Jan. 6, 2017

Weekly Restaurant Report: Leftovers, Bombshells And Cold Weather

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About: The Restaurant ETF (BITE), MENU, Includes: ARCO, BBRG, BH, DPZ, FRSH, HABT, JACK, MCD, NDLS, PZZA, RICK, RT, SONC, STKS

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Summary

Trend Line: Labor, Technology, and Restaurant Activism.

November & December: A Tale of Two Months.

Leftovers: The Best of 2016.

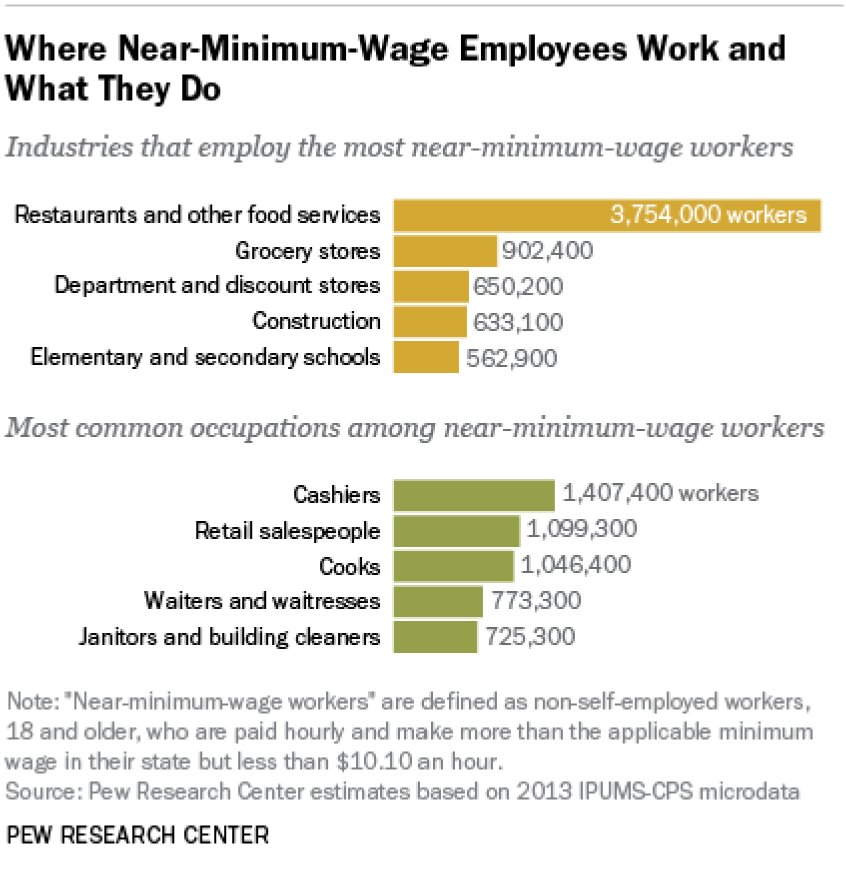
Stock of the Week: RICK goes ballistic.

Leftovers: The Worst of 2016.

Happy first trading week of the year everyone! And welcome to the leftover edition of the Weekly Restaurant Report. This week we spin a tale of two months, explore breastaurants, and look back at the best and worst of 2016, all the while our keeping our eyes on the prize.

