



Zombie Stock #2 – Could Go to \$0 As Fed Raises Rates

Time is running out for cash-burning companies kept afloat with easy/cheap access to capital. These “zombie” companies are at risk of going bankrupt if they cannot raise more debt or equity, which is not as easy as it used to be.

As the Fed raises interest rates and ends quantitative easing, access to cheap capital is drying up quickly. At the same time, many companies face declining margins and may be forced to default on interest payments without the possibility of refinancing. As these zombie companies run out of the cash needed to stay afloat, risk premiums will rise across the market, which could further squeeze liquidity and create an escalating series of corporate defaults.

This report features [Freshpet](#) (FRPT: \$55/share), a zombie company with a high risk of seeing its stock go to \$0/share. We also feature [Carvana](#) (CVNA: \$25/share) [here](#) and [Peloton](#) (PTON: \$11/share) [here](#).

[Learn more about the best fundamental research](#)

Zombie Companies with Little Cash Are Risky

Companies with heavy cash burn and little cash on hand are risky in today’s market. Being forced to raise capital in this environment, even if the company is ultimately successful, is not good for existing shareholders.

Figure 1 shows the zombie companies most likely to run out of cash first, based on free cash flow (FCF) burn and cash on the balance sheet over the trailing-twelve-months (TTM). Each company in Figure 1 has:

- Negative [interest coverage ratio](#) (EBIT/Interest expense)
- Negative FCF over the TTM
- Less than 24 months before it needs more capital to subsidize the TTM FCF burn rate
- Been a [Danger Zone](#) pick

Not surprisingly, the companies that are most at risk of seeing their stock price go to \$0 are the ones with a poor underlying business model, which was overlooked by investors during the 2020-2021 meme stock-driven market frenzy. Companies such as Carvana, Freshpet, Peloton, and [Squarespace](#) (SQSP) have less than six months of cash on their balance sheets based on their FCF burn over the past twelve months. These stocks have a real risk of going to zero.

Figure 1: Danger Zone Stocks with Less than Two Year’s Worth of Cash on Hand: as of 1Q22

Company	Ticker	Interest Coverage Ratio	Months Before Bankruptcy
Carvana Co.	CVNA	-2.3	1
Freshpet Inc	FRPT	-13.1	1
Peloton Interactive Inc.	PTON	-33.3	3
Squarespace Inc.	SQSP	-0.8	5
Sweetgreen Inc	SG	-1487.1	8
Rivian Automotive Inc	RIVN	-119.4	10
Beyond Meat Inc.	BYND	-54.9	11
Snap Inc.	SNAP	-37.8	13
GameStop Corporation	GME	-157.3	18
Allbirds Inc	BIRD	-183.6	20

Sources: New Constructs, LLC and company filings.

To calculate “Months Before Bankruptcy” we divided the TTM FCF burn by 12, which equals monthly cash burn. We then divide Cash and Equivalents on the balance sheet through 1Q22 by monthly cash burn.

And Overvalued Zombie Stocks Are the Riskiest



Stock valuations that embed high expectations for future profit growth add more risk to owning shares of zombie companies with just a few months' worth of cash left. For the riskiest zombie companies, not only does the stock price not reflect the *short-term* distress facing the company, but it also reflects unrealistically optimistic assumptions about the *long-term* profitability of the company. With these stocks, overvaluation risk is stacked on top of short-term cash flow risk.

Below, we'll take a closer look at Freshpet and detail the company's cash burn and how much further its stock price could fall.

Freshpet (FRPT: \$55/share)

We put Freshpet (FRPT) in the Danger Zone in [February 2022](#), and the stock has outperformed the S&P 500 as a short by 24% since then. Even after falling 69% from its 52-week high and 44% YTD, we think the stock has much more downside.

Freshpet has grown the top line at the expense of the bottom-line, and sales growth has driven more cash burn, which puts the stock in danger of declining to \$0 per share. The firm's free cash flow (FCF) has been negative every year since 2017, and its FCF burn has worsened in recent years.

Since 2017, Freshpet has burned through \$691 million in FCF, per Figure 2.

