Fogo de Chao: A "Medium Rare" Investment Opportunity [1]

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Excess returns are hard to find at scale, but for those running smaller bases of capital and turning over a lot of rocks, interesting opportunities usually present themselves regardless of broader market conditions. Down from over $17 to under $11 since May, shares of U.S.-based churrascaria **Fogo de Chao** (FOGO) present a medium-rare investment opportunity. Simply put, shares trade at a ~10% steady-state free cash flow yield and the company has a decade-long opportunity to reinvest that cash flow into new restaurants at a RONIC in the teens to twenties. For those who are interested in models, a conservatively-projected 10-year DCF pegs the value of shares at $15+, while assumptions more in line with management's long-term guidance would justify a share price in the high teens (and potentially $20+ if everything goes right). I have no particular interest in restaurants, but FOGO is a unique situation with best-in-class margins and proven national scalability that isn't baked into the valuation. At this price, in fact, you don't have to underwrite much/any growth to consider Fogo de Chao an interesting investment opportunity.

There's no fundamental bear case on FOGO – we've asked around – and recent selling is likely attributable simply to a technical factor: limited liquidity in the stock combined with investors bailing on the restaurant sector. The company's public market cap is currently ~$300MM, but private-equity sponsor T.H. Lee owns ~80% of the stock, making the public float far too small for even most small-cap funds to bother working on. We anticipate one of two scenarios: either T.H. Lee sells FOGO for a price north of $15-16 sometime during the next two years, or FOGO remains a public company and becomes a long-term value creation story. Either way, at the current price under $11, we believe prospective investors can easily compound their capital at 20%+ over the next 2-3 years while bearing minimal fundamental downside risk.

Background/Story/The Opportunity

Fogo de Chao was founded by two brothers, Jair and Arri Coser, with a restaurant in Porto Alegre, Brazil in 1979. The chain slowly expanded over time, entering the U.S. in 1997 (with the first location in Addison, TX – an upmarket suburb of Dallas). Restaurant development was accelerated by private equity involvement, and T.H. Lee purchased the company in 2012, since which time it has grown from 25 restaurants to 42 at the end of the most recent quarter.

For those who've never visited Fogo or another Brazilian churrascaria concept, it works a little differently than a traditional steakhouse: there's no menu per-se; it's a prix-fixe meal. There is a buffet table of salads, cheeses, and other items – that, incidentally, is so good that you'll find plenty of Yelp reviews from vegetarians who go to Fogo just for the salad bar – but for most guests, the big attraction is the all-you-can-eat fire-roasted meat, carved tableside. In addition to standard American items like filet, ribeye, chicken drumsticks, leg of lamb, and pork ribs, Fogo offers Brazilian specialties like picanha, fraldinha, and alcatra. What all this amounts to from the consumer's point of view is a fantastic value proposition vis-à-vis other high-end steakhouses: the meat quality (to my palate) is in the same ballpark, you get all you can eat of 10+ different kinds of meat and a whole salad bar, while Fogo's average check (around $60) is below that of high-end steakhouse competitors such as Sullivan's ($64), Ruth's Chris ($79), Del Frisco ($113), Capital Grille ($70+), Morton's ($80+), and so on. [2]

As attractive as the model is for consumers, it's even more attractive for investors. Given that Fogo is generally not cooking to order, its kitchen is smaller and less complex than that of many peer restaurants. Perhaps more importantly, the gauchos who serve the meat tableside are also the ones who cook it. This dual

