Restaurant Brands International Inc. Is Treading on Thin Ice in its Latest Battle

Description

It states right there in the marketing brochure for potential franchisees: “We at **Restaurant Brands International Inc.** (TSX:QSR)(NYSE:QSR) will absolutely not trust you as a new franchisee, and you can expect us to question your every move as an existing franchisee, but we welcome your money with open arms!”

No, it doesn’t really state that, but it does highlight the problem that Restaurant Brands CEO Daniel Schwartz faces in his company’s very public battle with a group of its franchisees.

This spat between the two parties has gotten to the boiling point, as Fool.ca contributor Joey Frenette recently alluded to in his article addressing the fracas.

“As a long-term shareholder, I wouldn’t think too much about the debacle, as it will have little to no impact on the company’s top line,” Joey wrote September 25. “Disputes between franchisees and franchisers are really nothing new in the restaurant industry, nor are they anything to be worried about. It will be interesting to see how this story unfolds, however.”

By choosing to allow its dirty laundry to be aired publicly, Daniel Schwartz has lost control of the situation. Now, to counter a lawsuit by the Great White North Franchisee Association (GWNFA), he’s accused long-time franchisees of handing over confidential information to the media, breaching their licensing agreement with the company.

As Joey rightly points out, the public doesn’t care about what goes on behind closed doors between the two parties; they just want to know that the quality of Tim Hortons’ products doesn’t suffer as a result of the squabbles.

The public might not care, but here is why investors should.

The franchisees are lifeblood of business

Under an asset-light business model, such as the one operated by Restaurant Brands, the franchisees are the lifeblood of its business. Without them, it has no business.

You can't expect franchisees to be ripped off on the prices they pay head office and think that all is well in the world. Eventually, as we're seeing, people fight back.

"As Tim Hortons management charges higher prices for coffee and other supplies, restaurants have had to lay off workers, the franchisees say," wrote *Bloomberg* in July. "Store owners are stocking up on bags of sugar at Costco, where it's cheaper than what the corporate parent charges. Even knives and scissors are more expensive under 3G."

Consumers might be blind to internal politics, but when franchisees can no longer field a competent team to serve customers because the margins have been sucked dry, eventually the service and product quality starts to suffer, and down go sales.

This fight is a serious matter that Daniel Schwartz is failing to handle appropriately.

Same-store sales at Timmys falling

In the last four quarters, Tim Hortons has averaged same-store sales growth of 0.9%, 410 basis points fewer than in the same four quarters a year earlier. Worse still, it has had two consecutive quarterly declines in same-store sales and hasn't had a quarter above 3% growth in same-store sales since Q1 2016.

That's five quarters and counting. Miraculously, its earnings have gone up. Why do you think that is?

Well, for starters, franchisees are paying approximately $14,000 more per year to buy coffee from the head office than they used to, according to former Tim Hortons executive Tim Gilks. That's a lot of money multiplied across the 4,500-franchised Tim Hortons locations.

The problem with cutting costs and gouging franchisees is, eventually you run out of levers to artificially increase profits, at which point, sales growth is the only option available.

This dispute could spread to both Burger King and Popeyes.

Bottom line

3G Capital's other big food conglomerate is **Kraft Heinz Co.** (NASDAQ:KHC). Earlier this year, Kraft Heinz was rebuffed in its attempt to purchase **Unilever NV (ADR)** (NYSE:UL) for US$143 billion, primarily because Unilever's board didn't want to see its hardworking employees sent packing by the ruthless Brazilians and Warren Buffett.

Kraft Heinz found out the hard way that if you only focus on cost cutting, eventually, you'll run out of potential acquisitions, because no one will want to sell to you knowing full well employees will be given the short stick in any deal.

The same thing will happen to Restaurant Brands if it isn't careful.

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