Investment Report

MTY Food Group Inc. (TSX: MTY)

"The best business is a royalty on the growth of others, requiring little capital itself" – Warren Buffett, 1978

LSIF April 2018 Call

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Analyst: George Nikoletos

Recommendation: Buy

Target Price: $72.00

Margin of Safety: 41%

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1. Introduction

MTY Food Group Inc. (or "MTY") is one of North America's leading franchisors in the food and restaurant industry. The company's primary business consists of franchising numerous brands in the quick-service restaurant (QSR) industry. MTY's concepts can be found in food courts and malls, street front locations, and other non-traditional formats such as in gas stations, convenience stores, cinemas, and others.

The company reports sales through the following segments:

I) Royalties
II) Franchise and transfer fees
III) Rent
IV) Sale of goods (including construction revenue)
V) Other franchising revenue
VI) Other

Royalties and sale of goods are the two largest segments, accounting for 75% of total revenue combined.

To forecast sales, the standard retail model of sales per store was used, with a growth rate being applied to sales per franchise and corporate restaurant. Additionally, the number of net new franchise and corporate locations was explicitly forecasted. MTY's revenue was then derived from the royalties that they collect from their franchisees. The smaller segments of the business (i.e. rent) have been forecasted using a growth rate, and make up 25% of the total revenue.

1.1 Investment Thesis

MTY Food Group's stock is currently undervalued because the market is not potentially appreciating the following:

I) MTY acquires companies at a very attractive ROI (mid-high teens %), and these acquisitions generate a higher return on capital than MTY would earn by focusing on improving SSSG or on aggressively opening new franchise locations. Sell-side analysts are heavily focused on same-store-sales growth, which understates how much shareholder value can be created through MTY focusing on M&A and not SSSG.

II) The North American QSR/fast food industry is very fragmented, and thus there are many more businesses that MTY will be able to acquire in the future, likely at equally attractive rates of return as past acquisitions. Analysts generally do not model M&A in their forecasts, which is why this point may be underappreciated in the market as a form of future value creation.

III) The market seems concerned with the high number of store closures in recent years as well as weak reported SSSG, as evidenced through sell-side research and publicly accessible investment blogs. With careful analysis of these metrics, it turns out that the underlying business is likely stronger than these figures suggest, and an appreciation of this point could give an investor an edge in the market.

Base Case Forecasts

Over the next 7 years, sales grow at an average of 2.6%. This is being driven by the number of locations that MTY's franchisees will open over the period, the growth rate in sales per restaurant, and the royalty rate that MTY collects.

With respect to margins, MTY's EBITDA margin is forecasted to increase from 35% to 43% over the forecast period. MTY has had EBITDA margins above 40% in the past, but this number is likely compressed due to the large acquisitions they have done in the last few years. The financial model does not implicitly assume further M&A, and thus normalized margins can be assumed once MTY fully integrates all of the recent deals.

1.2 Road Map

This report provides explanations of the investment thesis arguments, key financial model projections, followed by sensitivity analyses of economic scenarios. Section 2 explains the investment thesis arguments, with qualitative and quantitative analysis to support each assertion. Section 3 outlines the assumptions used in the base case model forecasts. This includes the sales forecast, margin assumptions, and capital requirements of this business. Section 4 displays valuation of MTY Food Group using the discounted cash flow (DCF) method. This section will then look at MTY's valuation in three additional scenarios: bull case, bear case, and a case where the future per share NPV of expected M&A is included. In section 5, MTY is compared to its competitors on key metrics. Lastly, Section 6 summarizes and concludes this report's key points. Section 7 includes appendices that support various claims made in the body of the report.

2. Thesis Arguments

This section explains the three main thesis arguments that are each a potential source of mispricing in the market. Each section will begin with the main argument, followed by numerical and qualitative evidence to support the statement. Finally, this section will be concluded with an explanation of how M&A has been incorporated into the financial model forecasts, and how it affects MTY's valuation.