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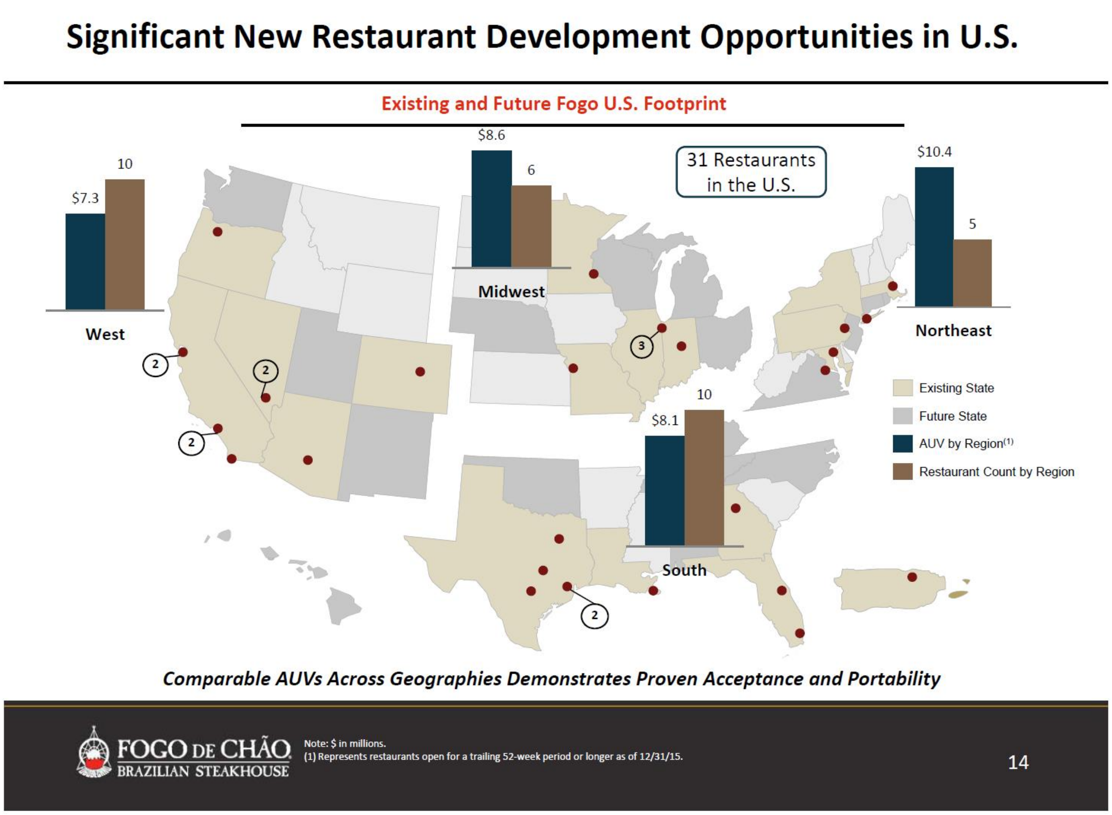
[1] Our sense of humor is currently under construction; please excuse our puns.

[2] Sullivan/Ruth/Del Frisco avg. check from RUTH and DFRG latest 10-Ks; data estimated for Capital Grille and Morton's.

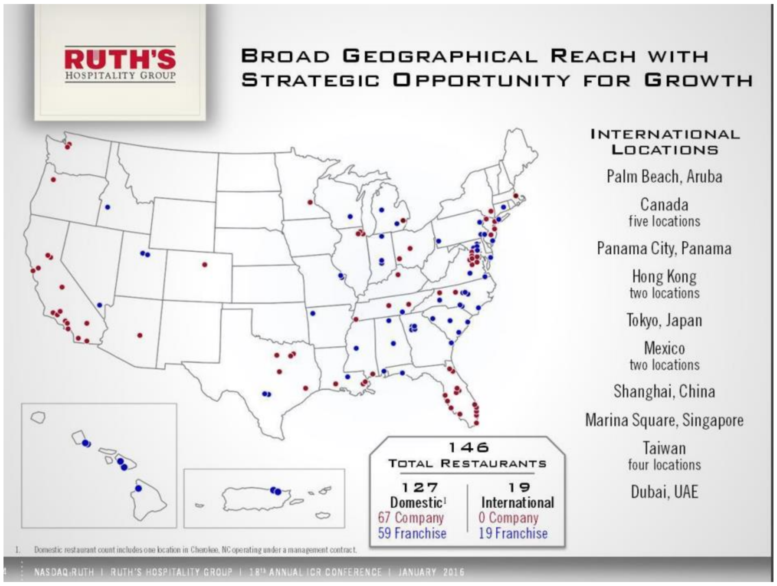
role of both server and chef, with tableside plating, not only means less direct back-of-the-house labor costs (since those roles are mostly eliminated), but also means that gauchos end up compensated quite well (high five figures and potentially beyond) from customer tips even though they're not compensated highly directly by Fogo de Chao. (For those wondering, they are compensated above minimum wage, so Fogo is also relatively more insulated from labor-cost escalation than that of peers.)

