GRANT'S
INTEREST RATE OBSERVER®

Vol. 35, No. 11a Two Wall Street, New York, New York 10005 • www.grantspub.com JUNE 2, 2017

Rumblings in the great white north

What are the chances of Warren Buffett being wrong? The chances of Buffett being wrong in the elevated company of 3G Capital, Bill Ackman and Mr. Market himself? High, we are about to contend.

Now unfolding is a bearish analysis of Restaurant Brands International, Inc. (QSR in New York and Toronto), the 3G-sponsored roll-up in which Buffett and Ackman are major investors and to which the excitable Mr. Market has assigned a record-high share price (and reciprocally low interest costs). Debt, interest rates, stagnation, valuation and the Ten Commandments are the points of focus.

3G got into the fast food business with its 2010 acquisition of Burger King Holdings, Inc. Burger King was a tired brand which the Brazilian cheapskates proceeded to revivify, and not through cost-cutting alone; they actually sprang for some new uniforms, rejiggered the packaging and toned up the menu—pre-acquisition, the bill of fare had been pejoratively described as "male-oriented."

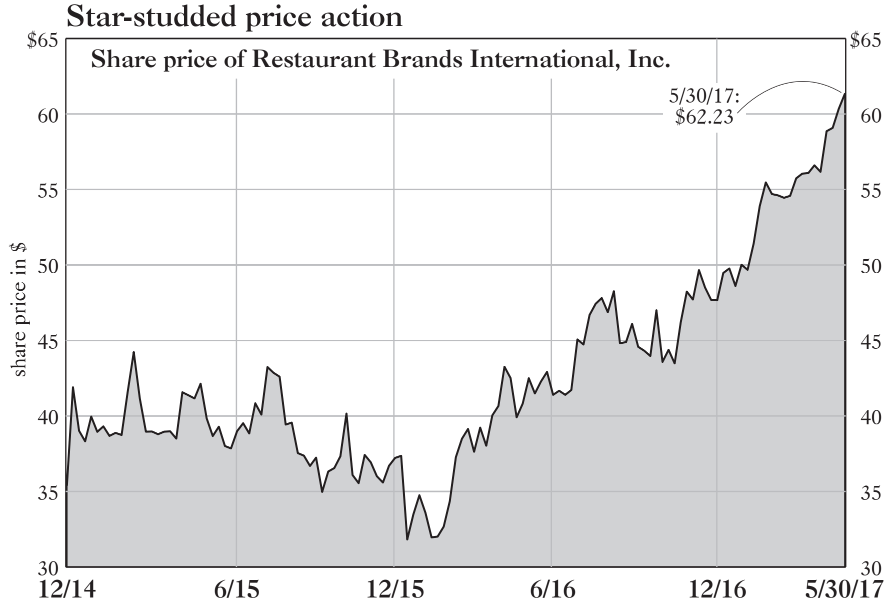
Restaurant Brands International, as corporate Burger King rebranded itself, bought Tim Hortons, Inc. in 2014 and Popeyes Louisiana Kitchen, Inc. two months ago. 3G doesn't mind spending money when it comes to M&A. It paid 16.1 times earnings before interest, taxes, depreciation and amortization (EBITDA) for Hortons, the favorite destination of Canadian coffee-drinkers and donut-eaters, and 21.3 times EBITDA for Popeyes, the fried-chicken and biscuit purveyor. As a multiple of trailing revenues—6.7 times—the price that 3G paid for Popeyes is the richest for any $100 million-plus North American restaurant acquisition for all recorded time (*Grant's*, March 10).

In the words of colleague Evan Lorenz, the RBI business model is "capital-light and debt-heavy." Franchisees, not RBI, manage all but a handful of the Burger King, Hortons and Popeyes eateries. What the parent oversees are its leveraged balance sheet, its low, low Canadian tax rate (of which more below) and its fractured relations with Hortons franchisees. The three acquisitions have encumbered RBI with debts of $12 billion, net of cash, an amount equal to 6.1 times trailing pro-forma-adjusted EBITDA; in 2016, EBITDA covered cash interest expense and preferred dividends by 2.5:1.

