Restaurant Brands International

MFIF

Restaurant Brands International (NYSE: QSR)

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We are marketweight Restaurant Brands International's 5%, 2025 notes. Restaurant Brands International (RBI) is the parent holding company of Tim Hortons, Burger King, and Popeye's Louisiana Kitchen. As a prominent Quick-Service-Restaurant company, RBI has rapidly expanded into emerging markets in order to spur growth. While this strategy has helped the company's top line, comparable sales in the Tim Hortons brand, which accounts for two-thirds of revenue, have been flat and declining. The TH segment is also battling an $850 million lawsuit from a group of franchisees, which was filed in 2017. As well, the company's new acquisition of Popeye's Louisiana Kitchen adds considerable credit risk. Bought at an exorbitant multiple of 21x, PLK will have an uphill battle attempting to expand globally while also competing against Yum Brands' KFC.

Despite the higher relative value yield of RBI's 25's, the 60 bp reward does not outweigh the downside prospects. With a pending lawsuit, lagging sales, and large debt load, the company will have to overcome many hurdles before returning to a formidable state. Thus, given the potential risk factors, RBI's 25's are not appetizing enough to bite into at the moment.

Capitalization Table

Restaurant Brands International Capitalization Table
Outstanding Debt Metrics & Leverage

Type of Debt	Rate (%)	Maturity	Debt Outstanding ($MM)	% of Gross Debt	xLTM Adj. EBITDA	Market Value	Price	Yield	xLTM Adj. EBITDA
Senior Revolving Credit Facility	LIBOR+150	10/13/2022	$ -	0.0%					
Senior Term Loan B	LIBOR+225	2/17/2024	$ 6,373.0	53.5%		$ 6,400.9	$ 100.44	4.50%	
Senior Note	4.625%	1/15/2022	$ 1,250.0	10.5%		$ 1,257.2	$ 100.58	3.89%	
Senior Note	4.250%	5/15/2024	$ 1,500.0	12.6%		$ 1,440.4	$ 96.03	4.95%	
Total First-Lien Debt			**$ 9,123.0**	**76.5%**	**4.36x**	**$ 9,098.5**			**4.35x**
Senior Note	5.000%	10/15/2025	$ 2,800.0	23.5%		$ 2,691.6	$ 96.13	5.55%	
Total Second-Lien Debt			**$ 2,800.0**	**23.5%**	**5.70x**	**$ 2,691.6**			**5.64x**
Total Debt			**$ 11,923.0**	**100.0%**	**5.70x**	**$ 11,790.1**			**5.64x**

Notes to capitalization table:
RBI issued its debt utilizing the debt-vehicle B.C. United Liability Corporation under the ticker BCULC. The 2025 second-lien notes covered in this report were issued in September of 2017 to refinance the company's previous 6% 2022 second-lien notes. In addition, RBI issued an additional $1.3 billion to the Term Loan B facility to fund the PLK acquisition.

Bond Data

Bond Maturity: 10/15/2025
Rating: B3/B-
Price: $96.91
Coupon: 5%
Current Yield: 5.16%
YTW: 5.51%
Spread: 251.71 bps
Call Date: 10/15/2020
Call Price: $102.50

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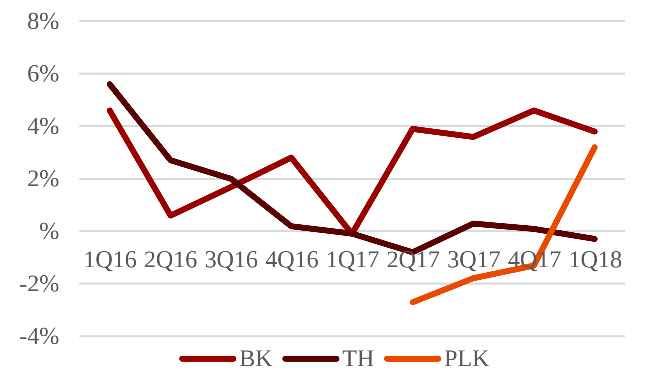
Tim Hortons comparable sales slide despite BK rise
Poor comparable sales within the Tim Hortons segment have drawn concern from investors. For six consecutive quarters, the segment has seen slow comparable sales within the -50-50 bps range. This is applicable to a variety of factors that stem from lower lunch-time revenues and the brand's negative publicity over minimum wages in Canada. After the Ontario Province raised the minimum wage in 2017, Tim Hortons decided to remove paid breaks, benefits, and other incentives for its employees. This drew large criticism throughout the country and deteriorated the morale of the brand. As minimum wages are expected to increase to $15.40 in British Columbia, it will be intriguing to see how Tim Hortons responds.

