Kerrisdale Capital

November 2020

Tattooed Chef, Inc. (TTCF)

Recent SPAC Acquisition is Already Past its Sell-By Date

We are short shares of Tattooed Chef, a $1.2bn packaged-food company that trades at about 7.5x 2020 revenues despite extreme customer concentration and flagging retail sales. Having recently gone public through acquisition by Forum Merger II Corporation, a special purpose acquisition company (SPAC), financial details regarding Tattooed Chef's business are sparse. Investors have nonetheless bestowed a fanciful valuation on the company based on the torrid year-over-year growth rate of its namesake brand over the last few quarters, and the rosy projections made by management for 2021.

But in-depth interviews with the brand's largest customers and a thorough analysis of scanner data from Nielsen paint an ominous picture. Tattooed Chef's rapid revenue growth isn't a reflection of broad-based sales growth but an artifact of the company's relationship with a *single* customer – Sam's Club, which accounts for about 70% of branded revenue. In a bid to try and "beat Costco at its own game" and foster a "treasure-hunt-type" shopper experience, Sam's Club began stocking its frozen-food section with some Tattooed Chef prepared meals in late 2018. The initial success led to growing volumes at Sam's in 2019 and 2020, with pandemic-driven consumer purchasing patterns greatly benefiting the frozen food category in the current year.

Though successful, Tattooed Chef's unusual approach of launching with Sam's Club leaves the company ill-prepared to expand elsewhere. Sam's buyers are adamant about offering Tattooed Chef products that can only be found in club stores, which paradoxically means that successful products sold at Sam's will be extremely difficult to leverage elsewhere. That only *partly* explains Tattooed Chef's absence from the grocery channel. Another snag is that despite constant references to "innovation," Tattooed Chef's business with Sam's is concentrated in just a few items, while its oft-cited relationship with Costco consists almost entirely of private label frozen vegetables. The dearth of creativity will make it impossible to displace hot brands like Caulipower or Daiya in grocers' freezers. Finally, the relative lack of operational complexity involved in mainly selling a few SKUs to every-day low-price retailers leaves Tattooed Chef woefully unprepared for managing the intricate details of merchandising, distribution, and product assortment that are required for success in the much larger grocery channel.

More worrying than an inability to expand into the grocery channel is recent scanner data that shows that across its customer base, over two thirds of which is comprised of Sam's, the Tattooed Chef brand has dramatically underperformed comparable frozen food brands in recent months. While frozen food categories have begun their typical post-summer sales acceleration, *Tattooed Chef's sales at retail have just experienced their worst 3-month period since last December*. That's not exactly the mark of a "disruptive" and rapidly growing upstart that's portrayed in the company's investor presentation. Worse yet, breadth of the brand's sales has narrowed considerably in recent months, concentrating primarily in just a handful of frozen prepared meal products and losing almost all momentum in frozen mixed vegetables.

Going public through a SPAC acquisition has allowed Tattooed Chef to avoid the kind of scrutiny that might reveal customer concentration risk far more serious than suggested by the company's disclosures. It's also allowed for a pandemic-driven paroxysm of consumer frozen food purchases at one retailer to be portrayed as sustainable sales momentum. But the reality cannot be hidden for long: Tattooed Chef's frozen food sales are melting, and investors will be left holding the bag.

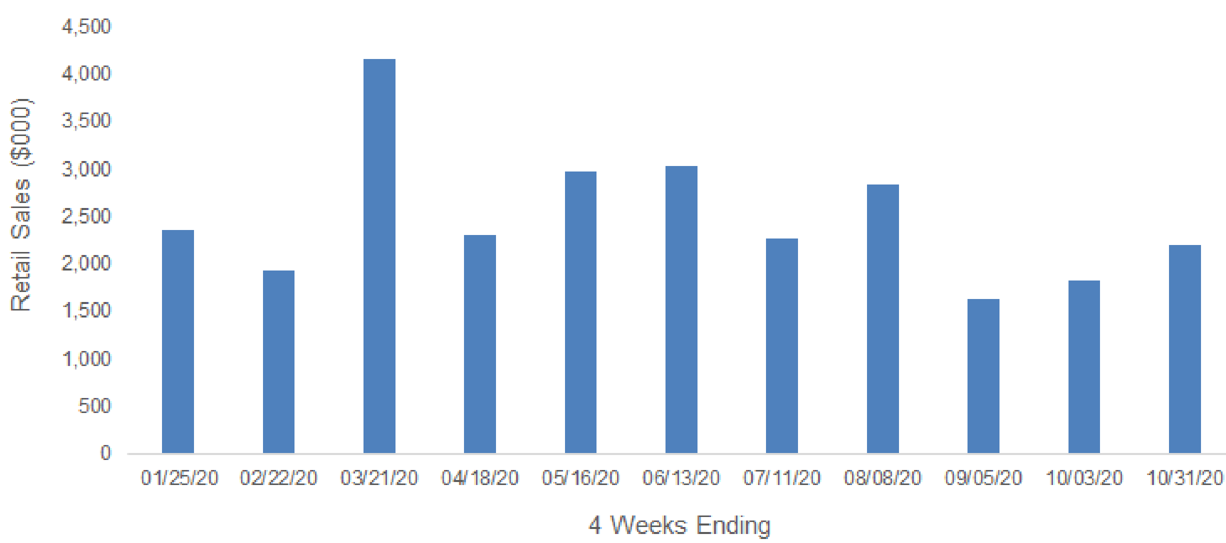
Table of Contents

I. Investment Highlights

Retail sales of the Tattooed Chef brand have already stalled, suggesting a weak brand that is already suffering from consumer fatigue. Investor excitement around Tattooed Chef is centered around its eponymous branded products, which comprise about 55% of the company's year-to-date revenues and are almost entirely responsible for the 90% year-to-date revenue growth rate. The brand's products include "plant-based" frozen prepared meals such as cauliflower macaroni and cheese, cauliflower pizza, and acai bowls, as well as frozen vegetables like riced cauliflower and zucchini/squash spirals.

The narrative that has developed around the brand is that Tattooed Chef products are a chic and modern "plant-based" take on stodgy frozen prepared foods and vegetable mixes, which puts the brand in a great position to gain market share against legacy brands like Birds Eye, Green Giant, and Stouffer's. A more extreme version of the narrative is that the "highly disruptive lifestyle brand" (CEO Sam Galletti's description on the recent earnings call) belongs in the same category as rapidly growing "plant-based" versions of traditional proteins such as oat milk and Beyond Burgers. To date, it's been difficult to evaluate the Tattooed Chef brand because the only information available to investors has come in the form of sparse disclosures in the company's merger proxy, one presentation that management gave (and repeated since) when the acquisition was announced this past June, and its recent vague earnings release. Both the presentation and the recent earnings call also included tantalizing revenue growth guidance of ~75% for the 2020 calendar year and 50% for 2021.