The RBI brands are well-regarded and, in the context of a North American continent fairly overrun with restaurants, well-situated. Fast food, unlike casual dining (e.g., Applebee's, Chili's, Ruby Tuesday), is at least holding its own in the marketplace, according to John Hamburger, president of Franchise Times Corp. and publisher of the must-read *Restaurant Finance Monitor*. "Doing OK," says Hamburger, is about the highest accolade he can confer nowadays on any restaurant-industry segment.

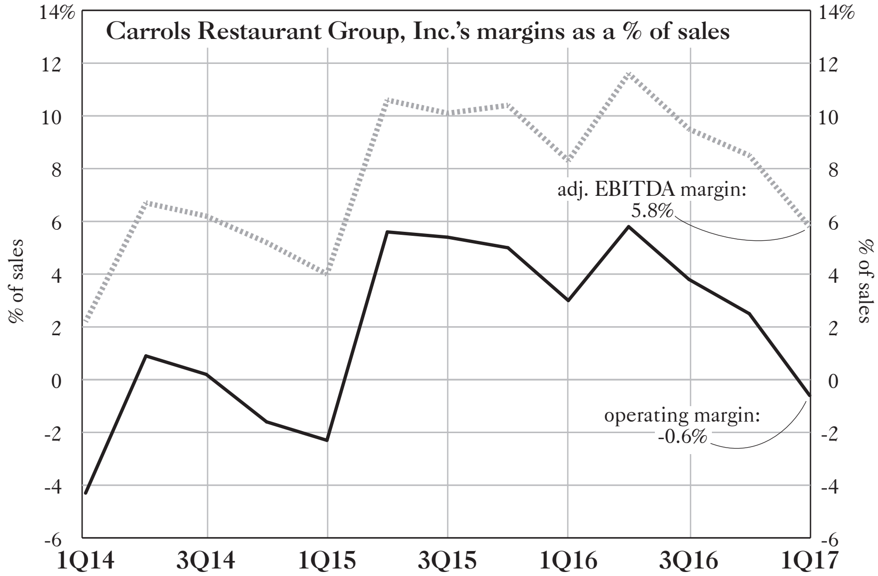
Tim Hortons—"Timmy's" to its adoring Canadian fans—is the company powerhouse. In the 12 months ended March 31, Hortons outlets generated $6.5 billion in sales, 23% of the RBI total. They contributed $1.1 billion in adjusted pro forma EBITDA, or 55.5% of the corporate whole. Compare and contrast the contribu-

Star-studded price action



source: The Bloomberg

Pressure cooker



source: company reports

tions of Burger King, $799 million, and Popeyes, $85 million.

"Hortons stands apart," Lorenz observes. "It's not just that Canadian readers of *Grant's* prefer its coffee to Starbucks coffee by a factor of maybe 12-to-1 (I've asked), or that Hortons sells eight out of every 10 cups of coffee north of the border. No, what makes Tim Hortons singular is its unusual profitability for the franchisor."

How does the franchisor, RBI, make money? It earns a royalty, calculated as a percent of its franchisees' sales (3%–5%), as well as a lease fee, which is likewise determined as a percent of franchisee sales (as high as 10% for some Tim Hortons lessees). Not least—in the specific case of Timmy's—RBI earns a markup on the sales of paper products, food and other consumables that franchisees are contractually obligated to purchase from what amounts to the company store. This sourcing protocol accounts for a substantial part of Horton's unusually high profit contribution.

What drives RBI's earnings growth? Key are net store openings. No surprise, then, that RBI is pushing to propagate new franchisee-operated restaurants, mainly outside of North America. Thus, in mid-2010, there were 12,174 Burger King restaurants in the world; today, 15,768. At year-end 2014, there were 4,258 Tim Hortons locations across the globe; today, 4,644. The hope for Popeyes—and the reason that RBI paid such a seemingly extravagant multiple for the chain originally called Chicken on the Run—is that it, too, will catch on in foreign parts; who doesn't like chicken?

