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Check, please, waiter

Five years ago, restaurant stocks traded at an average forward price-earnings multiple of 16 times. Today, they trade at an average forward multiple of 26 times. Tomorrow is the subject at hand, and Wendy's (WEN on the Nasdaq) is the point of focus. In preview, we're bearish.

It's easy enough to explain the spike in restaurant stocks over the past nine months. Gasoline prices plunged, hiring accelerated and the dollar strengthened. The first of these stimuli was perhaps the most potent. Like jet aircraft, American consumers run on petroleum. The statistical correlation between restaurant share prices and oil prices is strong and negative.

Not to be forgotten is the statistical correlation between restaurant stocks and the restaurant companies that issue them—the shares are more than pieces of paper. As businesses, restaurants are cyclical, faddish, competitive and, increasingly, leveraged. The stocks are similarly cyclical and faddish. In many of these attributes, leverage not least, Wendy's is exhibit "A."

It doesn't take much to start a new restaurant. Tiny interest rates and avid venture capital further reduce the barriers to entry. If it were otherwise, McDonald's, biggest of the American eatery chains, wouldn't be shrinking its North American store count. Nor would it have been recently reduced to inviting its customers to "Pay with Lovin," calling your mother or asking a perfect stranger to dance—in lieu of settling the check in cash.

While restaurant stocks may rise or fall together, the restaurant industry is divided into four distinct segments. No. 1 is "quick service restaurants," a.k.a. fast food, e.g., McDonald's, Burger King and Wendy's. Within QSRs exists a thriving subtype called fast casual dining, of which Chipotle is the archetype. Fast food accounted for 79% of customer traffic in the 12 months to March, according to the NPD Group.

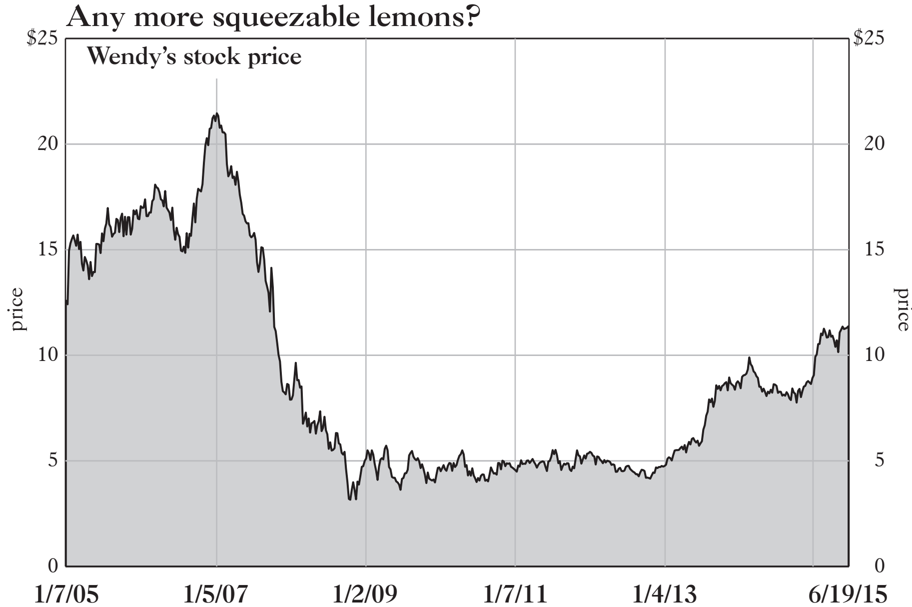
Niche No. 2, midscale dining, attracts 10% of customer traffic. IHOP and Cracker Barrel are representative members of the mid-scale coterie. They don't accept reservations and they usually don't serve alcohol.

Segment No. 3, casual dining, pulls in another 10% of the eating public. Applebee's and Chili's, examples of the type, do accept reservations and may serve you a drink. Fine dining is type No. 4, claiming 1% of the traffic. Call ahead for a table, study the wine list and don't forget your credit card.

People may have to eat, but they don't have to go out to eat. "Overall, the industry is not growing in terms of traffic," Bonnie Riggs, restaurant-industry analyst for NPD Group, tells colleague Evan Lorenz. "It is flat and has been flat for the last five years." Millennials, 74 million strong, bear the brunt of the blame, if blame is the word, Riggs goes on. During the Great Recession, young people learned to cook. Many decided they liked it. "It's not that they are not going out to eat," Riggs adds, "it is that they are not going as often as they once did."

