Restaurant Brands NZ

UNDERPERFORM

USA Double Down — California Acquisition

Restaurant Brands (RBD) has announced the acquisition of a 70 store California based KFC franchisee for ~NZ$111m. The transaction price appears reasonable and the desire for a US beachhead acquisition has been well signalled, however we are yet to be convinced on the strategic merits. The US is a large and highly competitive market with KFC same store sales (SSS) modest at best, limited promotional control, and no obvious synergies. At this stage we assume the acquisition is value neutral and our target price is unchanged at NZ$10.30. Trading at ~28x 12-month forward PE, we believe significant earnings growth is priced in. In light of trading multiples and execution risk on aggressive growth plans we rate RBD UNDERPERFORM.

Acquisition details

RBD's acquisition of a Southern California franchisee (59 KFC stores and 11 combined KFC/Taco Bell stores) represents an established beachhead in a new market. However, synergies are limited and with a clear mandate to grow further into the US it adds considerable risk to RBD's existing business. We understand existing management will largely stay in place, which is important to mitigate some of the risk associated with entering a new market.

- **Multiple paid:** The acquisition multiple, 6.1x trailing Store EBITDA, appears fair relative to similar RBD transactions and well behind RBD's trading forward EV/ Store EBITDA prior to the announcement, ~12x.
- **Financing:** The acquisition will be fully debt funded, lifting FY21E net debt/EBITDA to ~1.0x (~4.5x after adjusting for leases).
- **Acquisition conditions and timing:** The transaction remains subject to approval from both the franchisor, Yum!, and existing landlords. Given RBD's existing relationship with Yum! we expect conditions should be easy to meet. The acquisition is expected to settle in March 2020.

Strategic rationale

Near-term growth centres on a limited store reinvestment programme, which is already in place, with RBD considering opportunities to further invest in the market through either additional store roll out or further bolt-on acquisitions. Quarterly KFC US SSS growth has been relatively lacklustre in recent periods, ranging from -1% to +2%. In addition we see limited scope for RBD to extract margin expansion in the near-term given both cost pressures and the competitive nature of the US quick service restaurant market. At this stage we assume limited growth, organic or acquisitive, from the California business with RBD yet to provide detail on its specific growth ambitions.

Change in balance date

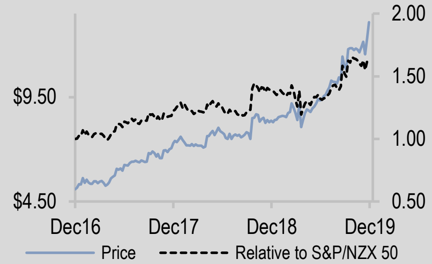
RBD has changed its balance date to 31 December from 28 February, to better align with majority shareholder Finaccess Group. With little clarity around the impact of seasonal differences we have left our forecasts on a like for like basis at this stage, i.e. forecasts are based on a February balance date.

Investment View

Transformational acquisitions in Australia, Hawaii, and more recently California mean RBD is now a materially different business. The combined portfolio offers a significant array of growth options, albeit brings additional complexities and higher risk. We rate RBD as UNDERPERFORM with substantial growth already priced in.

NZX Code	RBD
Share price	NZ$13.10
Target price	NZ$10.30
Risk rating	Medium
Issued shares	124.4m
Market cap	NZ$1,629m
Avg daily turnover	87.9k (NZ$804k)

Share Price Performance



Financials	18A	19E	20E	21E
NPAT* (NZ$m)	40.8	42.2	46.7	57.9
EPS* (NZc)	33.2	34.1	37.8	46.9
EPS growth* (%)	17.1	2.8	10.8	24.0
DPS (NZc)	28.0	0.0	0.0	0.0
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	17.3	17.6	16.6	13.6
EV/EBIT	26.8	27.2	25.4	20.5
PE	39.5	38.4	34.7	28.0
Price / NTA	n/a	n/a	n/a	19.4
Cash div yld (%)	2.1	0.0	0.0	0.0
Gross div yld (%)	3.0	0.0	0.0	0.0