And who doesn't like RBI? Among the analysts on the case, 10 rate the stock a buy, nine a hold and exactly none a sell. Maybe the sky-high price constrains the holdouts. The shares change hands at 37.9 times trailing adjusted earnings, or 42.9 times trailing GAAP earnings. Analysts have penciled in non-GAAP earnings-per-share growth of 16% in 2017, 32% in 2018 and—straining their eyes to see through the brick wall of futurity—14% in 2019. The 2018 figures reflect a boost from the expected refinancing of the $3.3 billion of 9% cumulative compounding perpetual voting preferred shares that Berkshire Hathaway owns (its contribution to the Tim Hortons acquisition); the stock becomes callable on Dec. 12.

The credit markets, too, bestow their blessings: 4¼% was the coupon attached to $1.5 billion of single-B-plus-rated secured first-lien bonds of 2024 in an upsized deal that came to market on May 3 at par. The interest cost was 1.25 percentage points below the BofA Merrill Lynch US High Yield 'B' Effective Yield Index, which is quoted at 5.52%; proceeds are earmarked to refinance Buffett's preferred.

Nor—unusually nowadays in corporate North America—is management unloading its shares. The single insider transaction in the past 12 months was a 5,000-share purchase. As for Ackman, RBI is the top holding of his Pershing Square Capital Management as of March 31; the fund held stock worth $2.4 billion, which, adjusted for the dilution of the voting preferred shares, controls 8.4% of RBI's corporate voting power.

These are the bullish auguries. There are others. To start with, in the first quarter, RBI's same-store sales growth screeched to a halt, registering 10 or 20 basis points of contraction per segment vs. growth of 2% or thereabouts in the full 12 months of last year. On the April 26 earnings call, management blamed the dip on the year-ago incidence of Sadie Hawkins Day: It happens that 2016 was a leap year. (McDonald's Corp. showed 1.7% growth in first-quarter U.S. same-store sales, the Sadie Hawkins factor notwithstanding.)

"Something I find curious," Lorenz observes, "is that RBI has reduced the level of detail it provides. Through last year, management disclosed same-store sales growth, total sales growth and restaurant counts by geographic region. This is critical information for analyzing a company trading at a lofty multiple based on expectations of rapid international growth. In the place of these tables, RBI now only shows same-store sales in the most important region for each chain. So, for instance, we know that Tim Hortons' Canadian same-store sales fell by 0.2% in January–March and that, in the identical three months, same-store sales at American locations for Burger King and Popeyes dipped by 2.2% and 0.4%, respectively."

The bearish story on Restaurant Brands hinges on the franchisees: on their profits, or lack thereof, and on their complaints (especially the complaints of the Hortons franchisees). Some of the facts are front-and-center, others must be inferred and still others may be adjudicated.

You can infer something un-bullish from the public filings of Carrols Restaurant Group, Inc., the largest Burger King franchisee, with 788 stores, and a major RBI investee. Through convertible preferred shares, RBI owns 20.6% of Carrols (TAST on the Nasdaq), which, in turn, owns the right of first refusal on Burger King franchise transfers in 20 American states.

Carrols' operating margins are tumbling. They came in at negative 0.6% in the first quarter of 2017, from a peak of 5.6% in the second quarter of 2015. Over the same span, its "adjusted EBITDA" margin, a softer, more forgiving metric, was sawed in half, to 5.8%.

No mystery why, CFO Paul R. Flanders explained on the May 9 earnings call: "These decreases reflected a higher level of promotional activity since last year, continued pressure on labor costs and deleveraging of fixed costs due to the comparable sales decrease and seasonably lower average sales volumes."

The troubles at Tim Hortons go deeper than money and margins, though (at least for the investor) all is finally reducible to those vital elements. In a series of articles in the Toronto *Globe and Mail*, Marina Strauss details allegations against corporate management by disgruntled franchisees, as well as from a former Hortons CEO. Here are some of the complaints: The quality of products the franchisees must purchase from RBI—paper goods, food, condiments—has declined as their prices have increased; a switch to single suppliers for many such items has led to periodic supply interruptions, a.k.a. "stock-outs"; and corporate district managers have turned the famous 3G cost-control culture into an instrument of intimidation and brutality. Perhaps the most explosive allegation is that RBI has raided a franchisee marketing fund to pad the parent's bottom line. In each case, the franchisees charge, 3G is shifting costs from the corporate P&L to their own.

