The Wendy's Company (31/12/2012)

Five percent of the fund's capital is invested in The Wendy's Company (Wendy's). Wendy's is the third largest quick service restaurant (QSR) company in the hamburger sandwich segment globally (McDonald's is the largest). The business is comprised of 6,543 restaurants of which 1,447 are company owned and 5,096 are franchised. The company owns the underlying property of approximately 700 restaurants.

The fund started accumulating this position in October 2011 and has added to the holding periodically. The fund's average cost is $4.68.

We regard the investment opportunity in Wendy's as a longer term business reinvigoration opportunity. We believe Wendy's holds a uniquely positioned brand and provides a differentiated higher quality food offering. We view these characteristics as strong enough to reinvigorate the core operations and provide a viable platform to profitably extend the business into a national breakfast offering, international markets and underpenetrated areas of the US market.

Wendy's was founded in 1969. Its offering is generally well known in the US because of the prevalence of its restaurants and the prominent media profile its founder Dave Thomas built as the company spokesperson in various television commercials until he passed away in 2002. We have been familiar with the business since 1990, initially as consumers and then as financial analysts observing its (then) seemingly unstoppable financial and share market progress. Wendy's was successful because of the higher quality of its food offering and its ability to innovate relative to its peers.

As the chart below illustrates the share market performance of the company was very strong until 2006. Initially this performance came from the strong performance of the core Wendys' offering. However, from 2005 their sales and operating performance declined markedly. Nevertheless, the share price continued higher as investors were attributing significant value to Tim Hortons, a Canadian based coffee and baked goods business that Wendy's spun out in September 2006.

It strikes us as odd to drive past QSRs in the US and see lines of cars waiting at Burger King and McDonald's drive throughs for their breakfast and coffee and then to drive past a Wendy's that is invariably closed. We think Wendy's is interesting because they have no national breakfast offering, an extremely underdeveloped level of international operations and market positions that are under-represented in some areas of the US. To some extent we consider the company has an obvious road map of opportunities looking forward and a brand and food offering that will ultimately enable them to expand into these areas. The key issue in our mind is the performance of the core existing operations since 2005 and an assessment of whether there is a structural problem or if it can be reinvigorated. If the later, there is a significant investment opportunity.

Wendy's motto of "A Cut Above" is consistent with where we perceive their brand and food offering to sit amongst their QSR peers. These observations are supported by various industry surveys. Despite these seemingly positive traits, we consider that the operating performance of the business has been mixed to poor from 2005 until 2010. Over this period, Wendy's has generated volatile and often negative same store sales performance and variable earnings contributions.

	2005	2006	2007	2008	2009	2010	Cumulative
North American system wide same store sales	-3.2%	0.6%	1.3%	1.0%	-0.7%	-0.6%	-1.7%

Wendy's performance sits in stark contrast to the sector and particularly McDonald's who have realised significant success via improving the quality of their food offering, improving their service and restaurants, innovating across menu options, establishing a breakfast offering (now accounting for 25% of revenues) and leveraging their business model into offshore markets. Accordingly, Wendy's enterprise value has languished at around $3 billion which contrasts to McDonald's at around $100 billion and Burger King around $8.5 billion.

We consider the QSR sector as being low margin, high volume and generally a capital intensive industry. There is also the need for consistent menu innovation and promotions to keep the offerings fresh and front of mind for consumers. The franchisor also needs to maintain an economic balance that is sustainable for both them and the franchisees. Given the nature of the business we feel the quality of management can make a big difference to the profits shareholders ultimately earn. It is certainly not the sort of business that can just be left to run itself. When we looked at the troubles Wendy's had encountered since 2005, we felt the issues were more around execution and our impression was that Wendy's did not really move forward in comparison to their peers. The food seemed consistently good, the restaurants while clean and functional felt dated, and our impression was there didn't seem to be successful innovation in their menu. Our view was Wendy's continued to do what they had always done well but the market was getting more competitive and their competitors were improving. Given the nature of the business these miss-steps were magnified through their operating performance.

We started to take a closer look at the business early in 2011 when the company began to post positive same store sales numbers. We saw this as an encouraging initial sign, and this has continued for the last six quarters. It is still very early days in our minds, but we regard this recent trend as encouraging.