*Historic/forecast numbers based on normalised profits

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Restaurant Brands NZ Ltd (RBD)

Priced as at 23 Dec 2019 (NZ$) **13.10**

12-month target price (NZ$)*	**10.30**
Expected share price return	-21.4%
Net dividend yield	0.0%
Estimated 12-month return	-21.4%

Spot valuations (NZ$)	
1. DCF	9.90
2. Sum of the parts	9.00
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.02
WACC	8.1%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	1,497
(Net debt)/cash	(241)
Less: Capitalised operating leases	-
Value of equity	1,256

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	766.3	824.9	856.6	1,059.9	1,134.2
Normalised EBITDA	**97.9**	**100.7**	**106.0**	**129.5**	**141.9**
Depreciation and amortisation	(34.7)	(35.5)	(36.8)	(43.8)	(45.4)
Normalised EBIT	**63.2**	**65.2**	**69.2**	**85.8**	**96.5**
Net interest	(5.6)	(6.8)	(3.9)	(4.4)	(4.2)
Associate income	-	-	-	-	-
Tax	(16.7)	(16.3)	(18.6)	(23.4)	(26.5)
Minority interests	-	-	-	-	-
Normalised NPAT	**40.8**	**42.2**	**46.7**	**57.9**	**65.8**
Abnormals/other	(5.4)	(6.4)	-	-	-
Reported NPAT	**35.5**	**35.7**	**46.7**	**57.9**	**65.8**
Normalised EPS (cps)	33.2	34.1	37.8	46.9	53.2
DPS (cps)	28.0	-	-	-	-

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	17.3	17.6	16.4	13.2	12.1
EV/EBIT (x)	26.8	27.2	25.1	20.0	17.8
PE (x)	39.5	38.4	34.7	28.0	24.6
Price/NTA (x)	n/a	n/a	68.3	19.4	10.7
Free cash flow yield (%)	2.2	2.1	2.7	3.4	3.6
Net dividend yield (%)	2.1	0.0	0.0	0.0	0.0
Gross dividend yield (%)	3.0	0.0	0.0	0.0	0.0

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	11.3	9.6	17.8	19.3	23.1
Interest cover EBITDA (x)	17.5	14.8	27.2	29.1	33.9
Net debt/ND+E (%)	43.7	36.8	24.2	30.9	18.8
Net debt/EBITDA (x)	1.6	1.3	0.8	1.1	0.6

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	48.1	7.7	3.8	23.7	7.0
EBITDA (%)	43.3	2.8	5.3	22.2	9.6
EBIT (%)	44.1	3.2	6.1	23.9	12.5
Normalised NPAT (%)	33.6	3.3	10.8	24.0	13.5
Normalised EPS (%)	17.1	2.8	10.8	24.0	13.5
Ordinary DPS (%)	21.7	-100.0	n/a	n/a	n/a