Tattooed Chef – Brand sales of Frozen Vegetables, Prepared Foods, and Pizza by consecutive 4-week periods for CY 2020



Source: Nielsen scanner data, Kerrisdale analysis

Retail scanner data from Nielsen, which includes the brand's sales at Sam's Club, suggests an entirely different narrative than the one of a "disruptive" frozen vegetable juggernaut. While it's true that the brand's 2020 sales far exceeded those of 2019, the momentum has slowed considerably in recent months, with sequential sales performance dramatically underperforming industry sales patterns in comparable frozen food categories. The chart above tells a story that's less about an upstart brand rapidly gaining share from dull competitors, and more about a brand that was flashy enough to get consumers to try it, but just not good enough to create permanent customers. While almost every frozen food brand saw retail sales decline from the panic-driven retail buying fueled by the pandemic in March, it's almost impossible to find a brand where sales *declined* in the last 3 months from the typical July trough, let alone as significantly as they did for Tattooed Chef.

As we detail in the report that follows, Tattooed Chef's branded retail sales trajectory over the course of 2020 has been markedly weaker than that of emerging brands that have demonstrably taken off with consumers. Even legacy brands with comparable products, such as Morningstar Farms, have found renewed pandemic-driven interest from consumers and have exhibited a much stronger sales cadence. By contrast, Tattooed Chef has gained traction only sporadically with 2-3 seasonal prepared food items sold at Sam's Club, while failing to innovate beyond those products or make any headway in the frozen vegetables category. The result has been significant overall deceleration of sales at retail that will inevitably affect revenues in coming quarters.

In fact, this seems to have been unintentionally alluded to in Tattooed Chef's most recent investor presentation, which projects that 52% of the company's 2020 revenue will consist of branded products and the rest will come from private label sales. But branded sales accounted for about 56% of revenue over the first three quarters of the current fiscal year, so the annual projection contemplates an *approximate 30% sequential branded revenue decline in the fourth quarter*, which should theoretically be the seasonally *strongest* quarter of the year. It's just another indication of the brand's weakness, even as management has talked up 2021 revenue guidance and increased distribution.

Tattooed Chef's customer concentration risk is much more than meets the eye. The most recent merger proxy filed by the company shows that in the 6 months ending this past June 30th, its two largest customers accounted for 39% and 32% of revenues, respectively. Based on the company's investor presentation disclosures, as well as discussions with frozen food buyers at Sam's Club and Costco, Sam's is the top customer and expects to account for 35-40% of the company's total projected 2020 revenues of $148 million. But that actually understates the concentrated nature of Tattooed Chef's sales.

To understand why, it's worth remembering that the company's extravagant 7.5x sales valuation anticipates the rapid growth of *branded* sales. Adjusting for the much less exciting 45% of revenues coming from the private label business year-to-date, the branded business trades at closer to 13x 2020 projected sales. Sam's Club accounts for 35-40% of *total sales*, or about *70%* of these valuable branded sales.

Our discussions with Sam's frozen food buyers and our analysis of Nielsen's scanner data suggest a further element of concentration that poses a risk to Tattooed Chef's investors: the overwhelming majority – we estimate over 75% – of the Sam's Club business consists of just 4 products –cauliflower pizza, cauliflower burgers, cauliflower macaroni and cheese, and a seasoned corn bowl. The story at Costco, which accounts for about a third of the company's *total* sales, is slightly different but also underscores the company's concentration risk. Most of the Costco business is private label, but on the branded side, Costco stocks just 2 SKUs, including a slightly modified version of the corn bowl sold at Sam's.[1]

Almost the entire value of Tattooed Chef rests on the moderate success the brand has had selling just a few different items to mostly one customer that belongs to one relatively narrow sales channel – club stores. It makes little sense to expect that performance to presage large-scale success in the vastly different grocery channel.

Tattooed Chef's customer concentration reflects the limitations that impede its expansion into the grocery channel and will also make that expansion even more challenging. The layers of concentration risk – few products, few customers, one sales channel – are a feature, not a bug, of Tattooed Chef's façade of commercial success. Prior to launching the Tattooed Chef brand, Ittella, as the company was known prior to last year, had a small business selling primarily large bags of Ittella-branded frozen riced cauliflower to both Sam's and Costco. Those relationships were instrumental in getting the branded Tattooed Chef line in front of the frozen food buyers at the clubs, both of which were willing – to varying degrees – to give the new brand a try in their stores.

The club sales channel is characterized by large stores selling very few SKUs in large quantities and sizes, and at low but generally stable prices. In other words, from the standpoint of the vendor, it's a relatively simple business because there's no need for creative product assortments, detailed merchandising plans, or complicated distribution logistics. A new vendor just needs one or two products to which the consumer takes and the sales will follow. Still, the club channel is the last place branded food companies will try and penetrate – the customers are brutally cost-conscious and they want just one or two products, specially designed so that the consumer can't find it at supermarkets, and at the risk that if the product bombs, a new one has to be designed (or the club store relationship severed). Given Ittella's already existing relationship with Sam's and Costco, though, it made perfect sense for Tattooed Chef to start there.

[1] This excludes the one-time acai-bowl promotion that Tattooed Chef ran at Costco over 8 weeks in August and September, which we discuss below, and which resulted in significant losses.

But aside from the fact that both channels sell packaged food, there's not much in common between the club business and the grocery/supermarket business, and Tattooed Chef has none of the attributes needed to enter the latter. While the company's investor presentation mentions "innovation" 13 times and boasts of 39 branded SKUs sold over the course of 2020, even management had to admit in the most recent earnings call that only 15 SKUs were sold through the club channel, while 13 SKUs generated enough sales at retail to make it past the low bar required to be included in retail scanner data.. The *product* count is closer to 8 after adjusting for small differences that technically necessitate another SKU, and the business at Sam's and Costco can be attributed almost entirely to 4-5 items. That's a far cry from 39. And it's not for lack of trying – many of those 39 have been attempted, including at Sam's, and simply didn't catch on. Putting new products on a shelf isn't innovation. *Successfully selling* those products is but Tattooed Chef hasn't been able to do that, and it won't be possible to enter the grocery channel without it.

