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Fast-food takeout

You could hardly ask for a better jobs report than January's—hourly wages popped by 3.2%—or a happier consumer data point than December's—serious mortgage delinquencies faded to the lowest rate since 2007. Yet the restaurant business stumbles along as if the nation were on a crash diet.

Speculation on the inability of even the best restaurant managements to generate top-line growth in excess of the rate of inflation is the first order of business. A new analysis of Restaurant Brands International, Inc., the fast-food roll-up sanctioned by the investments of Warren Buffett, Bill Ackman and 3G Capital, is the second. In preview, with due respect to the international bullish triumvirate, we renew our bearish call on RBI (on the New York Stock Exchange, the ticker is QSR).

You could almost say—we'll say it—that the tribulations of the American restaurant industry are a mirror to the 2019 state of the Union. At play are the consequences, for good and ill, of a decade's worth of cheap capital. In evidence, too, is the persistence of weak restaurant pricing, the central bankers' inflationary intentions notwithstanding. It may surprise the Federal Open Market Committee to discover that Burger King is offering 10 chicken nuggets for $1, or that, at McDonald's, $5 buys you two sandwiches.

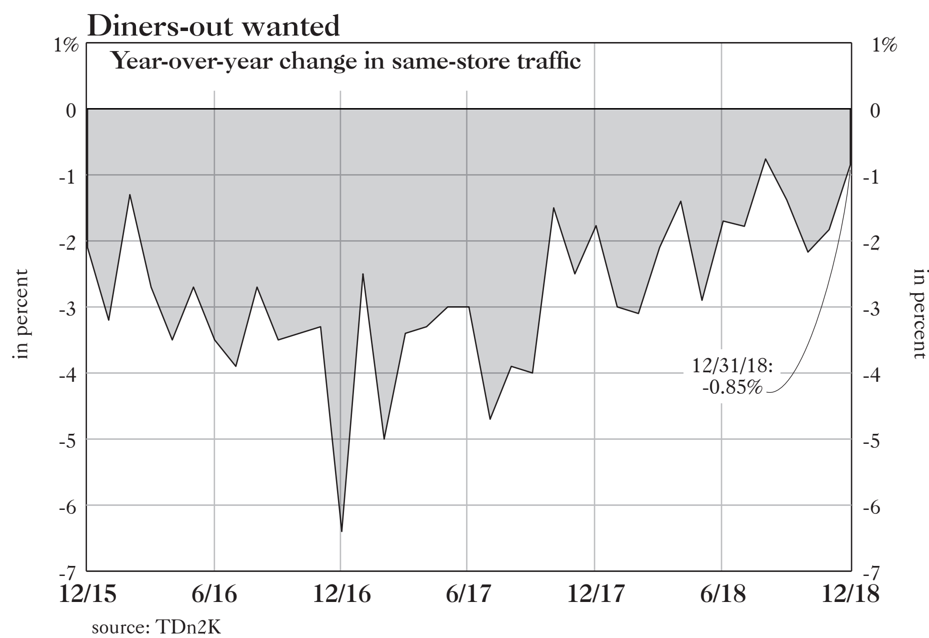
We happen to have a theory about these goings-on: Capital-for-the-asking led to restaurant overexpansion, which led to weak menu prices, which led to margin compression, which led to class conflict. The restaurant-specific conflict finds expression in the new animus between the franchisees and franchisors as well as in the bicoastal imposition of a $15 minimum wage.

Facilitated by low interest rates, restaurant construction boomed even in the Great Recession. According to NPD Group, Inc., the store count climbed by 1.9% in 2008 and 1.4% in 2009, and it kept growing through 2016. To many a fast-food chain, the prospective return on investment took a back seat to the visible cost of investment.

Hence, what David Henkes, a senior principal at Technomic, Inc., calls restaurant saturation, even "over-saturation." Or, perhaps, an under-saturation of diners. "Traffic—the number of people going to restaurants—is essentially flat," Henkes tells colleague Evan Lorenz, "because you have more restaurants that are serving more consumers per capita than ever before."

As usual, facts emerge in earnings season. For instance, Brinker International, Inc., parent of Chili's and Maggiano's Little Italy, reported satisfactory revenues (up 3.2% year-over-year to $790.7 million vs. estimates of $780.4 million) but weak restaurant operating margins. Discounting pushed them down to 12.4% from 14.9% in the comparable quarter in 2017. "How long can you continue to drive sales growth with traffic declines?" CEO Wyman Roberts rhetorically inquired on Brinker's Jan. 29 earnings call.

