“Size truly matters…”

- Stanley Ma

Sohn London

November 14, 2019

Jacob Liu
jacob.liu@rotman.utoronto.ca

Source: 2017 Shareholder Letter

Investment Thesis

MTY Food Group
TSE: MTY

Market Cap
$1,351.6 CAD Million

Days to Cover
1.9

Analyst Buy/Hold/Sell
2/5/0

Current Price / Consensus TP
53.70 / 63.43 (+18% upside)

The Bull Thesis

- *"The **King of the Food Court**…They have shown that they have a competitive advantage when buying and integrating new fast food brands."*

  Jeff Mo, PM Mawer, December 22, 2018

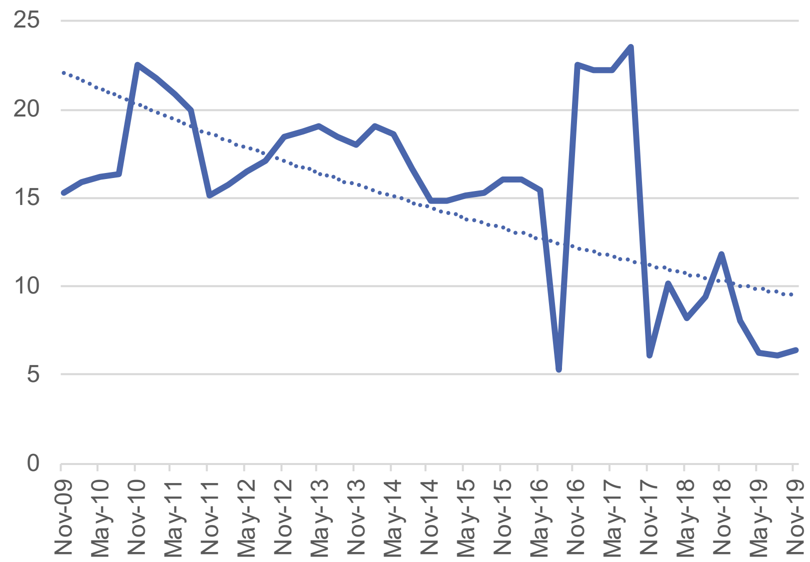
- *"[InterContinental Hotel] can be **asset-light**, they can focus mostly on the value of their brand, and they collect this **steady stream of revenues through royalties**… it's an attractive business model… I think about some of the **quick food service companies** that we own in our Canadian Small Cap portfolio"*

  – Rob Campbell, PM Mawer, Feb 20, 2019

Source: Bloomberg, National Post, Mawer Podcast

Investment Thesis

MTY ROIC 6.4% (Nov. 2019)



My Own View

Bulls are overlooking the fact that:

- **i) deteriorating unit economics at the franchisee-level poses a great threat to the sustainability of future royalty streams;**
- **ii) the asset-light business model may not be asset-light anymore when the franchisor needs to invest capital into its struggling franchisees and acquire new restaurants to maintain flat SSS; and**
- **iii) accounting-driven roll-up strategy masks worsening fundamentals.**

Source: Bloomberg

MTY Overview

Business Description

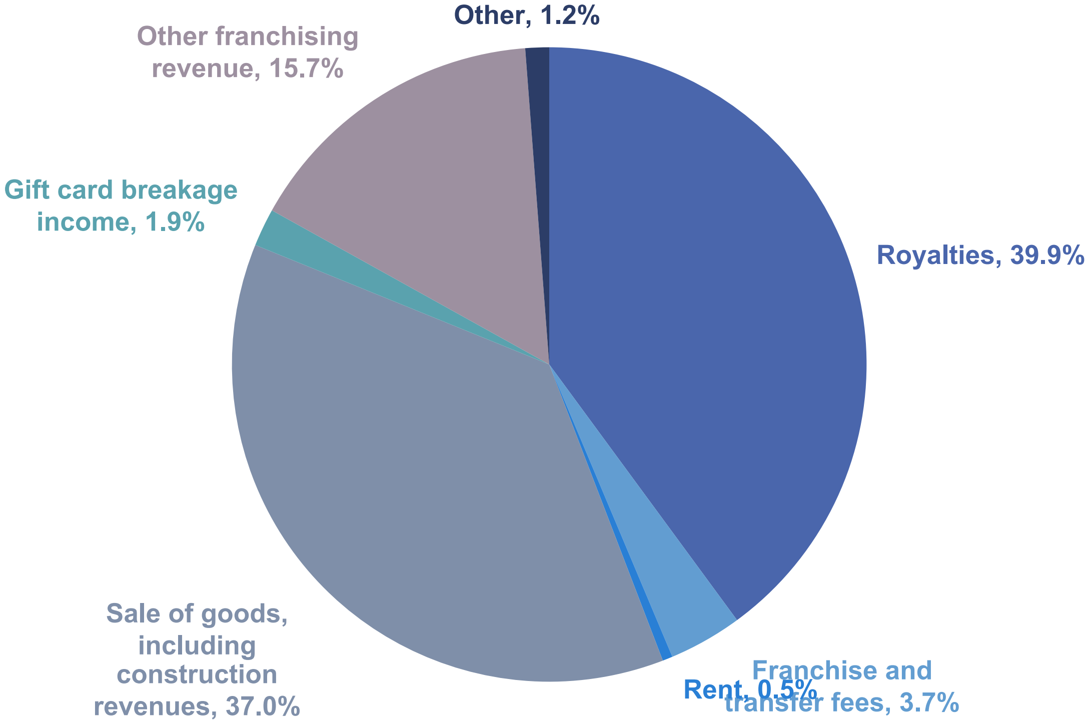
- MTY Food Group (the “Company”, “MTY”) is a North American franchisor in the quick service and casual dining food industry. The Company also operates a distribution center and food processing plant in Quebec.
- MTY competes in two major geographic segments: i) the Canadian operations and ii) the U.S. & International operations.
- Its main sources of revenue are royalties, franchise fees, sales of services and materials to franchisees, and other franchising revenues.
- As part of the Papa Murphy’s acquisition, MTY’s network now has 7,441 locations (98% franchised vs. 2% corporate) and pro forma $4 billion system sales globally.
- MTY’s current market share in North America remains under 1%. As of 3Q19, 55% of MTY’s locations are based in the U.S. vs. 44% in 3Q18; 38% of its locations are based in Canada vs. 47% in 3Q18. Globally, MTY’s international locations remains steady with 7% vs. 9% in 3Q18.

