

# INTERNAL REPORT

Nutrisystem, Inc.

May 6, 2016  
Joseph W. Garner

(NTRI - NASDAQ)  
Update Report

Current Price	\$25.52
52-week High	\$30.92
52-week Low	\$17.44
Price Target	\$32.00

Rating	Buy
Shares Out	29.4M
Market Cap	750.5M
Avg. Daily Vol	448.1K

FY16 EPS	\$1.23
EPS Growth Rate	15%
FY16 PE	20.7
FY16 PEG	0.7

Book Value/Share	\$2.28
Cash/Share	\$0.76
Insider Ownership	2.9%
Institution Ownership	98.3%

## Business Description

**Nutrisystem**, based in Fort Washington (PA), is a leading commercial weight loss company whose products and services include a nutritionally balanced weight loss program, multi-day weight loss kits available at select retail locations, and digital tools to support weight loss. The company's primary offering is a four-week food package direct shipped to the consumer that consists of breakfasts, lunches, dinners, snacks, and flex meal plan recipes that are supplemented with fresh fruits, vegetables, and dairy products. The meal plans feature more than **150** portion-controlled menu options at different price points including frozen and ready-to-go entrees, snacks, and shakes that serve as the foundation of a low Glycemic Index diet. Nutrisystem also offers comprehensive individualized counseling options from trained weight loss counselors, registered dietitians, and certified diabetes educators that are supplemented by the company's digital weight loss tools. Nutrisystem generated over **\$460 million** in revenues in 2015.

## Competitive Advantages

- **Strong and Well-Established Consumer Brand** – Nutrisystem is one of the most widely recognized brands in the commercial weight loss industry, as it has helped consumers with their weight loss goals for over **40** years. In the last eight year alone, the company has invested over **\$1.0 billion** in marketing the Nutrisystem brand. According to *ConsumerAffairs.com*, Nutrisystem ranked as the **#1 weight loss program brand** for 2016. (<https://www.consumeraffairs.com/nutrition/nutrition.htm#>) The strength of the brand has enabled the company to successfully differentiate itself from a plethora of small, and often fad-oriented, competitors.
- **Time Tested Product Efficacy** – Nutrisystem has a long term track record of demonstrated success in enabling consumers to meet their weight loss goals. The company's proprietary consumer research found that its customers lost an average of one to two pounds per week and tended to stay on the program for eleven to twelve weeks. The company has also sponsored clinical research trials at leading academic centers in patients with Type 2 diabetes that demonstrated statistically significant and clinically meaningful weight loss and improvements in HbA1c, as well as improvements in secondary endpoints, such as waist circumference, total plasma cholesterol, and blood pressure.
- **Compelling Consumer Value Proposition** – Nutrisystem offers consumers a convenient, private, and cost effective alternative to traditional weight loss programs. The company's weight loss program is ordered via the Internet or telephone and is shipped directly to the consumer, providing the convenience and anonymity that weight loss programs delivered via weight loss centers cannot offer. In addition, the meals are clearly labeled and easy to prepare and eliminates the confusion of reading nutrition labels, measuring portions, or counting calories/points/carbohydrates. The Nutrisystem program is also priced at as little as **\$9.82 per day**, positioning it as one of the most economical commercial weight loss programs.
- **Highly Efficient, Low Cost, and Scalable Business Model** – Nutrisystem primarily operates via a direct-to-consumer distribution channel where it interacts with its customers via telephone and the Internet. As such, the company has avoided the fixed cost laden and capital intensive bricks-and-mortar weight loss center model employed by several of its competitors. The company has also streamlined its back-of-the-house operations by outsourcing the production of its food products and fulfillment operations to third party providers. As a result, the company has a largely variable cost-based operating structure that enables it to flex with demand in a relatively rapid manner. Also, capital requirements are relatively low, ranging from **\$7.6 million** to **\$13.0 million**, or less than **3%** of total revenues, over the past three years. This has resulted in a highly profitable business model that generated a Return on Invested Capital of over **65%** and Free Cash Flow of over **\$40 million** in 2015. Nutrisystem's flexible and highly profitable business model enables the company to respond to the market in a relatively time efficient manner and provides the company with the cash flow

necessary to aggressively pursue growth investments such as product innovation, program marketing, and acquisitions, while paying an attractive dividend and funding share repurchases.

