

Introduction

GNC Holdings ("GNC") is a leading multinational health and wellness brand which is a manufacturing and retail business at its core. GNC manufactures its own branded products, while also manufacturing white-label products for third-party companies. Its retail segment consists of company-owned physical stores, franchise locations, and e-commerce. Of its 8,500 locations, approximately 75% of them are in the United States, while the remaining 25% of stores are spread across about 50 different countries. Through its physical and online stores, GNC sells performance and diet supplements, vitamins, health and beauty products, other food and drink products, and general sports-related goods.



At the time of this writing, GNC's market capitalization is about \$120 million, which has been cut from over \$4 billion as recently as mid-2015. Its revenue and cash flows for the 2018 fiscal year were \$2.4 billion and \$77 million, respectively. Its stock has hit a 52-week low of \$1.32 and a 52-week high of \$4.65. At today's price of \$1.42, is the stock undervalued?

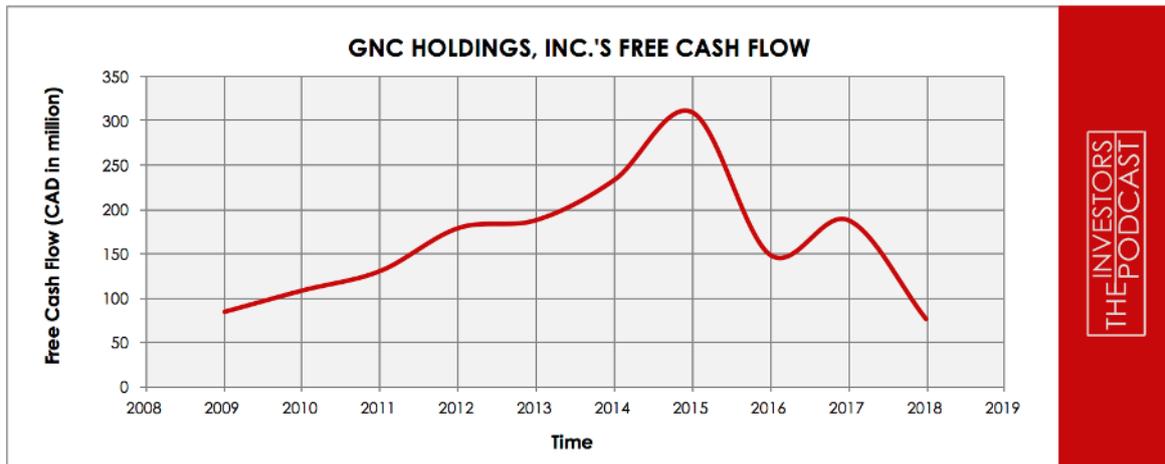


Source: Google Finance

The Intrinsic Value of GNC Holdings, Inc.

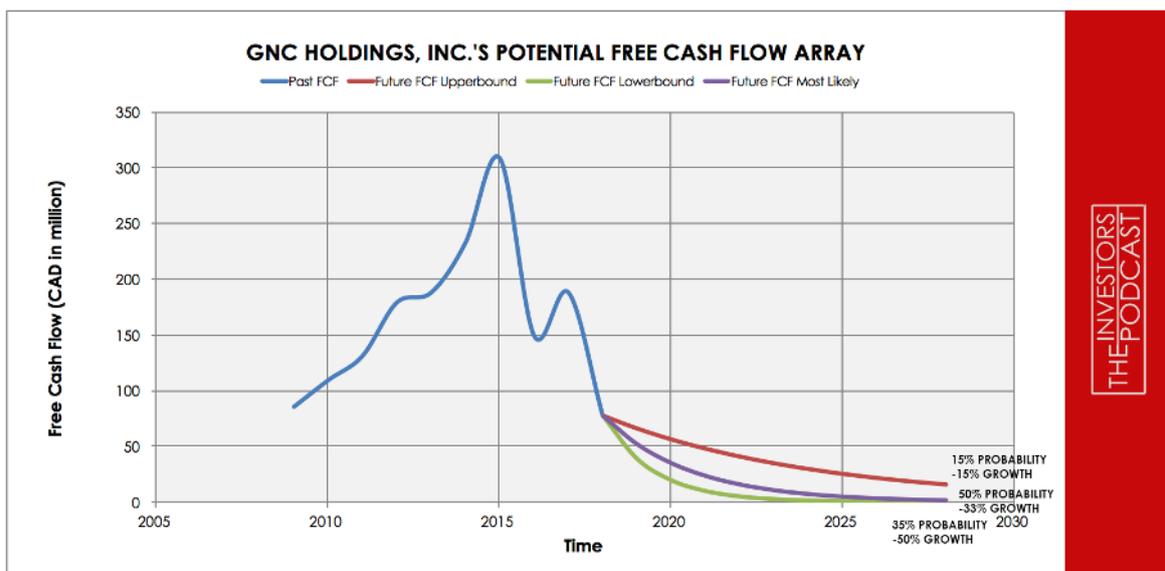
With net income being easily manipulated and not a true representation of the cash available to a company's owners, we prefer to use free cash flow to value a company's stock. Using free cash flow instead of net income

