**The Henry Fund**
Henry B. Tippie College of Business
John Moore [john-r-moore@uiowa.edu]

# Quick-Service Restaurants

**February 15, 2021**

**Consumer Discretionary**

**Industry Rating** **OVERWEIGHT**

## Investment Thesis

We recommend an overweight rating for the quick-service restaurant industry over the next year. The COVID-19 pandemic had substantial impacts on many sectors. Even during times of economic uncertainty, quick-service restaurants like McDonalds, were able to drive revenue through third-party delivery services, drive-thru options, and off-premise sales. Revenue in the U.S. is forecasted to grow by 17% in 2021 and return to pre-pandemic levels[2]. We believe that increases in economic activity and high travel estimates for 2021, position the industry to experience substantial revenue growth in 2021.

**Drivers of Thesis**

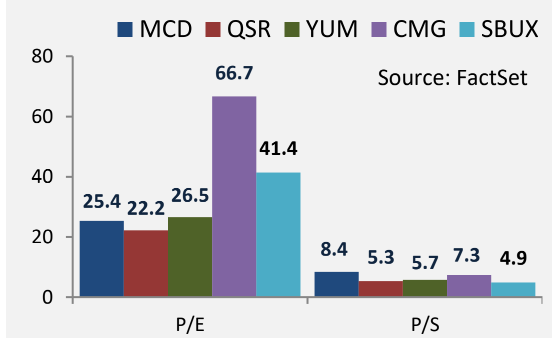
- Quick-service restaurant operators were able to enhance the customer experience even during the pandemic and the uncertain economic conditions. We believe that despite negative growth in 2020, the industry will make a strong recovery and grow by 17% in 2021 and grow by an annualized 5.9% over the next five years.
- International demand and globalization opportunities provide large-scale operators the ability to expand their footprint into new markets, like Asia and South America, through their robust franchise business model. This expansion will help drive industry revenue by generating a stronger customer base.
- Digital advancements in the industry prove to be effective revenue drivers for industry operators and simplify the restaurant-to-consumer delivery process. This has helped operators enhance the experience for customers and increase their average check size.

**Risks to Thesis**

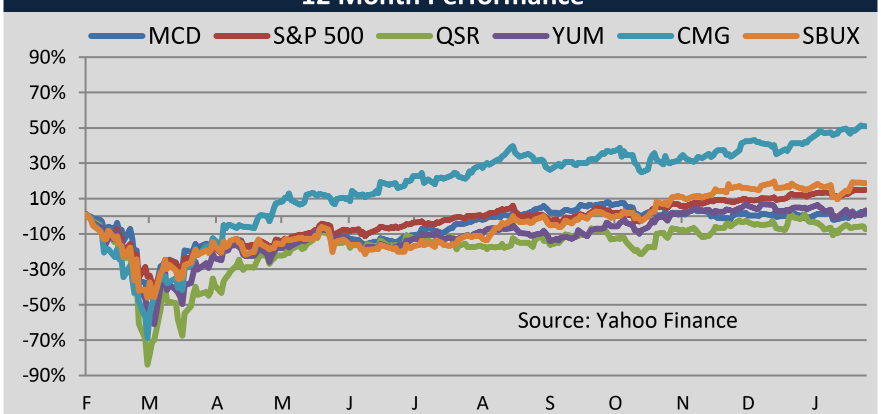
- As the economy continues to reopen, consumer spending may potentially be allocated towards full-service dining restaurants, which threaten quick-service restaurant operators, based on a more diverse menu offering.
- Technological advances within restaurants present security and data breaches that could negatively impact brand perception, user privacy, and lead to a poor customer experience.

## Key Industry Statistics

| Key Industry Statistics | Source: FactSet |
|---|---|
| **Market Cap** | **($B)** |
| MCD | $159.4 |
| QSR | $35.0 |
| YUM | $31.8 |
| CMG | $43.0 |
| SBUX | $139.3 |
| **P/E NTM** | |
| MCD | 26.6 |
| QSR | 23.2 |
| YUM | 26.2 |
| CMG | 65.5 |
| SBUX | 37.9 |
| **P/S NTM** | |
| MCD | 7.8 |
| QSR | 3.6 |
| YUM | 5.6 |
| CMG | 6.0 |
| SBUX | 4.8 |
| **EPS 2020** | |
| MCD | $6.31 |
| QSR | $2.64 |
| YUM | $2.94 |
| CMG | $12.52 |
| SBUX | $0.79 |




## 12 Month Performance




## Industry Description

The quick-services market operates by delivering convenient food products in a timely-manner to consumers by on-premises, take-out, or food delivery options. Operators also sell beverages such as coffee, water, soda, but not alcohol. Overall, the quick service food industry enables customer's convenient, quick, and healthy food options while away from home at an affordable rate.

## EXECUTIVE SUMMARY

The quick-service restaurant industry provides a positive investment outlook based on its resilient presence during the COVID-19 pandemic, historical revenue growth, and convenient options to consumers. As the economy continues to recover and people return to "normal" we believe this industry will prove favorable to consumers and investors over the next five years. We recommend an **OVERWEIGHT** position for this industry.

As consumer trends, digital advances, and health initiatives grow more common in the industry, we believe large operators like McDonald's who have the largest global presence, will be successful in the everchanging industry. McDonald's current industry position creates significant advantages for them to extend current and new product lines, serve a superior breakfast menu, and further expand the brand into international markets.

