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Whopping large debts

Two Mondays ago, when TOMS King, LLC, a Burger King franchisee with 90 stores in Ohio, Pennsylvania, Virginia and Illinois, filed for bankruptcy protection, extreme financial engineering moved back into the amber spotlight. We write not to harry the restaurant industry per se but to point out the risks that inflation presents to leveraged capital structures.

In 2010, the Brazilian investment fund 3G Capital bought Burger King Holdings, Inc. Four years later, 3G merged the fast-food chain with the Canadian coffee giant Tim Hortons, Inc., forming Restaurant Brands International (QSR on the New York Stock Exchange). Chicken-concept Popeyes Louisiana Kitchen, Inc. joined the roll-up in 2017, with sub-sandwich maker Firehouse Restaurant Group, Inc. following in 2021.

Radical cost-cutting is the 3G way of management. Out go costly tenured staff; in come the "Ph.D.s," their successors, the "poor, hungry and driven." Out go the color copiers; in come the monochrome units. Each fiscal period, employees have to justify every outlay in a practice known as zero-based budgeting. No mechanistic building on the prior period's budget on 3G's watch.

Even as it conducted its own acquisition spree, RBI prodded its franchisees to take on debt to buy one another. With fewer franchisees to manage, the parent needed fewer supervisory employees to crack the whip on revenue-deficient underperformers. "That gave Restaurant Brands the ability to cut G&A, including marketing and franchise supervision," John Hamburger, the president of Franchise Times Corp., advises via email.

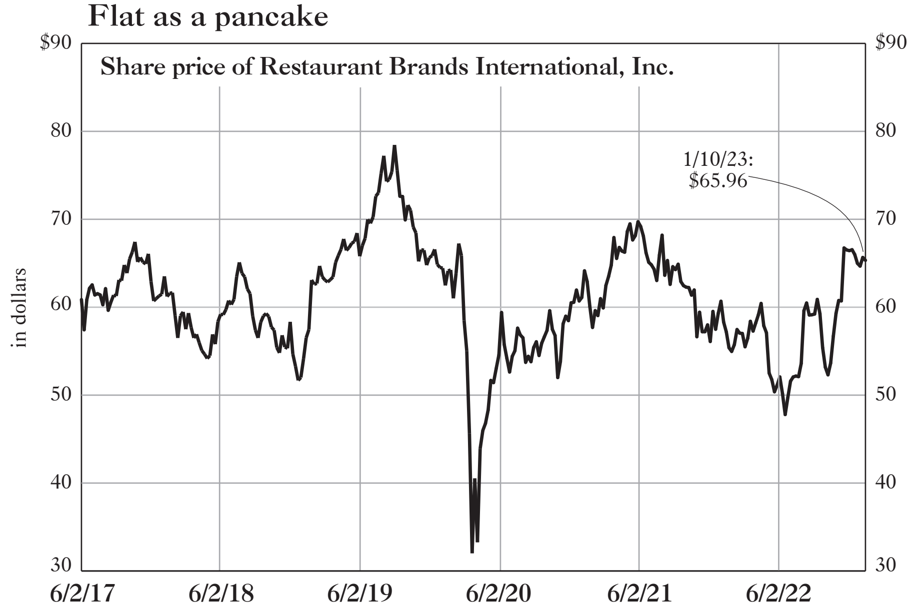
The legacy of these acquisitions is that both RBI and its franchisees are heavily leveraged. As of Sept. 30, 2022, the double-B-rated Restaurant Brands balance sheet showed $12.3 billion in net debt, a sum equal to 5.7 times trailing Ebitda. RBI's largest franchisee, Carrols Restaurant Group, Inc., which operates 1,022 Burger King and 65 Popeyes outlets, is a public company with all the associated, informative transparency. As of Oct. 2, 2022, Caa1/triple-C-plus-rated Carrols showed net debt plus leases amounting to $1.3 billion, or 7.9 times trailing Ebitda plus rent, or Ebitdar.

Every now and then a window cracks open to reveal towering leverage in American fast-food franchisees. Last June, for instance, Fitch Ratings downgraded GPS Hospitality Holding Company, LLC, which operates 365 Burger Kings, 62 Pizza Huts and 19 Popeyes, to triple-C-plus from single-B-minus. Fitch noted that GPS's net debt plus operating leases summed to 9 times trailing Ebitdar and that leverage might climb to 10 times by year end.

"Typically, in a fast-food business, you would max out around five or, on rare occasion, six times [leverage]," Hamburger tells *Grant's*. "Other franchise systems wouldn't allow it to get out of control like that."

Of course, heavy debt pairs badly with adversity; Restaurant Brands and its franchisees are more vulnerable than they would otherwise be to the banana peels

Flat as a pancake



source: The Bloomberg

of corporate life, micro and macro alike. Perhaps the "Have it your way!" team would have been better served with a little more marketing. In the three years ended Sept. 30, 2022, Burger King's American same-store sales declined by a cumulative 0.9%. For comparison, over the same period, Wendy's Co. expanded its American same-store sales by 16.2%, McDonald's Corp. by 21.6%.

The encumbered franchisees were ill-equipped to handle the post-virus surge in prices. "Recent increases in costs of shipping and food, decreased availability of labor, and inflation generally have exacerbated the Debtors' cash flow issues," TOMS King chief restructuring officer Daniel Dooley wrote the court in support of the bankruptcy filing. Hamburger advises *Grant's* to expect additional bankruptcy filings from other Burger King operators.

In October 2021, as part of a plan to improve its American operations, Restaurant Brands appointed Tom Curtis, a former executive vice president at Domino's Pizza, Inc., president of Burger King U.S. and Canada. Last September, the company activated its "Reclaim the Flame" turnaround strategy for North America, which commits RBI to investing $150 million in advertising and $250 million in restaurant upgrades for its franchisees over the next two years.

Unfortunately, "Reclaim the Flame" is progressing as the consumer is retrenching. According to Black Box Intelligence, comparable sales across all U.S. restaurants advanced by 3.4% year over year in November, a deceleration from the 5.2% growth logged in October. Notably, these declines occurred in the context of a strong jobs market and growing wages. A recession would only add to the degree of difficulty of the projected turnaround.

Nevertheless, QSR trades at 24.4 times trailing earnings and 19.8 times enterprise value to trailing Ebitda. Perhaps Mr. Market reasons that it's the franchisees, not Restaurant Brands, that face operating income deleveraging from slowing sales and rising prices. It's a line of demarcation, however, that RBI's commitment to invest in its franchise base has blurred, and that puts the fancy QSR multiple at risk.

Since we first had our bearish say on Restaurant Brands in the issue of *Grant's* dated June 2, 2017, QSR has generated a total return of 29.5%, lagging the 77.5% gain in the S&P 500. Leverage isn't necessarily the fail-safe accelerant of share-price performance that it's so often cracked up to be.

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