

Rev/Employee: \$952.37 k Number of Employees: 25,355 Avg ROIC: 3.92% Food and Staples

USFD: Pursuing an Independent Path

US Foods Chairman & CEO Pietro Satriano (55) has more flexibility and control over his firm now that his original private equity backers KKR and Clayton, Dubilier & Rice (CD&R) have sold their shares via several secondary offerings in 2017. KKR and CD&R once had a combined ownership stake of 75.6% following the firm's 2016 IPO at \$23, but a failed merger with Sysco the year before dictated a stand-alone growth strategy. Now, we see a better capital structure for outside investors although we note insiders have sold significant stock in the last year. CEO Satriano has returned USFD to its core strategy of quality differentiation through innovation (Great Food. Made Easy.) following the FTC's blocking of the proposed merger with Sysco in 2015. SYF and USFD are the #1 and #2 players respectively in the food distribution industry. We like Satriano's general strategic premise that quality trumps volume or price over time in the specific markets USFD serves. The Board has made improvements to management's incentive plan and the seasoned management team is clearly focused on a 2020 operating plan that differentiates them from their larger competitor.



Executive Team Skills Fit CEO Satriano's focus on product differentiation is predicated on a Lean continuous improvement methodology. At Investor Day last month, Satriano said, "The way I think about continuous improvement is as both a tool set and, as importantly, it's a mindset. It is a mindset by which you engage frontline employees in identifying best practices, standardizing those best practices across the enterprise, and then continuously improving upon those practices. All in the never-ending quest to eliminate waste, to

	OLD SCHOOL	US FOODS
Corporate Relationship	Limited Compliance	<ul style="list-style-type: none"> Empowered Single Point of Contact Consistent Execution
Seller	Administrative	<ul style="list-style-type: none"> Consultative Selling Local Support
Specialist Resource	Ad Hoc	<ul style="list-style-type: none"> National Coverage Cost Management, Culinary Support
Business Development	Siloed	<ul style="list-style-type: none"> Corporate and Local Alignment
Pricing	Locally Managed	<ul style="list-style-type: none"> Centrally Set and Managed Reliable Audits
Enabling Technology	Limited	<ul style="list-style-type: none"> E-commerce and Mobile Punch Out Capabilities

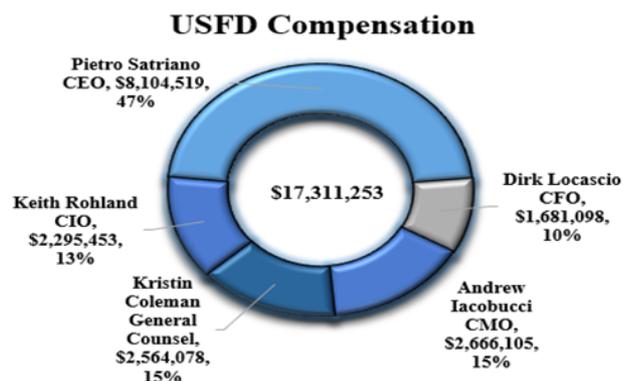
Source: USFD 3-15-18

improve the customer experience, and to reduce and improve our cost structure." Last year CEO Satriano acquired 3 broadline foodservice distributors and 2 other specialty distributors and he says his acquisition pipeline remains robust. USFD's focus is on selling to independent restaurant chains, along with healthcare and hospitality customers, where cost is less of a volume driver and quality of product is integral to brand equity. The CEO says acquisitions are a key part of his strategy, as organic growth has been lackluster in the last year. His senior management team is comprised of 12 EVP/SVP executives with functional responsibilities. Satriano has been the CEO at U.S. Foods since 2015, after serving as the Chief Merchandising Officer for four years, and became Chairman last December. We like his early experience with BCG and Monitor consulting, but most of working career has been spent moving back-and-forth between the food industry and the customer loyalty/rewards industry. We like his prior work experience as an EVP at Loblaw Brands from 2002-2008 and note that it was bracketed by two stints at the Loyalty Group, running their US air miles program (2000-02) and their Canadian air miles program (2009-11). Satriano has a BA and an MBA from Harvard University. CFO Dirk Locascio (46) was promoted to his current role in February 2017. He is the former Controller, a CPA, and has worked in USFD's finance department since 2009. He replaced Fared Khan, who left to take the CFO role at Kellogg last year. CFO Locascio is targeting 10% EBITDA growth for 2020 and lowered the firm's average borrowing cost by 50 basis points last year and says there's potential for another 25 basis point reduction this year. Management used the majority of the IPO proceeds to repay debt, and it has fallen to \$3.8 billion (from 5.4x EBITDA to 3.6x). We think the CFO has also done a good job on cost containment and he says there is further room for operating expense improvement, the bulk of which will likely come from the supply chain. Chief Supply Officer Ty Gent (58) was brought out of retirement about a year ago after a 3 decade career at PepsiCo, most recently as SVP of Operations for Central and South America and SVP of Logistics for North America. Chief Merchandising Officer Andrew Iacobucci (51) works closely with EVP Steve Guberman who heads National Sales. Iacobucci has been with USFD since January of 2017 and previously worked at global Dutch food retailer Ahold USA as their EVP, Merchandising, but we note it was for less than a year.