A Wendy's Co. franchisee we know (he asks to go nameless) affirms that business is a struggle—though, for him, still a profitable one. The corporate of-



fice sets the strategy: more technology, annual remodeling (10% of one's stores a year), more locations. To the franchisees falls the obligation to implement the grand design. In pricing, the corporate directive envisions a kind of barbell, featuring low prices on one end, high prices on the other. The hope is to nurture the more affluent customers while accommodating everyone else. The trouble is that all the growth is at the low end, our source relates, echoing the Brinker's complaint: Since transactions are down, he says, "the only real growth we've gotten in recent years is with pricing."

So chicken-nugget prices are falling even as labor costs are rising. On the first day of the new year, 21 states and 19 cities raised the minimum wage, in the case of Seattle, to $16 an hour. It's no skin off the nose of the franchisors, who license their brands in exchange for a royalty fee but themselves operate few, if any, restaurants; it's the franchisees who pay the bills.

Jack in the Box, Inc. (JACK on the Nasdaq) tells the tale. Same-store sales rose by 0.5% or less in the three most recent fiscal quarters. Rent, wages and other operating costs almost certainly rose faster. Even so, the JACK front office is pressing its franchisees to open their wallets to pay for expensive renovations—in 2018, rooflines on 27% of the stores were 40 years old, five years older than the senior-most fast-food target demographic.

Franchisees, booking lower income and facing higher capital commitments, have bridled. In July the National Jack in the Box Franchisee Association voted "no confidence" in Jack's CEO, Leonard Comma. In October, the Association demanded Comma's ouster and an audit of the company's marketing fund. "We often have spirited debates with our franchise community about how we will achieve our goals and objectives," Comma dryly remarked on the Nov. 20 earnings call. On Dec. 4, the spirited franchisees filed suit.

If Jack in the Box feels the franchisees' pain, you wouldn't know it by management's plan to boost corporate leverage to 5.0 times net debt to earnings before interest, taxes, depreciation and amortization from 3.7 times. (Why 5.0? Because, CFO Lance F. Tucker told dialers-in on the November call, some of the businesses with which JACK competes are leveraged by as much 6.5:1.) Proceeds of the contemplated debt offering would be applied to share repurchases. Or, then again, according to a December press release, management might just sell the company.

"JACK isn't unique," Lorenz observes. "In October, McDonald's franchisees voted to band together in an independent association, a first in the burger chain's 64-year history. They wanted a time-out on store remodeling and a say on discounting. *Restaurant Business* broke the news that, according to a November survey of franchisees (undertaken by the franchisees themselves), nearly 9 of 10 respondents were 'unsatisfied with their cash flows.'"

It's no good sign for the run-of-the-mill fast-food franchisee that the McDonald's franchisees, aristocrats of fast food, are struggling. According to the monthly trade magazine *QSR*, the average McDonald's restaurant generates $2.7 million in revenue each year, more than $1 million more than Jack in the Box ($1.5 million), Wendy's ($1.6 million) and Burger King ($1.4 million).

Still, the stock market sees nothing it doesn't like in the business of earning a 5% royalty on the gross revenue of franchised restaurant operators. Aging rooflines and obstreperous franchisees notwithstanding, JACK trades at a ratio of 10.9 times enterprise value to adjusted EBITDA, or 19.6 times trailing adjusted earnings per share.

"There is the belief that the franchisor model, this model of collecting the royalties, is kind of geared to the current environment," John Hamburger, president of the Franchise Times Corp., tells Lorenz. The argument goes like this, Hamburger continues: "Prices are going to go up because wages are going up. Operating expenses are going up, so they will eventually have to raise prices. The place to be is the franchisor where you are collecting a percent of sales."

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Commanding the valuation it does, JACK gives fair warning about the Wall Street standing of Buffett-blessed Restaurant Brands International. Of the 22 analysts on the case, 17 say buy, not one says sell. Shares trade at 18.9 times enterprise value to adjusted EBITDA, 24.1 times trailing adjusted earnings. Since our analysis in the issue of *Grant's* dated June 2, 2017, the share price has risen by 2%, the S&P 500 by 12%.

You'll recall that RBI doesn't operate restaurants. It owns brands—Burger King, Tim Hortons and Popeyes—and collects royalties, 3% to 5% of its franchisees' sales. Where it controls the lease underlying a property, it likewise earns a lease fee.

Restaurant Brands has another source of revenue. To Tim Hortons, and to Tim alone, it sells coffee beans, food, paper cups, kitchen equipment. Restaurant-supply sales help to explain Tim's outsize contribution to RBI's results. In the third quarter of 2018, the Canadian coffee-and-donut chain delivered 22% of the parent's system-wide sales, 52% of its EBITDA.

