Buying: The Restaurant Group PLC (RTN)

Improve the portfolio : *As companies grow (or shrink) and as their share prices go up (or down) the attractiveness of the investment changes. If a company's share price shoots up quickly its shares may no longer represent good value for money, while a company that falls into a long-term decline may no longer be remotely defensive. In both situations selling can be the right course of action.*

Price on 1st April 2016	Index	Sector
393p	FTSE 250	Travel & Leisure
FTSE Market Cap	**Revenue**	**Normalised Post-tax Profit**
£790 million	£685 million	£69 million

"[we] operate over 500 restaurants and pubs in the UK's casual dining sector, with a plan to double in size over the next 8 to 10 years. Our guests are at the heart of everything we do with a simple aim to deliver great food and drinks with excellent service in relaxed, comfortable surroundings." (www.trgplc.com)

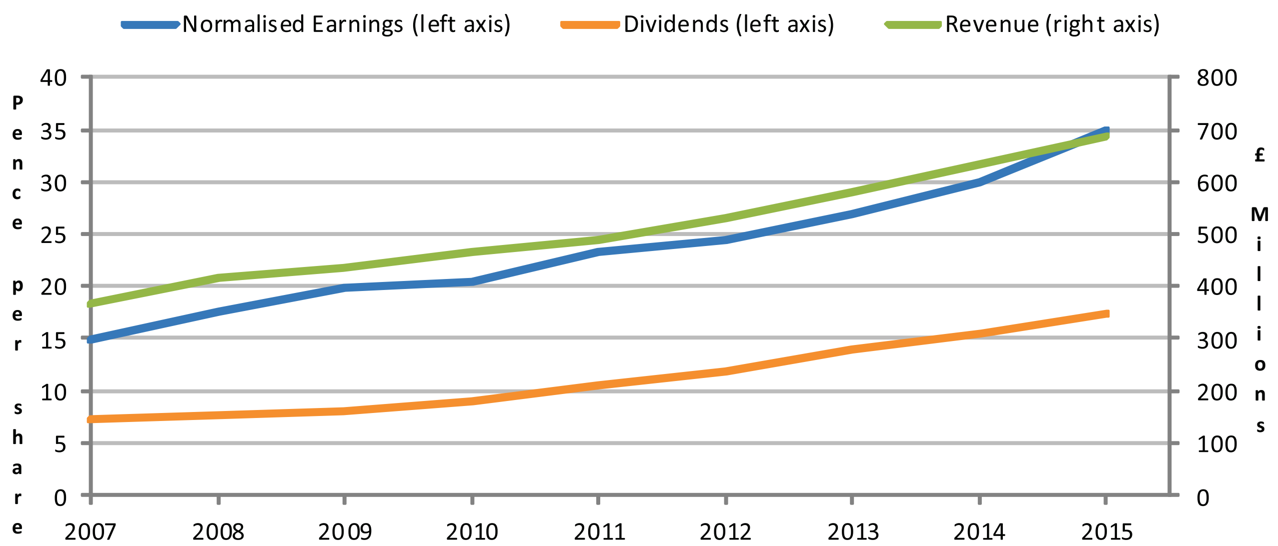
Overview

The Restaurant Group (which I'll shorten to TRG) started life in 1987 as City Centre Restaurants. Its purpose was to take over and run the Garfunkel's chain of primarily London-based themed restaurants, which had in turn been lauched in 1979 by the "godfather" of UK casual dining, Philip Kaye. The company quickly grew to become the largest independent operator of branded restaurants in the UK, operating brands such as Cafe Uno, Garfunkel's, Deep Pan Pizza and Frankie & Benny's at sites ranging from the high street to leisure parks and airport concessions.

At the start of the new millennium the company ran into a weak economy and found itself struggling. Profits turned to losses and a new Chairman, CEO and management team were brought in. The key problems were seen as excessive debts combined with too many brands and too much exposure to the highly competitive high street market. The turnaround strategy was to sell off underperforming businesses to pay down debts and focus the remaining more profitable businesses on cash generation. That cash would be used to grow the business by expanding high performance brands into areas of the market with high returns, high barriers to entry and good growth prospects; i.e. leisure parks and concessions. That same strategy continues today.