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	13.9	14.2	15.1	14.8	16.3
Return on equity (%)	20.3	18.8	17.5	18.0	17.1
Return on funds employed (%)	17.6	13.7	14.3	15.2	14.9
EBITDA margin (%)	12.8	12.2	12.4	12.2	12.5
EBIT margin (%)	8.2	7.9	8.1	8.1	8.5
Capex to sales (%)	4.1	4.5	4.6	4.7	4.8
Capex to depreciation (%)	105	122	126	130	136
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	84	0	0	0	0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**97.9**	**100.7**	**106.0**	**129.5**	**141.9**
Working capital change	(8.7)	(6.5)	(0.0)	3.1	1.1
Interest & tax paid	(21.4)	(23.0)	(22.5)	(27.8)	(30.7)
Other	-	-	-	-	-
Operating cash flow	**67.8**	**71.3**	**83.5**	**104.8**	**112.3**
Capital expenditure	(31.1)	(36.9)	(39.7)	(49.8)	(53.9)
(Acquisitions)/divestments	(143.4)	10.2	1.8	(113.4)	(3.3)
Other	1.2	(0.0)	-	-	-
Funding available/(required)	**(105.6)**	**44.5**	**45.5**	**(58.4)**	**55.1**
Dividends paid	(23.7)	(17.7)	-	-	-
Equity raised/(returned)	-	-	-	-	-
(Increase)/decrease in net debt	**(129.3)**	**26.8**	**45.5**	**(58.4)**	**55.1**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Store numbers					
KFC - NZ	94	94	99	101	104
Other NZ	55	48	47	45	43
Total New Zealand	**149**	**142**	**146**	**146**	**147**
KFC - Australia	61	61	62	66	71
Hawaii	82	80	81	85	89
California	0	0	0	70	70
Divisional EBITDA (NZ$m)					
KFC - NZ	66.5	70.4	75.8	81.2	85.7
Other NZ	5.2	2.9	2.6	3.0	3.4
KFC - Australia	22.0	29.1	29.9	32.4	35.7
Hawaii	24.1	23.7	26.8	30.9	35.0
California	0.0	0.0	0.0	17.2	19.0
Other	4.8	3.1	0.0	0.0	0.0
Total store EBITDA	**122.6**	**129.2**	**135.1**	**164.7**	**178.8**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(13.7)	(13.8)	(13.8)	(16.9)	(18.1)
Fixed assets	157.2	153.4	156.0	277.2	290.9
Intangibles	246.3	249.1	243.8	238.3	232.6
Right of use asset	-	-	-	-	-
Other assets	17.9	20.4	20.4	20.4	20.4
Total funds employed	**407.7**	**409.1**	**406.5**	**519.0**	**525.9**
Net debt/(cash)	156.7	130.8	85.3	143.7	88.6
Lease liability	-	-	-	-	-
Other liabilities	49.4	53.6	53.6	53.6	53.6
Shareholder's funds	201.6	224.7	267.6	321.7	383.6
Minority interests	-	-	-	-	-
Total funding sources	**407.7**	**409.1**	**406.5**	**519.0**	**525.9**

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

California beachhead acquisition

RBD has entered into an agreement to purchase a 70 store Southern California franchisee business, which operates brands familiar to RBD, KFC and Taco Bell. Whilst this is an established beachhead acquisition, synergies are limited and with a clear mandate to grow further into the US it adds considerable risk to RBD's existing business. We understand existing management will largely stay in place, which is important to mitigate some of the risk associated with entering a new market.

Acquisition details

The key acquisition details are:

- **Price:** US$73m (~NZ$111m).
- **Funding:** The acquisition will be fully debt funded.
- **Acquisition conditions:** The transaction remains subject to approval from both the franchisor, Yum!, and landlords. Given RBD's existing relationship with Yum! we expect conditions should be easy to meet.
- **Timing:** Settlement expected in March 2020.
- **Multiple paid:** The acquisition multiple, 6.1x trailing Store EBITDA, appears fair relative to similar RBD transactions and well below RBD's trading forward EV/ Store EBITDA prior to the announcement of ~12x.

Figure 1. Similar transaction summary (NZ$m)

Purchaser	Collins Foods	RBD	RBD	Collins Foods	RBD	RBD	RBD	Collins Foods	RBD	RBD
Seller	Comp. Food	QSR	QSR	Wright G.	Samesa	Oshamma	PIR	Yum!	Yum!	GACC
Date	Nov-13	Apr-16	Apr-16	Jul-16	Mar-17	Mar-17	Mar-17	Jun-17	Aug-17	Dec-19
Country	Australia	Australia	Australia	Australia	Australia	Australia	USA	Australia	Australia	USA
No of stores acquired	44	42	42	13	2	3	82	28	10	70
Price paid ($m)	61.9	91.5	91.5	27.0	2.4	7.0	105	115.4	30.2	110.6
Price / store ($m)	1.4	2.2	2.2	2.1	1.2	2.3	1.3	4.1	3.0	1.6
Revenue ($m)	122.5	111.0	129.4	34.2	n/a	n/a	121.0	98.1	31.8	143.9
EBITDA ($m)	11.5	16.7	20.0	4.6	n/a	n/a	18.3	17.7	4.9	18.2
EBITDA margin	9.4%	15.0%	15.4%	13.3%	n/a	n/a	15.1%	18.0%	15.5%	12.6%
EV/EBITDA	5.4x	5.5x	4.6x	5.9x	n/a	n/a	5.7x	6.5x	6.1x	6.1x

