The Stock Picker's Guide to Tim Hortons for 2014

Description

There is perhaps no other company more synonymous with Canadian culture than **Tim Hortons** (TSX:THI)(NYSE:THI). The company has a 42% market share of the quick service restaurant (QSR) market, well ahead of closest competitor **McDonald's** (NYSE:MCD).

Tim Hortons is of course best known as the place to go in the morning, whether it's for breakfast, a morning snack, or just for coffee. Not surprisingly, Tim Hortons ranked number one in The Reputation Institute's survey of Canadian brands last year, finishing well ahead of **Canadian Tire**.

Thanks in large part to the wonderful market position Tim Hortons has in Canada, the company is very profitable, with an operating margin of 20% and a return on equity of 37%. And because its customers are extremely loyal, earnings are quite smooth, which is not especially common among Canadian companies. This has allowed Tim Hortons to raise its dividend every year for the last seven years, even during the recession.

But the company still has issues. First, most regions in Canada have all the Tim Hortons locations they can handle, and it shows in the company's growth numbers. Last quarter, sales growth across Canada was 5.4%, and only 1.9% on a same-store basis. Meanwhile, competitors have been getting aggressive. McDonald's has made the most progress with its McCafe coffee and popular breakfast sandwiches such as the Egg McMuffin. **Starbucks** (Nasdaq:SBUX) has also made some progress, prompting Tim Hortons to upgrade the layout at many of its locations.

Such is the problem that mature, profitable companies face. If a business earns excellent returns on investment, that provides plenty of motivation for competitors. And if there's little room for growth, all that the market leader can do is try to hang on to the customers it already has. While Tim Hortons does have growth opportunities, such as potentially increasing its market share at lunch time, the company is certainly playing defence at this point.

Tim Hortons does not have those same problems in the United States, where it has struggled to replicate its success in Canada. In the most recent quarter, sales growth was over 10% south of the border, but that was driven primarily by new openings; same-store sales growth came in at only 3%.

Perhaps the best news for Tim Hortons investors recently concerns capital allocation. Likely driven by American hedge funds, the company has been aggressively buying back shares, even raising $900 million in new debt recently to further fund buybacks. Of course that results in a more levered balance sheet, but with Tim Hortons' consistent earnings and cash flow, the company should not be threatened. And with interest rates at such low levels, earnings per share should get a nice boost from this tactic.

Tim Hortons investors remain generally optimistic, which is reflected in the share price. The company's shares have nearly doubled in the last four years, and now trade at nearly 20 times earnings. Considering the lack of growth prospects and the increasingly competitive environment, such optimism may not be appropriate. The company's shares, just like its coffee, should come with a warning label.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:SBUX (Starbucks Corporation)
2. NYSE:MCD (McDonald's Corporation)

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