19 JUNE 2020

Stocks Down Under

> *If your idea of a 7-course meal is a bucket of KFC and a six-pack, you might be a redneck.*

- Jeff Foxworthy (b. 1958), American stand-up comedian

RESTAURANT BRANDS NEW ZEALAND

Fast food, fast earnings growth

COLLINS FOODS

The stock could Sizzle in the post COVID era

GARDA PROPERTY GROUP

Another one for the yield junkies

RESTAURANT BRANDS NEW ZEALAND

Fast food, fast earnings growth

Stocks Down Under rating: ★★★★

ASX: RBD
Share price: A$ 8.80
Market cap: A$ 1.1BN

It's been one of the more amazing share price turnarounds of the Post Corona Crash Recovery. On 23 March 2020 Restaurant Brands New Zealand – the Auckland-based company, which brings you KFC, Pizza Hut and Carl's Jr in the Land of the Long White Cloud, saw its stock on NZX close at a mere NZ$6.60. It had been NZ$13.99 on 30 December 2019. Restaurant Brands stock, which trades on both NZX and ASX, has now made up almost all that was lost. And no wonder. Kiwis liked KFC and Pizza Hut before the Crisis, and a short time in lockdown won't have slaked that appetite.

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ASX: CKF
Share price: A$ 7.96
Market cap: A$ 921M

Best known for its KFC and Taco Bell chains, Brisbane-based Collins Foods operates food service retail outlets across Australia, Germany and the Netherlands. It is also owns Sizzler restaurants in Australia and franchises Sizzlers in Asia. Despite the challenging operating environment brought on by the Coronavirus pandemic, the quick service restaurant (QSR) company has been resilient as sales have begun to return to pre-crisis levels. Increased interest in takeaway and home delivery services have accelerated the group's digitisation efforts. An increasingly digital consumer combined with expansion plans should support growth in the post-COVID world.

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Market cap: A$ 225M

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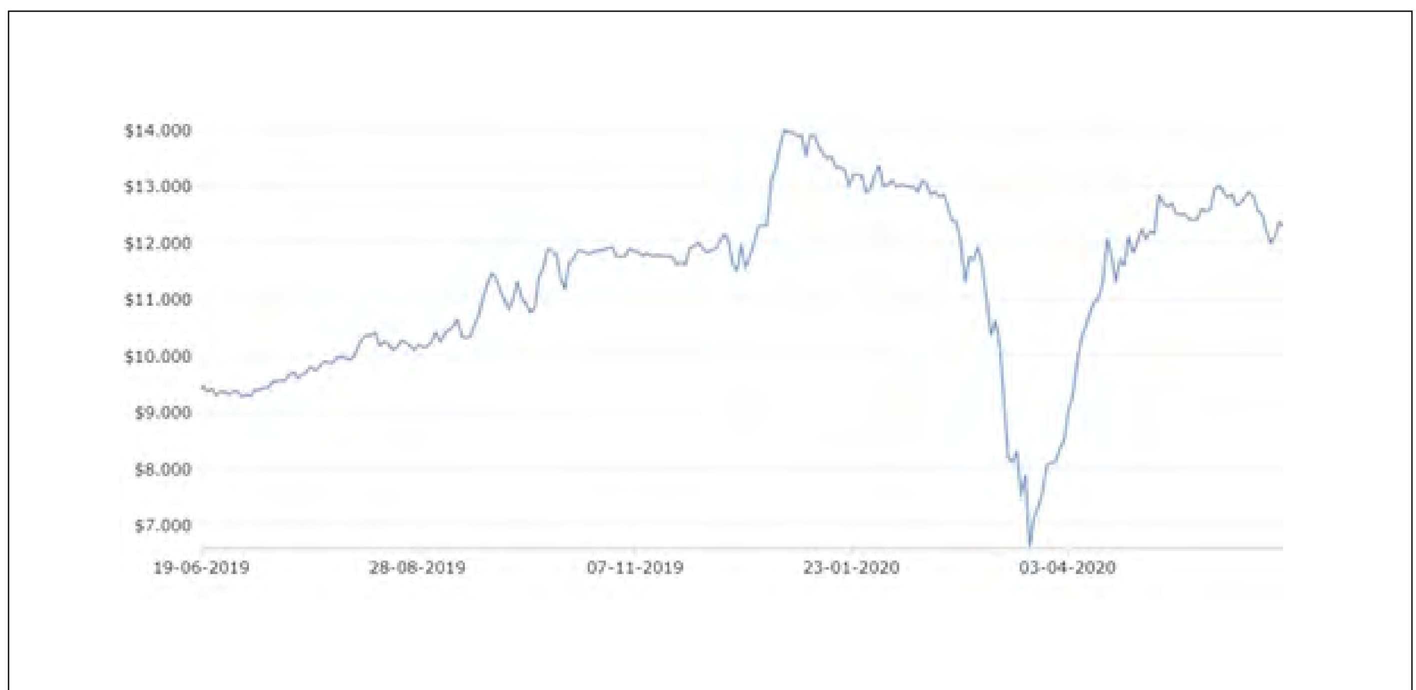
Share price chart



