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Workers of the world

Evan Lorenz writes:

They say that smoking, like death and taxes, is impervious to macroeconomic change, but inflation is challenging that chestnut. Cigarette sales in America, for instance, fell by 9.4% last month versus a 7.9% drop in February, easier year-ago comparisons notwithstanding.

British smokers, too, appear to be cutting back, judging from the year-over-year declines of 8.8% and 7.3% registered in February and January, respectively. Rather than pay up for ready-made smokes, sticker-shocked Brits are increasingly rolling their own.

Following is macro-cum-micro examination of the effect of inflation on shoppers and consumer-facing businesses. In preview, *Grant's* is bearish on Texas Roadhouse, Inc. (TXRH on the Nasdaq) and Greggs plc (GRG on the London Stock Exchange).

Separating noise from signal is especially daunting today. Consider two contradictory observations: the first, from high-end furniture retailer RH, that softening first-quarter demand coincided with Russia's invasion of Ukraine; and the second, from cruise operator Carnival Corp., that bookings in the week ended April 3 were the highest by far in any seven-day period in the company's history.

From the fourth quarter of 2019 through the fourth quarter of 2021, consumer spending on goods increased by an inflation-adjusted 15.6% while outlays on services declined by an inflation-adjusted 0.7%. Could that be a sign that formerly locked-down consumers are pivoting to services from goods? Or that they are retrenching in the face of higher inflation?

Maybe the answer is both. Taiwan Semiconductor Manufacturing Co. Ltd. recently warned about a slowdown in demand for PCs, smartphones and TVs, the very things that filled the Amazon boxes that cheered the quarantined masses in 2020–21. According to a March 28 Nikkei dispatch, Apple, Inc. has told its suppliers to slash production rates of AirPods as well as the just-announced iPhone SE and iPhone 13.

Bank of America Corp.'s inaugural Consumer Checkpoint survey finds that lower-income households are beginning to reduce spending in the face of a rising cost of living. Though credit card–financed spending rose by 11% last month, families earning $50,000 or less a year increased borrowings by just 4%. Households earning more than $125,000 boosted their credit-card outlays by 11.8%. Gasoline charges vaulted by more than 41% from a year earlier.

Inflation is a source of worry for 76% of the American public, according to a March 23–24 survey by CNBC + Acorns Invest in You. Asked how they would respond to a continued uptick in prices, 52% said that they'd dine out less frequently, 42% that they'd drive less frequently and 40% that they'd cancel a planned trip or vacation.

It's no mystery why lower-income consumers are economizing. Over the past 12 months, according to car-shopping website Edmunds.com, the average monthly payment for new vehicles soared to a record $648 from $575 a year ago, and that for used vehicles to $538 from $432. Over the same span, apartment rents climbed by 17.1%, home prices by 19.2% and the rate on a 30-year mortgage by 1.79 percentage points, to 5.06%.

Texas Roadhouse, Inc. at a glance
all figures in $ millions except per share data

	2021	2020	2019	2018	2017
revenue	$3,463.9	$2,398.1	$2,756.2	$2,457.4	$2,219.5
operating income	297.2	23.8	212.0	187.8	186.2
net income	245.4	31.4	174.5	158.0	131.7
earnings per share	3.50	0.45	2.46	2.20	1.84
shares	70.1	69.9	70.9	72.0	71.5
cash	335.6	363.2	107.9	210.1	150.9
debt	100.0	240.0	0.0	0.0	52.0
total assets	2,512.0	2,325.2	1,983.6	1,469.3	1,330.6

source: company reports

Greggs plc at a glance
all figures in GBP millions except per share data

	2021	2020	2019	2018	2017
revenue	£1,229.7	£811.3	£1,167.9	£1,029.3	£960.0
operating income	153.2	-7.0	114.8	82.6	72.3
net income	117.5	-13.0	87.0	65.7	56.9
earnings per share	1.14	-0.13	0.85	0.65	0.56
shares	102.7	101.0	102.3	101.9	102.1
cash	198.6	36.8	91.3	88.3	54.5
debt	0.0	0.0	0.0	0.0	0.0
total assets	894.0	753.3	794.8	494.1	447.3

source: company reports

On April 1, the UK energy regulator raised the cap on household energy bills by 54%, or by an average of £2,000 ($2,626) a year, and £3,000 might be in the cards come the next adjustment in October, estimates Investec plc. Gobsmacked by heating bills, the Brits may scarcely notice the 1.25% boost in National Insurance coverage that was slated to begin April 6—a small mercy.

