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Burgers with relish

Evan Lorenz writes:

In the United States, restaurants have plenty of customers but lack employees, whereas in Latin America it's the other way around. While U.S. employers are doling out wage hikes and margin-diluting fringe benefits, Latin American restaurateurs are tapping their feet for the lockdowns to end. In preview, *Grant's* is bullish on Arcos Dorados Holdings, Inc. (ARCO on the Big Board), the McDonald's master franchisee in South America, Central America and the Caribbean.

Arcos Dorados owes its 2007 creation to Woods Staton. The former McDonald's executive paid $700 million for the Central and South American division of the burger behemoth that he formerly managed. Capital International, Inc., Gavea Investment A.D., L.P. and DLG South American Partners, LLC were his money partners. Now Arcos Dorados (Spanish for "golden arches") is McDonald's single largest franchisee.

As for why the parent was willing to sell: "We weren't put on this earth to deal with this kind of volatility," *The Wall Street Journal* quoted then–CFO Matt Paull as saying about the monetary and macroeconomic drama in Latin America. "It makes us nervous, and it makes some of our shareholders nervous."

Today, Arcos Dorados manages 2,242 restaurants, including 1,580 company-operated units and 662 subfranchisee-operated ones. It divides the business into fourths: Southern Latin America (comprising Argentina, Chile, Ecuador, Peru and Uruguay), which kicked in 27% of first-quarter revenues; Caribbean (a long string of islands plus Colombia, Venezuela and French Guyana), 21%; Brazil, 36%; and Northern Latin America (Costa Rica, Mexico and Panama), 16%.

Arcos pays the franchisor, McDonald's, a royalty fee (set to 5.3% of sales in 2021) and ticks a host of operational and financial boxes. It must open a certain number of stores and invest to refresh a portion of its store base every year. It must meet certain financial covenants, including a ratio of net debt to Ebitda of no more than 4.25 times.

Another stipulation puts public shareholders in the governance back seat. The master franchisee agreement directs Staton to hold at least 51% of the voting stock, which he does through a dual stock class that confers on him the right to five votes per share versus one for public shareholders. All told, Staton owns stock commanding 38.6% of the economic rights to Arcos and 75.9% of the voting interests. Arcos's agreement with McDonald's expires in 2027 but is renewable at decade-long increments thereafter.

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Arcos Dorados's initial public offering almost top-ticked the stock markets of the countries in which Arcos sells hamburgers. The MSCI EM Latin America Index carved out its post-financial-crisis high exactly one week and one day prior to the franchisee's April 13, 2011 debut. Since then, Latin American stocks have generated a cumulative 24.6% loss in dollar terms, including reinvested dividends, compared with a 298.7% gain for the S&P 500.

By combining inauspicious timing with an aggressive initial valuation, Arcos has managed to underperform even that lamentable record. Out of the blocks, the stock was priced at 31.5 times 2011 earnings, more than twice the 14.6 times multiple that the parent commanded. No surprise, then, that Arcos has lagged the broad Latin American market with a 62.2% loss since its IPO a decade ago while McDonald's has produced a 308.9% return, both including reinvested dividends.

Arcos shareholders soon wished they had taken Paull's 2007 warning to heart. At the IPO, Argentina and Venezuela contributed 13.8% and 7.6%, respectively, of corporate revenue. During the next nine years, Argentina's economy contracted by 26.4% in dollar terms and Venezuela's by 86.6%. Neither did Brazil's 2015–16 recession, in which real output in local terms declined by 6.7%, exactly burnish Arcos's results. For reference, the peak drawdown in U.S. economic activity following the housing bust was 4%.

As Arcos borrows in U.S. dollars and generates earnings in local currencies, such home-market problems as the Venezuelan catastrophe quickly metastasized into balance sheet trouble. The leverage ratio bulged to 4.38 times Ebitda on June 30, 2014, from 1.8 times at year-end 2013. The possibility that McDonald's could use that violation as grounds to withdraw its franchisee agreement sent the Arcos share price tumbling to an all-time low of $2.15 on Feb. 12, 2016, compared with the IPO price of $17 per share.

