

# McIntire Investment Institute

At the University of Virginia



Green Mountain Coffee Roasters (NASDAQ: GMCR)

Harrison Freund

September 23, 2010

# Agenda

- Business Description
- Thesis/Key Points
- Misperceptions
- Risks/What Signs Would Indicate We Are Wrong?
- How It Plays Out
- Recommendations
  - VAR will be included in various parts throughout

# Business Description

- GMCR sells the Keurig/K-Cup system for coffee, tea, and coca.
  - 200 Types of drinks offered in K-Cups
  - Sold to the AH (At home, through department stores, 19,000\*) and AFH (Away from Home, sold to office supply stores)
- Specialty Coffee Business Unit (SCBU) sells coffee beans and grounds to retail stores and Keurig products to supermarkets (13,450)
- GMCR hedges part of its coffee—As of June 26, 2010 58% was fixed
- Vertical integration

# Business Description

- The Keurig and specifically the high margin K-Cups account for a large part of Green Mountain's revenue.

<b>Net sales (in millions)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
• SCBU . . . . .	\$382.4	\$285.9	\$230.5
• Keurig . . . . .	\$420.6	\$214.4	\$111.2
• Total Company . . . . .	\$803.0	\$500.3	\$341.7

# Business Model—Razor and Blade



Zero-Margin Keurig coffee maker

Very high-margin K-Cups,  
try to sell many.

# Thesis Point 1: Self Defeating Business Strategy

- The business model works as follows: sell the Keurig units close to cost and then mark up the K-Cups with *only* GMCR's coffee. (Razor and blade)



# Thesis Point 1: Self Defeating Business Strategy

- The higher income, more “green” customers actually prefers the less waste of the reusable cup and ability to use their own coffee.
- They wanted to create a product where you could only buy their K-Cups, but now you can use your own coffee instead.
- Conclusion: GMCR has shot themselves in the foot.



## Thesis Point 1: Self Defeating Business Strategy--VAR

- “Being frugal (all right, cheap) by nature, I held off on buying a single-serve coffeemaker until I could find one I liked that offered a reusable filter.”
- “I've always felt a little guilty every time I throw out a used K-Cup. It seems like they're not only completely UNrecycleable, but totally UNbiodegradeable as well.”
- “Unfortunately you really need one of these things to use your Keurig properly unless you are dedicated to spending lots of money and killing the environment with K-Cups.”
- Taken from Amazon.com



## VAR—Mud House Coffee Shop, Charlottesville, VA

- When asked about Keurig single serve here's what the employees had to say:
  - “They're really expensive”
  - “The pre-packaged coffee isn't very good, taste and quality are sub-par”
  - “Plus it's really wasteful to throw the plastic packets out”

## Thesis Point 2: Add in Patent Expiration

- Though the company writes how wonderful the Keurig system all over their annual report and 10-k, they only mention once that...
- The K-Cup patents expire in 2012 (some less important patents expire in 2023)
- VAR—Coffee manager for A&P already saw plans for private label K-Cups ready in 2012.

## Thesis Point 2: Add in Patent Expiration

- The developers of Keurig originally gave various companies (Tully's, Timothy's, Diedrich, Van Houtte) licenses to produce the K-Cups. Those coffee companies and gave Keurig a royalty.
  - The agreements were very liberal; these four companies could sell these licenses to any other company

## Thesis Point 2: Add in Patent Expiration

- Van Houtte was one of those original licensors. Net Sales of K-Cups were a 100 million dollars or less.
- *Expensive* transaction done with a Private Equity firm; GMCR pays 890 million or at least more than 8.9 times sales! Bidding war
- Tully's acquisition cost 40 million. In next conference call, management said they threw off 2 million in sales. That's a 20X price to sales!!
- Same with Dietrich they overpaid because they got into a bidding war with Peets.'
- GMCR is nervous and willing to pay exurbanite prices to protect its patents for a little bit longer
- "Exclusive of the acquisitions, revenue growth decelerated sequentially and from F2009." —Analyst at Stifel Nicolaus

## Thesis Point 3: The numbers speak for themselves

- The fad is about to break...

