RESEARCH REPORT

November 2, 2020

Restaurant Industry Player Analysis

Food for Thought

Starbucks has been a longtime holding in the CONS U.S. portfolio, having initiated our position in the company nearly five years ago. Amidst all the changes in dining that have occurred since the outbreak of the COVID pandemic, the CONS team chose to revisit our thesis on Starbucks to see whether or not the long-term earnings power of the business has changed.

In addition to our pitch on Starbucks, the CONS team also conducted other mini pitches on McDonald's and Restaurant Brands International, both of whom compete with Starbucks across the globe. Our intention with the mini pitches was twofold:

(1) To make ourselves aware of any initiatives from these competitors that might harm our investment in Starbucks

(2) To determine whether or not we should consider an investment in one of these competitors

In summary, we believe that Starbucks remains a very high quality busines with a long runway for growth ahead. While COVID has certainly presented a near-term headwind for the business, we believe that the long-term earnings power of the business has not been fundamentally impaired. McDonald's is clearly the highest quality chain in our coverage universe, but we believe that the valuation is too expensive to warrant an investment at this time. Finally, Restaurant Brands International has a similarly long runway for growth like Starbucks but is currently experiencing some operational hurdles that have hurt performance in recent years. The CONS team believes that Restaurant Brands could warrant further research given its low valuation at this time (~17x 2020E earnings).

52 Week Performance

Consumers

Bronwyn Ferris
bferris@quiconline.com

James Boulter
jboulter@quiconline.com

Anchal Thind
athind@quiconline.com

Taras Wylynko
twylynko@quiconline.com

Petar Mijacevic
pmijacevic@quiconline.com

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Starbucks - Company Overview

Starbucks Corporation ("SBUX") is an American marketer and retailer of specialty coffee, beginning operations in Seattle in 1985. Since then, the Company has grown to a global store count of over 32,000 locations in 81 markets, cementing itself as a dominant global player. Initially known as a "third place" for customers to relax over gourmet coffee, Starbucks has been able to realize significant growth in domestic and international markets, all while creating an exceptional and consistent customer experience. The Company drives revenue from an almost even split by store count of company-operated locations, and lower-margin licensed stores, though company-operated cafés account for 81% of revenue. Revenue can be decomposed into three operating segments:

1) **Americas (69%).** This includes the U.S., Canada, and Latin America. Over the past five years, the segment has matured and been greatly aided by increased usage of the My Starbucks Rewards platform, resonating strongly with North American consumers.

2) **International (23%)**. This includes China/Asia Pacific (CAP), Europe, Middle East, and Africa (EMEA). Starbucks has undergone a streamlining of international operations in recent years, moving to full company ownership of the fast-growing China segment (Exhibit I), but licensing the majority of slower-growth cafés in the EMEA segment, helping boost SSSG in recent years.

3) **Channel Development (8%)**. This represents the CPG segment, consisting of sales of flagship coffee grounds and ready-to-drink beverages directly to grocery, warehouse club, and retail stores. In 2018, the Company inked a $7B perpetual licensing agreement with Nestle to sell the products internationally, an area significantly lagging store growth at the time. Although this will continue to be a relatively small component of the business, greatly enhanced distribution through Nestle and ongoing royalty fees will be a strong tailwind for the segment.

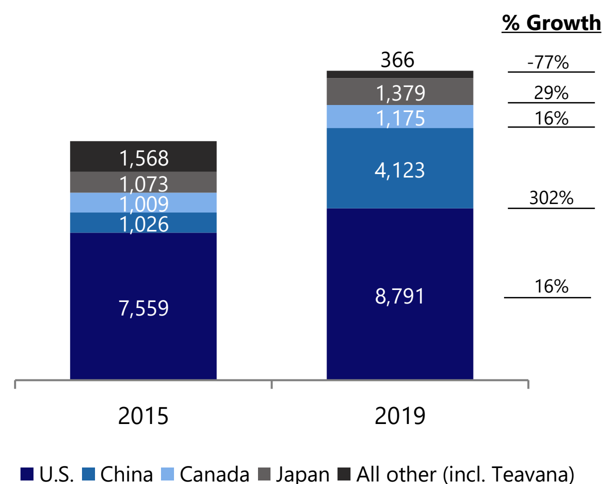
Management and Stewardship

While a more in-depth analysis of management could be done in a full pitch, we continue to have confidence in the Company's experienced team. A target 89% of NEO compensation is variable, with a 13% annual incentive having the recent introduction of a 30%-weighted individual performance factor. 76% of this mix is a long-term incentive, with a 40/60 split of time-based RSUs and PRSUs that examine 3-year EPS performance and "Total Shareholder Return", a blended metric examining ROIC, share appreciation, and return of capital to shareholders. Additionally, CEO ownership is required to be a 6x multiple of revenue, with Kevin Johnston steadily increasing ownership since 2009 to an all-time current high.

The Consumers team opened a position in Starbucks in 2015, after a promising initial report. Since then, much of the original thesis has played out, warranting a revisit to assess current and future performance, in comparison to other QSR businesses in our universe.

EXHIBIT I

Company Owned Stores by Market



Source(s): Company Filings

Starbucks - Industry Overview

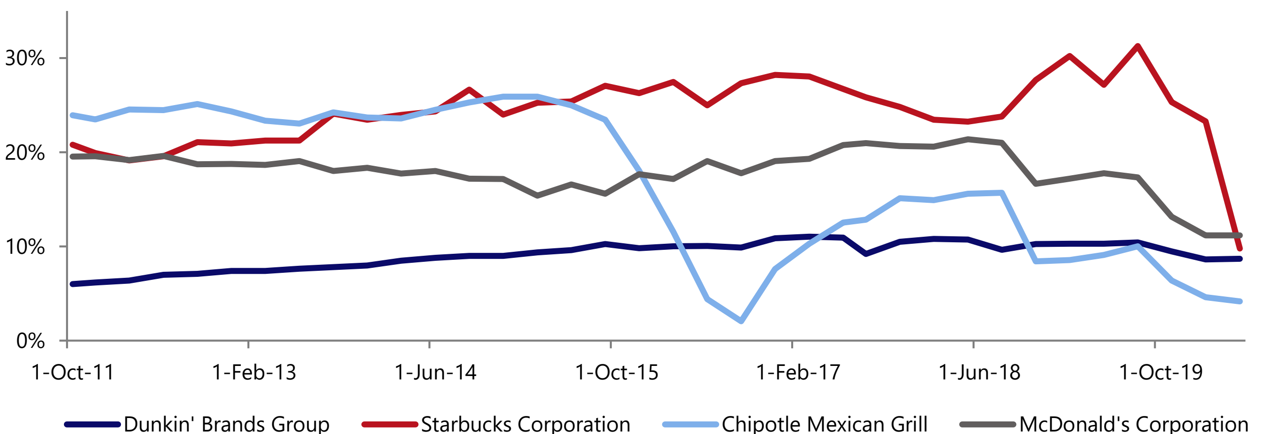
Starbucks operates in the broader quick service restaurant (QSR) industry, mainly comprised of major international fast-food chains. The industry can be segmented into coffee and snack shops, limited service, full service, and casual dining establishments. Over the past five years, gourmet coffee and tea chains, as well as the general breakfast food segment, has seen strong growth due to consumers opting for healthier options and on-the-go items. Moving forward, the coffee category is expected to grow 27% from 2018 into 2023, trailing only the chicken and bakery categories.

Within the coffee and snack shop segment, Starbucks experiences competition from smaller local players, but mainly other large chains. As the restaurant industry has become more franchised and focused, existing players have had the opportunity to establish strong digital platforms to connect with customers, helping create an experience surrounding food purchasing. This has been a significant headwind for smaller players, as national brands can combine this presence with a consistent product offering to create scale advantages. These barriers are also evidenced in high returns on capital for dominant players, with Starbucks being at the top of the industry (Exhibit II). In recent years, a wave of consolidation has passed through the industry, as franchise-driven chains benefit from sharing operations expertise, supply chain savings, and digital competencies with acquirees. The most recent deal in the industry was Inspire Brands' $11.3B take-private of Dunkin' Brands, which may put more pressure on Starbucks to compete with other massive chains.