## Assessment of Management

Nutrisystem is led by its President and CEO **Dawn M. Zier**. Ms. Zier joined the company in November 2012, after having served in several executive capacities at *RDA Holding Co.*, the parent of *The Reader's Digest Association*, including President of International, President of Europe, and President of Global Consumer Marketing. She is an accomplished Direct Marketing executive, having received the **2014 Direct Marketer of the Year** award from *Target Marketing* and the **2014 Silver Apple Award** from *Direct Marketing New York*. Since arriving at Nutrisystem, Ms. Zier has implemented a strategy that has successfully turned around the company's financial performance and returned the company to a growth path by refocusing on product innovation, weaning the business from persistent discounting, offering customizable programs featuring premium food offerings, implementing a more disciplined data-intensive approach to marketing, and streamlining the cost structure. She has also rebuilt the company's senior management team, most notably through the additions of Chief Marketing Officer **Kiera Krausz** (previously served in senior marketing and business development roles with *Animated Storyboards*, *Time, Inc.'s QSP subsidiary*, and *Reader's Digest Association*) and Chief Financial Officer **Michael P. Monahan** (previously served in senior finance related positions with *PetroChoice Holdings*, *Exelon*, and *Accenture*, as well as *Nutrisystem's VP of Finance*). The financial results produced by Ms. Zier's team have been impressive. After six consecutive years of declining revenues, Nutrisystem returned to a double-digit revenue growth rates in 2014 and 2015. In addition, over the period of 2012 to 2015 the company realized a more than four-fold improvement in both EPS and Return on Invested Capital to **\$0.96 per share** and **65.6%**, respectively.

Nutrisystem's corporate governance standards are relatively strong. The company has a non-classified Board of Directors that consists of several accomplished consumer products and media executives and includes only one insider (*Ms. Zier*). The company also operates under a "pay-for-performance" model where over **70%** of executive compensation is driven by performance based incentives, including the achievement of revenue, adjusted EBITDA, and EPS targets. While management equity holdings are meaningful at **2.9%** of the total shares outstanding, we would prefer to see a higher level of equity ownership by officers and directors further aligning the interests of management with shareholders.

## Growth Drivers

- **Nutrisystem is Addressing a Large and Growing Market** – According to the *National Institutes of Health (NIH)*, **35.7%** of the U.S. adult population is considered to be obese with over **6%** of the adult population considered to be extremely obese. The prevalence of obesity is similar for both men and women, however **74%** of the adult male population is considered to be either overweight or obese. In addition, nearly **one-third** of children and adolescents are considered to be overweight or obese. This is leading to several health concerns, including a rising rate of individuals with diabetes, which topped **29 million** individuals in 2014, according to the *Center for Disease Control and Prevention*. As a result, the U.S. weight loss market grew to a sizable **\$64 billion** in 2014, according to *Marketdata Enterprises*. *Nutrisystem represents less than 1% of the overall domestic weight loss market, despite being a leading commercial weight loss program, offering considerable opportunity for further market penetration.*
- **Attracting New Customers and Re-Activating Prior Customers** – Under the direction of the company's new senior management team, Nutrisystem has emphasized product innovation and customizable programs featuring premium food offerings backed by a highly effective data-intensive approach to marketing. This has resulted in a refreshed and revitalized brand that has proven effective in attracting new customers and re-activating prior customers. In 2015, new customer revenues grew **15%** y/y driven by increased customer starts, improved pricing, and a longer length of stay. At the same time, reactivation revenues grew **7%** y/y and represented a meaningful **25%** of total revenues. The trends remained strong in Q1-16 as new customer revenues grew **15%** y/y and reactivation revenues accelerated to also grow **15%** y/y. We believe that the company is well positioned to continue to generate double-digit revenue growth for the foreseeable future.
- **South Beach Diet Represents a Compelling Second Brand Offering** – In December 2015, Nutrisystem acquired **The South Beach Diet** brand from *SBD Holdings Group* for **\$15 million**, including the addition of South Beach Diet founder **Dr. Arthur Agaston** to Nutrisystem's Science Advisory Board. Nutrisystem is gearing up for the launch of a South Beach Diet weight loss program into the direct-to-consumer channel in January 2017. During 2016, the company plans to invest **\$3 million** (*\$0.09 per share*) in product marketing, website development, product development, clinical trials, and back-office infrastructure. The South Beach Diet

represents a meaningful second brand under the Nutrisystem umbrella and an intriguing growth opportunity for the company. Given the relatively modest acquisition price and launch costs, we estimate The South Beach Diet program has the potential to become a highly accretive offering for the company. Assuming an incremental profit margin of **15%**, we estimate Nutrisystem will generate a positive payback when it exceeds **\$120 million** in revenues, which will likely be achieved by 2018. We estimate that The South Beach Diet program has the potential to add over **\$0.10 per share** in incremental EPS in 2017 and over **\$0.25 per share** in incremental EPS in 2018.