2.1 Investment Thesis I: Attractive Returns from Acquisitions

MTY's ability to acquire companies at a positive NPV has created a large amount of value for shareholders and is currently a source of potential mispricing in the market. MTY has averaged three acquisitions per year of varying sizes, and these transactions are the primary additives to the number of locations; they have acquired an average of ~140 locations per year. However, much of the sell-side coverage is focused on the SSSG metric, which is where the potential mispricing arises. MTY's CFO, Eric Lefebvre, explained that acquisitions have been the company's primary focus for growth for the last decade or so. He noted that the management team is careful with allocating capital to improving SSSG, as there is often a point of diminishing returns where the costs outweigh the benefits.[1] Due to SSSG being a secondary focus for MTY, it is important that the return on capital of the deals are attractive and do not destroy shareholder value. The numerical analysis below suggests that the return profile of the average deal is strong, likely averaging a high-teens IRR, and is positive NPV.

To illustrate the attractive return profiles (NPV and IRR) of MTY's transactions, the Manchu Wok and Country Style deals are analyzed in detail. Manchu Wok is presented below in Figure 1, and Country Style is presented in Appendix 1.

2.1.1 *Manchu Wok Transaction*

Manchu Wok was bought for a price of $7.9M in 2014, and had 132 locations at the time (19 of which were corporate-owned). Manchu Wok's system sales (this is the total amount of sales that all the locations generate, *not* the royalty that Manchu Wok collects) were $95M in 2014. Figure 1 below is a stylized model of what MTY's financial return could look like from this deal (in thousands of $CAD):

[1] LSIF Conversation with MTY's CFO, Eric Lefebvre

Figure 1 – MTY's Acquisition of Manchu Wok

Manchu Wok Transaction Analysis												
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Terminal
System Sales		95,000	97,850	100,786	103,809	106,923	110,131	113,435	116,838	120,343	123,953	
MTY Royalty		6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	
MTY Royalty in $		5,700	5,871	6,047	6,229	6,415	6,608	6,806	7,010	7,221	7,437	
EBITDA		2,109	2,172	2,237	2,305	2,374	2,445	2,518	2,594	2,672	2,752	
FCF	(7,889)	1,476	1,521	1,566	1,613	1,662	1,711	1,763	1,816	1,870	1,926	30,375
PV FCF	(7,889)	1,354	1,280	1,209	1,143	1,080	1,020	964	911	861	814	11,771
Cash-on-Cash Return		*17%*	*16%*	*15%*	*14%*	*14%*	*13%*	*12%*	*12%*	*11%*	*10%*	
IRR	26%											
EV/EBITDA Paid Multiple	3.7x											
NPV	14,520											

Due to the lack of disclosure on MTY's deals, many assumptions have been used. First, sales grow at 3% for the discrete period and 2.5% in the terminal year. It is assumed that MTY collects a 6% royalty of the system sales (which is quite conservative, as they likely collect 10% of total franchisee sales when all fees are accounted for). MTY's 37% EBITDA margin from 2014 is used (which can be assumed to be a fully-synergized margin), and then a 70% EBITDA/free cash flow (FCF) conversion rate is applied to forecast FCF. MTY has averaged 75% EBITDA/FCF conversion, and this figure was reduced by 5% for conservatism. Applying a 9% discount rate implies an NPV of $14M, at a 26% IRR. Since MTY's WACC is ~8%, they are earning a very high return on these deals which creates a lot of value for shareholders. One additional point to mention is that if the sales growth rate is changed from 3% to 0%, the IRR is still strong at 23% which demonstrates the insensitivity of this deal to a key driver.

2.1.2 *Key Factors in the Attractive Return Profiles of MTY's Acquisitions*

Though Manchu Wok and Country Style are two of many deals this company has done, the ROI and NPV of the other deals are likely equally or more favourable. There are a few drivers of why their acquisitions are NPV positive and earn such a high rate of return:

i) MTY typically acquires second-rate operators with weak financial performance or brand;
ii) MTY acquires many companies in the private market;
iii) MTY is one of few companies willing to buy these weaker restaurant brands;
iv) The selling company often approaches MTY to buy them out, rather than MTY initiating the deal

With respect to the first point, MTY often purchases second and third-rate franchises with poor finances or a struggling brand (e.g. Country Style). MTY can then improve the financial performance through sourcing economies of scale, consolidation of administrative tasks, and centralized marketing initiatives. Additionally MTY's CFO, Eric Lefebvre, stated that they are willing to close poorly performing locations of acquired companies.[2] After speaking with Mr. Lefebvre, it seems as though MTY has stricter criteria for closing stores than the selling management team. This may be due to MTY wanting to earn a higher overall margin than the original management team, which may be a driver of why they are more willing to close underperforming stores that drag on margins (this point was not concluded in the conversation with Mr. Lefebvre, though). These closures and economies of scale will naturally improve margins and profitability of the acquired companies (though possibly with a decrease in sales), which contributes to the positive NPV.