In 2017, we reported on the growing rancor between RBI and its disaffected Tim Hortons franchisees. Joining forces as the non-company-affiliated Great White North Franchise Association (GWNFA), the splinter group had filed a C$500 million suit against RBI alleging, among other charges, the misappropriation of the franchisees' ad fund to cover corporate expenses.

RBI returned fire in September, seizing the four restaurants owned by David Hughes, then-president of GWNFA, on the ground that he had disparaged the company in violation of his franchise agreement. Neither GWFNA nor RBI came to the phone to comment for this article, the company citing the close proximity of a scheduled fourth-quarter earnings release on Feb. 11.

The market isn't waiting for it, though. A Jan. 23 boost in the quarterly payout, to 50 cents from 45 cents, which points to a 3.2% dividend yield, helped to lift the Restaurant Brands share price by 9.8%. Titillating, too, was the announcement that Daniel Schwartz, the former CEO, will become executive chairman to focus on "talent acquisition, capital allocation and major strategic initiatives," a stock-market dog whistle for M&A.

But even before that speculation, the Street was expecting that Restaurant Brands, between 2018 and 2021, would generate compound annual growth in sales of 5.1% and in adjusted EPS of 10.6%. Nor do the bulls find fault with the RBI capital structure. While rated single-B-plus, for middling speculative-grade, and leveraged 5.3 times net debt to EBITDA, the company generated enough operating income in the third quarter to cover interest expense by 3.5:1. The second-lien Restaurant Brands 5s of 2025 change hands at 97.5 to yield 5.5%, a spread of 301 basis points over Treasurys, 140 basis points better than the average junk bond.

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Speaking at the Spring 2018 *Grant's* Conference, the afore-quoted Hamburger boiled down the bear case on the franchised restaurant business to the growing inequality between franchisees and franchisors. "You can't have one side of the franchise contract getting fabulously rich while the other side faces these headwinds alone," said our speaker. "The concept of a moat around the franchisor is a myth. That somehow a brand can separate itself from the unit-level economics of its franchisees is not grounded in reality." (See *Grant's*, April 20, 2018.)

Those economics are becoming problematical. In December, industry-wide restaurant traffic slumped by 0.85%. To generate same-store sales growth of as little as 2%, the chains pursue the lose-lose stratagem of competitive discounting while loading capital-spending demands on the sagging shoulders of their franchisees. If this were 2016 in America, the franchisees would be the deplorables, the franchisors the out-of-touch elite.

Burger King franchisees are spending $650,000 a unit to comply with the corporate remodeling program, according to Carrols Restaurant Group, Inc., Burger King's largest franchisee. Another such initiative is said to be in the works for Burger King, while the RBI front office is pushing for upgrades across the Tim Hortons chain.

Some franchisors have sacrificed their own margins to show solidarity with their struggling franchisees. Wendy's is one such example, McDonald's another. It's uncertain how successful these overtures will prove to be. As noted, McDonald's franchisees are up in arms despite the parent's offer to cover 55% of the cost of restaurant remodeling for work completed by 2020, 40% for work performed thereafter. "And McDonald's is the gold standard," a buy-side analyst who asks to go nameless tells Lorenz. "We know that Jack in the Box franchisees are upset and organizing. How healthy are these other systems that are less desirable?"

While the number of restaurant units has slowly begun to contract (down 1% in spring 2018 from the year-earlier census), Domino's Pizza, Inc., America's No. 1 pizza chain by sales, has embarked on a drive to add 2,000 stores to its existing 5,751 U.S. locations. "Fortressing" is how the C-suite describes this imperial ambition. Perhaps Domino's has earned the benefit of the doubt, but even the best managements can overreach, as Domino's itself seems to have done in Australia.

Domino's Pizza Enterprises Ltd. (DMP on the Australia Securities Exchange), the master franchisee Down Under, is on an expansion drive. In the three years ended in mid-2018, it had boosted its store count in Australia and New Zealand to 819 from 670. Such growth did not occur spontaneously. Sixty percent of it resulted from headquarters' command to subfranchisees to split their territories and build new stores. In October, DMP ordered an additional 380 stores in the Antipodes, splits accounting for 80%–90% of the increase.

In the language of worldwide populism, the yellow-vest/deplorable/Brexit-like Aussie franchisees turned out to condemn the plan. "In a nutshell, Domino's took the opportunity to ruin my personal and professional life and left me on the edge of bankruptcy," read one complaint to an Australian parliamentary investigatory committee. "It was not only me who got scammed by Domino's dream selling ideas, but a lot of other people as well. Broken marriages, bankrupt people and a lot of people's health has been affected by these giant corporations."

Back, now, to North America. "There are too many marginally profitable restaurants kept alive by low interest rates and financial engineering," Hamburger told Lorenz the other day. "If we were to get a recession, the dominoes would fall and you would have a pretty significant unit decline in the industry."