Source: Company filings

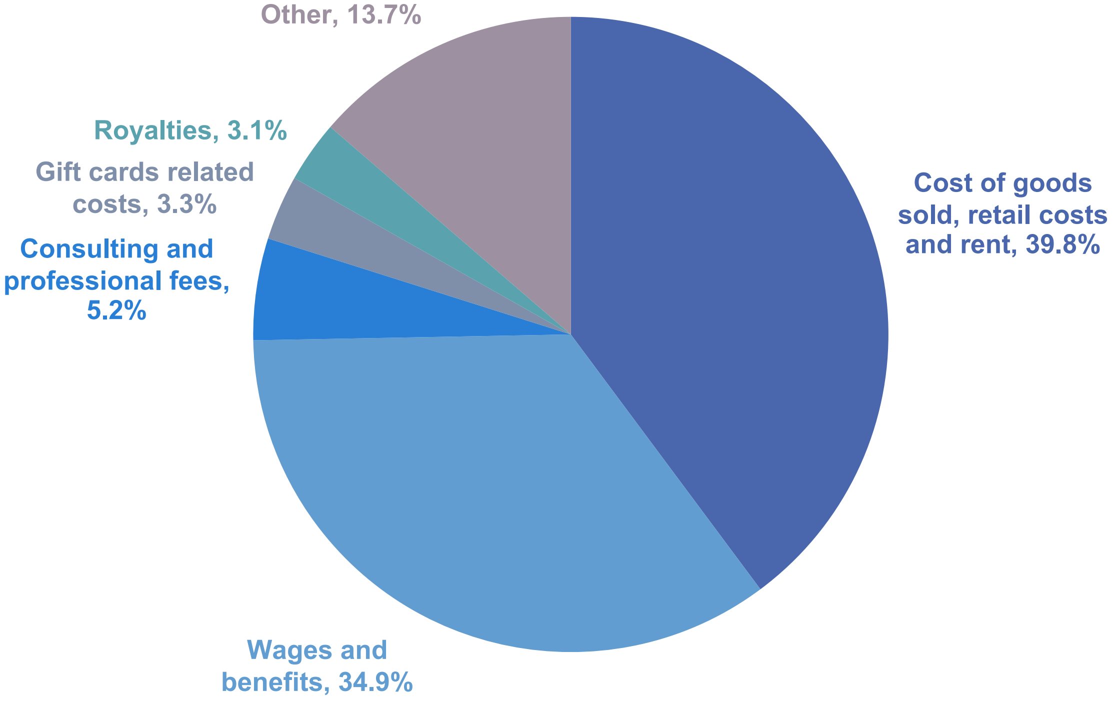
MTY Overview

Revenue and OpEx Breakdown

Revenue



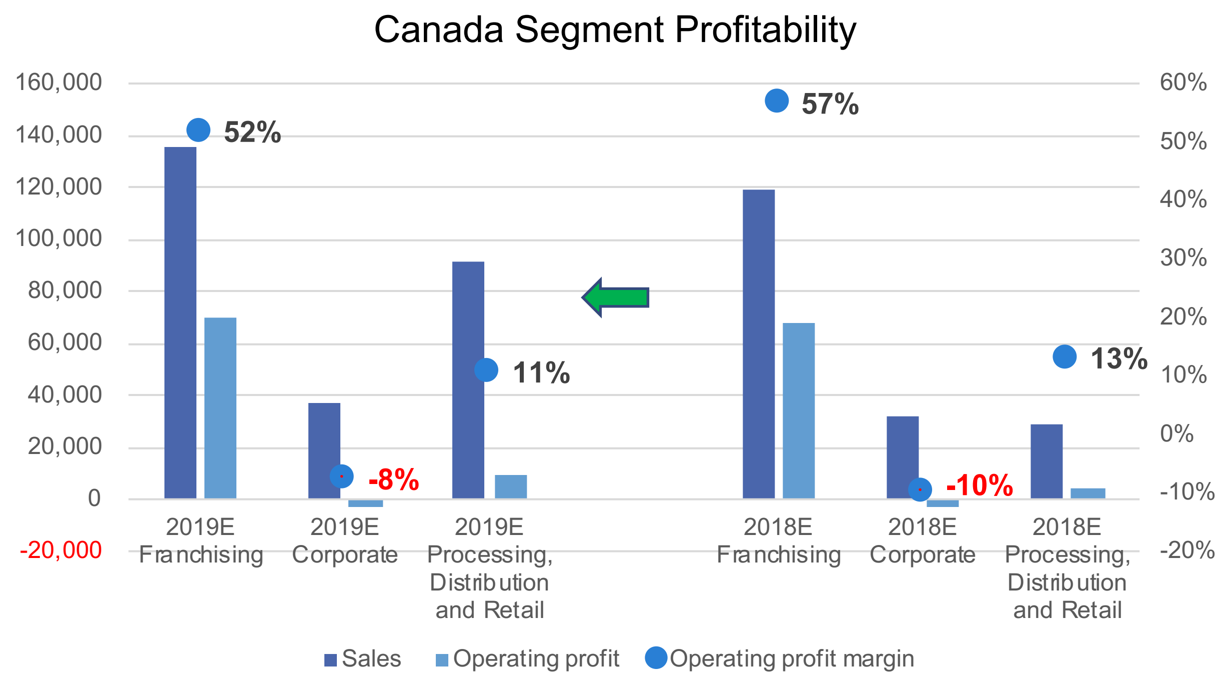
OpEx

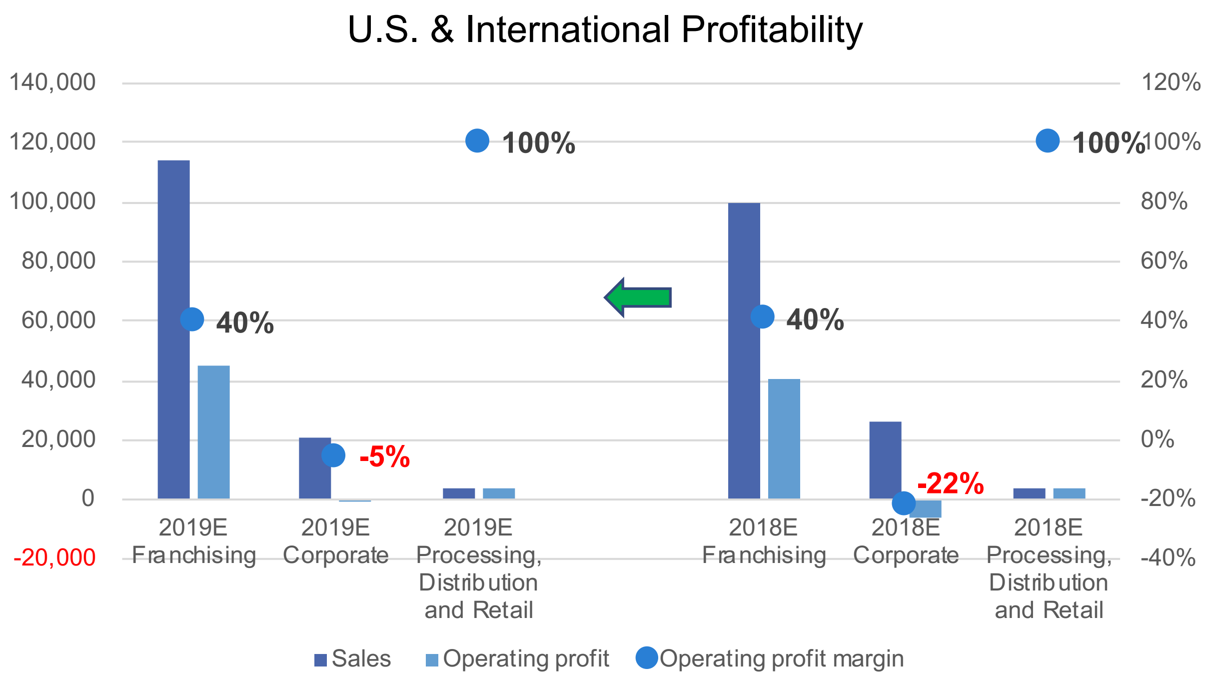


Source: Company filings

MTY Overview

Segment Breakdown





Source: Company filings, estimates based on annualized 6-month 2Q19 and 2Q18 segment information, excluding interco and promotional funds

MTY Business Analysis

Growth-by-acquisition in a no-growth business

- For the past three years, excluding acquisitions, MTY grew organic revenues in the low-single digit range in Canada and flat/negative in the U.S. and international regions.
- Note that the growth in revenues in Canada was largely driven by a ~6-7% price-increase. In 2018, SSS was flat/negative, **implying traffic was down materially**.

MTY Franchise operations - CAD $ in mil

Canada revenue analysis:		*growth %*	**USA & Int'l revenue analysis:**		*growth %*
Revenues, 2015 fiscal year	**104.0**		**Revenues, 2015 fiscal year**	**4.3**	
Organic - recurring	**0.7**	***0.7%***			
Initial franchise/renewal fees	1.5	*1.4%*	In FY16, MTY benefited from the		
Turnkey, sales of material, rent	1.3	*1.3%*	impact of the acquisitions of Kahala		
Other	-0.2	*-0.2%*	Brands and BF Acquisition Holdings		
Revenues, 2016 fiscal year	**107.3**	*3.2%*	**Revenues, 2016 fiscal year**	**40.7**	*847%*
Organic - recurring	**3.6**	***3.4%***			
Initial franchise/renewal fees	-1.1	*-1.0%*	In FY17, MTY benefited from the		
Turnkey, sales of material, rent	-4.1	*-3.8%*	impact of the acquisitions of Kahala		
Other	2.2	*2.1%*	Brands and BF Acquisition Holdings		
Revenues, 2017 fiscal year	**107.9**	*0.6%*	**Revenues, 2017 fiscal year**	**107.7**	*165%*
Organic - recurring	**6.7**	***6.2%***	**Organic - recurring**	**-0.8**	***-1%***
Inorganic - acquisitions	58.1	*53.8%*	Inorganic - acquisitions	7.4	*7%*
Other	-3.6	*-3.3%*	Other	-0.9	*-1%*
Revenues, 2018 fiscal year	**169.1**	*56.7%*	**Revenues, 2018 fiscal year**	**113.4**	*5%*