Source: Company reports, Forsyth Barr analysis

Valuation neutral

At this point in time we have assumed the California transaction will be value neutral for shareholders given an acquisition price of US$73m and capital requirements for store reinvestment.

Figure 2. California acquisition forecasts

	FY21E*	Comment
Store EBITDA	**17.9**	**Based on +1.5% SSS growth and no new store openings, stable margins**
G&A	(5.0)	Assume G&A costs ~3.5% of sales
EBITDA	**12.9**	**We see limited scope for margin expansion in the near term**
Depreciation	(5.7)	Assumes depreciation of 4.0% of sales, in line with other RBD businesses
EBIT	**7.3**	
Net interest	(2.2)	Assumes incremental net funding cost of 2.0%
PBT	**5.1**	
Tax	(1.5)	Assumes effective tax rate of 29%
NPAT	**3.6**	
EV	110.6	
ROIC	4.6%	Below our estimate of RBD's WACC of 8.1%
EV/EBITDA	8.5x	Well below RBD pre-announcement trading EV/EBITDA of ~15x

Source: Company reports, Forsyth Barr analysis, *full 12 months

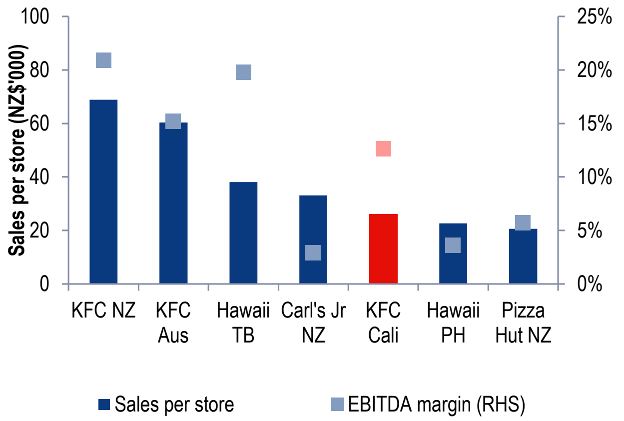
USA Double Down

RBD has illustrated clear intentions to pursue growth opportunities in the US and therefore the California acquisition should not come as a surprise to investors. However, it does raise questions around where RBD sees the growth opportunities and its ability to add/extract value in that market.

- The key opportunity near-term centres on a limited store reinvestment programme, which is already in place and has another year to run.
- RBD is also considering opportunities to further invest in the Southern California market through either additional store roll out or further bolt-on acquisitions.

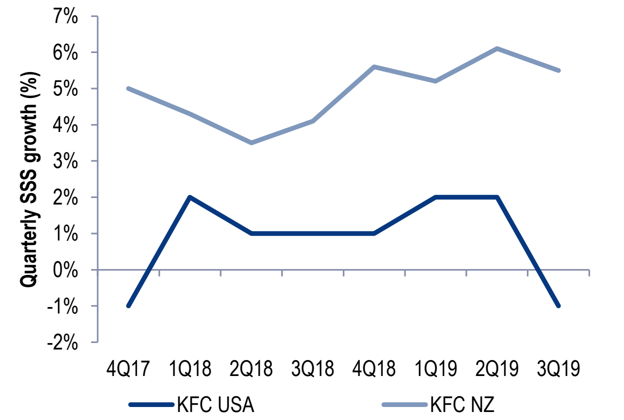
Same store sales growth for KFC USA has been relatively lacklustre in recent periods (Figure 4) and we see limited scope for RBD to drive material margin improvement given (1) the competitive nature of the quick service restaurant market and (2) limited control over promotional activity.

