3,245	3,245
Accumulated comprehensive loss	(346)	(346)	(346)	(346)	(346)	(346)	(346)
Accumulated earnings	20,999	22,365	23,791	25,269	26,794	28,363	29,963
Common shares in treasury	(17,112)	(17,612)	(18,112)	(18,612)	(19,112)	(19,612)	(20,112)
Total shareholders' equity	**8,704**	**9,570**	**10,496**	**11,474**	**12,499**	**13,568**	**14,668**
Noncontrolling interests	(51)	(51)	(51)	(51)	(51)	(51)	(51)
Total equity	**8,653**	**9,519**	**10,445**	**11,423**	**12,448**	**13,517**	**14,617**
Total liabilities and equity	**38,797**	**39,586**	**40,511**	**41,426**	**42,366**	**43,326**	**44,225**

Table 24 – Kroger's forecasted balance sheet

15. Cash Flow Statement Forecasts – Kroger

Cash Flow Statement (Million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Cash Flows from Operating Activities:							
Net earnings	1,533	1,590	1,659	1,719	1,774	1,826	1,862
Depreciation and amortization	2,568	2,632	2,713	2,781	2,844	2,901	2,937
Asset impairment charge	-	-	-	-	-	-	-
LIFO (credit) charge	-	-	-	-	-	-	-
Stock-based employee compensation	-	-	-	-	-	-	-
Sponsored pension plans	-	-	-	-	-	-	-
Goodwill impairment charge	-	-	Non-recurring items were assumed as 0				-
Deferred income taxes	-	-	-	-	-	-	-
Gain on sale of business	-	-	-	-	-	-	-
Gain on Ocado securities	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Store deposits in-transit	(24)	(30)	(38)	(32)	(29)	(27)	(17)
Receivables	(32)	(41)	(52)	(43)	(40)	(36)	(23)
Inventories	(137)	(175)	(222)	(184)	(170)	(155)	(99)
Prepaid and other current assets	(12)	(15)	(19)	(16)	(15)	(13)	(9)
Trade accounts payable	121	155	196	163	151	137	87
Accrued expenses	25	31	40	33	31	28	18
Income taxes receivable and payable	-	-	-	-	-	-	-
Contribution to pension plans	-	-	-	-	-	-	-
Other	76	96	123	102	94	85	54
Net cash provided by operations	**4,118**	**4,244**	**4,401**	**4,523**	**4,640**	**4,746**	**4,811**
Cash Flows from Investing Activities:							
Payments for PP&E	(3,026)	(3,102)	(3,198)	(3,278)	(3,352)	(3,419)	(3,462)
Proceeds from sale of assets	166	-	-	-	-	-	-
Proceeds on financial instruments	-	-	-	-	-	-	-
Payments for acquisitions	-	-	Non-recurring items were assumed as 0				-
Purchases of stores	-	-	-	-	-	-	-
Net proceeds from sale of business	-	-	-	-	-	-	-
Purchases of Ocado securities	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Net cash used by investing activities	**(2,860)**	**(3,102)**	**(3,198)**	**(3,278)**	**(3,352)**	**(3,419)**	**(3,462)**
Cash Flows from Financing Activities:							
Proceeds from long-term debt	-	-	-	-	-	-	-
Payments on long-term debt	(360)	(360)	(360)	(360)	(360)	(360)	(360)
Borrowings on commercial paper	-	-	-	-	-	-	-
Dividends paid	(215)	(223)	(233)	(242)	(249)	(257)	(262)
Excess tax benefits on stock awards	-	-	-	-	-	-	-
Proceeds from issuance of capital	-	-	-	-	-	-	-
Treasury stock purchases	(500)	(500)	(500)	(500)	(500)	(500)	(500)
Investment in equity of n.c. interest	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Net cash used by financing activities	**(1,075)**	**(1,083)**	**(1,093)**	**(1,102)**	**(1,109)**	**(1,117)**	**(1,122)**
Cash and temporary investments:							
Beginning of year	429	611	669	779	923	1,101	1,312
Net increase in cash	182	58	109	144	179	211	228
End of year	**611**	**669**	**779**	**923**	**1101**	**1312**	**1540**

Table 25 – Kroger's forecasted cash flow statement

16. Beta computation

Each company's beta was computed through a bottom-up approach. This methodology calculates the company's beta by regressing each competitors' 5-years monthly returns on the S&P 500 index. The S&P 500 index was chosen as a reliable proxy for the market portfolio, since it is market-weighted and includes the 500 largest stock in the economy, reflecting the degree to which investors are diversified (Damodaran, 1999).