Worse yet, discussions with Sam's buyers reveal that Sam's has made it clear to Tattooed Chef that it strongly prefers that the attempt to penetrate the grocery channel be driven by frozen vegetable mixes rather than the higher-margin prepared foods that have sold well at Sam's. Unsurprisingly, Sam's has no desire to compete with supermarkets on a narrow set of successful products that Sam's itself was responsible for seeding. The impetus to keep its largest customer happy by testing any potentially successful product at Sam's, and the consequent inability to leverage that successful product at a larger scale, will be a lasting and damaging legacy of the initial success that Tattooed Chef attained through the club channel.

Finally, it's quite apparent that Tattooed Chef's executive team isn't really aware of the merchandising competence necessary to build branded relationships with grocers. Merchandising means targeted price reduction programs, seasonal promotions, shelf placement consulting, and other subtle elements of selling packaged foods through grocers that are entirely absent from the club store relationships. As one large packaged foods distributor told us, "selling to an EDLP [every-day-low-price] customer doesn't prepare you for selling into Kroger's or Whole Foods…Tattooed Chef's announcement that they'll sell frozen enchilada bowls direct to consumer shows that they're amateurs…they have no idea what they're doing." Neither do their shareholders.

II. Company Overview

Tattooed Chef, Inc: Capitalization and Financial Results

Capitalization

Share price ($)	$	16.83
Fully diluted shares (mm):		
Shares outstanding		55.2
Founder Shares		2.5
Sponsor Earnout Shares		2.5
Holdback Shares		5.0
Dilutive impact of warrants		6.5
Total		71.7
Fully diluted market cap (mm)	$	1,207
Less: net cash		90
Enterprise value	$	1,117
EV/revenue (2020 Guidance)		7.5x
Adjusted EV/branded revenue*		13.0x

Financial Results

	2018	2019	TTM
Private Label Revenue	$ 41	$ 64	$ 65
Branded Revenue	2	18	71
Total Revenue	**$ 47**	**$ 85**	**$ 136**

Source: company filings, Kerrisdale estimates
**Adjusted EV/branded revenue assigns a 1x revenue multiple to private label sales*

According to Tattooed Chef's investor presentation, the company was founded in 2009 by Salvatore "Sam" Galletti as Stonegate Foods, an Italian vegetable importer, and quickly pivoted in 2010 to selling private label products (mostly to Trader Joe's according to various industry participants with whom we spoke). In 2015, the company changed its name to Ittella ("Galletti" backwards, but without the "G") and began manufacturing in its own facility, still selling mostly private label products, but at some point it added Ittella-branded frozen vegetables into its sales mix (primarily large bags of riced cauliflower).

The Tattooed Chef brand was created in 2017 by Sam's daughter, Sarah, ***the*** tattooed chef, who articulated the brand's founding myth to investors in June:

> *While I was working as a chef abroad…I noticed a lack of great tasting plant-based foods in retail channels and wanted to bring in delicious high-quality ingredients that are easily accessible for consumers…So, I came back with the idea to transition the company to be plant powered.*[2]

Based on a podcast interview she gave in March, "chef abroad" is perhaps a bit of hyperbole given that her experience in Italy involved 3-4 months of working in a Pasticceria in Calabria making gelato and croissants. According to the interview, when she came back from Italy she "literally had a dream about Tattooed Chef…the design and the name and that I wanted to focus

[2] The quote is from Sarah Galletti's prepared remarks on the investor conference call held by Forum Merger II on June 12, 2020, in the wake of the acquisition announcement.

on sustainable ingredients…and plant-based foods." In the interview, Sarah explains that a lot of her "weird, crazy ideas do happen in my dreams," which could possibly explain the fact that the brand has only had a single digit number of successful products two and a half years into its existence. While it's difficult to know exactly which version of the founding story is the "right" one, the company wants the Tattooed Chef brand to represent healthy, "plant-based," organic foods ranging from simple mixed vegetables to more trendy prepared foods like pizza and cauliflower macaroni and cheese.

In our view, it's highly unlikely that Sam ever imagined turning his daughter's consumer packaged foods project into a half-billion-dollar payoff. More likely is that he assigned some resources to the brand, helping it get into Sam's, where it unexpectedly took off with its first major hit being the cauliflower mac-and-cheese in early 2019. Over the last two years, the company has also penetrated Costco, with whom Ittella had a prior relationship, as well as some of the Ahold-owned supermarket chains and, most recently, Target.[3] With the recent completion of its acquisition by Forum Merger II Corporation, the company officially changed its name to Tattooed Chef.

The Galletti family is no stranger to the food business. Sam's father started selling fresh and frozen seafood to supermarket chains in 1975, which Sam and his brother turned into Southwind Foods in 1999. Southwind is currently a half-a-billion-dollar-a-year wholesale brand with relationships across over 30 different grocery chains, ranging from Supervalu to Whole Foods, as well as national food service distributors like Sysco and US Foods. In that context, it's curious that Ittella didn't try to distribute Tattooed Chef-branded products more traditionally, leveraging Galletti's longstanding relationship in the grocery channel, which is several times the size of the club channel and a lot more profitable. As we discuss at greater length below, that unorthodox go-to-market strategy makes a bit more sense when considering that branded sales require a completely different set of institutional capabilities than the private label business.

Perhaps more perplexing than the go-to-market strategy is Tattooed Chef's go-public strategy. Instead of raising capital by filing for an initial public offering, Ittella chose to be acquired by Forum Merger II Corporation, a Special Purpose Acquisition Corporation (SPAC) – or "blank check" company – that was originally underwritten by Jefferies and EarlyBirdCapital. Under the terms of the deal that was originally struck between Forum and Ittella, the Galletti shareholders (primarily Sam) would receive:

- 34.5 million newly issued shares in the combined entity
- An additional 5 million newly issued "holdback shares," half of which would vest if the stock would consistently trade above $12/share within three years of the deal closing, and the other half of which would vest if the stock would consistently trade above $14/share within the same timeframe.
- $50 million in cash

[3] Ahold is certain to be the "Grocer I" referenced on page 16 of the investor presentation, but we believe that the financial importance of the relationship is negligible and we estimate that it accounts for less than 10% of branded sales.

- An *additional* $25 million in consideration that Galetti could choose to receive either in cash or in the form of 2.5 million shares.