Source: Tradingview

If there's one industry that is growing globally no matter what, and growing fast, it's QSR, that is Quick Service Restaurants. There will be endless books, articles and documentary films decrying the supposed evils of fast food. Fast Food Nation by Eric Schlosser and The Omnivore's Dilemma by Michael Pollan are two of the more reasonable polemics against the industry. But the customers keep voting with their feet, in greater and greater numbers. And why not? The food and drinks tastes good, it's family friendly and you can generally bank on the customer service.

Strong growth in 2019 for those yummy brands Down Under

That's why, in calendar 2019, Yum! Brands (NYSE: YUM – the old fast food division of PepsiCo) saw its worldwide system sales grow 9%, with KFC growing at 10%, Taco Bell at 9% and Pizza Hut at 8%. And when Yum! Brands is doing well, so is Restaurant Brands New Zealand, since it has all three of these brands in its portfolio, in Australia (in NSW and ACT), New Zealand and the US state of Hawaii. There are also 18 'Carl's Jr.' stores in New Zealand, with the located rights to the burger chain licensed from America's CKE. Restaurant Brands recent changed its balance date to 31 December, so comparisons were a little difficult, but the company estimated system growth of 5% through 2019.

Obviously, this year won't be as good as 2019 for Restaurant Brands because on 23 March the stores in New Zealand were shut while the stores elsewhere could only do drive-through, take-out and delivery sales. However, New Zealand was back to drive through and delivery by 28 April and by May service was back in stores as per normal. Which is why the stock has been recovering so strongly.

Growth plans

Restaurant Brands, 75% owned by Mexico's Finaccess as of last year (it paid NZ$9.45 per share), remains in growth mode. Just before Christmas 2019 the company announced that it was buying 70 KFC and Taco Bell stores in southern California as part of its US expansion plans, although this transaction has yet to settle.

Right now, the company is executing on a July 2019 deal that allows it to open 60 Taco Bell stores in NSW and the ACT as well as in New Zealand. Impressively, the company hasn't allowed concern about the state of the economy to hinder the Taco Bell rollout. The second New Zealand restaurant, in downtown Auckland, opened its doors on 16 June. We're told that the first Kiwi Taco Bell, at a west Auckland shopping centre called LynnMall, has been doing well since its November 2019 launch.

Valuation looks good too

Restaurant Brands has recovered smartly since March, but we believe there's still more upside from here. Currently the stock is trading at an EV/EBITDA multiple of 18.6x forecast calendar 2021 earnings but that drops to 14.3x in 2022. That's pretty reasonable given 36% p.a. forecast EBITDA growth for those two years. It's also worth noting that Yum! Brands' EV/EBITDA on 2022 forecast numbers is 18.2x, i.e. higher than for Restaurant Brands. So long as the folks Down Under take to TexMex food like they've taken to KFC, the upside for shareholders could be delicious.

Mind you, almost all trading in RBD takes place on NZX, so if you want to get a taste of this one, you'll need to buy it there.