Growth Rate	Dividend Yield	Profitability	PE10
10.0% (min 2%)	4.4%	18.6% (min 7%)	16.7 (max = 30)
Growth Quality	**Debt Ratio**	**Pension Ratio**	**Rank**
100% (min 50%)	0.8 (max 5)	No Pension	4 (out of 235)

Green = Better than FTSE 100; Pink = Worse than FTSE 100; Red = Outside the "rule of thumb" minimum or maximum values



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality and that its shares are likely to improve the portfolio in the long-run.

Maintaining and increasing portfolio diversification

1. Will this purchase leave the portfolio's average UK revenues at less than 50%?

YES TRG's businesses are focussed 100% on the UK. However, the model portfolio's average UK exposure is currently less than 40%, so it will still be under 50% after the addition of TRG.

2. Will this purchase leave the number of holdings from cyclical sectors at 15 or less?

NO The portfolio currently holds 15 cyclical sector stocks and TRG is also from a cyclical sector (Travel & Leisure). I am willing to bend this rule of thumb to a small degree because there is a lack of attractively valued defensive stocks at the moment.

3. Will this purchase leave the number of holdings from this company's sector at 3 or less?

YES There are currently no Travel & Leisure stocks in the portfolio.

Avoiding value traps

Good management

1. Is the company focused on a clear and consistent goal and strategy?

YES The company has consistently pursued the same goal and strategy since it began its turnaround in 2000/2001. The goal is described in the annual reports as:

"Our core objective is to grow shareholder value by building a business capable of delivering long-term sustainable and growing cash flows. We do this by providing great food, drink and service in well-appointed restaurants and pubs."

The company's strategy is also clearly described in multiple annual reports, for example:

"The Group's strategy for growth is focused on those brands that have a high return on capital, good growth prospects and significant barriers to entry - Leisure Parks and Concessions display these three characteristics."

"Our business model is to grow through a combination of like-for-like sales growth and new site development. The profits from this growth are converted into cash at a healthy rate, which we use to maintain our existing estate in good order, pay dividends and invest in more new sites generating high levels of return. This has proven to be a very successful and value-accretive business model which has enabled the Group to grow in a predominately organic way funded principally by internally generated cash flows. This model delivers high returns, growth and income for shareholders in the form of dividends."

2. Does the company have an obvious core business that the strategy is focused on?

YES TRG's core business is the management of branded restaurants across the UK.

Adequate financial control

3. Do the Key Performance Indicators (KPIs) focus on factors beyond revenue and EPS growth such as profitability, leverage, liquidity and investment?

YES The company's KPIs include operating profit margin and return on invested capital, both of which are measures of profitability. Leverage indicators are not included, but the company has almost no debt.

Low costs

4. Scale: Is the company in the leading group in terms of market share?

YES TRG is currently fourth (behind Pizza Express, Nando's and Pizza Hut) in a league table of UK casual dining businesses by number of sites.

5. Experience: Has the company had the same core business for many years?

YES TRG has had the same core business from day one in 1987.

Caution with big projects

6. Is the company free of "bold" projects which could push it into a major crisis?

YES I cannot see any bold bet-the-company projects underway at the moment.

7. Is the company free of the need for large capital expenditures (capex)?

NO TRG is a high capex company because it consistently spends more on capex than it generates in profit after tax. This is because the company must build and/or fit out restaurants before they generate a penny of revenue. As a growth business the company is constantly adding new sites, at a rate of almost 50 per year at present.

Companies that need to spend large amounts on capex in order to grow are more susceptible to slowdowns in cash generation as they will then not have sufficient cash to fuel their capex-intensive growth. They are also more likely to take on large amounts of debt in order to fuel growth when organic growth is too slow for the CEO's liking. In TRG's case, I am not overly worried about its high capex requirements. From a recent annual report:

"Our philosophy regarding capital expenditure remains consistent – we focus on cash generation and on securing a return on invested capital at rates ahead of TRG's weighted average cost of capital. We continue to apply the same levels of analytical rigour, commercial analysis, experience and risk adjustment to each capital project that we undertake. This approach has served TRG well and we do not intend to deviate from it. This disciplined and consistent approach has also ensured that our new openings continue to deliver strong returns. It is particularly encouraging that returns from our openings in recent years have been at some of the highest levels achieved in the past decade."

The company's high profitability score of almost 19% (well above the average of 10%) backs up this notion that these large capital expenses are in fact a good use of shareholder funds.

