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Margins to go

Evan Lorenz writes:

"This isn't complicated, really," said Carrols Restaurant Group, Inc. CEO Daniel T. Accordino last month as he set out to explain his corner of the dining-out business. You need 3%–4% same-store sales growth, measured year-over-year, to leverage your operating expenses, which, however, he added, in the first half of 2019, "we didn't get." Nor, perhaps, is Carrols getting it now. In August, industry-wide, comparable sales and store traffic fell 0.7% and 3.9%, respectively, from year-ago levels, according to TDn2K.

To anticipate the conclusion of this unfolding restaurant-themed analysis, *Grant's* is newly bearish on GrubHub, Inc. (GRUB on the Big Board) and we are familiarly bearish on Restaurant Brands International, Inc. (QSR on the New York Stock Exchange) and Middleby Corp (MIDD on the Nasdaq).

Without recalling some of the consequences of artificially low interest rates, you'd struggle to square sloppy restaurant sales with an apparently stout economy. Thus, in August, America added 130,000 jobs, leaving the unemployment rate unchanged at the half-century low of 3.7%. Hourly wages rose 3.2% year-over-year last month, in excess of the 1.7% rise in the CPI.

The source of the struggles of the dining-out business is more micro than macro. The villain of the piece is the overproliferation of restaurants (*Grant's*, Feb. 8). Nor is the rise in home delivery helping matters.

GrubHub, one of the dominant online and mobile platforms for restaurant pick-up and delivery, operates under its own eponymous brand as well as under the Seamless, Eat24 and MenuPages brands. In the second quarter, GRUB boasted 20.3 million active users who ordered an average of 488,900 meals a day for a total of $1.5 billion in gross food sales.

Business is booming. In the second quarter GrubHub's sales soared by 36%—not that the restaurants that did the cooking shared much of the bounty. In the first place, they bear fees that amount to 20%–30% of each order (in the June quarter, GRUB's take equaled 22.3% of sales). To convey the magnitude of this burden, Carrols's operating margin last quarter worked out to 0.6% of sales. In the second place, customers who order online typically don't buy drinks, one of the highest gross-margin items on the menu. Altogether, for the restaurants, delivery means a kind of profitless prosperity.

Then, too, delivering food is a highly competitive business. A restaurant operator with whom I spoke (he manages more than 100 stores nationwide) says he loses money on each order placed through DoorDash, Inc. Our informant says he contacted his DoorDash rep to negotiate a reduction in the 30% fee he was paying, perhaps to 25%. But before he could plead his case, DoorDash had retreated to 20%.

GRUB has flourished in cities. Its current expansion outside those dense metropolitan areas is taking its toll on margins. Average orders per customer and adjusted earnings before interest, taxes, depreciation and amortization per order shrank, in the second quarter to 2.17 and $1.23, from 2.44 and $1.75 a year ago. In the first quarter of 2012, before the new outreach to suburbia, the average customer placed 6.94 orders per quarter. In consequence, GRUB's growth has not delivered increased earnings, rather the opposite: Adjusted Ebitda dropped to

GrubHub, Inc.

all figures in $ millions unless otherwise indicated

	2014	2015	2016	2017	2018	TTM
revenues	253.9	361.8	493.3	683.1	1,007.3	1,183.8
adjusted Ebitda	78.7	105.0	144.6	184.0	233.7	207.9
operating income	45.0	61.9	83.1	89.8	85.0	34.0
net income	24.3	38.1	49.6	99.0	78.5	25.7
gross food sales	1,787.4	2,353.6	2,998.1	3,783.7	5,056.8	5,552.7
active users (in millions)	5.0	6.7	8.2	14.5	17.7	20.3
adj. Editda/order (in $ per order)	0.85	1.27	1.44	1.52	1.47	1.20
total assets	978.9	1,060.2	1,197.5	1,543.8	2,065.7	2,343.2
cash	241.2	266.7	285.8	185.9	225.3	377.0
debt	0.0	0.0	0.0	173.5	341.8	492.7

source: company documents

$54.7 million in the June quarter from $67.4 million in the year-ago period.

"One of my reasons for being short these companies is, in fact, the labor arbitrage," James Chanos, founder and managing partner of Kynikos Associates, L.P., tells me. He estimates that the typical driver makes around $12 per hour. Assuming that each works for 40 hours a week, the cost of owning a car comes to $2 per hour plus another $2 per hour for fuel. "The killer that a lot of drivers don't realize is that they are 100% on the hook for Social Security and Medicare, which is 15.3%," Chanos says. "Normally, if you're an employee, you pay 7.65% and your employer pays 7.65%. But independent contractors have to file those taxes, and it is not progressive. It is on the first dollar."