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Share price chart

Source: Tradingview

Strong interim result driven by KFC Australia

Collins Foods' 1HY20 result displayed strong growth in both revenue and earnings. Revenue increased 9.2% to $448.8m. This was driven by strong top line growth at KFC Australia led by the popularity of value deals and product innovations. Underlying EBITDA was up 7.4% to $57.7m and underlying NPAT was up 9.1% to $23.9m. The EBITDA margin expanded from 17% in 1HY19 to 17.5% across KFC Australia. It was the result of strong same store sales growth and cost control measures related to improvements in the company's systems.

The balance sheet was in good health at the end of the half year. It had a cash balance of $77.2m and a credit facility of approximately $395m. Net debt decreased by $8.9m to $217.3m. The company's net leverage ratio declined from 2.08 to 1.84 due to strong operating cash flow and remained well below the covenant maximum of 2.75. Net operating cash flow was down $2.1m to $33.7m due to the timing of working capital flows but remained at a healthy level, in our view.

Looking to resume expansion plans as pandemic passes

Soon after buying the franchise rights to Taco Bell in 3 Australian states, including Queensland, in September 2018, Collins stated its plans to roll out 50 Taco Bell restaurants over a five-year period. It recently opened its fifth Taco Bell restaurant in Southport followed by a sixth in Logan Central in October 2019 and a seventh in Currajong in November 2019. Prior to the crisis, it was targeting the construction of 20 Australian Taco Bell restaurants in CY20. And while it has fared relatively well, the group has not been immune to the struggles faced by the broader retail sector as stay-at-home orders led to slower customer traffic for Taco Bell Australia. Although the COVID-19 outbreak put the brakes on the expansion plans, Collins has a strong pipeline of Taco Bell sites in place and the group's expansion plans should resume as the pandemic passes.

Fortunately, the KFC Australia operations have done well during the pandemic owing to robust drive-through and home delivery demand. Same store sales in the KFC Australia business slipped by only 0.9% from 30 March to 3 May. Excluding the stores located in shopping centres, same store sales would have been up 4%. Sizzler Australia experienced a bigger sales decline because of dine-in restrictions, but has added takeaway and home delivery services. Sales in Germany and the Netherlands, which together represent about 15% of total sales, were down 28% and 40% respectively in the same five-week period, but have improved from initial COVID-19 outbreak levels.

Overall, the company's cost management and sales maximisation efforts during the pandemic have served them well. Taco Bell sales have returned to pre-COVID levels. With the Australian and European economies reopening, Collins has the potential to perform well in the post-COVID environment. Job layoffs and tighter household budgets in a recessionary economy are likely to drive people to inexpensive QSRs.

Digital initiatives reshaping the company

Collins' digital initiatives are rapidly changing the nature of its businesses. A focus on delivery and digital channel growth has been the engine behind KFC Australia's strong performance during the pandemic. Delivery is now available at approximately 100 KFC Australia locations through Deliveroo and Menulog. Many consumers who turned to takeaway and delivery options to satisfy their fast-food cravings may never go back to the in-store alternative.

The company's popular "click and collect" app has been instrumental in driving sales and customer loyalty. External digital menu boards for drive-thru are being rolled out and will continue to be upgraded over the next several years. Behind the scenes, the group's "Digital Ops" strategy is a multi-year program designed to reduce paper and manual systems in support of more efficient shift management. In the post-pandemic world, QSR's with a strong online presence are likely to outperform. We believe Collins' digital initiatives are a step in the right direction.

Prior to the pandemic, Sizzler was seeing same store sales growth of 4% led by Sizzler Asia where royalty revenue was up 17.9% over the prior full year. The continued expansion of the group's Sizzler footprint across Asia is another opportunity for growth. Meanwhile, the return of domestic tourists bodes well for Sizzler Australia traffic as travellers seek to make up for lost time with a value-oriented casual dining experience. Global expansion plans and a move towards digitisation support the potential for Collins Foods shares to sizzle over the next several years.

Given the near 20% EBITDA growth expected for FY21, which started in May, we believe the shares are trading at an attractive 12x EV/EBITDA multiple. Don't buy them for the dividend, though, because Collins Food only offers a 1.6% yield.