The measurement period was chosen to offset the fact that assets do not trade on a continuous basis, which prejudices correlation with the market, and that firms' characteristics vary over time (Damodaran, 1999).

Consequently, for firms listed for more than three years, monthly returns should encompass enough observation (Damodaran, 1999).

Hence, following the KPMG's recommendation for 2019 on, the corporate tax rate used was 27% KPMG (2019). Later, using each peer's reported net debt to market capitalization ratio, levered betas were converted into unlevered beta. To exclude outliers, the median 5-year unlevered beta was used.

Afterward, following the incorporation of each corporation's capital structure, following the observation that company betas tend to the mean of all betas (Blume, 1975), the subsequent adjustment was applied:

$$\text{Adjusted } \beta_L = \frac{2}{3}\beta_L + \frac{1}{3}$$

Consequently, with the usage of the methodology and inputs stated above, Kroger and Sprouts Farmers Market present Betas amount of 0.977 and 0.745, respectively.

17. Capital Structure

To compute the firm's capital structure, one must start by calculating the company's market cap and estimating the market value of its debt.

Kroger and Sprouts' market cap at the data collection date amounted 17,637 M and 2,150, respectively, which corresponded to the following formula:

$$Market\ Cap = Number\ of\ Shares * Price\ per\ share$$

Whereas, the company's market value of debt was computed by incorporating the existing loans into one coupon bond using Equation 7 and later summing it with the market value of outstanding public tradable bonds at the collection date, which is given by the following equation:

$$Market\ Value\ of\ Debt = Market\ Value\ of\ Bonds + Market\ Value\ of\ Loan$$

As a result, Table represents the current capital structure of both companies.

(Million USD)	Market Cap	Debt's Market Value	D/EV
Kroger Co.	17,637	15,490	47%
Sprouts Farmers Market	2,150	554	20%

Table 26 – Kroger and Sprouts' capital structure

18. Firm's peers and relative valuation

In order to employ an accurate peer group, one must perform a k-mean cluster analysis.

Therefore, the first step is to choose the initial group of comparable firms. In Kroger's case, the peer group equals the comparable group stated in the firm's annual report, (The Kroger Company, 2019a) whereas in the Sprouts' situation, since the company does not disclose its competitors, all firms encompassing the Food Retail & Distribution sector with market cap greater than 1 billion were used (Thomson Reuters 2019).

Hence, one must choose the variables which will support the cluster analysis. Therefore, Market Cap, ROIC, Revenue estimates, historic EV/EBIT, and EBITDA margin were considered. The choice of these variables relies on the fact that they are intrinsically correlated with the firm's size and operational profitability.

Later, to create several clusters, all variables were normalized and three different centroids we selected. Hereafter, using solver, each centroid was set that the sum of squared error residuals would be minimal. Note that Sprouts' alternative targets were not used in the k-cluster analysis since their market cap is lower than 1 billion USD and some indicators and were not disclosed by Thomson Reuters Eikon.

As a result, the following clusters and implicit valuations were computed.

Kroger - Cluster	Company name	EV/EBITDA	P/E
1	Walmart Inc	10.1	39.8
1	Target Corp	7.0	13.1
1	Walgreens Boots Alliance Inc	9.0	13.9
1	Tesco PLC	7.1	16.4
2	Koninklijke Ahold Delhaize NV	8.4	14.5
2	CVS Health Corp	11.8	0.0
2	Kroger Co	7.2	7.5
3	Costco Wholesale Corp	17.3	32.7
	Median cluster 2 (excluding Kroger)	**10.1**	**7.3**
	Kroger's implicit share value	**44.77**	**28.33**

Table 27 – Kroger's relative valuation

Sprouts- Cluster	Name	EV/EBITDA	P/E
1	Kroger Co	7.2	7.5
1	Sysco Corp	12.6	25.3
1	Core-Mark Holding Company Inc	10.9	23.6
1	US Foods Holding Corp	10.1	16.7
2	Caseys General Stores Inc	10.9	24.0
2	Chefs' Warehouse Inc	16.6	44.8
2	Performance Food Group Co	12.8	19.3
2	Sprouts Farmers Market Inc	10.4	19.0
3	Walmart Inc	10.1	42.3
	Median cluster 2 (excluding Sprouts)	**12.8**	**24.0**
	Sprouts' implicit value per share	**29.39**	**30.45**