8. Are revenues generated by the sale of a large number of small-ticket items rather than major one-off contracts?

YES Revenues are generated through the sale of millions of individual meals each year, served to diners across the UK on a daily basis.

Caution with acquisitions and mergers

9. Has the company avoided mergers or large acquisitions in the last few years?

NO There was one "large" acquisition (i.e. greater than that year's profit) during the last ten years. The acquisition came in 2007 and was for the Brunning & Price pub restaurant business. The acquisition doesn't seem to have created any major problems and Brunning & Price is still a successful part of TRG today.

10. Has the company avoided large acquisitions that have little to do with its core business?

YES As a pub restaurant business the Brunning & Price acquisition was closely related to TRG's own core restaurant business.

Ability to adapt to changing market demand

11. Does the company operate in defensive markets?

NO The casual eating out market is cyclical. Although peoples' need to eat is defensive (i.e. not materially affected by recessions) they do not need to eat out. When times are tough people can very easily choose to eat cheaply at home, rather than more expensively at a restaurant. Another factor relevant to TRG is that many of its restaurants are located on leisure parks next to entertainment venues such as cinemas. In a recession it seems reasonable to assume that people will be less willing to visit cinemas and are therefore less likely to be anywhere near one of TRG's restaurants. The same applies to its concessions at airports.

However, during the recession of 2009/2010 TRG's business proved to be extremely resilient and actually managed to grow during that period rather than stagnate or decline. This is at least some evidence that TRG is more resilient than most restaurant businesses, although of course that does not mean it will be impervious to future recessions.

12. Does the company operate in markets where the pattern of demand (whether cyclical or defensive) is unlikely to be disrupted in the short or medium-term?

YES I don't see any obvious reason why the pattern of demand within the eating out market will change significantly in the medium-term. Yes, people can now order Pizza/Chinese/Indian/etc. online, but I don't see how that's any different to being able to order food from a leaflet stuffed through your letter box.

13. Does the company operate in markets where demand is expected to grow?

YES The company thinks it will be able to expand from its current portfolio of approximately 500 restaurants, to somewhere between 850 and 1,000 as the eating out market continues to grow over the next ten years. At that point the UK market would be saturated with TRG's restaurants and additional growth would likely be around the rate of UK GDP growth. International expansion would be the next logical step if double digit growth rates are to be produced beyond that point.

Competitive product, service and price

14. Does the company generate most of its profits from products or contracts that do not need to be replaced in the next 10 years?

YES Although meals and menus have to be continually improved, changed and even replaced, this is more of an ongoing process rather than a big periodic high-risk "replacement" project.

15. Does the company sell differentiated products that do not compete purely on price?

YES In my layman's opinion, the strong branding of TRG's restaurants means that it does not have to compete purely or even primarily on price, and I think that opinion is backed up by its high levels of profitability.

When people visit a leisure park cinema and want to have a pre- or post-movie meal, they will either want to eat (for example) pizza (Pizza Hut), Mexican (Chiquito), or Italian/American (Frankie & Benny's), and price is probably not the key differentiating factor between the various options, although of course it is still one of the factors.

Indifferent to commodity prices

16. Is the company relatively immune to commodity price movements?

YES Food ingredients are mostly commodities and so TRG is affected by their price movements. However, I think there are probably enough substitutes within its menus to mitigate the impact of price fluctuations in any one food commodity, e.g. if pasta is expensive then people can eat a potato-based mean instead. I also don't think broad food price inflation would be strong enough to make people switch from eating out to eating in, as marginal demand for food is mostly in poor countries rather than rich countries like the UK, so it is the poor people of the world who are first to reduce demand in the face of rising food prices.

Sound financial policy

17. Does the company have a target rate of return on investment of more than 10%?

NO Although the company produces consistently high rates of profitability it does not have an obvious profitability target within its annual reports. Return on invested capital is one of its KPIs, but no target figure is provided. However, given the company's track record and stated focus on profitability and cash flow, this is less of a concern that it otherwise might be.

18. Is the company's use of leverage conservative enough given the preceding answers?

YES TRG uses almost no debt because it already has a high level of leverage from its heavy use of leased rather than mortgaged property. In other words, paying rent is like paying a mortgage, but with a mortgage the debt would be visible on the balance sheet whereas with a lease the financial obligation is effectively kept off the balance sheet. However, the obligation to pay the rent is still there.