Second, there is naturally a valuation multiple differential that exists between private and publicly traded companies. Mr. Lefebvre confirmed that MTY takes advantage of this pricing inefficiency in order to earn a higher return and positive NPV on their acquisitions. Specifically, MTY's average deal multiple has been 6.6x EBITDA, while they have historically traded at 12x EBITDA.[3] This shows the purchase "multiple arbitrage" that MTY is able to earn when acquiring businesses.

[2] LSIF Conversation with MTY's CFO, Eric Lefebvre
[3] Scotiabank GBM estimates

Third, there are not many national conglomerates willing to purchase small, second-rate companies like MTY. For example, CARA Foods (a leading Canadian food franchisor) is more focused on full-service restaurants rather than fast food. Restaurant Brands International has a small portfolio (three brands), and their corporate strategy is not based around holding a large portfolio of diverse brands. The fact that there are few willing buyers of these smaller firms that MTY is buying is also a contributing factor to the favourable pricing that MTY can get, and thus the positive NPV.

The fourth point is discussed in further detail in Section 2, but the main takeaway is that MTY is often approached by the selling company, and thus are the only buyer. Again, this gives them favourable deal terms.

Another important point is that the cash flows they receive from these deals are generally very low risk. Since their portfolio is made up of such a large number of brands (67 brands), and since the locations are quite geographically diversified, they are essentially receiving a perpetual stream of cash flows that seem to be very insensitive to macroeconomic trends on an aggregate basis. Additionally, they receive a portion of *revenue,* and thus profitability is important but not paramount with respect to MTY's business, lowering the risk that MTY assumes.

Valuation with Acquisitions

Given that acquisitions are such an integral part of MTY's core business, it was decided that M&A should be explicitly modeled and included as an economic scenario in addition to the other cases. In the supplemental financial model on the "Acquisitions" tab, acquisitions have been integrated on an NPV per share basis. The section below outlines how this analysis was conducted, and how it is factored into the forecasted share price.

In order for one to explicitly model acquisitions, two criteria must be met: i) the management team has a proven track record for consistently deploying capital on M&A; ii) known deal metrics (price paid, margins of the typical target, etc.). With respect to the first criteria, MTY's CFO stated they will always be looking for deals, and that they will not likely ever run out of targets in the United States once the Canadian market is consolidated (also discussed in Section 2.2).[4]

With respect to the second criteria, one can find the deal metrics necessary to model M&A and factor this into the share price:

- The average deal multiple is 6.6x EBITDA;
- The typical margins for an acquired franchisor are slightly lower than MTY's, at ~25%-35% EBITDA margins

Figure 2 below shows a 5-year income statement and FCF calculation of what $60M of capital deployed in one year could look like:

