March 25, 2022

INVESTMENT THESIS

Farmer Bros Co (FARM: $7.06; $129M market cap) is an underappreciated national coffee roaster, wholesaler and distributor of coffee, tea and culinary products. After years of mismanagement and lackluster execution, turnover in ownership and at the board level paved the way to place agents of change in leadership positions. A new management team installed late in 2019 has made significant strides in improving company operations, but those improvements have been obfuscated by volumes that have declined materially due to Covid restrictions. Recent commentary from management and slides from a March investor presentation suggest company end markets have turned the corner. This market-leading distribution company with prized assets now sits on the cusp of an inflection in trajectory that could produce a multi-bagger over the next two years as earnings and cash flows move materially higher.

REASON FOR OPPORTUNITY

As one of just six coffee roasters and distributors in the United States, this longtime family-run company has produced reliable profits for most of its 100-year existence. However, shares have been out of favor for much of the last five years. Operational execution since 2017 was characterized by struggles at the company. In 2018, prior management failed in a sorely needed transition from its severely antiquated roasting facilities and headquarters. The outdated facilities and missteps in the changes at the company's headquarters resulted in stockouts, cost overruns, and a general inability to get coffee beans to its end customers in a dependable and cost-efficient manner. In addition, the company made a couple of acquisitions that were poorly integrated with its existing operations. After the missteps and shareholder infighting, a transformation in the shareholder base and at the board level catalyzed a change to a new management team. FARM's new leadership appointed Deverl Maserang as CEO in September, 2019. Mr. Maserang has extensive experience with turnarounds and within the coffee logistics space from his time as a VP of Global Supply Chain for Starbucks.

Right as it seemed that Farmer Brothers' operations were starting to turn the corner, the pandemic hit. Covid-19 significantly affected the majority of Farmer Bro's customer base. During the past two years, volumes decreased by as much as 70% at one point during the height of the lockdowns. Despite the pandemic, FARM was able to finally complete the transition to its new $100M+ facility. In addition, FARM which has implemented a "Fix, Optimize and Grow" plan, has now entered into the growth stage segment of its strategy. Based on current developments and our internal research, we believe it is not a stretch to suggest that Farmer Bros could reach a $50mm EBITDA run rate by the end of this year.

VARIANT PERCEPTION

One of the most important and overlooked aspects about an investment in Farmer Brothers' pertains to the value of the company's assets. The new plant alone cost in excess of $100M to build over a multiyear period. And the DSD network which has been built over 110+ years would likely cost multiples of the plant value to duplicate today. Accordingly, when this business is well-managed, the company should be able to generate attractive returns on capital. However, investors have not seen these results for years, due first to mismanagement, and more recently from a decline in volumes from pandemic restrictions. This now looks set to change with improvement showing up in the P&L moving forward.

THE BUSINESS

What it is - FARM is an importer, roaster, and distributor of coffee and some coffee-related products. It broadly divides its business into two categories: Direct-Store-Delivery (DSD) and Direct Ship. In the DSD business, the company delivers their products to clients such as small cafes, restaurants, hotels, and other customers. The DSD business also supplies and services coffee brewing equipment (CBE) to customers as part of their value proposition. In Direct Ship, they use third party services to bulk ship their products. Some examples of this business would be coffee for a large convenience chain or private label coffee for a small grocery chain.

Market dynamics – FARM's main industry, coffee distribution, is a $76 billion industry that is growing at 3-5% annually. Specialty coffee trends are providing the industry with tailwinds. For example, refrigerated ready-todrink tea and coffee sales grew by 13.6% in 2021. The coffee distribution business has high barriers to entry and the industry has seen consolidation over the past few years. What differentiates FARM from its competitors is its national reach and its ability to execute sophisticated manufacturing practices. Additionally, their refurbished Coffee Brewing and Equipment (CBE) segment, recently rebranded "Revive", provides the company a frequent reason to check in with their customers, and further cement existing relationships.