Table 28 – Sprouts' relative valuation

19. Scenario Assumptions – Sprouts Farmers Market

Revenues' growth rates	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Pessimistic Case	8.80%	8.00%	7.30%	6.80%	5.50%	3.50%	2.00%
Base Case	9.30%	8.50%	7.80%	7.30%	6.00%	4.00%	2.50%
Optimistic Case	9.80%	9.00%	8.30%	7.80%	6.50%	4.50%	3.00%

Table 29 - Sprouts' scenario assumptions

20. Income Statement Forecasts – Sprouts Farmers Market

Income Statement (million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Sales	**5,692**	**6,175**	**6,657**	**7,143**	**7,572**	**7,875**	**8,071**
Cost of sales	(3,782)	(4,103)	(4,423)	(4,746)	(5,031)	(5,232)	(5,363)
Gross profit	**1,910**	**2,072**	**2,234**	**2,397**	**2,541**	**2,643**	**2,709**
SG&A	(1,535)	(1,666)	(1,795)	(1,927)	(2,042)	(2,124)	(2,177)
Direct store expenses	-	-	-	-	-	-	-
Store pre-opening costs	-	-	-	-	-	-	-
Store closure and other costs	(13)	(14)	(15)	(17)	(18)	(18)	(19)
EBITDA	**362**	**392**	**423**	**454**	**481**	**500**	**513**
Depreciation and amortization	(110)	(119)	(128)	(138)	(146)	(151)	(155)
Income from operations	**252**	**273**	**295**	**316**	**336**	**349**	**358**
Other income	-	-	-	-	-	-	-
Loss on extinguishment of debt	-	-	-	-	-	-	-
EBIT	**252**	**273**	**295**	**316**	**336**	**349**	**358**
Interest expense	(27)	(27)	(27)	(27)	(27)	(27)	(27)
Income before income taxes	**224**	**246**	**267**	**289**	**308**	**322**	**330**
Income tax provision	(61)	(66)	(72)	(78)	(83)	(87)	(89)
Net income	**164**	**180**	**195**	**211**	**225**	**235**	**241**

Table 30 – Sprouts' forecasted income statement

21. Balance Sheet Forecasts – Sprouts Farmers Market

Balance Sheet (million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Current assets:							
Cash and cash equivalents	19	17	13	8	9	13	25
Accounts receivable, net	44	48	52	56	59	61	63
Inventories	289	314	338	363	384	400	410
Prepaid expenses	30	32	35	37	40	41	42
Deferred income tax asset	-	-	-	-	-	-	-
Total current assets	**382**	**411**	**438**	**464**	**492**	**516**	**540**
Non-current assets							
Property and equipment	825	888	956	1,030	1,107	1,188	1,271
Intangible assets	193	192	191	189	188	186	185
Goodwill	368	368	368	368	368	368	368
Other assets	14	15	16	17	18	19	19
Deferred income tax asset	-	-	-	-	-	-	-
Total Non Current Assets	**1,400**	**1,463**	**1,531**	**1,604**	**1,681**	**1,761**	**1,843**
Total Assets	**1,782**	**1,874**	**1,969**	**2,068**	**2,173**	**2,277**	**2,384**
Current liabilities:							
Accounts payable	278	301	325	348	369	384	394
Accrued salaries and benefits	53	58	62	67	71	73	75
Current portion of lease obligations	-	-	-	-	-	-	-
Current portion of long-term debt	-	-	-	-	-	-	-
Total current liabilities	**331**	**359**	**387**	**415**	**440**	**458**	**469**
Long-term lease obligations	127	127	127	127	127	127	127
Long-term debt	453	453	453	453	453	453	453
Other long-term liabilities	168	182	196	210	223	232	238
Deferred income tax liability	50	50	50	50	50	50	50
Total non current liabilities	**798**	**812**	**827**	**841**	**853**	**862**	**868**
Total liabilities	**1,129**	**1,171**	**1,213**	**1,256**	**1,293**	**1,320**	**1,337**
Stockholders' equity:							
Preferred stock; $0.001 par value;							
Common stock, $0.001 par value	0	0	0	0	0	0	0
Additional paid-in capital	657	657	657	657	657	657	657
Accumulated other income	1	1	1	1	1	1	1
Retained earnings	(5)	44	97	153	221	299	388
Total equity	**653**	**703**	**756**	**812**	**880**	**957**	**1,046**
Total liabilities and equity	**1,782**	**1,874**	**1,969**	**2,068**	**2,173**	**2,277**	**2,384**

