



**QUO VADIS**  
CAPITAL

Proprietary Structural Analysis & Forecasting

# ValueX Vail 2019: Off-Radar \$16B High ROIC Compounder Trading at a Discount



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## Presenter Bio – John Zolidis

- **Founded Quo Vadis Capital, a research boutique with an outsourced analyst model and Registered Investment Advisor (RIA) in 2017**
- **Analyst following U.S. consumer sector since 1999**
- **Named to Wall Street Journal's Best on the Street list in 2005**
- **Frequently cited in the financial media**
- **Education at Kenyon College & Oxford University (Mansfield College)**
- **Presented at value investment conferences in Vail, Klosters and Cyprus**
- **Based mostly in Paris, France**

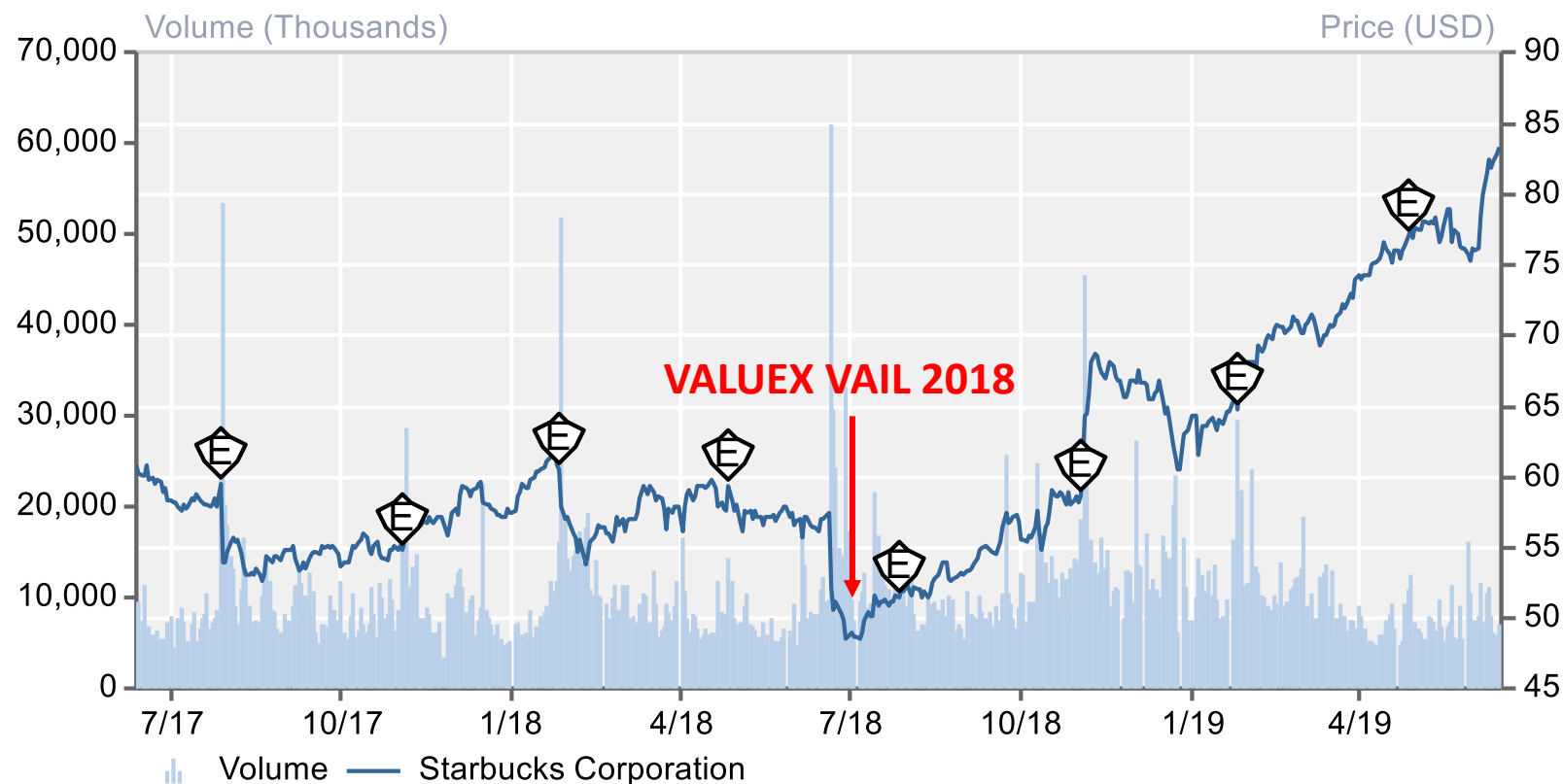
## Quo Vadis Capital, Inc. : Our Process

