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Waiter, the check

Strong investment *in* restaurants makes a notable contrast with weak sales *at* restaurants (eatery receipts were down in May nationwide for the third consecutive month, according to Black Box Intelligence). "The capital is flowing," relates John Hamburger, president of Franchise Times Corp. and publisher of *Franchise Times* magazine and *Restaurant Finance Monitor*, "but the business conditions are deteriorating."

Middleby Corp. (MIDD on the Nasdaq), a well-financed, long-established and fast-growing maker of capital goods for the kitchen, is the company under the *Grant's* lens. In preview, we're bearish on it.

People have to eat, and investors want to invest (not a few private-equity investors feel as if they have to invest). The trouble, in 2016, is that the urge to eat and the propensity to invest have fallen out of phase. National restaurant chains, pinched by rising rents and punished by new federal labor regulations, need traffic. To entice the customers, the restaurateurs are offering "four for $4" (Wendy's) or "McPick two for $5" (McDonald's). Where this leaves a richly valued maker of high-end kitchen equipment—fryers, toasters, dough handlers, warmers, refrigerators, charbroilers, convection ovens, combi ovens, conveyor ovens, bakery ovens—is the question before the house.

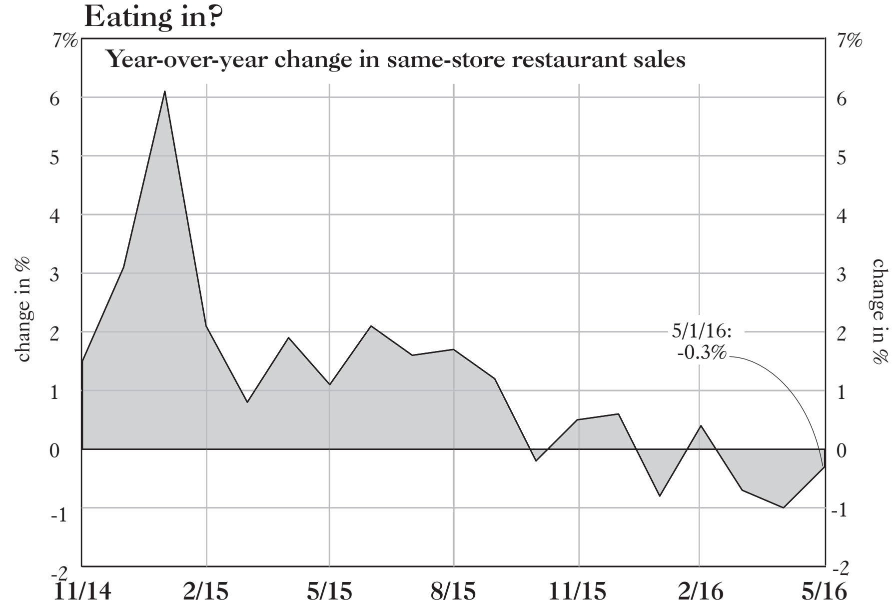
Joseph Middleby and his partner John Marshall started making custom portable ovens in Elgin, Ill., in 1888. Many years later, the founders' descendants sold out. In 1983, a leveraged investor with a public ticker bought in. Today's Middleby, a serially acquisitive stock-market darling, commands a 27 times forward P/E multiple, a celebrity CEO and a sell-side fan club that, for this year, projects 23% sales growth and 26% earnings growth. To not a few of its fans, Middleby is simply best-in-class.

Though a citizen of the world, Middleby generates 63% of its sales in North America, with the balance apportioned among Europe and the Middle East (26%), Asia (7%) and Latin America (3%). The company operates in three divisions: commercial food service (which delivered 54% of first-quarter sales and 27.4% operating margins), residential kitchen (31% of sales and 6.2% operating margins) and food processing (15% of sales and 22.7% operating margins).

Commercial food service is the principal breadwinner, accounting for 73% of operating profits before allocation of corporate overhead expense. It designs and manufactures the appliances that restaurants, convenience stores, retail outlets, hotels, etc., use to put the food on the table. Brands include Blodgett, Pitco Frialator and TurboChef.

