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CHUCK JAFFE

Stupid Investment of the Week

Commentary: Peet's Coffee & Tea stock brews up a valuation storm

By [Chuck Jaffe](#), MarketWatch

Last update: 9:05 p.m. EST Jan. 29, 2009

BOSTON (MarketWatch) -- Every day the economy drags down and the stock market doesn't rebound, there's some other expert or pundit telling people how to save money.

And one of the top suggestions for people looking to squeeze a few hundred extra bucks per year out of their budget seems to be to give up specialty coffee, or brew it from home.

Not being a coffee drinker myself, this has never been a suggestion that would work for me. But being interested in food and retail stocks, there's a clear-cut line between the cut-the-fat mentality and the bottom line for coffee-based businesses.

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The average investor probably does not want to cross that line, which is one reason why Peet's Coffee & Tea Inc. is the Stupid Investment of the Week.

Stupid Investment of the Week highlights the conditions and characteristics that make a security less than ideal for the average investor, and is written in the hope that showcasing trouble in one situation will make it easier for the reader to avoid problems elsewhere. While obviously not a purchase recommendation, neither is the column meant to be an automatic sell signal.

At first blush, Peet's (PEET) is hardly the poster child for the coffee business's curdling hopes. That would be Starbucks Corp. (SBUX), which actually was featured in this column in April 2008, and which this week announced plans to close 300 shops in response to continued profit declines.

That said, the problems that have already hit Starbucks, the industry leader, have not necessarily played out at Peet's, a much smaller company. Whether they will is the real concern, because if Peet's follows the same bumpy path as Starbucks, it will be a bitter drink for investors to swallow.

Peet's is no fly-by-night idea created during consumption-crazy times. The company was created in 1966 when a Dutch immigrant named Alfred Peet founded the first Peet's Coffee & Tea retail store in Berkeley, Calif. The company's reputation was built on "artisan roasting" and "freshness," the idea that coffee is best when the time between roasting and serving is minimized.

That concern for craftsmanship built a loyal following, and allowed Peet's to grow from that first corner store into roughly 185 stores today. Perhaps more important is the company's burgeoning presence on grocery-store shelves, which has allowed Peet's to spread from its West Coast roots all the way into New England today.

Moreover, management has been conservative and defensive in its growth plans, and the balance sheet historically has looked pretty good. Morningstar gives the stock an "A" grade for financial health, although Peet's gets a "D" grade for profitability.

Latte debt

But the real concerns may lie off the balance sheet and in the footnotes. David Trainer, president at New Constructs, a Nashville, Tenn.-based investment research company, just moved Peet's onto his firm's "most dangerous stocks" list, due largely to \$85 million in off-balance sheet debt that Peet's has taken on to pursue its growth strategy.

That off-balance sheet debt represents nearly one-third of Peet's market capitalization, and while it may not show up in a measure of financial health like Morningstar's grading, Trainer said it cannot be ignored.

"In our opinion, [Peet's] will soon follow the fate of Starbucks and be forced to accept the failure of the scalability of its business and begin closing its stores," Trainer said. "The stock price does not agree with us, as it implies PEET will grow revenues and improve margins over the next 20 years. Specifically, the current stock price implies PEET will grow revenues at 20% compounded annually for the next 12 years while achieving a profit margin that is 30% better than what it has accomplished the last two years. Or in perhaps simpler terms, the current stock price implies profits growth of over 450%."

Trainer contends that if Peet's can't improve its profit margins, the off-balance sheet debt makes the closing of stores inevitable.

Bitter brew

While New Constructs research is much more confident that Peet's is headed for a fall than most other firms that follow the stock, the one clear concern that many analysts share about the coffee company is valuation.

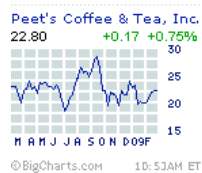
It seems that the market is already waking up to that concern, with Peet's down about 9% this month, and showing the kind of volatility that is more bitter to an average investor than sucking down burnt coffee grounds.

Throw in the volatility in coffee commodity prices, the changing retail environment for coffee -- where seemingly every convenience store is looking to add a high-end brand at a discount price -- and an economy where "give up the luxury coffee drinks" qualifies as advice on how to improve your net worth, and you have a dangerous time for any coffee chain, but particularly one that is looking to grow big-time from a non-dominant position.

While Peet's may not suffer the same big fall of Starbucks -- which lost more than half of its value in 2008 -- it seems unlikely to gain much even if the economy is able to get back into a growth mode. The one thing that might save the valuation may already be built into the price -- namely a takeover, as the coffee competition continues to heat up.

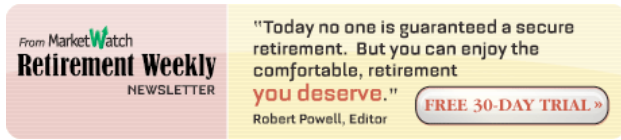
Rich Moroney, editor of the Upside newsletter, noted that Peet's "is expected to post impressive per-share profit growth for 2008 and 2009, which is reflected in the stock trading at more than 20 times earnings. "If the company stumbles," he said, "the stock could be vulnerable because of its rich valuation."

Few things in the current stock market can be described as "richly valued." By now, investors should know that in a troubled economy where every market



condition is on edge, richly valued is less a compliment than it is a warning. In this case, it's evidence that there are clouds in the coffee future at Peet's. ■

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.



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