From a quantitative standpoint, FOGO's four-wall labor costs end up in the low 20s as a percent of revenue, substantially below most peers (which are typically around 30%). With comparable food and other occupancy expenses, this translates to Fogo's restaurant base having a four-wall margin of 30%+ at $8MM+ average unit volumes. These phenomenal margins result in very attractive cash-on-cash returns for new restaurant development; the company quotes them at 40%+ but that includes assumed tenant improvement allowances of around $1 million as well as not factoring in any incremental G&A, marketing, or maintenance capex costs associated with the new restaurants. However, even once you factor these costs in, Fogo has best-in-class returns and depending on your assumptions, their cash-on-cash returns (defined as incremental cash EBIT divided by total capital investment) should be in the high teens to low twenties under conservative assumptions, and potentially much higher depending on how you treat G&A leverage over time. (I will discuss this in the valuation section.)

One of the most interesting aspects of the Fogo story is that it has already proven itself in most major DMAs and there's really no risk of concept rejection – i.e., the tempering factor for many hot restaurant growth stories is the question of whether or not their regionally successful concept scales nationally. (The answer is often no; think about the relative density of taco shops in Texas and bagel shops in New York City.) Judging by both unit AUVs and thousands of favorable Yelp reviews, Fogo has already demonstrated acceptance pretty much everywhere, which shouldn't be that surprising because steak is pretty portable:



At this point, then, expansion is pretty much as simple as putting new boxes on the ground. Management has a long-term target of 100+ new restaurants in the U.S., which would imply a total store count of 130+ in the U.S. This seems high to me, and it's reasonable to assume that restaurants in tertiary markets would have a less attractive financial profile, so I've personally assumed that Fogo can open 43 new U.S. restaurants over the next decade, bringing the total U.S. restaurant count to ~75 and the total 2026 U.S. restaurant revenue (at an $6.7MM AUV) to around $500 million. This isn't a random number – Ruth's Chris has a higher level of revenue today, if you gross up their reported franchise revenues into actual system-wide revenues and subtract some for their international locations. Ruth's Chris is still growing, but they're entering less attractive markets and have limited opportunity to continue to infill major DMAs (for example, they already have three restaurants in San Antonio and six in the D.C. metro). So, using their current revenue base as the long-term target for Fogo – again, well below management's expectation – seems like a reasonable way to go about it.



In addition to U.S. locations, Fogo may develop a few company-owned restaurants in Brazil or potentially Canada (to tax-efficiently use cash generated there), but the vast majority of international restaurants (typically located in capital cities) will be via a joint venture. The economics on these JVs are actually quite attractive: Fogo puts up no capital, and receives both a straight "royalty" license fee that is a small percentage of revenues, along with 50% of restaurant-level profits after the partner has recouped their capital investment. Even at lower-than-projected AUVs or margins, this would equate to "found money" – after an initial 3-4 year payback period, each restaurant opened via JV would probably generate upper six or lower seven figures in annual pre-tax profit for FOGO. While I have <u>excluded any potential contribution from JVs to my model since I believe this opportunity is unproven/uncertain relative to the domestic restaurant opportunity,</u> if Fogo can open 10 – 15 of these over the next decade, it would result in several dollars per share of incremental value that I am not including as part of my analysis.

<u>Valuation</u>

Restaurants are pretty straightforward to analyze. Assuming the concept is defensible, the key questions are:

1) How much cash is being generated by existing boxes?
2) How accretively can that cash be redeployed into new boxes?
3) How many boxes can be built?