Figure 1: RBI Comparable Sales



Uphill battle for PLK Expansion
A key part of RBI's future success is expanding the Popeye's segment to Brazil & the greater Latin America region. Although this effort has strong merits, RBI's management has underestimated the size of Yum Brands' KFC. Although Latin America only accounts for 5% of the KFC sales, the segment has seen annual growth of 12% and 4Q17 growth of 11%. Ultimately, the PLK segment will not only need to post growth rates that are comparable to KFC, but also be able to attract customers away from their competitor.

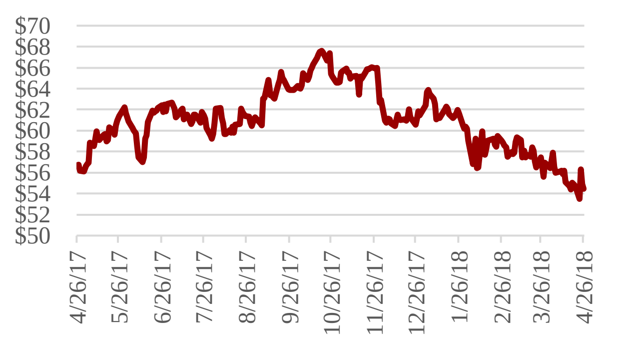
Risks

- Tim Hortons lawsuit could result in significant settlement that drains FCF
- Turnaround in comparable sales can tighten bond
- DPZ/PZZA merger can increase leverage
- PLK segment outperforms street expectations
- Emerging markets strategy does not produce mid-single digit growth

Table 1: Top Equity & Debt Holders

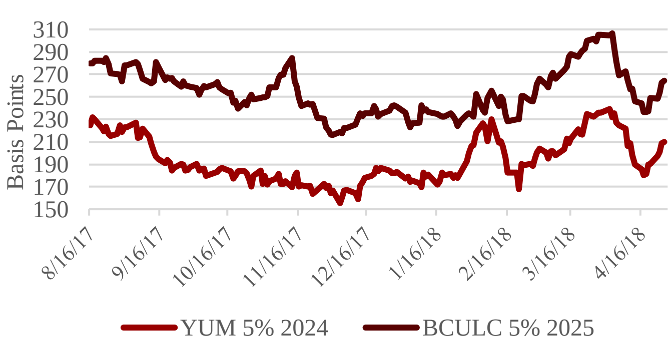
Top Equity Holders		Top Debt Holders	
Pershing Square Capital	10.05%	BlackRock	2.38%
FMR LLC	5.53%	Allianz SE	1.69%
T Rowe Price	5.25%	FMR LLC	1.65%
Royal Bank of Canada	4.38%	Invesco LTD	1.64%
Principal Financial Group	3.69%	Manulife Financial	1.59%
Berkshire Hathaway	3.39%	Eaton Vance	1.45%
Franklin Resources	2.77%	TIAA-CREF	1.04%
Alexandre Van Damme	2.18%	Goldman Sachs	0.94%
Vanguard	2.12%	Vanguard	0.83%
Bank of Montreal	1.98%	JP Morgan	0.59%

Figure 2: QSR Equity Chart (1Y)



Relative Value

Figure 3: QSR Relative Valuation



Insufficient risk premium vs. YUM
Although RBI trades approximately 60 bps wide to YUM, the additional risk taken by investing in RBI is *not worth the yield.* Historically, these bonds have traded at this spread differential for months. We believe this is justified given RBI's leverage is 2.5x higher than Yum's. In addition, the recent acquisition of Popeye's, slow Tim Hortons comparable sales, and looming lawsuit bring additional risk to RBI. Thus, for such a low premium, the bonds are not attractive enough at their current yield. Looking forward, MFIF expects the spread between RBI & YUM to remain in the 60 bps range. In the event the situation with the TH lawsuit worsens or comp sales remain at their current levels, RBI's 25's can widen to the 280-300 bps range.