	Sept 09—Q4	Dec 09—Q1	March 10—Q2	June 10—Q3
Keurig (no margin)	675,000	1,500,000	731,000	846,000
K-Cups (some margin)	413,812,363	649,900,000	720,000,000	683,000,000


## Thesis Point 3: The numbers speak for themselves

- Attachment rates: K-Cups sold per quarter/Keurigs on market.
  - Measures if people are buying the high margin K-Cups.
    - What conclusions can we draw from the *consistent* trend since 2006?

---

Keurig	K-Cups
675,000	413,812,363
1,500,000	649,900,000
731,000	720,000,000
846,000	683,000,000

613.0553526  
298.8045977  
247.7632485  
182.0362473



The attachment rate=K-Cups/sum of Keurigs



## Thesis Point 3: The numbers speak for themselves

- CEO—“which we have indicated usage rates at least for our standard brewers had been in the 2 to 2.5 K-Cups per brewer per day”



## Thesis Point 4: Self Defeating Business Strategy--VAR

- VAR—Buy-side Analyst at a long only fund who met with Keurig guys, here's what they had to say about the declining attachment rates:

“We don't care. We just don't focus on those rates. All we focus on getting out as many brewers as possible, the K-Cups will follow.”

--What?!?

## Thesis Point 4: Self Defeating Business Strategy

- The 'alleged business model' is the razor and blade, sell lots of high margin K-Cups
- Instead, the inept/unsophisticated management team has got it backwards and is focusing on zero margin Keurig units.
- Hidden message: There's a reason they haven't been bought by Nestle....

# Thesis Point 5: Ridiculous Valuation

- GRMC with other coffee/beverage companies  
comps: (P/E is from Bloomberg)

Company	P/E (Latest FY P/E from Bloomberg)
Peet's Coffee and Tea Co.	30.6
Coffee Holding Co.	11.11
Nestle SA	19.38
Campbell	14.53
Kraft	13.32
J.M Smucker Co. (Folgers)	14.01
Hansen Natural Corp (Natural juices)	17.14
Green Mountain Coffee Roasters	61.00*

<HELP> for explanation, <MENU> for similar functions.  
 90<GO> to save current settings as default view, 1<GO> to Hide Panels

GMCR US Equity 95) Defaults 96) Actions Graphical Financial Analysis

Range 05/22/04 - 09/22/10 Weekly Fiscal Period Qtr Cur. LCL Axis Custom

- 11) Fields (6 Selected)
- Net Revenue Margin 2) Browse
  - Return on Assets
  - Return on Common Equity
  - Estimated Return on Equity
  - Cur Enterprise Value
  - Cur Enterprise Value
  - BEst EV
  - Cur EV/Book
  - Cur EV/T12M EBIT
  - Cur EV/T12M EBITDA
  - BEst EV/EBITDA
  - Cur EV/T12M Sales
  - Debt Ratios
  - Debt/Equity
- 12) Securities >>
- 13) Panels >>
- 14) ECO, FX & Comdty >>
- 15) Standard Templates >>
- 16) Custom Templates >>



Security Details (Green Mountain Coffee Roasters Inc) Return on Assets (GMCR US Equity)

Price	35.81	BEst EPS (Y)	.71	BEst P/E	50.51	High	12.99 on 6/27/2009
52 Week High	37.32	BEst EPS (Y+1)	1.18	BEst P/B	N.A.	Low	4.75 on 12/30/2006
52 Week Low	19.8667	BEst EPS (Y+2)	1.63	BEst Sales	1.35B	Average	8.59
Price Chg 1Yr	13.44333	BEst EPS (Y+3)	N.A.	BEst EBITDA	210.20M	Median	9.95

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
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# Thesis Point 6: Less expensive options

In 3 colors 



**MINI Plus**  
Personal Brewer  
**\$99.95**



**Elite**  
Home Brewing System  
**\$109.95**



**OfficePRO™**  
Brewing System  
**\$129.95**



**Special Edition**  
Home Brewing System  
**\$139.95**



**Platinum**  
Home Brewing System  
**\$169.95**



**Cuisinart®**  
Home Brewing System  
**\$199.95**



**B155**  
Small-Medium Office | Home Office  
Brewing System  
**\$249.95**



**Breville**  
Home Brewing System  
**\$249.95**

## Thesis Point 6: Less expensive options



Black and  
Decker—29.99



Hamilton  
Beach—  
36.99/59.99



Senseo—64.99

## Thesis Point 7: Growth Will Slow

- There's no where left to go
- Contracts have already been extended to Wal-Mart, Macy's, Costco, Bed Bath and Beyond, Kohl's, and Target
- New growth scheme is to use Keurig units for cold beverages, (iced tea for example)
  - Will people really use coffee machines to make cold beverages when you can simply buy cold drinks? (Snapple, Iced Teas, Sodas, Juices...)