Simplistically, at under $11, FOGO is trading at a 10% steady-state free cash flow yield (i.e. the amount of cash generated by existing restaurants, net of all corporate costs and including stock comp as a cash cost, divided by their current market cap.) As discussed above, new boxes will generate a teens-to-twenties return, and even under my conservative assumptions, the company has a decade-long runway to grow the restaurant count by a high-single-digit percentage per year, while still generating free cash flow that can be used to pay down debt, pay a dividend, or buy back shares. That seems like a pretty attractive proposition.

(Admittedly, FOGO has a little over 2x debt-to-EBITDA, so EV/NOPAT yield is a little lower at around 8% - but I view the 1-2x leverage range as sustainable for the business long-term and given that they'll be within this bracket in a reasonably short timeframe, FCF is a reasonable way to analyze the business.)

While I usually eschew DCFs because I believe they lend a false air of precision, since Fogo's future path is pretty straightforward – i.e. they throw off cash and use it to build new boxes – I did break with usual practice and build a 10-year model. Key assumptions include:

- $5.5 million in per-unit cash capex costs (vs. company assumption of $4.5 million – essentially, I've assumed they just don't receive the $1MM in tenant improvement allowance that they typically receive. As a sense check, if you look at their actual cash capex costs and ignore TIAs, this is vaguely in line with what they've been paying over the past few years.)
- $1.0 million in per-unit pre-opening costs
- $50,000/yr in incremental maintenance capex expense for each unit (implying a current maintenance capex base of $2.3 million.)
- $6.5MM new unit AUVs at 25% four-wall margins (vs. company assumption of $7MM at 27% four-wall margins – although note that I don't explicitly model in a ramp, which is more than offset by conservatism elsewhere)
- Corporate marketing expenses flat at 3% of revenue over time, G&A expenses decreasing in a roughly linear fashion from >7% of restaurant revenues to ~6.1% (vs. sub-5% for RUTH if you gross up franchise royalty revenues, and FOGO guidance of 3% inflation per year off the current base, that implies somewhere in the 5 – 5.5% of revenues range a decade out.)
- 1% comps.
- <u>Restaurant development ceases in ten years at 75 U.S. restaurants – no credit given for future restaurant development.</u>
- Terminal valuation in 2026 of 11x FCF.
- <u>No incremental contribution assumed from joint ventures.</u>
- 35% tax rate
- 10% equity discount rate and 5.00% interest rate on debt (with no return assumed on residual cash.)
- Stock comp treated as a cash cost.

Under these assumptions, FOGO ends up being worth over $15 per share today, implying 40% upside from the current share price to fair value, providing patient, long-term oriented shareholders with the ability to compound capital over the next 2-3 years at a 20%+ rate. Given the 10% free cash flow yield, strong relative value proposition to consumers, and extremely high four-wall margins, we believe FOGO offers a substantial margin of safety and is severely mispriced. Remember again that I've modeled this somewhat conservatively and have excluded potentially significant incremental G&A leverage, contributions from the JVs, lower-than-expected AUVs and higher-than-expected capex, half of the long-term restaurant development than they think they can achieve and even less than RUTH has already achieved with a worse value proposition to consumers, etc – so even if things don't track exactly to management's plan, I am very confident that this company is fundamentally worth no less than $15 per share based on currently-available information.

Risks

You will notice that there is nothing particularly fancy about this thesis; FOGO has a great value proposition for consumers relative to other fine dining establishments, it has a great financial model, and a long runway of accretive reinvestment opportunity – seems like a slam dunk. Yet it's trading at 10x steady-state free cash flow and under 8x this year's EBITDA. When something looks this easy, I get a little bit suspicious, so I've spent a significant amount of time attempting to identify all major risks. I came away believing that there is no "smoking gun" and the recent price decline is simply attributable to illiquidity, negativity on the restaurant sector, and lack of attention by competent investors. Below, I've listed every risk that I could come up with, that my collaborators could come up with, and that we've heard from discussing the stock with other investors. I've included even ones that seem pretty farfetched.

