Buy Cara Operations Ltd. at a Discount

Description

Investors weren't impressed by **Cara Operations Ltd.'s** (TSX:CARA) third-quarter earnings, knocking its stock for a loss in November 6th trading.

While analysts were expecting a lot more from the restaurant operator, the results weren't the end of the world.

Here's why it's a good time to buy CARA stock.

Big picture

Analysts were expecting earnings of 45 cents and revenue of $196 million; Cara delivered 34 cents per share in earnings and $189 million in revenue. That's a 24% miss on earnings and a 4% miss on sales.

Ouch.

A total of nine analysts cover CARA stock at the moment; four have it as a buy, four have it as a hold, and one has it as a sell. The sell analyst has a 12-month price target of $21, which is around Cara's 52-week low.

I've never been a fan of analyst estimates, because they're often either way too optimistic or pessimistic about a company's outlook in the coming quarter and year.

I like to look at the actual results to see where progress has been made and where there's room for improvement.

Progress made

Acquisitions have substantially increased Cara's system-wide sales over the past year. Up 37% in Q3 2017 to $684 million, Cara generates royalties from those system-wide sales, so an almost 40% jump will add to the bottom line.

In the first three quarters of the year, Cara has been busy renovating 47 corporate and franchised locations both inside and out. Also, Cara's added 122 restaurants to its system in the first nine months of fiscal 2017. Both of these moves also add to the bottom line.

Through the first nine months of 2017, Cara's earnings have grown by more than 50% to $1.33 from $0.88 a year earlier.

Part of that increase is from the top-line rise in revenue, but another major contributor in 2017 has been Cara's control of costs. In Q3 2017, SG&A costs were 42.8% of $188 million in gross revenue; a year earlier, they were 460 basis points lower.

It's always a good thing when gross revenues rise faster than operating expenses.

Room for improvement

There's no question the 0.9% same-store sales growth in the third quarter won't be setting any records. However, CEO Bill Gregson was quick to point out that business is moving in the right direction.

"While we are not satisfied with SRS of 0.9% for the quarter, we are encouraged by the positive trend," Gregson stated in its earnings press release. "We will continue to focus on our goal of long-term sustainable SRS growth, which will be driven by the combination of our renovation strategy, focus on menu innovation, commitment to improved operations and guest experiences, and our investments in digital and e-commerce."

In fiscal 2016, Cara's same-store sales declined by 1.7%, including a 2.8% drop in the fourth quarter. If Cara can deliver positive same-store sales growth in Q4 2017, it will have improved the annual number by 170 points or more.

We will see in March if that happens. Gregson seems confident the company's moving in the right direction.

A new segment

Cara announced in October that it was paying $24 million to acquire the Pickle Barrel chain of Toronto-area restaurants. With $50 million in annual revenue, I view the acquisition as a winner, because it gets the company into the catering business, where Pickle Barrel's experience can leverage Cara's multitude of brands available to potential catering clients.

Now, not only will Cara generate revenue from its corporate locations as well as franchising royalties and fees, it brings catering revenues into the equation, which helps cover the cost of keeping its kitchens open.

I expect big things from catering two to three years from now once it's been able to integrate Pickle Barrel.

Bottom line on Cara's stock

At the beginning of October when Cara stock was trading around $24, I recommended that investors forget about **Freshii Inc.** (TSX:FRII) and buy Cara instead. On November 1, before announcing earnings, Cara hit $27 before dropping on the news.

Now back to where it was in early October, I'm recommending investors buy on the dip. A year from now, it should be delivering positive same-store sales growth and substantially higher earnings.

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