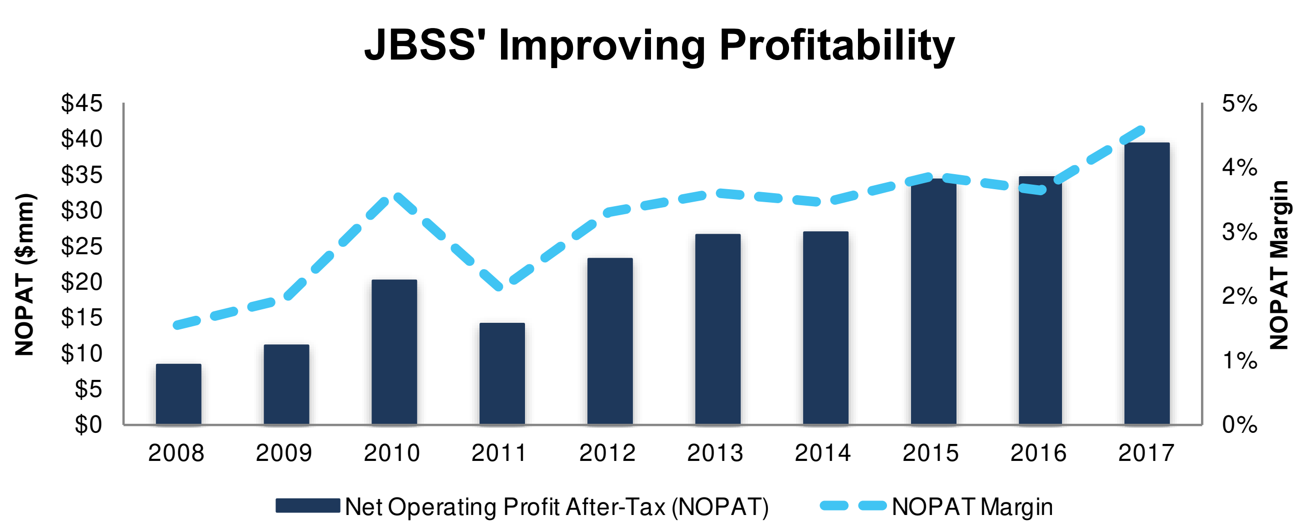
Transitioning Business Model Coupled with a Competitive Advantage

While transitioning from a commodity based business (nut processing) to a consumer facing and branded product business, this firm has consistently grown profits, improved margins, and properly incentivized executives to create shareholder value. Add in a cheap valuation, and this stock not only finds itself on October's Exec Comp Aligned with ROIC Model Portfolio but John B. Sanfilippo & Sons (JBSS: $59/share) is also this week's Long Idea.

JBSS' Impressive Profit Growth

We briefly featured JBSS in March 2015, and, while the stock is up 63% (vs. +22% for the S&P), it remains undervalued and warrants a deeper look. JBSS has grown revenue 5% compounded annually over the past decade. Over the same period, after-tax profit (NOPAT) has increased 8% compounded annually, per Figure 1. Improved profit growth has been fueled by rising NOPAT margins, which have increased from -2% in 2007 to 5% in 2017. Over the long-term, JBSS has grown NOPAT by 7% compounded annually since 1998.

Figure 1: JBSS Profit Growth Over Past Decade



Sources: New Constructs, LLC and company filings

JBSS has generated a cumulative $157 million (22% of market cap) of free cash flow (FCF) over the past five years. JBSS's $45 million in FCF in 2017 equates to a 6% FCF yield compared to 2% for the average S&P 500 stock.

JBSS has also exhibited excellent stewardship of capital as it transitioned its operations. Over the past decade, JBSS has improved its return on invested capital (ROIC) from -3% in 2007 to 12% in 2017. JBSS' improving balance sheet efficiency is further evidence of good capital stewardship. Since bottoming in 2007, JBSS' invested capital turns have increased from 1.6 to 2.6 in 2017.

