Canadian IPO Market Heats Up Heading into 2017

Description

In a sign that the IPO market could be on the road to recovery, Freshii Inc., a restaurant chain that specializes in healthy fast food, is planning to sell shares to the public only a few months after **Aritzia Inc.** (TSX:ATZ) founder Brian Hill and his private equity partners were able to cash in to the tune of $400 million.

Aritzia didn't get any of that $400 million to fund its store expansion across North America—a point I made in my argument against investing in its IPO.

Now it's Freshii's turn to come to market with hat in hand, and while it's encouraging that non-resource companies are choosing to go public in this country, IPOs generally underperform in the first 12-24 months unless they are properly priced.

So, the question as we head into 2017 is a simple one: should you buy Freshii's IPO?

Freshii pros

- It's bringing healthy foods to the masses—always a good thing.
- It has 244 stores of which 98% are franchised; it's a nice, asset-light business model.
- It's one of the fastest-growing multinational restaurant chains in the world.
- It's had 14 consecutive quarters of same-store sales growth, including 5.3% in the third quarter ended September 30.
- The average store is 1,200 square feet (not too large), costs US$260,000 to build, and generates US$478,000 in annual revenue with a 40% cash-on-cash return, which is defined according to the preliminary prospectus as "estimated year two store-level operating profit after royalties and advertising, but before the impact of store owner-operator or manager salaries, divided by the target cash build-out costs of approximately $260,000 (in local currency)."
- System-wide sales have grown from US$29.1 million in 2013 to US$87.1 million in the first nine months of fiscal 2016.
- Pro forma adjusted EBITDA grown from US$1.9 million in fiscal 2013 to US$5.5 million in the first nine months of fiscal 2016.

- It’s converting about 86% of its income to free cash flow.
- It collects 6% royalties on gross sales plus a $30,000 franchise fee paid in U.S. dollars except here in Canada.

Freshii cons

- It plans to have at least 810 stores worldwide by the end of fiscal 2019, which means it will have to open 566 stores in 39 months—an average of 15 per month. In the past three fiscal years, it has averaged five store openings per month.
- Freshii management is projecting same-store sales growth of 3-4% over the next three years. While it appears conservative, it generated just 0.8% same-store sales growth in fiscal 2013. Same-store sales growth has been erratic.
- The third leg of its growth strategy is to grow its pro forma adjusted EBITDA to at least US$20 million by the end of fiscal 2019. That’s a compound annual growth rate of 50%—a tough goal to achieve given the costs of running an 800-store franchise compared to one with 244 stores.
- The company paid US$4.9 million to terminate a relationship with a franchise consultant who was hired to help sell franchises. Now, it plans to handle that internally with social media campaigns, etc. I don’t see a problem with that, but that does cost money.

Bottom line

Freshii is doing something that you rarely see with IPOs. It’s conducting a treasury offering and secondary offering simultaneously to raise funds for both the company and its existing shareholders.

While that’s a positive, for sure, the fact that there is a dual-class share structure means founder and CEO Matthew Corrin will continue to control the company’s voting rights through his Class B shareholdings, no matter how many Class A shares he sells in the secondary offering.

I was skeptical of Aritzia’s IPO, and I’m just as skeptical of Freshii’s move to capture investor interest. If an IPO values Freshii at anything upward of a $300 million market cap, I wouldn’t touch it, especially when you can buy other stocks, such as **Restaurant Brands International Inc.** (TSX:QSR)(NYSE:QSR).

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