And when they do go out, the young set's destination of choice is more likely to be Chipotle, Panera Bread

Any more squeezable lemons?



source: The Bloomberg

Co. or Shake Shack than McDonald's, Burger King or Wendy's—that is, fast casual rather than fast food. "While, for now, the fast casual group accounts for only 5% of traffic," Lorenz relates, "it's growing at the expense of other restaurant categories. Barring a change in millennial preferences, fast food, mid-scale and casual dining may struggle for traffic growth for years to come."

"Traffic," or head count, as distinct from same-store sales, is the restaurant metric of choice. According to NPD surveys, fine-dining traffic grew by 2% in the 12 months ended March 31; fast-food traffic grew by 1% in the same span. Mid-scale registered 2% shrinkage, casual was flat. Traffic at fast casual, resurgent behind Chipotle, enjoyed a 7% bump.

John Hamburger, guiding light of the newsletter *Restaurant Finance Monitor*, likes to say that "there is McDonald's—and everybody else." The giant registered U.S. store sales of more than $35 billion in 2014. Burger King and Wendy's together produced $17 billion. For perspective, Chipotle took in just $4.1 billion. Still, entrepreneurs strive to duplicate Chipotle's stupendous success. R.J. Hottovy, retail and restaurant analyst at Morningstar, characterizes the Chipotle implementation of the fast-casual business idea in these words: "[I]t combines the pricing power of a casual dining chain with the cost structure of a quick service restaurant chain. That's a pretty powerful thing.

"The number of times I've heard a company try to pitch itself as the next Chipotle," Hottovy adds—"if I had a dollar for every time I've heard that!"

The elephant in the dining room is Bezos & Co. Amazon is making its disruptive presence felt in ways both indirect and overt. As to the first, the Amazon-fomented revolution in retailing has created real estate vacancies that facilitate the founding of new restaurants. As to the second, as Lorenz points out, "Amazon is pushing out a new app to its so-called Prime subscribers called Prime Now. In Manhattan, I can order groceries and prepared meals from D'Agostino, the Gourmet Garage, Billy's Bakery and Amazon itself. The app promises that deliveries will arrive within one hour."

Curiously, though, industry-wide traffic is stagnant, as expansion continues apace. "From a traffic standpoint," says Chris Stent, vice president of investor relations at McDonald's, "the industry is not growing much at all but the unit counts are increasing. That, to us, doesn't make sense over the long term." In what might be a McDonald's first, the company is on track this year to close more American stores than it opens. Measured by same-store sales (not by traffic), McDonald's registered a 2.6% first-quarter decline in U.S. locations. Wendy's, by contrast, reported a 3.2% same-store gain in its North American operations.

Growth comes later

source: company reports

Wendy's is the chain that Dave Thomas founded in Columbus, Ohio, in 1969. Who didn't love the commercials featuring the shy and fumbling entrepreneur who probably couldn't have raised a dime on "Shark Tank"? It's a very different front office since Triarc Cos., led by Nelson Peltz, bought control in 2008. Financial engineering is front and center nowadays: debt is soaring as the share count is plunging. "Asset lite" in the name of shareholder value are the managerial watchwords.

Availing itself of the hospitality of the Fed's emergency interest rates (now in year eight), Wendy's is paying a blended rate of 3.9% on a new $2.275 billion asset-backed security term facility. Proceeds will refinance $1.5 billion of debt and fund a newly announced $1.4 billion share buyback. When all is said and done, the balance sheet will be leveraged to the extent of six times 2014 EBITDA, up from 3.4 times at the end of the first quarter and 2.6 times at the end of 2013. At the current share price, anticipated buybacks would cut the number of shares by a third.

You'll have to wait for the projected shareholder payday. Not even a sub 4% borrowing cost is low enough to deliver immediate accretion. "Due primarily to the magnitude and timing of the repurchases," CFO Todd Penegor told dialers-in on a June 3 call, "we expect the increased interest expense from the refinancing to offset the EPS benefit from share repurchases through 2016."

Henry Singleton, CEO of Teledyne and pioneer in corporate capital allocation a half-century ago, was wont to repurchase stock when the price was low. Wendy's is paying 35 times estimated 2015 net income to buy back its shares—which shares, incidentally, Peltz and the insiders (save an optimistic general counsel) have been heavily selling.

