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BMO Nesbitt Burns

Miatello Investment Management
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This Time is Different

With the fact that most forecasts for 2023 were wrong it seems crazy to step up to the plate and try. In a world of transparent economic information, instant communication, and market reactionary trading, what we get is wild volatility. Some of the volatility is initiated by programmed algorithmic traders triggered by various data points and then automatic momentum traders exacerbate trends. It seems impossible to make sense of market moves. Without making an explicit forecast it might be safer to point out underlying secular trends that are bound to have an effect.

It all starts with the world central banks whose mandates are wholly or mostly to engineer an acceptable low rate of inflation consistent with stable growth. The investment industry intently considers, dissects, and analyzes the Fed's communications to determine the direction and timing of rate changes and changes in other tools of monetary control. The key market indicator is the US Treasury 10-year bond. As we wrote last October, the yield on this bond hit 5% and threatened to move higher, with negative equity market implications. Between a Powell speech on Oct 19th and the end of October the market concluded that peak rates had occurred, and the right move was to buy bonds. Within two months the yield plunged to 3.8% because of a 14.1% increase in the 10-Year bond price. In resonance with the bond market, the MSCI World Equity Index increased 10.6% in a broad-based rally. The sentiment change saved the year's returns and left market participants feeling blessed.

Now to the future. In 2024 short to medium term rates will drop as inflation continues to decline, but what about the longer term? First, there is a demand supply problem in the government fixed income market. There will be a massive bond supply as fiscal deficits continue to need funding. However, central banks will not be buyers as they have committed to shrinking their balance sheets after absorbing incredible amounts of government debt during the pandemic. To clear the market, higher interest rates will be needed. Second, there is a global worker scarcity resulting from aging populations. This gives labour power to increase wages thus pressing on inflation. Bonds must react by staying at yields higher than historical yields. Third, in global

trade, supply chains are becoming less efficient as resilience to interruption takes more precedence over efficient just in time historic practice. This higher product cost drives prices higher for end users. Other problems are global protectionism which would increase under President Trump, increased defence spending to thwart the "New Axis of Evil," the enormous resources directed to the green energy transition, and finally the Left's ongoing demand for income redistribution. A truly daunting set of factors that indicate the era of the last 10 years of low interest rates will be gone for at least ten years.

Higher interest rates mean lower corporate profits thus lower returns for equities. Additionally, growth stocks, the winners of the last ten years, will be the most negatively affected. It will be a market that plays to active stock management, not index investing. This time is different, indeed.

In the Spotlight: Restaurant Brands International ("RBI")

RBI originates from the Brazilian private equity firm, 3G Capital ("3G"). In 2010, 3G acquired Burger King ("BK"). BK was privatized then relisted in 2012. Upon the acquisition of Tim Hortons ("TH") in 2014 both BK and TH rolled into the holding company RBI in which 3G was the major shareholder. In 2017, RBI acquired Popeyes Louisiana Chicken and Firehouse Restaurant Group (submarine sandwiches) in 2021.

Reviewing the operational history of RBI under 3G stewardship, the enterprise could be judged a failure. The most obvious metric was BK's US relative market share decline against McDonald's and Wendy's. In Canada, one third of TH franchisees rebelled against RBI in the face of large decreases in restaurant profitability as average store EBITA decreased 31% from 2018 to 2022 at $220,000. The failing grade is not surprising since 3G was using the typical private equity firm playbook of cutting costs by squeezing every business relationship.

RBI's zero-based budgeting method restricted franchisee support spend, contributing to low investment in Capex and Opex against agile peers. Finally, 3G Capital woke up and in 2022 hired one of the most proven leaders in the Quick Service Restaurant industry. Patrick Doyle, former CEO of Domino's Pizza, joined as Executive Chair in November 2022. The signing was controversial in the financial press as it was a big pay package that, if Doyle delivers, will reward him handsomely. As for his part, Doyle personally bought $30m of stock. Investors knew best however and pushed the stock higher.