Trend Line: Labor to Smart Menus

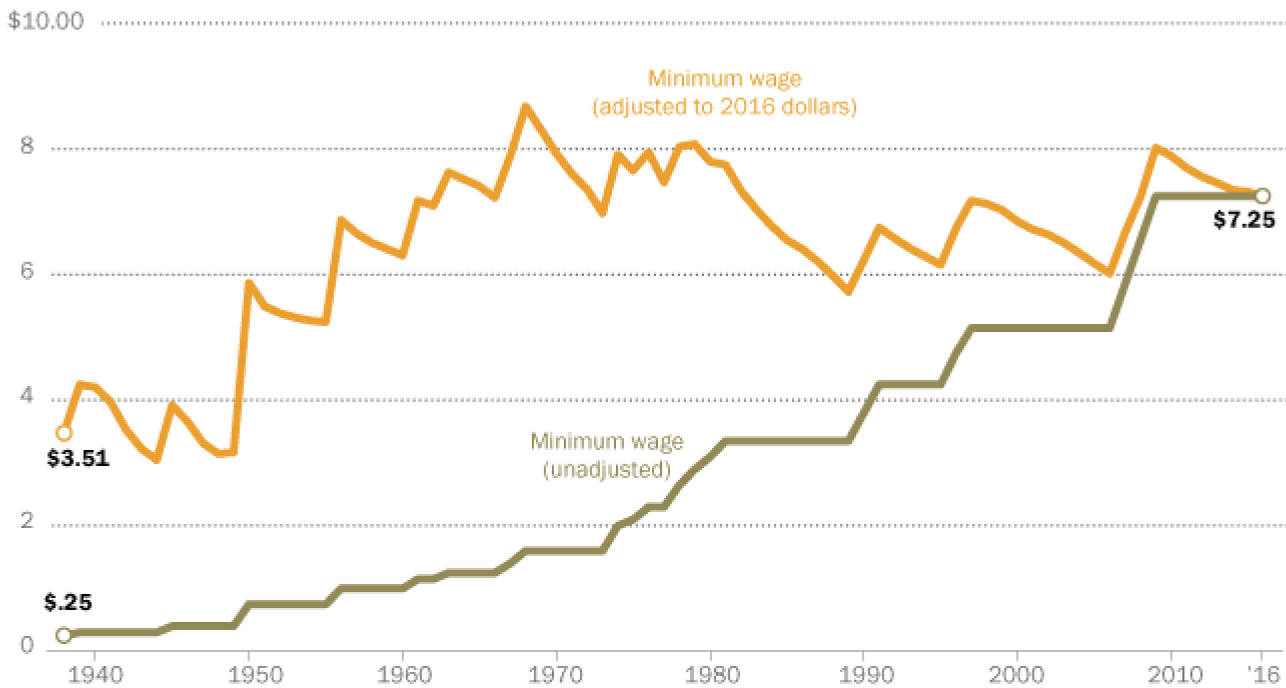
Rising wages remain a concern for the restaurant industry in 2017, and labor constitutes the largest single expense for most operators. Restaurants rely on minimum-wage workers more than any other sector, and as wages rise throughout the country, the industry will find difficulty retaining part-time and underpaid mid-management employees. A recent Pew Research Center article reiterates some industry facts about minimum wage.



Obviously tips come into play, but the cost of employment is rising for restaurant operators/owners, and some off this may be offset with potential tax benefits via the new Trump administration. Health-care costs remain up in the air as talk of repealing the ACA dominant political headlines. Technology is another trend that may emerge in forms of kiosks as well as other labor saving initiatives.

Federal minimum wage, 1938-2016

Shown in nominal (not adjusted for inflation) dollars and 2016 (inflation-adjusted) dollars



Note: Wage rates adjusted for inflation using implicit price deflator for personal consumption expenditures.
Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Pew Research Center analysis.

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As the chart above indicates, federal minimum wage peaked in 1968, but several states with higher mandatory minimum wages have kept pace with inflation. Keep in mind many of these restaurant workers (and operators) pay increasing rents/leases, which has outpaced so-called flat or lack of "inflation" this past decade in most parts of the country, especially urban areas.

The best way restaurants can improve the bottom line; labor and food costs, as well as the obvious, increasing volumes. Margins rely heavily on labor, and execution, and technology could be the story of 2017 for the quick-service restaurant. Last week the WRR interviewed industry insider Dan Weiskopf, who had this to say:

"For me the most important trend remains the activism and how the companies will continue to be re-invented and return capital to shareholders. Innovation in the industry driven by technology and private equity seeking to create efficiencies will not slow down. The "Smart Menu" that is driving the changes in the industry will integrate franchisor and franchisee efforts and tie business interest to the singular purpose of meeting the consumer need efficiently. These are smart people so I am glad they are working for me in this industry."