## INDUSTRY DESCRIPTION

Quick-service restaurants differentiate themselves from full-dining restaurants, by offering lower price options, drive-thru ordering, limited menu items, and do not offer a form of table ordering. These operators focus on convenience and quick delivery to their customers. Most consumers in this industry have limited-time, money, and want a quick premium experience when dining away from the home[2]. Many players operate in this industry at a local and global level.

Below are the main quick-service restaurant competitors that we analyzed, and their number of restaurants operated and the percentage of these restaurants that are company-operated and franchised.

| TCKR | Company-Operated | Franchised | Total |
|---|---|---|---|
| MCD | 7% | 93% | 39,198 |
| QSR | 1% | 99% | 27,025 |
| YUM | 2% | 98% | 50,353 |
| CMG | 100% | 0% | 2,768 |
| SBUX | 51% | 49% | 32,660 |
| DPZ | 2% | 98% | 17,644 |
| WEN | 5% | 95% | 6,828 |

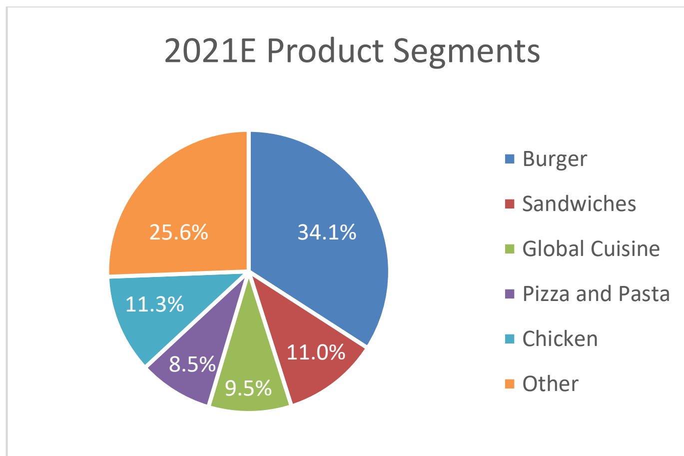
Source: FactSet

The ownership structure in this industry is split between corporate-operated stores and franchised stores. However, franchising heavily depends on financial resources available, entrepreneurial experience, and the legal environment[1].

The factors that will dictate success for a restaurant in the future include the ability to franchise operations, having a clear market position, an innovative menu, and provide a strong convenience to customers through drive-thru and digital ordering. Investors should consider quick-service restaurants with these qualities to excel in the future to capture industry revenue.

## Product Segments

The quick-service restaurant industry is segmented by type of food they serve. Based on changing consumer demands, many restaurants serve a variety of options like burgers, chicken sandwiches or other fusion cuisines.

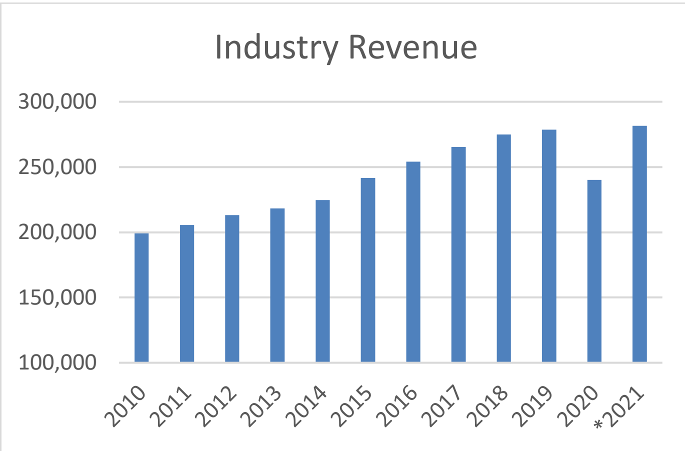



Source: IBIS World

The chart above displays industry products and the expected share of industry revenue each product will account for in 2021. Fragmented consumer segments have caused large chains like McDonald's and Burger King to increase their menu items in other areas, serving healthier and customizable options[2]. We believe healthier options like chicken and fresher food options will continue to increase their share of the industry's revenue over the next five years.

## Industry Revenue Growth

In 2020, revenue in the U.S. declined by 13.8%. Industry revenue for the year was $240.1B[2]. Prior to 2020, the U.S. industry grew by 3.6% on average from 2016-2019. The chart below shows revenue growth from 2010 to 2020 in the United States.




Source: IBIS World

The pandemic drastically affected the industry's revenue in 2020 in the U.S. and internationally. However, we expect a strong recovery in this industry, and will see pre-pandemic growth levels over the next five years. We forecast that industry revenue in the United States will increase by an annualized rate of 5.9% to $320.4B[2]. Internationally, we expect mass market development from industry operators and global revenues to account for $953.9B (2.1% annualized growth) from 2021-2025[2].

## Company-Operated Stores

Quick-service operators drive revenue from company-owned stores and franchised or licensed business models. Company-operated stores provide significant benefits to supporting franchise models. Through company-owned restaurants, quick-service operators can improve operations and employee training. With a combination model of both franchising and operating owned restaurants, companies can experiment with new products, marketing tactics, and pricing strategies to strengthen the company-wide brand[1].

Company revenues are made up of sales from operations and fees from franchised restaurants. Fees are generally determined by business and operating expenses, and the amount of the company investment[2]. Over the next five years, we believe that operators will decline their number of company-operated restaurants and focus on increasing their franchised operations.