Figure 3. Sales/store per week and EBITDA margin



Source: Company reports, Forsyth Barr analysis

Figure 4. Quarterly same store sales growth



Source: Company reports, Forsyth Barr analysis

Southern California market structure

We understand the seller is the largest KFC franchisee operator in Southern California with 70 of the ~260 stores in the region. A number of other franchisees operate ~30 stores with a large number of smaller operators with four or less stores. We expect bolt-on opportunities to arise through consolidation of smaller operators who have limited access to capital to carry out required store refurbishments over time.

Growth mandate

RBD has a clear growth mandate. The combined business has a significant array of growth options:

- **New Zealand —** Opening additional KFC stores as well as the roll out of the Taco Bell franchise.
- **Australia —** Targeting further KFC store acquisitions alongside Taco Bell brand store roll out. Some store refurbishment occurring.
- **Hawaii —** RBD has a pipeline of store refurbishments across both the Taco Bell and Pizza Hut portfolios.
- **California —** Limited store refurbishment combined with further bolt on acquisitions and or additional store openings.

The key question this raises is constraints on management's time. With RBD adding extra capacity to its borrowing facilities, capital discipline and execution become even more important for the larger, more complex portfolio of brands and markets.

Gearing and balance sheet

The acquisition is to be fully debt funded, with further growth also likely to be funded through existing balance sheet headroom; as such we do not expect a dividend to be reinstated any time soon. We understand RBD is targeting net debt/EBITDA below 2.0x although may lift as high as 2.5x for short periods. We forecast FY21E net debt/EBITDA to be well below that threshold at ~1.0x, although when adjusting for significant amount of operating leases (IFRS 16) that lifts to ~4.5x.

Earnings changes

RBD has recently announced a change to its balance date to 31 December (from 28 February) to align with majority shareholder Finaccess Group. For clarity, earnings changes below are stated on a like for like basis (i.e. under the old balance date).

We have incorporated the California business into our earnings forecasts assuming settlement occurs end March 2020. We assume SSS growth of +1.5% based on recent KFC USA SSS growth trends and consistent EBITDA margin given lack of promotional control, labour pressures, and competitive landscape limiting margin expansion in the near-term. At this stage we factor in no further bolt-on acquisitions/store openings, and await further detail around expansion plans.

Figure 5. Forecast changes (NZ$m)*

		FY20E			FY21E			FY22E	
	Old	**New**	**chg %**	**Old**	**New**	**chg %**	**Old**	**New**	**chg %**
Total Revenue	856.6	856.6	-	923.9	1,059.9	14.7%	983.6	1,134.2	15.3%
Store EBITDA	135.1	135.1	-	147.5	164.7	11.6%	159.8	178.8	11.9%
Total EBITDA	106.0	106.0	-	117.1	129.5	10.6%	128.2	141.9	10.7%
Normalised Profit	**46.7**	**46.7**	**-**	**54.5**	**57.9**	**6.2%**	**62.5**	**65.8**	**5.2%**
Underlying EPS	37.8	37.8	-	44.1	46.9	6.2%	50.6	53.2	5.2%
DPS	-	-	-	-	-	-	-	-	-

Source: Forsyth Barr analysis, * assumes February year end

Investment summary

Restaurant Brands (RBD) is a well-run corporate franchisee, focussed on fast food. Recent earnings growth has been driven by KFC which continues to have positive momentum. Early signs from Taco Bell are encouraging in Hawaii, while Pizza Hut is under pressure and needs work. Carl's Jr continues to underperform but is no longer a growth priority for capital investment. We like the investment attributes of RBD, with above-WACC returns and a supportive industry backdrop and a material array of growth options; however, significant growth is already priced in at current multiples. Our rating is UNDERPERFORM.