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Iacobucci and CEO Satriano share a tenure with the Loblaw Companies where EVP Iacobucci worked for 10 years, including as President of their Discount Division. CIO Keith Rohland (50) joined USFD in 2011 and is one of the longest tenured managers. He has recently redesigned the firm's website to make it friendlier for prospective customers.

Compensation and Alignment Analysis Changes to the Board's composition in the last two years has led to dramatic improvements in the pay and governance structure at USFD, but there is more to be done. We like that the Board amended executives' severance agreements to eliminate certain tax gross-up payments, along with adding options to the long term equity LTIP mix. The CEO's annual target compensation mix, is 15.5% salary, 22.6% cash bonus, and 61.8% equity LTIP (split equally between options, PSUs, and RSUs), which we think will provide strong alignment with his investors. The CEO received a salary increase to \$1 million this year. In 2017, CEO Satriano's total pay was worth about \$8.1 million, with \$5.6 million in equity, a \$971k salary, a \$1.5 million bonus, and \$30k in other pay. CFO Locascio also received a large 51.5% salary hike this year to \$500k from \$330k, due to his promotion, and we note that his salary is still less than his predecessor's \$650k. The CFO's total pay last year was \$1.7 million, but included only \$801k in equity, which we think is low. Management's restricted stock "RSUs" time vest ratably over 4 years, encouraging retention and will significantly boost the team's equity skin-in-the-game as the new hires vest in their initial grants. Management's annual cash bonuses are determined by adjusted EBITDA (90%) and net debt (10%) targets. We like that the Board has ended a previous bonus component of "extraordinary individual performance", but think the bonus plan need to incorporate a third revenue growth related metric to properly incentivize the executives. The long term equity LTIP emphasizes cash flow with a 70% weight on adjusted EBITDA, with the balance determined by ROIC.



Equity Ownership Analysis Current Directors and officers own relatively little stock in USFD. Total D&O beneficial ownership is about 1.1 million shares, which is only 0.5% of USFD, although we note the senior executive ranks have many new additions. CEO Satriano is the leading personal stakeholder, with 512k beneficial shares, but this represents only 2x his total pay. CFO Locascio and CIO Rohland own 118k and 212k beneficial shares, respectively. We note that all executives are expected to own at least 3x their salary levels within 5 years of being hired. Management's 1.4 million vested options are deeply in-the-money at a weighted average strike price of \$18.5 which provides strong alignment with outside shareholder (though we note that about 70% of that stake belongs to CEO Satriano). Insider selling over the last 18 months by CEO Satriano and CIO Rohland is cautionary. They sold 46% and 33% of their beneficially owned shares, respectively. The CEO's net proceeds from stock sales since May of last year are about \$8.4 million and CIO Rohland's are about \$1.9 million. We note that former CEO and Director John Lederer (62) sold stock with net proceeds of over \$44.6 million in the last year.

Capital Allocation Practices CFO Locascio has been clear about the team's capital allocation plans for the next three years and we think it will improve the firm's operating profile materially. The CFO intends to increase CapEx to 1.1%-1.2% of sales (a step-up from the 0.7%-0.9% range over the last 3 years) to correct for prior CapEx spending that did not keep up with D&A. CapEx is budgeted at \$800 million - \$1 billion range, with M&A coming in at \$600 million, and \$300 million in share repurchases. This leaves \$800 million - \$1 billion for repaying debt. Management says they are looking for 4 - 6 tactical acquisition transactions costing about \$200 million per year (last year they completed 5 deals for a total of about \$182 million). CFO Locascio also wants to reduce debt and bring USFD's net leverage ratio down to 2.5x from the current 3.4x. The Board has also approved a share repurchase authorization for this year and management has bought back 10 million shares, which were subsequently retired,



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from the December secondary offering by CD&R and KKR selling their remaining shares. Management's stated capital allocation plans will require significant increases in operating cash flow, which was \$748.4 million last year, and CFO Locascio says he expects to generate OCF of \$2.6 billion - \$2.8 billion over the next 3 years.

Material Fiduciary Issues Chairman Satriano's Board has seen major changes with the departure of its private equity owners and shift to public ownership. The Board is currently comprised of 8 Directors, with 6 new ones since 2016. Rober Dutkowsky (63, CEO of Tech Data) is the lead independent Director. This includes 4 new members in 2017-2018 including: Ann Ziegler (59) and Sunil Gupta (59). Director Ziegler was appointed last November, and we think she brings good financial experience as the former CFO of CDW (2008-17). Director Gupta is a professor at Harvard Business School and Chair of the HBS General Management program that we think should prove useful to USFD.