Certainly, the Canadian economy is wheezing. "I think we're just on the precipice of embarking on a serious recession, Jim Mylonas, global macro strategic at Montreal-based BCA Research, Inc., told Bloomberg on Jan. 23. "It's not a matter of if, but when."

Growth in Canadian retail sales declined to 0.5% in November from 3.9% in June. Since Canada's population expanded by 1.4% in the fourth quarter, measured year-over-year, per capita retail sales actually fell. According to a January MNP Ltd. poll, a C$200 rise in monthly expenses would push 46% of Canadian households into insolvency, up from 39% in a September survey. The Office of the Superintendent of Bankruptcy Canada reports that 5.1% more households and 8.9% more businesses sought bankruptcy protection in November 2018 than in the year-earlier period.

The Canadian housing bubble has burst. In January, in Vancouver, house sales fell by 39.3%, prices by 4.5%, each measured year-over-year. In December, in Toronto, house sales dropped by 12.7%, prices by 4.3%. Our neighbor to the north is, of course, more levered to real estate than the United States was in the mid-Oughts. At year-end, 7.7% of the Canadian work force was employed in construction, vs. 5.7% of the U.S. work force at the peak in April 2006. Household debt currently totals 174.6% of income in Canada vs. 99.4% in the United States (and 133.8% at the American peak in December 2007).

RBI, as its heavy reliance on Tim Hortons attests, is Canada-centric. The trouble is that the parent's restaurant-supply hookup with Tim Hortons franchisees adds an element of operating leverage to the financial leverage already in place. "Unlike clipping a royalty fee," Lorenz points out, "there are real costs associated with operating a buying group, warehouses and a delivery network. This means RBI has operating leverage to any decline in Tim Hortons sales, which is the very thing that the franchisor model supposedly eliminated. (RBI sees to it that an analyst can't determine what proportion of profits at Tim Hortons is derived from royalties, rents and logistics.)

"If Canada's slow-moving housing bust plays out anything like America's a decade ago," Lorenz proceeds, "RBI could face big problems. Only recall that same-store sales at Starbucks declined by 5% in fiscal 2008 (ended Sept. 30) and 6% in fiscal 2009."

Low growth sweetens no one's disposition, and franchisees and franchisors have had their tussles before. What's different today is, to start with, the greater capital intensity of the fast-food business, and the heavier burden of debt required to sustain it. We here conjecture, as figures are hard to come by, but it appears that franchisees are bearing a disproportionate share of the cost.

"And it's not just the capital you spend," says our friend, the Wendy's franchisee. "It's the contract fees. You might pay $35,000 for hardware and point-of-sale technology for one restaurant, but then you are paying a few thousand every year for maintenance support for those, like call centers. I can tell you that just the maintenance support has probably been 50 basis points on our bottom line."

"Besides," Lorenz notes, "there is the existential question of how many restaurants you really need to satisfy consumer demand. Home-delivery is rapidly growing, taking share from in-store visits.

"While chains like Burger King are in the process of rolling out their own ordering apps," Lorenz goes on, "most consumers have flocked to companies like Seamless North America LLC, Grubhub, Inc. and Uber Eats, which aggregate multiple restaurants onto one easy-to-use platform. Unfortunately for restaurant operators, these aggregators take between 15–30% of gross sales as commission, i.e., almost all the operating profit a traditional restaurant earns. If the lodging industry furnishes any preview, this is bad news for the dining sector. Hotels, like restaurants, feature large franchisors (e.g. Hilton Worldwide Holdings, Inc.) and smaller franchisees. Online-travel agents like Expedia Group, Inc. (*Grant's*, Jan. 12, 2018) have taken the vast majority of online sales despite the availability of online ordering apps from the hotel brands."

"Virtual" or "ghost" kitchens are popping up to capitalize on the delivery wave. Kitchen United, which is funded by Google Ventures, rents large buildings and subleases space specifically designed for delivery-focused restaurateurs. This lowers the capital cost and the time to start a new virtual store. In October, Bloomberg detailed how Uber Eats scans neighborhoods for unmet dining opportunities—it concludes, for instance, that Crown Heights, Brooklyn, is short one burger spot. Armed with this information, it invites local entrepreneurs to open a virtual store.

Two years ago we qualified our bearish analysis with the non-bearish fact that no RBI insiders were selling. We have an update. As of the Oct. 30 reporting date, 3G had sold $560.7 million worth of shares and Daniel Schwartz, the former CEO and current executive chairman, $30.1 million worth. Other insiders have also lightened up over the past year. They may be right or they may be wrong, but they are not uninformed.

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