Corporate history – Founded by Roy E. Farmer in 1912, Farmer Bros.' was initially established to roast coffee beans and sell them from door to door. Roy E. Farmer served as CEO until he died unexpectedly in 1951, which led Roy. F Farmer to assume control of the company, taking it public in 1952. Roy Farmer presided over the company for the following five decades. By the beginning of the 1990s, Farmer Bros. ranked as the leading supplier of coffee to restaurants, institutions, and offices west of the Mississippi.

Since 2000, the company has generally been profitable each year until just the last few years. However, beginning in 2017, it became apparent that management needed to transition away from the 85 year old plant in Houston. Unfortunately for FARM, management completely botched the facility conversion. In addition, the company also mismanaged the integration of its acquisition of Boyd's Coffee. These setbacks ultimately led to a change in leadership. In September 2019, the board of directors selected Deverl Maserang as its new CEO to enhance its operations.

INVESTMENT CONSIDERATIONS

Large and growing market – DSD is a potential high value growth channel. The system has approximately 95 branches (excluding branches held for sale), over 200 fleet routes (400+ routes pre-COVID), and 50K delivery points annually. Over time, as DSD sales return additional routes will also return. COVID aside, the branch system is a significant barrier to entry, but more importantly it can be significantly leveraged by increasing products sold through the system.

Transition to Northlake plant now complete – The multiyear transition to the new facility was finally completed this past summer. FARM spent over $100M on Northlake and it is considered one of the best facilities in the US. The Northlake plant will allow FARM to produce higher margins and has ample capacity. In turn, this will allow FARM to lower its capex going forward. After ~$14M in estimated spend this year, maintenance capex is likely to fall to ~$8M - $10M annually going forward.

Unfilled distribution network – FARM undertook several efforts to improve customer service and profitability. This included the closing of Houston, while also increasing and repositioning production at Northlake, and the build-out of the Rialto Distribution Center. With its recent cap-ex investment in the Northlake plant, management estimates it can lift production to 100+mm lbs. annually. The opening of the Rialto Distribution Center will also help FARM reduce freight costs and enabled the consolidation and sale of three DSD facilities.

Improving margin structure – Gross margin improvement will be driven by rebalancing and manufacturing improvements (by closing Houston / and getting Northlake at full capacity) and the Rialto distribution center. As well, the combination of volumes recovering and the leverage of the DSD branch system should help expand gross margins. These moves should lower production cost per pound and lift gross margins over 30% (then towards 35%) vs. last year's margins of 25%.

High ROICs – Distribution businesses are often capable of high returns on invested capital due to limited capex needs and high recurring free cash flows and FARM is no exception. As the company grows into its distribution footprint, we forecast the company will reach EBITDA margins of 10% by 2024, which is consistent with other DSD peers.

Balance Sheet – FARM currently has $3.6 million in cash & short-term investments, along with $91 million in debt. Included in the outstanding debt is a revolving credit facility at a current interest rate of 2.75%. Of the $90M facility, $43.5M is currently drawn. The term loan of $45.5M carries a current interest rate of 7.50% (LIBOR + 6.5% per annum, with LIBOR Floor 1.0%). In addition, FARM also has $38.56 million in accrued pension liabilities. Despite the still depressed volumes in trailing financials, the company has remained ebitda positive and operated at cash flow break even or positive. However, there is room to improve the balance sheet. Prepayment terms on outstanding debt ease in April and provide optionality on financing terms as cash flows begin to improve. The company also has a strong base of leverageable assets. For example, the Northlake plant alone could fetch $60M+ in an SLB; likewise, their truck fleet offers an opportunity here as well.

NOLs – As of 6/30/21, FARM had approximately $178.1 million in federal and $139.7 million in state net operating loss carryforwards that will begin to expire in the years ending 6/30/30 and 6/30/22, respectively, meaning the company is unlikely to be a meaningful taxpayer at any point in the near future.

Ownership/Management – Checks with former employees and industry participants confirm that its previous problems were internally generated and fixable. For example, they had too many SKUs and often struggled to fulfill customer orders. Additionally, with the changed strategy and less need for additional volumes to fill unused capacity, management has telegraphed they intend to devote a greater focus towards the more profitable DSD business going forward. With Chairman of the Board Christopher Mottern (former CEO of Peet's Coffee and Teas) and CEO Deverl Maserang now at the helm, the company has the right leadership in place with the precise experience and knowhow to lead FARM forward.

