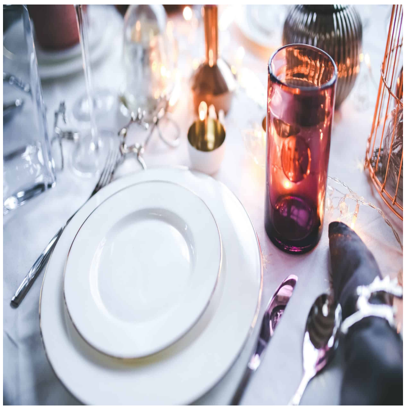

Why This Underperforming Restaurant Stock Can Outperform

Description

Before you shrug off **Cara Operations Ltd.** (TSX:CARA) as an investment due to its recent underperformance, you should hear its story.

The story of Cara Operations

On an initial look, it would seem that Cara has only traded on the Toronto Stock Exchange since 2015 — a short history. In reality, the company had traded on the exchange as early as 1968.

In 2004, it was taken private by the founding family, which refocused Cara as a branded restaurant company. Unfortunately, the proceeds from non-core-asset sales were used to expand the business instead of paying down debt. By 2012, the company was swimming in a lot of debt — with its leverage ballooning to 6.4 times net debt to EBITDA.

That said, in the eight-year period, Cara's system sales still managed to increase from $1.1 billion to $1.3 billion, which shows that there is value in its brands.

In 2013, **Fairfax Financial Holdings Limited** and its affiliates recapitalized the company, deciding to use Cara Operations as a platform for their restaurant investments. Fairfax then appointed new management, which transformed the company for the better.

Excellent management

Cara's transformation has been led by Bill Gregson, who has been the company's CEO and president since October 2013 and chairman since April 2015.

He is a chartered accountant with extensive experience in retail operations. He led the turnaround of The Brick and served as the company's CEO and president from 2009 to 2012, which ultimately led to the sale of the company to **Leon's Furniture**.

chicken dinner
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The multi-year transformation is going well

From 2013 to 2016, Cara's operations swung from a net loss of -$42.2 million to net earnings (before tax) of $96 million. In the same period, its assets more than doubled to $1.3 billion. As well, its system sales grew 48.8% to a little more than $2 billion.

This is thanks to the efforts of Cara management's successful execution to focus on growing its sales, consolidating restaurant brands in the industry, driving synergies, controlling overhead costs, and maximizing earnings.

Cara's acquisitions of St-Hubert and Original Joe's last year are expected to boost its system sales to $2.8 billion this year. Moreover, they are expected to be accretive to earnings per share (EPS) on a full-year basis.

The business

Cara is Canada's oldest and largest full-service restaurant company. It grows by acquisitions and franchising its operations.

In the past month, you might have eaten at its restaurants, including Swiss Chalet, Harvey's, Milestones, Montana's, Kelsey's, East Side Mario's, Casey's, New York Fries, Prime Pubs, Bier Markt, Elephant and Castle, State & Main, and Landing restaurants.

At the end of 2016, Cara had 15 brands and 1,237 restaurants, of which 83% were operated by franchisees. It had 55% of its locations in Ontario.

Last year, Cara generated sales of $463 million and net income of $67 million, which led to EPS of $1.22. As well, its operating margin was north of 22% and its return on equity (ROE) was north of 17%.

Going forward

Gregson expects the company to do more acquisitions in the future and to grow its system sales to $3.7 billion by 2020-2022. It would be great if Cara could maintain an ROE north of 15%.

Investor takeaway

The recent drag on Cara's share price has partly been due to its exposure to resource regions: Alberta and Saskatchewan. It has 12% and 2%, respectively, of its locations in these provinces.

At about $26.50 per share, Cara Operations trades at an attractive price-to-earnings ratio of about 15.5 for a company that has double-digit growth potential.

An analyst at **Bank of Nova Scotia** has a one-year price target of $33 on the stock, implying an upside potential of 24%. Additionally, the stock offers a sustainable yield of 1.5% that will add to returns.

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