In the context of the typical $10/share SPAC stock price and assuming a mostly rational deal price, the key implications of the deal were that:

- The combined company would have 60-62.5 million shares outstanding (depending on the cash vs. shares split chosen by Galletti), implying a market capitalization of just over $600 million. The cash remaining on the balance sheet would be approximately $100 million, which would be used in theoretically the same way IPO proceeds would be used.
- Galletti would receive $50-75 million in cash and another $345-370 million in stock.
- Galletti would own 57-59% of the combined entity.

Strangely, two key decisions made by Galletti in the context of the deal *seemingly* resulted in his leaving a lot of money on the table:

- If Galletti wanted to raise $100 million at a $600 million valuation, a more traditional IPO would have left him much better off. Public shareholders would infuse the company with $100 million and receive about a sixth, or 16.5% of the company, while Galletti and his partners would retain shares worth $500 million – just over 83% of the company. By comparison, the deal with Forum would leave Galletti with $75 million in cash, and a 57.3% ownership stake worth $345 million, for a total of $420 million. While some of that $80 million difference would surely have gone to bankers' fees, Galletti seems to have left a lot of money on the table.[4]
- The average stock price of Forum in the 30 trading days preceding the deal's close was about $24. Given the choice of receiving the last tranche of consideration detailed above in the form of either $60 million worth of Tattooed Chef stock or $25 million in cash, Galletti chose the cash, leaving $35 million on the table.

Even for a wealthy family with a stake in a separate $500 million business, leaving over $100 million on the table begs the question: what might Sam Galletti know that public shareholders do not? One of the historical pitfalls of SPAC acquisitions is that the resultant public shareholders know a lot less than they would in the context of a more traditional IPO and roadshow. The Tattooed Chef deal proxy and investment presentation – the only information investors had to evaluate the underlying operations – are sparse, with barely over a year's worth of financial data and little in the way of operational detail or comprehensive retail data.[5]

In order to understand whether Tattooed Chef merits the extremely generous valuation it has garnered from investors, we interviewed key personnel at its two largest customers, as well as

[4] Another way of looking at this is that if Tattooed Chef raised $100 million by going public in a traditional fashion at a valuation of $600 million, Galletti and his partners could have retained the same 57.35% holding as they did through the deal with Forum by selling about 26% of their stake for $156 million in cash, or about $80 million more than the $75 million they received through the deal with Forum.

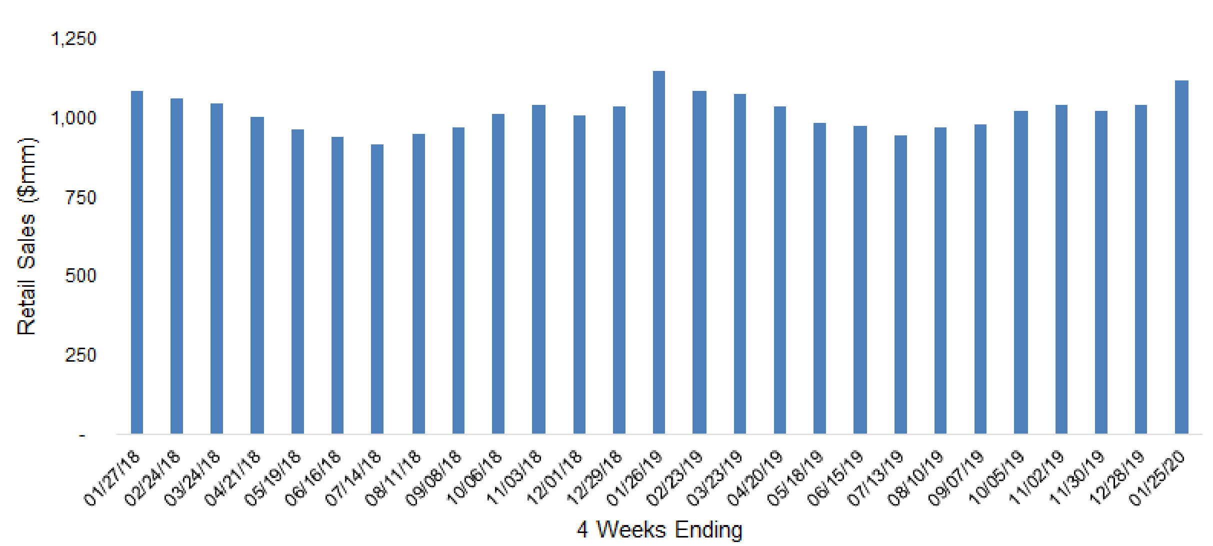
[5] Compare, for the example, the IPO prospectus of Vital Farms, an organic eggs & dairy company that went public this past July.

packaged goods distributors, and frozen food buyers at some of the largest grocers in the US. We also conducted a thorough analysis of Nielsen scanner data to ascertain the brand's trends at retail. We believe that Galletti took the SPAC route to going public because it provided a rapid way for the Gallettis to monetize their stake in a business almost entirely dependent on one customer and a handful of products that greatly benefited from pandemic-associated disruptions in the frozen food industry. The decision to take $25 million in cash over $60 million in stock as late as just a few weeks ago also makes sense in light of recent commercial developments: according to scanner data, retail sales of Tattooed-Chef-branded products have decelerated dramatically in the last few months, considerably underperforming almost all frozen food brands. Tattooed Chef is actually worth just a fraction of the sum for which it was acquired, and we think the Gallettis know it.

III. Retail scanner data indicates that the Tattooed Chef brand's momentum has already stalled

As the chart below demonstrates, overall frozen food sales at retail normally follow a steady course, peaking in January, declining steadily through the middle of the summer, and then increasing steadily over the course of the winter back to January:

Frozen prepared foods, vegetables, and pizza: combined retail sales January 2018 to January 2020