GROWTH PROSPECTS
Management is pursuing a "fix, optimize, and grow" strategy.

Fix – By migrating operations to the Northlake and Rialto Distribution Center facilities, management has recently concluded the "fix" phase of their turnaround strategy. Progress is already beginning to show up in the financials, even though sales remain quite depressed from pre-Covid levels. In the prior quarter, even with revenues still down some 20-25% from pre-Covid levels, the company has already returned to prior pre-Covid gross margins levels. Equally promisingly, the company is now seeing green shoots on volumes, with management reporting many days in the current quarter having been the best since the onset of the pandemic.

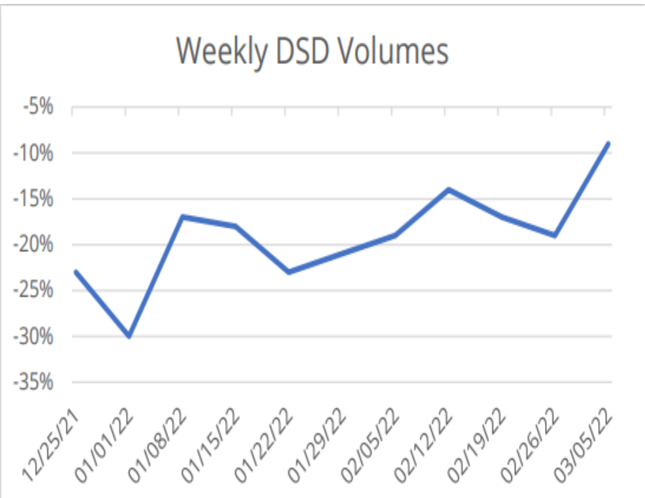
Optimize – After having conversations with former employees and competitors, it's clear that FARM has a number of other areas it could improve efficiency. FARM has several key initiatives in place that should reinvigorate the more profitable Direct Store Distribution (DSD) segment. As an example, FARM recently rolled out HighJump handheld devices to their delivery representatives, a software-based platform focused specifically on DSD models to maximize sales while reducing distribution costs. Additionally, since 2019, SKU count has been nearly cut in half, with management now anticipating to add back new and better selling SKUs

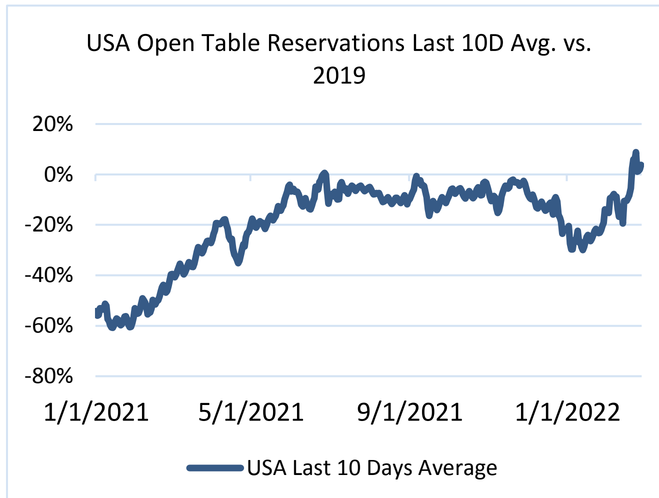
Grow - At this point, the company simply needs customer doors to open and stay open. However, once the economy is fully reopened, management will need to execute on a strategy that allows FARM to expand its overall volumes and increase their customer base. As COVID fades over time and FARM adds additional products, we believe DSD can become a significant driver of coffee volumes, differentiated products, and margin expansion.

Share gains – Acquisitions are a final growth driver. With the DSD market historically being highly fragmented and some peers rumored to be looking to exit, acquisitions may be likely down the road. By folding new volumes into the network, FARM could see attractive paybacks within just 12-18 months on future acquisitions.