Earnings and cash flow outlook

- **Marketing and new products:** Marketing, product innovation and promotional appeal is key to keep the brands fresh and relevant to customers. It is important not to stand still in the quick services business.
- **Store rollout:** There is store rollout opportunity for KFC NZ (~15 stores) and in Australia for KFC through store rollout or bolt-on acquisitions. Hawaii and California also present opportunities, albeit these will likely take time.
- **Input costs:** This is dominated by food and labour. RBD's main flexibility to respond to higher input costs is through the product mix of its sales. Customer purchases can be influenced by targeted promotions.

Business quality

- **Business expansion:** RBD's expansion into Australia, Hawaii, and California through acquisition presents growth opportunities but also risks. We see Australia as a more natural fit but are more cautious on the US.

Financial structure

- **Balance sheet and dividends:** FY19 net debt was down NZ$28m with no interim dividend and continued to fall in 1H20. Gearing is down from 44% to 35%. RBD has announced it has ceased dividend payments to retain funding for growth.

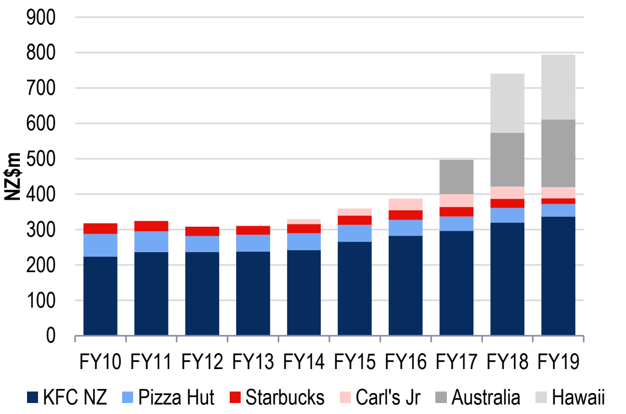
Risk factors

- **Corporate franchisee:** A relationship breakdown with its franchisor, particularly for KFC (its major earnings driver).
- **Fast food operator:** Any change in consumer preference away from fast food or change in government regulation or taxes on fast food.
- **Minimum wage:** Any increase can weigh on profitability, if RBD cannot offset this through price changes and/or menu mix. RBD has pricing power in its key KFC brand and labour productivity can help offset cost pressure.in its key KFC brand and labour productivity can help offset cost pressure.

Company description

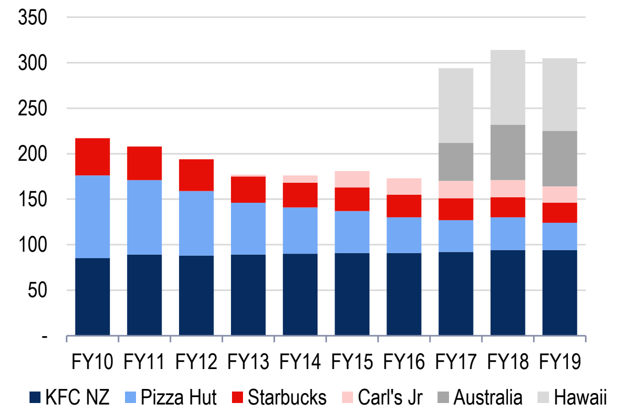
Restaurant Brands is the major fast food operator in New Zealand. It is a corporate franchisee which operates the NZ outlets of KFC, Pizza Hut, and Carl's Jr. KFC is its largest and most successful business. Two recent acquisitions (KFC stores in NSW, Australia and the sole franchisee of Taco Bell and Pizza Hut in Hawaii, Guam and Saipan) have materially changed the business. RBD also recently sold its NZ Starbucks business.