Potential near-term comps weakness

Comps in the restaurant industry have softened, and FOGO is expecting a mid-single-digit comp decline in the back half of 2016 (after several years of comps well above the industry norm, driven by initiatives such as Gaucho Lunch.) My model starts by assuming the low-end of company guidance and 1% comps thereafter. If comps continue to be bad into next year, that could reduce my valuation estimate – but with a 40% gap between the current stock price and fair value on conservative assumptions, a few percentage points in 2017 comps either way is pretty much completely irrelevant to the company's long-term value. Anyone who calls themselves a value investor but isn't willing to buy a 10% free cash flow stream with a decade's worth of 20% reinvestment opportunity because of the risk of a few soft quarters is completely missing the point.

Balance sheet / operating deleverage in a recession

By my math (which treats stock comp as a cash cost and does not add it back to Adjusted EBITDA), FOGO will end the year with roughly ~2.3x debt-to-Adjusted-EBITDA (which is basically GAAP EBITDA plus pre-opening expenses, which I conceptually view as part of new-restaurant growth capex.) Obviously, restaurants have meaningful operating leverage, and in a severe recession, FOGO's EBITDA would undoubtedly decrease.

However, even in a near-catastrophic scenario where EBITDA were to decline by 50%, FOGO would still be generating over $25 million in EBITDA, with current interest expense under $6 million – so even if interest expense doubled on skyrocketing LIBOR, combined with the catastrophic restaurant scenario described above, we don't see solvency risk here. Even in the worst-case scenario, FOGO would not only be covering its interest, but still paying down debt (if it halted new restaurant development.)

"prime location" risk

It is reasonable to question whether U.S. locations 35 – 75 will perform as well as locations 0 – 40; one could reasonably assume that the best locations have been built first. While this is true, we'd note that management's new-unit assumption of $7MM AUV / 27% margin is well below the stabilized fleet average of $8.5MM AUV / 30%+ margin, and our internal assumption of $6.5MM AUV / 25% margin is even one step lower – yet we still come up with a $15+ fair value.

I would also argue that it's silly to assume that all the prime sites are already gone; there are hardly only 35 A+ restaurant sites in the U.S. For example, FOGO currently only has one location in Dallas, where its brand is arguably the strongest; they could easily support 4-5. Indeed, they are opening another three locations – one in Uptown, one in Legacy (near the "billion dollar mile" including the new Cowboys facility, the new Toyota headquarters, etc), and one in Fort Worth. I would be astonished if each of these locations can't support very strong AUVs. I can't speak to their siting in other locations with the same level of on-the-ground knowledge, but have noted that most of their new locations are typically co-sited with other high-end restaurant tenants, suggesting that they're not taking any wild siting risks. Finally, see my earlier comments about Ruth's Chris.

Infill Cannibalization risk

Some analysts have inquired as to whether FOGO sees any cannibalization when building new units in the same city. Credit card data from Chicago does not support that this has been occurring, and given that my internal assumptions on both new unit performance and the long-term TAM are significantly lower than management's, this risk doesn't concern me.

Soft Near-Term AUVs

There was an erroneous sell-side report recently that pegged new-unit AUVs during Q2 at a very confusing sub-$3MM level. We spoke to Tony Laday and believe that this analyst's math was wrong and actual new-unit AUVs are about $5MM (or 70% of targeted levels), which is lower than the 90% management had hoped for by this stage but not concerning given the 3-year ramp period and relatively recent vintage of most of the non-comparable base (six to nine months old as of the end of Q2). After reviewing hundreds of Yelp reviews, analyzing the sites, and talking with management several times, we are confident that these sites will perform fine over time and that this does not represent any real risk to FOGO's long-term development plan but is rather just temporary softness driven by macro factors and a couple idiosyncratic local situations that should clear up over time.

Brazil risk

The implosion of the real and the slow Brazilian economy have certainly not helped Fogo, which has 12 restaurants in the country. However, we view Brazil as more of a risk in the rearview mirror (albeit a high profile one) than one that really makes or breaks the case on the stock – Brazilian restaurants, as of the most recent quarter, represented under 15% of consolidated company revenues, with contribution margins that are only very slightly (100 – 200 bps) higher than the U.S. Given that Brazil will, over the next few years, shrink to a single digit percentage of total revenues, and also given the wide discount between the current stock price and fair value, this doesn't seem particularly meaningful to us; over the long term there's actually a pretty good chance that they get some improved performance out of their Brazilian restaurants (whether constant or reported currency) over the long term.