Year ending		Q1	Q2	Q3	Q4	FY
1999	Company	9.9%	8.3%	7.1%	6.4%	7.9%
	Franchised					
	Systemwide					
2000	Company	3.5%	2.8%	2.8%	3.2%	3.1%
	Franchised					
	Systemwide					
2001	Company	1.4%	2.8%	1.6%	2.4%	2.1%
	Franchised	1.1%	3.1%	2.3%	3.6%	2.6%
	Systemwide					
2002	Company	5.6%	6.6%	5.0%	1.0%	4.7%
	Franchised	8.1%	9.5%	7.8%	3.0%	7.1%
	Systemwide					
2003	Company	-3.1%	-2.3%	0.5%	8.6%	0.9%
	Franchised	-1.7%	-2.0%	0.9%	7.6%	1.1%
	Systemwide					
2004	Company	9.1%	5.9%	2.0%	-4.3%	2.9%
	Franchised	7.6%	3.7%	0.9%	-4.0%	1.8%
	Systemwide					
2005	Company	-2.2%	-4.6%	-5.0%	-2.9%	-3.7%
	Franchised	-1.0%	-3.9%	-5.6%	-1.9%	-3.1%
	Systemwide					
2006	Company	-4.8%	0.7%	4.1%	3.1%	0.8%
	Franchised	-5.2%	1.0%	3.9%	2.7%	0.6%
	Systemwide					
2007	Company	3.8%	0.7%	0.2%	-0.8%	0.9%
	Franchised	3.7%	0.4%	1.3%	0.2%	1.4%
	Systemwide					
2008	Company	-1.6%	0.1%	-0.2%	3.6%	0.5%
	Franchised	-0.1%	0.8%	0.2%	3.8%	1.2%
	Systemwide	-0.4%	0.7%	0.2%	3.7%	1.0%
2009	Company	0.3%	-1.2%	-1.4%	-4.1%	-1.7%
	Franchised	1.2%	-0.1%	0.4%	-2.6%	-0.3%
	Systemwide	1.0%	-0.4%	-0.1%	-3.0%	-0.7%
2010	Company	0.2%	-2.9%	-3.1%	-0.9%	-1.7%
	Franchised	1.0%	-1.4%	-1.3%	0.6%	-0.3%
	Systemwide	0.8%	-1.7%	-1.7%	0.2%	-0.6%
2011	Company	-0.9%	2.3%	1.8%	5.1%	2.0%
	Franchised	0.4%	2.3%	0.7%	4.2%	1.9%
	Systemwide	0.1%	2.3%	0.9%	4.4%	1.9%
2012	Company	0.8%	3.2%	2.7%		
	Franchised	0.7%	3.2%	2.9%		
	Systemwide	0.7%	3.2%	2.8%		

What really got us engaged in Wendy's as a prospective investment was the approach the new management team led by Emil Brolick was taking to drive the business forward. They have clearly identified the need to reinvigorate their existing North American operations as the priority. They see an opportunity to revive an iconic brand whose problems since 2005 have been self inflicted. The program they have enunciated involves a significant capital program of refitting existing company owned restaurants, lifting the bar on employees and service, revisiting their pricing levels and putting more resources behind their advertising and marketing initiatives. As they are getting confirmation of the sales uplift from the new stores they are accelerating their capital spend into the store refit program and encouraging franchisees to do the same. The aggressiveness they are approaching this program with is more typical of an owner operator or private equity environment.

The path they are taking the business forward in resonates strongly with us because it is aimed at addressing the crux of what we suspect are the problems within the business. We also appreciate their directness and transparency as they align the organisation towards what is important and set a clear benchmark for accountability. We suspect it would have been easier and more palatable to shift their focus towards building a national breakfast offering or getting more aggressive in international markets but without fixing the core ultimately this would have just proved a short term fix. The approach they have taken sits consistently with our view of the brand and the longer term opportunity for the business. If they can revive the core operations then they have a truly unique and enviable base to leverage into these related areas.

We consider the risks of the fund's investment in this company to be relatively high - there are multiple execution risks, we have acquired the position at a point where the capital expenditure program is ramping up and there is just tepid confirmation of the returns from this spend. We regard the risks as worth taking because of the nominal enterprise value of the business and our regard for the brand. We also feel there is a management team and shareholder base that is aligned with realising this reinvigoration. If our thesis is right this will be evident initially through an improving trend in the company's same store sales followed by improving earnings and cash flow. Given the nature of the business this dynamic will be sustained for many years as they initially drive more activity and better returns through their core operations and subsequently leverage this footprint into a national breakfast offering and international rollout. Should our view prove correct, the business will be worth many multiples of its current $3 billion enterprise value.

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