Table 31 – Sprouts' forecasted balance sheet

22. Cash Flow Statement Forecasts – Sprouts Farmers Market

Cash Flow Statement (million USD)	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Cash flows from operating activities							
Net income	164	180	195	211	225	235	241
Adjustments to reconcile net income:							
Depreciation and amortization	110	119	128	138	146	151	155
Accretion of asset retirement	-	-	-	-	-	-	-
Amortization of financing fees	-	-	-	-	-	-	-
Loss on disposal of PP&E	-	-	-	-	-	-	-
Gain on sale of intangible assets	-	-	-	-	-	-	-
Store closure and other costs	-	-	-	-	-	-	-
Loss on extinguishment of debt	-	-	-	-	-	-	-
Share-based compensation	-	-	-	-	-	-	-
Deferred income taxes	-	-	-	-	-	-	-
Changes in working capital:							
Accounts receivable	(4)	(4)	(4)	(4)	(3)	(2)	(2)
Inventories	(25)	(25)	(24)	(25)	(22)	(15)	(10)
Prepaid expenses	(3)	(3)	(3)	(3)	(2)	(2)	(1)
Other assets	(1)	(1)	(1)	(1)	(1)	(1)	(0)
Accounts payable	24	24	23	24	21	15	10
Accrued salaries and benefits	5	5	4	5	4	3	2
Other long-term liabilities	14	14	14	14	13	9	6
Cash flows from operating activities	**284**	**309**	**334**	**359**	**380**	**393**	**401**
Cash flows from investing activities							
Purchases of PP&E	(167)	(181)	(195)	(209)	(222)	(231)	(237)
Proceeds from sale of PP&E	-	-	-	-	-	-	-
Proceeds from sale of intangible assets	-	-	-	-	-	-	-
Purchase of leasehold interests	-	-	-	-	-	-	-
Cash flows used in investing activities	**(167)**	**(181)**	**(195)**	**(209)**	**(222)**	**(231)**	**(237)**
Cash flows from financing activities							
Payments on term loan	-	-	-	-	-	-	-
Proceeds from revolving credit	-	-	-	-	-	-	-
Payments on revolving credit	-	-	-	-	-	-	-
Payments on lease obligations	-	-	-	-	-	-	-
Payments of deferred financing costs	-	-	-	-	-	-	-
Cash from lease obligations	-	-	-	-	-	-	-
Repurchase of common stock	(100)	(130)	(142)	(155)	(157)	(157)	(152)
Proceeds from stock options exercise	-	-	-	-	-	-	-
Excess tax for stock options exercise	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Cash flows used in financing activities	**(100)**	**(130)**	**(142)**	**(155)**	**(157)**	**(157)**	**(152)**
Cash and temporary cash investments:							
Beginning of the year	2	19	17	13	8	9	13
Net increase in cash	17	(2)	(3)	(6)	1	5	12
Cash at the end of the period	19	17	13	8	9	13	25

Non-recurring items were assumed as 0

Non-recurring items were assumed as 0

Table 32 – Sprouts' forecasted cash flow statement

23. Synergy computation – Scenario analysis

Base Case	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue Enhancements Kroger	0.00%	0.00%	0.01%	0.01%	0.01%	0.01%	0.01%
Revenue Enhancements Sprouts	0.00%	0.10%	0.40%	0.50%	0.50%	0.50%	0.50%
COGS Sprouts	0.00%	(0.02%)	(0.08%)	(0.10%)	(0.10%)	(0.10%)	(0.10%)
SG&A Sprouts	0.00%	(0.50%)	(2.00%)	(2.50%)	(2.50%)	(2.50%)	(2.50%)
Synergy Realization %	*0%*	*20%*	*80%*	*100%*	*100%*	*100%*	*100%*

Pessimistic Scenario	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue Enhancements Kroger	0.000%	0.001%	0.004%	0.005%	0.005%	0.005%	0.005%
Revenue Enhancements Sprouts	0.00%	0.05%	0.20%	0.25%	0.25%	0.25%	0.25%
COGS Sprouts	0.00%	(0.01%)	(0.04%)	(0.05%)	(0.05%)	(0.05%)	(0.05%)
SG&A Sprouts	0.00%	(0.40%)	(1.60%)	(2.00%)	(2.00%)	(2.00%)	(2.00%)
Synergy Realization %	*0%*	*20%*	*80%*	*100%*	*100%*	*100%*	*100%*