Residential kitchen, a business unit created only four years ago, features such appliance brands as Viking, La Cornue and AGA. Though the newcomer generates almost one-third of company-wide revenue, it chips in but 9% of operating income (again, before the overhead allocation). To bulls, the residential unit is Middleby's great white hope. Just watch, they say, as the front office raises its profit-

Eating in?



source: Black Box Intelligence

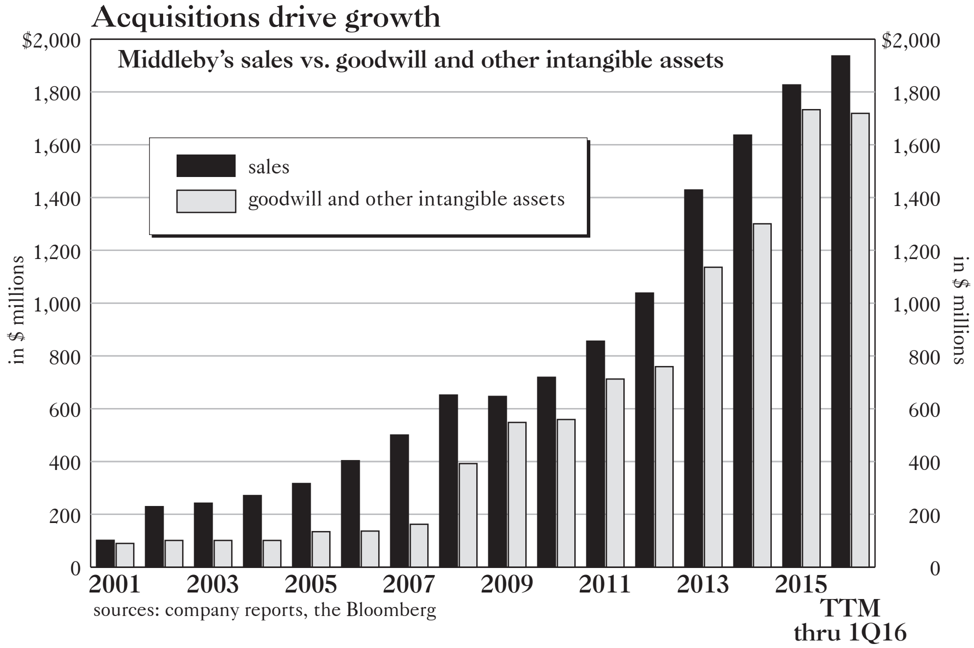
ability up to the mark of the remunerative commercial food-service division.

Food processing manufactures the machinery that bakes, grinds, slices, mixes, massages, dumps, cools and presses. You need it to make hot dogs, bacon, muffins and other processed foods. Baker Thermal Solutions and RapidPak are among the units that together contribute 17% of operating income.

At the heart of the bullish case is the conviction that the worse the restaurant operating environment, the more you need the 1980s-vintage Middleby Jet Sweep pizza oven, the contemporary Middleby TurboChef Bullet oven and the innumerable Middleby items produced in between. "You are seeing an explosion in labor costs," Hamburger tells Lorenz. "Minimum wages are going up. This overtime rule [which covers anyone earning less than $47,476 per year and goes into effect on Dec. 1] is nasty. Obamacare. The combination of labor and rent causes the next casualties [in the restaurant industry]. Unless these restaurants can keep high enough volumes, they can't afford to pay for this. That is what is going on right now in the restaurant business." Quite right, the bulls reply: All the more need to automate, all the better for Middleby.

CEO Selim A. Bassoul, who worked his way up to the top job in 2001, is integral to the bullish narrative. Sales and operating income grew at compound annual rates of 22.9% and 30.8% from the time of his accession through 2015. They had declined at compound annual rates of 4% and 1.8%, respectively, in the five years before he took over. The lagging residential food-service unit—the one with 9% operating margins—will sooner or later improve to match the institutional unit's performance metrics, the one with the 27%-plus operating margins, or so the bulls insist.

Bassoul has achieved this meteoric growth rate with the corporate checkbook. He wasn't on the job long before Middleby purchased Blodgett Holdings, Inc., Maytag Corp.'s commercial-appliance division, for $95 million. In the three years through 2015, Middleby acquired 16 companies for a total of $1 billion, picking up such brands as Celfrost Innovations Pvt. Ltd., Viking, and AGA Rangemaster Group Plc. Thus, while sales in the residential-kitchen division rose by 112.9% year-over-year in the first quarter 2016, organic growth actually declined by 19.6%.