Source: Nielsen scanner data, Kerrisdale analysis

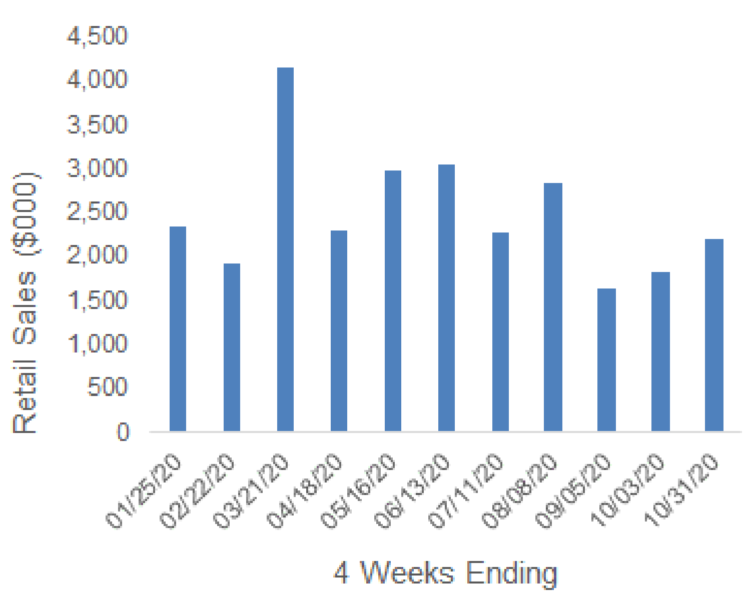
That pattern broke down this year (see below) coincident with the beginning of the Covid-19 pandemic, when "pantry-loading" led to a massive increase in both sequential (+43%) and year-over-year (+45%) frozen food sales for the 4 weeks ending March 21st. Relative to 2019, growth has remained strong since March (though gradually declining), as the pandemic has consumers eating at home much more often than usual. But the normal seasonal pattern has recurred, with a decline in frozen food sales through the middle of the summer and an increase (albeit more subdued than usual) moving through the autumn and into the winter.

Frozen prepared foods, vegetables, and pizza: combined retail sales CY2020

Source: Nielsen scanner data, Kerrisdale analysis

But Tattooed-Chef-branded products, including at Sam's Club, look *extremely* different:

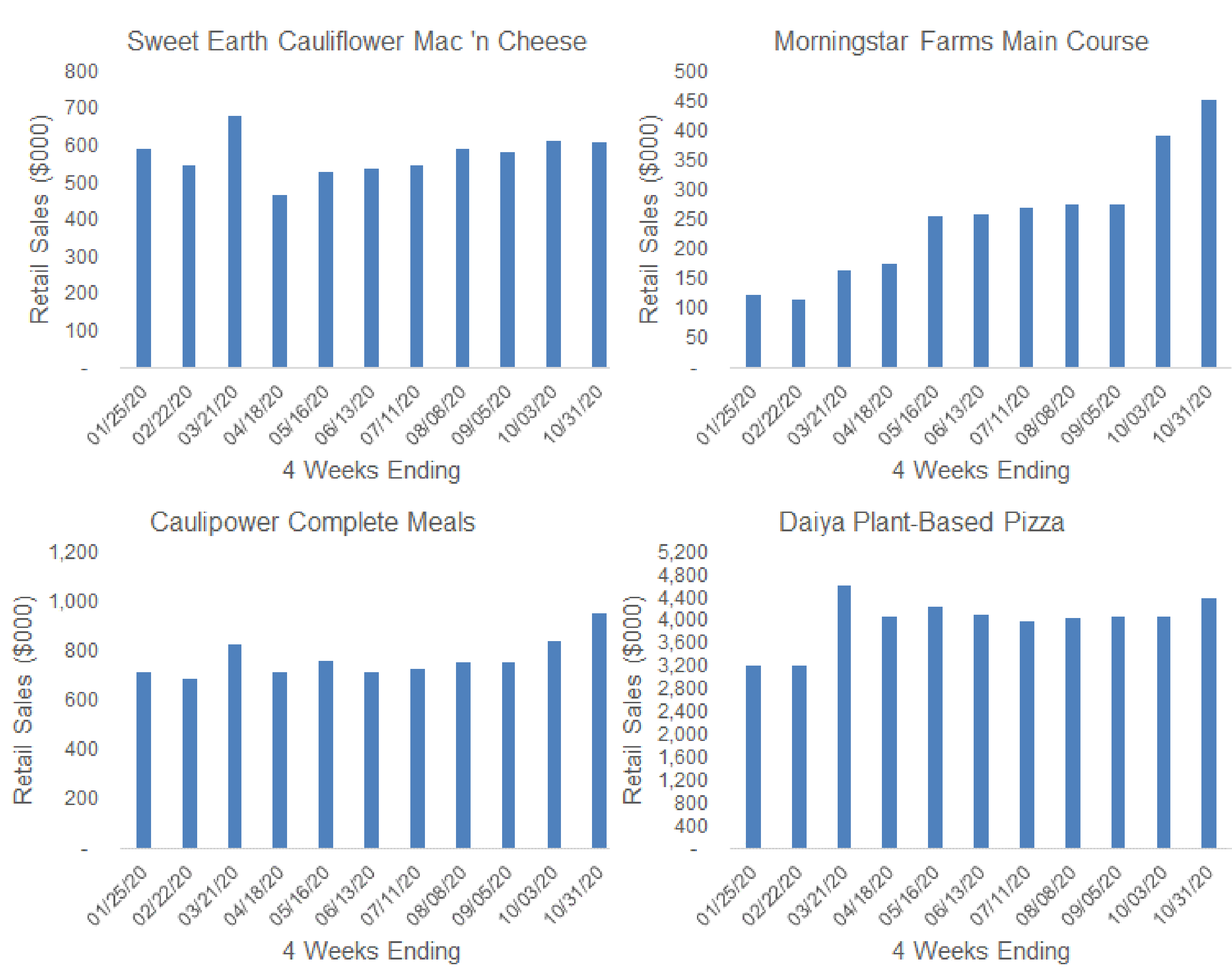
Tattooed Chef frozen prepared foods, vegetables, and pizza: combined retail sales CY2020



Source: Nielsen scanner data, Kerrisdale analysis

Like the overall frozen food category, Tattooed Chef retail sales greatly benefited from the pandemic-driven spike in March and then declined in the aftermath. But the most recent periods saw a marked retail sales deterioration relative to this past summer, which is the reverse of the pattern exhibited by the frozen food category as a whole. It's even more surprising considering that Tattooed Chef is supposed to be a small and rapidly growing "disruptive lifestyle brand" that's "on trend" and impervious to the vicissitudes of relatively trivial seasonal patterns. Other brands that fit that description, with products in similar categories, suffered no such declines in the last 3 months. In fact, many of them have approached, or even eclipsed, the retail sales levels they reached in March:

CY 2020 Retail sales for growing brands in categories comparable to Tattooed Chef



Source: Nielsen scanner data, Kerrisdale analysis

The above products all belong to the "plant-powered" prepared meal categories to which Tattooed Chef is also supposed to belong. They include relatively newer brands like Caulipower and Daiya, and much older brands, like Morningstar Farms and Sweet Earth, that have been acquired by large CPG companies but have found new life as a result of both the pandemic and the consumer trend towards vegan versions of traditional foods. Their retail performance stands in stark contrast to *Tattooed Chef's -45% sequential sales decline from July* to August/September, and even more precipitous 60% decline from the March highs. Even in October, which saw the brand expand into Wal Mart stores, retail sales remained 22% lower than in July and early August. Tattooed Chef's three most recent months represent its worst rolling-three-month performance at retail since December of last year, which is completely inconsistent with the conception of a hot emerging brand.