Optimistic Scenario	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue Enhancements Kroger	0.000%	0.003%	0.012%	0.015%	0.015%	0.015%	0.015%
Revenue Enhancements Sprouts	0.00%	0.15%	0.60%	0.75%	0.75%	0.75%	0.75%
COGS Sprouts	0.00%	(0.03%)	(0.12%)	(0.15%)	(0.15%)	(0.15%)	(0.15%)
SG&A Sprouts	0.00%	(0.60%)	(2.40%)	(3.00%)	(3.00%)	(3.00%)	(3.00%)
Synergy Realization %	*0%*	*20%*	*80%*	*100%*	*100%*	*100%*	*100%*

Table 33 – Synergy assumptions

24. Merged Firm's WACC computation

Beta Computation	
EV Kroger	33,128
B_u Kroger	0.60
EV Sprouts	2,705
B_u Sprouts	0.52
Pro-forma B_L	**0.59**
B_L	**0.97**
Adjusted Levered Beta	**0.98**
R_f	2.09%
R_m	5.75%
K_e	**7.71%**
K_d	2.55%
T	27.00%
E/EV	54.37%
D/EV	45.63%
WACC	**5.35%**

Table 34 – Combined firm's WACC computation

25. Past Transactions within the industry

Announcement Date	Deal Size (million USD)	Target Name	Acquirer Name	Premium [63]
26/07/2018	2,816	SuperValu Inc	United Natural Foods Inc	67%
16/06/2017	13,598	Whole Foods Market Inc	Amazon.com Inc	27%
14/03/2016	1,317	Fresh Market Inc	Apollo Global Management LLC	24%
28/04/2014	2,141	Susser Holdings Corp	Energy Transfer Partners LP	41%
09/07/2013	2,449	Harris Teeter Supermarkets Inc	Kroger Co	34%[64]
		Median		**34%**
		Average		**39%**

Table 35 – Past transactions within the industry

[63] 1 day before announcing date
[64] Premium calculated taking in consideration the firm's market cap on the date where the company announced evaluating strategic alternatives

26. Transaction and Integration Fees Estimation

Fees (million USD)	2019E	2020E	2021E
Integration Fees	8	28	4
Distribution of the fees	20%	70%	10%
Transaction Fees	40	-	-
Total	**48**	**28**	**4**
PV fees	47	26	4
Sum of PV	**76**		

Table 36 – Transaction and integration fees estimation

27. Merged Firm Base-Case Income Statement

Income Statement (million USD)	2018	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Sales	**126,369**	**129,277**	**132,859**	**137,305**	**141,107**	**144,602**	**147,701**	**149,702**
Cost of Sales	(98,354)	(100,574)	(103,320)	(106,741)	(109,658)	(112,344)	(114,734)	(116,277)
Gross Margin	**28,015**	**28,703**	**29,539**	**30,564**	**31,449**	**32,258**	**32,967**	**33,424**
SG&A	(22,606)	(23,161)	(23,802)	(24,519)	(25,183)	(25,825)	(26,388)	(26,752)
EBITDA	**5,410**	**5,542**	**5,737**	**6,045**	**6,266**	**6,434**	**6,579**	**6,673**
Depreciation and amortization	(2,573)	(2,678)	(2,752)	(2,845)	(2,923)	(2,996)	(3,060)	(3,101)
EBIT	**2,837**	**2,864**	**2,984**	**3,201**	**3,342**	**3,438**	**3,519**	**3,571**
Other non-recurrent gains	1,984	-	-	-	-	-	-	-
EBIT (including non-recurrent items)	**4,821**	**2,864**	**2,984**	**3,201**	**3,342**	**3,438**	**3,519**	**3,571**
Interest expense	(647)	(598)	(585)	(573)	(560)	(548)	(535)	(522)
EBT	**4,174**	**2,266**	**2,399**	**2,628**	**2,782**	**2,890**	**2,984**	**3,049**
Income tax provision	(937)	(612)	(648)	(710)	(751)	(780)	(806)	(823)
Net Income	**3,237**	**1,654**	**1,751**	**1,919**	**2,031**	**2,110**	**2,178**	**2,226**
Noncontrolling interests	32	-	-	-	-	-	-	-
Net Income attributable	**3,269**	**1,654**	**1,751**	**1,919**	**2,031**	**2,110**	**2,178**	**2,226**