Labor Cost Risk

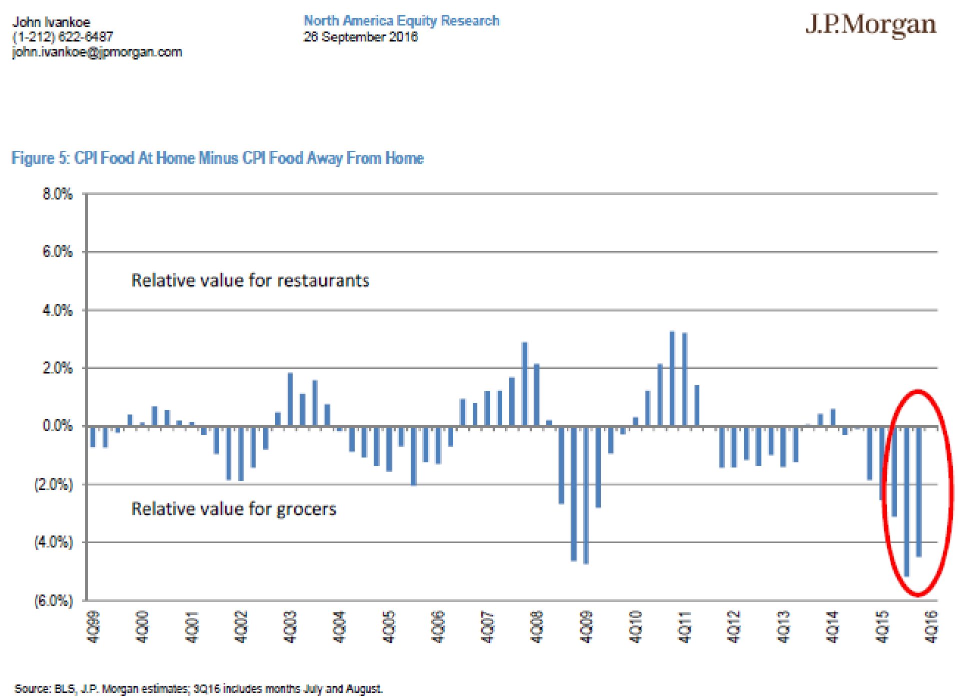
Due to both existing wage pressure and politicians discussing minimum wage hikes, labor costs could certainly increase going forward for restaurants; this is one of the overhangs on the sector. However, given that FOGO already spends substantially less on labor than most competitors – and also given that its gauchos are already paid above minimum wage by the restaurant – the potential impact of this factor on FOGO is far less than on most restaurants, and likely only amounts to a few hundred basis points of potential margin headwind over time, which is offset by my already-low assumptions.

Moat/Competition

We've spoken to a number of investors who ask about competitors (primarily Texas de Brazil) and whether Fogo has any "moat." We would argue that there is a soft moat in terms of the brand and ability to source gauchos from Brazil, as well as an intrinsic soft moat in terms of siting on prime real estate. More broadly, we think Fogo actually has far less competition than the majority of the restaurant space – it is relatively trivial to open a generic steakhouse or burger joint, whereas it is a little more challenging to open a churrascaria.

Restaurant-to-Food-At-Home Price Delta Risk

Several analysts and news reporters have recently highlighted the widening gap between the cost of eating out and the cost of eating at home; someone recently sent me this chart from J.P. Morgan:



While this certainly suggests a little bit of a trend back to home cooking vs. eating out, I think this is almost completely irrelevant to FOGO – there is literally nobody who says "eh, I don't feel like making a casserole/sandwich/spaghetti tonight… hey kids, let's go to a high-end steakhouse." While the broad restaurant softness affects everyone, this sort of price gap is more likely to penalize concepts like CMG/PNRA/BJRI/MCD/WEN which are actually a credible alternative to dinner at home than high-end steakhouses people visit for special occasions, date nights, business dinners, etc. More broadly, FOGO is actually poised to benefit in a more price-conscious environment, as it is a lower check than other fine dining establishments with comparable quality, far more variety, unlimited quantity, and an experience that can't be replicated at home. I personally don't visit steakhouses very often because I can grill a great ribeye for $15 all in, and it's probably 80% of the way to what they'd serve at RUTH for $50+ - but FOGO is something you can't replicate at home.