Figure 6. Divisional revenue breakdown



Source: Forsyth Barr analysis, Company reports

Figure 7. Store footprint



Source: Forsyth Barr analysis, Company reports

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
Global Valar S.L.	75.0%

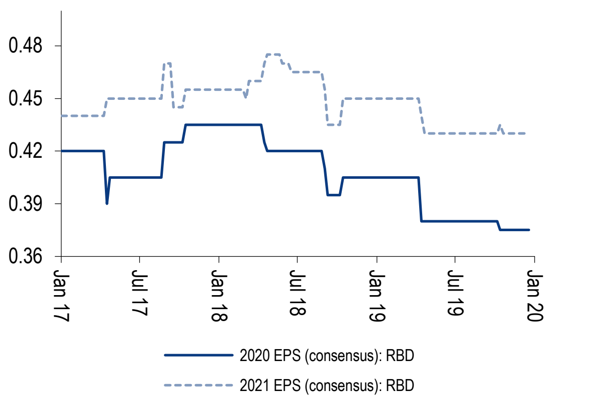
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect RBD's balance date - February)			(m)	2019E	2020E	2019E	2020E	2019E	2020E	2020E
Restaurant Brands NZ	**RBD NZ**	**NZ$13.10**	**NZ$1,629**	**38.4x**	**34.7x**	**17.7x**	**16.8x**	**27.4x**	**25.8x**	**0.0%**
Briscoe Group *	BGP NZ	NZ$3.75	NZ$833	13.1x	12.8x	8.1x	7.9x	8.7x	8.4x	5.6%
Kathmandu Holdings *	KMD NZ	NZ$3.38	NZ$997	12.9x	11.4x	8.5x	6.5x	10.2x	7.9x	5.4%
Michael Hill Intl *	MHJ NZ	A$0.69	A$268	9.9x	9.3x	4.8x	4.6x	7.2x	6.7x	7.6%
The Warehouse Group *	WHS NZ	NZ$2.86	NZ$992	13.1x	11.9x	6.1x	5.7x	9.4x	8.6x	6.3%
Domino's Pizza Enterprises	DMP AT	A$53.86	A$4,645	33.0x	27.4x	18.6x	15.3x	24.5x	19.9x	2.6%
McDonald's Corp	MCD US	US$197.14	US$148,465	25.8x	24.8x	18.6x	17.9x	21.7x	21.1x	2.4%
Starbucks Corp	SBUX US	US$88.46	US$104,471	29.6x	27.6x	19.3x	17.2x	25.6x	21.8x	2.0%
Wendy's Co/The	WEN US	US$22.26	US$5,121	15.9x	37.2x	21.9x	20.1x	33.0x	29.6x	1.9%
Yum! Brands Inc	YUM US	US$100.59	US$30,425	22.0x	26.5x	17.4x	19.7x	18.4x	20.9x	1.7%
Domino's Pizza Inc	DPZ US	US$292.00	US$11,943	33.3x	30.4x	24.5x	22.4x	26.8x	24.6x	0.9%
Collins Foods	CKF AT	A$9.35	A$1,090	23.1x	20.9x	13.9x	12.7x	20.9x	18.5x	2.5%
			Compco Average:	**21.0x**	**21.8x**	**14.7x**	**13.6x**	**18.8x**	**17.1x**	**3.5%**
EV = Current Market Cap + Actual Net Debt			**RBD Relative:**	**+82%**	**+59%**	**+21%**	**+23%**	**+46%**	**+51%**	**-100%**

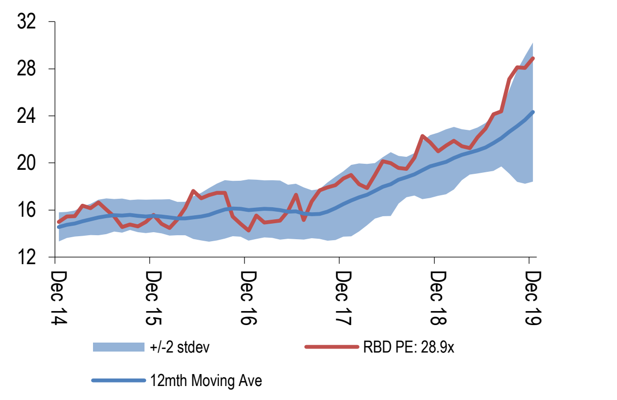
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (RBD) companies fiscal year end

Figure 8. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE



Source: Forsyth Barr analysis