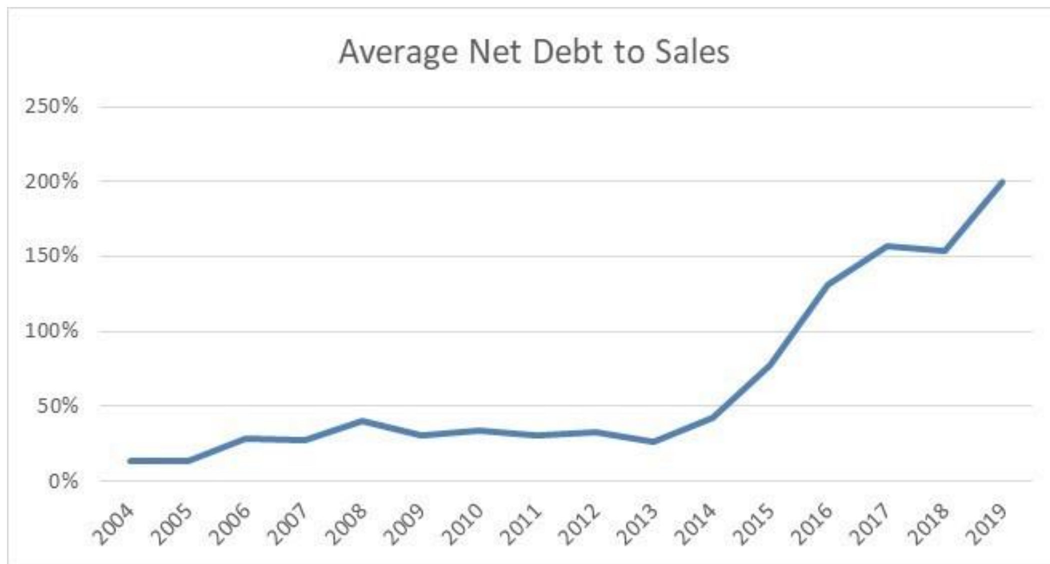
JUNK IN THE TRUNK

Russell Clark's Market Views

"After years of growth, the QSR chains look like they are facing a crash diet."

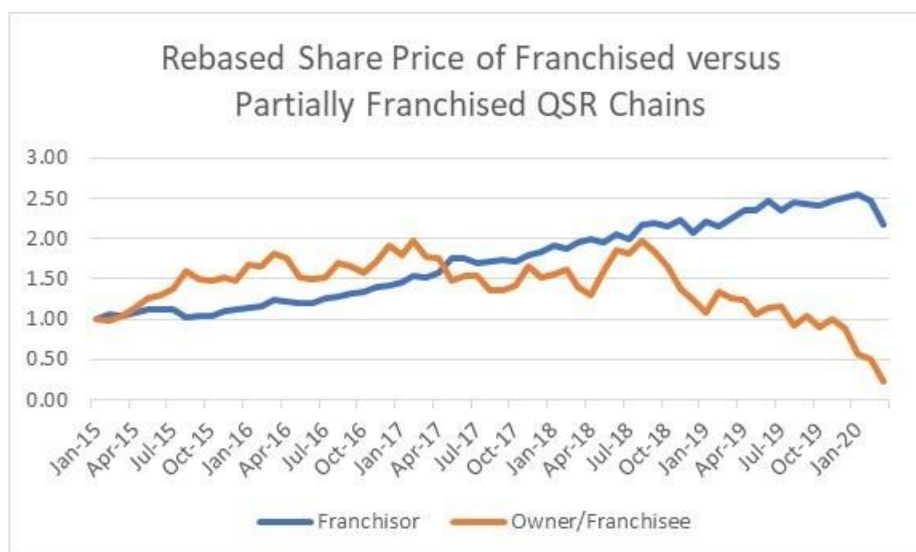
The US dominates the market for multinational quick service restaurant ("QSR") chains. The largest and most well-known brands were all founded and are listed in the US. Until recently, the QSR chains would run some of their stores themselves, and the majority would be franchised. This would create two distinct revenue streams for the QSR chains. Franchisees pay a royalty and advertising fee as a percentage of gross sales, typically somewhere between 10 and 15% of gross sales, whereas company operated stores would pass on all their sales, but also all their costs. Typically, the QSR chains would only operate a minority of their stores, but changes in operating margins at these owned and operated stores would have an outsized effect on earnings. Over the last few years, the big chains have moved to franchise a larger percentage of stores, which has allowed operating margins to improve dramatically. We show average franchise rates and average operating margins for the three largest US QSR chains below.

When a QSR chain sells a company operated store to a franchisee, this frees up capital that can be returned to shareholders. The higher margin and more stable cash flow of the franchise model has also allowed these companies to gear up much more than historically. Average net debt to sales of the top 3 US QSR's has risen from around 30% to 200% today



The increase in debt to buy back stock has also led to a collapse in the tangible equity of the industry. Some companies still have positive equity if we include goodwill, but even with goodwill, the industry has a negative equity position.

In simple terms, when a restaurant is franchised, the franchisee typically pays a royalty based on gross sales and a separate advertising fee back to the parent company. In recent years, we have seen the quick service restaurant industry bifurcate into chains that are fully franchised and those that are partly franchised. Fully franchised chains have outperformed partially franchised stores substantially. For consistency, in the graph below selected chains are either predominantly burger or pizza chains listed in the US.



The big difference in performance of the franchisor and the franchisee is that the franchisee bears most of the costs. This means if costs are growing faster than sales, this will destroy profitability for the franchisee. However, for a franchisor rising sales at a franchisee leads to directly to higher sales, and higher profits. The two parties have very different incentive structures.

The only problem for the franchisor is if the franchisees become so unprofitable that they face bankruptcy. In this case, the franchisor will need to offer support in rent reductions and loans, or face the loss of sales. The large US QSR chains should be considered as landlords to a specific tenant and the risk is if that particular tenant class faces an industry wide contraction. After years of growth, the US QSR chains look like they are facing a crash diet.

INFORMATION

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