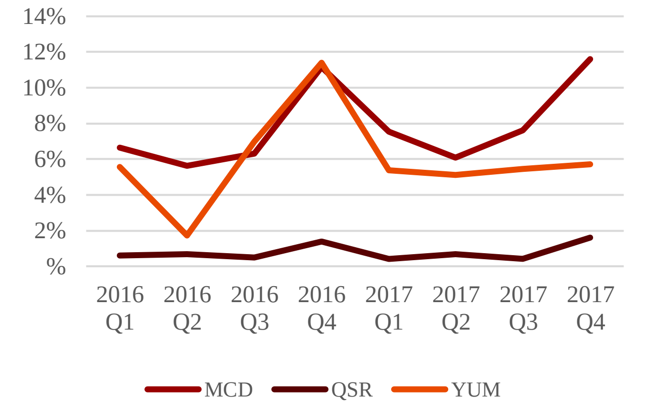
Table 2: Competitor Financial Performance & Health

	QSR	YUM	MCD
EBITDA	$2,091.9	$3,014.0	$10,916.1
Operating Margin	39.36%	46.97%	41.86%
% Franchised Locations	100%	96.7%	91.6%
Debt/EBITDA	5.70x	3.13x	2.71x
EBITDA/Interest Expense	3.86x	6.85x	11.85x
FCF	$1,092.2	$712.0	$3,697.5
ROIC	10.0%	52.1%	22.9%
Credit Rating	B3/B-	B2/B	Baa1/BBB+
YTW	5.51%	4.81%	N/A

Complacent Management Strategy with Tim Hortons

Management has presented a contradictory message with its Tim Hortons segment. While executives have voiced their intentions to revitalize the relatively struggling brand, the company has spent little in capital expenditures to revamp its locations. In comparison to key competitors YUM & MCD, RBI has spent significantly less of their sales on capital expenditures (1% vs. 5-6% of competitors). Instead, management was keen on improving shareholder value via buybacks, dividends, and redeeming all of the company's preferred shares. Although management stated in their 1Q18 earnings call that a $550 million plan would be implemented to revamp TH locations in Canada, RBI has been too late to react. As comparable sales continue to falter, the bond should trade sideways or widen.

Figure 4: RBI's Low Capex/Sales vs. YUM & MCD



Exploring the Possible Acquisitions (DPZ & PZZA)

Equity Purchase Price				
		DPZ		PZZA
Current EV/EBITDA		24.30x		12.83x
Exit EV/EBITDA multiple		28.00x		15.00x
LTM EBITDA	$	565.6	$	194.7
EV Conclusion	$	15,836.8	$	2,920.5
Cash				
Total Enterprise Value	$	15,836.8	$	2,920.5
Current Debt	$	3,121.5	$	466.6
Equity	$	12,715.3	$	2,453.9
Shares Outstanding		42.28		32.22
Equity Purchase Price	**$**	**300.73**	**$**	**76.17**
Current Price		250.27		63.55
Equity Premium Paid		20.16%		19.86%

In mid-February, an article speculated that RBI was considering a bid to take over Domino's Pizza (DPZ). Strategically speaking, the acquisition makes sense for RBI as the company has no exposure to the pizza segment in the QSR space. If the company merges with DPZ, they would have an even greater diversified portfolio that would compete with Yum! Brands' Pizza Hut.

