



3 Ways to Play The Second Cup Ltd. Sale

Description

The Second Cup Ltd. (TSX:SCU) announced less-than-scary third-quarter earnings Halloween morning, but it was the news that it's exploring strategic alternatives—a polite way of saying it's up for sale—that had shareholders feeling like they'd just received a timely treat.

The rumours of who's going to purchase the troubled coffee chain have already begun to circulate; the two obvious candidates at this point are **MTY Food Group Inc.** ([TSX:MTY](#)) and **Cara Operations Ltd.** (TSX:CAO). But there are others.

How do you play this? The obvious answer is to buy Second Cup stock and hope that a premium is in the works, despite it losing \$1.1 million in the first nine months of fiscal 2016.

That is a possibility given it was able to generate an EBITDA profit of \$357,000 in the third quarter on \$37.7 million in system-wide revenues. More importantly, if you exclude Alberta, the rest of the country experienced a slight increase in same-store sales—a very important selling feature for any buyer. It says there is hope.

Any buyer at this point gets 298 cafes, 26 of which are company owned with the rest franchised. A majority of Second Cup stores are in Ontario or Quebec (210 locations in fiscal 2015) with the rest primarily in Alberta and the Atlantic Provinces. Any strategic buyer would already have a big presence in central Canada or are looking to plant a flag here.

As for the name, Second Cup, it's still got legs. Carried on the books for approximately \$31 million, it took a \$30 million impairment charge in 2014 to reflect a deterioration in its business and stock price. That said, there still appears to be value in the brand.

How much would someone pay for Second Cup?

Starbucks Corporation ([NASDAQ:SBUX](#)), **Dunkin Brands Group Inc.** (NASDAQ:DNKN), and **Restaurant Brands International Inc.** ([TSX:QSR](#))([NYSE:QSR](#)) have enterprise values that are 17,15, and 12 times EBITDA, respectively. All three of them would get an offer 20-40% higher than their current valuations.

Second Cup's 12-month EBITDA is \$456,000. In the same 12 months ended September 26, 2015, it was -\$310,000. Part of that improvement is timing; part is the closing of 14 company-owned locations that were no longer draining the company's resources. It's hard to know if its relatively new store design is contributing in a material way.

At its current enterprise value of \$34.8 million, it's got a multiple of 70 times EBITDA. Clearly, Second Cup management are going to have to work hard if they want to receive an offer of more than \$2.40 per share.

Of the two franchise operators mentioned previously, MTY Food Group would appear to be the better fit as CEO and founder Stanley Ma tends to be more of a risk-taker when it comes to acquisitions, and MTY already has several coffee-centric brands, including Country Style and Cafe Depot.

Cara, on the other hand, is in the middle of digesting two acquisitions, including the \$537 million purchase of St Hubert. Although 72% of its locations are in Ontario, which aligns nicely with Second Cup, all of its brands are generally casual, sit-down dining with the exception of Harvey's. I don't see them wanting to jump into the fray.

A long shot could be Dunkin Brands, which once had a big presence in Quebec. They'd obviously have to convince the franchisees to rebrand under the Dunkin umbrella. It would be a tiny acquisition for them, but I'm not sure they would want to tangle with Tim Hortons on its home turf.

Another possibility is a private equity firm teams up with Toronto-based Chairman Brands, owners of the Coffee Time and Robin's Donuts brands, to take Second Cup private. It has recent experience making strategic acquisitions, so add them to the list.

Ultimately, I believe that someone will be willing to pay more than \$2.40 per share for Second Cup. Who that someone is remains a question mark, but if you want to make money, your best bet is to buy its stock, perhaps sell some puts on MTY, and wait for the next shoe to drop.

Worst-case scenario: you sell your Second Cup shares for little or no gain and end up taking delivery of MTY stock. You could do a lot worse.

CATEGORY

1. Investing

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1. NASDAQ:SBUX (Starbucks Corporation)
2. NYSE:QSR (Restaurant Brands International Inc.)
3. TSX:MTY (MTY Food Group)

4. TSX:QSR (Restaurant Brands International Inc.)

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