- **A Menu of Additional Growth Opportunities** – Nutrisystem is also pursuing a number of additional growth opportunities in the areas of innovative product offerings and new distribution channels. For example, in Q1-16 the company entered the Health & Wellness category with the introduction of *Shake360*, a shake-based meal supplement that offers three servings of vegetables and 16 grams of plant protein, along with probiotics and antioxidants in each shake. Nutrisystem has also been expanding its presence in the retail distribution channel with *Wal Mart* and several leading grocers through the offering of five-day meal packages and individually packaged snacks and Nutrisystem-branded products. Nutrisystem’s retail revenues grew **28%** in 2015 to **\$35 million**. After a slow start to 2016, retail revenues are expected to be relatively flat on a y/y basis in 2016 before resuming growth in 2017. In aggregate, we believe new product categories and new distribution channels have the potential to represent meaningful incremental growth opportunities for the company.
- **Operating Margin Expansion** – Over the past three years, Nutrisystem has realized a dramatic improvement in its operating profit margin from **2.59%** in 2012 to **9.27%** in 2015. However, the company remains well below the peak profit margins in the **20%-25%** range realized in 2006 and 2007. While we do not expect Nutrisystem to approach its prior peak margins in the foreseeable future as the company continues to invest in the development of new product offerings (*South Beach Diet and Shake360*) and new distribution channels (*retail expansion*), we do believe the company has a meaningful opportunity to expand its operating profit margin to a mid-teens percent of revenues by better leveraging marketing and general and administrative expenses. We estimate that each 100 basis point improvement in the operating profit margin will boost EPS by over **\$0.11 per share**, based on the company’s current revenue run-rate.

## Issues / Risks

The most notable risks associated with Nutrisystem shares include the following:

- The highly fragmented and competitive nature of the weight loss industry. Nutrisystem must remain competitive in the areas of program efficacy, price, taste, customer service, and brand recognition. Competition ranges from commercial weight loss programs, pharmaceutical providers, packaged diet food companies, nutritional supplement providers, and self-dieting.
- The fad oriented nature of consumers with regard to dieting, which can result in dramatic shifts in market share from one year to the next.
- Nutrisystem’s reliance on third party food manufacturers. The company could be challenged if it is unable to obtain sufficient quantity, quality, and variety of food offerings from its vendors. While the company’s supplier base is relatively diversified, its two largest vendors represented **19%** of inventory purchases in 2015.
- The ability of Nutrisystem’s management team to successfully establish The South Beach Diet as a commercial weight loss program, which is a change from the brand’s primary prior positioning as a self-directed diet program.
- The company’s reliance on developing and efficiently deploying highly effective advertising and marketing programs.

## Summary and Recommendation

Nutrisystem has been revitalized under the leadership of its new senior management team, firmly positioning the company as a sales leader and innovation leader in the commercial weight loss industry. The company has realized a recovery in new customer volumes and is re-activating prior customers at a much higher rate, leading to a dramatic improvement in the company’s revenue growth rate. In addition, the company continues to innovate in the areas of developing premium product offerings (*Uniquely Yours*), new weight loss programs (*The South Beach Diet*), and more engaging marketing programs. This has led to a dramatic recovery in both revenue and EPS growth with revenue growth of **15%** and EPS growth of **28%** estimated for 2016. We believe the company’s growth

prospects are not fully reflected in the share price with the stock trading at **21x** estimated 2016 EPS and only **17x** estimated 2017 EPS, which is well below the company's estimated earnings growth rate of over **25%** for the next two to three years. The valuation appears even more compelling on an EV/EBITDA basis where Nutrisystem is trading at **11.0x** estimated 2016 EBITDA and **8.8x** estimated 2017 EBITDA, as the stock is actually trading at a discount to its financially and strategically challenged commercial weight loss industry peers on 2017 estimates. Our 12-month price target is **\$36 per share**, or **22.5x** our 2016 EPS estimate, representing upside potential of over **40%**. We rate Nutrisystem shares as a **BUY**.