Doyle has brought over a number of Domino's executives for the complicated tasks required. The four businesses have widely diverse needs. BK US has embarked upon a revitalization program called Reclaim the Flame. There is a 5 year, $400m capital allocation to assist franchisees in refurbishing stores. Currently 42% of US stores are in the current refreshed design leaving 3,900 to be remodeled. BK's International presence is significant with over 1,000 stores in China amongst over 12,000 globally. TH is in a major international expansion with 648 stores in China (i.e., public company called Tims China) among an 1,827 international base. Objective is 2,750 stores by 2027. In Canada, TH is a colossus with 70% hot coffee market share, 60% in breakfasts and 70% in baked goods. There is still opportunity in the exploding cold coffee market and increased afternoon food attach. Popeyes is the biggest international opportunity with current 1,400 units in large markets India, China, and France in addition to 3,000 units in the US where it is close to the #2 chicken brand. In the US market, BK is #3 in burgers, Popeyes is #3 in chicken, and Firehouse is #6 in sandwiches. For these disparate tasks Doyle has assembled a combination of turnaround and growth executives matched with operational and ROI focused financial executives. In March 2023, Doyle appointed Joshua Kobza, age 36, as CEO, an 11-year veteran in various financial and operational leadership roles. He will give each of the five divisional leaders more autonomy to run their businesses.

RBI has over 31,000 stores with an objective of 40,000 by 2027. 2023 revenue is expected to be US$7 billion rising to $7.4 billion in 2024 and $7.9 billion in 2025. Consensus earnings per share are expected to be $3.24 this year rising to $3.43 in 2024 and $3.80 in 2025. We first bought RBI in June 2020 trailing on the heels of activist investor Bill Ackman of Pershing Square Capital who in Q2 2020 increased his stake. Pershing Square owns 7.5% of the equity. We bought at increments over the next year and a half. These are still early days in this turnaround/growth story.

Ask Brian about The Future

Dear Brian:

Given the bad economic and global news, why should I be positive about future market prospects?

Regards,
Ray

Dear Ray:

A colleague told me that most clients he spoke to last week thought they had lost money in 2023 when that was decidedly not true. In America, a yougov.com poll revealed that 56% of all adults, and 76% of Republicans, thought 2023 was bad or terrible for the country. A September World Economic Forum survey of 1,500 business leaders, politicians, and academics (the Davos crowd) showed “a predominately negative outlook for the world over the next two years that is expected to worsen over the next decade” with 54% expecting “some instability and a moderate risk of global catastrophes” in the short term and 30% expecting severe upheaval. Note this survey occurred before October 7th. Meanwhile the International Monetary Fund projects global growth in 2024 of 2.9%.

How do we reconcile this disparity? It is to recognize that we invest in the capital markets, not the geopolitical markets. Markets always look forward six to twelve months and price based on cold hard business facts. Markets are not swayed by media, politicians, popular psychology, or idealogues.

It is hard to do, I admit. In fact, it takes decades of experience in the markets to pierce the veils of hokum. That is part of the reason the Wealthsimple commercials advocating self-trading are delusional. There are many studies, easily found online, where self-directed investors as a group underperform the returns provided by the underlying funds. The reason is bad timing. Sorry people, you cannot do it yourself successfully.

To directly answer your question, you should be positive since the underlying economics are favourable and the psychology is negative. In our case, we invest in companies that are undergoing transformation. They have great prospects on a three-year horizon but are under a dark cloud on initial purchase. No matter the economy, the company will have enough improvement that should overcome any negative macro-economic effects.

Regards,
Brian

Sources: Financial Times, Washington Post, BMO Capital Markets, RBC Capital Markets, Scotia Capital Inc., J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Morningstar, Bloomberg, Restaurant Brands International, QSR Magazine, stockcircle.com

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