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Share price chart

Source: Tradingview

Yield and lease terms reflect high quality portfolio

The $405m Garda Diversified Property Fund is comprised of 17 office and industrial properties that generate reliable income. The office component is the slightly larger part of the portfolio at 53% of value, although the industrial side has increased due to recent acquisitions. The portfolio is well diversified geographically with Brisbane and Melbourne together representing about three-fourths of the portfolio with additional properties in Cairns, Mackay and Gold Coast. Its key tenants include Planet Innovation, J. Blackwood & Sons and Volvo Group, which represent about 10% of income each.

Garda's current portfolio has favourable earnings yield in relation to its peers. Its 6.1% FY20 earnings yield is above the peer group average of 5.9% and trails only two competitors. This is the result of the company's focus on developing newer, higher yielding assets across a variety of building types, tenant types and locations.

The fund is actively managed with the long-term in mind. The established income-producing properties have a 5.6 year weighted average lease expiry (WALE). This has increased from a WALE of 5.3 in FY19. The length of the group's lease terms is a mark of high quality. It is also a reflection of strong leasing activity. In 1HY20, 21,997 sqm of the portfolio's net leasable area (NLA) was leased and an additional 11,404 sqm was under discussion. Garda has a limited near-term portfolio expiry with only seven properties to address in CY20. Management sees only 8% of lease expirations taking place before FY22.

Botannica 9 an uncertainty in post-COVID environment

The COVID-19 crisis has had a minimal impact on Garda's portfolio thus far. It has taken a revenue hit of only $5,500 related to a single tenant departure. The company has granted some rent deferrals to a small number of tenants, but this amounts to less than $440,000, the entirety of which is expected to be repaid by the end of CY20. Occupancy rates have remained strong and stable at 83%. Excluding the new Botannica 9 property the occupancy rate is 97%. Going forward, however, we believe earnings may lag due to delays and continued uncertainty around the group's industrial projects.

Meanwhile, Garda's leasing of the Botannica 9 building at 588 Swan Street in Richmond is an area of concern. The location consists of a five-story office building and three levels of car park in the Botannica Business park within the "City Fringe" office market. It was completed in June 2019 but remains vacant. Garda will likely continue to struggle to secure leases for this building in the post-COVID-19 economic environment. Potential office tenants are likely to be cautious about committing to space in a business world that is moving towards working remotely. Due to the tougher leasing market, we believe Botannica may take at least a year to fill and continue to be a drag on the portfolio for some time. If it can find leasing success, however, it is estimated to generate around $4m of net income per annum on a fully leased basis.

Highly attractive dividend yield

Moving forward, the company's project pipeline is strong and should help deliver solid future returns. It presently contains six promising assets focused on industrial development. The recently completed Berrinba industrial development has an ongoing leasing program for its 5,000 sqm of warehouse space and 500 sqm of office accommodation in the established SouthWest1 Enterprise Park. Stage 1 of the Acacia Ridge project is also underway with re-development options and leasing outcomes in focus. Management has noted it is in advanced negotiations with prospective tenants at both Berrinba and Acacia Ridge. Other projects soon to be launched include the 17,000 sqm Wacol industrial development where bulk earthworks have begun. In total, Garda's project pipeline includes around 50,000 sqm of Brisbane industrial space. Projects totalling 22,704 sqm of NLA are forecast to start in 2HY20.

The group's financial position has strengthened due in part to the February 2020 refinancing of its senior bank facilities. The three-year, $200m syndicated facility with ANZ and St. George at an all-in debt cost of 3% increased its debt facility by $19.3m. Given the extensive development pipeline, the facility may be fully drawn by FY21. Garda has a favourable liquidity position that includes $20.5m in cash.

Although uncertainty around the Botannica 9 building is a significant risk, we believe the high-quality nature of the group's property portfolio and strong project pipeline make it worth building a position. On top of that, Garda's dividend yield of more than 8% should be very appealing to yield junkies.

Pitt Street Research Pty Ltd

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