November & December: A Tale of Two Months

Let's blame the weather, because it has been unreasonably cold throughout most of the country including here in Portland, which means consumers likely spent that holiday money online rather than at shopping centers with ancillary restaurants. Last month's Santa Clause edition of the WRR discussed the flat November restaurant industry numbers, and this week Nomura highlighted December as the worst month for same-store sales growth of the year. Besides cold weather and traffic, Nomura-Instinet analyst Mark Kalinowski slated December as the only month "where the industry as a whole generated negative same-store sales growth," and he provided hope for Q4 numbers as a whole:

Given that November 2016 was the second-best month for U.S. chain restaurant same-store sales during 2016, the overall fourth-quarter numbers likely will look very similar to those of the (lackluster) second and third quarters," Kalinowski wrote in a research note Wednesday. "In other words, the solid November results should prevent Q4 as a whole from being a disaster, but the negative December data could hold back some chains from surpassing Street expectations for Q4's same-store sales."

We don't necessarily agree with "solid November results," and maybe this sets up as a blame the weather, election, or Amazon (NASDAQ:AMZN) for what looks to be a lackluster holiday slash Q4 earnings season. Many restaurant groups operate in or near shopping centers, and traffic declines at these locations only complicate labor costs as staffing issues occur during cold weather and/or the holidays. Overall, restaurants have seen a slowdown in traffic in 2016, which stems from economic uncertainty, a decline in grocery costs, and overcapacity. Since Q3 sales and traffic trends point down, and when most companies in the restaurant sector report Q4 earnings in the coming weeks we don't expect many surprises to the upside.

On the plus side, November and December moved most restaurant stocks out of bear territory and/or into positive returns for the year as the market took off with the Trump election. Most the sector moved up regardless of fundamentals, and many stocks continue residing in overbought territory. How this plays out this for some individual companies during earnings season is what makes markets, and restaurant stocks have much to prove after the recent rally.

Leftovers: The Best & Worst of 2016

As we check the expiration dates and clean out the refrigerator, a look at the best, and worst performers of 2016 can help identify trends moving forward. Some on this list may surprise you, and besides pizza, no overall theme appears amongst the companies, or restaurants they operate.

Arco Dorados (NYSE: ARCO) +73%: Arcos Dorados Holding Company is the world's largest McDonald's (NYSE:MCD) franchisee in terms of system wide sales and number of restaurants, operating the largest quick service restaurant chain in Latin America and the Caribbean. It has the exclusive right to own, operate and grant franchises of McDonald's restaurants in 20 Latin American and Caribbean countries and territories. The company operates or franchises over 2,100 McDonald's branded restaurants with over 90,000 employees. So there you have it, Big Macs and fries in Latin America. However, the stock peaked in late October at $6.60, and since the election and ensuing currency debacle, ARCO dropped over 14% and currently trades at $5.65 with significant debt (LT Debt/Equity = 1.72) and no dividend.

Papa John's (NASDAQ:PZZA) +53%: The stock has been in a solid uptrend for most the year, driven by high-single digit sales growth of 7.8% the past 5-years, complimented by double-digit EPS growth (13.70%). Fundamentals could be better, and valuation numbers of 30x to 34x earnings leave some room for significant dips in 2017. The company possesses little cash, and the dividend yields 0.93% at current prices. The stock hit highs of just over $90 in mid-December, and PZZA reports earnings at the end of this month.

Jack in the Box (NASDAQ: JACK) +49%: Shaky fundamentals juxtaposed with amazing growth numbers best describe JACK, which handily outperformed its fast-food peers. Recent talk of Jack-in-the-Box tacos takes me back to those late adolescent, and unspeakable nights of drive-thru food. The company does well with marketing, and growth numbers this past year put JACK well in front of the fast-food crowd. Last quarter JACK knocked earnings out of the park with Q/Q EPS growth of 52.60% on sales growth of 12.50% during the same period. Dividend of $1.60 per share yields 1.48% at current prices. However, JACK's current cash position comes in at an anemic $0.52 per share, with a book value of negative (-$6.64) per share. With no return on equity, the stock offers little margin of safety.