Looking ahead, one of the most prominent trends in the QSR industry will be the use of drive-thru locations to support sales. In the last decade, service times have steadily increased due to more complicated processes, and paired with the pandemic impairing dine-in abilities, a renewed focus on this offering is being experienced by almost every major chain.

EXHIBIT II

Consistently Superior Returns on Capital Compared to Industry Peers



Source(s): S&P Capital IQ

Starbucks - Runway in Asset Optimization and International Markets

The COVID-19 Catalyst

If the repositioning of over 800 North American restaurants in the next 18 months is a tall order, it's a good thing Starbucks carries Venti sizes. With forced lockdowns drying up revenue from in-store orders, existing intentions have been accelerated to transition to serve "on-the-go" transactions, which comprised roughly 80% of revenue pre-pandemic. This is a stark contrast from Starbucks' heralded "third place" experience of free Wifi and comfortable seating. That advantage has since been pressured by other QSR competitors looking to capitalize on the growing breakfast daypart segment. However, this helped emphasize one of the true competitive advantages of the brand: an unmatched product portfolio and fierce loyalty from daily users. Lack of seating capability showcased the immense strength of Starbucks' mobile offering, and consumers' willingness to use pickup and drive-thru alternatives, which crept up to 90% of sales in May.

U.S. Asset Optimization Opportunity

For the past couple of years, management has outlined plans to cater better to an increasing desire for convenience, and has been executing a portfolio optimization strategy to reduce congestion in its urban locations and take advantage of a more profitable drive-thru style format. This will involve the transition of urban cafés to Starbucks Pickup locations, which hold a much smaller footprint and can accommodate more customers at busy times. Supplementing it will be growth in the use of drive-thru locations, which only represent ~50% of the asset base, but accounted for 90% of location growth in 2019. At a unit level, management has elaborated that drive-thru locations produce 20-25% higher average unit volumes (AUV) than traditional stores, while carrying higher margins in part due to more efficient use of labour, overall creating a much more profitable entity. Assuming U.S. stores grow at historical levels though 2025, a system shift to drive-thru locations could yield strong prospects for profitability into the future. Moreover, due to the density of stores in urban markets (Exhibit IV), consumers will have lots of options to make purchases while certain locations close to reformat. Here, management has proven a dedication to being at the front of the market on this trend, positioning the business to engage better with customers and boost profitability.

EXHIBIT III

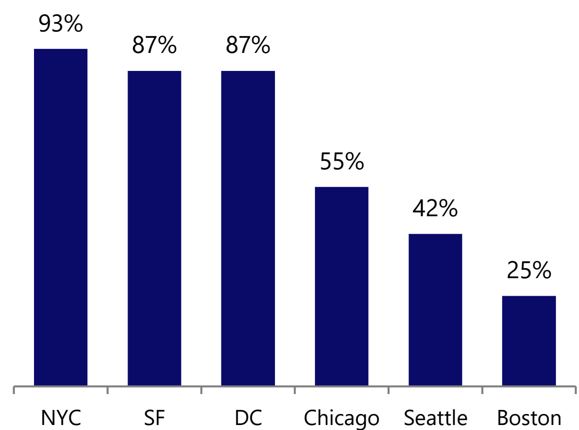
Profit Potential from Drive-Thru Locations

	2019			2025		
	Drive-Thru	Non-DT	System	Drive-Thru	Non-DT	System
Stores	4,334	4,334	**8,668**	5,984	3,563	**9,547**
AUV	2,202	1,393	**1,798**	2,739	1,733	**2,364**
Assume 5.6% annual SSSG						
Profit $ Per Store	584	273	**429**	795	392	**645**
Profit %	26.5%	19.6%	**23.8%**	29.0%	22.6%	**27.3%**
System Sales	9,545	6,038	**15,583**	16,393	6,175	**22,568**
System Profit Dollars	2,533	1,182	**3,715**	4,760	1,396	**6,156**

Source(s): Company Filings, Wells Fargo

EXHIBIT IV

% of Cafés with 1-6 Other Cafés in a 0.3mi Radius



Source(s): Aggdata, Wells Fargo

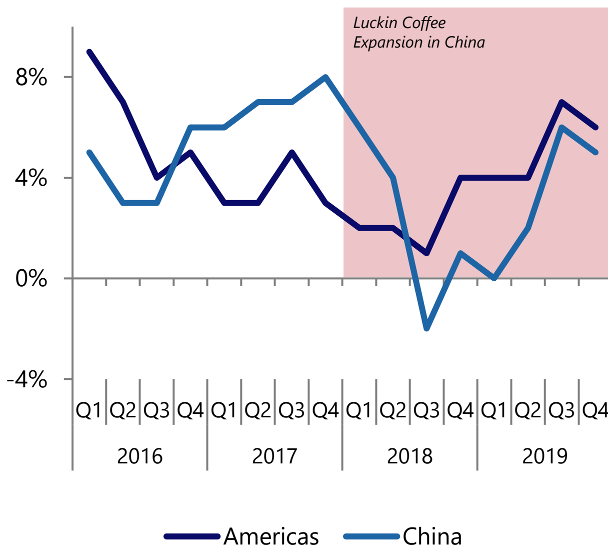
Starbucks - Runway in Asset Optimization and International Markets

Chinese Market Opportunity

The most burgeoning geographic segment of Starbucks' business over the past couple of years has been China. Beginning with 220 stores in 2010, Starbucks' presence has grown at a 36% CAGR to 4,706 stores in 2020, with an additional 600 expected to open in 2021. While the fundamentals of the business remain the same across all geographies, opportunities in the Chinese market have required different optimization than other locations. At a high level, the estimated cups consumed and price per cup of Chinese coffee are expected to grow at 11.4% and 14.7% CAGRs, respectively, though 2023, signalling that coffee is going to continue to be more widely accepted and coveted by consumers. In China, coffee is mostly considered a luxury good, but over half of chains in the country follow a widely-palatable Western format, allowing for a growing middle class to participate in sales.

EXHIBIT V

China vs Americas Historical SSSG



Source(s): Company Filings

Against the backdrop of a favourable environment for coffee chains, Starbucks has thrived. In 2015, roughly 98% of all coffee shops were chain-operated, with Starbucks having a 60% share. Being a foreign product, the industry has seen strong insulation from domestic businesses due to a lack of expertise, leaving it up to U.S. chains build the market. Here, Starbucks' unparalleled digital services have resonated strongly with consumers desiring a premium and personalized experience, more so than other chains selling vanilla lineups. Chinese customers are also much more interested in delivery service than North Americans, benefiting Starbucks' existing digital platform even more. At a unit level, Chinese cafés have a 2.2x sales to investment ratio and 77% ROI compared to 2.0x and 50% in the U.S.

Understanding of these advantages, management has been successful in focusing its asset base in growing U.S. and Chinese operations, working to capture the highest SSSG possible out of the business.

Rise and Fall of Luckin Coffee

Since 2018, Starbucks' biggest competitor in the Chinese market has been Luckin Coffee, who operates a model predicated on kiosk-style cafés that mainly serve pickup and delivery orders. This strong digital offering fueled Luckin's expansion from 300 stores in 2018 to nearly 4000 by the end of 2020. Such encroachment was quite visible in Starbucks' Chinese SSSG during 2018 (Exhibit V), but climbed to recovery in 2019. However, after doubling its valuation eight months since going public, significant fraud was uncovered and Luckin cleared almost its entire c-suite in May 2020, followed by a delisting from the NASDAQ. With almost 75% of revenue overstated, the path for Luckin is very unclear, leaving more room for Starbucks to grow and steal market share.

As a maturing and established global player in the QSR industry, Starbucks can leverage significant scale and an existing dominant position to realize substantial growth in Chinese and international markets.

Starbucks - Spinning Digital Flywheel Fuels Customer Captivity

One of the fastest growing and most distinct components of Starbucks' business model is the "Digital Flywheel", created by an industry-leading My Starbucks Rewards (MSR) platform, and integration of Mobile Order & Pay (MOP) capabilities. Coming out of the Great Recession, the Company was a very early mover in the space, initially aiming to engage its high-frequency customer base with a digital offering. By 2015, the program was growing rapidly, with more growth catalysed by the introduction of MOP across all U.S. locations. This began a powerful loop for which the Company uses the rewards program and app to collect data, and vastly reduces friction in the ordering experience by creating transparent pictures of its customer segments. This has been strengthened by enhancements such as a reduction in the threshold for rewards to encourage less frequent customers, tying rewards to spending and not transactions, and most recently, allowing customers to pay with a host of digital payment methods instead of just preloaded Starbucks cards. Now, with an accelerated focus toward "on-the-go" transactions and drive-thru ordering, this exceptional digital competency can be perfectly leveraged to ensure a smooth transition.

