Educated Investing

MPSIF newsletter: A Necessity So Bare

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Posted: 5/12/08

The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. In each issue of the Stern Opportunity, MPSIF will share a stock recommendation based on the recent work of a current MPSIF Analyst.

This edition features the research of MPSIF Growth Fund Analyst Cindy Chan. She recommended the purchase of Bare Escentuals (NASDAQ: BARE, a fast growing beauty product company, in late April. Based on her target price of $32, the MPSIF fund purchased 867 shares of the stock at cost of $23 per share.

Cindy is a first-year student at Stern specializing in finance and strategy. Prior to attending Stern, Cindy was a Senior Auditor at Gap Inc. where her core focus was on forensic accounting and investigations of internal fraud. Over the summer, she will be interning at Charles River Associates International, a financial, economic and strategy consulting firm.

When looking for stocks to research, Cindy focused on companies she already knew something about. She was familiar with Bare Escentuals' mineral-based beauty products and found the company met certain growth targets in her stock screening process.

"Bare Escentuals has strong brand equity with huge potential for product expansion as well as international expansion in key markets," Cindy says. "It currently presents a good buying opportunity due to exposure to discretionary spending."

Subsequent to MPSIF buying a position in the stock, BARE reported earnings that beat analyst estimates, while revenues missed estimates. After reviewing the quarter, Cindy still thinks the long-term growth story is in place and says BARE is on track expanding into international markets, while continuing its domestic growth.

Details of Cindy's research report:

**Business Description**

Bare Escentuals is one of the fastest growing prestige beauty companies in the
U.S. and a leader by sales and consumer awareness in mineral-based cosmetics.

The company develops, markets and sells cosmetics, skin care, and body care products under the brands:
bareMinerals - core foundation products and a wide variety of eye, cheek, and face products made primarily from finely milled minerals and do not contain any of the chemical additives bareVitamins, Bare Escentuals, and i.d. cosmetics - fashionable color cosmetics and accessories.

RareMinerals - innovative extension of our mineral-based expertise into the skin care category and offers women a natural, mineral-based alternative to traditional skin care products
MD Formulations brand - provides a complete professional skin care solution addressing the anti-aging market.

The company offers a highly differentiated, healthy and lightweight alternative to conventional liquid- or cream-based cosmetics while providing light to maximum coverage for all skin types.

A Bare Necessity

Growth driven by domestic distribution strategy: Bare Escentuals' distinctive multi-channel distribution model consists of infomercials, home shopping television, premium wholesale, company-owned boutiques, spas and salons and online shopping. This distribution model, through which each channel reinforces the others, provides 1) greater brand awareness, 2) across channels, 3) cost-effective consumer acquisition and education, 4) premium brand positioning without the large expenditures on print-based advertising and marketing common in our industry, and 5) improved convenience for consumers. This strategy is a core element of the company's success and the company continues to strive with this model.

International development in key markets: In 2007, the percentage of the company's international sales doubled and revenue grew by more than 140%. This is a very positive indication of the company's growth strategy to expand internationally. The company acquired UK distributor last year and plans to continue to develop brand awareness, test distribution, build infrastructure in UK, Japan, Germany, and France, which are the five of the largest countries by retail sales in the cosmetics and toiletries industry.

Impressive 4Q2007 results despite softer consumer backdrop and expected continued growth: BARE reported 4Q2007 EPS of $0.29, ahead of consensus. The upside came from sales growth of 31% and a +210 bps gross margin improvement that was above expectation, offset in part by greater support spending behind further expansion. 2007 net sales increased 30% (31% in Q4).
due to increased brand awareness and expanded distribution in US and abroad. Q4 gross margins increased 71.9% compared to 69.8% in prior year. Operating income FY2007 increased 22% (36% in Q4). Net Income FY2007 increased 75% (65% in Q4) as the company continues to pay down debt and lower interest expense.

**Investment Thesis**
Despite Bare Escentual's strong performance during 4Q07 indicating strong growth and improved gross margins, shares of BARE fell due to consumer's fear of the company's exposure to weak consumer discretionary spending. However, I believe that the growth prospect for this company is still strong due to 1) growing trend and demand for mineral-based cosmetics, 2) promising international growth, 3) high and stable gross margins, 4) continual strong increase in revenues, and 5) strong growth generated by all channels of distribution. The company's forward PEG of 0.7 shows that BARE is currently undervalued for its high growth.

**Valuation: Strong Growth at Value Price**

**PEG ratio implies a bargain**
At a 1-Yr forward PEG ratio of 0.7, this implies a bargain compared to its competitor's median PEG ratio of 1.5. I believe that due to the company's strong and promising growth prospects, it deserves at PEG ratio of at least 1.0. Using analysts' next 5 years (per annum) growth estimate of 25%, and 2008 estimate EPS of 1.18, the company should be trading at $29.5.

**DCF analysis gives BARE 59% upside potential**
Over the next 10 years, I projected BARE's revenue to grow by 20%, which is at the conservative end of analyst's company's sales growth guidance of 20-25% for FY2008. After the 4th year I projected BARE's revenue to grow at a lower growth rate of 15%, and then falling to 5% in 2016. At a 9.93% WACC, 3% terminal growth rate, 91.3 shares outstanding, BARE has a target price of $35.14 per share.

**About MPSIF**
The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. The fund, part of the overall NYU endowment, was established in 1999 through a generous gift from Michael Price, managing partner, MFP Investors, LLC and former chairman of Franklin Mutual Series funds. With roughly $1.9 million currently under management, MPSIF provides Stern MBA students interested in pursuing a career in asset management with hands on experience managing a real fund with significant assets. For more information, visit: http://pages.stern.nyu.edu/~mpsif/