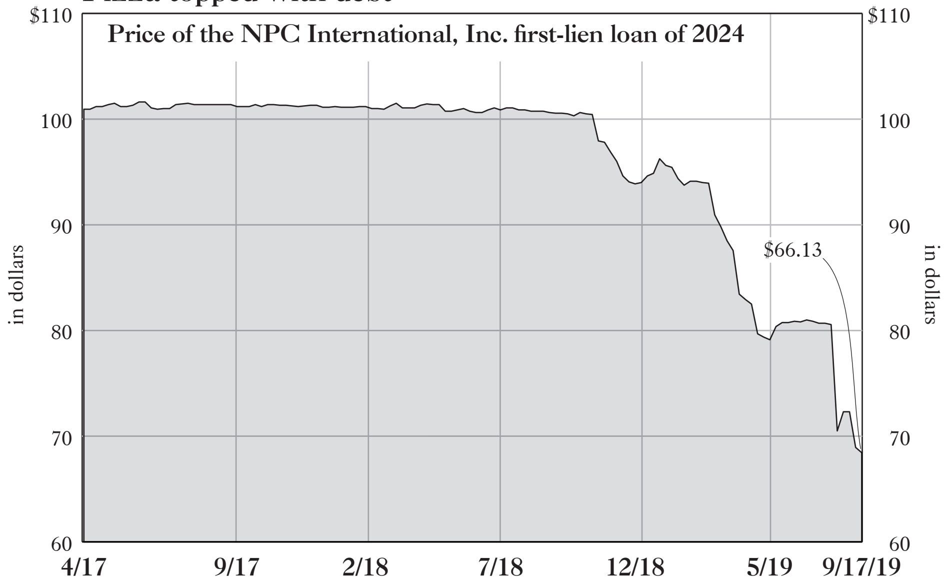
The bare fact is that many of GrubHub's drivers could earn more by preparing food than by delivering it. According to a Sept. 3 CNBC interview with Edward Rensi, the chairman of FAT Brands, Inc. and a former CEO of McDonald's, entry-level restaurant workers can make $15–$17 an hour in big metropolitan areas, $12–$13 per hour in smaller communities—"if you can get applicants."

Regulators, too, seem intent on eating GrubHub's lunch. California's new Assembly Bill 5 puts paid to the practice of classifying employees who fall inside the "usual course" of business as independent contractors. The law will force the likes of GrubHub and Uber Technologies, Inc. to begin paying Social Security, Medicaid and unemployment taxes on the earnings of their former gig workers. The New York State Liquor Authority is weighing potentially adverse regulatory action of its own.

But the regulators aren't responsible for GrubHub's latest PR problems. They didn't demand that the company register domain names for the restaurants on its platform or list GRUB-owned phone numbers on the websites it creates in the name of its clients. Why did GRUB do what it did? A customer order placed over the phone will be attributed to GrubHub, which can therefore take a fee. Yelp, Inc., too, lists GRUB-owned phone numbers for restaurants on its site, according to a report in Vice.

Consumers like everything about delivery except the cost. "We did a large consumer survey recently and asked for their biggest complaints with third-party aggregators," says Christopher O'Cull, who covers the sector for Stifel Financial Corp. "The No. 1 complaint is it is too expensive. People are questioning whether they want a $4 fee when they want to get a Big Mac combo delivered to them. It will be interesting if we ever go into an economic downturn."

Pizza topped with debt



source: The Bloomberg

GRUB trades at 49.9 times 2019 estimated earnings and 41.5 times enterprise value to Ebitda. Over the past 12 months, insiders have net sold 59,875 shares for proceeds of $6.5 million. Net debt foots to $115.7 million, a multiple of 0.6 to trailing adjusted Ebitda. Of the 33 analysts who cover the stock, 22 say buy and 10 say hold; one says sell.

Bulls believe that delivery will take a share from dining out and that GRUB will be one of the winners. "At the end of the day, what is the value proposition here?" Chanos rhetorically asks, and he answers: "You get to grow into a nongrowth market at very, very low margins where everyone is going to be constantly cutting prices. The valuations seem to be absurd if you step back and say, 'What happens if the bulls are right?'"