The company typically pays cash for acquisitions, funded through a combination of cash flow and debt. From 2001 through the first quarter of 2016, Middleby has generated $1.4 billion in cash from operations and spent $97 million on capital improvements, delivering free cash flow of $1.3 billion. Over that same period, outlays on acquisitions came to $1.8 billion. As the cost of those accessions has risen, so has net debt, to $707.4 million in April of this year from $225.7 million at year-end 2012.

Viking—acquired for $361.7 million at the end of 2012—is an all-purpose talking point. We bears invoke it as much as the bulls do. It's no secret that the division has suffered quality problems. Middleby itself is suing Viking's vendors for the allegedly shoddy work that led to the recall of 100,000 products (including ranges that turn themselves on) since the deal closed.

Certainly, no consumer product is without its detractors. The aggrieved CEO of an appliance retail store poured out his troubles to Lorenz: "I can't carry [Viking's] line when it is this bad. I got a call from a service manager who told me, 'We are on a call about a Viking range, and we need to rewire the harness.' I said, 'Shouldn't they have done that at the factory?' If the igniters don't work, that's one thing. If your convection elements don't work, that is another thing. But I'm not supposed to manufacture in the field. I'm not even sure if I'm insured for that. That was the last call for me—that kind of call."

Perhaps our source is unrepresentative. Perhaps Viking has been unfairly disparaged in *Consumer Reports* and in social media. Incontestable is the fact that competition in kitchen appliances, both residential and commercial, is hotting up.

Thus, when Middleby bought TurboChef, the innovative oven maker, for $160.3 million in 2009, the TurboChef name was proverbial. "TurboChef was the Kleenex," says L. Gene Clark, president of the commercial-appliance distributor Clark Associates, Inc. "You ask for TurboChef, you don't ask for a high-speed oven. Everyone is coming out with a high-speed oven right now. Some are not in the market yet, but they are in active development. If you look at who was competing against TurboChef five years ago, I don't think there were many options. Today, I can name a half dozen. Merrychef is Manitowoc's. Alto-Shaam is a private company that has one. Bakers Pride is a company that has one."

Middleby, which declined to come to the phone or to reply to emails, seems to do its R&D investing through mergers and acquisitions. In 2015, it laid out $22.4 million or 1.2% of sales on R&D, a slight decline from $22.6 million or 1.4% of sales in 2014. German commercial-appliance maker Rational AG spent 4.4% of sales on R&D in 2015. TurboChef spent 24.7% of 2006 sales researching its revolutionary ovens, leading to a 122% year-over-year increase in sales in 2007 (not resting on its laurels, the company spent 4.8% of sales on R&D in 2007). Whirlpool Corp. and Electrolux AB, the consumer-appliance titans, allocated 2.8% and 2.6% of sales to R&D in 2015, percentages that translated into investments of $579 million and $390 million, respectively.

"One thing taken with another," Lorenz points out, "it isn't clear that Middleby will be able to garner the same margins in its residential-kitchen division as it earns in the commercial food-service business. There are no public, pure plays in the high-end consumer-appliance industry. Whirlpool and Elextrolux, the largest public mass-market appliance companies, logged operating margins of 7.2% and 4.1%, respectively, in 2015. AGA Rangemaster, which was a pure play before Middleby bought it for $201 million in 2015, earned a 4% operating margin in 2014. This is not to say that there's nothing Middleby can do to sweat off corporate fat and lift margins—there is, and Bassoul et al. are improving operations—but it remains to be seen whether residential appliances can earn margins similar to those of commercial appliances."

Under the rules of purchase accounting, acquirers may apportion the assets of their acquirees as they wish for 12 long months after the transaction closes. Middleby has tended to tag those assets "goodwill and other intangibles" (GOI). Most assets so designated need not be amortized. And as they are not amortized, they do not impair the optics of reported GAAP earnings.