## Franchise Stores

Franchised stores provide quick-service restaurants an easier way to expand and increase their global presence. Industry operators choose to expand by franchising over company-operated stores because of the low capital requirements and risk associated with this type of growth. However, franchise revenue is lower, as it is not included in corporate revenue because companies do not collect revenue from the physical restaurant. While franchised operators only account for a small proportion of total industry establishments, these businesses account for a substantial share of the industry's total revenue[2]. The franchise business model enables large-scale restaurants to expand rapidly and profitably, even when the broader economy is not doing well[2]. Over the next five years, we believe franchise restaurants will increase by 3.5% adding roughly over 330,000 establishments to the industry[2]. Recently, operators have experienced relatively flat restaurant sales growth. This has caused industry operators to focus on selling company-operated stores and shift to franchising.

Franchise agreements typically last 20 years and these strategies drive revenue from fees, rent, and royalties. Royalty revenue is typically based on a percentage of total sales. While the initial fee cost in general is $50,000, and requires an initial investment of roughly $1 million, but these amounts differ across chains. For example, Burger King has a $50,000 fee, with a total investment of $315,000 to $2 million. While McDonald's initial fee is $45,000 and requires an initial investment of half a million dollars. Franchisees can lease buildings, equipment, and training from the franchisor, minimizing initial capital costs[2]. This allows the franchisor to lower operational costs, as many of the expenses and risks are shifted to the franchisee.

## Licensed Operations

Some operators like Starbucks provide licensing agreements, which is similar to franchise agreements. However, licensees are responsible for managing, operating, and providing capital investments. Some companies receive initial fees upon the opening of a new restaurant and receive a royalty based on a percentage of sales. Starbucks operates using a license business model. They collect fees and a royalty on retail sales and receive a margin on branded supplies, and equipment such as espresso machines and coffee brewers. Ingredients, and coffee and tea products are also sold to the licensee for resale to the customer[20].

## RECENT DEVELOPMENTS

### COVID-19 Impact

The pandemic and shelter-in-place orders caused many operators to temporarily close their in-service dining. This forced many operators to close permanently. Several operators took actions to conserve their cash flow liquidity and limited capital expenditures. Many recurring consumers opted to stay-in, and cook at home rather than eat out, this caused a 13.8% decline in 2020 for industry revenue in the United States. During the pandemic, 55% of individuals were eating more at home compared to eating out[38]. This specifically was due to many people not wanting to be exposed to the virus and were cautious about their disposable income spending. In addition, post consumption eating habits may be a little different post-pandemic. 47% of consumers claim to eat out for breakfast less often, while 29% claim to eat out for dinner less post-COVID[38]. Despite these impacts, we believe that many traditional consumers will resume their consistent purchase habits at quick-service restaurants.

### Consumption Demographics

Consumption patterns differ where income plays a large determinant in demand. Quick-service consumers are typically more budget conscious and take advantage of the convenience aspect[2]. In addition, restaurant traffic increases when consumers' family income increases. A study done by the CDC found that 45% of fast-food consumers are between the ages of 20-39, the oldest population (age 60+) accounted for only 24 percent of consumption. A little more than a third of the population measured (37%), was contributed by consumers aged 40-59 years[21].

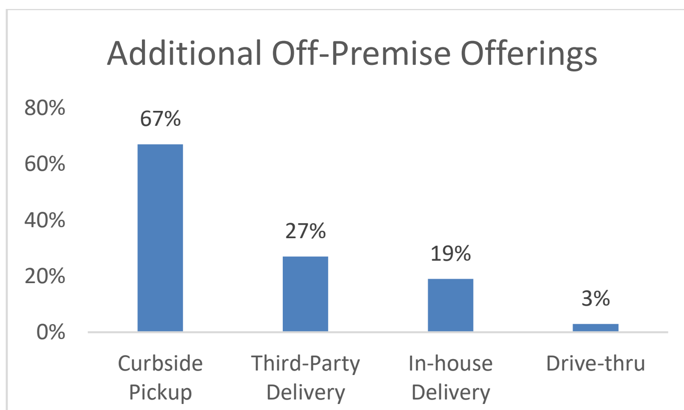
We believe that these percent allocations will remain steady over the next five years. The age ranges above signify why operators must provide a diverse menu that can serve teens and parents with children at affordable prices. This provides a competitive advantage, particularly favoring McDonald's or Burger King, who foster favorable options to these types of consumers.

### Cloud Kitchens

The cloud kitchen trend has skyrocketed since the beginning of the pandemic. These operations provide the kitchen piece of a restaurant but are operated based on delivery and off-premise dining. With setup costs around $100,000, and limited staff, these operations provide significant cost savings. We believe that the cloud kitchen service will grow at a 12% CAGR and reach an estimated $71.4B by 2027[22]. On-demand food delivery is heavily increasing in the quick-service restaurant industry. Cloud kitchens now supply a service to third party delivery apps like GrubHub and DoorDash[23]. Cloud kitchens normally operate as their own local restaurant, but some big brand quick-service restaurants such as Chipotle, Chick-fil-A, and Wendy's have adopted the business model. Cloud kitchens provide operators a potential upside through lower costs. However, we do not believe the cloud kitchen setting will threaten major industry players.

### Off-Premise Sales

The coronavirus outbreak caused a surge of consumers ordering off-premise, through takeout and delivery. Roughly 90% of quick-service operators adjusted accordingly to the pandemic, compared to the 56% in the traditional restaurant segment[15]. The most common options for off-premise dining have been curbside takeout or third-party delivery.