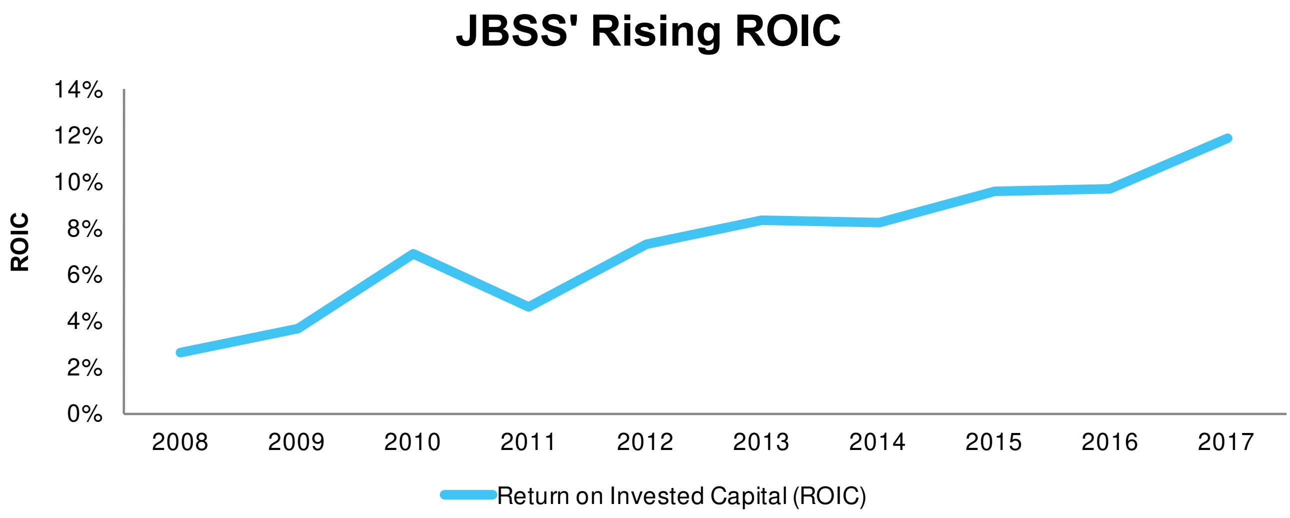
Executive Compensation Plan Is Directly Aligned with Creating Shareholder Value

JBSS executive's annual incentive compensation is paid as a cash bonus (30-40% of total comp) based on the Sanfilippo Value-Added Plan ("SVA Plan"). The SVA Plan rewards executives for meeting or exceeding year-over-year improvement targets for economic profit. JBSS defines economic profit as after-tax operating profit minus a capital charge at a 9% cost of capital (WAAC). Invested capital is defined as equity plus debt less excess cash above $2 million.

While the calculation methodology may not be perfect, the focus on economic profit and improving ROIC aligns the interests of executives and shareholders and helps to ensure the prudent stewardship of capital. Per Figure 2, JBSS' ROIC improved to 12% in 2017 from 7% in 2012 and -3% in 2007.

The focus on economic earnings helps ensure executives continue to be good stewards of capital. Accordingly, JBSS has grown economic earnings from -$29 million in 2007 to $23 million in 2017. JBSS' use of economic earnings to measure performance also earns it a spot on October's Exec Comp Aligned with ROIC Model Portfolio.

Figure 2: JBSS' ROIC Improvement Over the Past Decade



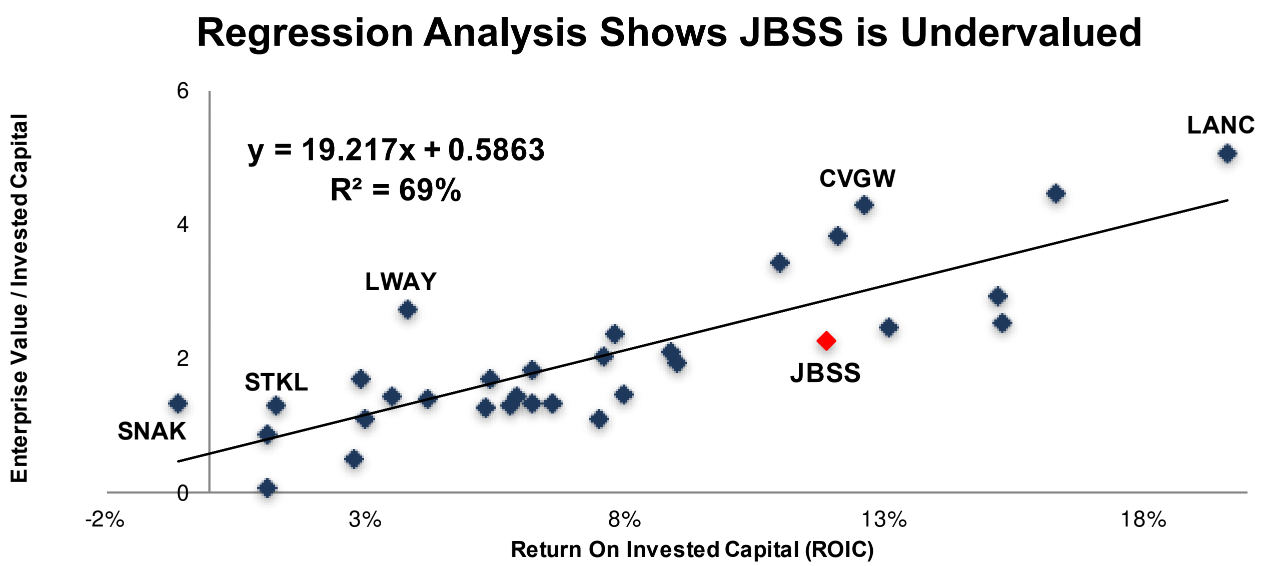
Sources: New Constructs, LLC and company filings

