STOCKS DOWN UNDER

18 JULY 2022

ASX Top 200 Stocks Down Under

It is in your hands, to make a better world for all who live in it.

- Nelson Mandela (1918-2013), South African President (1994-1999), anti-apartheid activist

COLLINS FOODS

Finger lickin' good

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Stocks Down Under rating: ★★★★

ASX: CKF
Market cap: A$1.1B

52-week range: A$8.04 / A$14.30
Share price: A$9.83

While most ASX investors are sweating over their companies' FY22 results, Collins Foods shareholders have already been satisfied by this company's results, given its financial year ends on May 1. Collins Foods' results have sent shares up by over 20% in the last fortnight – impressive in this climate. But can it continue to be 'finger lickin' good' in a market environment with the hottest inflation in 4 decades?

Share price chart

Source: Tradingview

A rare turnaround from a botched IPO

Collins Foods operates KFC and Taco Bell Restaurants in Australia, Germany and the Netherlands as well as the Sizzlers restaurants in Thailand and Japan. It began in 1968 in the USA, owning stores in America and Australia, relocating Down Under in 2005 after it was acquired by Pacific Equity Partners (PEP). It listed on the ASX in 2011 at $2.50 when Pacific Equity Partners (PEP) wanted to exit and similar to other IPOs where bigwigs are selling, it didn't start well – Nuix and Adore Beauty are two recent examples.

Just as it was with the first two firms, Collins Foods committed the cardinal sin of downgrading its profit forecasts within weeks after listing, by over 25%. It took until early 2015 for the company to surpass its IPO price, but has traded above it ever since. The catalyst was acquisitions that generated revenues and that scaled up in their own right, but also provided platforms for store expansions in new regions. It also divested many (but not all) of its Sizzlers stores, which had gone bankrupt in the US in the 1990s and were left behind in Australia by new competitors, such as Grill'd and Guzman & Gomez.

Bruised by COVID, but kept going

After a few years of growth, COVID-19 presented a number of new challenges for Collins Foods. The most prominent of these were lockdowns that closed food courts where its KFC and Taco Bell outlets were. The company had to cope with take-away service, either from its stores or through delivery services. But just 3 months into the pandemic, long-term CEO Graham Maxwell retired and was replaced by COO Drew O'Malley.

It was around that time that we last covered Collins Foods in Stocks Down Under, on 19 June 2020, giving it 4 stars at $7.96, albeit with a warning not to buy for the dividend yield (only 1.6% at the time), but for its future growth. Two years on, we believe we were right, judging by the company's financial results. In FY22, it delivered $1.2bn in revenue (up 11% from FY21), $207.2m in EBITDA (up 13%) and a statutory NPAT from continuing operations of $54.8m (up 47%). It paid a dividend of 27c per share (up 17%), which represents a yield of 2.6% at the current share price. It has $97.2m in cash, slightly up on the previous year, despite some repayment of borrowings, and a net operating cash flow of $119.9m - $153.3m before interest and tax. It had a slightly negative net cash outflow of $2.9m, which can be attributed to payments for acquisitions.

Obviously, the vaccine rollout and removal of restrictions contributed. But we can also credit it to the consolidation of its market position in the Netherlands. In October 2021, Collins Foods bought out the second largest franchisee in the market that expanded its footprint by 25% to 44 KFC restaurants and to more than half the market. Still, it has tried to focus on what it is doing even better rather than planting as many flags as possible as Dominos Pizza (ASX: DMP) appears to be doing. It has focused on installing solar at its restaurants and made digital investments, including in kiosks and menu boards.

Still in the woods

Looking to FY23, the company has not given financial guidance, but told shareholders it had 20-29 new restaurants planned and that same store sales growth was strong – 12.2% for KFC Netherlands and 19.4% for KFC Germany. Consensus estimates for FY23 suggest $1.3bn in revenue and $199.4m in EBITDA, up 12% and down 5% respectively from FY22. In FY24, consensus estimates call for $1.4bn in revenue and $220.2m in EBITDA, up 10% and 8% respectively. The stock is priced at just 9.2x EV/EBITDA for FY23, although it's P/E is pricier at 20.3x.

You might be asking why EBITDA is forecast to decline in FY23. We think analysts are pricing in rising inflation that will inevitably hit Collins' supply chains. Indeed, KFC's struggles have been highly publicised in recent times, having to use cabbage instead of lettuce in burgers because cabbage is cheaper. Beyond the risk of inflation, there are also the risks of pandemic restrictions being reintroduced, missing guidance (and consequential loss of confidence by shareholders) as well as food safety.

We think it's safe in the woods

Although the company has no control over pandemic restrictions or inflation, we take hope from the company's positive trading history in similar conditions in the past. As we observed in our insights article from 6 July 2022, fast food has a history of outperformance in poor economic conditions and Collins Foods shares specifically outperform in bear markets. This is because consumer spending on Quick Service Restaurants (QSRs) is less affected than full-service restaurants given the price points and value proposition.

Even among QSRs, we think KFC is better positioned compared to Dominos because of its loyalty program (with 330m members responsible for 62% of sales and growing) and its historically quicker payback period for new stores – just ~2 years compared to 5-6 years for Dominos. It has also been more conservative in expansion than Dominos.

Looking technically, we think Collins shares could reach an all-time high of $14 in coming months on current trading patterns, although a break below $8 would be a sign of bearish sentiment. Of course, these are always risks of various kinds and investors are ultimately judging a company on its capability to perform despite the risks. And you can have far more confidence in a company that has performed well in the past, even encountered some of these issues before. Collins Foods is one such company, in our view, and consequently it gets four stars from us.

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