Source: Net Advantage – Restaurants

Consumers responded favorably to these new options by increasing their off-premise appetites. Pre-pandemic, less than 60% of adults ordered takeout or delivery from restaurants. In contrast, during lockdowns, 65% of adults were ordering out for dinner and 45% for lunch[5]. Both increased from their pre-pandemic levels. Off-premise dining represents a major convenience to consumers. Based on the efficiency of off-premise dining, many people who are short on time will take advantage of these options. We believe that these dining preferences will continue post-pandemic based on their convenience to customers.

## Loyalty Programs

Digital advances will be a key industry driver to increase revenue and retain customers. Restaurants can customize and enhance their interactions with clients through customer loyalty programs. They collect this data through point-of-sale orders, and mobile and online ordering. On top of discounts and promotions, integrating this data allows restaurants to create personalized rewards based on ordering habits. For example, a restaurant can offer a free dessert on a customer's birthday[25].

Currently Starbucks, Panera Bread, and Chipotle operate successful rewards programs. Chipotle launched their program in 2019 and currently host 15 million members[24]. Starbucks rewards program proved to be incredibly favorable to the organization during the pandemic. In 2020, their membership to their rewards program climbed to approximately 21.5 million users. In the third quarter of 2020, they gained over 2.5 million users, a 15% increase from the prior year's same quarter[26]. Recently, McDonald's and Burger King have announced their new reward programs to retain customer loyalty and capitalize on the transition to digital. McDonald's currently has loyalty programs in other countries but is testing this new program in a few select states and plans to launch the program nationwide next year[27].

Chipotle and Starbucks are clear industry leaders who promote a strong loyalty program. This proved favorable during the pandemic through their substantial user growth. This corroborates the beneficial and premium experience these programs can have for their customers. This substantiates why quick-service operators need to be increasing their tech-focused approach to serving customers. Personalizing a customer's experience provides a premium feeling that allows the customer to return to the restaurant and creates the ability for the restaurant to retain that customer.

# INDUSTRY TRENDS

## Digital Ordering

The pandemic changed the dynamic of digital, creating a substantial leap in industry technology. We estimate that by 2025, more than half of quick-service restaurant sales will be digital transactions. Research by Deloitte states that 70% of consumers say they prefer to order digitally for delivery and 60% of consumers say they to prefer order fast-food digitally[8]. Mobile apps, self-order kiosks, and digital ordering simplify payment, ordering, and pick-up. Consumers have quick access to their favorite menu items and help restaurants increase their average check size by encouraging users to add more items based on promotional offerings.

However, a primary risk to the shift in technology is security and data breaches on platforms. An increase in external hacking, emphasizes that restaurants must provide a protected platform to maintain brand perception, loyalty, and continue to enhance the customer experience.

We believe technology use among consumers is expected to increase over the forecasted period. Only 9% of consumers ordered by phone or online in the first quarter of 2020. That number soared by 33%, and mobile orders increased alone by 286% by the end of the second quarter in 2020[9]. We believe that key operators like McDonald's must continue to transition their services to digital platforms. They are behind the curve in this area compared to Chipotle and Starbucks, who already operate strong platforms for their customers.

## Drive-thru Demand

The COVID-19 pandemic heavily shifted customer preferences to convenient and easy-pick-up options. This increased drive-thru traffic by 26% in April, May, and June. Each year on average, 50 million Americans eat fast food every day, generating over $500 billion in global revenue. The average American will spend $1,200 on drive-thru food each year[6]. As many restaurants shut down from the pandemic, drive-thru restaurants were a significant distributor and contributor for industry operators. Total average drive-thru times slowed by 29.8 seconds because of the increase in drive-thru demand[7]. Below is a table listing the drive-thru order accuracy and wait times for industry competitors.

| TCKR | Accuracy | Time (Sec.) |
|---|---|---|
| MCD | 85% | 284 |
| QSR | 90% | 235 |
| YUM | 75% | 242 |
| CMG | - | 60 |
| SBUX | 89% | 266 |
| DPZ | - | - |
| WEN | 87% | 230 |

Source: Statista

Clearly, Chipotle has the shortest time, as they link their drive-thru to their mobile app ordering. However, this option is not available at all restaurant locations. McDonald's has the longest wait time and is second to last in order accuracy. Wait time and delivering the correct order are key advantages to quick-service restaurants. The target consumer is focused on convenience and time management. Therefore, tech-focused additions such as mobile orders and digital menu boards will shorten the order process and will lower the margin of error between orders.

## Third-Party Delivery

The pandemic skyrocketed third-party delivery demand. Takeout and delivery only offerings created a reliance on third-party delivery services. Big players like DoorDash, UberEats, and GrubHub provide substantial convenience for consumers. More restaurants will continue to use third-party delivery services which will increase off-premise sales[15]. During the pandemic, 84% of operators were able to reach new and existing consumers using these third-party delivery services[10]. We believe third-party delivery options will continue to be utilized by industry operators moving forward. This provides operators like McDonald's or Chipotle the ability to access new customers based on these delivery options.

## Fast Casual Restaurants

Fast casual operators like Chipotle Mexican Grill and Panera Bread, promise their consumers high-quality, customizable, and convenient food options at a lower price than full-service restaurants. Consumers of fast casual restaurants age from 20-45 years old. The average ticket size of fast casual restaurants is between $8-$12[31]. Traditional fast-food operators like McDonald's, KFC, Taco Bell, have seen disruption in their systemwide sales as more consumers opt for the healthier, fast casual options. During the pandemic, Chipotle was able to successfully operate through digital orders and online delivery. Chipotle's digital sales grew over 216% year-over-year in the Q2 2020[29]. Now, Chipotle is expanding their drive-thru and digital operations[30].