Source: Company filings, own analysis

MTY Business Analysis

Same-Store Sales Vs. Change in Revenue per Store

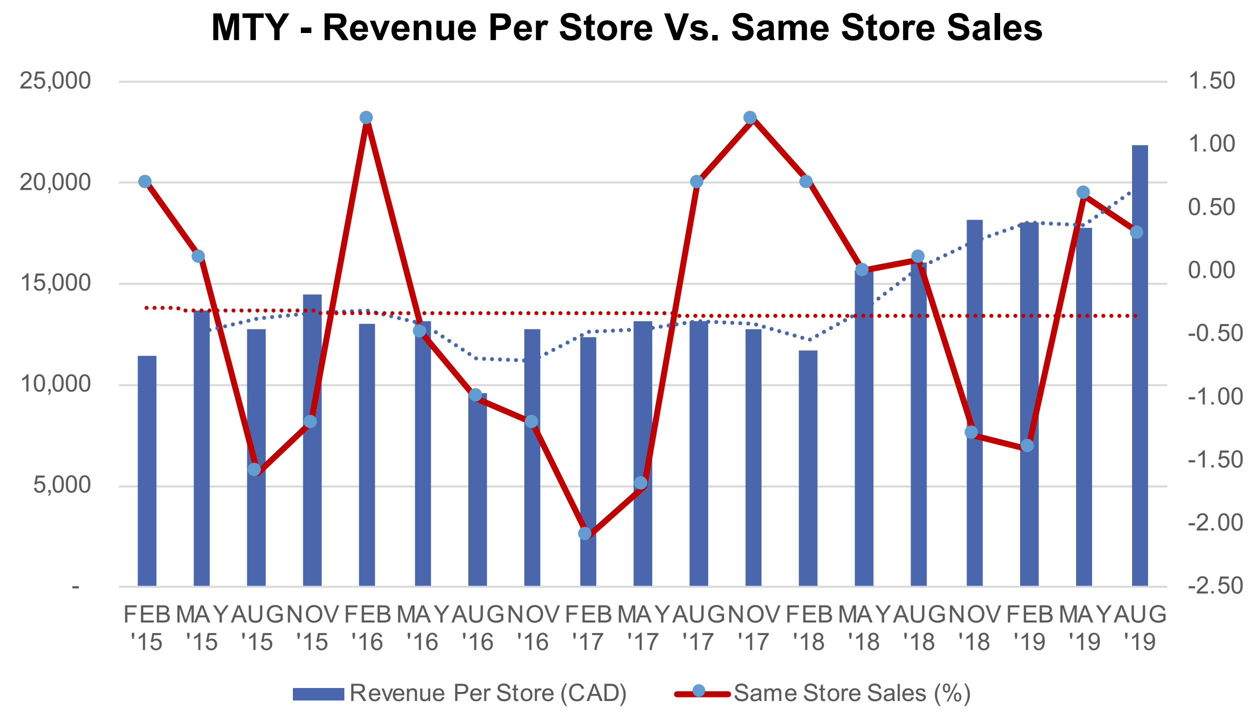
- Generally, when a retail/restaurant company is experiencing consistent top-line revenue growth, its same-store sales should be rising with average revenue at each location.
- However, there is a **divergence** between MTY's SSS and average revenue per store since Feb. 2018. This difference is largely driven by **increasing unit counts**.
- While new franchisees are contributing positively to revenue per store instantly after acquisitions, they tend to **perform poorly on a like-for-like basis** after being acquired by MTY.

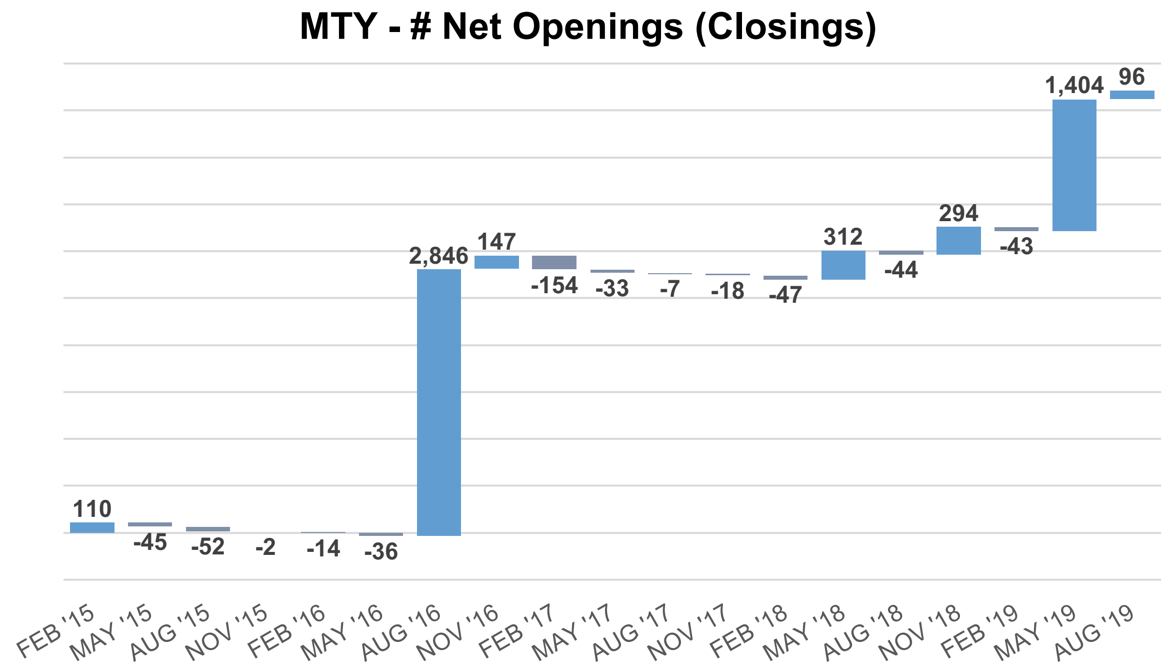
- For instance, MTY acquired 2,846 stores in Aug. 2016 (Kahala Brands). After 13 months in Aug. 2017, they are being included in the SSS universe.
- Starting from Nov. 2017, SSS dropped from positive 1.2% to negative 1.4% in Feb. 2019. In a 2% inflationary environment, this signifies the declining performance of acquired franchisees.
- Given industry traffic headwinds and consistent franchisee store closings, **I expected SSS to remain flat/negative going forward**.

Source: FactSet, own analysis

MTY Business Analysis

Same-Store Sales Vs. Change in Revenue per Store





Source: FactSet, own analysis

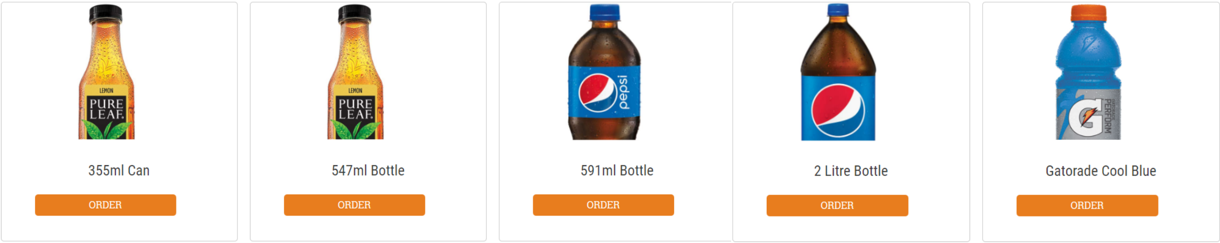
Papa Murphy's - Franchisor Analysis

Competes with…

- Regional and local pizza restaurants
- National chains
- Limited Service Restaurants (LSRs)
- Supermarkets that sell frozen take-home pizzas
- Pizzerias with sit-down/take-out options
- Delivery food services

Overview

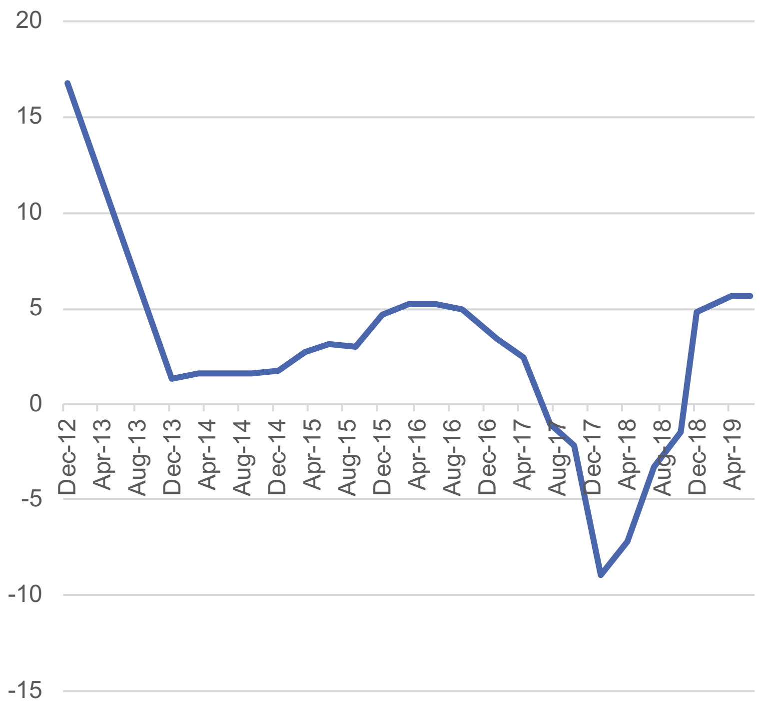
- With $809 million system-wide sales in fiscal 2018, Papa Murphy's is the 5th largest pizza chain in the U.S. as measured by system-wide sales and total number of stores.
- The QSR pizza market, a subset of the overall pizza category, was about $37 billion in 2018. The top five pizza chains accounted for approximately ~50% of QSR pizza restaurant sales.
- As a take-and-bake concept, Papa Murphy's only offers limited drink options online.