# Thesis Point 7: Growth Will Slow

	Dec 06	Dec 07	Dec 08	Dec 09	March 10
Retail	7000	10000	13800	17900	19000
Super markets		1300	2600	10000	12100
Total	7000	11300	16400	27900	31100
y/y %Change	61.4%	61.4%	45.1%	70.1%	11.5%

Thank you to Stifel Nicolaus



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Actual values are amber

Current value is light blue

Estimated values are white

(%) Units MLN

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
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# Misperceptions

- GMCR is a very “hot stock” why?
- Most of the sell-side analysts are focusing on the totally unsustainable numbers in GMCR’s financial documents without heeding the high valuation and other factors
- It’s fair trade/sustainable/giving to good causes; GMCR is a PC, warm and fuzzy stock.

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EquityANR

DELAY 10:20 Vol 507,458 Op 31.14 Q Hi 31.2 Q Lo 30.29 Q ValTrd 15544499

GMCR US Equity 95) Output To Excel 96) Alert Analyst Recommendations

Consensus (Months) 12  
 Consensus Rating 3.600  
 Buys 6 60.00%  
 Holds 1 10.00%  
 Sells 3 30.00%  
 Currency USD  
 Tgt Px 7/11 35.86  
 12 Months Consensus  
 US Average 3.385  
 Standard and Poor's 3.781  
 Standard & Poor's Mid 3.816  
 Russell 1000 Growth 4.250  
 1 Yr Rtn 54.29%



In-House 99) Corporate action: Stock Split Effective: 05/18/2010 \* is split adjusted

Firm Name	Analyst	Recommendation	Tgt Px	Date	1 Yr Rtn	BARR	Rank	Chart
1) SunTrust Robinso	CHAPPELL	buy	40.00	08/23/10	4.10%	4th	4th	
2) Janney Montgom	PINHEIRO	buy	40.00	08/23/10	54.29%	1st	2nd	
3) Dougherty & Com	MCKINLEY	buy	27.00	08/20/10	27.15%	3rd		
4) William Blair & C	ANDERSEN	market perform		08/19/10	0.00%	5th		
5) Stifel Nicolaus	ASTRACHAN	sell		08/13/10				
6) Roth Capital Part	BRENNER	buy	37.00	08/12/10				
7) Piper Jaffray	GIKAS	overweight	37.00	08/11/10				

<HELP> for explanation.

EquityANR

As of Sep22 DELAYED Vol 2,375,309 Op 37.24 Q Hi 37.31 Q Lo 35.63 B

GMCR US Equity 95) Output To Excel 96) Alert Analyst Recommendations

Consensus (Months) 12  
 Consensus Rating 3.800  
 Buys 6 60.00%  
 Holds 2 20.00%  
 Sells 2 20.00%  
 Currency USD  
 Tgt Px 7/11 36.57  
 12 Months Consensus  
 US Average 3.383  
 Standard and Poor's 3.782  
 Standard & Poor's Mid 3.720  
 Russell 1000 Growth 4.281  
 1 Yr Rtn 56.17%



In-House 99) Corporate action: Stock Split Effective: 05/18/2010 \* is split adjusted

Firm Name	Analyst	Recommendation		Tgt Px	Date	1 Yr Rtn	BARR	Rank	Chart
1) SunTrust Robinso	CHAPPELL	buy	M	40.00	09/20/10	22.02%	4th	3rd	
2) EVA Dimensions	TEAM COVER	hold	U		09/18/10				
3) Janney Montgom	PINHEIRO	buy	M	40.00	09/17/10	60.10%	1st	2nd	
4) Roth Capital Part	BRENNER	buy	M	42.00	09/15/10				
5) Dougherty & Com	MCKINLEY	buy	M	27.00	09/15/10	31.94%	3rd		
6) William Blair & C	ANDERSEN	market perform	M		09/15/10	0.00%	5th		
7) Stifel Nicolaus	ASTRACHAN	sell	M		09/14/10				

## Misperceptions—Overenthusiastic guy at Seeking Alpha

- **Green Mountain Coffee Roasters ([GMCR](#))** makes the revolutionary single-serving Keurig coffee brewers, and gets a royalty for every cup of coffee that's brewed in them, which is a great source of recurring income. Barriers to entry are high. The market is global. Revenues have grown every year of the past decade. And profit margins are healthy at over 8%.