EXHIBIT VI

Robust Digital Network Creates a Superior Customer Experience

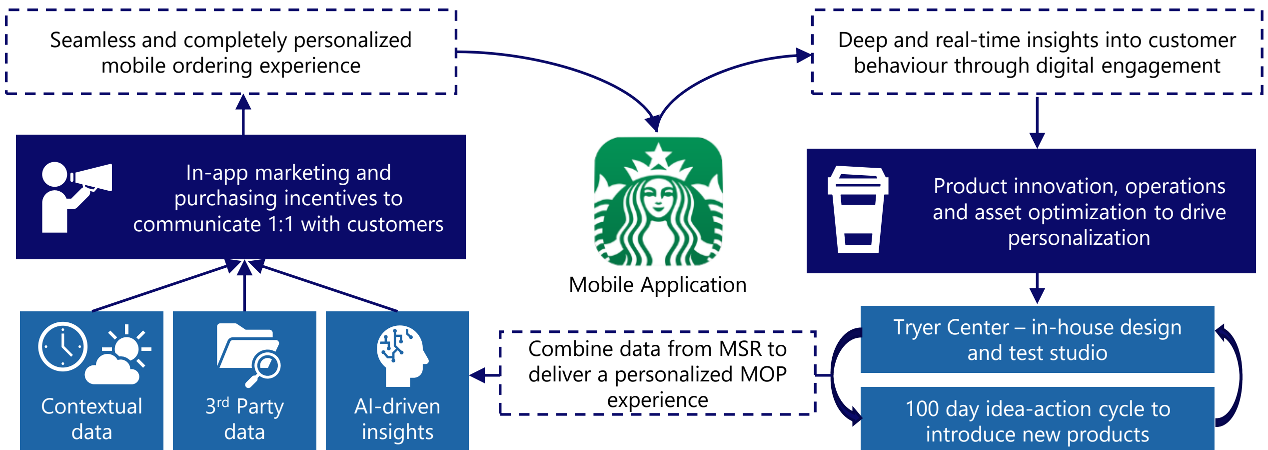


EXHIBIT VII

Starbucks Rewards Outpaces Competitors

North American QSR Loyalty Programs				
Program Name	Inauguration	Members (MM)	Program Transactions as % of Total Spend	Mobile Order % of Total Spend (Pre-Pandemic)
DD Perks	2013	13	13%	4%
Chipotle Rewards	2019	8.5	-	18%
Tims Rewards	2019	7.5	-	-
Starbucks Rewards	**2008**	**19.3**	**44%**	**16%**

Source(s): Company Filings, CNBC, Financial Post, QSR Magazine

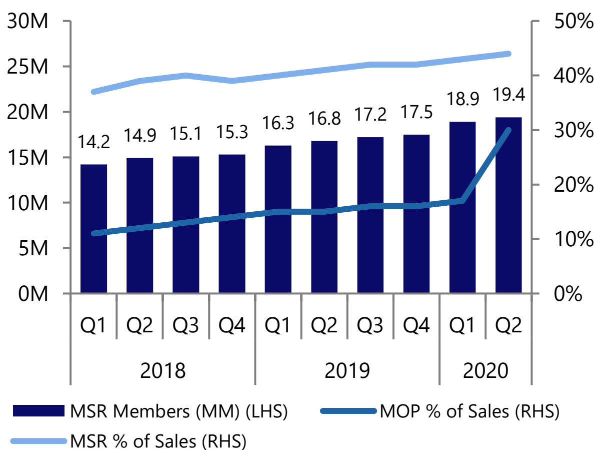
Starbucks - Spinning Digital Flywheel Fuels Customer Captivity

Strong Contribution to Revenue

The program helps grow revenue in two significant ways. First, it helps grow customer counts and transaction volumes. Decreasing barriers to begin earning "stars" has prompted additions across all segments, particularly in low-spend customers. On average, customers in the lowest spend and frequency category experience a 70% sales lift upon joining MSR, representing 65% of new members from 2013-2016. This offers a substantial incremental sales opportunity in adding new members, giving a strong foundation for comps growth. Second, MSR customers are significantly more lucrative than non-members. Despite comprising ~25% of total customer base, members drive 44% of total tender, spending an average of three times more than non members. Moreover, digitally-engaged customers purchase a much wider variety of products, often with low awareness but higher taste scores, carrying higher margins. On the cost side, clear visibility into demand patterns and daypart volume has allowed for the implementation of more efficient labour schedules and inventory management tools.

EXHIBIT VIII

Strong Growth in U.S. MSR Members and MOP Use



Source(s): Company Filings

Since 2013, membership has grown at a 21% CAGR, driven by highly effective marketing and continuous improvement, and mobile orders reaching almost 30% of sales after getting a boost from the pandemic. While most coverage is limited to the U.S., the Company has been just as active in engaging Chinese customers, inking partnerships with WeChat and Alibaba in 2020. Active members in China are an estimated 13.5M, and MOP accounts for 26% of sales.

Competition

Seeing the success of Starbucks' MSR program, naturally competitors have tried to mimic it, as inherently any restaurant is free to create its own platform. However, the Company has been protected from this threat due to structural benefits within its offering as well as being an early mover. Many loyalty programs function by accumulating data, giving Starbucks a significant advantage by having substantially more information about its customers than other coffee restaurants. The Company can then pair this information with its broad and pliable product base to deliver unique and personalized products to each customer. In comparison to other programs, Starbucks leads industry peers in total membership and MOP penetration (Exhibit VIII), with many competitors such as Dunkin and Tim Hortons not being able to create effective platforms until very recently. In general, loyalty programs for QSRs work best for those with the highest frequencies, such as breakfast/coffee-focused brands, and consumers maintain roughly 3 core memberships given the finite time in a day. As the industry matures and competitors have more time to build their platforms, Starbucks will face increased pressure, but has a strong foundation of loyalty and digital capabilities to insulate it. Ultimately, the Company will continue to deliver one of the most personalized and frictionless ordering experiences to a fiercely loyal customer base, fueling profitability and SSSG growth for years to come.

Starbucks - Risks

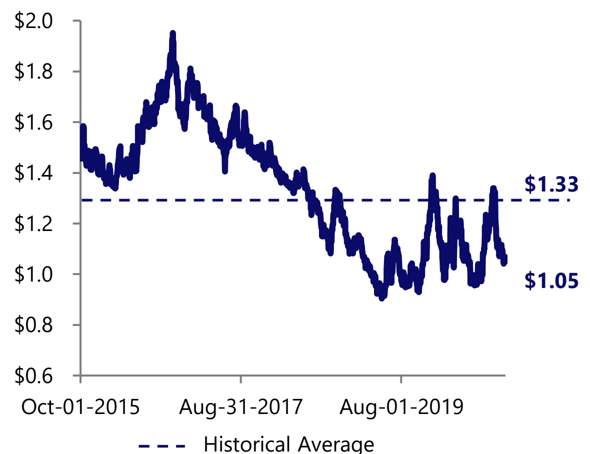
Despite the competitive nature of the global coffee and restaurant industry, Starbucks' current brand image, reputation, premium product offerings, digital rewards system, and barriers to entry limits risk to Starbucks' market share in North American markets. The main risks to Starbucks impacting operating margins and cash flow are increased input costs in food, US election risks, temporary and permanent store closures in transportation hubs, and changing consumer preferences.