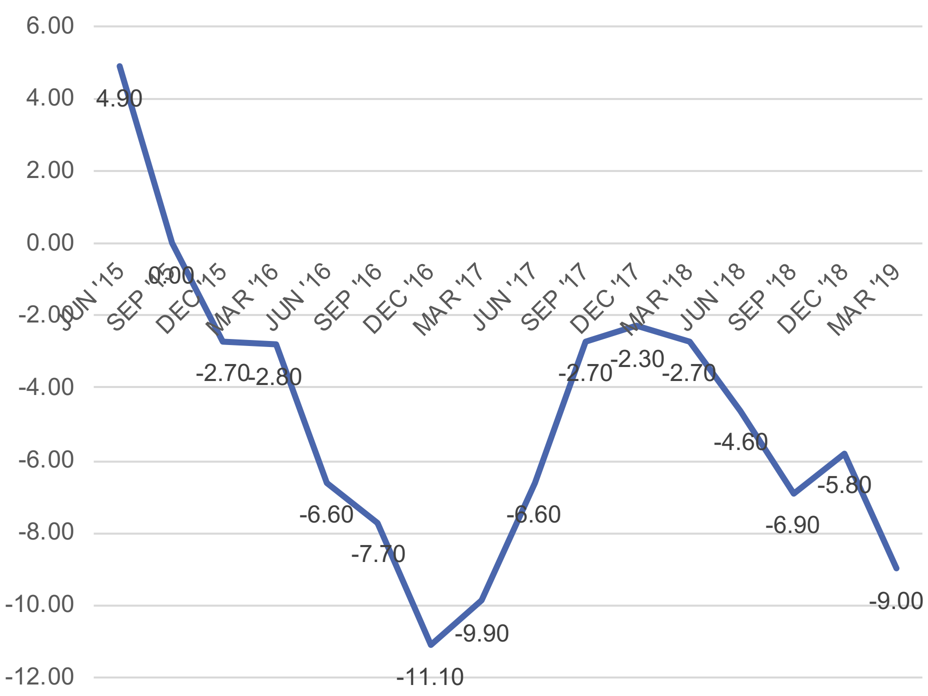
Source: Company filings, Papa Murphy's website

Papa Murphy’s - Franchisor Analysis

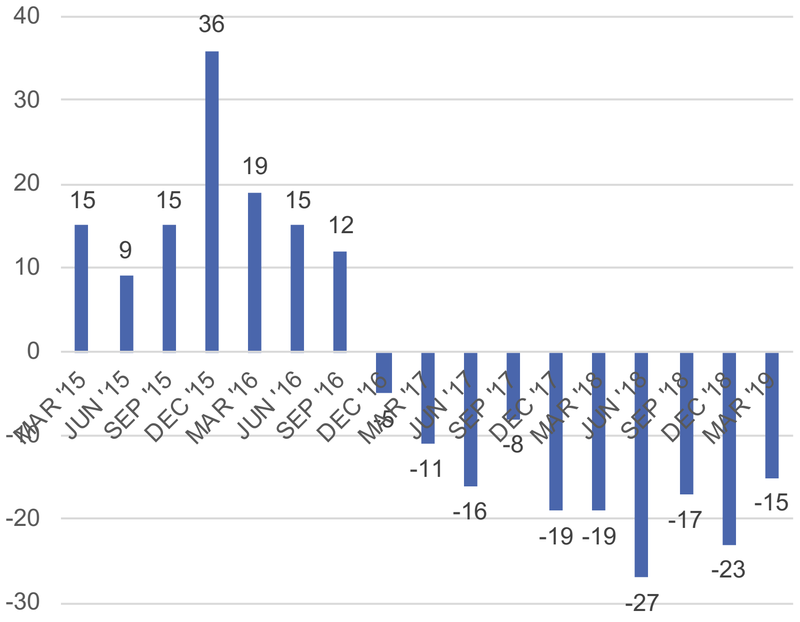
ROIC – 5.6% (June, 2019)



Same Store Sales (%)



Net Openings/Closings



Declining ROIC below cost of capital…

Consecutive negative SSS% for 14 Qs…

Consecutive net store closings for 10 Qs…

Source: Bloomberg, FactSet

Papa Murphy’s - Franchisor Analysis

Executive Departures…

- Mark Hutchens, EVP and COO, departed and joined Service King Collision Repair Centers as the CFO in 2019
- Richard Key, DVP, joined Tropical Smoothie Café in October 2018 as the SVP of Operations.

Lackluster financial and operating performance

- In the midst of its turnaround plan, Papa Murphy’s has embarked on a **refranchising strategy** given that management is being compensated based on EBITDA and Refranchising metrics.
- Generally, franchisors are far more likely to refranchise restaurants when their own company-owned operations are struggling. For instance, in 2018, Papa Murphy’s sold 20 company-owned stores in Colorado and 9 company-owned stores in Texas to franchisees, sending a bearish signal. Typically, franchisors choose to refranchise because they do not have a better alternative.
- In my view, MTY overpaid for a struggling pizza chain at 8.5x EV/EBITDA (~32% premium). As an independent company, **Papa Murphy’s had a 0.87 Altman Z-Score as of LTM 1Q19 (04/01/2019), exhibiting a high probability of going into bankruptcy within two years**.
- As a majority of restaurant franchisees are under pressure to expand or remodel, **I expect Papa Murphy’s may have to waive certain royalty fees and offer CapEx spending assistance in the future**.

Source: Company filings, Capital IQ, LinkedIn

Papa Murphy's – 4-Wall Unit Economic Analysis

Fiscal 2018 - $ in USD	High	Medium	Low
Number of Stores	**466**	**465**	**466**
1,283 franchisees, 114 corporate stores (92% vs. 8%)			
Average Net Sales by Category - System Stores	**865,311**	**505,086**	**311,497**
Average COGS	31.8%	32.5%	33.4%
Average Employee Labor	17.6%	18.3%	20.2%
Average Management	4.4%	5.4%	5.3%
Average Payroll Taxes	2.4%	2.4%	2.6%
Average Advertising	7.5%	8.8%	9.1%
Average Rent & CAM	4.4%	6.5%	9.8%
Average Other Store Expenses	8.0%	9.6%	11.7%
Average Royalties	5.0%	5.0%	5.0%
Average Store Contribution - Benchmark	**18.9%**	**11.5%**	**2.9%**
Above are represented as a % of Net Sales	100%	100%	100%

Cash-on-cash Return Analysis - $ in USD	High	Medium	Low
Initial Investment	**517,029**	**398,662**	**280,295**
Average Store Contribution	163,544	58,085	9,033
CapEx - Remodeling costs	70,000	50,000	30,000
General and administrative costs	6,400	6,200	6,000
Pre-tax and financing profit	**87,144**	**1,885**	**-26,967**
Pre-tax and financing returns	16.9%	0.5%	-9.6%
Equal-weighted Probability	33.3%	33.3%	33.3%
Cash-on-cash return, estimate (Pre-tax and financing)		**2.6%**	

Source: Franchise Disclosure Document, company filings, own analysis

- I believe a typical Papa Murphy Franchisee's cash-on-cash return profile may be lower than what the street is expecting, **averaging only 2.6% pre-tax and interests**.
- Note that according to 28 franchisee groups' lawsuits filed against Papa Murphy's (Case No. 14-2-00904-0), franchisees alleged that Papa Murphy's misrepresented its sales volumes in its franchise disclosure document and made other false representations to franchisees and understated the amount that franchisees in their region would have to spend on local marketing.
- As such, **I expect the true average return figure could even be lower than the equal-weighted return**.

Papa Murphy's – 4-Wall Unit Economic Analysis

Papa Murphy's - Summary of Brand Marketing Fund Contributions and Expenses
12/31/2018
$ in USD

Revenue and Other Sources		
Advertising fees	15,815,813	70%
Vendor payments	3,907,380	17%
Marketing kits	1,542,157	7%
Other revenues	1,244,096	6%
Total Revenues & Other Sources	**22,509,446**	
Fund balance (deficit) carryover from 2017	-5,460,883	
Total Funds Available	**17,118,559**	
Expenses		
Media placement, digital media, and kits	10,053,069	45%
Production, Research, Agency and Studio	6,130,599	27%
Field marketing support and product development	3,212,516	14%
Administrative support, facilities, and taxes	3,144,969	14%
Total Expenses	**22,541,153**	100%
Excess expenses over funds available (fund deficit)	-5,422,594	

- On top of franchisees' lackluster unit economics, MTY may continue to direct franchisees to **contribute cash to the marketing fund** and **execute a ~15% discount promotional strategy** to drive store sales. In light of rising labor costs, this strategy **may benefit franchisees' sales and MTY's royalties at the expense of franchisees' profitability**.

1Q19 Conference Call:

"...probably some capital investments as well. There is a need in various areas of the business to make sure that the stores are up to date, refreshed, and that the right technologies in place in the stores."