Fast casual operators pose a threat to traditional quick-service restaurants, specifically, because of their healthy menu items. This signifies why operators must continue to adjust their menus to current consumer preferences to remain competitive and attractive.

## Healthy and New Menu Items

The COVID-19 pandemic resurrected the significance of healthy eating habits and food choices, especially for individuals with underlying health conditions. According to the CDC, 1 in 3 people eat fast food on a given day[32]. Many consumers are continuing to grow more health conscious regarding fat and salt content, and fried food products[2]. This favors fast casual restaurants like Panera Bread and Chipotle. According to Statista, 64% of consumers believe that fast casual options are healthier options for quick service restaurants[33]. Many operators have a strong foundational menu. Therefore, health initiatives signify that operators must adapt their menu offerings to account for these consumer demands. Having a wider selection of healthy choices will be key moving forward.

### <u>Chicken</u>

Recent attractiveness towards chicken has created additional menu offerings from operators. McDonald's and multiple fast-food services have added fried chicken sandwiches. This has driven multiple fast-food restaurants to begin frying chicken for what they believe is the future of fast food. In the past year, 21% of consumers have increased their taste for chicken. In general, chicken menu options are more profitable than traditional beef offerings. Chicken commodity prices are cheaper than beef and are offered at a lower menu price[14]. This consumer demand shift will force operators to compete for the most satisfying offering.

### <u>Plant Based Options</u>

Replicating traditional vegetarian burgers may not be attractive to vegans, vegetarians, or even meat lovers. As meat-conscious consumers increase their presence in fast food, operators will need to focus on appealing options that will drive new revenue streams. McDonald's has recently announced a new meatless burger option. The

McPlant, is a new product that will contribute new channels of revenue and attract meat, vegan, and vegetarian consumers[13]. Based on these new trends, we believe that quick-service operators will need to make a strategic investment into plant-based fast-food products to remain competitive.

We believe that nutritional value will increase over the next 5 years. Large industry players like Chipotle or Panera Bread will appear favorable to consumers. Operators like McDonalds will have to slowly transition some items to account for these trends but should be able to do so based on their diverse menu offerings. Companies that will struggle with these health initiatives will be specialty operators, like Domino's and Pizza Hut.

## MARKETS AND COMPETITION

### Threat of New Entrants

The barriers of entry in this industry are low as new entrants can establish operations with low capital requirements and little to no customer base[2]. The top players in this industry account for less than 10% of the U.S. market share. We believe competition will remain high as the market in the U.S. is relatively saturated. Franchise strategies from key industry players will ease the ability to expand brand name[2]. Globally, many quick-service restaurants are owner-operators and serve a smaller local market and can succeed without being undercut by multinational companies. In addition, as consumer preferences change, product differentiation and offerings have contributed significant success to the industry. Even though barriers of entry are low, growth in this industry presents a challenge to smaller operators with low capital and smaller customer bases. Which raises the barrier for smaller operators to attempt to franchise restaurants. Therefore, players like McDonald's operate on brand name, competitive low pricing, and large global footprint. This enables them to purchase prime real estate locations at any expense unlike smaller operators[2].

### Threat of Substitutes

Other options substituted for quick-service restaurants are supermarkets, grocery stores, and full-service restaurants (coffee shops, bars, etc.). They offer luxury food selections and a different consumption experience[2]. The pandemic limited full-service restaurants, exposing the resiliency of quick-service restaurants and their competitive advantage through drive-thru and mobile order options. During economic downturns, consumers opt for lower cost options like home-cooked meals or quick-service restaurants[2]. However, when consumers have higher amounts of disposable income, there may be increased spending on a dine-in experience. Recently, boxed meal delivery services like Hello Fresh have grown increasingly popular for consumers who prefer simple ready-to-go meal options. Likewise, grocery stores offering delivery services like Fresh Direct or AmazonFresh provide convenient options for individuals to dine in the home[2]. These provide consumers options to gather cooking supplies and ingredients without having to leave their doorstep.

### Intensity of Competitor Rivalry

Competition in the quick-service restaurant industry is high and increasing. The number of locations is expected to increase by roughly 2.3% to 328,123 restaurants by 2026[2]. However, larger quick-service restaurants have a strong advantage based on their size and marketing abilities. Internationally and in the U.S. the industry is highly fragmented with operators competing by location, diverse menu items, food quality, and price. With about 250,000 operators in this industry, most are small and serve a local customer base. Due to the high competition, this drives prices of quick-service restaurants down, and for most industry operators, profits are low. In addition, consumers are growing more health conscious and it is important for operators to adjust their menu and quality of ingredients to remain competitive.

Over the past five years, overseas expansion has seen significant growth and we predict it is likely to continue. The U.S. has seen a slower growth rate and many large chains like McDonald's, Restaurant Brands International, and Yum! Brands Inc. are looking to emerge into high-growth markets like Asia and South America. The competition in these markets is likely to be achieved through increases in franchised restaurants. Currently, franchises produce a substantial share of total revenue[2]. In recent years, the business model has experienced rapid growth. Franchises perform well even during economic downturns. As large franchisors like McDonald's expand, their ability to access prime locations will position them to experience rapid growth and increase profitability.

