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DICHOTOMY CAPITAL

Roundy's (NASDAQ:RNDY)

June 12, 2013

Roundy's is an underappreciated and undervalued grocer in the Midwest. In this beaten down industry Mr. Market believes the threat from Wal-Mart and Target will drive out grocers like Roundy's(RNDY). This, a busted IPO, and dividend cut have left RNDY undervalued.

Currently the company trades for 5X 2012's FCF[1], although the current yield gives no credit to the expansion taking place in Chicago. New store openings, while a positive long-term development, are masking true cash flows from increased capital expenditures and pre-opening expenses. As these new stores mature and the associated opening costs go away, EBITDA margins will increase and obviously, so will free cash flow.

The current share price assumes that the company will continue to see same-store sales decline causing further shareholder pain like the recent dividend cut. While dividend cuts are normally associated with struggling companies, I believe this was not the case for RNDY. The company can more than adequately cover the dividend, grow out stores and still have cash leftover to pay down debt. Ultimately, the dividend cut will be seen as a prudent capital allocation by a management team that is shareholder friendly.

We can be assured that shareholders are being fairly represented for several reasons. There is a skewed shareholder base with one large PE owner who has owned the company since 2002. Management is world class and has a great history within the industry. We believe that the current expansion represents the CEO's legacy. The combination of owner's pride, prudent capital allocation, and robust cash flows at an attractive valuation make RNDY a compelling investment. If the company can hit their targets I believe that they will generate $1.67/share in FCF in 2014, implying a 22% FCF yield.

1. Author estimates that FCF in 2012 was $69 million

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Background

Roundy's (RNDY) is a regional grocer, selling under the Pick 'n Save, Rainbow, Copps, Metro Market, and Mariano's banners. As of 12/29/2012 there were 161 total stores, 93 of which were Pick 'n Save's. RNDY was bought by PE firm Willis Stein in 2002 for $750 million. Willis Stein hired Rob Mariano to head the company and stores increased from 61 to more than 150 by 2007. After that expansion, Willis Stein tried to sell the company and had "several interested parties."

Willis Stein failed to sell the company for $2.0 billion in 2007 and $1.2 billion in 2011, so an IPO took place in 2012 at $8.50/share, well below expectations. Willis Stein sold 4.5 million shares during the IPO, although they still hold 41% of all shares. Besides the partial shareholder exit, proceeds from the IPO were used to delever the balance sheet and to fund store openings in Chicagoland.

Chicago is a new area of development for RNDY, with their first store opening in 2010. Historically the company has operated in Milwaukee (Pick 'n Save and Metro Market), Madison (Copps), and Minneapolis (Rainbow Foods). Management is no stranger to the area; several members of the helped grow and develop Dominick's into one of the top grocers in Chicago.

By the end of 2012 RNDY had 8 stores in Chicagoland. The company has high expectations for Mariano's and the Chicago market in general. To free up cash to fund the Chicago expansion the company cut their dividend in November 2012 to free up cash flow. This did not sit well with Mr. Market.

A Tale of Two Stores (and four Cities)

On the surface RNDY looks poor with decreasing same-store sales (SSS) and declining EBITDA. These problems are temporary thanks to the Mariano's expansion, changes to the old stores, and management team.

Mariano's

Mariano's, named after CEO Bob Mariano, is Roundy's new store offering in Chicagoland. Mariano's sits squarely in-between high end grocers like Whole Foods and lower-cost grocers like Jewel-Osco. Stores average 65,000 square feet and "offer expanded produce sections, unique specialty departments and inviting ambiance," according to their S-1. Pictures can be seen here. To say Mariano's has been a success would be an understatement.

"*We continue to be very pleased with the strength of our five Mariano's Fresh Market stores in the Chicago area. The customer response to these stores has been overwhelmingly positive, and that is translating to financial performance well beyond our expectations. Our overall same-store sales for this group of stores at this point only includes two of those stores, opened in the low double-digits range year-over-year, and our new store that opened earlier this year is also already generating positive EBITDA*." Bob Mariano Q2 2012 Conference Call

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"*Our growth banner, Mariano's, continues to generate excitement with each customer in (the) Chicago area. Our current strategy intends to build around 5 stores per year. And as I mentioned earlier, we are increasingly confident that the Chicago market can support more than 30 Mariano's stores.*" Bob Mariano Q1 2013 Conference Call

The stores are clearly targeting higher income consumers, something that can be seen in the table 1 below. Most of the areas they are penetrating have per capita incomes over $30,000 and while their stores have sprouted up around Chicago there are clearly several other municipalities that have the capacity to add Mariano's. Areas that I believe could support Mariano's, solely based on income and population levels, are in bold.