- Focus on Consumer sector, specialize in companies which can be analyzed by estimating and segmenting **unit economics**
- Solve for ROIC and **Return on Incremental Invested Capital (ROIIC)** at the unit and corporate level
- In LONGS we look for companies with a high ROIC and/or a rising trend in ROIC, rising margins, or accelerating growth
- OUR FAVORITE INVESTMENT THEME is finding a companies **where the next dollar to be invested in the business is generating a higher return than the base business**. In other words, return on incremental investment is greater than return on overall investment ( $ROIIC > ROIC$ )

# Last Year's Idea: LONG Starbucks (SBUX)

➤ Up > 75% including dividends...

## Starbucks Corporation (SBUX-US)



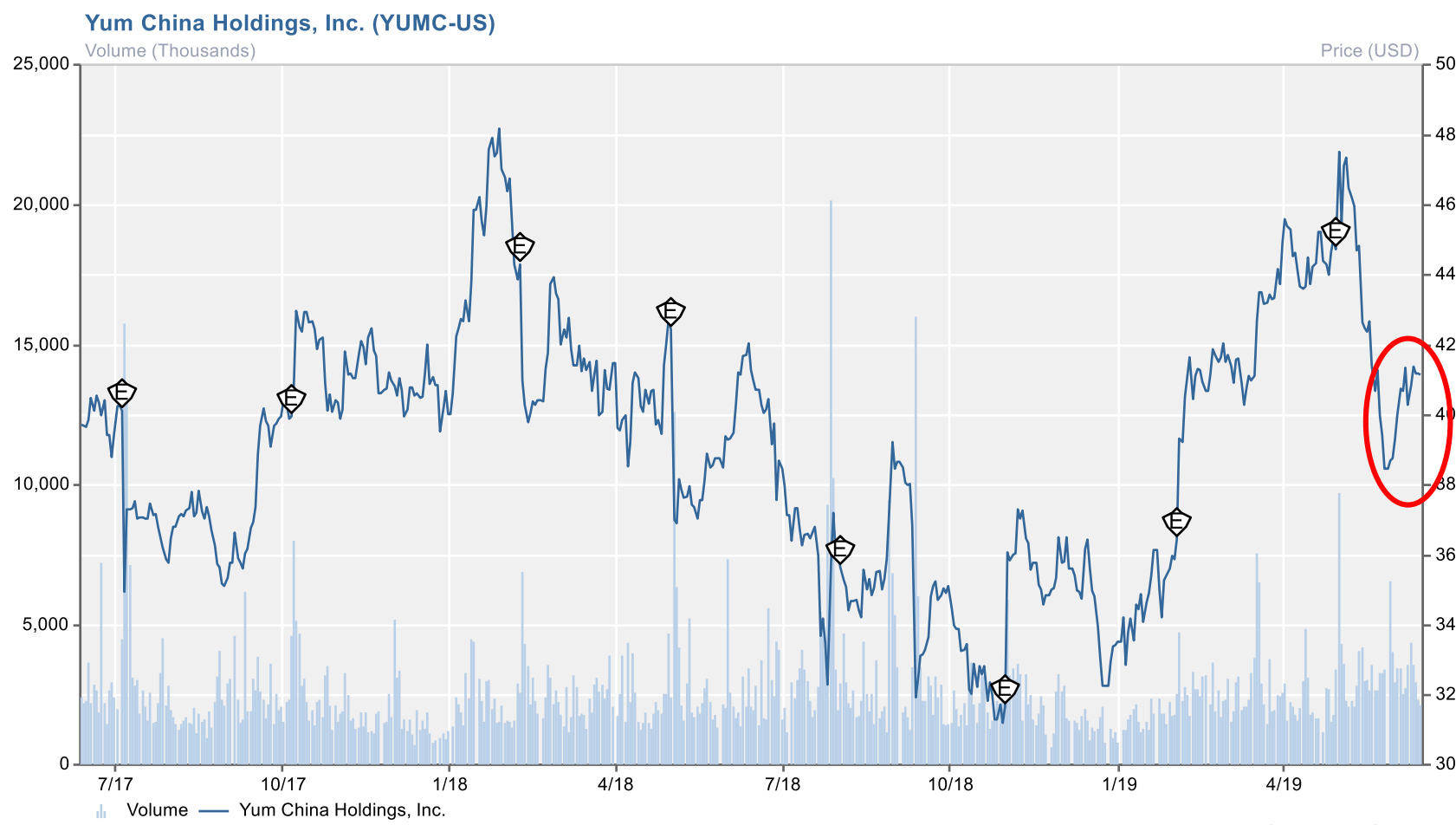
Source: FactSet Prices

## Last Year's Idea: LONG Starbucks (SBUX)

- Our call last year: BUY for growth in higher ROIC Chinese market, and boost to ROIC from amplified return of capital to shareholders
- What happened/ why did it work?
  - Same-store sales in China and the U.S. improved
  - The company repurchased ~\$13 B worth of stock
  - Favorable market for large cap high quality growth companies
- We continue to like SBUX long

# This Year's Idea: LONG YUM China (YUMC)

## Two Year Chart: Shares at similar levels to two years ago



Source: FactSet Prices

## What is Yum China Holdings, Inc. (YUMC)?

Created in a Nov 2016 spin-off of Yum Brands' Chinese operations for Kentucky Friend Chicken (KFC) and Pizza Hut

- YUMC is **largest restaurant operator in China** with over 8,600 locations.
- Trades on the U.S. exchange. Reports in USD and uses US GAAP.
- EBITDA margin: 15% most recent fiscal year
- FY19E Capex ~\$475M (5.2% of sales)
- **Balance Sheet: \$1.5B cash, No debt** aside from operating leases, \$3B Shareholders' equity
- FY18 Free cash flow was \$863M (\$2.18 share);
- Dividend \$0.48 (1.2% yield)
- Recent price \$41.00 on the U.S. exchange, current market cap: \$16B