Table 37 – Merged firm's base-case income statement forecasts

28. Merged Firm Base-Case Balance Sheet

Balance Sheet (million USD)	2018	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Current assets:								
Cash and cash investments	30	270	417	694	1,047	1,450	1,893	2,359
Store deposits in-transit	1,181	1,205	1,235	1,273	1,306	1,336	1,363	1,380
Receivables	1,630	1,665	1,710	1,765	1,813	1,856	1,895	1,920
Inventory	7,110	7,272	7,471	7,720	7,932	8,127	8,300	8,412
Assets held for sale	166	-	-	-	-	-	-	-
Prepaid and other current assets	619	634	651	673	692	709	725	734
Total current assets	**10,736**	**11,046**	**11,484**	**12,126**	**12,789**	**13,478**	**14,176**	**14,807**
Non-current assets:								
Property, plant and equipment, net	21,621	22,191	22,779	23,387	24,014	24,657	25,315	25,982
Intangibles, net	1,453	1,398	1,341	1,283	1,223	1,161	1,099	1,035
Goodwill	5,701	5,701	5,701	5,701	5,701	5,701	5,701	5,701
Other assets	1,347	1,349	1,350	1,351	1,352	1,353	1,354	1,354
Total non-current assets	**30,123**	**30,639**	**31,171**	**31,722**	**32,290**	**32,873**	**33,468**	**34,072**
Total assets	**40,859**	**41,685**	**42,655**	**43,848**	**45,079**	**46,350**	**47,644**	**48,879**
Current liabilities:								
Current portion of long-term debt	3,164	3,099	3,034	2,969	2,903	2,838	2,773	2,708
Trade accounts payable	6,313	6,458	6,636	6,858	7,048	7,222	7,376	7,476
Accrued salaries and wages	1,276	1,305	1,341	1,385	1,423	1,458	1,489	1,510
Deferred income taxes	-	-	-	-	-	-	-	-
Liabilities held for sale	51	51.00	51.00	51.00	51.00	51.00	51.00	51.00
Other current liabilities	3,780	3,856	3,952	4,076	4,179	4,275	4,362	4,418
Total current liabilities	**14,584**	**14,768**	**15,014**	**15,339**	**15,605**	**15,844**	**16,052**	**16,163**
Non-current liabilities								
Long-term debt	14,299	14,004	13,710	13,415	13,120	12,825	12,531	12,236
Deferred income taxes	1,612	1,612	1,612	1,612	1,612	1,612	1,612	1,612
Pension benefit obligations	494	494	494	494	494	494	494	494
Other long-term liabilities	2,034	2,049	2,063	2,077	2,092	2,104	2,113	2,119
Total long term liabilities	**18,440**	**18,159**	**17,879**	**17,598**	**17,318**	**17,036**	**16,750**	**16,461**
Total liabilities	**33,024**	**32,928**	**32,893**	**32,937**	**32,923**	**32,880**	**32,802**	**32,624**
Shareholders Equity								
Preferred shares	-	-	-	-	-	-	-	-
Common shares	1,918	1,918	1,918	1,918	1,918	1,918	1,918	1,918
Additional paid-in capital	3,245	3,245	3,245	3,245	3,245	3,245	3,245	3,245
Accumulated comprehensive loss	(346)	(346)	(346)	(346)	(346)	(346)	(346)	(346)
Accumulated earnings	19,681	21,103	22,608	24,257	26,002	27,816	29,688	31,601
Common shares in treasury	(16,612)	(17,112)	(17,612)	(18,112)	(18,612)	(19,112)	(19,612)	(20,112)
Total shareholders' equity	**7,886**	**8,808**	**9,813**	**10,962**	**12,207**	**13,521**	**14,893**	**16,306**
Noncontrolling interests	(51)	(51)	(51)	(51)	(51)	(51)	(51)	(51)
Total equity	**7,835**	**8,757**	**9,762**	**10,911**	**12,156**	**13,470**	**14,842**	**16,255**
Total liabilities and equity	**40,859**	**41,685**	**42,655**	**43,848**	**45,079**	**46,350**	**47,644**	**48,879**

