November 2021

Winners in the Wage Rate Bombogenesis

Once wages go up, they won't go down

Among the most boring things we could imagine discussing, inflation is at the top of the list. It's kind of like getting into a debate about global plate tectonics. You know it's happening, but you don't care and it's unlikely you'll change your behavior as a result.

Despite it being inherently dull, there is currently a debate about inflation. There is one group, primarily consisting of Jerome Powell, Chairman of the Federal Reserve, and a few people who work for the government, who think inflation is transitory. Then there is the other group, which is essentially everyone else who bothers to have an opinion, who believe Chairman Powell and his group are hopelessly naïve. This second group, of which you probably guessed we are members, think prices are going to remain elevated and even will go higher. What research makes us think this? Everyday we talk to consumer companies that are telling us they are raising prices and have more price hikes planned. That's it.

Why do companies want to raise prices? Simple. Costs are up. Here are the three factors driving operating costs higher. There is the supply chain mess. There are not enough shipping containers, not enough port workers and not enough truck drivers. On top of the shortages, Covid19 protocols are slowing everything down. There are commodity price increases. Oil, steel, wheat, coffee, beef, and other things (most things) are seeing prices go up. This is probably best explained by demand outstripping production. There is labor rate pressure (in the U.S.). There are not enough workers, esp. in the service and hospitality industries, to fill current openings. Retailers, restaurant operators and others are offering signing bonuses and raising wages to attract employees from competitors.

What do you do when your operating costs go up? Pass on the cost increases to customers. A Chipotle burrito will cost you 14% more on average this holiday than two years ago. A bag of fertilizer from Scott's Miracle Grow cost 5% more in August than July and prices are going up again for the same bag in January. If Starbucks wants to pay its baristas more than $20 an hour, on average in 2022, you can bet your daily brew is going to set you back more than it did a year ago.

Can you identify the transitory element of this upward cost and price spiral? The supply chain tie-up will eventually unwind. Commodity prices could go down (but they go up more as well). Some of these items we can't predict. We do feel very confident, however, in asserting that labor cost increases will not reverse. No company wants to be known as the business putting profits before people in this new ESG-focused social-media-shaming world. Bottom-line, if labor costs stay higher, companies won't be able to back down on price. So far, consumers have accepted the higher prices, which is further reinforcing the new cost and price structure. Dear Chairman Powell, please stop with the transitory talk. It's embarrassing.

Framework for Investing with Rising Prices and Wages

Inflation is supposed to be very scary for investors, but we believe there's a way to position to benefit from it. We're going to avoid a longer discussion of interest rates, the economic cycle and risk management and just get to the point: What characterizes stocks that are attractive to own now, based on what we know about wages and prices? Ideally, a business that has pricing power for its goods or services (customers will pay up, rather than substituting an inferior good or just putting off the purchase altogether) *AND* is not as exposed to structural labor cost increases.

The Franchised Business Model

Allegedly started in the U.S. by Benjamin Franklin, who was importing a model from medieval Europe that may have even started in ancient China, a franchised business is one where the parent (the franchisor) grants the right to use its trademarks and operating practices to an independent partner (the franchisee). The franchisee typically puts up its own capital and the franchisor agrees to provide some systems and services (sometimes including marketing and advertising). In consideration for the use of the brand and other services provided, the franchisee pays the parent a fee or royalty, typically 3% to 6% of revenues.

As investors, we already liked the highly-franchised business model before the wage rate bombogenesis began. That is, we want to own the parent, not the independent operator. Its key attractiveness is found in the operational leverage created – *using someone else's capital* – namely the capital of the franchisee – to grow the business. Within our client portfolio, we have owned two businesses with this model for some time. We've been long shares of Domino's Pizza (DZA) since inception. We added shares of fitness club operator, Planet Fitness (PLNT) during the Corona-panic, when people were fearful that no one would ever again leave their homes or step on a treadmill of dubious cleanliness.