Recent weakness at retail portends wholesale weakness in the coming quarters, beginning with the fourth quarter of 2020, which will only be reported by Tattooed Chef in February. But a close reading of the company's 2020 guidance in light of its year-to-date performance implies a sharp Q4 slowdown in branded revenue growth. Tattooed Chef has generated $108.9 million in revenue in the first 3 quarters of this year, with $60.8 million – or 56% – coming from branded products. In its most recent investor presentation, the company guided to $148 million in 2020 revenue with 52% coming from the branded business. The guidance implies fourth quarter revenues of $39 million – a slight deceleration from the third quarter's $41 million – but Q4 *branded* revenue of $16 million, *a 30% decline from the third quarter and the worst quarterly sales performance since the fourth quarter of 2019*. It's difficult to imagine that a *successful* emerging brand, let alone a "disruptive" force in frozen foods, could exhibit such a precipitous quarterly sales decline so early in its expected long-term growth trajectory.

In that context, it's worth considering Tattooed Chef's $220 million revenue guidance for the 2021 fiscal year, which implies a 50% annual growth rate. It's quite obvious that the company intends to reach that goal (or at least try) by brute force: in its recent earnings call, management announced an agreement with KeHE to distribute Tattooed Chef products to grocers around the country. KeHE distributes "fresh, natural & organic, and specialty food" to about 30 thousand stores across North America, and Tattooed Chef will be able to generate substantial revenues in 2021 *just by getting a few grocers to try its products*. For reasons discussed in the next section, we think that effort is likely to fall far short of the intended mark. But the 2020 retail trends for the brand further suggest that revenue at Tattooed Chef's *current* customer base is set to decline and any growth with *new* customers is likely to be very short-lived. 2020 for Tattooed Chef is a kind of roadmap for what happens as the brand meaningfully penetrates a small number of customers (in this case primarily Sam's Club): customer fatigue sets in for the brand's few major products very quickly.

While investors value Tattooed Chef as if its growth has only just begun, the recent retail performance and expected stalling of sequential revenue growth are indicative of a brand with little staying power that's incredibly unlikely to ever reach critical mass.

IV. Tattooed Chef's customer concentration risk is much greater than meets the eye, and severely constrains its ability to expand into the grocery market

For the first half of 2020, Tattooed Chef's largest 3 customers accounted for 86% of the company's revenue. But that extreme level of customer concentration *understates* the risk to the company's business from its reliance on just one customer – Sam's Club. Based on discussions with frozen food buyers at Sam's, we believe that "Customer C" discussed in the merger proxy, which accounted for 39% of Tattooed Chef's first half revenues, is in fact Sam's. For the whole of 2020, Sam's buyers expect to account for 35-40% – or about $55 million - of the $148 million in revenue to which Tattooed Chef has guided.

Those numbers don't accurately convey just how extravagant a valuation investors are placing on such a narrow slice of business. Recall that Tattooed Chef expects that 52%, or about $80 million, of 2020 revenues will come from branded products. Bearing in mind that the company's business with Sam's Club is comprised almost entirely of Tattooed-Chef-branded products, a better way to quantify the risk of customer concentration is to see Sam's Club as responsible for over 70% of Tattooed Chef's branded sales.

Additionally, though Tattooed Chef has boasted of "innovating" 39 different SKUs, retail scanner data and discussions with Sam's buyers indicate that sales to Sam's Club are highly concentrated in just a handful of products including cauliflower pizza, cauliflower burgers/nuggets, cauliflower macaroni and cheese, and a seasoned corn & cheese bowl.[6] Even that exaggerates the assortment of products at Sam's because, in its quest to foster a "treasure-hunt" atmosphere in its stores, Sam's has taken a seasonal approach to Tattooed Chef's more differentiated items, stocking the corn bowl and macaroni and cheese, for example, only twice a year for ~8 weeks each time. Meanwhile, the more consistently stocked cauliflower pizza has seen stagnant sales in recent months despite the increasing number of locations in which it's available, potentially reflecting consumer fatigue.

Despite paying tribute to innovation countless times in its investor presentation, we believe that part of the retail sales weakness in recent months is due to the company's *inability* to innovate new products that resonate with the consumer. High SKU counts might make for good optics, but the majority of the company's product introductions have failed to gain traction with consumers, and there's clearly a limit to how much cauliflower pizza Sam's Club's customers will buy. SKU-specific retail scanner data confirms that Tattooed Chef hasn't had any meaningful new product introductions over the last year, which bodes poorly for the prospects of meeting its comically aggressive 2021 guidance of +80% growth in branded products.

[6] SKU counts are also artificially inflated because even minor differences such as slightly different seasoning or package size will necessitate different SKUs.

The concentration of Tattooed Chef's sales in just a few items at Sam's Club is critical because the ~$70 million in private label revenues that the company expects to generate this year don't account for more than a small fraction of the current $1.1 billion enterprise value. We estimate that over 90% of that value resides in the $80 million branded business. As absurd as it might seem, just about three quarters of those revenues come from a single customer, and in our estimate, about three quarters of *that* comes from just 4 or 5 products. And yet, the branded business trades at about 13x this year's sales.

Beyond Sam's Club, the rest of Tattooed Chef's branded revenue is split between Costco, which stocks a maximum of two SKUs from Tattooed Chef in just 3 of their 8 regions, and a smattering of Ahold-owned supermarkets in the US. That highlights another layer of concentration that poses a risk to Tattooed Chef's business: close to 90% of branded sales are made into the club store channel. In our view, that exposure isn't accidental, and it reflects the underlying limitations of Tattooed Chef's business that will make it difficult for the company to expand into the grocery channel.

As discussed previously, Tattooed Chef's predecessor company – Ittella – was selling private label riced cauliflower to Sam's Club and Costco even before Sarah Galletti's dream inspired the creation of Tattooed Chef. When her father greenlit the Tattooed Chef project, there were two possible directions in which to go. Sam Galletti could have used his longstanding relationships with supermarkets and distributors to build the Tattooed Chef brand traditionally, starting to distribute regionally near Ittella's headquarters in Los Angeles and rapidly expanding after that if the brand resonated with consumers. Instead, he chose to pilot the new brand in Sam's Club and Costco stores, taking advantage of the relationships built with those customers on the private label side of the business.