Although an acquisition of DPZ is conceptually feasible, the financing of the deal would drastically deteriorate RBI's credit profile. RBI would increase leverage almost 5x to buyout DPZ's equity. This is attributable to the large equity valuation of 24.3x EV/EBITDA for DPZ. Consequently, RBI would have to buyout the company at a 28x multiple in order to make the deal comparable with a 20% equity premium. An important factor to consider with the possible DPZ acquisition is 3G Capital's ownership of RBI. The Brazilian fund may be willing to put additional capital into RBI in order fund large acquisitions such as that of DPZ.

Alternatively, RBI could make a play for DPZ's smaller competitor Papa John's (PZZA). Trading at a much lower multiple of 12.83x, PZZA is much more attractive as a long-term growth play. Because PZZA does not have the same technological efficiency as DPZ, RBI could revamp the company, expand it, and make it a formidable competitor in the pizza-chain industry.

In terms of financing, an acquisition of PZZA would be much less of a burden to creditors. Buying out the company's equity at a 20% premium would only increase RBI's leverage by 0.75x. As demonstrated by the PLK acquisition, RBI would likely be able to expand their Term Loan B facility to fund the acquisition.

Acquisition Effect on Leverage					
			DPZ		PZZA
		Current RBI	RBI Pro Forma Acquisition		RBI Pro Forma Acquistion
Debt	$	11,923.0	$	27,759.8	$ 14,843.5
EBITDA	$	2,091.9	$	2,657.5	$ 2,286.6
Debt/EBITDA		5.70x		**10.45x**	**6.49x**

Restaurant Brands International (QSR)

