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Here's the beef

Evan Lorenz writes:

After a decade of 13% compound annual returns on the S&P 500, it's no mystery why the public is more bullish on the stock market than it's been since at least 1987, according to the Conference Board's polling. It's no mystery, either, why John Q. Vanguard may ultimately be disappointed.

With the latest lurch higher, the Magnificent 7 constitutes 32% of the market cap of the S&P. "[I]t is extremely difficult for any firm to maintain high levels of sales growth and profit margins over sustained periods of time," David Kostin, chief U.S. equity strategist at Goldman Sachs Group, Inc., warned last week. Invoking mean reversion and the law of large numbers, Kostin pencils in 3% returns for the S&P over the next 10 years.

Nor is it just America's biggest tech companies that have pulled forward returns from the future through the agency of sky-high valuations. Shake Shack, Inc. (SHAK on the New York Stock Exchange), the fast-growing, premium burger chain, trades at over 300 times earnings. In preview, *Grant's* is bearish on it.

In 2001, Danny Meyer, the boldface Manhattan restaurateur, wheeled a hotdog cart into Madison Square Park, the then–neglected 6.2-acre patch of green in New York's Flatiron District in the mid-East 20s. A founder of the Madison Park Conservancy, Meyer had a motive that was civic. He upped the gustatory ante in 2004 with a freestanding kiosk that served a hamburger made by smashing ground beef on a grill to maximize the sear on the outside of the patty. So was born the "smashburger"—and Shake Shack along with it.

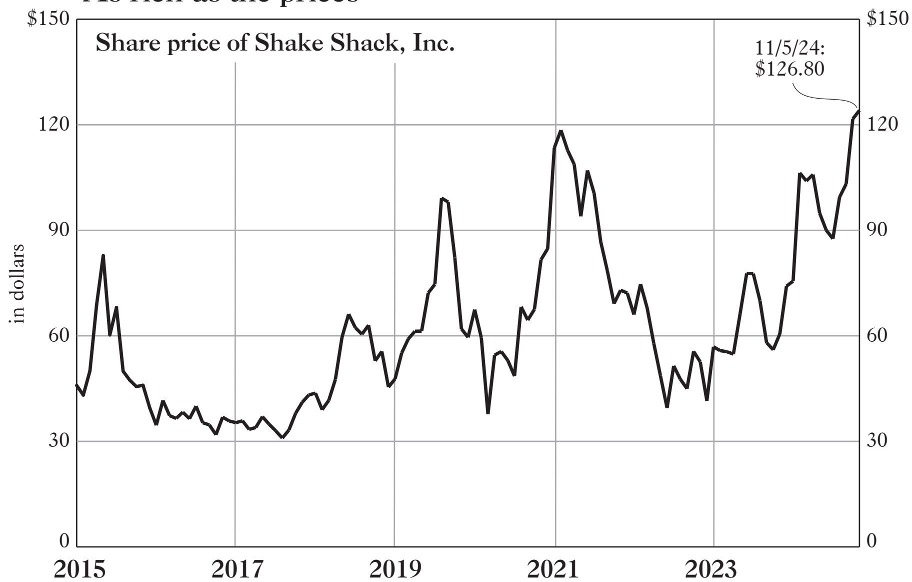
"Stand for Something Good" is the corporate motto, and Shack's made-to-order Angus beef burgers, crispy chicken sandwiches, hand-spun milkshakes and house-made lemonades are as good as they are expensive. A burger, fries and small soda will run you $17–$19 in most markets compared with $11–$13 for approximately the same order at McDonald's, Wendy's and Burger King.

Over the past two decades, Shack has expanded to 552 locations, including, in the United States, 310 company-owned stores and 42 franchised locations, along with 200 franchised units abroad. In the third quarter, revenues climbed by 14.7% compared with the like period a year earlier and same-store sales rose by 4.4%.

Today's reluctant consumer makes recent results all the more impressive. Price-conscious grocery shoppers are trading down to store brands from pricier national ones, and inflation-squeezed households are dining out less frequently than they used to.

Restaurants have turned to discounting. McDonald's, for example, charges just $5 for a McDouble or McChicken sandwich, a small order of fries and a small soft drink plus a four-piece pack of chicken nuggets (*Grant's*, July 5). Yet U.S. same-store sales grew by an anemic 0.3% in the third quarter—which

As rich as the prices



source: The Bloomberg

ended the month before the E. coli outbreak news splashed.