Improving ROIC Correlated with Creating Shareholder Value

We know from Figure 3 below, and numerous case studies, that changes in stock prices are strongly correlated with ROIC. As such, getting ROIC right is an important part of the investment decision making process. A recent white paper published by accounting firm, Ernst & Young, shows material superiority of our forensic accounting research and measure of ROIC versus the largest research providers.

Per Figure 3, ROIC explains 69% of the difference in valuation for the 32 packaged food peers under coverage. Despite JBSS' 12% ROIC, which is well above the 8% average of the peer group, the firm's stock trades at a discount to peers as shown by its position below the trend line in Figure 3. If the stock were to trade at parity with its peers, it would be $77/share – 31% above the current stock price. Given the firm's rising ROIC and properly aligned executive compensation, one would think the stock would garner a premium valuation.

Figure 3: ROIC Explains 69% Of Valuation for Packaged Food Stocks



Sources: New Constructs, LLC and company filings

JBSS' Consumer Goods Business Is Gaining a Competitive Advantage

John B. Sanfilippo & Sons generates its revenue in three distinct markets: Consumer (63%), Commercial Ingredients (19%), and Contract Packaging (18%). Beginning in 2007, JBSS began focusing its business more on the consumer goods/branded foods segment. This shift can be seen in the changing make up of its revenues. In 2007, the consumer business accounted for 51% of revenues while the commercial ingredients accounted for 32% and JBSS' export business accounted for 9%. This transition allowed JBSS more control over product pricing and has allowed the firm to improve its margins in the midst of falling margins across the industry.

As a provider of snack nuts, healthy nuts, and baking/cooking nuts, JBSS faces competition from any number of other consumer food providers. Competitors include the likes of Lancaster Colony (LANC), J&J Snack Foods (JJSF), Seneca Foods Corp (SENEA), Kellogg Company (K), General Mills (GIS), and previous Danger Zone stock Lance Inc. (LNCE).

The margin improvement noted earlier is a sign of JBSS' growing competitive advantage. Figure 4 below shows the average NOPAT margin for JBSS's peer group. As the peer group average has fallen from 5% in 2013 to 4.1% TTM, JBSS' NOPAT margin has improved from 3.6% to 4.7%. JBSS' ability to buck the trend has turned a margin disadvantage into an advantage against its peers. Moving forward, JBSS' higher margins allow the firm greater flexibility in procuring raw materials (nuts), expanding its geographic footprint, and competitive pricing all while remaining profitable.

Figure 4: JBSS' Profitability on Rise

Net Operating Profit After Tax (NOPAT) Margin						
Company / Peer Group	**2013**	**2014**	**2015**	**2016**	**2017**	**TTM**
JBSS Peer Group Average	5.0%	5.2%	5.3%	5.9%	4.2%	4.1%
John B. Sanfilippo & Sons	3.6%	3.5%	3.9%	3.6%	4.7%	4.7%
Margin Advantage: JBSS vs. Peers	**-1.4%**	**-1.7%**	**-1.4%**	**-2.3%**	**0.5%**	**0.6%**

Sources: New Constructs, LLC and company filings.

Bear Case: Success Solely from Nut Price Increases

As with many consumer goods producers, the raw material costs can play a large role in determining a firm's profitability. Bears will point to rising nut prices as the sole reason for JBSS' improving NOPAT and rising margins. However, this belief requires JBSS' profits to move directly in line with nut prices. However, this correlation has not always been present. From June 2011-June 2012, the spot price of pecans, cashews, peanuts, and walnuts all fell. These four nut groups made up 68% of total sales in Fiscal 2012 but despite the price declines, JBSS' NOPAT margin rose from 2.1% in fiscal 2011 to 3.2% in fiscal 2012. More recently, the correlation of profits to nut prices did not hold true when prices fell in fiscal 2017, per Figure 5. Prior to this year, nut prices experienced five consecutive years of price growth. Over this time, JBSS' NOPAT grew well above and beyond the rate of change in price. The increased growth can be attributed to JBSS' efficiency initiatives and ability to introduce popular products. Most importantly, in fiscal 2017, when nut prices fell 1% year-over-year, JBSS' NOPAT continued to grow 14%. If nut prices were the only reason for JBSS' profit growth, the NOPAT growth achieved in 2017 should not have been possible.