Churrascaria "Fad" Risk

Some people we've spoken to have questioned whether Fogo, or churrascarias in general, are "gimmicky" restaurants that people will visit once then not return to. I believe this argument is nonsensical and invalidated by the continuing popularity of other styles of ethnic food with a preparation or "experience" element (think Japanese sushi/steak, Korean BBQ which you may know as "galbi," Mongolian hot pot, fondue, etc.) More broadly, FOGO customers tell management that if not dining at Fogo, they would be at Ruth's (makes sense) or Cheesecake Factory (which is still a bit of a head scratcher to me, but is driven by the fact that Fogo is a more casual/non-stuffy/family-friendly environment than most fine dining establishments, and has a significant portion of its patronage from consumers making $75k/yr or less.)

Passive shareholder risk

This is the issue we've spent the most time thinking about – as mentioned, sponsor T.H. Lee retains ownership of just about 80% of the company, which means for all practical purposes they can do whatever they want without worrying about other shareholders. T.H. Lee bought the company in 2012 for a $400 million enterprise value but paid only about $150MM for the equity, which would put their per-share cost basis in FOGO in the mid-single digits on a per-share basis. FOGO is held in their 2006 fund and they are likely looking to harvest over the next two years. We believe that they will either look to sell shares via a secondary, distribute them to LPs, or sell the entire company. We believe it is notable that they chose to retain the degree of ownership that they did in 2015 when they conceivably had the option to sell more shares public (given how oversubscribed the IPO was, and the significant pop thereafter.)

Given FOGO's near-term development plans, we believe that two years from today, FOGO will be generating $60 - $65MM in Adjusted EBITDA, with around $100 million in net debt. It would be completely inconceivable for T.H. Lee to sell the company at less than 8 - 9x EBITDA, given the best-in-class margins and returns and the fact that transaction multiples for far inferior restaurant concepts would support a higher valuation. (T.H. Lee itself paid around ~9x by my math, in 2012, when multiples were generally lower than they are today – and my own intrinsic fair value estimate is around ~10.5x EBITDA.) For both optics and fundamental/relative value reasons, we believe any potential sale would likely be at or above a floor of $15 - $16+, which (in our opinion) would take away a lot of the long-term value potential from public shareholders, but still provide a very substantial return over the next two years.

(Alternatively, of course, one could view T.H. Lee's involvement as a significant positive – i.e. there is a significant owner who is incentivized to maximize the stock price over the next two years – but I'm just trying to play devil's advocate here.)

As for management specifically, we believe the current team would remain in place regardless of ownership. We don't have any strong view on management but have spoken to CFO Tony Laday several times and came away positively; CEO Larry Johnson has overseen the brand's expansion since 2007 and restaurants built during that time have clearly done well.

Liquidity Risk

It should go without saying that FOGO is rather hard to get in and out of at scale. Herein, of course, lies the opportunity – those of us without liquidity constraints can profit.

Conclusion

I believe the financial case for owning FOGO at the current valuation is extremely compelling; what risks exist are relatively modest, and offset by the absurdly low valuation – at a 10% steady-state free cash flow yield with a reasonable balance sheet and a decade-plus runway of reinvestment at a teens-twenties RONIC, you can take a ton of hits and still make significant money on this investment. I believe the stock is worth $15+ on conservative assumptions and potentially over $20 in fair value today if you factor in company assumptions on AUVs/capex, income from JVs, full operating leverage on G&A, and some restaurant development beyond 75 U.S. locations.

FOGO has been scaled up to my second-largest position and I sleep pretty well at night owning it. If anyone sees any major risks that I haven't listed, please do let me know – I'm still looking for a credible bear thesis on this stock and just haven't found one.