Domino's Pizza (NYSE: DPZ) +48%: Give me Pizza! The Domino's story illustrates the convergence of millennial technological trends and food delivery, and features pizza, which every generation loves to eat. The DPZ bull story contains technological aspects like watching your pizza get made online, as well as the recently popular Domino's rewards program. The company has its finger on the pulse of the consumer, and the reimaging of stores throughout the country the past 5-years helped drive the narrative. The stock, however, looks like a fundamental mess, or a growth at all cost kind of story. Like JACK, Domino's trades with a negative book value, virtually no cash, with no return on equity. Sales growth numbers of 16.90% Q/Q and 7.10% the past five years help explain the stock's performance, which has been nothing short of phenomenal. December has been a cold month for DPZ, but the stock sits within 5% of all-time highs. Earnings come on January 17th, and this report should be one to watch as far as sector sentiment goes. Stay tuned.

Biglari Holdings (NYSE: BH) +48%: Biglari Holdings gets very little analyst coverage, and these sorts of holding companies can be hard to value as restaurants equal only part of the big, questionable equation. BH owns several companies, shares in other companies and restaurants, and this quagmire of assets creates uncertainty and concern. The stock gets some love on Seeking Alpha, and the company's leader, Sardar Biglari, carries some controversy regarding his compensation and other dealings. Because the company dabbles in much more than restaurants, the balance sheet and other fundamental analysis exist beyond our scope, and we have very little patience for over-compensation issues. However, readers interested in BH, the controversy or otherwise, should check out this article from fellow SA contributor Kevin Quon, who outlines a bullish thesis citing the company as undervalued and unconventional, which produced a very poignant comment section, all recommended reading for the curious investor.

Stock of the Week: RCI Hospitality Holdings (NASDAQ: RICK) gained 79% for the year, and sits atop many 2016 best of lists for restaurant stocks. However, RICK operates primarily nightclubs, which we tend to avoid both as investments and places of leisure. The WRR covers restaurants, and initially we disqualified RICK from our best of list, then we added an honorable mention category before deciding on RICK as our stock of the week! The newer Bombshells concept (think Hooters in military garb) caught traders' imaginations in December, and the stock took off from $12 per share to a high of $17.99 before giving some back to finish the year. The super-hot Bombshell franchise competes in the "breastaurant" category, and from glancing at the comparative yearly sales from last quarter's earnings report, it seems that maybe investors cannot see the numbers clearly.