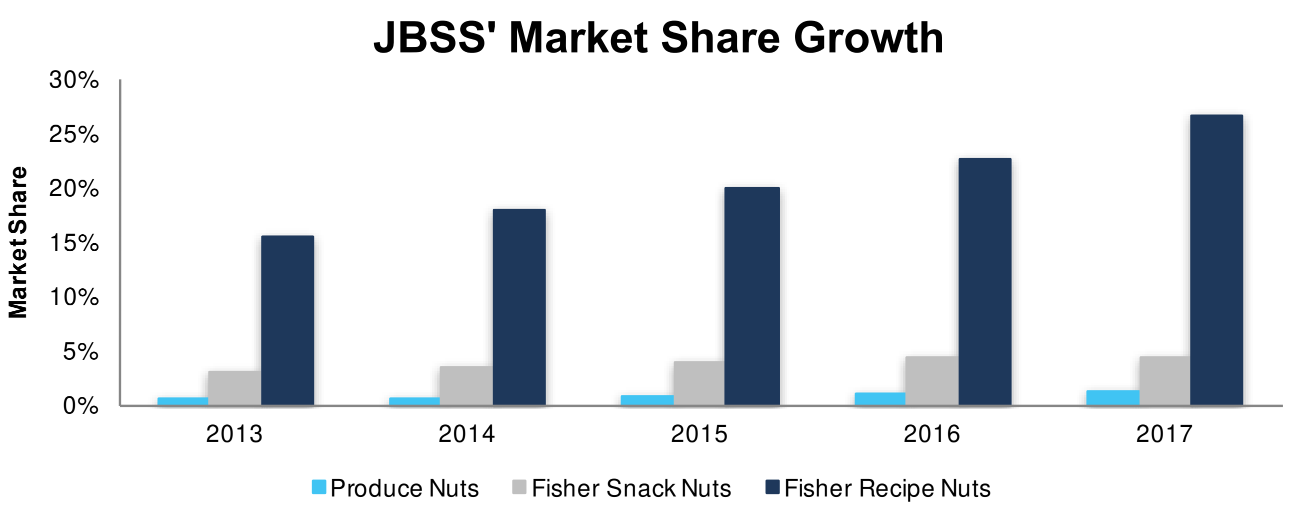
Figure 5: JBSS' Profit Growth vs. Change in Nut Prices

% Change	Fiscal 2012	Fiscal 2013	Fiscal 2014	Fiscal 2015	Fiscal 2016	Fiscal 2017
Nut Prices	13%	6%	1%	4%	4%	-1%
NOPAT	63%	15%	1%	27%	1%	14%

Sources: New Constructs, LLC and company filings.

Beyond nut prices, JBSS has undergone efforts to increase its consumer presence with the addition of its produce nut brands Orchard Valley Harvest and Sunshine Country. Additionally, the company has gained significant market share in its recipe nuts brand, Fisher Recipe. Per Figure 6, JBSS' Fisher Recipe's market share has increased from 16% in 2013 to 27% in 2017. It's Fisher Snack brand market share has improved from 3% to 4%, and the produce nut market share has increased from 0.6% to 1.3% over the same time. The company's ability to grow market share while improving profitability is another testament to the firm's competitive strengths and bodes well for future profit growth

Figure 6: JBSS' Market Share Growth by Product



Sources: New Constructs, LLC and company filings.

Lastly, the bear case is further weakened by analyzing JBSS' valuation. The stock's current valuation ignores JBSS' years of profit growth and significantly undervalues its business. More details are below.

Recent Pullback Creates Buying Opportunity

After reporting fiscal 1Q18 results, in which revenue missed expectations, JBSS fell 13%. Management expects its Orchard Valley Harvest and contract packaging segments to make up for a downturn in Fisher nuts and consensus expectations for full year earnings have not fallen. This unwarranted price decline creates further disconnect between the fundamentals of the business and JBSS' valuation, which presents an excellent buying opportunity.