[Hint: Remodeling CapEx]

- Eric Lefebvre, CEO

Source: Franchise Disclosure Document

Accounting Red Flags

#1 Elevated Loans Receivable Allowance and Understated A/R Allowance

($ in CAD - thousands)	2014	2015	2016	2017	2018	1Q'19	2Q'19	3Q'19
Loans receivable, net - Current	181	240	3,138	2,817	2,134	1,382	2,315	2,204
Loans receivable, net - Long-term	505	217	4,866	3,109	5,970	5,775	5,637	5,415
Loans receivable, net - Total	686	457	8,004	5,926	8,104	7,157	7,952	7,619
Allowance for doubtful accounts	9	11	900	1,182	2,928			
Loans receivable, gross	695	468	8,904	7,108	11,032		No quarterly disclosure	
Allowance %	**1.3%**	**2.4%**	**10.1%**	**16.6%**	**26.5%**			
Accounts receivable, net	16,809	18,734	36,106	34,151	49,168	49,095	55,267	60,363
Allowance for doubtful accounts	4,305	5,388	8,007	9,611	9,320	8,792	7,846	8,805
Accounts receivable, gross	21,114	24,122	44,113	43,762	58,488	57,887	63,113	69,168
Allowance %	**20.4%**	**22.3%**	**18.2%**	**22.0%**	**15.9%**	**15.2%**	**12.4%**	**12.7%**
Revenue	115,177	145,203	191,275	276,083	353,303	396,880	408,332	458,383
DSO, net - Loans Receivable	2.2	1.1	15.3	7.8	8.4	6.6	7.1	6.1
DSO, net - Accounts Receivable	53.3	47.1	68.9	45.1	50.8	45.2	49.4	48.1
Total DSO, net - Receivable	**55.4**	**48.2**	**84.2**	**53.0**	**59.2**	**51.7**	**56.5**	**54.1**

- MTY's rising loans receivable allowance suggests that **MTY has been very aggressive in terms of making various advances to franchisees**. MTY's loans receivable typically bears an interest up to 9% annually.

- I believe a large portion of these potential collections **may not materialize** in the future and may **hurt earnings** going forward.

Source: Company filings, own analysis

Accounting Red Flags

#1 Elevated Loans Receivable Allowance and Understated A/R Allowance

($ in CAD - thousands)	2014	2015	2016	2017	2018	1Q'19	2Q'19	3Q'19
Loans receivable, net - Current	181	240	3,138	2,817	2,134	1,382	2,315	2,204
Loans receivable, net - Long-term	505	217	4,866	3,109	5,970	5,775	5,637	5,415
Loans receivable, net - Total	686	457	8,004	5,926	8,104	7,157	7,952	7,619
Allowance for doubtful accounts	9	11	900	1,182	2,928			
Loans receivable, gross	695	468	8,904	7,108	11,032		No quarterly disclosure	
Allowance %	**1.3%**	**2.4%**	**10.1%**	**16.6%**	**26.5%**			
Accounts receivable, net	16,809	18,734	36,106	34,151	49,168	49,095	55,267	60,363
Allowance for doubtful accounts	4,305	5,388	8,007	9,611	9,320	8,792	7,846	8,805
Accounts receivable, gross	21,114	24,122	44,113	43,762	58,488	57,887	63,113	69,168
Allowance %	**20.4%**	**22.3%**	**18.2%**	**22.0%**	**15.9%**	**15.2%**	**12.4%**	**12.7%**
Revenue	115,177	145,203	191,275	276,083	353,303	396,880	408,332	458,383
DSO, net - Loans Receivable	2.2	1.1	15.3	7.8	8.4	6.6	7.1	6.1
DSO, net - Accounts Receivable	53.3	47.1	68.9	45.1	50.8	45.2	49.4	48.1
Total DSO, net - Receivable	**55.4**	**48.2**	**84.2**	**53.0**	**59.2**	**51.7**	**56.5**	**54.1**

- Expected loss rate suddenly decreased from **55.6%** in 1Q19 to **44.7%** in 2Q19 then to **42.2%** in 3Q19 when the 61 days plus accounts receivable subcategory balance increased from **$13.4 million** (1Q19) to **$14.5 million** (2Q19) then to **$17.0 million** (3Q19)
- Had allowance percentage remained at the historical 4-year average of 21% (2014-2017), operating income would have been **$2.8 million lower** in fiscal 2018, **$3.2 million lower** as of TTM 1Q19, **$5.2 million lower** as of TTM 2Q19, and **$5.5 million lower** as of LTM 3Q19.

Source: Company filings, own analysis

Accounting Red Flags

#2 Stretched Payables – Boosting Cash Flow Metrics

($ in CAD - thousands)	2014	2015	2016	2017	2018	1Q'19	2Q'19	3Q'19
Accounts payable and accrued liabilities	14,151	24,361	48,808	57,555	68,700	66,960	90,937	88,851
Operating expenses	72,518	94,521	125,650	182,357	225,560	260,678	271,166	318,129
DSP	**71**	**94**	**142**	**115**	**111**	**94**	**122**	**102**

- It is also worth noting that MTY's DSP metric has been **elevated** over the years. Spikes in DSP are largely driven by inheriting working capitals through acquisitions.
- It begs the question how sustainable is this trend; and when DSP will return to the previous normalized level in the 60s – 70s range.

Source: Company filings

Accounting Red Flags

#3.1 Stub-Period Spring-Loading – Papa Murphy's Acquisition

- I believe that MTY may have engaged in **spring-loading during the stub-period** to make the target company look worse than it is.
- In short, Papa Murphy's net tangible equity dropped by **-11%** within 2 months and dropped by another **-16%** during 3Q19.
- Post-acquisition, the combined company's **growth**, **profitability**, and **cash flows** are stronger than would otherwise be the case.

Source: Company filings, Bloomberg, own analysis, "Spring-loading when no one is looking? Earnings and cash flow management around acquisition" F. Zhang, S. Chen, and J. Thomas

Acquisition of Papa Murphy's (FRSH)
(in thousands of CAD)

Annoucement date: 04/11/2019 **Acquisition date: 05/23/2019**	**FRSH Balance Sheet 4Q 18 12/31/2018**	Interim % Δ	**FRSH Balance Sheet 1Q 19 04/01/2019**	Interim % Δ	**MTY - FRSG Initial PPA 2Q 19 05/31/2019**	Interim % Δ	**MTY - FRSG Initial PPA 3Q 19 08/31/2019**
Cash	7,860	*-94%*	488	*1255%*	6,617	*-63%*	2,435
Accounts receivable	4,858	*-23%*	3,723	*4%*	3,873	*0%*	3,873
Inventory	748	*-2%*	730	*64%*	1,195	*0%*	1,195
Prepaid expenses	2,962	*10%*	3,260	*-39%*	1,992	*0%*	1,992
Assets held for sale	0	*n/a*	0	*n/a*	0	*n/a*	20,724
Current assets	16,428	*-50%*	8,201	*67%*	13,677	*121%*	30,219
Property, plant and equipment	6,633	*-11%*	5,879	*-14%*	5,031	*-82%*	930
Intangibles	155,840	*-3%*	151,185	*-99%*	1,277	*14783%*	190,054
Goodwill	138,713	*-2%*	135,793	*122%*	301,311	*-62%*	115,012
Total assets	**317,615**	*-5%*	**301,058**	*7%*	**321,296**	*5%*	**336,215**
Accounts payable & accrued liabilit	17,385	*-30%*	12,111	*106%*	24,923	*5%*	26,131
Unredeemed gift card liability	3,680	*-20%*	2,944	*-4%*	2,840		2,840
Current liabilities	21,065	*-29%*	15,055	*84%*	27,763	*4%*	28,971
Other long-term liabilities	5,176	*-11%*	4,604	*-76%*	1,083	*0%*	1,083
Deferred income tax	31,516	*-1%*	31,328	*-2%*	30,672	*4%*	48,565
Total liabilities	**57,757**	*-12%*	**50,986**	*17%*	**59,518**	*32%*	**78,619**
Equity - Net purchase price	n/a		n/a		**261,778**	*-2%*	**257,596**
Goodwill as a % of net purchase price					*115%*		*45%*
Net tangible equity	**-34,696**		**-36,906**		**-40,810**		**-47,470**
% change			*-6%*		*-11%*		*-16%*

Accounting Red Flags

#3.2 Spring-Loading – Purchase Price Allocation (PPA) Adjustments

- I believe IRG may have artificially depressed **stub-period** performance so that it could transfer its financial results to the acquirer MTY. As of May 2018, IRG's net tangible equity dropped by **63%** from its last independent reporting date in October 2017.

- In the ordinary course of business, net tangible equity should not decrease significantly without external shocks.