Summary Model

	2016	2017	1Q18	2Q18E	3Q18E	4Q18E	FY18E	FY19E
Revenues								
Tim Hortons	$ 3,001.4	$ 3,154.6	$ 763.5	$ 787.7	$ 843.5	$ 838.1	$ 3,232.9	$ 3,297.6
Burger King	$ 1,144.4	$ 1,219.2	$ 389.9	$ 312.8	$ 334.0	$ 367.3	$ 1,404.0	$ 1,495.3
Popeye's Louisiana Kitchen	$ -	$ 202.3	$ 100.4	$ 103.4	$ 106.5	$ 109.7	$ 420.0	$ 523.4
Total Revenue	**$ 4,145.8**	**$ 4,576.1**	**$ 1,253.8**	**$ 1,203.9**	**$ 1,284.0**	**$ 1,315.2**	**$ 5,056.9**	**$ 5,316.2**
Food & Beverage Costs	$ 1,727.3	$ 1,850.3	$ 429.1	$ 481.6	$ 513.6	$ 526.1	$ 1,950.4	$ 2,046.7
Franchise & Property Expenses	$ 454.1	$ 477.6	$ 104.2	$ 126.4	$ 134.8	$ 138.1	$ 503.5	$ 521.0
SG&A	$ 318.6	$ 415.5	$ 110.8	$ 99.9	$ 106.6	$ 109.2	$ 426.5	$ 404.0
Other Operating Expenses	$ (20.9)	$ 96.8	$ (1.6)	$ (1.6)	$ (1.6)	$ (1.6)	$ (6.4)	$ (6.4)
Operating Income	**$ 1,666.70**	**$ 1,735.9**	**$ 611.3**	**$ 497.6**	**$ 530.6**	**$ 543.4**	**$ 2,183.0**	**$ 2,350.8**
Net Interest Expense	$ 466.9	$ 512.2	$ 140.6	$ 140.6	$ 140.6	$ 140.6	$ 562.4	$ 562.4
Other Non-Operating Expense	$ -	$ 122.0	$ -	$ -	$ -	$ -	$ -	$ -
EBT	**$ 1,199.8**	**$ 1,101.7**	**$ 470.7**	**$ 357.0**	**$ 390.0**	**$ 402.8**	**$ 1,620.6**	**$ 1,788.4**
Taxes	$ 243.9	$ (133.6)	$ 3.8	$ 72.6	$ 79.3	$ 81.9	$ 237.6	$ 363.6
Minority Interest	$ 340.3	$ 586.5	$ 133.9	$ 101.3	$ 110.6	$ 114.3	$ 460.0	$ 507.3
Preferred Dividends	$ 270.0	$ 22.7	$ -	$ -	$ -	$ -	$ -	$ -
Net Income	**$ 345.6**	**$ 626.1**	**$ 333.0**	**$ 183.2**	**$ 200.1**	**$ 206.7**	**$ 923.0**	**$ 917.6**
EBITDA Reconciliation								
Net Income	$ 345.6	$ 626.1	$ 333.0	$ 183.2	$ 200.1	$ 206.7	$ 923.0	$ 917.6
(+) Minority Interest	$ 340.3	$ 586.5	$ 133.9	$ 101.3	$ 110.6	$ 114.3	$ 460.0	$ 507.3
(+) Net Interest Expense	$ 466.9	$ 512.2	$ 140.6	$ 140.6	$ 140.6	$ 140.6	$ 562.4	$ 562.4
(+) Taxes	$ 243.9	$ (133.6)	$ 3.8	$ 72.6	$ 79.3	$ 81.9	$ 237.6	$ 363.6
Operating Income	$ 1,396.7	$ 1,591.2	$ 611.3	$ 497.6	$ 530.6	$ 543.4	$ 2,183.0	$ 2,350.8
(+) D&A	$ 172.1	$ 181.1	$ 47.0	$ 47.0	$ 47.0	$ 47.0	$ 188.0	$ 188.0
EBITDA	$ 1,568.8	$ 1,772.3	$ 658.3	$ 544.6	$ 577.6	$ 590.4	$ 2,371.0	$ 2,538.8
(+) Other 1x Costs	$ 7.7	$ 217.3	$ 28.2	$ -	$ -	$ -	$ 28.2	$ -
Adjusted EBITDA	**$ 1,576.5**	**$ 1,989.6**	**$ 686.5**	**$ 544.6**	**$ 577.6**	**$ 590.4**	**$ 2,399.2**	**$ 2,538.8**
Free Cash Flow								
Adjusted EBITDA	$ 1,576.5	$ 1,989.6	$ 686.5	$ 544.6	$ 577.6	$ 590.4	$ 2,399.2	$ 2,538.8
Capex	$ 3.7	$ 10.6	$ 5.4	$ 9.7	$ 8.4	$ 10.5	$ 34.0	$ 42.5
Cash Interest	$ 466.9	$ 512.2	$ 140.6	$ 140.6	$ 140.6	$ 140.6	$ 562.4	$ 562.4
Adjusted Cash Tax	$ 243.9	$ (133.6)	$ 3.8	$ 72.6	$ 79.3	$ 81.9	$ 237.6	$ 363.6
Gross FCF	$ 1,132.0	$ 1,099.9	$ 354.7	$ 321.8	$ 349.4	$ 357.4	$ 1,565.3	$ 1,570.3
Working Capital	$ 8.1	$ 353.8	$ (446.0)	$ 161.9	$ 161.9	$ 161.9	$ 39.6	$ 37.6
Net FCF	**$ 1,140.1**	**$ 1,453.7**	**$ (91.3)**	**$ 483.7**	**$ 511.2**	**$ 519.3**	**$ 1,604.9**	**$ 1,608.0**
Credit Metrics								
Debt/EBITDA	4.74x	6.32x					5.04x	4.77x
EBITDA/Interest	3.90x	3.56x					4.27x	4.51x

Model Commentary

In accordance with growth rates experienced in FY16 & 17, we expect a significant $400+ million EBITDA expansion for 2018. This is largely attributed to the international growth of the Burger King segment, in which MFIF estimates the brand will grow at a 6.5% clip. Although Tim Hortons comparable sales have lagged, the net growth of the segment should increase by 2%. This reflects RBI's introduction of TH to the Asia markets and a partial rebound of comparable sales as the company plans on revamping their Canadian locations. For the PLK segment, MFIF expects mid-single growth for the brand, which also is conservative relative to KFC's double-digit growth in 2017.