At its current price of $59/share, JBSS has a price-to-economic book value (PEBV) ratio of 1.0. This ratio means the market expects no meaningful growth in JBSS' NOPAT over the remaining life of the firm. This expectation seems overly pessimistic for a firm that has grown NOPAT by 8% compounded annually over the past decade and 7% compounded annually over the past two decades.

If JBSS can simply maintain NOPAT margins (4.7%) and grow NOPAT by just 4% compounded annually for the next decade, the stock is worth $83/share today – a 43% upside. Add in the potential 4% (or greater) yield detailed below, and it's clear why JBSS could be a great portfolio addition.

Dividends Could Yield Upwards of 4% And Shows Management Cares About Investors

JBSS has no share repurchase plan but, instead, provides investors significant yield in the form of special dividends. In fiscal 2013, JBSS declared a $1/share special dividend, which was its first dividend since 1995. The company has increased its special dividends each year since. In its most recent fiscal year, JBSS issued $5/share in special dividends, which equates to 50% compounded annual growth since 2013. Using the stock price from the last day of each fiscal year, JBSS' special dividends would have yielded 5.9% in fiscal 2016 and 8.0% in fiscal 2017.

Beginning in fiscal 2018, JBSS announced it would adopt an annual cash dividend policy, along with special dividends at the discretion of the board. The first annual dividend was $0.5/share and was announced alongside a $2/share special dividend. So far the dividend payments in fiscal 2018 equate to a 3.7% yield given JBSS' current stock price. If management adopts a similar special dividend policy as in the past, shareholders could see significantly higher dividend yields going forward. Best of all, JBSS' free cash flow allows for future dividend growth. Since 2013, JBSS has paid out $123 million in dividends and generated cumulative free cash flow of $157 million. FCF generation above and beyond dividend payments provides safety in the current yield while also allowing room to increase the dividend.

Continued Earnings Growth Could Boost Shares

Despite the revenue miss in fiscal 1Q, consensus EPS expectations remain the same as they were 90 days ago. In other words, the stock took a hit despite no change in future profit expectations. Going forward, a single quarterly beat could "reset" the stock price to a much higher level, and one that better matches the profit opportunities of the business.

Such a scenario has played out before. In October 2016, JBSS reported earnings that beat revenue expectations and the stock soared 13% in the following two weeks. Compared to the price the week prior to earnings, JBSS increased nearly 40% in a three-week span. A similar earnings beat could be the catalyst to send shares flying again.

Apart from earnings, continued growth in JBSS' produce nut category and continued market share growth will provide a runway for future profit growth. In either case, this stock offers low valuation risk, a large potential yield and significant upside potential.

Insider Trading and Short Interest Trends

There is little insight to be gained from recent insider trading trends. Insider activity has been minimal over the past twelve months with 32 thousand shares purchased and 33 thousand shares sold for a net effect of one thousand shares purchased. These sales represent less than 1% of shares outstanding.

Short interest trends are more insightful. There are currently 962 thousand shares sold short, which equates to 9% of shares outstanding and 26 days to cover. Short interest has risen 46% from 661 thousand shares at the end of December 2016. However, JBSS has proven its ability to continually grow profits and now any positive earnings report could squeeze shorts and send shares even higher.

Auditable Impact of Footnotes & Forensic Accounting Adjustments

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to John B. Sanfilippo & Son's 2017 10-K:

Income Statement: we made $8 million of adjustments, with a net effect of removing $4 million in non-operating expense (<1% of revenue). We removed $2 million in non-operating income and $6 million in non-operating expenses. You can see all the adjustments made to JBSS' income statement here.

Balance Sheet: we made $67 million of adjustments to calculate invested capital with a net increase of $44 million. The most notable adjustment was $10 million in other comprehensive income. This adjustment represented 3% of reported net assets. You can see all the adjustments made to JBSS' balance sheet here.

Valuation: we made $83 million of adjustments with a net effect of decreasing shareholder value by $83 million. There were no adjustments that increased shareholder value. Apart from $61 million in total debt, which includes $2 million in off-balance sheet operating leases, the largest adjustment was $22 million in underfunded pensions. This pension adjustment represents 3% of JBSS' market cap. Despite the net decrease in shareholder value, JBSS remains undervalued.

Attractive Funds That Hold JBSS

The following funds receive our Attractive-or-better rating and allocate significantly to JBSS.

1. Royce Special Equity Fund (RYSEX) – 2.8% allocation and Attractive rating.
2. PowerShares Dynamic Food & Beverage Portfolio (PBJ) – 2.6% allocation and Very Attractive rating.
3. Hancock Horizon US Small Cap Fund (HSCIX) – 1.6% allocation and Attractive rating.

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Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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