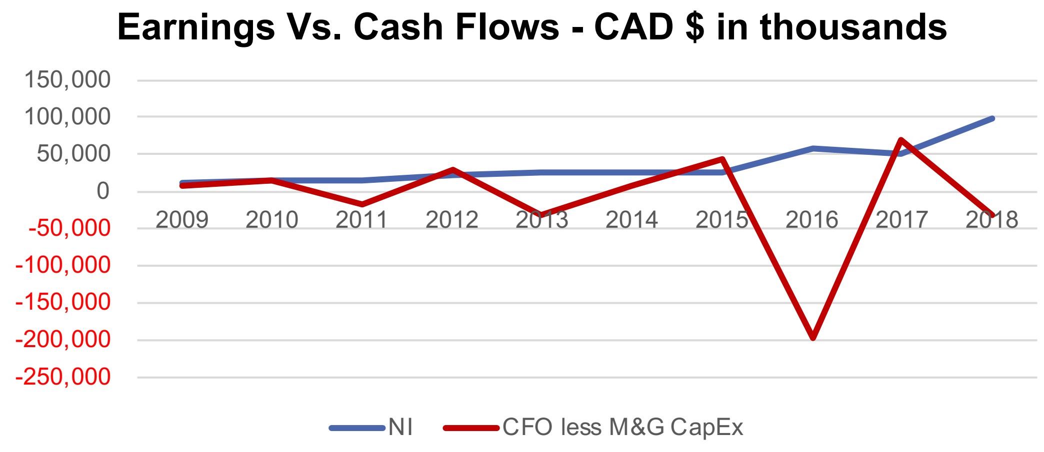
Acquisition of Imvescor Restaurant Group (IRG)
(in thousands of CAD)

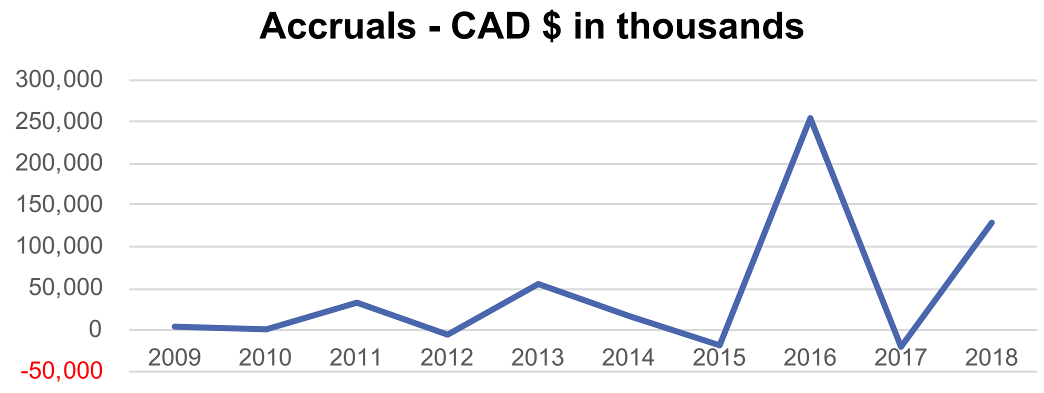
Annoucement date: 12/12/2017 **Acquisition date: 03/01/2018**	**IRG** **Balance Sheet** **3Q 17** **2017-07-30**	Interim % Δ	**IRG** **Balance Sheet** **4Q 17** **10/29/2017**	Interim % Δ	**MTY - IRG** **Initial PPA** **2Q 18** **05/31/2018**	Interim % Δ	**MTY - IRG** **1st Adj PPA** **3Q 18** **08/31/2018**	Interim % Δ	**MTY - IRG** **2nd Adj PPA** **4Q 18** **11/30/2018**	Interim % Δ	**MTY - IRG** **3rd Adj PPA** **1Q 19** **02/28/2019**
							Material IC Weakness Identified				
Cash	3,824	*-2%*	3,737	*26%*	4,702	*-2%*	4,615	*0%*	4,615	*0%*	4,615
Accounts receivable	9,950	*-11%*	8,882	*25%*	11,121	*-4%*	10,623	*-8%*	9,788	*0%*	9,788
Notes receivable	0	*n/a*	0	*n/a*	0	*n/a*	367	*0%*	367	*0%*	367
Inventory	820	*234%*	2,736	*-92%*	214	*0%*	214	*0%*	214	*0%*	214
Prepaid expenses	556	*-4%*	534	*-28%*	387	*-7%*	361	*-43%*	204	*0%*	204
Current assets	15,150	*5%*	15,889	*3%*	16,424	*-1%*	16,180	*-6%*	15,188	*0%*	15,188
Notes receivable	754	*5%*	795	*15%*	915	*-8%*	844	*34%*	1,134	*0%*	1,134
Projects under construction	0	*n/a*	0	*n/a*	567	*0%*	567	*119%*	1,242	*0%*	1,242
Property, plant and equipment	3,523	*45%*	5,117	*22%*	6,248	*-12%*	5,484	*-10%*	4,945	*-29%*	3,525
Intangibles	114,639	*0%*	114,564	*71%*	195,900	*0%*	196,247	*8%*	211,147	*0%*	211,147
Goodwill	6,509	*0%*	6,509	*1504%*	104,403	*1%*	105,890	*-12%*	93,029	*5%*	98,063
Total assets	**140,575**	*2%*	**142,874**	*127%*	**324,457**	*0%*	**325,212**	*0%*	**326,685**	*1%*	**330,299**
Accounts payable & accrued liabilitie	9,403	*53%*	14,343	*-3%*	13,967	*-1%*	13,883	*5%*	14,610	*0%*	14,610
Unredeemed gift card liability	2,918	*-7%*	2,714	*77%*	4,800	*7%*	5,157	*0%*	5,157	*0%*	5,157
Deferred revenues	0	*n/a*	938	*-41%*	549	*0%*	549	*-2%*	539	*0%*	539
Income tax payable	1,718	*82%*	3,134	*-88%*	390	*-98%*	9	*1844%*	175	*0%*	175
Current liabilities	14,039	*51%*	21,129	*-7%*	19,706	*-1%*	19,598	*5%*	20,481	*0%*	20,481
Credit facility	19,000	*-18%*	15,500	*29%*	20,000	*0%*	20,000	*0%*	20,000	*0%*	20,000
Other long-term liabilities	1,296	*-54%*	598	*-100%*	0	*n/a*	0	*n/a*	138	*0%*	138
Deferred income tax	17,055	*-7%*	15,820	*123%*	35,234	*0%*	35,394	*0%*	35,252	*10%*	38,866
Total liabilities	**51,390**	*3%*	**53,047**	*41%*	**74,940**	*0%*	**74,992**	*1%*	**75,871**	*5%*	**79,485**
Equity - Net purchase price	n/a		n/a		**249,517**		**250,220**		**250,814**		**250,814**
Goodwill as a % of net purchase price					*42%*		*42%*		*37%*		*39%*
Net tangible equity	**-31,963**		**-31,246**		**-50,786**		**-51,917**		**-53,362**		**-58,396**
% change			*2%*		*-63%*		*-2%*		*-5%*		*-12%*

Source: Company filings, own analysis

Accounting Red Flags

#4 Quality of Earnings



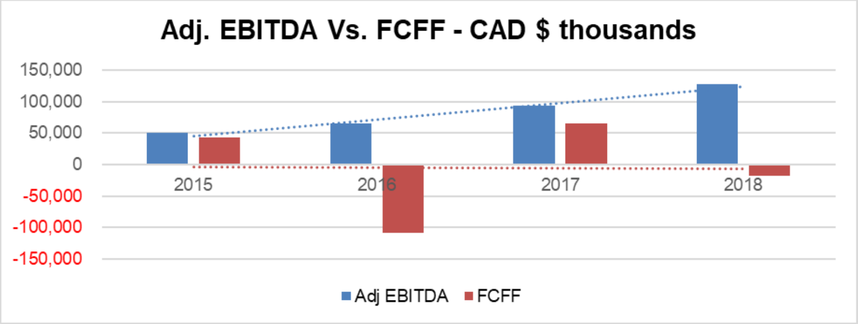


- As documented in Patricia Dechow's earnings management research, current period high accruals tend to correlate with subsequent period reversals.
- MTY's accruals jumped to ~$130 million in November 2018 (2nd highest amount in the last 10 years). The increasing divergence between earnings and cash flows illustrates the deterioration of earnings quality.
- As the difference widens, I expect there could be a **reversal** in the next 12-18 months.

Source: Company filings, own analysis

Accounting Red Flags

#5 Non-GAAP Metrics



(in thousands CAD $)	11/30/2018
Income before taxes	82,900
Depreciation - property, plan and equipment	2,755
Amortization - intangible assets	24,749
Interest on long-term debt	11,717
Impairment of property, plant and equipment and intangible asset	5,531
Unrealized foreign exchange gain	-11
Interest income	-649
Gain on disposal of property plant and equipment and intangible assets	-710
Loss on revaluation of financial liabilities recorded at fair value through profit and loss	1,461
EBITDA, reported by management	**127,743**
EBITDA, defined as EBT + Interest expense, net + D&A	**121,472**
EBITDA, acquired - Imvescor Restaurant Group	**20,100**
EBITDA, organic	**101,372**
Difference between "EBITDA, organic" and "EBITDA, reported by management"	***26.0%***

Source: Company filings, own analysis

- There has been a significant **divergence** between management's self-reported cash flow proxy EBITDA and MTY's true free cash flow metric based on my analysis.
- Additionally, management presents its EBITDA metric after adjusting for several non-operating items and true expenses. Unlike other publicly traded companies, MTY still regards such adjusted figure as "EBITDA" not as "adjusted EBITDA" in its company filings.