allows investors to value the company based on the actual cash it generated for its owners. Below is a chart of GNC’s free cash flow for the past ten years.



From the bottom of the Housing Crisis in 2008-2009 to its peak in 2015, GNC was able to grow its cash flow from \$85 million to over \$309 million, a compounded annual growth rate (CAGR) of 20%. However, since then, it’s cash flow has been in a near free fall. Its 2018 free cash flow was \$8 million *lower* than it was a decade ago. The various risks discussed in detail in the “Risks” section below illustrate the causes of this large decline.

To value GNC’s stock, its future free cash flows must be estimated. To do this, the array model below has been developed to account for three potential outcomes of GNC’s future free cash flows.



The upper-bound line (red) illustrates a -15% contraction rate with a 15% probability of occurrence. The middle line (blue) represents a -33% contraction with a 50% probability of occurrence. Finally, the lower-bound (green) line illustrates a -50% contraction with a 35% probability of occurrence. The contraction in GNC’s free cash flow generation is assuming that competitors and online retailers continue to disrupt the retail

industry, GNC's management fails in its strategic and joint venture initiatives, and the United States economy enters into a recessionary period, resulting in a significant slowdown in consumer spending.

Looking at these growth rates and probabilities, you will notice there is a drastic skew towards negative growth/contraction over the next decade. This may seem quite pessimistic, which it is, but it also allows for a conservative valuation and to consider the potential downside risk. While protecting downside risk is almost always important when making an investment, I see it as even more important in a situation like GNC. The stock may appear undervalued on a quantitative basis, which we will visit in the next part of this article, but the momentum of the stock has been very strong downwards, leading to a potential "falling knife" or "value-trap" situation.

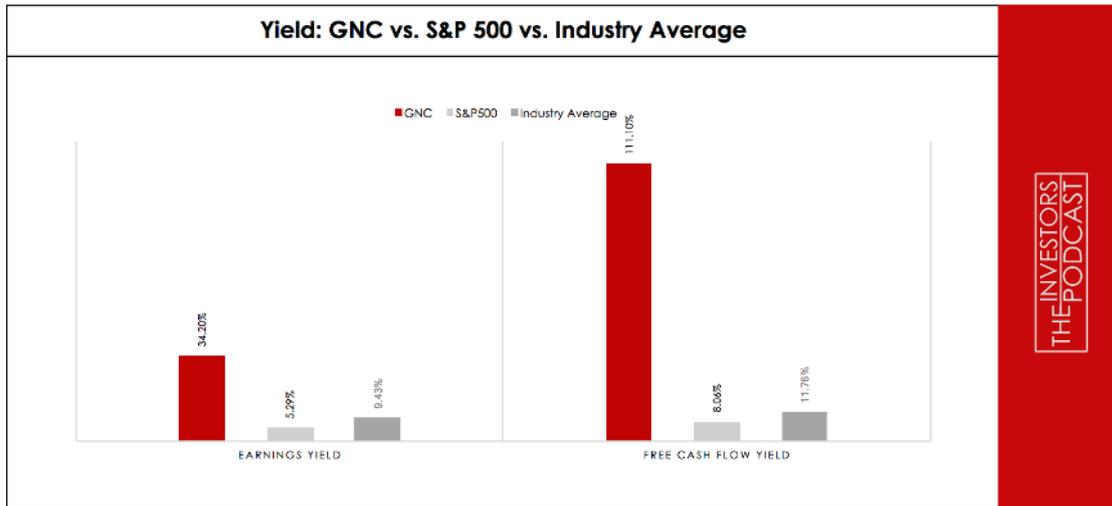
When creating a valuation model, one must consider the economic environment in which their investment would be made. In today's environment, it is likely wise to estimate growth rates very conservatively with a margin of safety. Any outperformance of the conservative growth rates would provide investors with additional returns above and beyond what was expected.