But a forbearing McDonald's granted its franchisee covenant waivers through the second quarter of 2016, and Arcos used that abeyance to sell $170 million's

Arcos Dorados Holdings, Inc. at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
revenue	$1,927.8	$1,984.2	$2,959.1	$3,081.6	$3,319.5
net operating income	-66.4	-66.8	159.9	123.5	272.9
net income	-126.8	-149.5	79.9	36.8	129.2
shares	207.6	207.3	204.1	205.2	211.1
earnings per share	-0.61	-0.73	0.39	0.18	0.61
cash	148.2	166.0	121.9	197.3	328.1
debt	651.2	673.2	595.8	589.8	621.5
total assets	2,173.1	2,294.0	2,557.7	1,578.0	1,803.7

* Twelve months ended March 31, 2021.

source: company reports

worth of real estate to pay down debt and cut operating expenses. By Sept. 30, 2016, Arcos's leverage ratio had declined to 4.08 times, putting it back on the right side of the law.

Then came Covid-19. In full-year 2019, the company's restaurants generated a same-store growth rate of 11.8% in local currencies and an Ebitda margin, excluding Venezuela, of 10%, the highest since going public. Nothing seemed more natural than to sign on to an ambitious restaurant-opening and reinvestment program with the McDonald's front office for the beckoning years of 2020–22.

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Latin America was hit harder by Covid than its big northern neighbor and is behind the United States in vaccination rates. As we go to press, 49.2% of Americans are fully vaccinated, compared with 16.4% of Brazilians, 17% of Mexicans and 20.5% of Colombians. Such facts help to explain why same-store sales for McDonald's in the United States surged by 13.7% in the first quarter over the first three months of 2019, compared with a drop of 2.5% for the Arcos Dorados store base, in local currency terms.

However, business is bouncing back. "In the case of Brazil, we are seeing how quickly sales levels recover once government restrictions are relaxed," CEO Marcelo Rabach said on the May 12 earnings call. "Compared with 2019, sales in the first week of April were down 40%. By the last week of the month, sales had recovered to down 20%, and in the first week of May, sales are already back to within 10% of the same period in 2019."

The competitive environment for Arcos has improved, too. For one thing, its biggest competitor, BK Brasil Operacao e Assessoria a Restaurantes S.A., which holds the rights to the Burger King franchise in Brazil, went public in December 2017. As a private company, BK Brasil cut prices to win market share. Now, as a public company, it must focus on profits.

And in Latin America, as in North America, the virus-cum-lockdown has done surviving restaurant owners a good Darwinian turn. "We believe recent industry trends have made for a complicated scenario, particularly for smaller, less formal and non-chain players in the restaurant business, which have led to relevant closure of these kinds of restaurant operations across regions," JPMorgan Chase & Co. analysts Ulises Argote and Lucas Ferreira comment. "Although official data across LatAm is not easily available, data points to around 30% of total restaurants being closed since the start of the pandemic." According to CREST, a restaurant-data unit of NPD Group, Arcos is gaining market share.

One might suppose that, surging commodity prices notwithstanding, the cull of the competition would allow for higher pricing, and so it appears. Gross margins notched a 20 basis-point improvement in the first quarter of 2021 compared with the year-ago period. "We have seen a more rational, competitive environment, with less aggressive pricing and promotional activity," Daniel Schleiniger, head of Arcos's investor relations, tells me.

Technological adaptation has paid another pandemic dividend. In the first quarter, Arcos snagged 37% of sales made on a digital device, surpassing the 29% that McDonald's Corp. posted in the same quarter. "The McDonald's mobile app [which Arcos developed for Latin American use] has the highest user rating in the industry and has surpassed 52 million downloads as of last week with mobile 'order and pay' sales starting to gain momentum as well," Chief Operating Officer Luis Raganato told analysts. "According to App Annie, at the end of the first quarter of 2021, we had more than two times the number of active users as our closest competitor in our key markets [did], including a 30 percentage-point expansion in the gap since last year."

"Any crisis is an opportunity," remarks John Haskell, founder and CIO of the Atla Capital Global Urbanization Listed Fund, which holds a position in Arcos. "In this case, the crisis in Latin America has been an opportunity in belt-tightening, and they have stripped costs out of their operations. If you go back a few years, you will learn about their implementation of a digital initiative to better schedule staff for the right hours in all of their stores. They are able to reduce staffing costs across the board. They've really stripped down costs, and that is only really possible in tough times when you have a mandate to cut down on SG&A."

Investors conferred a fancy multiple on Arcos in 2011 in anticipation of growth in the underpenetrated Latin American markets. That story is still alive, even if Covid interrupted it. Adjusting for population size and purchasing-power parity of the respective currencies, Schleiniger tells me, Latin America has maybe one-third or one-fourth as many quick-service restaurants as the United States. "One way to think about that is, pre-pandemic, when we looked at the 2020–22 opportunity, we had said that we would open between 95 and 100 restaurants per year."

