RESTAURANT BRANDS REPORTS Q4 - BEATS BY $.01 "ADJUSTED" - THE DEVIL IS IN THE DETAILS

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RESTAURANT BRANDS REPORTS FOURTH QUARTER RESULTS – BEATS BY $.01 “ADJUSTED” – THE DEVIL IS IN THE DETAILS

CONCLUSION:

Restaurant Brands is here to stay (not surprisingly), but the operating details of this situation reflect a great deal of financial engineering rather than predictable, above average, long term operating progress. The unit growth at Burger King will continue, but the profitability “levers” are largely played out. Tim Horton’s has serious franchisee tension still to be dealt with, and we are sure that peace will be made. However, the improvement in franchisor margins at Horton’s, (which the franchisees claim was largely at their expense) will not be duplicated. Popeye’s is no doubt the best growth vehicle within this brand portfolio, but their scale is not large enough to move the overall corporate profitability or cash flow by much. The bottom line is that the earnings and cash flow of this situation are unlikely to grow by more than mid single digits in the near future, having grown by even less than that in calendar ’18. The cash generation may well be used to reduce the $11B of net debt, but that hasn’t been the case in the last two years. The dividend, yielding 3.2% currently, is secure, but the stock is no bargain at 23x ’19 earnings, and about 20x trailing EBITDA.

THE RESULTS:

Restaurant Brands (QSR), one of the highest visibility “asset light”, “free cash flow” multi-brand franchisors, with Tim Horton’s, Burger King, and Popeye’s, and they reported their ’18 yearend result this morning. We have written many times on this situation, which readers can access through the “Search” function on our home page. With that background, the highlights of the fourth quarter report follow. Readers should know that the fourth quarter sales were reported in mid-January, and QSR ran up about 10%, from $57 to $63 on something of a relief rally. Today’s report filled in the accompanying profit numbers.

Refreshing our memory of the comps, Tim Horton’s had Q4 and calendar ’18 comps of 1.9% and 0.6% respectively. Burger King had comps of 1.7% and 2.0% respectively. Popeye’s had comps of 0.2% and 1.6% respectively. Traffic has not been described but can be assumed to be two or three points less than the same store sales.

Unit growth was better. Tim Horton's net unit growth was 2.1% and 2.1% respectively. Burger King was 6.1% and 6.1%, Popeye's was 7.3% and 7.3%.

The reported GAAP (remember General Accepted Accounting Principles?) earnings per share are a bit confusing because of a change in accounting "Standards". In Q4, Diluted EPS was $0.64 (New Standard) and $0.68 (Previous Standard) vs. $1.59 (Previous). The twelve months were $2.42 (New) and $2.49 (Previous) vs $2.54 (Previous). Setting aside the Q4 quarterly adjusted large fluctuation, ***the year, on a GAAP basis was down, on either standard.***

Investors are very interested these days in EBITDA, so that was provided, by segment, on an "adjusted" basis, and adjusted EPS was provided as well.

Tim Horton's had adjusted EBITDA, in Q4 of $297M (New Standard) and $295M (Previous Standard) vs. $304M (Previous). ***That's down***. For the year, TH had segment EBITDA of $1,127M (New) and $1,128 (Previous) vs $1,136M (Previous). ***That's down***. ***Burger King***, in Q4 had adjusted EBITDA of $247M (New) and $265M (Previous) vs $265M (Previous). ***That's flat to down.*** For the year, BK had $928M (New) and $950M (Previous) vs $903M (Previous). ***That's up 2.7% and 5.2% respectivel***y. ***Popeye's,*** for Q4, had adjusted EBITDA of $37M (New) and $42M (Previous) vs. $37M (Previous). ***That's flat to down***. For the year, Popeye's had adjusted EBITDA of $157M (New) and $169M (Previous) vs. $107M (Previous). ***That's up sharply, 47-58%, but we will come back to this,*** in the next paragraph. ***Adding up*** the segment EBITDA, total Q4 was $581 (New) and $602M (Previous) vs. $606M (Previous). ***That's down.*** Total calendar adjusted EBITDA was $2,212M (New) and $2,247 (Previous) vs $2,146 (Previous). ***That's up 3.0-4.7%.***

However, in a note following the segment breakdown, the company says "since RBI's consolidated results include Popeye's starting in Q2 of 2017 (post acquisition), RBI's consolidated year over year results…are favorably impacted by the inclusion of a full year of Popeye's in 2018 and only a partial year in 2017."

While we cannot know what Popeye's organic annual change in EBITDA was, it seems reasonable that an "adjustment" to the $50-$62M apparent increase in PLKI's annual EBITDA would have largely wiped out the increase in adjusted EBITDA for the company as a whole.

It's possible that our interpretation of the above is misguided, but, at best, QSR's EBITDA is growing year to year at a very modest rate. If we are right, it is growing hardly at all.

Moving on, net unit growth is steady, most importantly at Burger King, their most well established worldwide brand, with 17,796 locations, up 6.1% in '18. Popeye's is growing nicely, up 7.3% on a smaller base of 3,102 units. Tim Horton's continues to grow, at a 2.1% rate in '18, on a base 4,846 restaurants, in spite of the well publicized franchisee unrest. Clearly, unit growth, internationally in particular, is the largest opportunity for improved profitability and cash flow. The potential for growth at Tim Horton's in China was emphasized, with an objective of 1,500 units over ten years, the growth led by an affiliate of QSR. Ongoing growth in Brazil is also predictable, also led by a QSR affiliate, in this case publicly traded in Brazil. The same Brazilian affiliate is leading the growth there of Popeye's.

The conference call consisted of the Company reiterating their dedication to building profitable sales for each of their franchise systems. Analysts questioned management about the unit level profitability, and the company continues to claim that franchisee profitability improved in '18 vs. '17. Various questioners seemed skeptical, citing wage increases as a continuing burden. Since comp sales are up 2.0% at best, and traffic (while not disclosed) is likely down, virtually every publicly held company has reported that profit margins are suffering under these conditions and it is unclear why Burger King, Tim Horton's or Popeye's would be an exception.

The Company adhered closely to their mantra of building top line sales for each of their franchise systems, which truly does solve all other issues. As referenced above, while one could question their assertion of improved franchise profitability, we can't doubt the Company dedication to improved future sales. Loyalty programs, digital ordering, renovations, and other operating initiatives are important elements in maintaining market share, at the very least, and hopefully building it.

In terms of "capital allocation", reference was made to ongoing "delevering" of the balance sheet. This is an important objective since net debt is 5.1x the *adjusted* EBITDA of 2.1B. However, the free cash flow of $1.1B was a lot less, after dividends and $550M of repurchased exchange units from their 3G affiliate. Furthermore, there has yet to be any "delevering", since net debt is still $11.8B, virtually unchanged from a year earlier, still at a year end high after calendar '17 capital allocations to dividends, another $500M plus repurchase from 3G, and redeeming Warren Buffet's $3B of preferred stock.

CONCLUSION: Provided at the beginning of this article

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