## Why might YUMC be Interesting?

- Company's unusual listing means coverage is unusually thin. 100% Chinese company that only trades on the U.S. exchange.
- Hong Kong based analysts are sleeping when the stock is trading. U.S. based analysts are on the other side of the planet from operations.
- Several reporting eccentricities make analysis challenging
- The business is complex and thus takes extra work to analyze
- Has not been public for a long time
- U.S. based investors are afraid of China with trade tensions not helping
- African swine fever likely means unusual inflation in proteins coming

***Net, a combination of current worries and a company with limited coverage set up the current entry point***

## Investment Thesis to Prove

*YUMC is a high margin, high ROIC business with the opportunity to deploy significant capital over multiple years at incrementally higher rates of return all while generating material excess cash flows.*

*From a valuation standpoint, shares trade at a discount to mature businesses in the same industry in the U.S. that operate with much less attractive environments. Further, we forecast that existing cash balance and free cash flows over the next five years could equal 40%+ of the current market value. There is also an opportunity for YUMC to use leverage to augment EPS growth and financial returns for shareholders.*

*We expect rising EBIT, ROIC and FCF to drive multiple expansion for YUMC as the story becomes better appreciated.*

## How we propose to analyze YUMC (our process)

- Step 1: Review segment contribution to revs & profit, unit level ROIC and capital deployment
- Step 2: Quantify excess free cash flows available to be returned to shareholders over next five years
- Step 3: Review valuation and make arguments for valuation expansion and value creation

***We will show that YUMC has superior returns, rising ROIC trends, a much larger TAM, huge CF generation and reinvestment opportunity and is cheap vs. comparable companies.***

