



## Tim Hortons: The Next Target of Activist Investing

### Description

A challenge to the authority and a call for change. A ray of hope for the masses and the stink of trouble for the management. Emotions abound when an activist investor targets a management team.

For **Tim Hortons** (TSX:THI, NYSE:THI), the activist struggle has come from Scout Capital, a firm that focuses on investing in high-quality, underperforming companies for the long term. Scout now owns 8.4 million shares in Tim Hortons, representing 5.5% of the company.

### Scout Capital's track record

It's tough to build our expectations for Scout Capital's activism because activism isn't really typical of the firm's style. Its only other activist position was in **DineEquity** ([NYSE: DIN](#)) in early May, a company in which it developed a 6.6% ownership. Last November, Marcato Capital Management also filed a 13D showing a 5.5% stake in DineEquity and intending to speak to management, so Scout clearly wasn't alone in its interest here.

DineEquity owns two franchise restaurant brands: Applebee's and IHOP. According to Morningstar, in 2009-2012, DineEquity averaged a 29.75% return on equity. However, recently earnings have been subpar. With a dividend-adjusted fall of 4% since Scout Capital developed its stake just shy of two months ago, it's still too soon to tell how this will turn out.

### Scout wants change

While we wait and see how Scout's DineEquity investment plays out, Scout has published a letter to Tim Hortons management laying out a plan to improve capital allocation.

Scout Capital believes it can "double free cash flow per share to C\$4.50/share by 2015" if management follows the Scout plan. Moreover, Scout believes Tim Hortons could be worth \$90 to \$112 if it follows through. The stock currently sits in the mid-\$50's.

This sounds fantastic on paper, but let's look at some of the actual changes Scout Capital is proposing.

## 1. Leverage up and repurchase shares quickly while they're cheap

Scout Capital recommends that Tim Hortons increase its leverage to 3x Debt/EBITDA to give the company excess capital to accelerate its share repurchase program. Scout believes that this should allow Tim Hortons to repurchase 23% of shares in the near term and, if continued, 7%-9% of its shares per year into the future, allowing EPS to compound nicely over the coming years.

Scout Capital believes Tim Hortons can handle this higher leverage because its franchising business is extremely stable and predictable, especially in the Canadian segment. Scout Capital fairly points out that **Domino's Pizza**, Burger King, **Dunkin' Brands**, and DineEquity all have Debt/EBITDA ratios between 4.7x and 5.3x, much higher than Tim Hortons' current rate and higher even than what Scout proposes it lever up to.

## 2. Further align management incentives with shareholders

Currently, Tim Hortons uses EBIT as its sole incentive metric. However, out of context, EBIT alone doesn't tell the story of an entire company. Therefore, Scout Capital believes Tim Hortons should make a few changes to its incentive structure by adding:

- A) Per share metrics like EPS or FCF/share
- B) Efficiency metrics like Incremental Returns on Invested Capital
- C) Total Shareholder Returns vs. Peers

Scout Capital rightly points out that using EBIT as a metric for incentives eliminates focus on optimizing Tim Hortons' balance sheet. I fully agree that metrics like ROIC or Return on Equity should be added to the judgment of management incentives.

However, the addition of per share metrics like EPS can be misguided as it promotes share repurchases to solve problems rather than create rewards. While the previous suggestion to increase leverage allows for further share repurchases while shares are still cheap, making EPS an incentive metric gives management incentive to accelerate share repurchases to cover up earnings struggles, even if shares are too expensive.

Moreover, I think using Total Shareholder Returns vs. Peers is inconsistent with fundamental management as well. A management's goal is to increase the total value of the company over the long term, but total return incentives are inherently short-term. Using more fundamental metrics like growth of book value, a concrete measure of the company's total value, much like **Berkshire Hathaway** does, better aligns shareholders with management.

## 3. Change U.S. expansion strategy

Scout Capital points out that cumulatively, Tim Hortons has invested \$644 million for U.S. expansion over the past 10 years while only having received -\$13 million in EBIT over the same time period.

Scout asks Tim Hortons to slow down, believing that U.S. expansion is only worthwhile if the returns are high enough. When this happens, Scout believes that franchisees will be happy to invest their own

capital, lowering capital intensity in their U.S. business and allowing them to deploy their strong cash flows elsewhere.

### THI U.S. Capital

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I disagree strongly with this point, however, as I think Scout Capital is missing a huge part of the Tim Hortons business model. The reason Tim Hortons is working so well in Canada, with relative market share nearly three times its closest competition, isn't because "unit economics are good" suddenly, although that certainly is true. It's because Tim Hortons hit critical mass in its Canadian markets. In its 2010 10-K filing, \$200 million in invested capital ago, Tim Hortons said:

*In 2011, our development strategy will focus on working to establish a greater density of restaurants in our most developed U.S. markets to accelerate the time it takes to create **critical mass** for convenience and advertising scale in those markets. [emphasis mine]*

Tim Hortons gets its stores to its positive economics by hitting critical mass, giving Tim Hortons the benefit of both scale and cultural impact. Just as Tim Hortons is easily associated with Canada now, it hopes one day to be quickly associated with the northeast U.S. as it expands, and once that cultural connection is made along with the leverage of scale it develops with its immensely capital-intensive investments, Tim Hortons should be able to shoulder out its competition in the U.S.

### Final thoughts

Scout's belief that the economics of Tim Hortons restaurants in the U.S. will ever be as outstanding as its Canadian system without assistance and patient buildup is a bit naive. Competition in this industry is fierce. Even Dunkin Brands, a company that trades now for 45x earnings, was only able to grow revenue 22% in the last four years.

Meanwhile DineEquity, subject of much recent activism and home of inherently American brands like Applebee's and IHOP, have seen revenues *decline*.

Overall, Scout Capital clearly isn't your everyday short-term activist. Its activism strategy is long-term oriented, but it's far from perfect.

Even still, while there are flaws, I believe if Scout Capital can make changes, it will increase Tim Hortons' value more than the trouble it seems to create.

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