The wholesale club channel is much smaller than the grocer channel, the latter of which accounts for about 60% of the retail grocery sales in the US. Grocery sales at wholesale clubs are also dominated by just two players – Costco and Sam's club, both of which are known for extremely low prices and aggressive price negotiation with vendors. By their nature, wholesale clubs stock a limited range of grocery products in large quantities and sizes, most of which they expect to be highly differentiated from the fare available at supermarkets, and a lot of which is rotational, seasonal, or available for a limited time. Anyone who has shopped at the grocery section at a wholesale club knows that the only products consistently stocked are "plain vanilla" grocery staples like fruit and vegetable mixes, dairy products, and other "unprepared" foods. Items like Tattooed Chef Mexican Style Street Corn are available much more sporadically. At worst they are quickly discarded if customers don't take to them; otherwise, they're given only a limited number of rotational stocking opportunities so that customer fatigue can be avoided. Though these strategies succeed at cultivating the "treasure hunt atmosphere" for which club stores are known, they also explain why the club store channel is usually the last one to be addressed by CPG companies: profitability is limited, SKU count is low, and consistent production schedules are atypical.

So why did Ittella start by rolling out Tattooed Chef in the club channel? Perhaps because what the club store channel lacks in volume, profitability, and consistency, it somewhat makes up for in sheer simplicity, particularly from the standpoint of a small vendor. For one thing, the limited product selection played right into Tattooed Chef's lack of product assortment, and it continues to accord with their demonstrated inability to successfully innovate new concepts. Tattooed Chef didn't need a coherent brand proposition to sell at Sam's and Costco; it just needed a few products that could sell well during 2 or 3 8-week periods per year for a couple of years. Additionally, relationships with supermarkets and their distributors are high-touch, requiring the vendor to develop comprehensive merchandising programs that include strategic targeted price reduction plans (i.e., when products go on sale), product size and assortment ideas, price point and shelf placement proposals, and a differentiated brand presentation. Selling into wholesale clubs, on the other hand, just requires delivering product for every-day low-price retailers to stock on their shelves. In short, selling an array of products into the grocery channel requires a complex set of institutional capabilities that Tattooed Chef never possessed, *and which it continues to lack*, but which were never needed to hit the shelves at Sam's or Costco.

Tattooed Chef revenue and profitability 2019-2020

Fiscal Quarter Ending:	3/31/19	6/30/19	9/30/19	12/31/19	3/31/20	6/30/20	9/30/20
Private Label	14.3	13.5	19.0	17.0	15.1	14.0	18.4
TC	1.7	1.9	5.8	9.8	17.6	20.6	22.6
Other	1.0	0.9	-	-	0.4	0.1	
Total Revenue	**17.0**	**16.3**	**24.8**	**26.8**	**33.2**	**34.8**	**41.0**
Gross Profit	3.4	1.9	4.5	3.9	9.2	3.7	3.8
Gross Margin %	*20.0%*	*11.9%*	*18.2%*	*14.4%*	*27.9%*	*10.8%*	*9.2%*
EBITDA	2.1	0.4	2.3	2.2	7.0	2.0	1.5
EBITDA Margin %	*12.1%*	*2.2%*	*9.4%*	*8.3%*	*21.2%*	*5.6%*	*3.6%*

Source: Company filings, Kerrisdale analysis

Unfortunately for Tattooed Chef, the club channel has lived up to its reputation of being tough on vendors and consequently much less profitable. As the table above indicates, Tattooed Chef's gross margins have pretty consistently declined as the branded proportion of revenues has increased. The only exception to that has been the first quarter of the current year, in which gross margins jumped to abnormally high levels entirely because pandemic-induced supply chain disruptions at large CPG companies forced retailers to scramble to find frozen food inventory *at any price*. In the following quarter, branded revenue comprised 60% of the total, yet gross margins declined back to the ~10% level, and were in fact lower than the corresponding quarter in the previous year (when branded revenue was only 12% of the total). For Tattooed Chef to imply, as it does in its investor presentation, that 2020 EBITDA margins increased *commensurately* with branded revenues, is flatly disingenuous. It seems a lot more likely, based on the above table, that private label revenues are in fact *more* profitable than branded sales to wholesale clubs, which is much more consistent with CPG sector trends in general.

Moreover, the most recent quarter, in which gross margins declined to their lowest level in 2 years, is likely to be a lot more representative of the club channel business than management has led on. During prepared remarks on the third quarter earnings call, management blamed a “one-time” promotion at Costco in which Tattooed Chef Acai bowls were sold over the course of 8 weeks (the typical seasonal club offering window) and which cost Tattooed Chef $1.4 million in gross profit. Management portrayed this as their own decision aimed at “growing brand awareness.” But running costly promotions at Costco is not an exception to the modus operandi of selling to wholesale clubs, it’s the rule, and it puts Tattooed Chef in the unenviable position of overwhelmingly selling its product to customers that will squeeze the company on costs.

Beyond the weaknesses that that make the club stores perhaps the only attainable sales channel (at scale) for Tattooed Chef, the reliance on Sam’s will exacerbate the difficulties in penetrating the grocery channel.[7] In our discussions with Sam’s Club’s frozen food buyers, they explained that they’ve made it very clear to Tattooed Chef that they expect that the Tattooed-Chef-branded products on their shelves remain unique to Sam’s. Sam’s Club sees itself, in its buyers’ words, as responsible for “helping to launch [Tattooed Chef] to where it is today.” As such, Sam’s buyers believe that they are due some fealty from Tattooed Chef and have no desire to compete with supermarkets on a limited set of products that have thus far sold well in their seasonal rotations at Sam’s. That virtually kills any opportunity for the company to leverage its small number of successful products into larger opportunities. And while we’ve seen Tattooed Chef, and some of its more excited investors, try and talk up expansion in Wal Mart, it’s fairly clear from Sam’s buyers that they won’t tolerate any of the successful Tattooed Chef products in the club’s freezers being cannibalized by sales at Wal Mart. That’s almost certainly why Tattooed Chef has recently boasted of penetrating half of the Wal Mart store base; the other half is probably off limits due to proximity to a Sam’s Club.