It is also important to recognize that the above-estimated contraction rates are *not* expected to be exact each and every year over the next decade. In fact, that is very unlikely. GNC's results will likely fluctuate from year-to-year. We do not attempt to estimate results on a yearly basis; rather we look to estimate accurate growth/contraction rates annualized over 5-10 years.

Assuming the estimated outcomes discussed above prove accurate, GNC's stock may be priced at an 11.3% annual return at today's price of \$1.42.

Two other valuable quantitative metrics to consider when analyzing a stock's potential return are the earnings yield (inverse P/E) and free cash flow yield (inverse P/FCF). At the time of this writing, GNC's current earnings and free cash flow yields are 34.2% and 111.1%, respectively. This is due to its low P/E ratio of just 2.92x and its P/FCF ratio of just 0.90x. Its earnings and free cash flow yields are significantly above our DCF analysis and are at levels that are not realistic. In many cases, these yields are indicative of the potential return an investor might earn by owning a stock, but not always – as we can see here with GNC. This example provides investors with a reminder that an investment cannot be made blindly based solely on quantitative metrics with the expectation of actually obtaining those returns. An investor must consider other quantitative factors, as well as qualitative factors when developing an investment thesis.

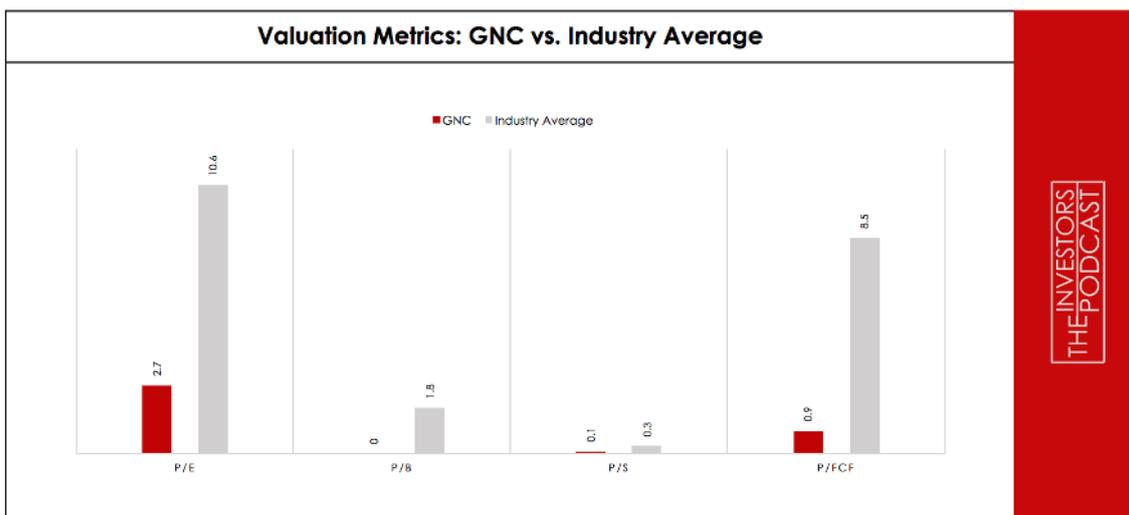
Given the abnormally and likely unrealistically high yields just discussed, GNC appears to be priced significantly better than the S&P 500 and the industry average on an earnings and free cash flow yield basis. This relationship is not unexpected as it is indicative of investors having a much higher required rate of return when investing in a struggling individual company than they do when investing in a broad index, like the S&P 500. The graph below illustrates the earnings and free cash flow yields for GNC, the S&P500, and the industry average.



Source: Google Finance, Morningstar

Up to this point, everything quantitative about GNC’s valuation indicates it may be undervalued and priced to outperform the S&P 500 over the next decade. However, before we come to that as our final conclusion, let’s further compare GNC to its competitors.

In the graph below, you will see GNC’s valuation metrics compared to that of the industry’s average on a P/E, P/B, P/S, and P/FCF basis. GNC currently trades at a significant discount to the industry averages on a P/E, P/S, and a P/FCF basis (GNC’s book value is negative, so its P/B value is incalculable). Given GNC’s risks that we will discuss in the next section, it is reasonable to believe that GNC should trade at a discount to the overall industry. The size of the discount is subjective to the investor; if you believe that GNC’s risks are overstated by the market and it shouldn’t trade at this deep of a discount to its competitors, you may consider the stock undervalued. However, if you believe the market is rightly capturing the risks facing GNC, then the discount may be warranted.