New Products Offerings – The company is rolling out new SKUs for promising upstart brands such as NuZee and High Brew. Also, FARM's internal product innovations are also starting to bear fruit. The Coffee Brewing Equipment arm now called Revive looks to be another great way the company can deepen relationships with customers by providing expedient service for coffee brewing equipment.

Recent Trends – The firm recently shared that as of the first week of March, weekly DSD volumes were approximately 8% below pre-covid volumes, which is the highest that FARM has had since the pandemic began. In addition to these positive developments, the most recent OpenTable data suggests that restaurant reservations averages over the last 10 days nationwide have finally returned to 2019 figures. These recent trends should continue to bode well for FARM's DSD business if dining reservations remain and exceed current levels.





VALUATION

Analyst coverage is light with only Roth Capital Partners currently covering the name. The stock is currently trading below its larger category peers, though we believe current multiples reflect little of the anticipated EBITDA growth.

	Price	EV	EV/Sales FY22	2024 EBITDA Estimate	EV/FY 24 EBITDA
LANC	$155.80	$4,176M	2.6x	$316M	13.2x
THS	$32.85	$3,431M	0.7x	$533M	6.4x
JBSS	$82.37	$952.8M	1.1x	$120M	8.0x
FARM	$7.03	$217.1M	0.5x	$58M	3.7x

PROSPECTIVE RETURNS

FARM recently announced that the turnaround plan management has implemented is starting to take hold. Last quarter, FARM had gross margins of over 30% which returned to pre-covid figures, albeit with volumes still meaningfully lower than pre-covid levels. F2Q marked the company's 6th consecutive quarter of growth. We believe that FARM is currently at an inflection point and these most recent updates bode well for FARM's core DSD business. From 2016 to 2018, the company historically had adjusted EBITDA margins of just around 8% despite network inefficiencies from poor management practices associated with prior management. In our projections, the base case assumes that in 2024 FARM can produce revenues of just over $608M, in line with pre-Covid levels, with an EBITDA margin of 9.5% by 2024, along with an annualized top line growth rate of 15.2% over the next three years.

Case	Description	FY23 Assumptions	FY24 Assumptions
Bull	Volumes return to pre-pandemic levels and the company gains more market share than anticpated as we enter into 2024	23% sales growth on - better than pre-covid volumes	10% sales growth on - greater market share gains than initially thought

	FY 2022 E	FY 2023 E	FY 2024 E
Sales	$473.4	$582.3	$640.6
growth	*19.0%*	*23.0%*	*10.0%*
EBITDA	$15.2	$46.5	$67.2
margin	*3.2%*	*8.0%*	*10.5%*
growth	*178.4%*	*206.8%*	*44.5%*
Incr margin	*27.6%*	*28.8%*	*35.5%*
EPS	-$1.06	$0.58	$1.78
growth	*51.0%*	*154.7%*	*206.9%*

EBITDA X	TEV	Target Price	Return
6.0x	$403.0	$17.6	149%
7.0x	$470.1	$21.3	202%
8.0x	$537.3	$25.1	255%

Case	Description	FY23 Assumptions	FY24 Assumptions
Base	Volumes return to pre-pandemic levels and the company meets the EBITDA margin expectations set out in its turnaround strategy	21% sales growth on a full return to pre-covid sales - Incremental margin pick up as SG&A spend begins to normalize	8% sales growth on a gains in market share - 9.5% EBITDA margins based on the transformation plan being fully put into place

	FY 2022 E	FY 2023 E	FY 2024 E
Sales	$465.5	$563.2	$608.3
growth	*17.0%*	*21.0%*	*8.0%*
EBITDA	$10.2	$39.3	$57.7
margin	*2.2%*	*7.0%*	*9.5%*
growth	*280.1%*	*284.0%*	*46.7%*
Incr margin	*23.5%*	*29.8%*	*40.7%*
EPS	-$1.32	$0.20	$1.28
growth	*39.0%*	*115.2%*	*540.0%*