Increased Coffee Prices

While Starbucks has secured most coffee costs in fixed or to-be-fixed contracts with suppliers for the remainder of FY 2020, short-term volatility in coffee prices is unlikely to impact COGS. Long-term rises in coffee prices may have a considerable long-term impact on COGS, resulting in increased product pricing or reduced operating margins. With a projected CAGR of 4.22% from 2020-2025, growth drivers in the global market for coffee are increased demand for coffee pods and capsules and ready-to-drink coffee and increased consumption globally, particularly in the China, Asia, Pacific area and Southern European markets. There is a low risk of a short-term rise in coffee prices as a large supply of arabica coffee produced for luxury coffee restaurants has exceeded the demand due to global stay-at-home conditions. In the long-term, increases in coffee prices are likely as the price is relatively low, considering high historical volatility in the market in response to drastic demand changes or supply shortages. Considering the current low price of $1.05, current futures contracts projecting prices of $1.23 by 2023, and the average five-year coffee price of $1.33/pound, a correction is due once stay-at-home restrictions are lifted and demand is back to pre-COVID levels. Lastly, dwindling supply due to unsustainable production and the effects of climate change that decrease the quality and overall supply of coffee will also influence future prices.

EXHIBIT IX

5-year Historical Arabica Coffee Bean Prices ($/lb)



Source(s): S&P Capital IQ

Changing Consumer Preferences

Starbucks' position as a premium coffeehouse makes it quite susceptible to macroeconomic downturns that reduce consumer spending and change consumer preferences. If long-term consumer spending and real GDP growth stagnate due to slower economic recovery, preferences in the coffee market may change, with consumers reducing discretionary spending on luxury coffee and shifting it towards cheaper take-out, instant coffee, and at-home coffee alternatives. Additionally, increasing preference towards coffee pods and capsules and ready-to-drink coffees poses a risk to . Starbucks' licensing agreement with Nestle distributes and sells ready-to-drink and coffee pods and capsules under its Channel Development Business, providing the company with a position in this market. However, a shift of consumer purchasing towards these coffee consumption methods would reduce out-of-home spending on coffee and would impact Starbucks' in-store sales that represented ~ 92% of revenue in 2019.

Starbucks - Risks

Election Risks

Starbucks is highly sensitive to the results of the 2020 US Election. A Biden-Harris election win may restore dine-in sales for Starbucks through improved COVID-19 management, increase labor expenses due to federal minimum wage changes, and repeal the 2017 Tax Cuts and Jobs Act.

Firstly, a Biden-Harris administration's increased restrictions on social-distancing and masks in response to the COVID-19 pandemic are likely to reduce cases across the United States and will partially restore Starbucks' eat-in sales that comprise 20% of revenues, while also decreasing Starbucks Pickup and drive-thru sales that have increased over the past months due to a lack of eat-in availability. Secondly, changes to US federal minimum wages are likely with the Biden-Harris campaign promise of raising the federal minimum wage from $7.25 to $15.25. Given Starbucks' current average minimum wage of $9.25 across the United States, the federal minimum wage increase will raise Starbucks' labor costs for minimum wage employees across the United States by 54%. This increase in labor costs will result in layoffs, increased product pricing, store closures, faster store transformations to Starbucks Pickup to reduce labor, and incurred costs impacting operating margins. Thirdly, the Biden-Harris campaign's promise of repealing the 2017 Tax Cuts and Jobs Act will increase Starbucks' corporate tax rates. Tax rates for restaurants declined an average of 12.5% since the 2017 tax cuts, and a full reversal of this act would bring rates back to FY 2016 levels, with the projected impact on tax rates in FY 2022 for Starbucks being an increase from a 22.5% to 33.7%, directly impacting Starbucks' cash flows available to investors.

Despite Starbucks' risk exposure to the Biden-Harris campaign's proposed economic policies, Starbucks has moderate exposure relative to competitors in the restaurant industry. Lastly, if a Trump-Pence re-election occurs, while minimum wage and corporate taxes are likely to remain unchanged, eat-in sales will stagnate until a vaccine for COVID-19 is developed and distributed across the United States, limiting the eat-in revenue Starbucks has yet to recuperate.

Temporary Store Closures & Reduced Sales

Currently, 87% of Starbucks' global licensed stores (99% of company-operated stores) are open after vast temporary closures in response to COVID-19. Starbucks has stated that most of these current temporary store closures are primarily in airport, college, and university locations within their Americas sector. With a large proportion of Starbucks' closed licensed locations in airports within North America and globally, given analyst predictions that recovery in the travel industry may take between 2-5 years, Starbucks faces significant potential long-term losses or permanent closures of these licensed stores. Additionally, the temporary store closures in college and university locations in its North American portfolios are likely to continue until the proven efficacy of a COVID-19 vaccine – with a prospectus for widespread development and distribution across most developed countries by 2022. This forecast depends on vaccine efficacy, production capacity, supply chain, and distribution methods, and the actual timeline could be prolonged. While most stores are reopened, and Starbucks faced only a global comparable-store sales decline of 9% for Q4 2020 (YoY), there is a 23% decrease in comparable transactions – relative to the 20% of revenues eat-in customers comprise. Another important note is the accelerated impact of COVID-19 on Americas permanent store closures as Starbucks planned to close up to 400 stores in the region. Starbucks can reduce the impact of COVID-19 on sales until a vaccine is in play by accelerating its strategy of transitioning stores and customers to using Starbucks Pickup (in-store or curbside) and drive-thru sales.

Restaurant Brands International: Company History

Restaurant Brands International ("RBI") is the parent company for three popular QSR brands: Burger King, Tim Hortons, and Popeyes Louisiana Kitchen.

Burger King

The origins of Restaurant Brands trace back to September 2010, when Burger King was taken private by 3G Capital for $3.26 billion after poor performance. A Wall Street Journal Article at the time attributed the poor performance to scant menu development, flawed pricing and an overworked strategy of focusing on so-called super fans (people aged 18 to 34 years old who accounted for half of all visits to Burger King outlets, but had been disproportionately hurt by the Great Financial Crisis).

After being taken private, management focused on more creative marketing and product introductions to increase profitability. Management also aggressively decreased the number of company-owned restaurants from 10% to less than 1% in only three years, thereby turning Burger King into the royalty-collection business that it is today (see graph below).

Burger King merged with a SPAC, Justice Holdings, 18 months later. Under the terms of the deal, 3G Capital received $1.4 billion in cash and retained 71% ownership in the company, with Justice Holdings shareholders owning the remainder. This transaction valued Burger King at ~$4.83 billion.

Tim Hortons

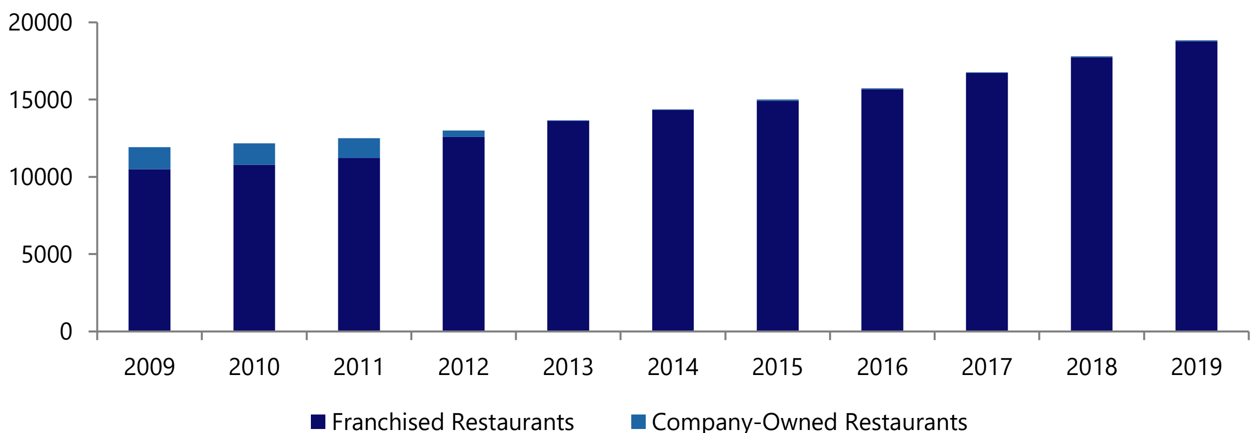
In 2014, Burger King announced a merger with Tim Hortons to create RBI. Tim Hortons was valued at C$12.5 billion in the deal, or ~15x TTM EBITDA. Upon closing, RBI maintained the headquarters of Tim Hortons in Oakville, while Burger King kept its headquarters in Miami.