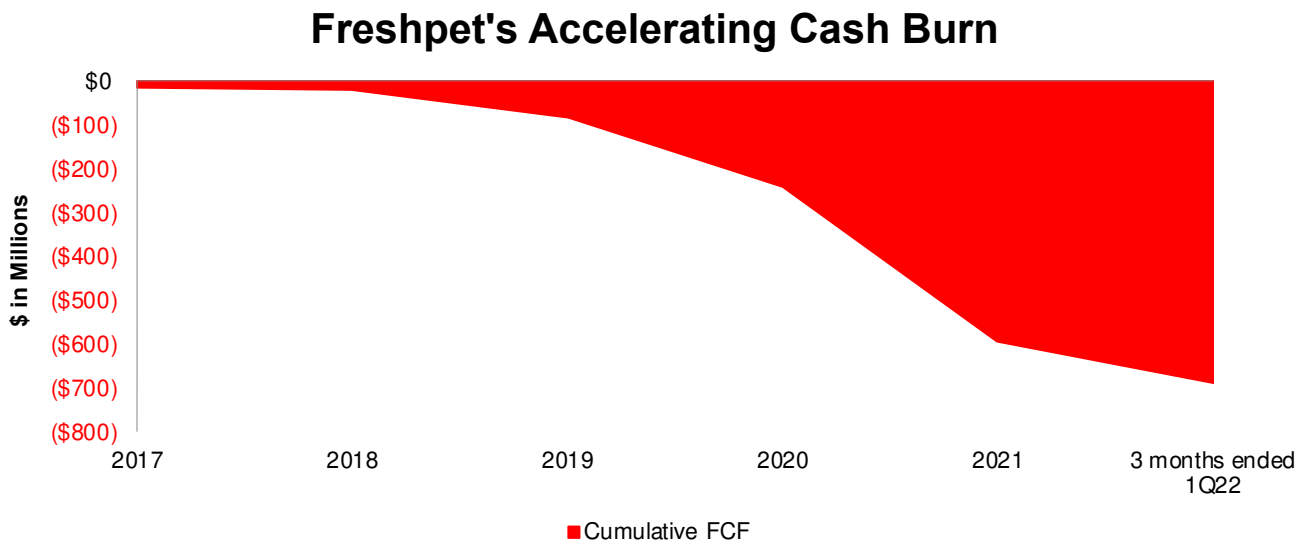
Over the TTM ended 1Q22, Freshpet burned \$386 million. With just \$30 million in cash and cash equivalents on the balance sheet at the end of 1Q22, Freshpet's cash balance could only sustain its FCF burn for less than one month after 1Q22. Freshpet issued shares that provided a net \$338 million to the company in May 2022.

Freshpet management notes that the cash would be used for "general corporate purposes", which can include capex, development of its kitchens, investments, or repayments of debt.

Based on TTM cash burn rates, this fresh cash can keep the company afloat for 9 more months from today.

If Freshpet continues to expand its manufacturing and distribution capacity and incur heavy advertising expenses to support its revenue growth, it could run out of cash in less than 9 months.

Figure 2: Freshpet's Cumulative Free Cash Flow Through 1Q22



Sources: New Constructs, LLC and company filings

Priced to Be Bigger Than J.M. Smucker and General Mills Pet Food Segments

Below we use our [reverse discounted cash flow \(DCF\) model](#) to analyze the future cash flow expectations baked into Freshpet's stock price. We also provide two additional scenarios to highlight the downside potential in shares if Freshpet's revenue grows at more reasonable rates.

If we assume Freshpet's:



- NOPAT margin immediately improves to 6% (compared to Freshpet's -6% margin in 2021, -7% margin over the TTM, and equal to the peer group market-cap weighted average TTM margin¹) and
- revenue grows 34% compounded annually through 2028, then

the stock would be worth \$55/share today – equal to the current stock price.

In this [scenario](#), Freshpet generates \$3.3 billion in revenue in 2028 or equal to Colgate-Palmolive's TTM pet food sales, 1.2x J.M. Smucker's TTM pet food sales, and 1.6x General Mills' TTM pet food sales.

Keep in mind, the number of companies that grow revenue by 20%+ compounded annually for such a long period are [unbelievably rare](#), making the expectations in Freshpet's share price outright unrealistic.

DCF Scenario 2: Shares are Worth \$43 at Consensus Growth

We perform a second DCF scenario to highlight the downside risk to owning Freshpet should it grow at consensus revenue estimates. If we assume Freshpet's:

- NOPAT margin improves to 6% in 2021,
- revenue grows at consensus rates in 2022 and 2023, and
- revenue grows 28% each year from 2024-2028, then

the stock would be worth [\\$43/share](#) today – or 22% below the current stock price. In this scenario, Freshpet generates \$2.6 billion in revenue in 2028 which is still 80% of Colgate-Palmolive's TTM pet food sales, equal to J.M. Smucker's TTM pet food sales, and 1.3x General Mills' TTM pet food sales.