## Misperceptions—Overenthusiastic guy at Seeking Alpha

- “Barriers to entry are high.”
  - People can get coffee through a variety of avenues.
  - Other companies have cheaper single-serve coffee machines and the K-Cup patent expires in 12 months...
- “The market is global.”
  - GMCR can only really expand in America.
  - Ex. Italy prefers the Bialetti Macchina per Café (Personal VAR)
  - Finally, because the focus is on quality in Europe but on speed in America, Keurig will fail in Europe.



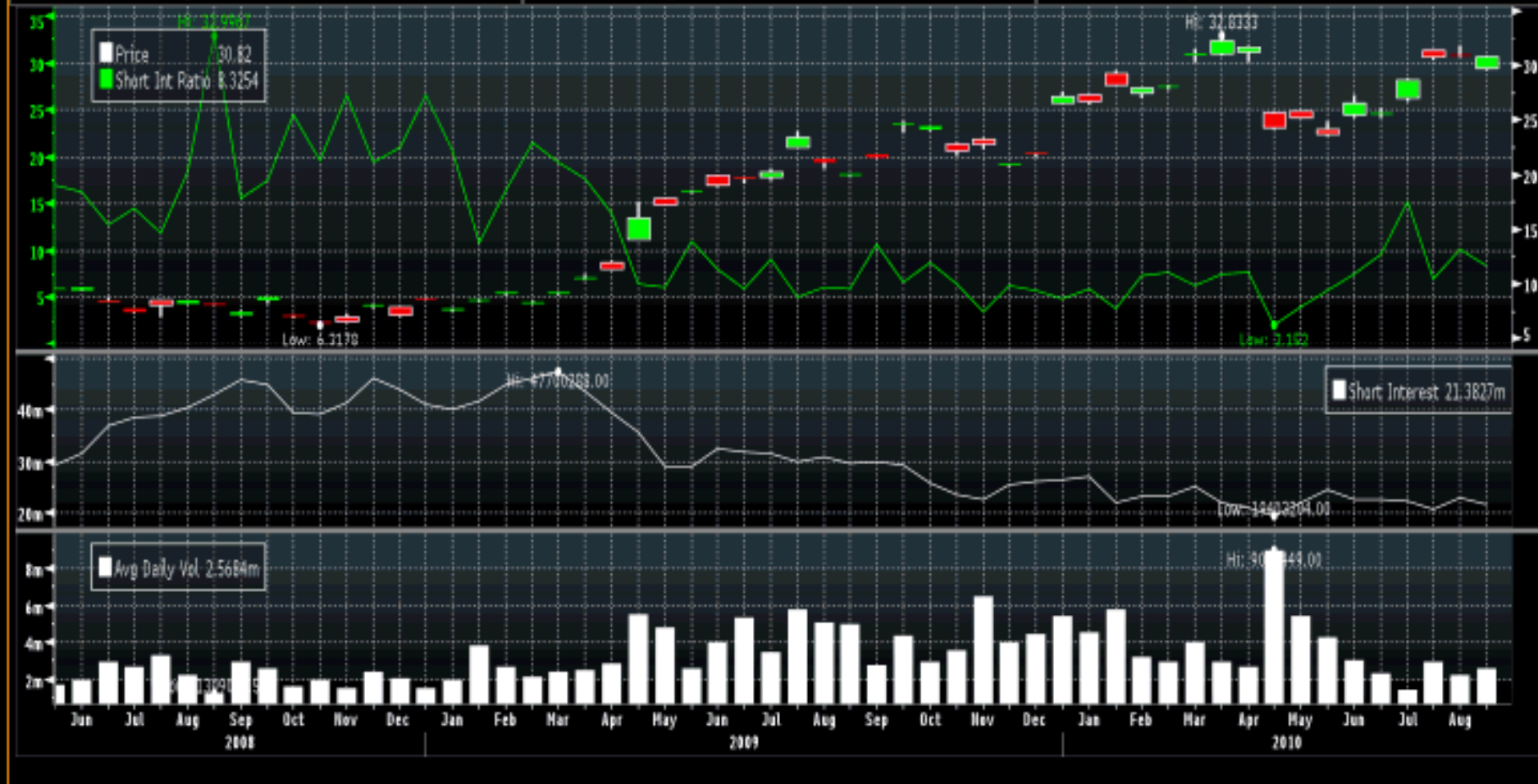
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EquitySI

