Another Falling Knife That Could Cut Your Portfolio – Part 2

We counsel investors not to try and catch falling knives – stocks that have seen steep declines but still have further to fall. As the market rotates away from high-flying growth names to more stable cash generators, investors need reliable fundamental research, more than ever, to protect their portfolios from falling knives.

We continue to post an exceptional hit rate on spotting overvalued stocks. Currently, 62 out of our 65 Danger Zone stock picks are down from their 52-week highs by more than the S&P 500. Figure 1 lists the open Danger Zone picks that are down at least 40% from their 52-week highs. Our Focus List Stocks: Short Model Portfolio, the best-of-the-best of our Danger Zone picks, outperformed the S&P 500 as a short portfolio by 36% in 2021 with 29 out of our 31 picks outperforming the index.

This report highlights one particularly dangerous falling knife: Sweetgreen (SG: $31/share). We highlight four other falling knives in other reports published today: Allbirds (BIRD: $12/share) here, Carvana (CVNA: $150/share) here, Wayfair (W: $140/share) here, and Shake Shack (SHAK: $64/share) here. Each of these stocks have dropped at least 40% from all-time highs, yet still carry at least 40% additional downside risk.

Figure 1: Danger Zone Picks Down >40% From 52-Week High – Performance through 2/4/22

Company	Ticker	Off 52-Week High
Peloton Interactive Inc.	PTON	-84%
Robinhood Markets Inc.	HOOD	-82%
Koss Corp	KOSS	-80%
AMC Entertainment Holdings	AMC	-79%
Cronos Group Inc.	CRON	-77%
GameStop Corporation	GME	-71%
Pinterest Inc.	PINS	-70%
Beyond Meat Inc.	BYND	-68%
Allbirds Inc.	BIRD	-67%
Rivian Automotive	RIVN	-66%
Affirm Holdings Inc.	AFRM	-64%
LivePerson Inc.	LPSN	-63%
DoorDash, Inc.	DASH	-62%
Express Inc.	EXPR	-60%
Carvana Co.	CVNA	-60%
Wayfair, Inc.	W	-60%
Spotify Technology	SPOT	-55%
Coinbase Global Inc.	COIN	-55%
Snap Inc.	SNAP	-53%
Domo Inc.	DOMO	-52%
Sweetgreen Inc.	SG	-52%
Diebold Nixdorf, Inc.	DBD	-52%
Squarespace Inc.	SQSP	-51%
Shopify Inc.	SHOP	-50%
Shake Shack, Inc.	SHAK	-49%
Eventbrite Inc.	EB	-46%
Warby Parker Inc.	WRBY	-45%
LYFT Inc.	LYFT	-45%
PROS Holdings, Inc.	PRO	-42%
Uber Technologies Inc.	UBER	-42%
Netflix Inc.	NFLX	-41%
Zendesk, Inc.	ZEN	-41%

Sources: New Constructs, LLC

Falling Knife: Sweetgreen (SG): Down 53% from 52-Wk High & 100% Downside Remaining

We put Sweetgreen in the Danger Zone in in November 2021 prior to its IPO. Since the opening price on IPO date, the stock is down 49% while the S&P 500 is down just 5%. The pain is not over for Sweetgreen's shareholders as the stock could fall to $0. We detail why Sweetgreen's undifferentiated business, industry-worst profitability, and competitive challenges could lead to $0/share in our report here.

Sweetgreen Is Priced to Grow Faster than Chipotle Did

When we use our reverse discounted cash flow (DCF) model to analyze the future cash flow expectations baked into Sweetgreen's current valuation, we can provide clear, mathematical evidence that $31/share appears too high and offers unattractive risk/reward.

To justify its current price of $31/share, Sweetgreen must:

- improve its NOPAT margin to 4% (vs. -57% in 2020) in 2021, 8% in 2022, and 12% (Chipotle's best-ever margin) from 2023-2030, and
- grow revenue by 28% (vs. -20% in 2020) compounded annually for the next ten years (over 3x the expected industry growth rate through 2025).

In this scenario, Sweetgreen would generate $2.6 billion in revenue in 2030, which is nearly 12x its 2020 revenue. In this scenario, Sweetgreen's 28% revenue CAGR is higher than the 22% revenue CAGR Chipotle achieved in its first 10 years after going public.

In this scenario, Sweetgreen also generates $313 million in NOPAT in 2030, which implies a total increase of $439 million, given its 2020 NOPAT is -$126 million. For reference, once going public, it took Chipotle nine years to increase NOPAT by $440 million. However, Chipotle was offering a differentiated product and, more importantly, was already profitable.

In other words, Sweetgreen must grow revenue faster, and improve profits on par with Chipotle in its first decade as a public company, or the stock is worth much less than its current valuation.

83% Downside Even if Growth Exceeds 2x Fast Casual Projections

A second DCF scenario highlights the downside risk should Sweetgreen's revenue grow by "only" 2x projected industry growth.