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On Sept. 10, the Wendy's Co. share price plunged by 10.2%. Breakfast was the culprit—not just the news that the fast-food retailer was going to take another stab at selling the Most Important Meal of the Day or that management had already failed in the same attempt in 1985, 2007 and 2012. Cost was rather the issue: Wendy's will spend $20 million in advance of the launch this year and has pulled its guidance for next year. As a result, the company projects a 10.8% drop in adjusted Ebitda in the second half of 2019, down from Aug. 7 guidance of a 2.1% decline. McDonald's Corp., which describes the struggle for restaurant traffic as a "street fight," has also circled breakfast as the meal to pull more consumers through the door.

Sara Senatore and her team at Sanford C. Bernstein Ltd. find that the valuations of fast-food stocks have nearly doubled, to 29.3 times earnings from 15.4 times, from a decade ago. Remarkably, much of the upswell occurred in the past three years and "valuations remain at historical peaks." Even so, the analysts contend that fundamentals justify the share prices: "large-cap [quick-service restaurant] margins and returns are also above peak, as refranchising has transformed these companies into asset-light models; the average large-cap QSR combined margin has expanded 830 basis points in the past decade, 690 basis points in the past three years alone."

Of course, other reasons can be found to explain the popularity of restaurant franchisors. The asset-lite model, in which brands sell stores to franchisees and clip a percentage of their sales, is said to be immune from the vagaries of the economic cycle, including rising wages and commodity costs. Restaurant stocks also fill a void: Many portfolio managers cut their teeth on retail stocks, but Amazon.com has rendered those shares uninvestable. Bulls call the eating-out sector "Bezos-proof."

Franchisors' margins have been soaring, but the margins of their putative partners, the franchisees, remain earthbound. Just why this is so isn't entirely clear since so few franchisees issue public financials.

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Restaurant Brands International, the nation's fourth-largest franchisor by market cap, owner of the Burger King, Tim Hortons and Popeyes brands, reported second-quarter growth in sales and adjusted Ebitda of 4.2% and 3.2%, respectively.

Carrols, the largest franchisee within the RBI system, and No. 4 nationally, with 1,023 Burger King and 58 Popeyes outlets, reported a 21.6% jump in second-quarter sales (thanks to acquisitions) but a 27.4% plunge in adjusted Ebitda.

"[O]ur restaurant-level profitability and adjusted Ebitda were challenged by a number of factors, most significantly by the deleveraging from flat comparable-restaurant sales," the afore-quoted Accordino said on the Aug. 8 earnings call. Positive 0.1% growth in same-store sales failed to offset a 3%–4% rise in commodity costs and a 5.2% jump in labor expenses.

The launch of Popeyes's much-heralded chicken sandwich and Burger King's Impossible Whopper will likely give the franchisee a third-quarter sugar rush. But what then? In the June quarter, single-B-rated Carrols failed to cover its $6.9 million in interest expense with $2.1 million in operating profit.

NPC International, Inc. the nation's No. 2 franchisee, operator of 394 Wendy's outlets and 1,237 Pizza Huts, is in a worse way, credit-wise, than Carrols. On April 18, S&P Global Ratings downgraded NPC's senior secured first-lien loan of 2024 to triple-C-plus from single-B-minus. Among the reasons given: negative free cash flow and leverage above eight times Ebitda. The first-lien credit, which pays Libor plus 350 basis points, is quoted at 66.1 cents on the dollar today, down from 93.9 cents at the start of the year.

Like their acquisitive brand owners, franchisees have spent the past decade getting larger by rolling up competitors. In 2008, according to *Restaurant Finance Monitor*, the largest U.S. franchisee, then NPC, generated $690 million in revenues. In 2018, the 10th-largest franchisee beat that mark with room to spare ($703 million) while the top-four franchisees each cleared more than $1 billion.

The failure of a large franchisee could challenge the comfortable belief that franchisors have separated themselves from the economics of running a restaurant. "If we go into a recession, and there were starting to be layoffs, you would see 20% of the restaurants in the country closed," John Hamburger, president of Franchise Times Corp., tells me. "It would be catastrophic."

Banks including Regions Financial Corp., Equity Bancshares, Inc., Cadence Bancorp and First Financial Bancorp have called out restaurants for an uptick in slow-paying loans. "The lenders have really tightened the screws in the space," Hamburger says. "It isn't like it was two years ago where basically the lenders were all over you. It has changed. Restaurant franchise lenders have been through this."

But the capital markets remain wide open, especially for the asset-lite franchisors. Two Fridays ago, Restaurant Brands issued $750 million in 3⅞% secured first-lien notes, due Jan. 15, 2028, at par. This is remarkable for a couple of reasons. The deal was upsized from $500 million to satisfy investor demand. Rated double-B/Ba2, the notes were the first eight-plus-year maturity U.S. junk bonds to be issued with a sub-4% coupon since at least 2017, according to Bloomberg.