Cash Flow Sustainability (Or Lack Thereof)

(CAD $ in thousands)	11/30/2015	11/30/2016	11/30/2017	11/30/2018
# Beginning Stores	2,727	2,738	5,681	5,469
# Closed Stores	258	301	553	456
Churn rate	**9.5%**	**11.0%**	**9.7%**	**8.3%**
Franchise rights				
Beginning balance	69,718	69,002	245,055	242,832
Amortization expense	-6,464	-10,504	-19,792	-24,187
Impairment charge	-2,962	0	-309	-1,248
Total Charge Amount	-9,426	-10,504	-20,101	-25,435
Total Charge %	**13.5%**	**15.2%**	**8.2%**	**10.5%**
Acquisition	2,069	174,547	7,899	80,159
Trademarks				
Beginning balance	63,084	66,999	323,261	323,190
Impairment charge	-4,931	0	-731	-2,223
Total Charge %	**8%**	**0%**	**0%**	**1%**
Acquisition	8,834	251,559	10,633	159,342
Franchise rights & Trademarks				
Beginning balance, total	132,802	136,001	568,316	566,022
Total Charge Amount	-14,357	-10,504	-20,832	-27,658
Total Charge %	**11%**	**8%**	**4%**	**5%**
Impairment - Discount rates - Franchise rights & Trademarks				
Canada	15.0%	15.0%	9.0%	7.7%
U.S.	15.0%	15.0%	9.0%	8.3%
Canada 10-year	1.63%	1.44%	1.92%	2.41%
U.S. 10-year	2.21%	2.30%	2.37%	3.01%

Source: Company filings, FactSet, FRED, own analysis

- MTY's franchising operation has been facing on average about **10% annual churn** in terms of store counts for the past years, coinciding with its constant amortization and impairment charges. As such, **it is imperative for MTY to continue acquire new brands every year in order to sustain a flat same-store sales growth rate and overstated cash flow performance**.
- Aside from its high churn rate, it appears that MTY has been **dramatically lowering its discount rate**, inflating the fair value of its assets and avoiding potential impairment charges. For instance, in 2018 a **1%** increase in discount rate would result in an additional **$1.5 million** impairment charge in the U.S. segment.
- Note that risk-free rates in both Canada and the U.S. have been relatively stable for the past four years in the 2% range. This suggests that management believes the risks associated with these intangible assets have significantly decreased over the course of two years. **This phenomenon contradicts with the struggling performance of the franchisees it acquired**.

Cash Flow Sustainability (Or Lack Thereof)

CAD$ in thousands, ex $ps	2015	2016	2017	2018	TTM 1Q19	TTM 2Q19	LTM 3Q19
Op Income	34,310	52,997	69,824	94,708	101,480	102,415	104,101
ETR	27%	20%	20%	22%	23%	23%	23%
NOPAT	25,059	42,334	55,550	73,692	77,835	78,552	79,845
Changes in WC	11,103	84,309	10,861	9,145	5,900 *	19,568	20,416
D&A	8,279	12,844	22,902	27,504	29,196	29,777	31,179
CapEx + Acq	-7,000	-248,523	-23,449	-128,525	-70,831	-327,879	-376,556
FCFF	**37,441**	**-109,036**	**65,864**	**-18,184**	**42,100**	**-199,982**	**-245,116**
EV, ex op leases	585,100	1,289,200	1,289,700	1,895,200	1,728,500	2,077,062	1,872,400
FCFF Yield	**6.4%**	**-8.5%**	**5.1%**	**-1.0%**	**2.2%**	**-9.6%**	**-13.1%**
Diluted S/O					25,220	25,220	25,220
Intangibles					745,512	767,960	945,092
Assumed economic life					15	15	15
FCFF per share - pre amortization					$ 1.67	-$ 7.93	-$ 9.72
Annual amortization expense per share					$ 1.97	$ 2.03	$ 2.50
FCF per share					**-$ 0.30**	**-$ 9.96**	**-$ 12.22**

* Removed IRG acquisition deposit of $51.9 mil in 1Q18

- Since MTY is **buying** struggling brands every year instead of growing them organically, the amortization and impairment expenses associated with these **melting ice cubes represent a real expense**. As such, the EBITDA metric that most investors are putting a multiple on is essentially a mirage of self-purported cash flows
- Moreover, given MTY's acquisitive nature, investors should account acquisitions of businesses and intangibles as part of both maintenance and growth CapEx to reflect the **capital intensity of MTY's core business model – growth through acquisitions**.
- After adjusting for such recurring capital outlay, MTY's free cash flow yield stands only at **-13.1%** as of 3Q19.
- Note that this free cash flow figure is before considering true amortization and impairment expenses. Adj. FCF/share stands at **$ -12.22**.

Source: Company filings, Bloomberg, own estimates

Off-Balance Sheet Leverage

CAD $ in thousands

Balance Sheet	
Add: Right-of-use (ROU) assets	74,243
Add: Leases receivable - net investments in sublease	551,916
Add: Leases liabilities in head leases	626,159

Income Statement	
Remove: Rent expense	13,999
Add: Depreciation of ROU assets	9,545
Add: Interest expense on head leases liabilities	37,570
Add: Interest income on subleases receivables	33,115
Interest expense, net impact	4,455

- MTY's leverage may remain **elevated** once the company adopts IFRS 16 in December 2019.
- Given that the lessor of a sublease is concurrently the lessee in relations to the head lease, MTY will have to recognize an asset and liability on its balance sheet with respect to the **head lease**.

Source: Company filings, own estimates

Off-Balance Sheet Leverage

CAD $ in thousands		
Operating income - LTM 3Q19	104,101	
Op. lease adj: remove rent expense	13,999	
Op. lease adj: add depreciation expense	9,545	
Operating income, adjusted - LTM 3Q19	**108,556**	
D&A - LTM 3Q19	31,179	
Op. lease adj: add depreciation expense	9,545	
D&A, adjusted - LTM 3Q19	**40,724**	
MTY LTM EBITDA, adjusted (incl. 1 quarter / 13% of Papa Murphy's)	**149,279**	**(A)**
Papa Murphy's LTM EBITDA - 1Q19 April 1, 2019	24,346	
Papa Murphy's 87% LTM EBITDA - Est. add'l 3Qs of contributions	**21,181**	**(B)**
Papa Murphy's early adopted ASU 2016-02 Leases		
MTY Est. EBITDA, adjusted (incl. est. Papa Murphy's full-year EBITDA)	**170,461**	**(C) = (A) + (B)**
Current portion of long-term debt	5,189	
Long-term debt	564,851	
Total debt	**570,040**	**(D)**
Operating Leases Adjustment (per 2Q19 disclosure)	**626,159**	**(E)**
Total debt & Operating leases	**1,196,199**	
Cash	43,687	
Net debt	**1,152,512**	**(F) = (D) + (E)**
Net debt / EBITDA, adjusted	**6.8x**	**(G) = (F) / (C)**

Source: Company filings, own analysis

- Adjusting for operating lease impacts and the acquisition of Papa Murphy's, I believe MTY's post-acquisition leverage will increase to **~6.8x** in the next 12 months.
- In 2Q19, MTY increased its credit facility from $500 million to $650 million ($513.7 drawn) and stepped up its credit facility's covenants from 3x to 4x for additional 9 months
- More recently, in 3Q19, MTY increased its credit facility to **$700** million.
- I believe MTY's leverage may stay elevated, **constraining its near-term ability to execute large acquisitions**.

Corporate Governance?

Executive Compensation

- *"The base salary of each of the Corporation's* ***NEOs*** *is set by the* ***Board of Directors*** *following an annual performance review."* - 2019 Proxy Statement

Stanley Ma
Chairman of the Board

In-law & Board/NEO
Marc Benzacar
COO, Fast-casual

Father & daughter
Katherine Ma
VP, Procurement

Husband & wife

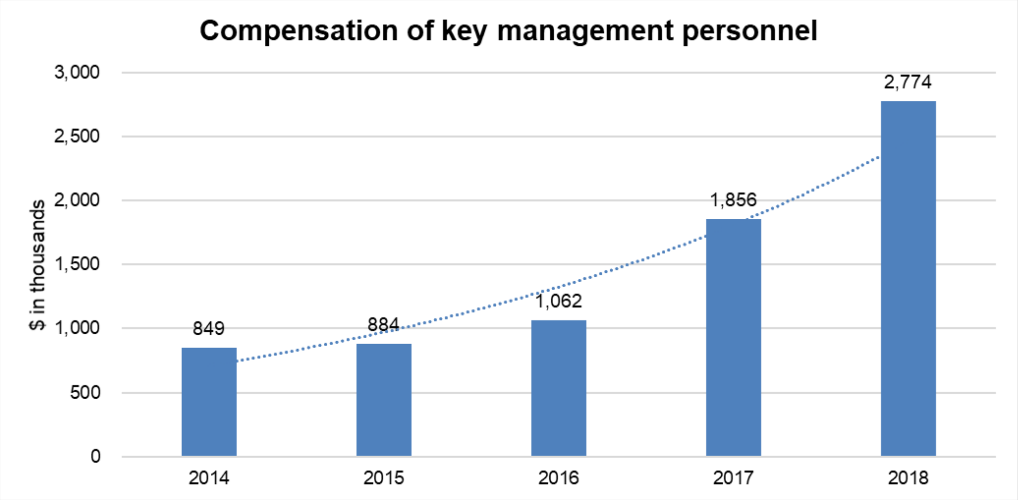
- According to MTY's proxy statement, unlike other peer companies, there is a **lack of independent compensation committee**. The familial relationships between Stanley Ma, Marc Benzacar, and Katherine Ma pose a concern regarding potential self-dealings.

