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It is not a coincidence that QSR stock was uncharacteristically weak, in a strong market, on Friday, as Kraft Heinz (KHC) was "taken out and shot", down 25% on the day.

Both KHC and QSR are heavily owned by 3G, a Brazilian based holding company. It should be noted that Warren Buffet's Berkshire Hathaway owns 22% of KHC, with a much smaller (3.3%) holding of QSR. Berkshire cashed out $3 billion of preferred stock in QSR a little over a year ago.

An extensive article in the weekend edition of the Wall Street Journal described how 3G "became the standard bearer for zero-base budgeting (ZBB), the accounting practice invented in the 1960s that 3G perfected and popularized, first with its acquisitions of Brazilian beer companies, and then globally. It requires justifying every expense each year, no matter how small, rather than using the prior year's budget as a starting point".

Quoting 3G co-founder, Jorge Paulo Lemann, the WSJ reported: "I'm a terrified dinosaur. I've been living in this cozy world of old brands and big volumes. You could just focus on being very efficient and you'd be OK. All of a sudden we are being disrupted in all ways. We bought brands and we thought they would last forever. Now, we have to totally adjust to new demands from clients".

The WSJ followed Lemann's comments by saying: "The results are exposing the limits of 3G's hyperfocus on a financial strategy to manage the companies, while not putting enough toward marketing, research and development."

Relative to Restaurant Brands:

Later in the same article: "3G shook up the restaurant industry with the purchase of Burger King in 2010, followed by acquisitions of Tim Hortons and Popeyes. Cost cuts led to higher margins, and RBI stock price soared. Restaurant Brands wasn't keeping up with change to the industry and consumer tastes, said Jeremy Scott, an analyst with Mizuho Securities, USA. Competitors such as McDonald's, Starbucks, and Panera moved to remodel their restaurants, adopt technologies including self-service kiosks and emphasize fresh ingredients. The firm was forced to pour money last year into restaurant remodeling, introducing new espresso drinks (at Tim Horton's) and simplifying menus. It is also

modernizing Popeye's cash registers to more easily track what customers are buying."

Duncan Fulton, chief corporate officer for RBI (QSR) said the company is not only focused on cost-cutting but has invested to grow the number of restaurants at its chains."

WSJ continued: "It's preferred measure of profitability, adjusted earnings before interest, taxes, D&A, grew 2.6% in the fourth quarter of 2018, the slowest growth the company has reported since BK's merger with TH. Mizuho's Mr. Scott said he expects the high spending to continue for another two years as RBI races to catch up, putting pressure on profits."

OUR READ:

We have written extensively over the last year or so (you can use the "Search" function on our Home Page) about the slowdown in earnings and EBITDA growth at QSR. The largest contributor to overall corporate EBITDA growth, from 2015-2017, was the improvement at Tim Horton's. This was not only the result of ZBB inspired cost cutting, but price increases of supplies sold to the TH system, which has resulted in major lawsuits from the franchise community. We have predicted that the lawsuits will be settled, but the tactics are history not to be repeated. The cost cutting referred to above no doubt also took place at Burger King, Tim Horton's in turn, and have already been implemented at the most recently acquired Popeye's. The unit growth is real, especially at Burger King and Popeye's, less so at Tim Horton's, but the "catchup" in systemwide support will absorb most of the increased royalties, and the "magic" at TH is no longer. We believe Mizuho's Jeremy Scott is correct in his analysis.

Furthermore: as we have pointed out in the past, a great deal of QSR's free cash flow (about $900M over the last two years) has been paid out to 41% owner, 3G, buying back stock at about 19x trailing "adjusted" EBITDA and over 20x forward earnings per share, hardly a bargain price. Obviously, the Board of Directors, with all but two members categorized as independent, thought a $550M stock buyback in '18 was more important than reducing debt. The debt, net of cash, of $11 billion was unchanged in the last twelve months, in spite of $2B of "adjusted EBITDA".

One final, call it "cautionary", note. Perhaps an analyst with more legal background than our own, familiar with governance standards in Canada (where QSR is domiciled), can explain why 3G's ownership is in the form of "Partnership Exchangeable Units". There must be an advantage for 3G, unlikely to help common shareholders, or this structure wouldn't be in place. Whether this issue is material or not, full transparency is always a positive. As Ronald Reagan put it: "TBV" ?

Roger Lipton