## PEER COMPARISONS

Operators in this industry continually alter and expand their menu options to keep up with the ever-changing consumer. Operators focus on a variety of offerings from burger and chicken sandwich focused, Mexican cuisine, pizza, fried chicken, and home-style meals. We compared McDonald's (MCD), Restaurant Brands International (QSR), Yum! Brands (YUM), Chipotle Mexican Grill (CMG), Starbucks (SBUX), Domino's (DPZ) and Wendy's (WEN).

| TCKR | Mkt Cap (B) | Sales 2020 ($B) | Share Price |
|---|---|---|---|
| MCD | $159 | $19.2 | $212.59 |
| QSR | $35 | $1.0 | $58.57 |
| YUM | $32 | $5.7 | $105.47 |
| CMG | $43 | $5.9 | $1,527.70 |
| SBUX | $139 | $23.5 | $104.85 |
| DPZ | $13 | $4.1 | $384.86 |
| WEN | $4 | $1.8 | $20.95 |

Source: FactSet

The chart above compares these competitors compare regarding their stock market value, system-wide restaurant sales, and current stock prices. This data shows that McDonald's is the industry leader regarding market capitalization and generates the second highest sales behind Starbucks. Chipotle is currently valued the highest in the market. Roughly operating a little more than 2,700 restaurants, Chipotle is positioned for revenue growth based on their unique and convenient product offerings. Starbucks is the leader in system-wide sales (company-operated and license operated). At the end of 2020, they operated 32,660 stores across the globe.

As the market in the U.S. grows more saturated, we analyzed the number of restaurants these competitors operate in domestic and international regions.

| TCKR | Domestic | International |
|---|---|---|
| MCD | 35% | 65% |
| QSR | - | - |
| YUM | 38% | 62% |
| CMG | 99% | 1% |
| SBUX | 47% | 53% |
| DPZ | 36% | 64% |
| WEN | 86% | 14% |

Source: FactSet

The quick-service restaurant industry in the United States/Domestic region is relatively saturated. Therefore, globalization is important for operators to enhance their brand. McDonald's has the strongest global presence compared to the other competitors. We believe they will continue to increase their position, specifically in high growth markets like China, to continue their dominance.

## Main Competitors

**McDonald's (MCD)**

McDonald's is the industry leader accounting for an 11.7% global market share in 2020[2]. McDonald's drives revenue from company-operated restaurants, franchised restaurants, and licensed affiliates in 119 countries. A superior competitive advantage McDonald's has is its unique breakfast menu. These offerings provide a valuable and convenient option for individuals traveling on their way to work in the morning. The pandemic affected McDonald's system-wide, and breakfast revenue based on the limited morning traffic and work-from-home orders. Despite this, McDonald's large global footprint and liquidity position create opportunities for McDonald's to make substantial investments to support the growth into international markets.

| MCD | Company-Operated | Franchised |
|---|---|---|
| Stores | 7% | 93% |

Source: FactSet

In 2020, McDonald's operated over 39,000 restaurants. The chart above displays that 7% of all restaurants are company-operated, while 93% are franchised. McDonald's future strategy is focused on expanding their franchised operations to achieve a 95% franchised and 5% company-operated business model.

**Restaurant Brands International (QSR)**

Burger King, Popeyes, and Tim Hortons are the quick-service restaurants under Restaurant Brands International's umbrella. Tim Hortons primarily operates in Canadian markets, while Burger King and Popeyes primarily operate in the United States. QSR operates primarily as a franchiser with almost 100% of all restaurants franchised. Burger King has a large presence in the U.S. and focuses on hamburgers, chicken, and specialty menu items at affordable prices. Recently, the release of the Impossible Whopper created a huge breakthrough for plant-based meat in the quick-service restaurant industry[2].

Popeyes Louisiana Kitchen is a fried chicken, home-style meal restaurant, specializing in New Orleans-inspired spices. Popeyes has recently launched a mobile app that offers free delivery to consumers. Popeyes also launched a chicken sandwich that heavily contributed to 2020 company sales. This new offering has had a domino effect across the industry, creating a surge in demand for fried chicken sandwiches[2].

| QSR | Company-Operated | Franchised |
|---|---|---|
| Stores | 1% | 99% |

Source: FactSet

At the end of 2020, Restaurant Brands International operated over 27,035 restaurants with 99% of stores franchised and only 1% company-operated.

**Yum! Brands (YUM)**

Yum! Brands is a large conglomerate of over 50,000 restaurants split between KFC, Pizza Hut, and Taco Bell. Yum has the largest total stores of all quick-service restaurant operators. However, its total sales rank in the lower end of the group. Yum primarily operates as a franchisor and over the last decade has dedicated its expansion into Chinese markets[2]. Over the last few years, Yum has seen revenue declines due to their increase in franchised restaurants. However, Yum's diverse restaurant portfolio has allowed the company to experience less losses during the pandemic compared to other operators in this industry[2].

| YUM | Company-Operated | Franchised |
|---|---|---|
| Stores | 2% | 98% |

Source: FactSet

At the end of 2020, Yum operated 50,353 stores with 2% company-operated and 98% franchised. We believe that they will compete heavily with McDonald's, as McDonald's increases their market position in China.

**Chipotle Mexican Grill Inc. (CMG)**

Chipotle emphasizes high-quality raw ingredients and allows customers to customize their meals through an assembly-line order process. Chipotle is the premier fast casual operator and are disrupting the traditional fast-food market. Over the last few years, Chipotle has added over 1,000 locations and experienced revenue growth from their company—operated business model[2]. Unlike other industry operators, Chipotle does not franchise any restaurants. Fast casual is increasing its prevalence among all age groups. The convenient and fresh appeal Chipotle presents provides a key competitive advantage compared to traditional quick-service operators, especially as consumers grow more health conscious.

| CMG | Company-Operated | Franchised |
|---|---|---|
| Stores | 100% | 0% |

Source: FactSet

Chipotle's global footprint is significantly smaller than its competitors as they operate only 2,768 stores, and 1% of those stores are international. Their revenue was also ranked at the bottom compared to their peers. However, based on their size and still relatively high revenues, they are positioned to continue to grow within the industry through their new digital and drive-thru advancements.