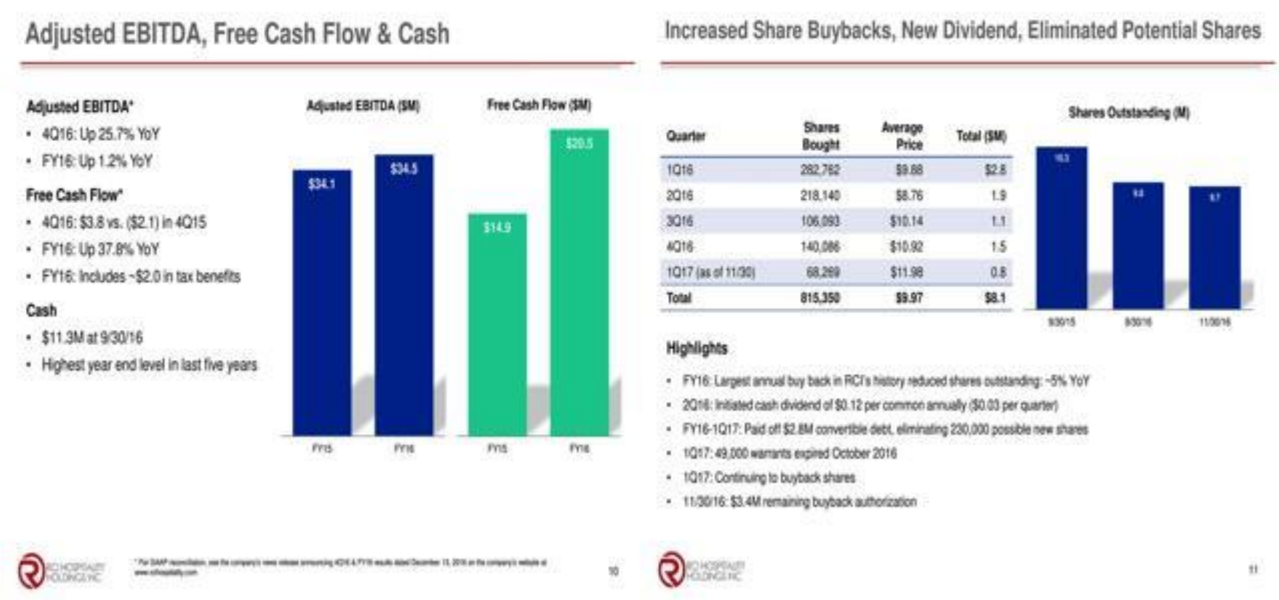
4Q16 vs. 4Q15

- Total club and restaurant sales of $32.0 million compared to $31.8 million.
- Same store sales of $31.0 million compared to $30.5 million.
- Nightclubs segment sales of $27.3 million compared to $27.5 million.
- Bombshells restaurant segment sales of $4.7 million compared to $4.2 million.

FY16 vs. FY15

- Total club and restaurant sales of $131.7 million compared to $132.8 million.
- Same store sales of $125.5 million compared to $127.2 million.
- Nightclubs segment sales of $113.0 million compared to $115.2 million.
- Bombshells segment sales of $18.7 million compared to $17.6 million.

The unreal momentum behind RICK ignited on December 2nd, when Sitori upgraded the stock, slapping it with a $27 price target. Earnings on December 13th continued the rally, which lasted all month on significant volume. The company reported excellent free cash-flow numbers, and shareholder friendly capital allocation measures followed. Page 10 and 11 of the presentation showcase some possible reasons for the rally.



Keep in mind RICK operates with a slightly different fiscal calendar, and debt-to-equity ratios of 0.83, and 0.75 long-term, raise some concerns. Valuation numbers for the company come with some cautionary discount as nightclubs and breastaurants operate in an ultra-competitive, fragmented, and trend-sensitive environment. However, the stock currently trades with an inexpensive P/E of 15.27, forward P/E of 9.66, and PEG of 0.38. These numbers seem inline for a club-orientated concept, and the recent run-up sparked some noteworthy Seeking Alpha coverage for RICK. We compiled a few of the standouts as fodder for investors interested in the breastaurant space. Keep your eyes on the prize.

SA contributor Detroit Bear- RCI Hospitality Holdings: Management Sticks to Shareholder-Friendly Script, But I'm Out

SA contributor Wolf Martin- RCI Hospitality Holdings: Where Do We Go From Here?

Worst performers of 2016: Destroying shareholder value

Papa Murphy's (NASDAQ:FRSH) -63%: Some pizza stories play out better than others, and Papa Murphy's stock imploded on a regular basis throughout 2016, and much of that had to do with earnings. In fact FRSH dropped (-23%) after the latest earnings call in November, and this after the stock got pummeled (-23%) back in May (2016). These implosions were one-day events at levels the stock has yet to see again. The good news, at the current price of $4.55 FRSH trades below its book value of $5.96. The bad news, debt: Debt/Equity = 1.12, and LT Debt/Equity = 1.07. With a market cap of $79.90 million and sales of $125.50 million, FRSH contains some potential for growth and margin expansion. Recent news of CEO Ken Calwell's resignation may spark some changes at the company, and Papa Murphy's turnaround status will be something to watch in the coming months.