It bears repeating that Tim Hortons generates 55.5% of RBI's trailing pro-forma-adjusted EBITDA. If there is a problem with Hortons, it is mathematically impossible for the Burger King and Popeyes divisions to grow fast enough to compensate for it.

Rebelliousness may not be Canada's foremost national character trait, but the formation, in March, of the Great White North (Hortons) Franchisee Association has something of the Spirit of 1776 about it. Separate and distinct from the company-sanctioned franchisee advisory group, the Great White North contingent is up in arms over RBI's management practices.

Defiance has already yielded some results. Thus, under heavy pressure, RBI agreed to delay the scheduled introduction of a digital app with which customers could order and pay in advance. On form, the franchisees contended, the front office would bungle the roll-out as it has dropped so many other operational balls.

"Every franchisee with whom I spoke confirmed that prices are up substantially on goods which they are required to purchase from the Hortons company store," Lorenz relates. "You can see it in the published financials. The Hortons division reports two revenue line items: a) 'sales,' meaning revenue earned both from customers and franchisees, and b) franchise and property revenues. What's clear is that, to RBI, 'sales' have become much more profitable: Between the first quarter of 2015, the first full quarter of ownership of Tim Hortons, and the first quarter of 2017, gross margins on sales increased to 23.7% from 13.3%. Between 2009 and 2013, the last five years of Tim Hortons as a standalone company, gross margins on sales ranged between 11.9% and 14%.

"Hortons has delivered strong earnings to the parent, as you might expect," Lorenz goes on. "Gross profits from franchise and property revenues increased by $17.8 million to $128.5 million between the first quarters of 2015 and 2017. Over the same period, gross profits on sales increased by $61.1 million to $124.9 million."

(You have to do some parsing to tease the fact of these rising prices from the RBI financials. The complicating factor is a category of restaurant classified as a variable-interest entity, a kind of halfway house between a company-owned establishment and a franchisee-owned establishment. After adjusting for VIEs, we affirm the conclusion that the front office has been jacking up prices to the franchisees.)

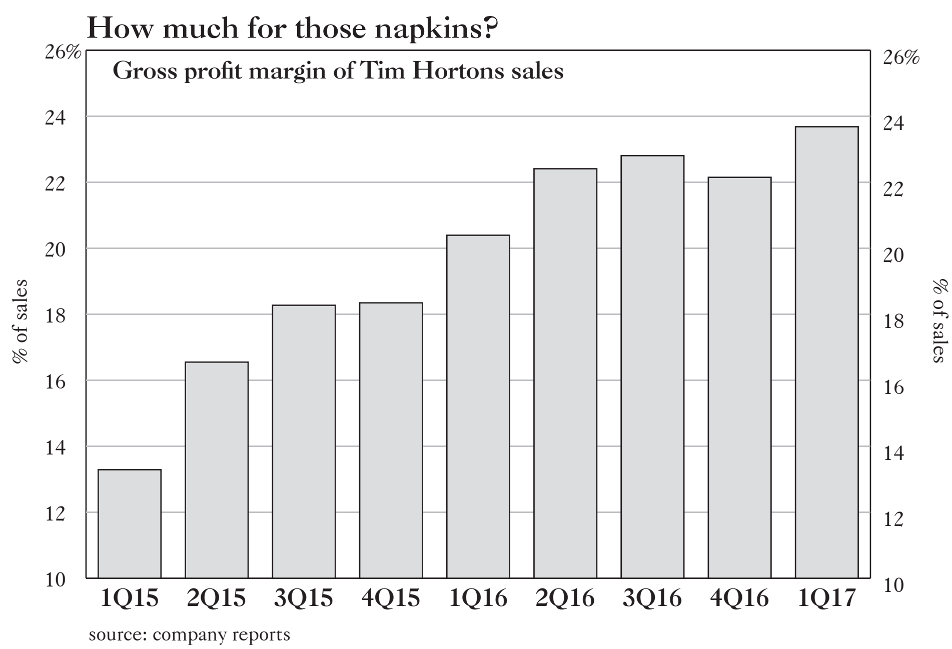
Lorenz spoke to as many Hortons franchisees as would pick up the phone. Perhaps the ones who came forward were predisposed to complain—no organization is without the type. And maybe no change of corporate control between people-oriented founders and number-centric technocrats has ever pleased everybody.