EBITDA X	TEV	Target Price	Return
6.0x	$346.1	$14.5	105%
7.0x	$403.8	$17.7	150%
8.0x	$461.5	$20.9	195%

Case	Description	FY23 Assumptions	FY24 Assumptions
Bear	Revenue growth is less than expected due to a new covid variant and margins fail to meet expectations	12% sales growth on - less than pre-covid volumes because customers were unable to keep their doors open	5% sales growth on - less market share gain than initially expected and smaller customer count -EBITDA margins don't hit the goal

	FY 2022 E	FY 2023 E	FY 2024 E
Sales	$445.6	$499.1	$524.0
growth	*12.0%*	*12.0%*	*5.0%*
EBITDA	$8.9	$22.4	$31.3
margin	*2.0%*	*4.5%*	*6.0%*
growth	*256.7%*	*150.9%*	*40.2%*
Incr margin	*30.6%*	*25.1%*	*36.0%*
EPS	-$1.27	-$0.49	-$0.01
growth	*41.1%*	*61.4%*	*98.0%*

EBITDA X	TEV	Target Price	Return
6.0x	$188.0	$5.7	-20%
7.0x	$219.4	$7.4	5%
8.0x	$250.7	$9.2	30%

Our Base case price target assumes an EV/EBITDA multiple of 7.0x on 2024 projections based on the same levels where its peers currently trade. Based on the assumptions above, we currently have a two-year price target of $17.70 which provides an upside of approximately of 150% based on where FARM currently trades today.

Our Bull case price target assumes an EV/EBITDA multiple of 8.0x on 2024 projections based on the execution momentum. Based on the assumptions above, we currently have a two-year price target of $25.10 which provides an upside of approximately of 255% based on where FARM currently trades today.

Finally, our Bear case price target assumes an EV/EBITDA multiple of 6.0x on 2024 under the assumption consumer trends and purchasing habits of coffee have been permanently and negatively altered. Based on the assumptions above, we currently have a two-year price target of $5.70 which provides a downside of approximately of -20% based on where FARM currently trades today.

RISKS

- Operational execution: Management must continue to drive both volume and productivity growth.
- Supply chain issues: Interruption of supply chain could adversely affect business and sales.
- Coffee prices: Coffee is a commodity and subject to fluctuating costs and supply.
- Consumer Preferences: Consumer preferences may change creating shifts potentially unfavorable shifts in demand patterns.
- Covid resurgence: Variants drive additional lockdown cycles.

CATALYSTS

- Earnings reports: Continued steady company execution should drive impressive EBITDA growth and attract new investors.
- Management guidance: Management has discussed offering long term guidance regarding the likely margin potential of the business in coming quarters.
- Addition to the Russell 2000 Index: At a current market cap of just over $100 million, the company could be added to the index once the company reaches a market cap threshold of $300 million.

APPENDIX – JBSS CASE STUDY
From our past research, there are plenty of examples of food service firms that have been able to consistently expand their margins year after year. In the case of JBSS, the firm has been able to incrementally improve its ebitda margins each year from 5.3% in 2011 to 9.2% in 2017, and the stock has been rewarded for doing so.

In the case of FARM, we believe that the margin expansion plans that management has laid out will produce similar results as to what JBSS experienced in recent years. While not identical, we think the set up for FARM could yield this same type of results.

JBSS							
(in millions USD)	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Revenue	$674	$701	$734	$779	$887	$952	$847
YoY Growth (%)	20.04%	3.91%	4.82%	6.03%	13.95%	7.31%	(11.07%)
EBITDA	$36	$54	$62	$65	$72	$72	$78
YoY Growth (%)	(23.14%)	50.43%	15.64%	4.91%	10.58%	(0.26%)	7.88%
EBITDA Margin - Adjusted (%)	5.31%	7.69%	8.49%	8.40%	8.15%	7.57%	9.19%
EPS	$1.06	$1.58	$2.21	$2.66	$2.61	$2.68	$3.17
YoY Growth (%)	(29.68%)	48.91%	39.63%	20.69%	(1.98%)	2.68%	18.28%