The Franchised Business Model & Inflation

The parent benefits from prices going up but doesn't own the labor cost. Genius! As we mentioned above, the franchisor usually earns a *fixed percentage* of revenues generated by the franchisee. Ergo, as the franchisees take up prices to combat increase costs across various parts of their businesses, the corporate parent's revenue rises. Meanwhile, the franchisee partner "owns" the labor, so this cost is borne outside the parent. Let us repeat. Rising prices benefit the corporate parent's revenue while the expenses hit the partner.

New Name in Client Portfolios: Driven Brands (DRVN)*

A long-term compounder that hasn't been widely examined. Driven Brands is a $5B market cap operator and franchisor of aftermarket automotive services in four segments, maintenance, repair, car wash, and parts. The company's brands include Meineke, Take 5, Maaco, CARSTAR, Car Wash USA Express and others. If you live in the U.S. you probably recognize these brands but you may not have heard of the corporate parent or the stock, as it has been a public company for less than a year. This is not to say that it is a new company. Several of DRVN's brands have been in existence for decades and the company's 5,200 locations did $3.4B in system-wide sales last year.

So, why do we like it? Three main reasons. First, we like the business model for the reasons we just outlined above. The store network is 82% franchised, which enables high profit margins (25% EBITDA margin), high returns on capital, and strong cash flows. The franchisor model positions DRVN to benefit from inflation in prices (it earns a royalty off revenues) with less direct exposure to labor cost pressure (the franchisee partners are responsible for this). Second, we like the growth and growth opportunity. The company has nearly doubled its store count, experienced a 40% CAGR (compound annual growth rate) in revenues and a 38% CAGR in adjusted EBITDA (profits) over the past five years. Looking forward, the company believes it can achieve at least $850M in EBITDA by 2026 using a 2021 EBITDA target of $350M as a base. We recently spoke with the company and believe there is upside to both the 2021 base and to the assumptions used in crafting the 2026 target. This brings us to the third reason we like the stock, which is the price today. At $32, the stock may not strike you as exceptionally cheap as it currently trades at a P/E of 29x and EV/ EBITDA of 17x compared to consensus fiscal 2023 forecasts. However, this is a discount or similar to the multiples the market is paying for other highly-franchised peers. (For example, Domino's trades at a P/E 29x vs. 2023 and Planet Fitness is currently at 44x.) We also believe there are temporary factors that have held back the stock (short history as a public company, overhang from likely stock offerings from the private-equity sponsor, not fitting neatly in a "sector" covered by many analysts).

Assuming DRVN can achieve $850M to $900M in EBITDA by 2026, consistent with its outlook, shares could be worth $90 to $96, essentially offering a triple over five years. We see this as a very favorable outcome and fits within our strategy to focus on long-term compounders (rather than trading gains).

Figure 1: Driven Brands Holdings, Inc. (DRVN) one-year chart. This company went public less than a year-ago and we believe it is relatively unknown by investors.

*We have another idea, recently added to the portfolio, that is even more exciting and a great play on wage rate inflation, but we'll keep that for another letter. Contact us if you just have to know now. We might tell you about it.

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Yours,

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York, NY and Paris, France or wherever he has his laptop.

Recent trips to Cyprus, NYC and Long Island, eyeing San Francisco for early December. In October, I traveled to the Eastern Mediterranean to Cyprus to give a presentation at the Cyprus Value Investing Conference, extend summer a bit and practice my Greek (mia akomi bira parakalo!). My presentation deck was on Foot Locker, which you can find here. Later in the month, I had a meeting (those are happening again) in New York with the CEO and CFO of Lovesac (LOVE) to test out LOVE's new "stealth" surround sound speaker system that is integrated directly into their modular couches (Sactionals). I will definitely need that for the next lockdown. A sedentary November is currently on the agenda but in early December San Francisco is calling me and it's been too long!

Midtown East, NYC: They keep loading up 57th Street with these impossibly tall and thin, tapering skyscrapers. After having worked in the World Trade Center for three years (but leaving before 9/11), I think I will stay closer to the ground.

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The analyst who is the author of this report has positions in Domino's Pizza (DPZ), Planet Fitness (PLNT), Driven Brands (DRVN). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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