As of Sep22 DELAYED Vol 2,375,309 Op 37.24 Q Hi 37.31 Q Lo 35.63 B

GMCR US Equity 95) Sector Analysis 96) Update Schedule Page 1/4 Short Interest

Date	05/22/08	-	09/22/10	<input checked="" type="checkbox"/> Display Avg Volume	<input checked="" type="checkbox"/> Display Price	DX SI Score	5
Short Interest	21,382,740		SI Ratio	8.33		% Float	20.05
Change In SI	-1,461,940		Change in SIR	-1.79		Change in % Float	-1.37



31) Short Interest 32) Data Explorers

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000

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# Misperception—Confusing Conference Calls

- “Shipments of 731,000 brewers with **Keurig branded brewing technology.**”
- “We sold over 1.4 million **brewers** this past quarter”
- “There also were 846,000 **brewers shipped system wide, with Keurig-branded brewing technology, including brewers shipped from our license partners, Breville and Cuisinart. This compares to 444,000 brewers shipped system wide**”
- <Q - Bryan Spillane>: One clarification and one question. Just of the 846,000 brewer ships, just how many were licensed – shipped by licensed partners and how many were shipped by Keurig?
- <A - Michelle Stacy, President, Keurig>: Hi, Bryan this is Michelle. At this point we are now only going to be reporting our brewer sales along with our licensed partners.

## Misperception—Confusing Conference Calls

- “growth was led by a 62% increase of total K-Cup portion packs shipped system-wide by **all Keurig-licensed roasters**”
- “Our first quarter net sales grew an impressive 77% driven by shipments of 650 million **K-Cup portion packs**”
- “129% increase in K-Cup sales to **retailers and from Keurig.com.**”

## Misperception—K-Cups

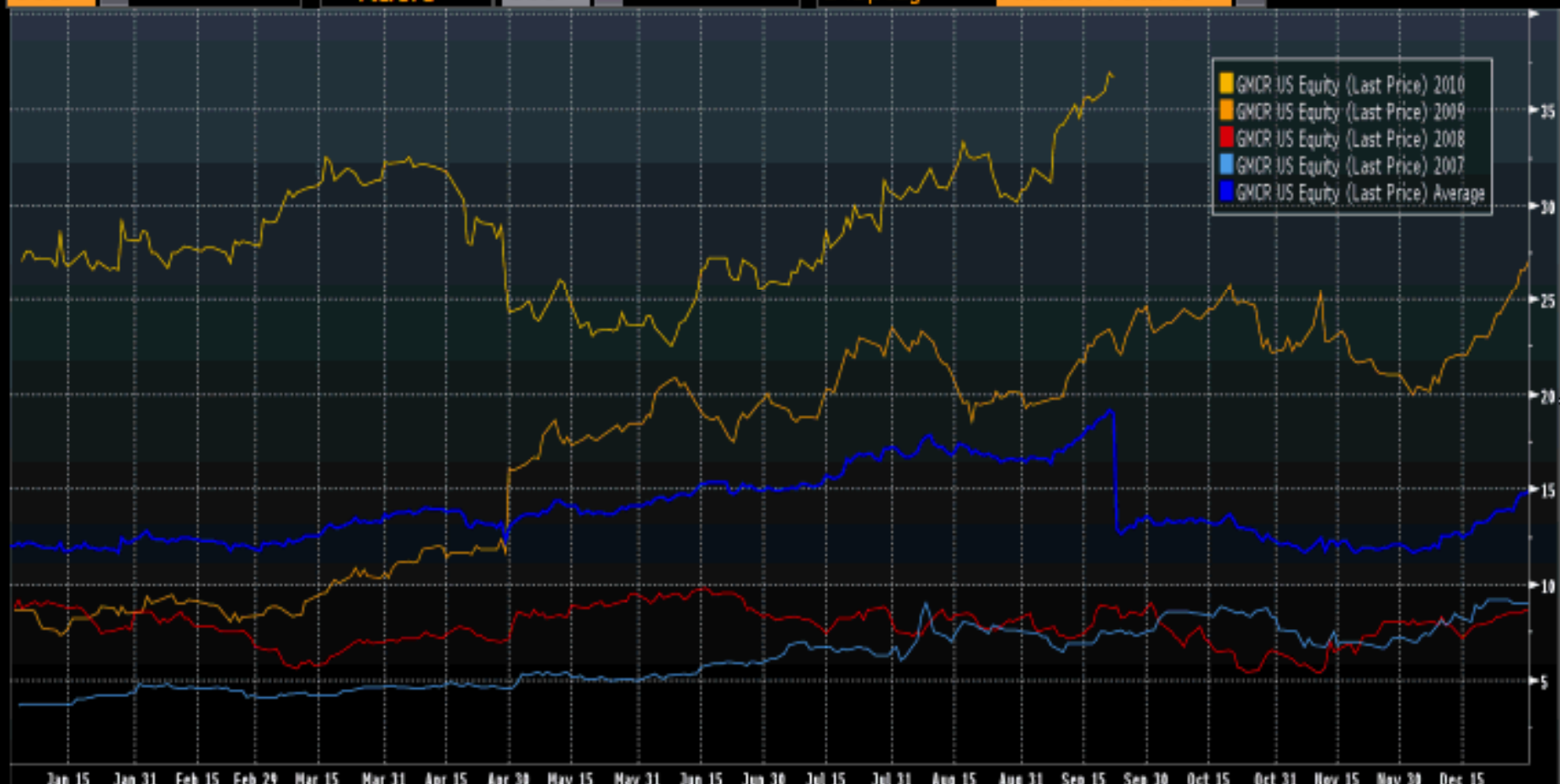
- <https://docs.google.com/a/virginia.edu/viewer?a=v&pid=gmail&attid=0.1&thid=12b2681c60aabed8&mt=application/pdf&url=https://mail.google.com/a/virginia.edu/?ui%3D2%26ik%3Db3d6390170%26view%3Datt%26th%3D12b2681c60aabed8%26attid%3D0.1%26disp%3Dattd%26zw&sig=AHIEtbTf92yx0DEL2GQvwl81Ork0oCFn9g>