Table 1. Mariano's Store Locations

Municipality	Population	Median Income Per family	Per Capita Income	Mariano's
Aurora	**199,672**	**$60,689**	**$25,491**	**Potential**
Elgin	108,395	$58,404	$21,112	
Joliet	148,402	$55,870	$19,390	
Naperville	**142,773**	**$130,164**	**$48,239**	**Potential**
Arlington Heights	75,101	$100,966	$41,654	Yes
Berwyn	56,657	$55,946	$20,143	
Cicero	83,891	$42,235	$14,339	
Des Plaines	**58,364**	**$65,806**	**$24,146**	**Potential**
Evanston	74,486	$102,706	$40,732	Yes
Gary, IL	80,294	$32,247	$16,300	
Hammond, IL	80,830	$46,905	$17,747	
Hoffman Estates	49,495	$85,301	$26,669	Yes
Kenosha, WI	99,218	$58,484	$23,728	
Mount Prospect	**54,167**	**$84,136**	**$34,002**	**Potential**
Oak Lawn	56,690	$47,585	$23,877	
Orland Park	**57,016**	**$77,507**	**$30,467**	**Potential**
Palatine	68,557	$74,915	$30,049	Yes
Racine, WI	78,860	$51,411	$20,246	
Schaumburg	74,227	$84,931	$31,586	Yes
Skokie	**64,784**	**$68,253**	**$27,136**	**(2014/2015)**
Tinley Park	56,703	$71,858	$25,207	Yes
Waukegan	89,078	$47,341	$17,368	
Wheaton	52,894	$108,706	$42,179	Yes
Chicago				Yes(4)
Vernon Hills	25,113	$110,343	$42,205	Yes
Frankfort	17,782	$122,466	$45,285	Yes

Source: Roundy's, US Census

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Obviously this expansion has costs including pre-opening expenses (training and inventory) and capital expenditures. Pre-opening expenses are estimated to be between $1.5-$2.5 million per store, based on competitors published figures. Management has stated that capital expenditures are around $5 million. The table below shows the estimated impact for 2011-2014, this does not include store remodels.

Table 2. Estimated Opening and Capital Expenses for Mariano's

	2011	2012	2013	2014
Opening Expense	$(4)	$(10)	$(10)	$(10)
CapEx	$(15)	$(20)	$(25)	$(25)

These costs are well worth it though. Stores were originally expected to do $750,000 per week in sales and according to management this was easily exceeded. Stores are now expected to generate around $50 million in sales per year at 5% EBITDA margins upon maturity.

With an estimated market of 30 stores in Chicago (13 currently open and two more opening soon), management is a little under halfway through. What Mr. Market seems to be doing though is applying the depressed EBITDA into the future, which I believe is incorrect. Based on my model I believe that 2014 will be the year that results start to bear fruit, something management has guided to in their earnings calls. The table below shows an excerpt from my model detailing the growth in EBITDA from the Mariano's stores only.

Table 3. Mariano's EBITDA growth

In Millions	**2011**	**2012**	**2013**	**2014**
Estimated (5%) EBITDA	$3.2	$9.1	$19.5	$28.3
Opening Expenses	$(4)	$(10)	$(10)	$(10)
Mariano's EBITDA	**$(0.8)**	**$(0.9)**	**$9.5**	**$18.3**

Source: Discussions with management & Authors calculations

The point with the table above is not to show an exact figure, but to highlight that things have been depressed and as management has stated, should improve in the next couple of years. This seems to be lost on the sell-side who only note the decline in operating margins and same-store sales decline.

If the plan in Chicago continues as planned and RNDY is able to open 30 stores with annual sales of $45 million (10% below what mature stores are generating now), that is $1.35 billion in sales from their Chicago stores alone. If these stores can continue to generate 5% EBITDA margins that would equal another $67.5 million in EBITDA. This is compared to a company that currently generates $3.89 billion in revenue and $198 million of Adjusted EBITDA in 2012. It should be no surprise that management is applying lessons learned at Mariano's to their other stores.