Table 38 – Merged firm's base-case balance sheet forecasts

29. Merged Firm Base-Case Cash Flow Statement

Cash Flow Statement (Million USD)	2018	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Cash Flows from Operating Activities:								
Net earnings	3,237	1,654	1,751	1,919	2,031	2,110	2,178	2,226
Adjustments to reconcile net earnings:								
Depreciation and amortization	2,576	2,678	2,752	2,845	2,923	2,996	3,060	3,101
Other Items	(1,637)	-	-	-	-	-	-	-
Changes in working capital								
Store deposits in-transit	(20)	(24)	(30)	(39)	(32)	(30)	(27)	(18)
Receivables	(216)	(36)	(44)	(56)	(47)	(44)	(39)	(25)
Inventories	(389)	(162)	(200)	(248)	(212)	(195)	(173)	(112)
Prepaid and other current assets	241	(14)	(18)	(22)	(19)	(17)	(15)	(10)
Trade accounts payable	217	145	179	222	190	174	155	100
Accrued expenses	419	29	36	45	38	35	31	20
Income taxes	289	-	-	-	-	-	-	-
Pension plans	(185)	-	-	-	-	-	-	-
Other assets	(5)	(1)	(1)	(1)	(1)	(1)	(1)	(0)
Other liabilities	25	14	14	14	14	13	9	6
Other	(94)	76	97	124	103	96	87	56
Net cash provided by operating activities	**4,458**	**4,360**	**4,536**	**4,801**	**4,988**	**5,137**	**5,264**	**5,344**
Cash Flows from Investing Activities:								
Payments for PP&E	(3,144)	(3,193)	(3,283)	(3,394)	(3,490)	(3,578)	(3,655)	(3,705)
Proceeds from sale of assets	865	166	-	-	-	-	-	-
Proceeds from financial instrument	235	-	-	-	-	-	-	-
Payments for acquisitions	(3,032)	-	-	-	-	-	-	-
Purchases of stores	(44)	-	-	-	-	-	-	-
Net proceeds from sale of business	2,169	-	-	-	-	-	-	-
Purchases of Ocado securities	(392)	-	-	-	-	-	-	-
Other	(75)	-	-	-	-	-	-	-
Net cash used by investing activities	**(3,418)**	**(3,027)**	**(3,283)**	**(3,394)**	**(3,490)**	**(3,578)**	**(3,655)**	**(3,705)**
Cash Flows from Financing Activities:								
Proceeds from long-term debt	3,891	-	-	-	-	-	-	-
Payments on long-term debt	(1,379)	(360)	(360)	(360)	(360)	(360)	(360)	(360)
Payments on short-term debt	(1,216)	-	-	-	-	-	-	-
Dividends paid	(437)	(232)	(246)	(270)	(285)	(296)	(306)	(313)
Excess tax benefits on stock awards	0	-	-	-	-	-	-	-
Proceeds from issuance of capital	65	-	-	-	-	-	-	-
Treasury stock purchases	(2,268)	(500)	(500)	(500)	(500)	(500)	(500)	(500)
Investment in equity of n.c. interest	0	-	-	-	-	-	-	-
Other	(32)	-	-	-	-	-	-	-
Net cash used by financing activities	**(1,376)**	**(1,092)**	**(1,106)**	**(1,130)**	**(1,145)**	**(1,156)**	**(1,166)**	**(1,173)**
Cash and temporary investments:								
Beginning of year	366	30	270	417	694	1,047	1,450	1,893
Net increase in cash	(336)	240	147	277	353	402	443	466
End of year	**30**	**270**	**417**	**694**	**1,047**	**1,450**	**1,893**	**2,359**

Table 39 – Merged firm's base-case cash-flow statement forecasts

Glossary

Acquisition - The buying by one company of a controlling ownership interest in another company.

Agency problem - The conflict of interest between a firm's managers and shareholders.

Basis point – financial terminology for 0.01%

Bond – debt obligation which represents a loan from an investor to a borrower

Buyback – share repurchase, acts as an alternative for dividends when remunerating shareholders

Conglomerate - Firms that operate in several largely unrelated industries.

Control premium – Difference between the market value of a firm and the acquisition price paid

Credit rating – the level of creditworthiness of a firm, typically assessed by an independent rating agency

Financial distress – condition in which a firm hardens in paying its debt obligations

Hubris – overpaying in an M&A due to an overestimation of the synergies encompassing a transaction

Investment grade – credit rating assessed to an entity stating its low probability of default

Peer group – cluster of firms that present similar features.

Tender offer – offer to buy shares of another company

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