SHAKE SHACK (SHAK) REPORTS - MIXED BAG, CONCEPT MATURES, AS MANAGEMENT PREDICTED - HERE'S SOME SERIOUS FOOD FOR THOUGHT !

Date : February 26, 2019

SHAKE SHACK (SHAK) REPORTS - MIXED BAG, CONCEPT MATURES, AS MANAGEMENT PREDICTED

Shake Shack reported their fourth quarter and year. It was very much as management had predicted, reflecting modest same store sales gains, cost pressures at the store level as well as continued high administrative expense level to support very rapid expansion. New locations, heavily weighted in Q4, opened at strong levels, which held the year's AUV of domestic company operated locations at $4.39M, down from $4.598M, about 100k higher than the guide. We should interject here that this "beat" might have been at least partially the result of heavy openings (17 out of 34 for the year) in Q4, including the honeymoon effect of 17 out of 120 total stores in the year's AUV.

Rather than dwell on Q4, which followed the trends of the individual quarters, the full year's result is probably most informative. 34 domestic company stores were opened against a base of 90. Same shack sales were up 1.0% and traffic was down about a percent. Shack level profit (EBITDA) was 25.3% of sales, down 130 basis points YTY. AUVs were down 4.6% to a still impressive $4.39M. For the year, Cost of Goods was down 10 bp to 28.3%. Labor was up 110 bp to 27.4%. Other Operating Expenses were up 130 bp to 11.6% partially offset by Occupancy Expenses which were down 80 bp to 7.3%. G&A expense was up 60 bp (not "leveraging" yet), and depreciation expense was up a noteworthy 30 bp to 6.3%. Pre-opening expense was constant at 2.7%, averaging about 360k per store. Pretax Operating Income was down, $31.7M (6.9% of revenues) vs. $33.8M (9.4% of revenues). Diluted EPS was $0.52 per share, not comparable to last year (with its adjustments).

Following the above numbers, management presented "adjustments", which brought the "adjusted pro forma net income" to $0.71 per share.

Rather than itemize the adjustments, we think it is more productive to focus on the store level operating metrics. New stores are, as predicted opening at levels closer to $3M than the current $4.4M domestic company AUV. Store level EBITDA of new stores is closer to 20% than the 25.3% of '18. Accordingly, management is guiding, for '19, to AUVS of 4.0-4.1M, with store level EBITDA of 23.0-24.0%. This guidance could prove to be conservative, but realistic expectations relative to past years is *lower.* This is a result of guidance, including total revenues up 28-29%, SSS of 0-1%, including 1.5% price. There will be a continued aggressive opening pace (36-40 new company openings plus 16-18 licensed), G&A of 66.4-68.2M, up 26-29% (leveraging slightly against the revenue gain), depreciation expense up 40% or more (higher investment per store?), pre-opening expense of $13-$14 M(a constant 350-360k/store).

Relative to Q4'18 and '18 as a whole, and implications for '19 and '20, our bottom line is that, based on cost expectations at the store level, and the corresponding lower store level margin, it will be hard for SHAK to show improvement in net income per share.

MORE IMPORTANTLY: OUR CONTRIBUTION:

Our contribution to the dialogue is that, *while the revenues per store have been, as management predicted, coming down, the investment per store is going UP.* The following three short paragraphs are copied from the '16, '17 and '18 10k filings.

Construction '16 10K

A typical Shack takes between 14 and 16 weeks to build. In fiscal 2016 the cost to build a new Shack ranged from approximately **$1.2 million to $3.4 million**, with an **average near-term build cost of approximately $1.8 million,** excluding pre-opening costs. We use a number of general contractors on a regional basis and employ a mixed approach of bidding and strategic negotiation in order to ensure the best value and highest quality construction.

Construction '17 10K

A typical Shack takes between 14 and 20 weeks to build. In fiscal 2017 the cost to build a new Shack ranged from approximately **$1.1 million to $3.3 million**, with an **average near-term build cost of approximately $1.7 million***, excluding pre-opening costs****. The total investment cost of a new Shack in fiscal 2017***, which includes costs related to items such as furniture, fixtures and equipment, ranged from approximately $1.6 million to $3.7 million**, with an average investment cost of approximately $2.2 million**. We use a number of general contractors on a regional basis and employ a mixed approach of bidding and strategic negotiation in order to ensure the best value and highest quality construction.