Chili's, boosted by aggressive promotions, managed to deliver same-store sales growth of 14.1% in the third quarter, but Denny's Corp. issued the more typical results by announcing the closing of 150 stores. Representative, too, were the bankruptcy-filing trio of BurgerFi International, Inc., Roti (a fast-casual Mediterranean chain) and Buca di Beppo.

Neither is Shack above discounting. It announced, for instance, a free-chicken-sandwich promotion to exploit the Sunday-closing policy of Chik-fil-A, the God-fearing poultry purveyor. "In an environment like this, fast-food restaurants have historically been the beneficiaries, because they have a reputation for lower prices and, on balance, it is still cheaper to eat at McDonald's than it is to eat at Shake Shack," Jonathan Maze, editor-in-chief of *Restaurant Business*, tells me. "That's not happening right now. Fast-food restaurants are the ones that are losing traffic. Casual dining is definitely losing traffic, but the upper end is doing fine."

This spring, Shake Shack named Robert Lynch its CEO. The former head of Papa John's International, Inc., Lynch rehabilitated the pizza brand following the defenestration of founder John Schnatter over that executive's widely publicized racial tirade in 2018. As the chief marketing officer of Arby's in his previous career stop, Lynch garnered laurels for the success of the "Arby's, we have the meats!" ad campaign of 2014.

"This is a situation where I have the luxury of coming into a business that has a ton of momentum, that has a really strong team, and we just need to challenge ourselves to look at things differently," Lynch told a Sept. 4 Goldman Sachs conference. His to-do list, said Lynch, included product innovation, a customer loyalty program, a cheaper path to opening new stores, a reduction in customer wait times and a new approach to advertising.

Nine underperforming restaurants will be closed, Lynch disclosed in August—Shake Shack had rarely taken such a step before—though many more restaurants will be opened, he added. Thus, on last week's earnings call, the CEO forecast the construction of 80–85 new Shacks next year, which would boost the pace of net unit growth to 14% in 2025 from an estimated 11.6% this year.

For all of that, Shake Shack is only marginally profitable. It produced $20.3 million in net income last year versus losses of $21.2 million in 2022 and $4.6 million in 2021. But—says the Street in so many words—the earnings history is bunk. The burger maker will generate $50 million in net income next year and $67.7 million in 2026.

The balance sheet looks better than the double-B-minus rating that Egan-Jones Ratings Co. assigns it. As of Sept. 25, Shack held $310.9 million in cash and equivalents against borrowings of $250 million, i.e., the zero-percent converts of 2028.

It's not just the food at Shack that's premium. The stock changes hands at 381 times adjusted trailing earnings and 111 times the estimate for 2025. For comparison, the restaurant component of the S&P 500 trades at 27.4 times trailing earnings and Chipotle Mexican Grill, Inc., one of the industry's best-performing growth stories, at 50.8 times earnings.

Short interest sums to 9.4% of the equity float, though arbitrage activity might explain that optically concerning figure (holders of the 2028 converts could be hedging their equity exposure rather than expressing a bearish opinion on the company's future). Over the past 12 months, insiders have sold 149,981 shares for proceeds of $15.8 million. On balance, the Street is bullish.

A fancy multiple implies fast growth, but the premium prices that Shack charges may themselves cap the chain's ability to expand. The American consumer makes two to four visits a year to restaurants with checks that range between $15 and $25. In its 2014 prospectus, Shack estimated that, over time, it could expand its domestic store count to 450, up from the 352 units in place on Sept. 25. Just how much time it didn't say.

Competition is hotting up within the premium-burger segment. This includes strong regional brands such as Whataburger (which is stepping out of its base in Texas), In-N-Out (a California stalwart) and Culver's (a Midwestern powerhouse) as well as upstarts like Freddy's Frozen Custard & Steakburgers and Five Guys. Smashburgers were a novelty when Shake Shack began serving them in 2004. In 2007, a startup had the gall to call itself Smashburger. It opened its first store in Denver, Colo., and subsequently expanded to more than 200 locations in the United States and Canada.

From 2019 through 2023, Shake Shack's top line grew by $493 million or 83%. Over the same span, analyst Brian Mullan points out in an Oct. 24 note for Piper Sandler & Co., "Culver's, Whataburger and In-N-Out all grew dollar sales more than Shake Shack did, by a factor of 2.9x, 2.4x and 1.5x, respectively.... [I]t would be fair to point out that Shake Shack had a smaller starting point in dollar sales terms, so we also took a look at unit count growth.... Culver's and Whataburger have each opened more net new restaurants than Shake Shack has, whereas In-N-Out has opened significantly less than Shake Shack has."