Bravo Brio Restaurant Group (NASDAQ: BBRG) -58%: A classic casual dining casuality in 2016, and as trends shift to fast-casual or delivery the company finds itself operating a large number of unprofitable restaurants. BBRG owns the Bravo Cucina Italiana and Brio Tuscan Grille, both full-service restaurants with an "upscale affordable" concept, according to the company. Negative operating margins, and negative profit margins raise red flags, and BBRG is fighting dining trends on a large scale. Nothing to see here except an ugly chart, but we will spare readers from that obscenity and keep tracking the stock to see if it finds any support in 2017.

Noodles (NASDAQ: NDLS) -56%: Another new fast-casual concept operating with negative margins, despite annual sales of nearly 4x its market cap (P/S = 0.27). For bears, this was an easy call. Why would a company try to compete on a nationwide scale with Asian food? Really? What's the catch, the draw? The concept represents nothing new, but rather a foolish way to burn shareholder equity. NDLS debuted as an IPO in 2014, and after exactly three months of pumped optimism, the stock sloped continuously down from $45 a share to the current price of $4.35. Apologizes to any bag holders. The good news, the stock may have put in a technical "multiple bottom" on the charts. The bad news, technical analysis does nothing for negative operating margins (-6.20%) and profit margins (-6.40%).

Ruby Tuesday (NYSE: RT) -40%: Is bad as it might seem for Ruby Tuesday, the stock recovered after some October insider buying, and shifting sentiment. RT gained over 40% in last quarter of 2016 alone, and if not for that the stock might be at the top of the worst of list. Some of the stories down here are starting to sound the same: each with negative margins, negative sales growth Y/Y, and negative returns on assets, equity, and investments. Believe it or not, RT currently trades below book value, but how investors value the company in the future remains to be seen. After this recent rally, RT sits just below (-1.90%) its 200-day moving average, and may struggle with mad resistance from here. No dividend, no growth, and no real reason for this rally.

Honorable Mentions: One Group Hospitality (NASDAQ: STKS) -26%, and Habit Restaurants (NASDAQ: HABT) -25%.

January Earnings Update

This just in (from Yahoo finance):

Ruby Tuesday shares drop on wider loss, and revenue declines (January 5th, 2016). The stock price fell in the extended session Thursday after the casual-dining chain reported a wider loss following a double-digit drop in revenue. Ruby Tuesday shares fell 19% to $2.87 after hours. The company reported a wider adjusted second-quarter loss of $0.18 a share, compared with $0.04 a share in the year-ago quarter. Ruby Tuesday reported second-quarter revenue of $214.7 million, a decline of nearly 18% from the year-ago quarter.

Most analysts saw this coming, and SA contributor Josh Arnold recently penned an article with a simple thesis, sell Ruby Tuesday into earnings, which earns our Call of the Week award.

Sonic Corporation (NASDAQ:SONC) reported FQ1 earnings on January 4th, beating expectations, but warned of "even tougher sales and margin hurdles" in the current quarter. Revenues fell 11% Y/Y to $129M while comparable sales fell 2%, vs. a 5.3% increase in the year-earlier period. SONC reaffirmed guidance for the fiscal year ending in August, expecting non-GAAP EPS remaining flat or declining by as much as 7% Y/Y, with comp-store sales remaining flat or falling by as much as 2%. As much as we like the Sonic-brand commercials, the numbers leave much to be desired.

That concludes another tasty edition of the Weekly Restaurant Report. Thanks for reading and commenting, and remember to eat well, be merry, and prosperity is yours!

In case you missed it:

Weekly Restaurant Report: Chipotle Drama, Wendy's Vs. DineEquity

Wendy's: Red Hot & Rolling

Weekly Restaurant Report: Generational Shifts, Leadership Changes and McDonald's

Coming Soon: WRR features and stories in the works…

Year of the Rooster: 2017 picks & predictions- look for publication sometime this weekend.

Special Report: 2017 Commodity Outlooks with Investor Resources

YUM vs. YUMC: An exercise in meta-investing

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