Because of this fixed rental expense it would be prudent to avoid piling on additional financial obligations in the form of debt, so I am happy that TRG takes this view.

19. Are the chances of this company becoming a value trap acceptably low (and if so, why are the shares attractively priced)?

YES I cannot see any obvious reason why TRG would be a value trap. The company appears to have a highly profitable business, low levels of debt and a proven ability to ride out tough environments with its current strategy. Why then is the share price so low compared to similarly successful companies?

I think the main reason is some recent bad news. In recent updates the company has stated that the trading environment is becoming more difficult and like-for-like growth may not be possible in the short-term. However, it has also said that overall growth is still likely as new sites continue to be added. Other negative factors mentioned include the referendum on the UK's continued membership of the European Union, the National Living Wage and global economic uncertainty. Management suggested that these were likely to be short-term problems rather than long-term, and that the underlying strengths of the business remained in place, all of which I am inclined to agree with.

To my eyes this all appears to be fairly normal. The economy is slowing down and we have a few one-off uncertainties. This is the sort of thing that all companies will have to face, over and over again, during their lifetimes. A good company should be able to cope with downturns and uncertainties with relative ease, and good companies can in fact often benefit from these situations as weaker competitors go out of business. My expectation is that TRG can ride out these problems and continue to succeed over the longer-term.

Uncovering competitive advantages

1. Does the company have any intangible asset advantages (brand names, patents, regulatory barriers)?

YES TRG's restaurants are strongly themed and branded so that people recognise them and know exactly what they're going to get, much like McDonald's, Pizza Express and other famous restaurant brands. Its existing dominant footprint of leisure park restaurants may also be an intangible asset, as leisure park developers may prefer to lease new restaurant space to TRG as they are a known quantity to both the developer/landlord and to the leisure park's future visitors.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to a competitor?

YES One of the key features of the company's strategy is that it focuses on leisure parks and airport (or other) concessions as each location only has space for a limited and fixed number of restaurants.

Once an out-of-town leisure park has been built, with for example a 20-screen cinema and three restaurants, there is no more space for additional restaurants. Each restaurant will usually be distinctly different, catering to different a demographic sector (e.g. young people, families with kids, or older/quieter customers) and as a result competition between them isn't too fierce. If TRG opens a Chiquito restaurant at the previously described leisure park and it is wildly successful, a competitor will not be able to open a similar Mexican-themed restaurant nearby, or at least not within the leisure park. This is a massive barrier to entry for competitors. It is also a switching cost for customers, because if they want to eat a Mexican meal after watching a film their only choice is Chiquitos, unless they want to drive or walk miles to find a competitor.

3. Do the company's products or services have a "network effect", i.e. become better as more people use them (e.g. Facebook, eBay)?

YES I have answered yes, although I think the effect is not of the same order of magnitude as it is for companies such as Facebook or eBay. The network effect for restaurants is that a full restaurant is more attractive to potential customers than an empty one. People naturally assume that the full restaurant must be better, otherwise why would it be full and the other restaurant empty? This assumption may or may not be correct in any given situation, but the network effect is still there.

However, it is only effective at the local level, in individual restaurants. The real power of the network effect happens when it extends across the entire company, as it does for Facebook and eBay.

4. Does the company have any durable cost advantages (e.g. unique location, unique low cost source of raw materials, greater scale)?

NO I don't think TRG has any cost advantages over its competitors.

Making the trade - Are you happy to own these shares for at least 5 years?

YES I think TRG is a highly successful company with a sensible and prudent business plan. It looks to me as if it is facing a difficult trading environment, which is not a surprise as the UK environment has been pretty tough for almost a decade. In the longer-term I think it is quite likely that the company will continue to grow and so I don't think this is an obvious value trap.

As a result I will be adding The Restaurant Group to the model portfolio and my personal portfolio a few days after this newsletter is published.

Higher ranked stocks that were not selected	Reason for not selecting
Amec Foster Wheeler	Debt ratio too high

"What we refer to as Wall Street has become a casino, one in which enormous — but momentary — changes in short-term stock prices are treated as intrinsic reality, rather than ephemeral perception."

— John C. Bogle, Remarks to the To the Student Body at the Roxbury Latin School