# Step 1: Review of Segment Contribution, Unit ROIC and Capital Deployment



## Profit Contribution by Segment: **KFC is 65% of Revs & 73% of EBIT**

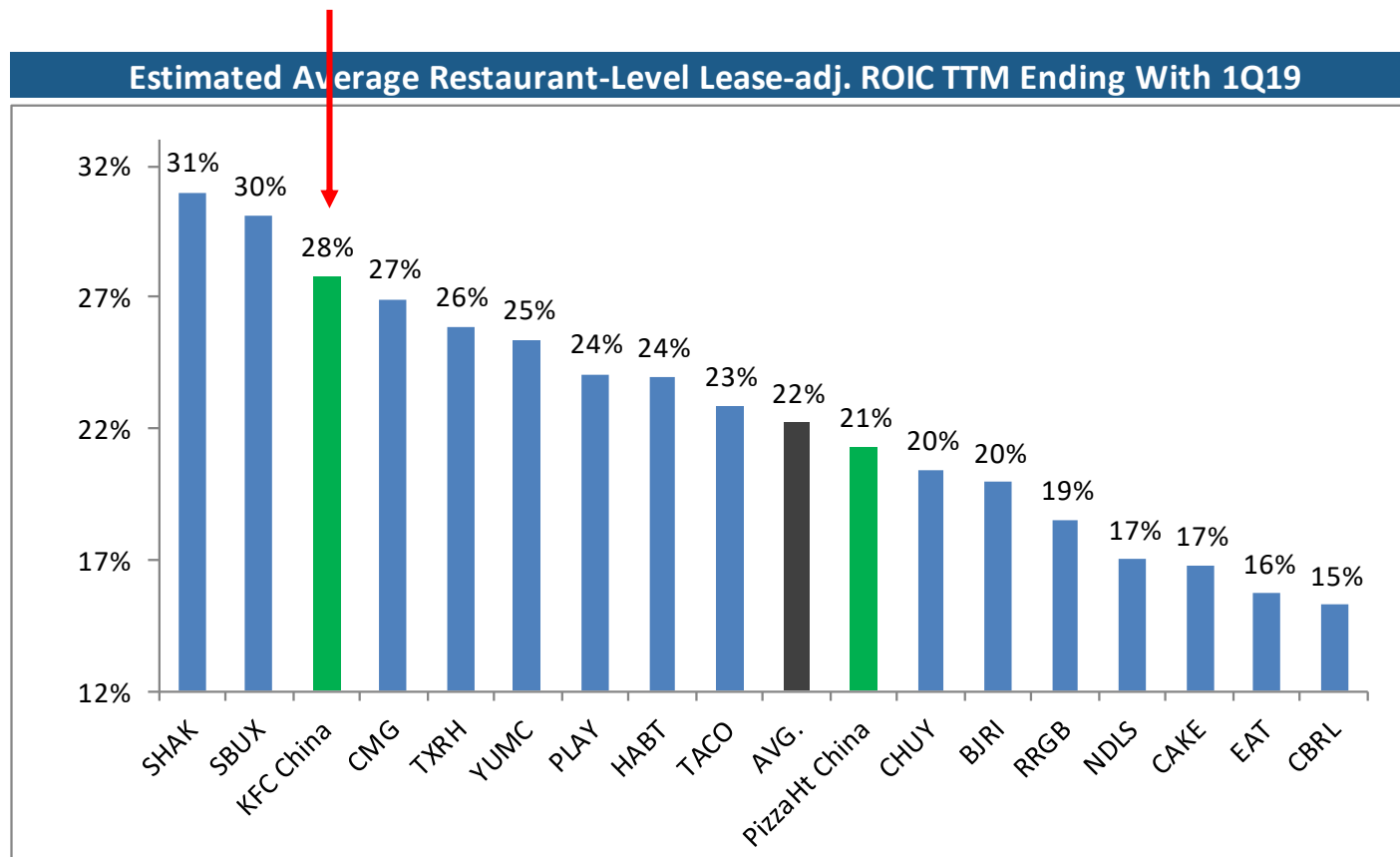
FY18 #s	company operated				Total
	KFC	Pizza Hut	Franchised	Other	
<b># of units</b>	<b>4,597</b>	<b>2,166</b>	<b>1,651</b>	<b>47</b>	<b>8,461</b>
<b>Revenues (USD)</b>	<b>\$ 5,503</b>	<b>\$ 2,106</b>	<b>\$ 790</b>	<b>\$ 16</b>	<b>\$ 8,415</b>
<b>Contribution to EBIT</b>	<b>\$ 619</b>	<b>\$ 75</b>	<b>\$ 158</b>	<b>3</b>	<b>\$ 855</b>
<b>Contribution to EPS</b>	<b>\$ 1.14</b>	<b>\$ 0.14</b>	<b>\$ 0.29</b>	<b>nm</b>	<b>\$ 1.57</b>
<b>In %</b>					
<b># of units</b>	<b>54%</b>	<b>26%</b>	<b>20%</b>	<b>1%</b>	<b>100%</b>
<b>Revenues (USD)</b>	<b>65%</b>	<b>25%</b>	<b>9%</b>		<b>100%</b>
<b>Contribution to EBIT</b>	<b>72%</b>	<b>9%</b>	<b>18%</b>		<b>100%</b>
<b>Contribution to EPS</b>	<b>73%</b>	<b>9%</b>	<b>19%</b>		<b>100%</b>