**Starbucks**

Starbucks operates as the largest coffee retailer with a 30.5% market share in the coffee industry[2]. Starbucks drives revenues from multiple sources, but two of their most prominent segments include both ready-to-drink coffee and ground coffee products. Currently, Starbucks has a 38% market share in the ready-to-drink coffee market and the second highest market share in the ground coffee market at 12%. Starbucks has also expanded into other product lines to capture a larger share of breakfast traffic and now includes food products for morning consumers and lunch customers.

| SBUX | Company-Operated | Franchised |
|---|---|---|
| Stores | 51% | 49% |

Source: FactSet

Starbucks currently operates 51% company-operated and 49% licensed stores and has grown to operate 32,660 stores in over 83 countries. We believe that Starbucks will look to increase their licensed store model to lower the company's risk, capital requirements, and improve company margins over the next few years.

## Price Comparisons

We compared competitors using the forward-looking price to earnings and price to sales ratios in the table below.

| TCKR | P/S FY21 | P/E FY21 |
|---|---|---|
| MCD | 7.8 | 26.6 |
| SBUX | 4.8 | 37.9 |
| QSR | 3.6 | 23.2 |
| YUM | 5.6 | 26.2 |
| CMG | 6.0 | 65.5 |
| DPZ | 3.6 | 30.8 |
| WEN | 2.8 | 32.8 |

Source: FactSet

Clearly, MCD, QSR, and YUM have very close multiples. A lower P/E ratio indicates a company may be doing well based on its past or it might be an undervalued investment. McDonald's has a slightly lower to middle P/E ratio within the peer group. The group's average P/E ratio 34.7, which is 1.3x that of McDonald's. Chipotle has the highest P/E ratio at 65.5. A higher P/E ratio means a stock's price is high relative to its earnings and signals potential for being overvalued. We do not believe Chipotle is overvalued based on its forward-looking P/E ratio; however, we do not believe they are the best investment based on this analysis. Chipotle trades at a much higher multiple compared to its peers because of its future earning potential. The company has a relatively small footprint compared to other operators. As they continue to innovate and add drive-thru services, the company has potential to perform favorably.

McDonald's leads its peers with the highest price to sales ratio at 7.8. The price to sales ratio shows what investors are willing to pay on a per-dollar basis for the company's shares. McDonald's appears overpriced relative to its peers by nearly 1.6x the group's average which is 4.9.

## Margin Comparisons

Below, we compared operating margin, gross margin, and net margin.

| TKR | Operating | Gross | Net |
|---|---|---|---|
| MCD | 38.1% | 58.3% | 24.6% |
| SBUX | 5.0% | 19.7% | 3.9% |
| QSR | 31.8% | 56.5% | 9.8% |
| YUM | 29.80% | 47.50% | 16% |
| CMG | 6.3% | 13.4% | 5.9% |
| DPZ | 17.7% | 38.7% | 11.9% |
| WEN | 16.3% | 28.2% | 6.8% |

Source: FactSet

Chipotle has the lowest margins across the board between all competitors. We believe this is because Chipotle operates purely company-operated stores. In 2020, Chipotle had similar revenues compared to Yum! Brands. However, Yum has significantly higher margins compared to Chipotle, which substantiates the benefits of the franchised business model. McDonald's is the leader across the board for operating, net, and gross margin. We believe McDonald's operational efficiency will continue in the future as the company continues to increase their franchised stores across all markets.

## Same Store Sales Growth

Same store sales growth is a key performance indicator in quick-service restaurants and their ability to adjust to the customer. A company declining in same store sales is failing to adjust to consumer preferences and becoming less competitive. Increases in same store sales reflects shifts in menu options, price increases, or increases in consumer traffic[15].

| TKR | 2019 | 2020 | 5 YR Avg. |
|---|---|---|---|
| MCD | 5.90% | -7.70% | 2.36% |
| SBUX | 5.00% | -14.00% | 0.20% |
| QSR | - | - | - |
| YUM | 3.00% | -6.00% | 0.40% |
| CMG | 11.10% | 1.80% | 0.58% |
| DPZ | 2.80% | 11% | 7.54% |
| WEN | 3.10% | -0.7% | 1.32% |

Source: FactSet

In 2019, CMG was the leader in same store sales based on their ability to drive consumer flow, optimize operations, and find locations that will be profitable for restaurant openings. McDonald's was the second leader at nearly 6% in 2019, but suffered a 7.7% decline in SSS in 2020, which we believe was heavily due to the COVID-19 pandemic. However, over the past 5 years, Domino's and McDonald's were the top contenders for same-stores sales. We believe these companies will continue to see growth as they advance their technology options for consumers and adapt their menu offerings.

## Conclusion

The key performance enhancers for a quick-service restaurant are heavily influenced by product offerings, digital ordering, and accessibility. Based on these indicators, we believe that McDonald's, Chipotle, and Starbucks are the leading operators who are positioned best moving forward.

McDonald's future strategy is to establish a strong digital platform and customer loyalty program to simplify access and to provide easier purchasing options for their customers. In addition, they are looking to expand their presence in markets such as eastern Asia and South America. This development will foster their ability to expand their product offerings, as well as increase their franchised business model and brand. We believe over time this will serve favorable to McDonald's margins.