Shake Shack, Inc. at a glance
all figures in $ millions except per share data

	TTM*	2023	2022	2021	2020
sales	$1,210.2	$1,087.5	$900.5	$739.9	$522.9
operating income	-8.5	5.9	-26.9	-15.9	-43.9
net income	8.7	20.3	-21.2	-4.6	-42.2
earnings per share	0.19	0.48	-0.54	-0.12	-1.14
shares outstanding	44.2	43.9	39.2	39.1	37.1
cash	310.9	293.2	311.2	382.4	-110.0
debt	246.4	245.6	244.6	243.5	0.0
total assets	1,675.4	1,605.9	1,512.0	1,457.6	1,145.3

*12 months ended Sept. 25, 2024.

source: company reports

These rapidly growing premium brands compete against one another, not with generic fast food. "We had a Freddy's open up right across the street from one of our Wendy's, and I thought for sure we would take a hit," one Midwestern franchisee tells me. "There was no impact whatsoever on sales. I called one of my managers and just asked her to debrief me on Friday. She told me, 'Yeah, they're more expensive. Their product seems pretty good. It's almost like they serve a different customer or maybe a different occasion.'"

Even among high-priced competitors, Shack is expensive: A burger, fries and soda cost 28% more than the same combo at Whataburger, 51% more than at Culver's and 67% more than at In-N-Out, as the aforementioned Piper Sandler report notes. "One day in my office I was talking to a couple of my younger employees," a restaurant expert, who asks to go nameless, tells me. "I asked them, 'What about Shake Shack? What do you think?' It was exactly what I was telling you: 'It's kind of expensive. I like Culver's more.' These are young kids. They are supposedly the Shake Shack customers in the Midwest."

"If any burger concept is telling you that their main point of differentiation is that they're made to order, then it doesn't have a point of differentiation because Wendy's makes your burger to order," says Maze. "The McDonald's Quarter Pounder is made to order."

In-N-Out, Whataburger, Culver's and Freddy's are next-generation burger brands. "Shake Shack could be there in theory, but that is not the route that they had set upon when they started expanding," Maze continues. "So their expansion strategy was built on higher volume locations that are a little bit more sporadic, and it could become a long-term challenge because investors are demanding more from them than they're going to be able to produce."

The law of diminishing returns, too, figures in the story. With few stores, a novel menu and a little buzz, Shake Shack could command premium prices. As it expanded outside its home base in New York, it has found new stores to be less productive. The average unit volume of a domestic Shake Shack outlet has declined to $3.7 million in 2023 from an average of $4.3 million between 2016 and 2018, despite the CPI rising by 27% between 2016 and 2023. Even the 4.4% spurt in third-quarter same-store sales is less impressive than it seems at first, given the 6% price hike in the three months ended Sept. 25.

As to Lynch, there's a footnote in the story of his Papa John's success. "Right before he left, they rolled out a big reorganization and a big discounting plan, and, after Lynch left, it exploded," John Gordon, founder of restaurant-focused Pacific Management Consulting Group, tells me. "It didn't work." On the back of declining same-store sales, the Papa John's share price has slumped by 25% since the start of the year.

Even assuming that Shake Shack can deliver on double the 450 stores it projected in its IPO prospectus a decade ago, the shares still appear overvalued. Suppose, analyst Rashul Krotthapalli of JPMorgan Chase & Co. proposes in a Sept. 24 report, that the burger-smasher can grow to 900 restaurants in the United States by 2033 along with 1,000 units abroad. Using a 20-times multiple on 2034 earnings and discounting that figure by 8% per year will yield a present value of $102, or $25 below current share price.

Shack Shake is by no means the only moon-bound restaurant stock: Cava Group, Inc. trades at 323 times trailing earnings, and Sweetgreen, Inc., which is unprofitable, has rallied by 247% in the year to date. However, as Mullan points out, those brands are "arguably 'creating new categories,'" that is, the Chipotle assembly-line approach to Mediterranean cuisine, on the one hand, and salads, on the other. "[W]e further note that in many cases [premium burger] competitors offer a better price/value equation to the consumer today than Shake Shack does, which is something that the new management team might need to address over the next few years."

After slashing prices, Lynch would be free to leave the company in search of the next restaurant in need of fixing. However, investors in the newly competitive Shake Shack would be stuck with the check.

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