If you look closely enough, the putative business distance that separates franchisors and franchisees is already closing. Thus, Wendy's itself is funding the push into breakfast—a franchisee I contacted says he expects to have "minimal" capital outlays. McDonald's is contributing 55% of the cost of remodeling in the United States, and RBI is handing over an unspecified amount to the estimated C$700 million price tag to refurbish Tim Hortons stores in Canada (*Grant's*, July 13, 2018). Tims owners, however, may choose to examine the teeth of this gift horse. Said Alex Macedo, president of the Hortons division at RBI, at the May 15 investor day: "Historically, with Tims in Canada, we have not seen a material comp uplift from new models, which we attribute to our high brand density and frequency." In the second quarter, Tim Hortons, which generated 49% of RBI's Ebitda, expanded same-store sales by an anemic 0.5%.

RBI trades at 27.2 times estimated 2019 earnings and 20.1 times enterprise value to Ebitda. As of June 30, net debt footed to 5.3 times trailing Ebitda. Of the 26 analysts who cover the stock, 19 say buy, six say hold—and one says sell. Over the past 12 months, RBI insiders and 3G Capital, which holds a 32% equity position in RBI, have sold shares worth $3.8 billion.

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Remember Middleby, manufacturer of restaurant and kitchen appliances and the capital goods used to make packaged foods (*Grant's*, June 17, 2016)? The commercial food-service division, which produces restaurant equipment under brands such as TurboChef and Blodgett, contributes 73% of adjusted Ebitda. The residential division (brands such as Viking and AGA) and food-processing division (RapidPak and Drake) chips in 15% and 12% of adjusted Ebitda, respectively.

In the June 17, 2016 issue, *Grant's* laid out the bear case for Middleby. Poor franchise economics, we speculated, would lead to a slowdown in restaurant orders. While Middleby has completed more than 50 acquisitions over the past decade, the legacy of those integrations creates its own headaches. We identified the high-end residential brands that MIDD had purchased as problematic, and sales in the residential division fell to $149.9 million in the second quarter of this year, from $176 million in the second quarter of 2016. Then, too, we were skeptical of MIDD's M&A accounting, which classifies most of its acquired assets as intangibles and goodwill.

On July 30, TriFin Advisors, an investment firm that positions itself first and publishes second, issued a 46-page report to update the bear case. MIDD makes no secret of its "premier customers," TriFin notes—it lists them in its investor presentations. Add up the expected capital expenditures from this group, the report finds, and you will see diminishing projected outlays for 2019–21. "[W]e've seen customer delays in timing of replacements and roll-outs, which may extend certain anticipated 2019 business, with some of these chain customers into 2020," CEO Timothy Fitzgerald acknowledged on the company's Aug. 7 earnings call.

MIDD faces a host of other problems. As of June 29, Middleby's net debt of $1.9 billion footed to three times Ebitda, near an all-time high for the company. The June 29 financials showed a 24% bulge in inventory, outpacing the 14% growth in sales and bringing days-inventory to a near record of 117 days. Then, too, Middleby faces difficult comparisons in the back half of the year. Sales, adjusted for acquisitions and foreign exchange, rose 1.3%, 2.9%, 3.3% and 0.8% over the past four quarters. These figures, however, were flattered by declines (0.4%, 7.2%, 5.7% and 2.1%) in the four quarters ended June 30, 2018.

In the footnotes, Middleby discloses what its pro forma sales would be had it owned all acquirees at the start of the reporting period. The pro forma growth rate tumbled to negative 1% in the first half from positive 0.1% in the first quarter, implying that Middleby and its acquisitions shrank by around 2% in the second quarter. "This doesn't bode well for some of the newer acquisitions they've made that they haven't fully annualized," Dylan Wehr, the principal at TriFin, tells me. "I think that creates an additional headwind not only to reported growth but also organic growth when they fully lap these acquisitions."

Middleby changes hands at 18.3 times 2019 estimated earnings and 13.9 times enterprise value to Ebitda. Of the 10 analysts who cover the stock, six say buy, four say hold—and none says sell. Over the past 12 months, insiders have sold a net 1,495 shares for proceeds of $195,661.

Put it all together and you see a pattern. Artificially cheap capital impels business action. It finances expansion, motivates entrepreneurs and gives employment to investment bankers. At the end of the cycle, it favors a new group of investors—the workout specialists. Perhaps the grave dancers are already waiting in the wings.

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