[4] LSIF Conversation with MTY's CFO, Eric Lefebvre

Figure 2 – 5-Year Income Statement and FCF Calculation of 1 Year of M&A Deals

Acquisitions ($M of CAD)	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Purchase Price	60					
EBITDA Margin	30%					
EV/EBITDA	6.6x					
Revenue	29.4	30.3	31.2	32.1	33.1	34.1
SG&A		21.2	21.5	21.9	22.2	22.5
EBITDA		9.1	9.7	10.3	10.9	11.6
D&A		0.6	0.6	0.6	0.7	0.7
EBIT		8.5	9.1	9.6	10.3	10.9
Revenue Growth		3.0%	3.0%	3.0%	3.0%	3.0%
Gross Margin		60.0%	65.0%	70.0%	75.0%	75.0%
EBITDA		30.0%	31.0%	32.0%	33.0%	34.0%
D&A		2.0%	2.0%	2.0%	2.0%	2.0%
EBIT		28.0%	29.0%	30.0%	31.0%	32.0%
Free Cash Flow						
EBITDA		9.1	9.7	10.3	10.9	11.6
Less: D&A		0.6	0.6	0.6	0.7	0.7
EBIT		8.5	9.1	9.6	10.3	10.9
Less: Taxes @ 26.0%		2.2	2.4	2.5	2.7	2.8
NOPAT		6.3	6.7	7.1	7.6	8.1
Add: D&A		0.6	0.6	0.6	0.7	0.7
Less: CAPEX		0.3	0.3	0.3	0.3	0.3
Less: Working Capital		0.2	0.2	0.2	0.2	0.2
Free Cash Flow		6.4	6.8	7.3	7.7	8.2

The way the above model works is as follows. First, year 1 revenue is calculated using the above two metrics, as well as an assumed amount of capital deployed ($60M in this case). The revenue is calculated using: purchase price/multiple paid/margin. Next, an EBITDA margin and D&A amount are assumed, which flow into the income statement to calculate EBIT. Last, FCF is calculated in the bottom portion by using the implied EBITDA, assuming a tax rate (26% here), and CAPEX and working capital as a % of revenue. D&A, CAPEX and working capital are being modeled using MTY's historical numbers as a % of revenue for simplicity. This gives an implied FCF that is used in the next part of the analysis.

The above section only assumes MTY will acquire for one future year, so it was necessary to calculate multiple years of acquisitions on an NPV per share basis, which is presented below in figure 3:

Figure 3 – NPV per Share of 4 Years of Acquisitions with Compounding Effects

Annual Acquisition Compounding		2018E	2019E	2020E	2021E	Terminal
Revenue		30.3	61.5	93.7	126.8	129.9
SG&A		21.2	42.7	64.6	86.8	
EBITDA		9.1	18.8	29.1	40.0	
D&A		0.6	1.2	1.9	2.5	
EBIT		8.5	17.5	27.2	37.4	
Free Cash Flow						
EBITDA		9.1	18.8	29.1	40.0	
Less: D&A		0.6	1.2	1.9	2.5	
EBIT		8.5	17.5	27.2	37.4	
Less: Taxes @ 26.0%		2.2	4.6	7.1	9.7	
NOPAT		6.3	13.0	20.1	27.7	
Add: D&A		0.6	1.2	1.9	2.5	
Less: CAPEX		0.3	0.6	0.9	1.3	
Less: Working Capital		0.6	1.2	1.9	2.5	
Free Cash Flow		6.0	12.4	19.2	26.4	417.0
Discount Factor		0.9	0.8	0.8	0.7	0.7
PV FCF		5.5	10.4	14.8	18.7	295.4
Purchase Price	(240.0)	6.0	12.4	19.2	26.4	417.0
NPV	**104.82**					
IRR	**16.0%**					

The above analysis begins in 2018E, which is the first year of M&A's income statement and FCF from figure 2. 2019E's numbers are Year 1 financials plus Year 2 financials from figure 2. The logic here is that it is assumed that MTY will be able to improve the margins of the acquired companies, so each year of financials will be different (as the margin improvement comes to fruition). Specifically, EBITDA margins improve by 1% each year from 30% in year 1 to 34% in year 5 (shown in figure 2). Each following year follows the same logic (i.e. 2019E is year 1, 2, 3 summed together). The terminal year is calculated using the perpetuity method, with a 9% discount rate and 2.5% terminal growth rate.

Assuming $60M of capital is deployed per year (i.e. three $20M deals), at a 30% EBITDA margin, with a 6.6x EV/EBITDA multiple, 4 years of acquisitions yields a 16% IRR (consistent with historical deal returns) and a positive NPV of ~$5.00 per share of value. This NPV per share is then added to the share price that the organic model (which assumes no M&A) implies. Scenario 2 in Section 4.0 presents the DCF valuation using this method in more detail.