## Unit Level Review: Co-Operated **KFCs Produce Highest per Unit Profit Dollars and Greatest ROIC**

FY18 #s	Company operated			Other	Average
	KFC	Pizza Hut	Franchised		
<b>AVERAGE UNITS</b>	4355	2224	1718		
<b>Revs per unit \$M USD</b>	\$ 1.26	\$ 0.95	\$ 0.46		
<b>Unit-Level CF per Unit</b>	\$ 0.29	\$ 0.17	\$ 0.09		\$ 0.22
<b>Unit-level After-Tax Net Inc.</b>	\$ 0.10	\$ 0.02	\$ 0.07		\$ 0.08
<b>CAPITAL PER UNIT \$M USD</b>	\$ 0.54	\$ 0.57	\$ 0.10		\$ 0.46
<b>4-WALL CASH ROIC</b>	53%	30%	94% / ∞		47%
<b>4-WALL AFTER TAX ROIC</b>	39%	22%	68%		35%

source: Company reports, Quo Vadis Capital, Inc. estimates

# ROIC Compare: KFC China Unit ROIC Ranks Near Best Concepts



Source: Company Reports & Quo Vadis Capital, Inc. estimates; PLAY and CBRL use Jan YE

## **Going Forward We Expect Substantially All of the Company's Capital Deployment for New Units to Favor the Higher Margin & ROIC KFC Format**

Accordingly, new capital deployed should generate a higher return than capital in the base business (ROIIC > ROIC)



## We expect YUMC to invest \$500M+ Per Year Over the Next Five Years With Most Allocated to New Higher-ROIC KFCs

This Level of Investment is Justified by the size of the Chinese market, Chinese economic growth, and compares favorably to the domestic U.S. market which is smaller and saturated with existing restaurant concepts

Put Differently, **YUMC's ability to deploy capital at scale to high ROIC projects vastly exceeds that of domestic U.S. restaurant operators** (SBUX is an exception)

## Step 2: Quantify Excess Capital Available for Return to Shareholders

新品 NEW!



**Despite \$500M+ of Capex Per year to fund ~650 New Units (8% unit CAGR) we also anticipate significant FCF generation**

In FY18 YUMC spent \$470M opening ~550 restaurants and still produced \$863M (\$2.18/ share) in FCF, ending the year with a cash balance of \$1.47B

**We forecast cumulative FCF generation of \$5B over the next five years. Together with existing cash (of \$1.5B) this equals ~42% of the current market cap.**




The company recently initiated a small dividend (which we expect to grow) and started buying back stock. We expect capital return to become a bigger part of the story going forward.

Note also that many restaurant companies use financial leverage to fund incremental share buyback

## Step 3: Valuation: We Argue Shares are Undervalued



# Argument #1: Over 5 Years Margins and ROIC Should expand as KFC becomes a larger % of the business, justifying multiple expansion

	FY18A		FY23E	
	KFC	Total	KFC	Total
# of units	4,597	8,461	7,362	12,361
Revenues \$M USD	\$ 5,503	\$ 8,415	\$ 9,885	\$ 13,692
Contribution to EBIT	\$ 619	\$ 855	\$ 1,243	\$ 1,585
Contribution to Net Inc	\$ 452	\$ 622	\$ 908	\$ 1,155
<b>In %</b>				
# of units	54%		60%	
Revenues \$M USD	65%		72%	
Contribution to EBIT	72%		78%	

Source: Quo Vadis Capital, Inc. estimates; Note YUMC has not provided LT targets

## **Argument #2: Cash on the BS + FCF Generation Over Next 5 Years = 42% of Market Cap and EBITDA Could Compound at 11% CAGR reaching \$2B+**

Assuming EV/ EBITDA multiple holds constant at 10.6x, and \$6.5B in excess cash YUMC would be worth \$74 per share, representing an 80% return vs. today's \$41 price

\*assumes annual share repurchase of \$350-400M and dividend payments of \$170-\$180M

# Argument #3: YUMC trades at similar EV/ EBITDA multiples to CBRL, NDLS, TXRH & RRGB but should get a premium based on superior growth rate and long-term ability to deploy capital with superior market characteristics