"For example," notes Lorenz, "60% of AGA's acquired assets were designated GOI; only $75 million of the $344.3 million in purchased intangibles (total assets acquired were $574.4 million) were judged to be subject to amortization. The balance of acquired assets were earmarked 'current assets' ($153.5 million; e.g., inventories and receivables), 'property and equipment' ($58.7 million), 'cash' ($16.3 million) and 'other' ($1.9 million). It happens that, on Bassoul's acquisitive watch, the GOI balance-sheet line has grown faster than the 19.8% compound annual growth registered in overall assets.

"Few analysts will second-guess the accounting judgments of the management of a successful company or division. The fact is that the decline in sales of Viking ranges drove the aforementioned 19.6% year-over-year drop in organic sales in the residential division. Pending a timely fix—of which we see no sign—a writedown might be in store for some of the $309.1 million in GOI that the Viking transaction brought on board."

The bulls contend that margin-pinched restaurant owners must invest in labor-saving and efficiency-enhancing technology, and maybe they do, and will. The question is what form this prospective investment will take. Wendy's, for instance, has announced a plan to install self-ordering kiosks in its 6,000-plus restaurants in the second half of 2016. Kiosks replace labor, but only in the front of the house, i.e., in the part of the restaurant in which Middleby doesn't compete. (Domino's was the only restaurant chain to respond to a *Grant's* request for comment on plans for its capital spending. A spokesman for the pizza maker said that it intends to invest chiefly in digital commerce and store "repositioning," not kitchen hardware.)

The restaurant owners who matter most to Middleby are the franchisees, of which the big are getting bigger. Low-cost debt has facilitated a post-crisis wave of consolidations. In 2008, the largest operator in the annual *Franchise Times* roundup of top restaurant franchisees reported $679.5 million in sales. In 2015, it had $1.4 billion.

Few franchise operators are publicly owned. A partial exception is NPC International, Inc., which issues public debt. NPC, the second-largest franchise operator by sales according to *Franchise Times*, operates 1,240 Pizza Hut stores and 145 Wendy's outlets with trailing-12-month sales of $1.2 billion. NPC's debt, net of cash, foots to $535 million, or 4.8 times trailing EBITDA; it's rated single-B-minus/B2. In the first quarter, operating income covered interest expenses by 1.6 times (Middleby, by the way, covered by 16.4 times). To the extent that NPC's leverage is typical of that of large restaurant franchisees, the industry may lack the financial flexibility to spend as the Middleby bulls are hoping they will.

"We have a lot of franchise operators that are highly leveraged, and some are LBOs from pre-crisis or after crisis," a ratings-agency analyst who follows NPC and other restaurant companies tells Lorenz.

When big restaurant owners devour the little ones, relates Wallace B. Doolin, the chairman and founder of TDn2K, the parent company of Black Box Intelligence, capex usually follows. Formerly dark and dingy spaces are remodeled; kitchen machinery is replaced. Perhaps this dynamic has something to do with the dwindling multi-year trend in organic revenue growth in Middleby's commercial food-service business. Measured year-over-year, the trend is as follows: 3.6% in 2015 from 8.9% in 2014 and 11.1% in 2013. Bulls will cheer the first-quarter 2016 uptick in organic revenue growth to 5.6%, but the improvement was entirely owing to a spike in foreign sales; domestic sales, which deliver two-thirds of the revenue of Middleby's most important division, showed an organic dip of 0.6%.

It's a tenet of these pages that low-cost debt pulls demand from the future to the ZIRPy present. Maybe the debt-financed consolidation of big restaurant franchisees has given a temporal yank to the demand for commercial kitchen machinery.

As noted above, sell-side analysts project strong results into next year: year-over-year sales growth of 23% and 10% in 2016 and 2017, and year-over-year earnings-per-share growth of 26% and 18%. And they might be right, too, if the in-house M&A machine continues to whir. Just how much of the Middleby lustre is owing to acquisitions is apparent in first-quarter results: Company-wide growth in organic sales came in at 0.8%, compared to company-wide growth in total sales of 27%, mainly thanks to the purchase of AGA in September 2015. To keep the growth-stock constituency pacified and the P/E multiple elevated, Middleby can't put away its checkbook for long.

With a $7.1 billion market cap, MIDD is a liquid stock. Short interest—6.6% of the float—suggests that the bearish trade is yet uncrowded. Over the past year, insiders have sold 21,300 shares for proceeds of $2.2 million. Their purchases were nil.

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