- It raises the question whether the Board will provide an unbiased view of the performance of a COO who is the son-in-law of the former CEO/founder and current Chairman.

Source: Company filings, own research

Corporate Governance?

Executive Compensation



Short and Long-term Cash Incentives						
1) Certain levels of organic growth in EBITDA	*ST & LT*		(in thousands CAD $)	**3Q19**	**2Q19**	**2Q18**
2) Divisional free cash flows	*ST & LT*		**CFO**	27,220	21,077	25,422
3) Store openings	*ST*		**FCF**	26,680	21,767	23,883
Long-term Incentives			**Normalized FCF**	26,910	25,804	24,503
Stock Option 2016 Plan						
Eric Lefebvre, CEO						
Option exercise price		$48.36				
Expiration date		2027-11-04				
Value of in-the-money options		$3,444,000				

- Furthermore, MTY's current incentive compensation scheme deters shareholder value creations. Specifically, management enriched themselves by **increasing store counts and adjusted metrics**.
- Regarding "free cash flows", management claims, "We're very pleased with our free cash flow generation capabilities, which grew 5% to $25.8 million on a normalized basis" in 2Q19.
- I do not view this as a true FCF metric given that management **adds back recurring acquisition transaction expenses** and **fails to take into consideration of the capital intensity of acquisitions**.

Source: Company filings, Press Release

Valuation

Implied Cost of Equity Capital (ICC)

- Given price=$54, eps1= 3.50, g =21.90% (3-5 year growth rate est.), r_e=sqrt (0.219 / (53.7 / 3.5)) = 12%.
- In contrast, assuming an ERP of 6%, and a risk-free rate of 1.7% (Canada 30-year), a beta of 0.61, r_CAPM= 1.7% + 6% x 0.61 = 5%. Hence, the ICC for MTY is higher than the CAPM estimate.
- There could be three possible explanations: **1) Risk:** the market believes MTY is riskier than what the CAPM model suggests, **2) Mispricing:** MTY is undervalued, or **3) Forecasting Error:** the market does not believe sell-side analyst estimates and expects a lower EPS and/or slower growth (i.e. the market discounts MTY at a higher rate).

$$r_e = \sqrt{\frac{g}{(Price/eps_1)}}$$

Fundamental P/E Multiple

- Based on my research, a forward 15x P/E ratio does not necessarily suggest the company is grossly undervalued relative to other small-cap peer companies such as Recipe Unlimited (TSE: RECP). I believe the market is **too fixated on the lofty inorganic growth expectations** in future earnings and underestimates the riskiness of the equity. Assuming a normalized 10-year average 20% ROE (mean-reversion), a market implied cost of equity of 12%, the **implied expected long-term earnings growth rate is 8.1%** for a 15x forward P/E multiple.

$$\frac{P_0}{EPS_1} = Forward\frac{P}{E} = \frac{Payout\ Ratio}{r_e - g_n} = \frac{1 - \frac{g_n}{ROE_n}}{r_e - g_n}$$

Source: Partha Mohanram, Aswath Damodaran

Valuation

Probability-weighted Target Price

- I believe **heightened risks** associated with **leverage** and its **unsustainable business model** warrant a de-rating in MTY's future multiple.

- Assuming a 5.5% stabilized growth rate (Bloomberg consensus EPS growth rate from 2019E to 2020E is ~8%), the company should trade at a 11x forward P/E multiple.

- As shown below, my analysis suggests there could be a ~25% downside in the next 12-18 months.

Scenarios	Bear	Base	Bull
EPS 1, est.	3.3	3.4	3.5
Fwd Multiple	11.0x	13.0x	15.0x
Price / Share	$ 36.3	$ 44.2	$ 52.5
Probability	60%	30%	10%
Prob-wtd price		$ 40.3	
Implied downside		-25%	

Source: Bloomberg, own analysis

Catalysts

"We find pizza softens the blow of bad news."

- Sohn Conference
- An acquisition gone too far
- MTY IFRS 16 Implementation (December, 2019)

Source: New Yorker Magazine

Appendix: Insider Selling

Transaction Activities

Trade Date	Participant(s)	Net Sell (Shares)	Net Buy (Shares)	Close Price	Proceeds	Investments
10/21/2019	Murat Armutlu		0	$ 52.75		0
10/04/2019	Renee St-Onge		28	$ 63.96		-$1,791
09/03/2019	Renee St-Onge		31	$ 63.02		-$1,954
07/31/2019	Renee St-Onge		27	$ 65.48		-$1,768
06/28/2019	Renee St-Onge		27	$ 65.36		-$1,765
05/31/2019	Jason Brading, Renee St-Onge		180	$ 60.21		-$10,838
03/05/2019	Murat Armutlu		2,000	$ 54.96		-$109,920
04/30/2019	Renee St-Onge		31	$ 55.35		-$1,716
02/04/2019	Renee St-Onge		30	$ 57.88		-$1,736
01/03/2019	Renee St-Onge		29	$ 59.30		-$1,720
02/19/2019	Renee St-Onge		4	$ 60.62		-$242
01/02/2019	Renee St-Onge		32	$ 69.61		-$2,228
12/31/2018	Eric Lefebvre, Renee St-Onge		648	$ 60.64		-$39,295
11/30/2018	Renee St-Onge		24	$ 65.58		-$1,574
11/19/2018	Renee St-Onge		3	$ 66.51		-$200
08/11/2018	Dickie Orr	-3,000		$ 71.18	$213,540	
07/11/2018	Dickie Orr	-3,000		$ 71.38	$214,140	
07/26/2018	Gary O'Connor		100	$ 56.41		-$5,641
12/31/2017	Eric Lefebvre		550	$ 56.10		-$30,855
11/24/2017	Dickie Orr	-4,000		$ 53.04	$212,160	
12/31/2016	Eric Lefebvre		442	$ 50.56		-$22,348
12/31/2015	Eric Lefebvre		472	$ 32.43		-$15,307
10/29/2015	Dickie Orr	-3,000		$ 30.88	$92,640	
10/28/2015	Dickie Orr	-1,000		$ 30.73	$30,730	
10/27/2015	Dickie Orr	-4,000		$ 30.71	$122,840	
10/20/2015	Dickie Orr	-2,000		$ 30.99	$61,980	
10/19/2015	Dickie Orr	-2,000		$ 30.90	$61,800	
10/16/2015	Dickie Orr	-3,000		$ 30.66	$91,980	
10/15/5015	Dickie Orr	-3,000		$ 30.73	$92,190	
12/31/2014	Eric Lefebvre		404	$ 33.71		-$13,619
12/12/2014	Dickie Orr	-2,400		$ 35.12	$84,288	
11/12/2014	Dickie Orr	-3,600		$ 35.15	$126,540	
10/12/2014	Dickie Orr	-2,000		$ 34.09	$68,180	
09/12/2014	Dickie Orr	-2,000		$ 34.34	$68,680	
08/12/2014	Dickie Orr	-3,500		$ 34.24	$119,840	
05/12/2014	Dickie Orr	-2,700		$ 34.51	$93,177	
04/12/2014	Dickie Orr	-1,800		$ 34.27	$61,686	
03/12/2014	Dickie Orr	-2,000		$ 34.39	$68,780	
06/23/2014	Dickie Orr		10,000	$ 28.90		-$289,000
06/19/2014	Dickie Orr		7,000	$ 28.94		-$202,580
06/18/2014	Dickie Orr		3,000	$ 28.75		-$86,250
05/20/2014	Dickie Orr		2,000	$ 30.07		-$60,140
05/02/2014	Murat Armutlu		550	$ 31.22		-$17,171
12/31/2013	Eric Lefebvre		342	$ 34.28		-$11,724
11/26/2013	Dickie Orr	-2,000		$ 31.45	$62,900	
11/27/2012	Dickie Orr	-3,000		$ 20.33	$60,990	
11/26/2012	Dickie Orr	-3,000		$ 20.63	$61,890	
10/14/2011	Eric Lefebvre		1,000	$ 14.65		-$14,650
Total		**-56,000**	**28,954**		**$2,070,951**	**-$946,029**

......

Source: Bloomberg

Appendix: Insider Comment

Current Chairman

- While MTY's revenue and profit have been growing very steadily, Mr. Ma acknowledges that the company had a tough time in 2009 and early 2010 because of the economy, and could again if there's another dip. **"We are not recession-proof,"** he says.

Stanley Ma, Founder / Former CEO – October 7, 2011

Source: The Globe and Mail