With all that said, a dozen or so Hortons franchisees complained to Lorenz about managerial lapses at the franchisor level. Stock-outs, for instance: "The last time it was wrap [sandwiches], and [for] three or four days we had to run without wraps. That is a killer for us. How can you run a promotion, and run it on television, and it is couponed and everything else? We get people in the store, and when they get to the store it is not there. I don't have a good explanation. This never used to happen pre-3G."

The allegation that 3G is raiding the franchisee marketing fund is a point of especially bitter contention. Each store pays 3.5% of sales into the kitty, which finances local and national promotional drives; annual contributions run to $227 million. It isn't the parent's property.

Asked for comment, RBI did not entirely deny that it uses the fund for some non-marketing endeavors. It said that the spending—for whatever purpose it might be—complies with the letter of the contract governing the fund's activities. "We have a very specific set of policies with regard to what can be allocated to the ad fund, and those are all stipulated in formal documentation," said Markus Sturm, RBI's director of investor relations, in an interview.

Franchisees tell Lorenz that they have



depositions from former RBI employees to support the contention that the company is misdirecting advertising funds. The Great White North group says that it has engaged John Sotos, founding partner of the eponymous Toronto law firm Sotos LLP, to represent them as they build a case against Restaurants Brands International. Sotos declined to speak to *Grant's*.

"So, no, we can't definitively prove the company has raided this fund," Lorenz writes. "However, it is noteworthy that general and administrative expenses for the Tim Hortons segment rose to $25.1 million (3.4% of division sales) in the first quarter of 2017, up from $16.2 million (2.5% of division sales) in the first quarter of 2016. The jump came after franchisees started raising issues with the advertising fund, and the rise in G&A expense was a shock to analysts covering the stock."

In mid-March, a former CEO of Hortons in pre-RBI days, Don Schroeder, let fly at the new owners: "The callousness with which RBI has treated hundreds of loyal and long-serving members of the [Tim Hortons] corporate team as well as countless suppliers who for years had been committed to providing the system with new and innovative products, leaves me with the inescapable conclusion that, in the absence of some collective action, our family of storeowners will share the same fate."

In *The Globe and Mail*, Strauss reports a sharp ratcheting up in the failure rate on headquarter-administered inspections. Prior to January, 15% of Hortons outlets flunked the company's Global Performance System exam; thereafter, 69% missed the mark. Following more adjustments, in March, 85% failed. Adding insult to injury, franchisees protest, the ever-so-cost-conscious 3G front office has fired most of the restaurant-support team who might have been able to help.

A franchisee tells Lorenz about the infractions for which the 3G inspectors dinged one of his stores in Alberta: "Some of the stuff that happened on our report was the temperature of the dishwasher—after five, six runs, [it] was one degree below where it should be—and we had a mouse trap pointing in the wrong direction at the back of the house," he told *Grant's*. "I had no idea—I am 62—that you had to point a mouse trap a certain way. Some of the stuff on the GPS report was [that] we didn't have knives with the Tim Hortons logo on them, we didn't have sugar sifters with the Tim Hortons logo on them. Just ridiculous stuff. That is why people are walking away. You can't pay people enough money for the abuse and reports we are forced to do to keep RBI happy."

Some speculate that RBI is cracking the whip to invoke the rule that debars a failed franchisee from acquiring additional stores. All this, the musing goes, is to prepare the ground for a future consolidation of Hortons outlets in the acquisitive style of the Burger King roll-up Carrols.

The GPS score is one criterion by which RBI grades franchisees; financial stability is another. The complaint comes back to Lorenz that, to the corporate front office, financial stability means reporting the correct kind of profit margins.

"Three franchisees tell me that RBI rejects profit-and-loss statements if profit margins are too low," Lorenz relates. "One-hundred twenty-nine Hortons franchisees responded to an anonymous online survey in Alberta. They reported an average 6.29% operating margin, roughly half the 13%–14% margin that the company claims that franchisees earn company-wide."

