

Initial Screening Process:

While screening for potentially undervalued stocks we looked at the market capitalization, market to book and price to earnings. Ingles Markets Inc. (NASDAQ: IMKTA), is currently trading at \$33.05, has a P/E ratio of 7.86, a market to book of 1.2 and a market capitalization of \$670 million. Comparing these numbers with the screening thresholds we see that Ingles Markets Inc. meets the criteria of 13 P/E, 1.2 M/B and low market cap of less than \$1.2 billion. The conclusion is Ingles Markets Inc. is potentially undervalued and has to be investigated further.

Company Analysis:

Ingles Markets Inc. primarily operates in the retail grocery industry but, has other forms of revenue and is well diversified. The company has been in operations since 1967 and essentially functions as a family owned and operated business since the Ingle family controls 76% of the voting rights, as well as nearly 30% of the equity stake. This family control has led the company to diversify into property and building rentals, wholesale grocery distribution and dairy product production and packaging. They are asset heavy and are therefore able to take on above industry average leverage levels. Ingles Markets Inc. has maintained an average EBIT margin of 3.32%, which is better than the industry average due to its revenue diversification. Their margins have been very stable in the past. The industry itself has low barriers to entry, is highly fragmented and competitive. Due to their wide range of revenues, stable margins and long successful history we have assigned a medium business risk to Ingles Markets Inc. The optimal structure for a medium business risk company is 30%-49%. Ingles Markets Inc.'s target capital structure is 67.5% debt to capitalization, which was calculated using the average debt to capital over the prior 10 years, including capitalized operational leases (as a percentage of sales in the prior years). Using 67.5% as the company's target capital structure, we see that Ingles Markets Inc. has high financial risk. This leads to a debt rating of BB-, corresponding to a cost of debt of 5.82% (10-year risk free rate @2.82% + Spread of BB- @3.00%) and an equity risk premium of 5.90%. Even though the financial risk is high, we believe they can support this since they own so much real estate. Using these values, we get a cost of equity of 11.72% and a weighted average cost of capital of 6.24% (tax rate of 38.3%) (see Exhibit 1). The first pass ROIC was calculated to be 5.43% which is lower than their WACC and therefore we would expect to see a higher NAV than EPV.

Valuation:

The NAV for Ingles Markets Inc. has been calculated at \$132.63/share. The reproduction cost of the assets and liabilities are \$3.95B and \$1.26M, respectively, this includes all hidden assets. The number of shares outstanding was 20.3 million. (see Exhibit 2 for more details on the NAV calculation). The EPV of Ingles Markets Inc. was calculated to be \$36.57/share. To calculate this, the EBIT margin was normalized over the prior 10 years and applied to the current year's sales, the EBIT margin was calculated to be 3.32% (see Exhibit 3 for more details on EPV). The 2nd pass ROIC was calculated to be 2.20% (see Exhibit 1), which is lower than the company's WACC – this is consistent with the NAV being higher than the EPV.

Catalyst:

The higher NAV value suggests that there is unrealized value in this stock. The difference in the NAV and EPV is the catalyst value that can potentially be unlocked; this catalyst value is \$96.06/share. The difference in values arises from a couple of factors. First, the company's management controls the company, they have diversified revenues to include real estate and have vertically integrated operations which has limited their return on investment. Also, the Ingle family is targeting a higher capital structure than the optimal. The second is, Ingles Markets Inc is at a competitive disadvantage to larger players such as Wal-Mart, who hold competitive advantages due to their size and economies of scale. Both these catalyst drivers have a low probability of realization and for that reason we assigned the probability to be 20%.

Recommendation:

Ingles Markets Inc.'s share price was \$33.05, as at March 13th, 2018. The intrinsic value of Ingles Market Inc. is \$55.78/share, which was calculated by $IV = 36.57 + (132.63 + 36.57) \times 20\%$. Given this and our margin of safety threshold of 1/3, the entry price should be no more than \$37.19/share. Because the entry price is slightly more than the current share price we recommend to **BUY** Ingles Markets Inc. at this time. See Exhibit 4 for a summary of the analysis.