## Financial Summary

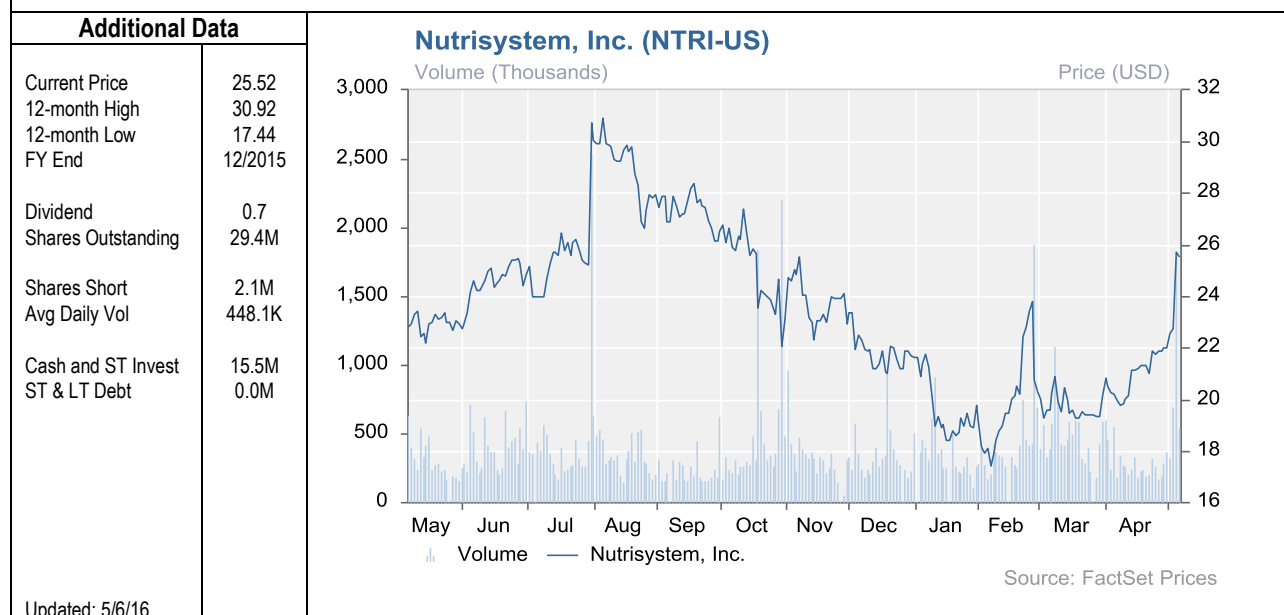
NTRI	Annual Results	FY15	FY16	FY17	FY15	3-15	6-15	9-15	12-15
	Revenue	462.6M	531.6M	664.8M	Revenue	137.2M	130.3M	104.9M	90.2M
EPS	0.89	1.23	1.57	EPS	0.10	0.42	0.25	0.19	
Y-Y Rev Growth	14.8%	14.9%	25.0%						
Y-Y EPS Growth	34.8%	28.2%	28.1%						

FY16E	3-16	6-16	9-16	12-16
Revenue	162.1M	149.0M	119.0	101.6
EPS	0.13	0.51	0.35	0.24
Y-Y Rev Growth	18.1%	14.4%	13.5%	12.5%
Y-Y EPS Growth	29.1%	23.5%	38.8%	23.7%

Comments	
Estimates reflect Emerald estimates	



Commercial Weight Loss	FY End	Share Price	52-wk High	52-wk Low	Market Cap. (\$M)	EV (\$M)	LT				FY2016 Rev (\$M)	FY2017 Rev (\$M)	FY2016 EBITDA	FY2017 EBITDA	FY2016 EV/EBITDA	FY2017 EV/EBITDA	
							FY2016 EPS	FY2017 EPS	Growth Rate (%)	P/E							
Weight Watchers International, Inc.	Dec	\$13.36	\$26.61	\$3.78	\$852.8	\$2,791.3	\$0.94	\$1.19	-4.20	14.2x	11.2x	\$1,208.8	\$1,270.1	\$272.38	\$290.71	10.2x	9.6x
Nutrisystem, Inc.	Dec	\$25.99	\$30.92	\$17.44	\$763.6	\$737.5	\$1.23	\$1.57	17.50	21.2x	16.6x	\$531.6	\$664.8	\$67.34	\$83.80	11.0x	8.8x
Medifast, Inc.	Dec	\$34.42	\$34.95	\$26.67	\$407.7	\$336.2	\$1.82	\$2.02	#N/A	18.9x	17.0x	\$281.9	\$298.7	\$37.70	\$39.20	8.9x	8.6x
				\$674.7		\$1,288.3			#N/A	18.1x	14.9x					10.04x	8.99x