Costs are going up for businesses, too. Beyond the surge in commodity prices and supply-chain snarls, wages are on the hop. On April 1, the minimum wage in Britain rose by 6.5%, though labor shortages on both sides of the Atlantic are rendering the minimum obsolete. It wasn't out of the goodness of its warm, corporate heart that Walmart, Inc. recently bumped up the starting pay for in-house truck drivers to $100,000, plus or minus, from $87,000.

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Texas Roadhouse, which operates the eponymous steakhouse brand in addition to sports chain Bubba's 33 and fast-casual burger concept Jaggers, was not necessarily structured with a new inflation in mind. Last year, wages accounted for 35% of total operating expense, with the average Roadhouse server earning $26,014 per year, according to Indeed.com.

Kent Taylor founded Texas Roadhouse in 1993 with a single location in Clarksville, Ind. Within the year there were five locations, but soon, in the volatile way of startups, there were only two. But Taylor persevered, and by the end of last year the company-operated store count reached 566, including 526 Roadhouse restaurants, 36 Bubba's locations and four Jaggers spots. One hundred and one franchised Roadhouse locations send royalty checks to the head office.

"I like Texas Roadhouse," John Hamburger, president of *Restaurant Finance Monitor*, tells me. "I can tell when I go to a Texas Roadhouse that the customers like it, too. It's kind of a blue-collar steakhouse."

That 21% of the company locations are situated in the minimally locked-down states of Florida and Texas goes far to explain why Roadhouse had a bang-up 2021. Revenue leapt by 44%, to $3.5 billion, overtaking the 2019 figure by 26% and leading to record earnings per share. Takeout sales contributed 17.1% to last year's total, from 7.2% in 2019.

As of Dec. 28, 2021, the balance sheet showed cash and equivalents of $335.6 million and more than $100 million of indebtedness. Operating leases, which summed to $644.8 million at year end, made up the biggest liability.

Out of 25 potential analyst opinions on the stock, 13 are buys, one a sell. Short interest of 5.8% of the equity float suggests that bears are digging into the story. Over the past 12 months, insiders sold a net 63,498 shares for proceeds of $6.3 million.

Sticker shock takes time to register with the occasional diner-out, and therefore to make its mark on the typical restaurant P&L, as Hamburger observes. "If you think about it," he says, "a customer goes out to eat and sees a much higher price. What is he going to do? He is going to pay it. But the next time he is thinking about where to go, that's when it starts to impact. 'Do I go back, or do I trade down? Do I switch?'"

The experience of Conagra Brands, Inc. (Slim Jim, Duncan Hines, Reddi-wip, etc.) may shed light on the inflationary future. Results for the quarter ended Feb. 27 showed a 6% rise in organic sales but a 2.3 percentage-point decline in adjusted operating margins, to 13.7%, from the same period in 2021. Price increases drove sales as underlying volumes fell by 2.6%. The company slashed earnings guidance for the year ending May 31 to $2.35 a share from $2.50. Inflation was the villain.

According to data from Nielsen Holdings plc, private-label food took share from pricier, branded goods on grocery shelves in the four weeks ended March 26. It's the first time since the issue of U.S. government stimulus checks around May 2020 that store brands have gained share.

Though casual-dining concepts such as Texas Roadhouse are more economically vulnerable than fast-food chains like McDonald's Corp., Roadhouse trades at 21.7 times the 2022 estimate, closer to the Golden Arches' 25.1 times than to the average 14.6 times assigned to such casual-dining operators as Brinker International, Inc. (which runs the Chili's and Maggiano's Little Italy chains), Darden Restaurants, Inc. (Olive Garden and LongHorn Steakhouse, among others) and Ruth's Hospitality Group, Inc. (Ruth's Chris Steak House).

As in America, so in the mother country: Some painstaking new research from ShadowFall Capital & Research, LLP, activist short sellers, analytically bridges the Atlantic.