Quo Vadis Capital, Inc. Restaurant Universe  
Relative Growth, Profitability, Balance Sheet & Valuation Metrics (Consensus Forecasts)

6/13/2019

	AVG.	BJRI	CAKE	CBRL	CHUY	CMG	EAT	HABT	NDLS	PLAY	RRGB	SBUX	SHAK	TACO	TXRH	YUMC
Recent Price		\$41.38	\$45.47	\$166.6	\$20.28	\$730.1	\$40.00	\$10.47	\$7.25	\$40.10	\$33.34	\$83.20	\$67.82	\$11.20	\$54.05	\$41.10
Mkt Cap (\$B)		\$0.9	\$2.0	\$4.0	\$0.3	\$20.5	\$1.5	\$0.3	\$0.3	\$1.6	\$0.4	\$104.1	\$2.5	\$0.4	\$3.9	\$15.9
ENT VALUE (\$B)		\$1.0	\$2.0	\$4.2	\$0.3	\$20.3	\$2.7	\$0.3	\$0.4	\$1.9	\$1.1	\$111.1	\$2.4	\$0.6	\$3.6	\$14.4
<b>Valuation Metrics</b>																
Vs. 2018A EPS (P/E)	25.7x	17.6	18.7	18.0	23.0	80.6	11.4	NM	NM	13.7	19.3	34.4	95.5	20.0	24.6	26.9
Vs. 2019E EPS (P/E)	23.6x	18.2	17.1	18.5	22.1	56.0	10.2	NM	48.5	13.0	28.8	29.9	118.6	22.4	23.6	23.8
Vs. 2020E EPS (P/E)	21.4x	16.2	16.0	17.8	20.9	43.6	9.9	NM	32.4	11.5	31.0	27.0	95.5	19.8	21.5	21.4
EV / 2019 Sales	1.6x	0.8	0.8	1.4	0.8	3.8	0.8	0.6	0.8	1.4	0.8	4.2	4.2	1.1	1.3	1.6
EV / 2018A EBITDA	11.9x	7.4	8.8	11.0	9.1	37.5	6.9	7.7	10.9	7.0	9.0	19.8	38.7	7.8	12.6	10.8
EV / 2019E EBITDA	11.1x	7.4	9.1	10.8	8.7	29.2	6.7	7.3	9.9	6.6	10.1	19.0	34.6	8.8	11.6	10.6
EV / 2020E EBITDA	10.2x	7.0	8.6	10.5	8.2	23.7	7.3	6.8	8.1	6.0	10.2	17.2	26.9	8.6	10.9	9.7
Free Cash Flow Yield ('19)	3.5%	3.8%	4.4%	0.5%	0.0%	1.7%	11.3%	-1.6%	8.6%	2.3%	13.6%	3.9%	0.1%	-0.6%	0.9%	4.2%
Dividend Yield	1.0%	0.9%	2.8%	3.3%	0.0%	0.0%	3.1%	0.0%	0.0%	0.0%	0.0%	1.6%	0.0%	0.0%	1.8%	1.3%

Source: FactSet

Note: EPS and EBITDA Estimates for CBRL are based on July YE, SBUX based on Sep. YE, EAT based on June YE; SHAK excluded from valuation averages



## Investment Recap:

- **Largest restaurant company** in China
- **Underfollowed** due to unusual US-only listing for Chinese company
- Highly profitable, 15% EBITDA margins, 21% ROIC, no debt, strong FCF
- **Shifting growth to higher ROIC KCF. ROIC > the business' base ROIC**
- Expect AUVs, margins, ROIC to rise and LDD EBITDA CAGR over next 5 years
- Massive opportunity for growth given size of Chinese market (LT target is 20K stores vs. 8K today)
- **Trades at similar multiple to mature U.S. resto cos** in challenged market
- Estimate cash on the BS + next 5 years FCF = 40%+ of current market cap
- Holding multiple steady = potential 80% return over five years but believe multiple will expand

## Risks & Other Considerations:

- The company is in China and is exposed to risks associated with China
- The business is complex with multiple segments
- The company provides limited guidance
- It is very challenging to model this company, in our opinion
- Our investment thesis is based on five year forecasts which are inherently less certain
- FX is a risk for US based investors
- African Swine Fever is causing inflation in proteins

# Disclosures

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