<HELP> for explanation.

EquitySEAG

95) Edit   96) Save   97) Options ▾   98) Heat Map   99) Hide   Seasonality Chart

Main Security	Optional Security	Chart View	Year Selection
GMCR US Equity	<input checked="" type="radio"/> None   < Enter Ticker >	Range   01/01 - 12/31	End Year   2011
Last Price ▾	<input type="radio"/> Spread   Last Price ▾	Period   Daily ▾	Num Years   5
USD ▾	<input type="radio"/> Ratio   USD ▾	Display   Actual Values ▾	



Jan 15   Jan 31   Feb 15   Feb 29   Mar 15   Mar 31   Apr 15   Apr 30   May 15   May 31   Jun 15   Jun 30   Jul 15   Jul 31   Aug 15   Aug 31   Sep 15   Sep 30   Oct 15   Oct 31   Nov 15   Nov 30   Dec 15

Australia	61	2	9777	8600	Brazil	5511	3048	4500	Europe	44	20	7330	7500	Germany	49	69	9204	1210	Hong Kong	852	2977	6000
Japan	81	3	3201	8900	Singapore	65	6212	1000	U.S.	1	212	318	2000	Copyright 2010 Bloomberg Finance L.P.								

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# Risks

- The company might somehow continue the trend despite the analyst's belief otherwise
  - The fad might go on for a bit more
- They exhibit strong y/y sales growth and net income
- Coffee is hard to short. A ritual/drug-like product
- Their firm is not burdened with much debt
- Shorting into their profitable quarter (winter)

# Risks

- They somehow can sell their product overseas
  - Joint venture w/ Lavazza (2<sup>nd</sup> after nespresso) to make single serve espresso machine. Vague on IR though
- This is one of the few growth (for now) stories in a pretty bearish market.
- Despite patent expiration in 2012, They have the most/best K-Cup flavors with a superior distribution chain
- The razor and blade is a formidable business model to short.
  - Their K-Cups are still high margin and profitable

# Risks--VAR

- President of Strategy at Walmart of outside runway (McDonalds, lenscrafters, coinstar)
- Knows coffee director very well he said that they
  - “Felt that they missed the boat on Green MTN”
  - “Plan for holiday season was to ramp up store presence 8 fold”
- Chief Marketing Officer of Bed Bath and Beyond
  - “Loves the product; has been a great sales item”

# Risks--VAR

Target in Framingham, MA, Kitchen/ Appliances

- How are sales of Keurigs and how are sales of K-Cups in relation to Keurigs?
  - “Split single between other coffee machines and the Keurigs. Customers are now buying a lot of the K-Cups”
- Do you see price increases affecting (K-Cup) sales?
  - “These people pay almost 200 dollars a machine...what’s a small price increase going to do?”