Thirty-five times happens to be Chipotle's forward P/E ratio, too. It's an instructive coincidence. Chipotle is growing, Wendy's isn't. The source of the valuation parity, according to those who presume to speak for the totality of investors, is Mr. Market's preference for royalty income over operating income. Of the 6,488 restaurants in the Wendy's chain, all but 15% are owned by the franchisees; if all goes according to plan, that 15% will shrink to 5%. So it is that debt-free Chipotle, which has no franchisees but which is expected to show a gain in earnings per share this year of some 23%, changes hands at the exact multiple of an "asset-lite" business that is projected to deliver a 5%

contraction in EPS this year. Question: Is a highly leveraged stream of royalty income as safe and predictable as an unlevered one? The market implicitly answers "yes." We have our doubts.

As busy as the late Dave Thomas was in the fanciful Wendy's test kitchens in those long-ago commercials, Peltz et al. seem just as engaged in their laboratory of financial invention. The aforementioned asset-backed debt issuance comes in three tranches: $875 million in 3.371% notes with a nominal maturity of 4 ¼ years; $900 million in 4.08% notes with a nominal maturity of seven years; and $500 million in 4.497% notes with a nominal maturity of 10 years. The interest cost on the notes shoots up by 500 basis points or more if, come the respective maturity dates, management has been unable to refinance them. The facility has a final maturity of June 2045.

The net of store openings and closings means there will be 20 fewer Wendy's outlets at the end of this year than there were in 2014; there will be perhaps a dozen more Wendy's outlets at the end of 2016 than there are (or are projected to be) at the end of 2015. Management paints a picture of vibrant growth over the next five years—by 2020, it says, the company will have added—gross—1,000 stores, virtually all of them franchisee owned.

"Image Activation" is the name of the store-remodeling program that management has been pushing since 2013. It costs between $450,000 and $650,000 per store, no small sum for stores that gross $1.5 million a year. The grand design is that each remodeled restaurant will enjoy an uptick in revenue on the order of 10% to 15%; such improvement would imply an incremental profit of $73,415 on a $550,000 investment, which is to say a 7 ½-year payback. Around 12% of the stores have had their images activated so far; management is pointing toward 60% compliance by 2020. It insists that franchisees perform the facelift on 10% of their properties every year. Wendy's and its fourth-largest franchisee, Maryland-based DavCo, are locked in litigation over the mandated remodeling. DavCo contends that the promised returns aren't worth the visible cost.

The overall problem at Wendy's, we would say, is the lack of a margin of safety. Peltz & Co. have devised a strategy for the kind of world in which everything clicks—in which, just for example, interest rates remain low, GDP expands, the minimum wage stays where it is, the price of gasoline flatlines, and McDonald's never awakens from its self-induced slumber to reclaim its lost market share (on this score, the Golden Arches recently announced the first value initiative under the new CEO, Steve Easterbrook: a double cheeseburger and fries for just $2.50).

Mathew T. Klody, managing partner of MCN Capital Management, Chicago—it was he who kindly brought the Wendy's idea to our attention—says that he's sold short a basket of restaurant names, of which Wendy's is his top pick to not click. "Domino's 10-year average price to forward earnings is 17. It is now 33," he says. "Papa John's is 19. It is now 36. Cracker Barrel is 14. It is now 22. People are thinking that Cracker Barrel is a pure oil play. Jack in the Box is 29 times. The average is 16. Popeyes is 31 times. The average is 20. It is just—you scratch your head, but these momentum cycles, you never know when they are going to crest. Two months ago, no one would have guessed that airlines would have fallen 20%-25% in the past month.

"I think some people are beginning to view the restaurant model as similar to an Internet stock or social media model," Klody goes on: "If we can build a great platform, we can scale this thing rapidly and dramatically." As high returns and high valuations draw new capital, so come new entrants, including the likes of Shake Shack, Meatheads and Five Guys to pressure the likes of Wendy's and Burger King.

"Don't forget about McDonald's," Klody adds. "I'm not short McDonald's because there are too many activist shenanigans that could happen, and expectations are low. But you wouldn't know that given the valuation. McDonald's is still pricey. Don't forget that if McDonald's ever wakes up, they can take a lot of share from these other players who have been near-term beneficiaries."

Peltz, who at one time owned 22% of the company, today owns 20%. At the end of the month, Wendy's is buying back $639 million in shares through a Dutch auction. Peltz and associates will dump $211 million worth of stock through a separate sale.

No one questions the shrewdness of Nelson Peltz. What we do question is how much more juice he can squeeze from the Wendy's lemon. He has layered on the leverage, bought back (or prepared to buy back) the shares. Now what?

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