Chipotle operates a strong, customizable menu that positions them to adjust to new health-conscious customers. Their digital presence and new drive-thru operations will position them to increase their traffic and decrease customer wait time. However, the company has a much smaller footprint compared to other operators. By only expanding through company-operated stores, this might limit their ability to expand as quickly as other QSR operators.

Starbucks is positioned to continue to increase their market share in the coffee market. They currently operate the highest market share and are looking to increase their position into emerging markets such as China. This market has seen increases in consumption and represents a substantial opportunity for gourmet coffee products. With over a 30.5% market share in the coffee industry, we believe that Starbucks is poised to remain a dominant player in the coffee and quick-service restaurant industry.

# ECONOMIC OUTLOOK

## Consumer Confidence Index

The Consumer Confidence Index (CCI) surveys the optimism of consumers regarding their financial situation, business environment, and consumer expectations about the U.S. economy's health. Operators in this industry like McDonald's, rely heavily on consumer optimism and spending preferences. June's CCI was 98.3, significantly increasing from 85.7 in April. This steep decline was driven by the economic conditions brought by COVID-19[15].

The CCI in 2020 ended at 100.78, 27% decline from 2019[2]. Despite COVID-19's impact and economic unpredictability, the increase in reopening the U.S. economy and the deployment of the COVID-19 vaccine brought significant recovery, positively shifting consumer confidence. We believe that consumer confidence will likely fluctuate as the economy and employment recover from the pandemic. We expect that consumer confidence will slightly decline in 2021 but increase over the next two years by 2.3% and return pre pandemic levels and the overall economy will return to normal growth[2].

## Unemployment Rate

The U.S. unemployment directly affects the consumer spending trends in the United States. In January of 2021, the unemployment rate fell to 6.3% (0.4% decline) to a total of 10.1 million people unemployed[34]. This is positive news and a significant decline from a 14.8% unemployment rate in April[34]. Soaring unemployment negatively affects the quick-service restaurant industry through declining disposable income, thus halting normal spending habits. As the economy recovers from the pandemic, higher employment rates and economic stimulus are likely to aid in consumer spending. This provides positive outlook for McDonald's and quick-service restaurant operators. As the coronavirus continues to be mitigated, increased consumption and restaurant traffic are likely to resume to pre-pandemic levels in 2021.

## Real Gross Domestic Product

Real Gross Domestic Product is the most effective measurement of the U.S. economic health. Real GDP illustrates the size and growth of an economy, encompassing private and public consumption, private inventories, government outlays, and the foreign trade balance[35]. In the second quarter of 2020, the U.S. saw its greatest decline in GDP since the great depression. Despite this, the U.S. saw a 33.4% increase in the third quarter and grew by 4% in the fourth quarter[37]. In 2020, the U.S. recorded a GDP of -4.27%[36]. As the global economy restores operations, and people return to working, consumer confidence will increase. We expect the economy will grow by an average of 2.3% from 2021 to 2025[36].

## Disposable Income

U.S. household disposable income is the amount of money that families have available for spending after accounting for taxes. Real disposable personal income in 2020 has remained roughly around $15,000 in the United States. Highly sensitive to labor market growth (unemployment rate), consumers in higher income brackets have relatively higher amounts of disposable income[3]. Fast-food operators, like McDonald's recognize the value in providing lower cost food options to serve both low-income and higher annual income consumers. As the COVID-19 vaccine is distributed, we expect the global economy to grow and increase employment rates[2]. A higher employment rate will support increases in disposable income and fast-food restaurants will see their revenues grow from consumer spending[3].

## CATALYSTS FOR GROWTH

In this highly competitive industry, continuous innovation of product offerings and technology will be a key success factor. The industry is focused on consumer preferences. The strongest players will adapt to consumer trends and supply their diverse products to a wide variety of customers. Quick-service restaurants will have a significant competitive advantage by investing in consumer-friendly mobile and online ordering platforms. These platforms can provide extensive reach to customers and generate revenue through easy access and personalization. These minor details will provide substantial payoff to operators who customize and analyze the data from these platforms to enhance their customer's experience.

**Investment Positives**

- Historical revenue growth has increased by an average of 4% over the last 10 years.
- We forecast that industry revenue will increase by 17% in 2021.
- Digital advances and mobile ordering present significant and simplified ordering, payment, and delivery options to consumers.

**Investment Negatives**

- Prolonged pandemic concerns could pose a threat to operating indoor restaurant dining at full capacity.
- Technology advances in the industry and a large user presence on restaurant mobile apps create a risk of security and data breaches threatening brand image and customer experience.

We are recommending an **OVERWEIGHT** position in the quick-service restaurant industry. The industry is experiencing significant recovery and growth from mobile platforms, menu innovations, and global unit expansion. As the COVID-19 pandemic is mitigated, we believe that consumption habits among consumers will recover, fostering significant revenue growth for industry operators.

## KEYS TO MONITOR

Industry operators must continue to adapt to economic and consumer preferences to remain a high-level competitor. In addition, the COVID-19 pandemic must be monitored. Dragging effects from the virus will limit restaurants from operating at full capacity. However, the industry proved resilient during the pandemic by utilizing drive-thru, mobile ordering and third-delivery services to generate revenue. We believe that restaurants who expand on these strengths will be poised for industry success.

Lastly, employment rates in the United States and internationally will dictate consumer spending. Slower recovery in these areas may negatively impact revenues for quick-service restaurants in the first half of 2021.

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