The risk that McDonald's chooses not to renew Arcos's franchisee agreement in 2027 seems remote. Big Burger's very M.O. is to concentrate on the asset-light franchisor side of the business rather than bear the cyclical risks and capital costs of restaurant operation. As of Dec. 31, 2020, McDonald's owned only 6.8% of the restaurants in its system, down from 27.7% before the 2007 sale of the Latin American operations.

Besides, McDonald's has no more desire to bring the economic volatility of Latin America back onto its balance sheet today than it did 14 years ago. Or perhaps less desire. The aforementioned waiver relief to Arcos for violations of its franchise agreement in 2014 was only the first. A second round of forbearance, stemming from Covid-induced business interruptions, was granted in 2020 and lasts through Dec. 31, 2021.

Hidden assets on Arcos's balance sheet provide some counterweight to these risks and mishaps. Today, the company owns land under 489 Arcos restaurants, out of a grand total of 2,242. In 2009, the real estate holdings were appraised at $930 million. The subsequent sale of $170 million's worth of real estate to lighten the debt load still leaves $760 million, a figure equal to 46% of the Arcos enterprise value, also based on 2009 property values.

"Even since 2009, metropolitan areas in Latin America have substantially developed," Haskell tells me. "The scarcity of land is something that is a secular trend that drives appreciation. I think there is real downside protection to that." For his part, Haskell reckons that the current value of these real estate holdings is closer to $1.1 billion, a figure equal to 66% of Arcos's enterprise value.

In the first quarter, trailing 12-month Ebitda came in at a Covid-ravaged $66 million, down 78% from 2019. Naturally, this collapse registered on the balance sheet, blowing up the ratio of net debt to trailing Ebitda to 7.9 times, not quite twice the covenant-stipulated maximum of 4.25 times.

For the denominator of that ratio, an optimist might use, instead, the 2021 Wall Street Ebitda estimate, which would reduce the leverage ratio to 2.7 times. A greater optimist could use the actual 2019 figure, which would pare the ratio of Ebitda to net debt all the way down to 1.7 times. And McDonald's seems prepared to credit the forecast, and/or the track record, more than the anomalous first-quarter print. In any case, the former parent has granted Arcos a waiver on leverage through the end of the year.

Earning and borrowing in local currencies, and recalling all too well the balance sheet tribulations of 2014–16, Arcos is using swaps to convert half of its debt into Brazilian real. Operations in geographies that use dollars or euros, e.g., Puerto Rico and the French West Indies, provide enough hard currency to service the other half of the debt, which is denominated in dollars.

The problems that dragged down the stock over the last decade offer optionality for the future. Arcos manages 110 restaurants in Venezuela, or 5% of the company total. Those outlets largely source supplies locally and are just about break-even on a free-cash-flow basis. However, owing to the collapse in the value of the bolivar, Venezuela contributed only 0.3% of revenues in the first quarter, down from 7.6% as recently as 2011.

"Venezuela has been written down to zero," Steven Grey, CEO and eponym of Grey Value Management, LLC, which holds a position in Arcos, tells me. "You have this business that somehow they are still managing to operate and run pretty well in what is a quasi-failed state." So count Arcos a prime beneficiary of any future conversion of President Nicolas Maduro to laissez-faire capitalism from anarcho-communism.

While currency depreciation has been a headwind for Arcos Dorados since the decade-old IPO, the exchange rates in Arcos's main markets look undervalued. That is, at least, as measured by the price of Arcos Dorados's own menu items. The Big Mac Index, which gauges whether a currency is under- or overvalued based on the price of that most iconic sandwich, indicates that the Brazilian real is 24% undervalued and the Mexican peso is 52% too cheap compared with the U.S. dollar.

While Federal Reserve Chairman Jerome Powell dismisses the surge in inflation as transitory, his confreres in Latin America are not so sure. Last week, the Central Bank of Chile became the third central bank in the region to raise rates this year, after Brazil and Mexico. The combination of cheap currencies and hawkish central banks could make currency translation a tailwind, instead of a perennial drag, on Arcos's results.

With six buys, four holds and no sells, Wall Street is moderately friendly to ARCO. However, analysts pencil in sales of just $2.7 billion in 2022, 9.4% below the 2019 mark. Based on these low expectations, Arcos is valued at 20.2 times estimated 2022 earnings. Based on 2019 results, the stock is valued at 12.9 times prior peak earnings.

But Arcos, having slashed costs, has put itself in a stronger competitive position than it was two years ago. "Is 2019 a ceiling or a floor for us in terms of margins?" Schleiniger asked and then answered: "We think in the medium to long term that 2019 was a floor."

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