Sam’s buyers have also strongly encouraged Tattooed Chef to stick with more staid frozen vegetables and vegetable mixes if they want to start penetrating the grocery channel, leaving the more differentiated prepared foods at Sam’s (and potentially Wal Marts in geographic locations that won’t cannibalize Sam’s). Our discussions with grocery chain buyers and supermarket distributors unfortunately gave us the impression that the last thing they really need is a chic or “edgy” bag of frozen vegetables (Cascadian Farms already serves much of that niche), and it’s worth pointing out that even if successful, frozen vegetables are neither as profitable, nor as large a market as frozen prepared meals.[8] It certainly won’t be enough to meet Tattooed Chef’s overly aggressive growth targets, let alone justify its egregious valuation.

---

[7] We exclude Costco from this analysis because the vast majority of what Tattooed Chef has sold to Costco is large bags of spiralized zucchini, which is sufficiently commoditized as to make the ensuing discussion irrelevant.

[8] Based on Nielsen scanner data, the market for mixed vegetables at retail is about 1/10th the size of the combined frozen prepared foods and pizza market.

The irony of Tattooed Chef's reliance on Sam's Club is that its lack of experience and competence in selling consumer packaged goods made Sam's the only realistic target for the company's initial product launches. Now that Sam's is its only major customer, the need to keep them happy will prevent Tattooed Chef from even *trying* to leverage its small number of successful products by rolling them out into the grocery channel. We expect Tattooed Chef to take its place among the many niche brands, besides private label brands like Kirkland and Maker's Mark, that can be found at wholesale clubs but seldom anywhere else.

V. Conclusion

For the current year, Tattooed Chef will generate about $70 million in private label frozen vegetable sales, $50-55 million in branded sales to Sam's Club, and $25-30 million in branded sales to Costco, Target and a single supermarket chain. Of those branded sales, about three quarters come from 4-5 prepared meal products and 2 frozen vegetable mixes. Retail scanner data shows that the brand's sales at retail have recently declined from summer levels in contrast to the frozen food category as a whole rising over that time, which suggests that the company's branded sales momentum has badly stalled. And yet, with a concentrated customer base and flailing momentum at the consumer level, the company has garnered a $1.1 billion valuation, or 13x its branded 2020 sales.

Poring through transaction data in the consumer packaged goods industry, the only recent deal with a somewhat relevant profile was a Blackstone-led group's $200 million investment in late July of this year in Oatly, a plant-based milk company based in Sweden but whose revenues are derived primarily in the US. With Oatly putting up two consecutive years of +100% revenue growth, the investment valued the company at about 5x 2020 revenues of $400 million. At the same valuation, Tattooed Chef would be valued at about $450 million, or $9/share.

That valuation might be justified if, like Oatly, Tattooed Chef had a clear track record of broad grocery industry penetration and a path to long term growth. But it doesn't. Discussions with both its customers and potential customers suggest that breaking into the grocer channel requires a set of capabilities that the company clearly doesn't possess, and the suggestion that growth will come from direct to consumer shipments of frozen products like cauliflower pizza is frankly laughable given the difficulty and expense of shipping frozen food. We think investors' best course of action is to make the same choice Sam Galletti did just a few weeks ago when he chose $25 million in cash instead of $60 million in stock – sell while you can, because once investors realize just how overvalued TTCF is, there won't be too many chefs left in this kitchen.

Full Legal Disclaimer

As of the publication date of this report, Kerrisdale Capital Management LLC and its affiliates (collectively "Kerrisdale") have short positions in the stock of Tattooed Chef, Inc. ("TTCF"). In addition, others that contributed research to this report and others that we have shared our research with (collectively with Kerrisdale, the "Authors") likewise may have short positions in the stock of TTCF. The Authors stand to realize gains in the event that the price of the stock decreases. Following publication of the report, the Authors may transact in the securities of the company covered herein. All content in this report represent the opinions of Kerrisdale. The Authors have obtained all information herein from sources they believe to be accurate and reliable. However, such information is presented "as is," without warranty of any kind – whether express or implied. The Authors make no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results obtained from its use. All expressions of opinion are subject to change without notice, and the Authors do not undertake to update or supplement this report or any information contained herein. This report is not a recommendation to short the shares of any company, including TTCF, and is only a discussion of why Kerrisdale is short TTCF.

This document is for informational purposes only and it is not intended as an official confirmation of any transaction. All market prices, data and other information are not warranted as to completeness or accuracy and are subject to change without notice. The information included in this document is based upon selected public market data and reflects prevailing conditions and the Authors' views as of this date, all of which are accordingly subject to change. The Authors' opinions and estimates constitute a best efforts judgment and should be regarded as indicative, preliminary and for illustrative purposes only.

Any investment involves substantial risks, including, but not limited to, pricing volatility, inadequate liquidity, and the potential complete loss of principal. This report's estimated fundamental value only represents a best efforts estimate of the potential fundamental valuation of a specific security, and is not expressed as, or implied as, assessments of the quality of a security, a summary of past performance, or an actionable investment strategy for an investor.

This document does not in any way constitute an offer or solicitation of an offer to buy or sell any investment, security, or commodity discussed herein or of any of the affiliates of the Authors. Also, this document does not in any way constitute an offer or solicitation of an offer to buy or sell any security in any jurisdiction in which such an offer would be unlawful under the securities laws of such jurisdiction. To the best of the Authors' abilities and beliefs, all information contained herein is accurate and reliable. The Authors reserve the rights for their affiliates, officers, and employees to hold cash or derivative positions in any company discussed in this document at any time. As of the original publication date of this document, investors should assume that the Authors are short shares of TTCF and stand to potentially realize gains in the event that the market valuation of the company's common equity is lower than prior to the original publication date. These affiliates, officers, and individuals shall have no obligation to inform any investor or viewer of this report about their historical, current, and future trading activities. In addition, the Authors may benefit from any change in the valuation of any other companies, securities, or commodities discussed in this document. Analysts who prepared this report are compensated based upon (among other factors) the overall profitability of the Authors' operations and their affiliates. The compensation structure for the Authors' analysts is generally a derivative of their effectiveness in generating and communicating new investment ideas and the performance of recommended strategies for the Authors. This could represent a potential conflict of interest in the statements and opinions in the Authors' documents.

The information contained in this document may include, or incorporate by reference, forward-looking statements, which would include any statements that are not statements of historical fact. Any or all of the Authors' forward-looking assumptions, expectations, projections, intentions or beliefs about future events may turn out to be wrong. These forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks, uncertainties and other factors, most of which are beyond the Authors' control. Investors should conduct independent due diligence, with assistance from professional financial, legal and tax experts, on all securities, companies, and commodities discussed in this document and develop a stand-alone judgment of the relevant markets prior to making any investment decision.