Source: Morningstar

The Competitive Advantage of GNC Holdings, Inc.

GNC's competitive advantages will be discussed in detail below:

- **Brand.** While GNC does face significant competition with many of its products, it does have a very strong brand. GNC's supplements and overall health products are very well known across the world and are known for being high-quality. It will be able to leverage its strong brand as the company continues to expand internationally.
- **Diversified Business.** Its diversified business model provides various avenues for potential growth, while also providing a hedge against competitive pressures. As the health and wellness industry continues to grow, GNC has the ability to take advantage of this buy, increasing its focus on manufacturing and white-labeling products to third-party companies.

Risk Factors

Let's look at the potential risks that can offset GNC's competitive advantages discussed above:

- **Weak Balance Sheet.** GNC *appears* to have a fairly strong cash position (1.14x its market cap), but in comparison to its debt levels, it is immaterial and misleading. It currently has nearly \$900 million in debt, in addition to \$518 million in capital leases, \$175 million in accounts payable, and over \$250 million in "other long-term liabilities." Also, a significant portion of its assets is not easily usable to generate cash or growth the business. Over \$800 million of its \$1.7 billion in assets is tied up in intangible assets and "other long-term assets." Its debt-heavy and cash-light balance sheet does not allow for GNC to take advantage of potential opportunities that may arise.
- **Severe Competition.** With the strong growth in the popularity of the health and wellness industry over the last 5-7 years, there has been a massive influx of competition into the industry. Combine the significant growth in new and strengthening competitors with the issues being faced by physical retailers (due to Amazon), GNC is faced with competitive pressures; it may not be able to overcome.
- **Economy.** Many of GNC's products are discretionary and premium. This means that if/when the economy enters into tough times, GNC is going to have significantly weaker demand for its products in two-fold because, 1) consumers do not *need* its products, and 2) its products are premium and expensive. When consumers have less disposable income, they will cut their spending on supplements, or transition away from the premium brands like GNC towards more affordable products.

Opportunity Costs

Although opportunity costs will not appear in your brokerage statements, it is a very real cost to investors that must be considered. When making an investment, an investor makes the conscious decision to forgo other investment opportunities for the one chosen. Despite having a positive real result, an investment could actually be negative when considering opportunity costs if capital is not allocated to its most successful and efficient use. GNC is currently priced to return better results than the 10-year treasury and the S&P 500 over the next decade, but it may not offer the best risk-adjusted return in comparison to other individual companies.

Macro Factors

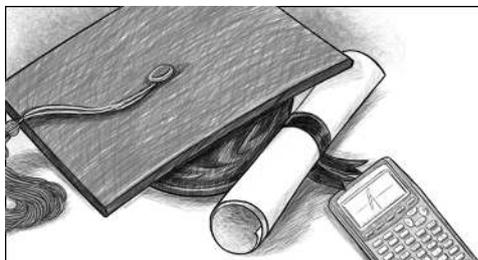
Attempting to time the market is rarely a recipe for success when investing, but it would likely be unwise to not at least consider the overall macro environment. Specifically, with brick-and-mortar retailers and premium brands like GNC, economic conditions play a pivot role in their success. During a recessionary period, consumer spending is significantly reduced, and retailers see their sales plummet. Unemployment is currently at, or near, 50-year lows, and U.S. private debt levels have exceeded previous major financial crisis. With

various economic indicators pointing to a potential peak, an investor should consider protecting oneself from an economic downturn.

Summary

On a quantitative basis, GNC appears to be a perfect Benjamin Graham “cigar-butt” or potentially Warren Buffett “value-investment.” However, the momentum of GNC’s stock indicates investors seeking a value opportunity might be instead purchasing into a value-trap. GNC provides a great example for investors of when they must look past the numbers and consider the qualitative side of the business. Purely quantitatively speaking, GNC would be a buy, but when you consider the headwinds it faces and the risks involved, an investor must carefully weigh the risk-reward opportunity presented. If you decide, based on your risk tolerance, that GNC provides a valuable opportunity rather a value-trap, with more potential upside than downside, it is recommended you consider your portfolio allocation strongly when initiating your position. Given the assumptions outlined in this analysis, a return of approximately 11.3% can be expected at today’s prices.

Disclaimer: The author does not currently hold any ownership in GNC Holdings, Inc. (GNC) and has no intentions of initiating a position over the next 72 hours.



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