Popeyes Louisiana Chicken

Finally, RBI acquired Popeyes Louisiana Chicken in 2017 for $1.8 billion, or ~21x TTM EBITDA. While Popeyes was acquired at a much higher valuation than Tim Hortons, management cited Popeyes' substantial runway for growth as justification for the premium price.

EXHIBIT

Burger King Restaurant Mix Over Time



Source(s): Company Filings, Wall Street Journal

Business Model Assessment

RBI has an asset-light, highly cash generative business model. Over 99% of RBI restaurants are franchised, meaning that RBI generates the vast majority of its revenue through high-margin royalty payments from franchisees.

Pros and Cons of RBI's Franchising Strategy

Franchised business models are popular with large QSR chains because it enables them to expand geographically at a fraction of the cost of building out a full restaurant base. That said, there are also drawbacks to this kind of business model, particularly as it relates to maintaining franchisee relationships – something RBI has struggled with in the past.

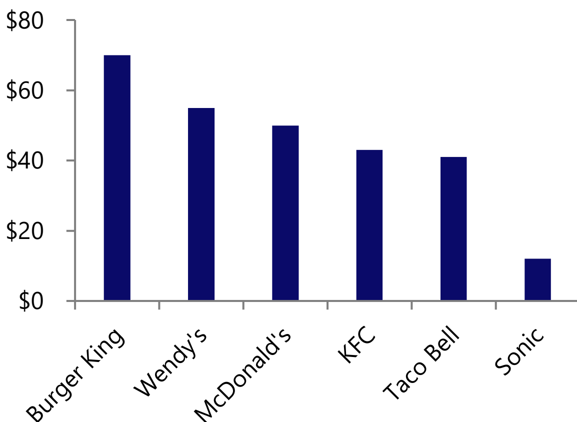
At the time Burger King was taken private, franchisee relationships were strained due to stagnating sales. These relationships were ultimately repaired over time as the profitability of Burger King restaurants increased (see bottom left). Presently, RBI's relationship with many Tim Hortons franchisees is strained. Years of poor menu innovation and weak same-store-sales coupled with recent complaints about the treatment of minimum wage employees has led to frustration amongst franchisees (in March 2017, ~70% Tim Hortons restaurant owners joined together to form the Great White North Franchisee Association to express their concerns).

While this is certainly a problem, it should be rectified with time. RBI has proven in the past that it can repair franchisee relationships and has reorganized Tim Hortons' leadership to do so once again. In December 2017 RBI appointed Alex Macedo, the former president of Burger King, to become the president of Tim Hortons. Macedo oversaw much of the turnaround effort at Burger King, making him well qualified to oversee a similar effort at Tim Hortons.

Recent initiatives like the introduction of self-order kiosks, new menu innovation and the launch of Tims Rewards should all help increase the profitability and repair the relationship with Tim Hortons franchisees over time. In fact, management disclosed at RBI's 2019 investor day that the average 4-wall EBITDA for a Tim Hortons franchise has increased from C$283K in 2014 to C$320K in 2018 (see bottom right).

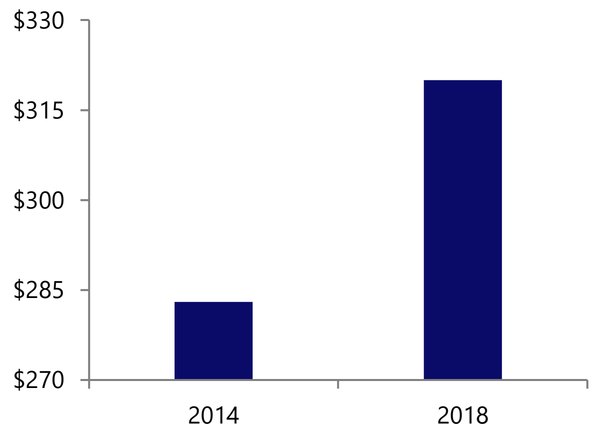
EXHIBIT

Improvement in Franchise EBITDAR ($000s, '17 vs '13)



EXHIBIT

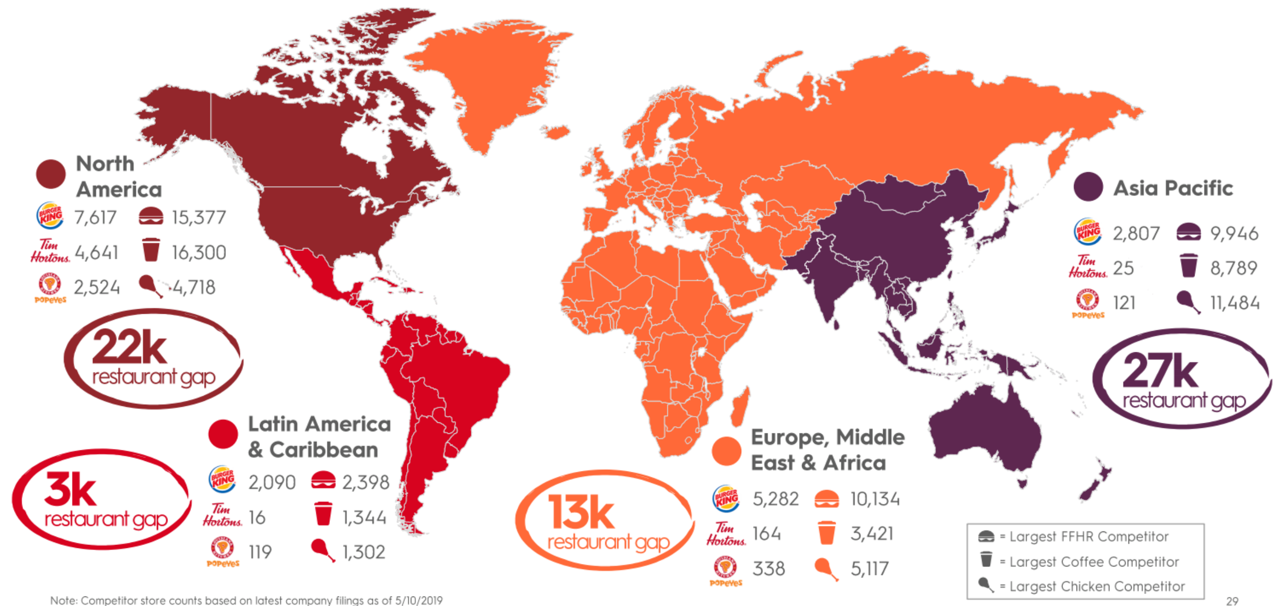
Tim Hortons Average 4-Wall EBITDA ($000s)



Source(s): Company Filings

Runway for Growth

At RBI's inaugural investor day in May 2019, management announced a long-term goal of 40,000 global restaurants, compared to the 25,700 restaurants that RBI had at the time. This represents a ~55% increase in units and is expected to occur over an eight-to-10-year timeframe. Management justified this with the graphic below:



RBI primarily uses master franchisee agreements when expanding internationally. This strategy has been highly successful for RBI because (1) it enables RBI to enter new markets much more quickly, and (2) it helps with projecting a consistent brand image which is an important consideration when entering new markets. Management highlighted several recently signed Burger King development agreements at the 2019 investor day:

Source(s): Company Filings

Runway for Growth

Burger King Strategy

Growth for Burger King will come through an increased number of restaurants coupled with menu innovation, particularly around the breakfast daypart. Management is expanding the Burger King restaurant count at approximately ~1000 stores per year, and recently introduced several new breakfast items and promotions including a monthly coffee subscription and new breakfast sandwiches.

Tim Hortons Strategy

Growth for Tim Hortons will come through international expansion, menu innovation and increased usage of the Tims Rewards loyalty program. While Tim Hortons has always struggled expanding into the United States, the brand has seen recent success in the Middle East, China, Spain and the United Kingdom. Expansion in these markets will enable Tim Hortons to keep growing despite a saturated Canadian Market.

Furthermore, menu innovation around the lunch and dinner dayparts, coupled with continued refinement of Tims Rewards should drive same-store-sales growth in the future.