DCF Scenario 3: FRPT Has 44%+ Downside

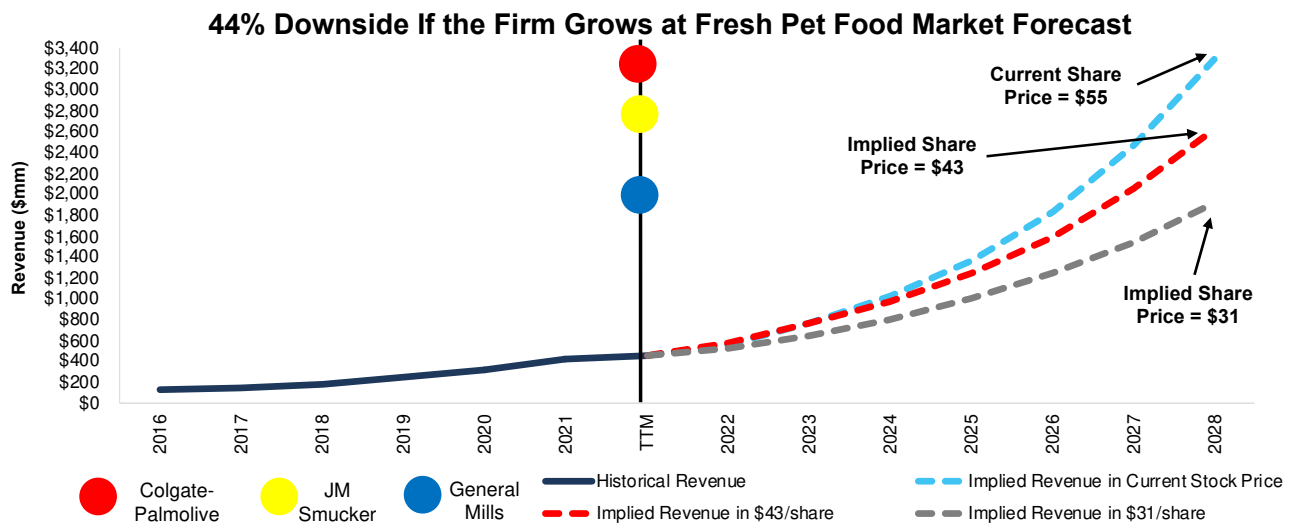
We review a final DCF scenario to evaluate the downside risk should Freshpet grow revenue at the consensus expectations for market growth. If we assume Freshpet's:

- NOPAT margin immediately improves to 6% and
- revenue grows at a 24% CAGR (equal to fresh pet food market forecast) through 2028, then

the stock would be worth just [\\$31/share](#) today – a 44% downside to the current stock price.

Figure 3 compares Freshpet's historical revenue to its implied revenue in each of the above DCF scenarios. We also include the TTM pet food sales from peers JM Smucker, Colgate-Palmolive, and General Mills.

Figure 3: Freshpet's Historical and Implied Revenue: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

¹ Peer group includes Amazon.com (AMZN), Chewy Inc. (CHWY), Colgate-Palmolive (CL), Costco Wholesale (COST), General Mills (GIS), Nestle (NSRGY), J.M. Smucker (SJM), and Tyson Foods (TSN).



Each of the above scenarios also assumes Freshpet grows revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is highly unlikely but allows us to create best-case scenarios that demonstrate the expectations embedded in the current valuation. For reference, Freshpet's TTM invested capital is six times its 2016 level. If we assume Freshpet's invested capital increases at a similar historical rate in DCF scenarios 2-3 above, the downside risk is even larger.

This article originally published on [June 23, 2022](#).

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our “novel database” enables investors to overcome these flaws and apply [reliable](#) fundamental data in their research.
3. Our proprietary measures of [Core Earnings](#) and [Earnings Distortion](#) materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in [The Journal of Financial Economics](#), a top peer-reviewed journal, [Core Earnings: New Data & Evidence](#) proves our Robo-Analyst technology overcomes material shortcomings in legacy firms’ data collection processes to provide superior [fundamental data](#), [earnings](#) models, and [research](#). More [details](#).

Key quotes from the paper:

- “[New Constructs’] *Total Adjustments* differs significantly from the items identified and excluded from Compustat’s adjusted earnings measures. For example... 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global’s (SPGI) Adjustments* individually.” – pp. 14, 1st para.
- “A final source of differences [between New Constructs’ and S&P Global’s data] is due to data collection oversights...we identified cases where Compustat did not collect information relating to firms’ income that is useful in assessing core earnings.” – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg’s in [Getting ROIC Right](#). See the [Appendix](#) for direct comparison details.

Key quotes from the paper:

- “...an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC.” – pp. 8, 5th para.
- “The majority of the difference...comes from New Constructs’ machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies.” – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts’ stock ratings outperform those from human analysts as shown in this [paper](#) from Indiana’s Kelley School of Business. Bloomberg features the paper [here](#).

Key quotes from the paper:

- “the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant.” – pp. 6, 3rd para.
- “Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts.” – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are [here](#).



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first two days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.