Construction '18 10K

A typical Shack takes between 14 and 20 weeks to build. In fiscal 2018, the total investment cost of a new Shack, which includes costs related to items such as furniture, fixtures and equipment, ranged from approximately **$1.4 million to $4.0 million**, with an **average investment cost of approximately $2.2 million.** We use a number of general contractors on a regional basis and employ a mixed approach of bidding and strategic negotiation in order to ensure the best value and highest quality construction.

Editor's comment: With depreciation guided to increase by more than 40% in '19, it's possible that the investment per store is moving higher still.

WHAT DOES IT MEAN??

You can see that, while there have been some changes in wordings (your interpretation is as good as mine), the $1.8M investment, as described in the '16K is a lot lower than the $2.2M investment of '18. AUV in '16 was $4.981M, virtually flat with '15. The pre-opening expense seems to have been about constant at 350k/location. Back in '16, the store level EBITDA was 28.2% (down from 29.1% in '15).

So: the store level EBITDA cash on cash return in '16 (adding the $350k of pre-opening to the $1.8M cost of construction) was 28.2% of $4.981M which implies $1.4M, an awesome 65% of the total $2.15M investment. (No wonder the new issue went to $90/share.) Today, however, the 23% expected EBITDA margin (at most) on new stores doing $3.3M (at most) would be a 29.7% cash on cash return. *People.....this is a big difference, and this could be the best case.*

We have copied below our conclusions after recent quarterly reports, which we stand by. More importantly, the latest information, as disclosed in the '18 10K and management's guidance going forward, provide investors with more food for thought (no pun intended). We saw that one analyst referred to SHAK as the next Krispy Kreme, which it's not, but SHAK isn't what it used to be.

Roger Lipton

CONCLUSION – from 8/7/18 after SHAK had run *down* 11% following Q2 report

SHAK ($56) has come down (11%) 23because it has been priced beyond “perfection” and never should have run up after Q1. The concept, as good as it is, can be expected to do an AUV somewhere between $3-3.5M per unit as the system is built out. Store level EBITDA will end up in the 20-23% range. A 23% EBITDA generation on $3.25M of sales would be $747K of EBITDA, or a 37% store level cash on cash return on the $2M investment , an admirable operating model. If we look down the road a few years to when SHAK has a couple of hundred units, growing not quite so fast, and growing after tax earnings and EBITDA at perhaps 25% annually, the stock might have a 40x multiple on expected after tax earnings. The problem is that the P/E on ’19 EPS estimates (that could be a reach) is twice that. It will therefore take SHAK several years beyond ’19, until 2022, for the fundamentals to catch up with today’s stock valuation of $2B. Of course, it’s possible that the P/E on next twelve month earnings could be even higher than it is currently, but the P/E range that the stock sells at will likely be contracting as time goes on. This expectation is under the optimistic assumption that there are no major mistakes along the way, in which case there would obviously be an immediate major adjustment downward. This discussion may be one reason why there has been almost continuous liquidation of common shares by insiders and private equity owners, to the tune of hundreds of millions of dollars ever since SHAK came public early in 2015.

CONCLUSION – From 5/10/18, after SHAK had run *up* 23% following Q1 report

As you no doubt suspect, while we have the utmost respect for this management team, our conclusion is that SHAK ($58) is priced beyond “perfection” at approximately 100x ’18 projected EPS and perhaps 70x what we consider an optimistic view of ’19. If you like EBITDA as a measure, based on “Adjusted Corporate EBITDA” of $65B in calendar ’17, the $2.2B market capitalization represents 33x TTM EBITDA. Especially considering that store level economics, while still more attractive than many other restaurant companies, are not as alluring as back in the day when Manhattan locations were annualizing at $7.4M and paying for themselves at the store level (before depreciation) in fifteen months. Management here is as good as it gets, but they are not magicians. This is still a people business, serving burgers, not providing a proprietary cancer cure.