Popeyes Strategy

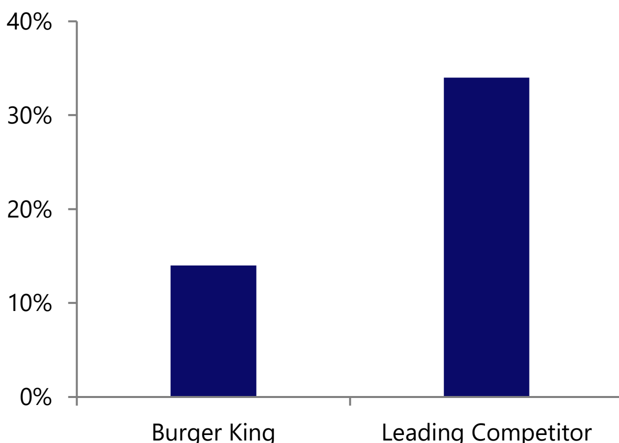
Growth for Popeyes will come through both international expansion and menu innovation.

With respect to menu innovation, Popeyes introduced its Chicken Sandwich in August 2019 to compete with Chick-fil-A's popular Original Chicken Sandwich. Popeyes' sandwich has been an incredible success thus far and has driven a significant amount of the brand's recent same-store-sales growth. While this success is unlikely to be repeated with a new menu item any time soon, it highlights the opportunity that Popeyes has to steal share from both KFC and Chick-fil-A.

Regarding unit count growth, management recently announced a master franchise agreement to open 1,500 new Popeyes restaurants in China over the next decade. For reference, these new units would represent 50% of the brand's current store base.

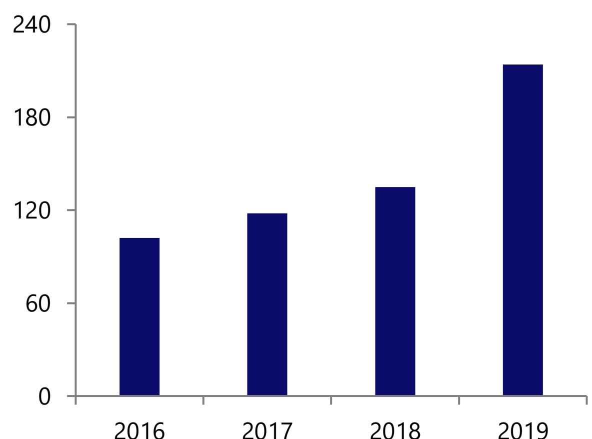
EXHIBIT

Breakfast as a Total Percentage of Sales



EXHIBIT

Popeyes Net Restaurant Growth



Source(s): Company Filings

Conclusion: Assessment of Business Quality & Next Steps

RBI is a high-quality business with a long runway for growth ahead. As seen below, the company has proven its ability to grow and adapt to the everchanging QSR landscape over time.

	Then	Now
Corporate Role	Operator & Franchisor *(Competing priorities)*	Franchisor *(Clear focus)*
G&A	High	Efficient and Scalable
Margin	Low	High
Capital Intensity	Medium / High	Low
Franchisee Profitability	Challenged	Strong and Growing
Unit Growth	Low	High
Diversification	1 Brand, ~1,000 Franchisees, ~80 Countries	3 Brands, >2,500 Franchisees, >100 Countries

While Tim Hortons continues to struggle, Burger King and Popeyes are executing well and should continue to take share in their respective categories. At only 17x 2020E earnings, CONS believes that RBI could warrant further research later in the fiscal year.

Source(s): Company Filings

McDonald's – Company Overview

Founded in 1948, McDonald's Corporation ("MCD") is deemed to be one of the strongest fast-food concepts throughout the globe, raising amongst the highest brand value of any modern company. The Company currently operates roughly 38,000 restaurants in over 100 countries. The Company mainly operates and franchises quick-service restaurants (QSRs) under the McDonald's brand. With nearly 93% of the Company's restaurants worldwide owned and operated by independent local business men as well as women, its revenue sources include company-operated restaurant sales and fees from franchisees.

Brand Recognition

QSR demand is largely driven by consumer tastes and disposable income. With that being said, reputation and the associated brand value play a key role in maintaining customer loyalty. MCD has managed to amass a huge, globally recognized brand name. In fact, McDonald's was the most valuable fast-food brand in the world with an estimated value of $129.32 billion (Exhibit XV).

YTD Performance

It is believed that MCD is in the early stages of an ongoing sales recovery after several years of declining sales results. This lackluster performance has not been witnessed by shareholders who have enjoyed around 100% returns over the past 5 years. This is in addition to buyback programs and ongoing value creation for shareholders over the same period as the stock recently beat the previous high of August 2019, in an impressive comeback since the selloff in March.

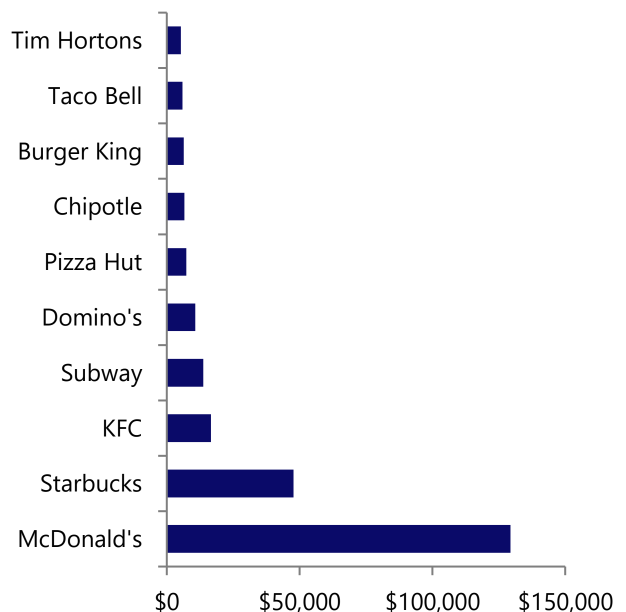
While the company's 2020 earnings were severely affected by COVID-19, unlike dine-in restaurants, McDonald's drive-thru service allowed it to remain profitable even during the pandemic. MCD recently reported a 4.6% comparable sales growth in its key U.S. market in Q3. The company has been making rigorous marketing efforts to grow in the U.S., where it has been experiencing weakness in the last couple of years. Although the comparable guest counts remained negative for the quarter, the company benefited from strong average check growth.

Outlook

While many competitors have suffered large restaurant closures as a result of the pandemic, MCD is well-positioned to capture additional market share as the economy and society begin to slowly reopen. This year, management has restarted revenue and investment growth through implementing a new menu strategy, ongoing digital integration, and allocating capital expenditures to restaurant upgrades. With an almost 10% share of the global informal-eating-out market, there is ample scope for it to grow in the future as it boasts a scale advantage compared to its peers.

EXHIBIT XV

Top Most Valuable QSR's Globally ($USD millions)



Source(s): Statista

McDonald's – Re-franchising Strategy Safeguards Earnings

In the restaurant industry, success lies in improving profit margins while simultaneously employing effective marketing efforts.

Since 2017, MCD changed its expansion strategy by shifting the management of restaurants from company-operated restaurants to franchised ones. Currently, nearly 95% of the company's restaurants are franchised.

