Value Investors: Canada’s Restaurant King Is Incredibly Cheap

Description

Value investing has evolved over the years. Instead of just looking for cheap stocks, investors want more. They’re on the hunt for great businesses that happen to be trading at bargain basement prices.

That’s the issue that confounds so many investors. Sure, there are some businesses that we can all agree are pretty great. But most fall into sort of grey area, especially after a year or two of lacklustre results. Will a company pull itself out of the funk that caused the share price to decrease? Or is it the beginning of value trap territory?

Let’s take a closer look at one such Canadian stock, a company that some really smart investors think is on the right track.

Canada’s restaurant king

Warren Buffett, who just happens to be the greatest investor of all time, is a big fan of restaurant stocks. In fact, Buffett has purchased many of North America’s top fast food stocks at one point, and his holding company owns Dairy Queen outright.

Meanwhile, the man many call Canada’s Warren Buffett, Prem Watsa, is also a fan of restaurant stocks. That’s evidenced by his large ownership position in **Recipe Unlimited Corporation** (TSX:RECP), a stock you might remember by its former name, Cara Operations.

Recipe is the owner of many of Canada’s top restaurant brands, including names like Swiss Chalet, Harvey’s, New York Fries, Montana’s, East Side Marios, and most recently, The Keg. In total, the company owns nearly 20 top Canadian restaurant brands that span some 1,400 locations across the nation and a little bit into the United States.

Recipe has done a nice job growing the business over the last few years. From 2013 to 2018, it nearly tripled the top line, increasing revenues from $1.3 billion to $3.6 billion. Adjusted free cash flow did even better, increasing some 500%.

Unfortunately, the latest results aren't exactly up to par. Same-store sales, a key metric in the restaurant sector, turned sharply lower in 2019, falling more than 3% through the first three quarters of the year. Like many other restaurant brands, Recipe blamed a tepid Canadian economy for the downturn, as well as increased competition in the sector. The good news about all of this is many of Recipe's competitors are also suffering, which would indicate it has more to do with the economy and less with any of the company's individual brands.

Although sales numbers don't look great, the company is still generating gobs of free cash flow. Although 2019's full-year results aren't out yet, free cash flow should be approximately $2.35 per share. After a steep sell-off in Recipe shares – the stock is down approximately 30% over the last year and shares trade at $18.63 each as I type this – that puts the stock at under 8 times trailing free cash flow.

Free cash flow on a per share basis should go up in 2020 too, even if underlying results continue to be tepid. That's because Recipe is buying back stock like it's going out of style. Through the first nine months of 2019, the company bought back nearly 10% of its shares outstanding. That's exactly what you're supposed to do when the stock is depressed, and the move will boost the bottom line in 2020 on a per share basis.

And finally, after the sell-off, Recipe shares are offering a compelling dividend yield for the first time ever. The current yield is 2.4%, and the dividend has been increased recently. The payout ratio is quite low compared to free cash flow, so the payout should keep marching higher.

The bottom line

Ultimately, an investment in Recipe shares comes down to this. Do you believe recent poor results are because of a sputtering Canadian economy, or because Recipe's brands are permanently broken?

If you believe the former, the stock is a screaming buy today. Shares are dirt cheap with plenty of upside potential once same-store sales increase again. If you believe the latter, then the stock is cheap for a reason and should probably be avoided.

Personally, I think the company's brands are too good to keep down. And Recipe has the potential to make further acquisitions to create growth that way.

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