"What makes this even more disturbing," says a franchisee who asks to go unnamed, "is it created a culture where owners started to report inflated monthly profit numbers to keep RBI off their backs and qualify for expansion. As an advisory board member, this made my job even more difficult, as RBI was not responsive to questions regarding profitability. Their response was that they've collected P&L numbers from store owners and [that] profits are 'healthy.' I spoke up in an advisory board meeting, that false numbers were being reported and why, and I was quickly shot down by management." Franchisees to whom Lorenz spoke claim that RBI does not try to match up monthly P&Ls with audited financials.

Lorenz took these complaints to RBI: Is it company policy to reject franchisee-submitted P&Ls, and, if so, on what grounds do you find fault? "There may be occasions where the numbers don't make sense and they don't tie to the audited financials they provide," Sturm, the IR executive, replied. "It is a self-reported mechanism. Aside from some glitches that may arise that we need to get back to them [about], no, we are not managing numbers if that is your question."

Nothing you have so far read will provoke surprise that 3G pays the lowest tax rate it can find. Still less would it startle an experienced tax observer if 3G/RBI were found to have overreached in the search for the lowest rate in the most advantageous domicile. RBI reincorporated in Canada, from the United States, following the 2014 Hortons acquisition.

"In footnote 10 of RBI's 2016 10-K report," Lorenz observes, "the company states that it earned $1.1 billion in pretax profits in Canada and $150 million in pretax profits in the rest of the world. (It is impossible to square these figures with RBI's other segment disclosure.) In 2016, RBI accrued a $243.9 million tax at an 20.3% rate on its profit-and-loss statement. However, that tax accrual comprised $163.8 million in current taxes and $80.1 million in deferred taxes (i.e., the tax rate on current-period taxes is 13.7%, and $80.1 million in taxes were accrued as a balance-sheet liability). Of current-period taxes, $78.6 million was paid to Canada, $46.9 million to U.S. federal or state coffers and $38.3 million to parts unknown.

"In the risk-factors section of that 10-K report," Lorenz proceeds, "RBI warns: 'Future changes to U.S. and non-U.S. tax laws could materially affect the Company.' Noting, specifically, that 'the U.S. Treasury has recently issued final, temporary and proposed Treasury Regulations under sections 385 and 7874 of the Code and indicated that it is considering possible additional regulatory action in connection with intercompany transactions and so-called inversion transactions.' That is to say, it appears that RBI is aggressive in shifting profits to lower tax jurisdictions."

Last month at the Berkshire Hathaway annual meeting, Warren Buffett defended the 3G model with some observations on the imperative need for productivity growth. To which Charles Munger added, "We don't see any moral fault with 3G."

Of course, it is better to live in a country in which Exxon Mobil Corp. generates $197.5 billion in revenues with 71,100 employees than in a country in which China Petroleum & Chemical Corp. (a.k.a. Sinopec) produces

$283.1 billion in revenue with 451,611 employees. It would also be better to own a business in which the venality of the owners was in the service of preserving and improving the brand rather than—inadvertently, through short-sighted fixation on the bottom line—debasing it.

"On the recruiting site Glassdoor.com," Lorenz winds up, "the 31 reviews from RBI employees give the company 1.8 stars out of a possible five—you expect as much, given RBI's focus on lean, people-free operations. What you might not expect are the kind of allegations that should at least raise eyebrows for current RBI shareholders and creditors. 'RBI has cut costs to the bone by getting rid of all the professionals in the organization and hiring kids out of school through their MBA program,' says a comment dated March 24. 'Turnover rate is at nearly 50%. They preach process and meritocracy but at the end of the day there is no meritocracy and process goes out the window. Decisions are made by a couple of key decision makers usually based solely on cost not what's best. Then when the poor decisions by these key decision makers result in poor results the blame is pushed back to you. They have destroyed not only the corporation but many small franchisees, their business and livelihood in the Burger King brand and are doing the same thing at Tim Hortons. Popeyes is next.' "

The criticism seems not to accord with the fancy RBI price/earnings multiple.

•