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Other Stores

The other three markets of Milwaukee, Minneapolis, and Madison are seeing declining SSS due to competition from Target, Wal-Mart, and conventional grocers. In 2012 there were 24 competitive openings, eight of which were super centers. Overall, these competitive openings reduced SSS by 2.7%. Management has guided for a similar impact in 2013.

While this is disconcerting, RNDY initiated some Mariano's concepts at 14 Pick 'n Saves in Milwaukee (M14). This group was compared to a control group of 20 stores in the Milwaukee area. The results of this experiment were positive according to management, M14 saw better comp comparisons and EBITDA "has tracked better in the M14". While there are no hard numbers for M14, investors will get a chance to see the impact on the remainder of the Milwaukee stores. The 69 stores in Milwaukee are expected to see improvement in 2014.

It is important to note that this could ultimately fail. What works in Chicago may not work anywhere else. The bad news is real news, sales are decreasing and competition is coming from large, well-funded companies. However, confidence in this plan is coming straight from the top.

Management

The grocery sector is incredibly competitive, therefore I feel it is vital to have a management team fully aligned with shareholders with years of experience. I believe this is what separates RNDY from numerous other chains and will ultimately help the company deliver upon its various targets.

Bob Mariano: CEO

Mariano has worked in grocery stores since 1968, starting at Dominick's. He spearheaded the development of the "Fresh Store" for Dominick's. Those efforts made him CEO after which he took the company public and finally sold it to Safeway in 1998. The current demise of Dominick's may indicate how vital Mariano was to the success of the store.

Regardless, Mariano joined Roundy's in 2002 and appears to be on a similar path, growing the store count, bringing innovative changes, and taking the company public for its large PE owner. The newest stores, as mentioned earlier, are named after Mariano. I believe that these stores represent his legacy. His public words show a tremendous amount of pride in the success of Roundy's and especially Mariano's.

Mariano owns over 1.132 million shares compared to a base salary of $955K in 2012. (14A)

Darren Karst: CFO

Darren worked with Mariano at Dominick's and left at the same time. He owns over 554,000 shares compared to a base salary of $700K in 2012. (14A)

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Willis Stein

Willis Stein owns 41.5% of shares outstanding. This large share position makes it unlikely that they will do anything deleterious to common shareholders. The company has tried to sell off their holdings several times with little success. In August of 2012 Willis Stein raised capital to return money to investors who bought stakes in their third fund, the same one that held Roundy's. Willis Stein did not sell their stake and stated that they intend to hold RNDY in a "sub-fund."

Valuation

Roundy's trades at a very attractive valuation, one that doesn't account for any growth. In the table below we can see my estimated FCF, based on 46.75 million shares outstanding. Chicago revenue growth is based on talks with management. Ex-Chicago sales decline by 2.3% in 2013, -2% 2014, -1% in 2015, and finally flatline in 2016. This is strictly a guess but seems reasonable given Target will stop expanding soon and there are new initiatives in Milwaukee.

Table 4. Estimated Free Cash Flow

In Millions	2013	2014	2015	2016
Ex-Chicago	$ 3,625	$ 3,552	$ 3,517	$ 3,517
Chicago	$ 390	$ 567	$ 736	$ 1,030
Total	**$ 4,014**	**$ 4,119**	**$ 4,253**	**$ 4,547**
EBITDA	$ 188.7	$ 201.8	$ 212.7	$ 227.4
Interest	$ 48.5	$ 47.6	$ 46.7	$ 45.9
CapEx	$ 65.5	$ 65.5	$ 65.5	$ 65.5
EBT	$ 74.7	$ 88.7	$ 100.5	$ 116.0
Tax Rate	40%	40%	40%	40%
FCF	$ 44.8	$ 53.2	$ 60.3	$ 69.6
Mariano's CapEx	$ (25)	$ (25)	$ (25)	$ (25)
Adjusted FCF	$ 69.8	$ 78.2	$ 85.3	$ 94.6
Per Share FCF	**$1.49**	**$1.67**	**$1.82**	**$2.02**

Clearly the company has no problem producing cash and I believe the model above is on the conservative side. The remodel cycle was completed in 2009 and management has stated that true maintenance CapEx is around $25 million. The next remodel cycle shouldn't start until 2016 if industry averages (7-10 years) are applied.