If we assume Sweetgreen's:

- NOPAT margin rises to 4% in 2021, 7% in 2022, and 11% (equal to Chipotle's TTM margin) from 2023-2030, and
- revenue grows by 16% (2x the projected industry growth CAGR from 2021-2025) compounded annually from 2021-2030, then

Sweetgreen is worth just $5/share today – an 83% downside to the current price.

Should Sweetgreen struggle to improve margins at such a rapid pace or grow revenue more in line with the overall industry, the stock could be worth nothing.

100% Downside if Sweetgreen Matches Shake Shack's Margins

We review an additional DCF scenario to highlight the downside risk should Sweetgreen's margins match Shake Shack instead of Chipotle.

If we assume Sweetgreen's:

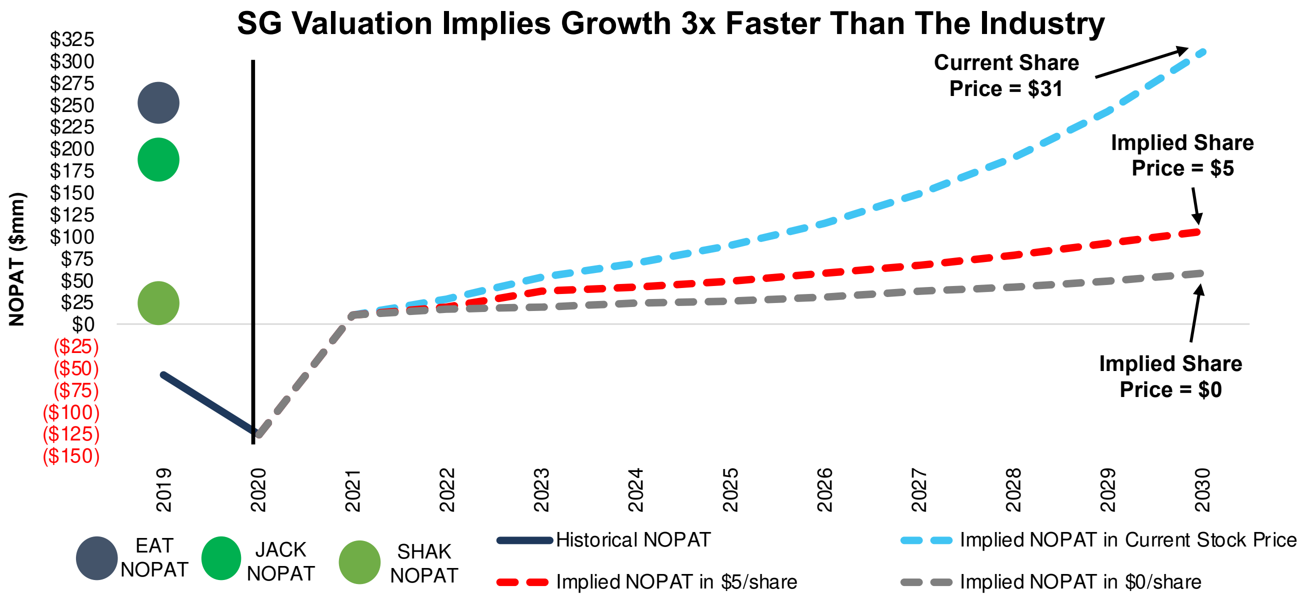
- NOPAT margin rises to 4% in 2021 and 6% (equal to Shake Shack's average margin since its IPO) from 2022-2030, and
- revenue grows by 16% compounded annually from 2021-2030, then

the stock is worth $0. See the math behind this reverse DCF scenario.

In this scenario, Sweetgreen's NOPAT in 2030 is $58 million. After accounting for total debt, preferred stock, and outstanding employee stock options that decrease shareholder value by $1.0 billion, there is no remaining value for shareholders.

Figure 2 compares Sweetgreen's implied future NOPAT in these three scenarios to its historical NOPAT. We also include the 2019 (pre-pandemic) NOPAT for restaurant peers Jack in the Box (JACK), Brinker (EAT), and Shake Shack (SHAK) for reference.

Figure 2: Sweetgreen's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

Each of the above scenarios also assumes Sweetgreen grows revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is conservative given the company plans to double its store count over the next three to five years. For reference, fast-growing, fast-casual restaurant Shake Shack grew invested capital 22% compounded annually from 2012 to 2020. Should Sweetgreen's invested capital grow at an even faster rate than assumed in the scenarios above, the stock has even more downside risk.

Fundamental Research Provides Clarity in Frothy Markets

2022 has quickly shown investors that fundamentals matter and stocks don't only go up. With a better grasp on fundamentals, investors have a better sense of what and when to buy and sell – and – know how much risk they take when they own a stock at certain levels. Without reliable fundamental research, investors have no reliable way of knowing whether a stock is expensive or cheap.

As shown above, disciplined, reliable fundamental research shows that even after plummeting, Allbirds, Sweetgreen, Carvana, Wayfair, and Shake Shack still hold significant downside.

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

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1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
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Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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