In Britain, there is not one minimum wage but many, each applying to a different age group. Thus, for instance, while the overall minimum wage rose by 6.5% in April, that for the 18-to-20-year-old contingent ticked up by just 4.1%. For beginning UK workers, it pays to grow older: Birthdays for young employees can deliver leaps in pay—individuals turning 21 will see a 40% bump in hourly earnings, those reaching 23, a 14% increase. Naturally, British employers may be excused for wanting time to stand still, and the feeling must be especially intense among any who tried to minimize employment costs by hiring the very young.

It happens that not every UK company breaks out employment costs within selling, general and administrative expense, or distinguishes part-time from full-time employees—altogether, the ShadowFall analysts had their work cut out for them. In the end, they were able to identify a dozen companies whose annual average wage was less than £25,000 and whose wage bill was a significant percentage of their overall costs.

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Greggs plc, a national bakery chain, scored near the bottom (i.e., from a short seller's point of view, near the top) on that highly curated screen. In 2021, wages made up 40% of total operating expenses. According to the footnotes of the 2021 annual report, the median Greggs employee earned £19,966 per year, including benefits. Management projects a rise in 2022 labor costs of just 4.3%.

Founded in 1939 by namesake John Gregg in Tyneside in northern England, the company started off selling freshly baked bread and scones. Today, the chain comprises 2,181 locations (of which 375 are franchised) across the UK. In 2013, Roger Whiteside, former CEO of Punch Taverns Ltd., stepped into the top role. Deciding that Greggs could no longer compete against supermarkets, the new head man set a course for "food on the go," and the £1.75 Greggs breakfast sausage roll is today's anchor product.

Under Whiteside, Greggs shed in-store bakeries in favor of centralized facilities and kept the dowager chain relevant with such innovations as a well-reviewed, zeitgeist-acceptable, ESG-compliant vegan sausage roll. (To judge by the reaction of the British press, the 2019 unveiling was a cultural phenomenon.) Operating margin jumped to 12.5% in 2021 from 4.4% in 2013. Time will tell about the advisability of a Greggs-branded clothing and accessories experiment that got under way this year.

Roisin Curie, the retail and property director for Greggs, is slated to succeed Whiteside as CEO next month. Worries that the incumbent might be stepping out at the top were somewhat allayed by pledges at the Oct. 5, 2021 analysts' day to double sales to £2.4 billion by 2026, from £1.2 billion in 2021, by building more stores, extending store hours and ginning up more delivery sales.

"We've got the opportunity to reach much further into the market because we can go multichannel now," Whiteside told participants on the March 8 conference call. "I'm feeling very optimistic about the business, and I'm feeling particularly pleased that we're able to hand over the reins to Roisin, because she's been working alongside me for the last eight years."

The Dec. 31 balance sheet showed a cash balance of £198.6 million, no debt and (the only long-term liabilities of note) £283.2 million in operating leases.

All but two analysts on the case say buy, though insiders have sold a net 9,831 shares over the past 12 months for proceeds of £235,296. With the stock trading at 20.2 times estimated 2022 earnings, much of the good news would seem to be priced in.

The company's exposure to rising labor costs are not priced in, we think. To meet its growth targets, north England–dwelling Greggs must branch out in the southeast, a more affluent region with wage rates to match its higher average income.

Of the £1.2 billion in targeted growth by 2026, the planned addition of 819 retail locations is expected to chip in £600 million. The delivery app and expanded trading hours will produce an additional £280 million, and a customer-loyalty program, more walk-in traffic at existing stores and sales of baked goods to other retailers will deliver the balance.

There can be no guarantee, needless to say, that Greggs will meet its ambitious growth target. Cost-conscious consumers may balk at online ordering, and new dinner options may or may not win over a clientele attached to the tried and true Greggs sausage roll (and its vegan alternative).

The company is guiding for capital expenditures roughly to triple from the 2021 level from this year through 2025. Besides building new shops, management is also refurbishing its existing network of 2,183 stores, including "increased capabilities in food preparation."

The words just quoted signify a kind of managerial U-turn. Whiteside almost tripled margins by consolidating food production outside of the Greggs locations; now it appears that the plan is to bring some of that labor-intensive preparation back—which may come at the expense of those elevated margins.

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