Even if one assumes that the CapEx ($25 million annually) to open new stores is really just true CapEx for the next refresh cycle, 2014 FCF of $53.2M works out to $1.17/share, a 15.6% yield to today's share price of $7.50.

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The cash will be used to pay a dividend of $22.4 million each year ($0.48/share per year). The remainder of the cash will likely be split between store improvements and paying down debt, something management guided to during the Q3 2012, Q4 2012, and Q1 2013 conference calls. The company currently has $72.88 million cash on hand versus $692 million in debt. Their debt is floating rate (L+4.5% with a 1.25% floor) so it seems logical that they pay down some debt. Management has not disclosed how much they plan to pay down but they do have mandatory principle payments. The table below shows the scheduled debt payments. The company will have no problem paying down debt and a dividend.

Table 5. Scheduled Debt Payments

Year	2013	2014	2015	2016
Principle Payments	$ 10.92	$ 13.03	$ 11.74	$ 11.90
Interest @ 7%	$ 48.50	$ 47.68	$ 46.76	$ 45.94
Debt by the End of Year	$ 681.08	$ 668.06	$ 656.32	$ 644.42

7% cost of debt assumes non-cash items

There is no exact fair value to RNDY. How much success Mariano's achieves and how quickly sales declines can be reversed will dictate a lot. Regardless, I believe that the company is undervalued and should be valued as a growing company rather than one in decline.

Conservative Approach

If we take 2013 FCF (before Mariano's adjustment), we arrive at FCF per share of $0.96. An 8X multiple, which assumes no growth gives a share value of $7.66, versus today's price of $7.50. In my opinion Mr. Market is pricing in very little growth in Chicago. There are 13 stores that should open by the end of 2013, all of which should generated over $40 million in sales during 2014. The declining sales in other stores (2.7%) will easily be outmatched by the increase in sales from Mariano's.

Optimistic Valuation

Arguably growth CapEx should be excluded and the company should be given some credit for their growth efforts. If we apply a 10X multiple to the 2013 FCF/share number in Table 5, we arrive at a fair value of $14.90/share, roughly double today's price.

If Mr. Market were to value RNDY at $14.90/share the dividend yield would be 3.22%, much closer to other grocers like KR(1.77%), AHONY(3.59%), HTSI (1.29%), VLEGA(2.82%) and SWY (3.48%).

In-between Approach

Finally, if we assume that all the growth CapEx (for Mariano's) will simply be applied to store remodels in the future (that is, actual CapEx is consistent) then 2014's FCF of $53.2 million should be used. This works out to $1.13/share. Applying a 10X multiple, because cash flows are increasing and debt is decreasing by $10-$14 million per year, gives a fair value of $11.30/share.

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Risks

- Competition proves to be far greater than expected. Wal-Mart, Target, and perhaps Amazon in the future, are not to be taken lightly. I believe that the increase in sales from Mariano's will drive a different customer to their stores. It's unlikely that a customer who wants to hear live piano while grocery shopping will opt for Wal-Mart. The M14 initiatives should help mitigate future threats.
- Mariano's saturates the markets or experiences competition from Whole Foods and Trader Joe's. Mariano's is significantly less expensive than Whole Foods (produce is 70% the price of Whole Foods) so again, the customer should be different. Dominick's is leaving a void in Chicago that will need to be filled, who better than the team that filled that void more than a decade ago?
- Interest rates climb. With floating rate debt of $696.5 million, every 1% increase in LIBOR (over 1.25%) will increase interest expense by $6.96 million.

Conclusion

Things have not gone as planned for Roundy's but hidden behind all the pessimism is a company trading at an attractive valuation with significant tailwinds. Mr. Market has punished the company and does not understand the potential that this company has as it executes on its Chicago plan, likely the CEO's legacy. Other analysts are too focused on what has happened and fail to look forward.

I believe in five years the dividend cut will be seen as a great use of capital and shareholders will be rewarded as the company is valued as a growing company with good prospects. In the end this may be what Willis Stein sees and this may explain why they aren't dumping their shares. The development of a sub-fund to hold RNDY was likely them trying to keep the position and let things develop.

Downside is limited because cash flows are robust now, even with competition from national big box stores. While the name could be dead money if the Chicago expansion doesn't grow as quickly as thought, a 6% dividend that is adequately covered(50% payout ratio on trough earnings) will compensate the patient investor. Sentiment changes take time, luckily we are patient investors.

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