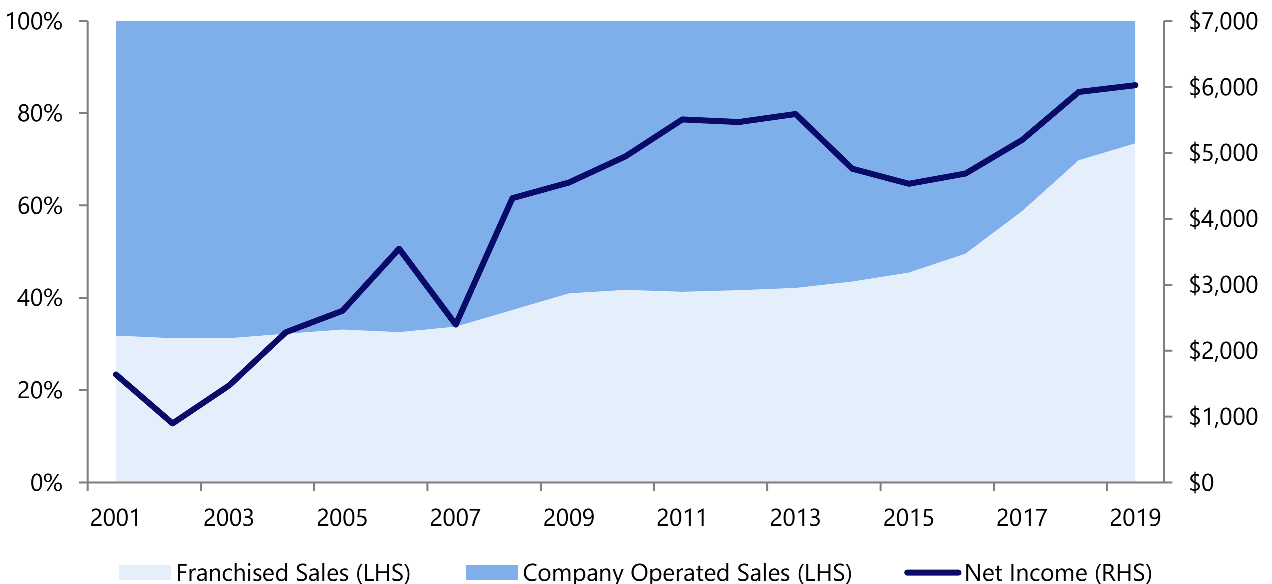
In January 2017, the company entered into a strategic partnership and sold the control of its Chinese business, thereby reducing its own share to 20%. The company intends to add over 1,500 stores more in the region within the next five years. In fact, it has already completed several other important re-franchising transactions since November 2016, including in the markets of Singapore, Malaysia, the Nordics, and Taiwan and is currently looking for similar deals in South Korea, Japan, and South-East Asia.

These partnerships are part of the company's efforts to streamline its business and focus on the quality of its offerings, which should further improve the attractiveness of McDonald's business. Thus, these deals will have an upside impact on its earnings and margins as the company is expected to gain from trimming its overall cost of operations and preserving its capital.

This strategy is successful in increasing the net income of McDonald's by leveraging its products to franchisees and relying more on rent and royalty income. Thus, revenue became more stable, predictable, and the economic impact on sales was decreased.

EXHIBIT XVI

Franchised vs. Company Operated Sales ($USD millions)



Source(s): Company Filings

McDonald's – Re-franchising Strategy Safeguards Earnings

Scale Advantage

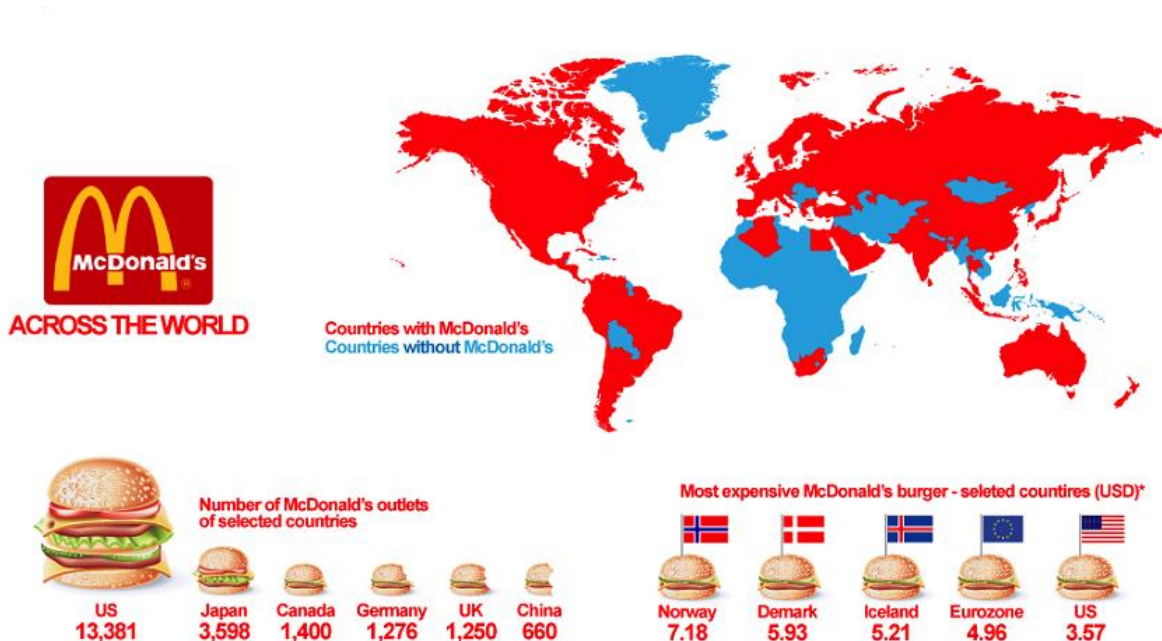
In light of the current economic and social climate, it is critical to point out MCD's scale advantage in the U.S. and how this reinforces the strength of the franchisee-owner model.

This is in addition to around 14,000 restaurants, alongside vertical integration networks within the distribution network that span worldwide. These factors, in particular, enable the company to negotiate more favorable terms with all major landlords and vendors. Such scale benefits the franchisee model, whereby MCD receives fixed payments via leasing arrangements with lessees, thus, reducing rental yield volatility.

Additionally, this benefit extends to outsourced delivery partners including UberEats and Skip the Dishes, to name a few. Evidence of this came to light as recently management employed the strategy of restructuring the exclusive UberEats delivery arrangement (originally in place since 2017). The new structure enables franchisees greater mobility in choices of outsourced delivery service, including DoorDash, Postmates, and Grubhub as partners. The exercise contributes to a cost reduction regime, where the commission rate on deliveries can be reduced relative to the competition, therefore, expanding delivery service appeal and profitability.

EXHIBIT XVII

Top Most Valuable QSR's Globally ($USD millions)



Source(s): Business Management EU

McDonald's – Runway for Growth

Focuses on Delivery to Drive Sales

In order to provide enhanced experience and convenience to customers, McDonald's is increasingly focusing on delivery. Prior to the pandemic, drive-thru accounted for about two-thirds of all U.S. sales while it now accounts for approximately 90%. McDonald's continues to roll out mobile order and pay, with a new curbside check-in option, which the company has already launched in nearly all 20,000 U.S. restaurants.

This effort contributes to ongoing levels of customer satisfaction and aligns with MCD's strategy of obtaining additional repeat customers while retaining existing ones. Moderate evidence of this strategy's success has been seen in Western Europe thus far, where double-digit sales growth has occurred annually since 2019.

Tech Integration

In 2017, McDonald's developed a new growth strategy called the velocity growth plan in order to improve sales through improved products and a complete digital transformation. This came into play during the pandemic, when having a digital strategy contributed to higher sales as customers could not dine out.

MCD has consistently shown its commitment for technology integration into the service model through ordering services including the mobile app. Evidently, this digital integration enables MCD to collect data for meaningful digital-marketing agendas while aligning with a new consumer narrative whereby customers no longer need to go to the restaurant to make purchases. This, in combination with aggressive pricing strategies, will lead to consumers making several impulse purchases as a result of the ease-of-use interface.

Efforts to Attract Customers in International Markets

McDonald's top five operating segments include the US, France, UK, Germany, and Canada, based on sales. Within these markets, around 1 billion potential customers, or 75% of the total population, lives within 3 miles of a McDonald's restaurant. In light of such a large customer base in such a short distance of a McDonald's, the company can deliver food faster and at a more desirable temperature in comparison to its competitors. Furthermore, this benefits the restaurant on a walk-in basis, where customers measure their food decisions on a convenience and distance basis. This is only amplified during a lockdown.

Moreover, McDonald's strategic efforts in international markets continue to drive comps higher as the company attempts to improve its performance areas such as Australia, Canada, France, Germany and the UK. The company intends to drive growth through the introduction of value meals, customizing the menu to local customer tastes, the reimaging of restaurants, efficient marketing and promotions, improved service, and increased convenience via delivery.

With the roll-out of self-order kiosks, digital menu boards, table service, and the mobile app, customers are offered more choices and flexibility as the company progresses toward its Experience of the Future initiative of adding technology to its eateries. Notably, the converted restaurants are now seeing even stronger financial results than those who have not yet made the switch.

All of the strategies above reduce the margin pressures faced throughout the pandemic, ultimately, contributing to top-line revenues and a solid runway for growth.

