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Not-so-fine dining

The $2 trillion stimulus bill is the law of the land, and Americans are dutifully keeping their distance from each other and from nearly everything else. What happens with the resumption of hugging, crowding, shopping, dining and drinking is the topic at hand. In preview, we're concerned about working capital, worried about franchisors—and bearish on prepared-foods maker Lancaster Colony Corp. (LANC on the Nasdaq).

The malign coronavirus might as well have targeted the restaurant industry specifically. A new survey by the National Restaurant Association finds that 44% of American eateries have shut their doors, 3% of them for good. Another 11% of respondents estimate that, without patrons, they have 30 days to live.

Employees, suppliers, landlords and franchisors are going unpaid. On Monday, restaurant-supply company Sysco Corp. said it's trimming capital expenditures and headcount and drawing down $1.6 billion of its $2 billion revolving credit line. Last week, The Cheesecake Factory, Inc. (among many others) informed its landlords that the April rent check will not be in the mail.

But surviving the shutdown is only half the battle. John Hamburger, the president of Franchise Times Corp., kindly came to the phone to discuss what's likely to follow. "Now," he told deputy editor Evan Lorenz, "let's look at all these restaurants that are closed. Where are they going to get the capital to open? It's like they will need a Marshall Plan."

The cessation of daily life has its costs. Food spoils, employees disperse, bank accounts dwindle.

"If you were to go back and look at some of the big casual-dining companies, it used to be that you could open these things for a couple hundred thousand dollars," Hamburger went on. "[A] Cheesecake [location] costs $1 million, sometimes, to open."

Besides, reopening restaurants will stretch the resources of the franchisors. In a normal business environment, a major brand might try to open 20 to 30 units a year, each additional unit taxing the brand's operational capacity. Come Covid-19 Liberation Day, each franchisor will confront the need to reopen most or all of its restaurants simultaneously.

These problems are not unique to dining out. Apparel retailers are sitting on inventory that will be out of season by the time shopping resumes. It's perhaps noteworthy that discounters TJX Cos., Inc. and Ross Stores, Inc. have canceled all orders through mid-June and are slow-walking their payments to vendors.

For some, there's an upside, as always. Survivors that can reopen will likely face less competition and earn better returns after the blessed return to normalcy. But the shutdown and cost to restart will accelerate the permanent closure of marginal units and struggling chains.

What sets the restaurant business apart is the divide between franchisors and franchisees. Wall Street loves the former—or did until just about a month ago—because the principal business of the franchisor was cashing checks from its hard-working franchisees. It was the latter who did the grubby work of actually running a restaurant. So it was that investors cheered as big-brand owners leveraged their balance sheets to five to seven times earnings before interest, taxes, depreciation and amortization.

Case in point is Restaurant Brands International, Inc. (QSR on the Big Board), a long-term *Grant's* whipping boy that owns the Burger King, Tim Hortons and Popeyes Louisiana Kitchen brands (*Grant's*, June 2, 2017). At year-end, RBI's net debt footed to 6.7 times Ebitda. RBI has drawn down its revolver (in the sum of $1 billion) and, in a gesture recalling the scene of Scrooge and Bob Cratchit chatting together on the day after Christmas, will be sending checks to its franchisees (worth some $70 million) and lowering and deferring rent payments.

There were cracks forming in RBI's system even before the viral hammer fell. On Feb. 25, Carrols Restaurant Group, Inc., RBI's largest franchisor, announced it was slashing capex, as the quarter ended Dec. 29, 2019 produced a net loss of $9.9 million versus a gain of $1.8 million in the year-earlier period. At the close of 2019, Carrols carried debt equal to seven times trailing Ebitda.

RBI has had a fractious relationship with its Tim Hortons franchisees, who collectively deliver 49% of RBI's Ebitda. According to Monday's Toronto *Globe and Mail*, the franchisees are demanding rent reductions and other concessions. Since Aug. 29, 2019, QSR's share price has nearly halved to $40.03 from $78.48.

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Lancaster Colony, founded in 1961 by Ohio entrepreneur John Gerlach, looks like a safety stock straight out of central casting. Frozen bread, salad dressing, dips and croutons are its stock-in-trade, the very kinds of things that panicked shoppers are likely hoarding. As of Dec. 31, the corporate treasury showed a cash balance of $202.2 million and not a penny of debt. "Lancaster Colony is proud to be one of only 13 U.S. companies with 57 consecutive years of regular cash dividend increase," CFO Thomas Pigottt reminded his audience on the Feb. 4 earnings call.

Originally spanning industries from decorative stemware to industrial glass, Lancaster entered the food business with the 1969 acquisition of T. Marzetti Co., a salad-dressing maker. The last non-food business, a candle operation, fetched $28 million in a 2014 sale. The Gerlach family today owns a 26.5% stake in the company, and the founder's son, John Gerlach, Jr., is chairman of the board.

While a relatively small player in the food industry—trailing sales amount to $1.3 billion versus $25 billion for Kraft Heinz Co.—Lancaster looms large in each of its niches. Thus, it controls 39.9% of the frozen-bread market at grocery stores, 24% of salad dressing, 84.6% of dips and 54.5% of frozen dinner rolls.

"What LANC's shareholders, which include the passive trio BlackRock, Inc. (8.4% of shares outstanding), The Vanguard Group, Inc. (7.8%) and State Street Corp. (6.5%) as well as a smattering of quants like Renaissance Technologies, LLC (2.1%), may not appreciate, however," Lorenz relates, "is the company's exposure to the rapidly shrinking restaurant sector. In 2019, the foodservice division, which counts 16 of the largest 25 restaurant chains as customers along with universities and colleges, contributed 50.5% of the top line versus 49.5% for the retail unit."

The exact composition of the corporate restaurant business is management's secret, but the principal products—refrigerated salad dressing and frozen garlic bread, dinner rolls and pasta—are not the mainstays of the businesses that are staying open during quarantine, namely fast-food joints with drive-through windows and pizzerias offering delivery.

"Bulls," Lorenz continues, "may point to the higher operating margins in retail (19.8% before corporate overhead) versus foodservices (12.3%) as a coronavirus cushion. However, retail margins are likely to decline if foodservice-sales collapse. According to the latest 10-K report, Lancaster operated 16 factories as of June 30, 2019. In all but one—the Cudahy, Wisc. facility, which makes sprouted-grain baked goods for retail distribution—the plants make products for both grocers and restauranteurs. So as foodservice-sales decline, the retail business will have to absorb much higher fixed costs.

"At 27.5 times trailing earnings and 16.5 times enterprise value to Ebitda, Lancaster is not priced for half of its business falling off a cliff, even if, after the virus abates, the pristine corporate balance sheet will aid in a fast recovery."

Of the three analysts who cover LANC, one says buy and two say hold. Bears have caught the scent, as 7.5% of the float is sold short. Insiders are mum, having neither bought nor sold a share in the past year.

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