Target in Cary, NC, Kitchens/Appliances

“I don’t see a good deal of people walking out with machines. Mostly the k cups now.”

Target in Cicero, IL

“It’s about 50/50. Which ever one is on sale tends to do better. We stock K-Cups, haven’t noticed anything with them.”



# Catalysts/How it plays out

- GMCR will sell a lot to stores for holiday season  
-But it will be hard to continue growth
- New growth will soon halt
- Reusable K-Cup and patent expiration will continue eat at traditional K-Cups
- Company will miss earnings estimates. Sell-side will jump ship and shares will plummet

# Recommendations

Due to the fact that this company is selling a fad stock and trading at fad valuation very close to the 52 week high, I recommend that MII immediately shorts the stock at a .75% weighting to the portfolio now and a .75% weighting after the holiday season.

<HELP> for explanation.

EquityHDS

As of Aug27 DELAYED Vol 1,652,666 Op 30.51 Q Hi 30.76 Z Lo 29.88 Q

GMCR US Equity 95) Searches 96) Actions 97) Feedback Page 1/24 Holdings Search

Green Mountain Coffee Roasters Inc CUSIP 39312210

21) Sources 22) Types 23) Countries 24) Metro Areas 25) Advanced Filters

Name Filter Sort By Amount Held

	Holder Name	Portfolio Name	Source	Amt Held	% Out	Latest Chg	File Dt
1)	STILLER ROBERT P	n/a	Form 4	15,361,865	11.64	-2,650	7/8/10
2)	WELLINGTON MANAGEMEN	WELLINGTON MANAGE	13F	11,385,299	8.63	4,125,890	6/30/10
3)	FIDELITY MANAGEMENT &	FIDELITY MANAGEMEN	13F	8,414,193	6.38	-3,116,400	6/30/10
4)	MAGOWAN STEPHEN P	n/a	13G	8,312,454	6.30	0	3/12/10
5)	LONE PINE CAPITAL LLC	LONE PINE CAPITAL L	13F	7,610,908	5.77	2,929,354	6/30/10
6)	WILLIAM BLAIR & COMPA	WILLIAM BLAIR & CO	13F	5,938,726	4.50	1,391,818	6/30/10
7)	ALYDAR PARTNERS LLC	ALYDAR PARTNERS L	13F	4,991,000	3.78	53,000	6/30/10
8)	VANGUARD GROUP INC	VANGUARD GROUP I	13F	4,739,184	3.59	400,215	6/30/10
9)	WINSLOW CAPITAL MANA	WINSLOW CAPITAL M	13F	4,268,742	3.24	4,268,742	6/30/10
10)	BLACKROCK INSTITUTIO	BLACKROCK INSTITU	13F	2,791,879	2.12	31,462	6/30/10
11)	TREMBLANT CAPITAL GR	TREMBLANT CAPITAL	13F	2,645,065	2.00	618,424	6/30/10
12)	VINIK ASSET MANAGEMEN	VINIK ASSET MANAGE	13F	2,577,254	1.95	-3,383,446	6/30/10
13)	MACKAY SHIELDS FINANC	Multiple Portfolios	MF-AGG	2,273,700	1.72	55,600	6/30/10
14)	TURNER INVESTMENT PA	TURNER INVESTMENT	13F	2,243,845	1.70	-269,426	6/30/10
15)	STATE STREET CORP	STATE STREET CORP	13F	2,212,721	1.68	-26,365	6/30/10
16)	BLACKROCK FUND ADVIS	BLACKROCK FUND AD	13F	2,063,217	1.56	-44,223	6/30/10
17)	NEXT CENTURY GROWTH	NEXT CENTURY GROW	13F	1,985,571	1.50	128,400	6/30/10

26) Latest Chg 27) Hist Held % Out on Page 68.07

# Questions