Valuation Summary

After evaluating these three business models, the Consumers team turned to valuation metrics to see whether market prices confirm our beliefs regarding business model strength and growth prospects. COVID-19 has dramatically changed some of these numbers as a result of depressed revenues or earnings. So, rather than this being an absolute measure of company specific value, we used comparative analysis to see which companies are favoured over others by the market. Overall, when evaluating P/E and EV/EBITDA ratios it seems that the market is pricing in the most growth in Starbucks. This is congruent with the Consumers team's belief in Starbucks' runway for growth in Asia. McDonald's growth prospects are much more operational in nature and less likely to dramatically transform the financial profile of the business. RBI's prospects, while substantial, are likely inherent with the most risk. RBI's growth is most likely to come from Popeyes expansion or a Tim Horton's turnaround, neither of which are guaranteed by any means. This validates the company's discount to McDonald's and Starbucks on a P/E and EV/EBITDA basis. Starbucks is valued at a discount on an EV/Revenue basis purely due to the fact that McDonald's and Restaurant brands benefit from higher margins than Starbucks.

EXHIBIT XVIII

Comparable Companies Models

Company Name	Market Cap ($MM)	Enterprise Value ($MM)	EV / EBITDA 2020E	EV / EBITDA 2019	Price / Earnings 2020E	Price / Earnings 2019	Net Debt / EBITDA 2020E	Net Debt / EBITDA 2019	TEV / Unlevered FCF 2019	EV / Revenue 2019
McDonald's Corporation	$158,494	$207,160	23.6x	19.7x	35.3x	26.3x	5.5x	4.6x	38.5x	9.8x
Yum! Brands, Inc.	$28,130	$38,111	20.4x	18.9x	30.8x	21.7x	5.3x	4.9x	31.6x	6.8x
Darden Restaurants, Inc.	$11,968	$17,063	26.2x	16.3x	(103.4x)	NA	7.8x	4.9x	37.1x	2.0x
Chipotle Mexican Grill, Inc.	$33,618	$35,704	58.9x	51.6x	123.7x	96.0x	3.4x	3.0x	84.2x	6.4x
Domino's Pizza, Inc.	$14,885	$18,898	24.0x	28.3x	30.1x	37.1x	5.1x	6.0x	51.4x	5.2x
Dunkin' Brands Group, Inc.	$8,217	$11,023	24.1x	23.1x	37.0x	34.0x	6.1x	5.9x	35.8x	8.0x
The Wendy's Company	$4,890	$8,363	20.3x	20.6x	41.3x	35.7x	8.4x	8.6x	33.8x	6.1x
Mean	$37,171.59	$48,046	28.2x	25.5x	27.8x	41.8x	6.0x	5.4x	44.6x	6.3x
Median	$14,884.67	$18,898	24.0x	20.6x	35.3x	34.8x	5.5x	4.9x	37.1x	6.4x
Starbucks Corporation	$102,030	$122,663	39.8x	22.1x	153.0x	27.4x	6.7x	3.7x	35.8x	4.5x

Company Name	Market Cap ($MM)	Enterprise Value ($MM)	EV / EBITDA 2020E	EV / EBITDA 2019	Price / Earnings 2020E	Price / Earnings 2019	Net Debt / EBITDA 2020E	Net Debt / EBITDA 2019	EV / Unlevered FCF 2019	EV / Revenue 2019
Starbucks Corporation	$102,030	$122,663	39.8x	22.1x	153.0x	27.4x	6.7x	3.7x	$36	4.5x
Yum! Brands, Inc.	$28,130	$38,111	20.4x	18.9x	30.8x	21.7x	5.3x	4.9x	$32	6.8x
Darden Restaurants, Inc.	$11,968	$17,063	26.2x	16.3x	(103.4x)	NM	7.8x	4.9x	$37	2.0x
Chipotle Mexican Grill, Inc.	$33,618	$35,704	58.9x	51.6x	123.7x	96.0x	3.4x	3.0x	$84	6.4x
Domino's Pizza, Inc.	$14,885	$18,898	24.0x	28.3x	30.1x	37.1x	5.1x	6.0x	$51	5.2x
Dunkin' Brands Group, Inc.	$8,217	$11,023	24.1x	23.1x	37.0x	34.0x	6.1x	5.9x	$36	8.0x
The Wendy's Company	$4,890	$8,363	20.3x	20.6x	41.3x	35.7x	8.4x	8.6x	$34	6.1x
Restaurant Brands International Inc.	$15,803	$29,221	15.2x	13.2x	17.4x	24.6x	6.2x	5.4x	$19	5.2x
Jack in the Box Inc.	$1,816	$3,983	14.8x	18.1x	17.3x	26.6x	8.1x	9.9x	$35	4.1x
Shake Shack Inc.	$2,582	$2,766	130.1x	39.6x	NM	130.2x	8.7x	2.6x	NM	4.7x
Mean	$22,393.78	$28,780	37.4x	25.2x	38.6x	48.1x	6.6x	5.5x	40.4x	5.3x
Median	$13,426.32	$17,981	24.0x	21.4x	30.8x	34.0x	6.4x	5.2x	35.8x	5.2x
McDonald's Corporation	$158,494	$207,160	23.6x	19.7x	35.3x	26.3x	5.5x	4.6x	38.5x	9.8x

Source(s): S&P Capital IQ

EXHIBIT XIX

Comparable Companies Models Continued

Company Name	Market Cap ($MM)	Enterprise Value ($MM)	EV / EBITDA		Price / Earnings		Net Debt / EBITDA		EV / Unlevered FCF	EV / Revenue 2019
			2020E	2019	2020E	2019	2020E	2019		
Chipotle Mexican Grill, Inc.	$35,015	$37,101	61.2x	53.6x	128.8x	100.0x	3.4x	3.0x	$88	6.6x
Yum! Brands, Inc.	$31,033	$41,174	22.1x	20.4x	34.7x	24.0x	5.4x	5.0x	$34	7.4x
Domino's Pizza, Inc.	$15,328	$19,342	24.6x	29.0x	31.0x	38.3x	5.1x	6.0x	$53	5.3x
Dunkin' Brands Group, Inc.	$8,747	$11,562	25.2x	24.3x	39.4x	36.1x	6.1x	5.9x	$38	8.4x
The Wendy's Company	$5,083	$8,455	20.2x	20.8x	42.6x	37.1x	8.1x	8.3x	$34	6.2x
Jack in the Box Inc.	$1,898	$4,066	15.1x	18.5x	18.1x	27.8x	8.1x	9.9x	$35	4.2x
McDonald's Corporation	$158,917	$206,520	23.1x	19.7x	33.6x	26.4x	5.3x	4.5x	$38	9.8x
Darden Restaurants, Inc.	$14,008	$19,104	29.3x	18.2x	(121.6x)	22.3x	7.8x	4.9x	$42	2.2x
Brinker International, Inc.	$2,142	$4,422	17.2x	11.8x	113.5x	15.4x	8.9x	6.1x	$58	1.3x
Mean	$30,241.39	$39,083	26.4x	24.0x	35.6x	36.4x	6.5x	6.0x	46.5x	5.7x
Median	$14,008.21	$19,104	23.1x	20.4x	34.7x	27.8x	6.1x	5.9x	38.3x	6.2x
Restaurant Brands International Inc.	$17,660	$31,696	16.5x	14.3x	19.3x	27.5x	6.5x	5.6x	20.6x	5.7x

Company Name	Market Cap ($MM)	Enterprise Value ($MM)	EV / EBITDA		Price / Earnings		Net Debt / EBITDA		EV / Unlevered FCF 2019	EV / Revenue 2019
			2020E	2019	2020E	2019	2020E	2019		
McDonald's Corporation	$158,494	$207,160	23.6x	19.7x	35.3x	26.3x	5.5x	4.6x	38.5x	9.8x
Starbucks Corporation	$102,030	$122,663	39.8x	22.1x	153.0x	27.4x	6.7x	3.7x	35.8x	4.5x
Restaurant Brands International Inc.	$15,803	$29,221	15.2x	13.2x	17.4x	24.6x	6.2x	5.4x	19.0x	5.2x
Mean	$92,108.98	$119,681	26.2x	18.3x	68.6x	26.1x	6.1x	4.6x	31.1x	6.5x
Median	$102,030.17	$122,663	23.6x	19.7x	35.3x	26.3x	6.2x	4.6x	35.8x	5.2x

Source(s): S&P Capital IQ

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