In conclusion, MTY's ability to create value for shareholders by acquiring companies at a positive NPV and strong IRR has created a large amount of value for shareholders, especially when one considers that these cash flows are generally very low risk. MTY's ability to redeploy this capital at similar rates of return has been proven time and again, and will likely continue as long as they can get attractive deal terms. It is possible that the market does not appreciate how much value MTY has created and will be able to create through deploying capital on M&A, as sell-side analysts tend to be overly focused on SSSG. Analysts typically cover many stocks in the same industry, and therefore SSSG is a metric that allows easy comparability in retailing, but in doing this, they may be missing key information as demonstrated here. MTY is able to generate a higher return on capital by buying companies than they are by committing capital to improving SSS. An investor with an appreciation for capital allocation can take advantage of the mispricing of this security for the reasons stated above.

2.2 Investment Thesis II: Fragmented North American QSR Market Presents Consolidation Opportunity

For a company that creates shareholder value through acquisitions, it is important that a) the deals are positive NPV; and b) that there are further acquisition opportunities. The fragmented nature of the North American QSR market presents an opportunity for MTY to further leverage their M&A model. As the analysis below will show, the Canadian market is much more consolidated that the US market, but both still have many companies that MTY could acquire.

2.2.1 Canadian QSR Market

The commercial foodservice market in Canada was estimated to have revenue of ~$64.5B in 2017. The QSR segment was estimated to be 45% of the commercial foodservice market, or $29B.[5] MTY's Canadian system sales in 2017 account for ~50% of total system sales.[6] Given this mix, MTY has ~5% share of the Canadian QSR market. For reference, CARA Operations – one of Canada's largest food franchisors - has approximately 7% share, illustrating the fragmentation of the Canadian food franchising industry.[7]

It is difficult to find information on the total number of Canadian food franchises or restaurant groups, but there is likely between 120-150 food franchise companies or restaurant groups that are large enough to warrant being acquired by MTY. For example, the Wikipedia article titled, "List of Canadian restaurant chains" outlines 82 major Canadian restaurants that have multiple locations.[8] These are only well-known brands, and do not include smaller restaurant groups. Additionally, this number includes full-service, fast-casual, QSR's, and various other restaurant types, but the point is that there is a number of targets that MTY could potentially acquire. Moreover, after speaking with MTY's CFO it was confirmed that, though the Canadian market has been consolidating for the last decade or so, there are still targets in the market that MTY is either looking at or has looked at. It should be conceded that these estimates are incredibly crude and very difficult to find information on, but the fact that Mr. Lefebvre said there are still a large number of targets in Canada should carry a large weight.

2.2.2 United States QSR (Fast Food) Market

The US fast food restaurant industry was estimated to have generated $245B in revenue in 2017.[9] Approximately 45% (or $1.1B) of MTY's system sales were generated in the United States. This implies MTY has under 0.5% of the US fast food market. Though some of the largest players such as McDonalds are estimated to have >15% share in the US market in 2017, "…nearly 48% of the market is made up of small-business operators that have nine or fewer employees. An additional 55% of establishments have between 10 and 99 employees" (IBISWorld, 2017).[10]

The number of players in the US restaurant industry is also incredibly challenging to find information on (likely because of the sheer number of restaurant chains and food franchising companies), so it is difficult to estimate how many companies exist. However, MTY's CFO explicitly stated that, "it is unlikely [they] will ever run out of companies to acquire in the United States".[11]

2.2.3 How the Typical Deal Process Works

MTY's CFO explained how the typical deal process works. On smaller deals (less than a $25M purchase price), the seller often approaches MTY and gives MTY a price they would like for their company. On these small deals, MTY is typically the only buyer which may be a contributing factor to the attractive purchase terms they get on these deals. Mr. Lefebvre said they often have prior relationships with the companies they buy, which may also explain favourable pricing (since the buyers know MTY's management and see how effective they are at operating a franchise company).

On larger deals, Mr. Lefebvre said they occasionally enter an auction process. He noted that they are careful not to lose price discipline when they enter auctions, and have often walked away from a deal once the price exceeds the price they were willing to pay. As an investor, this is an important fact for an acquisitive company like MTY, as it shows that they are strictly focused on financial returns of their deals, and do not let emotions get in their price discipline.

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[5] MTY Food Group 2016 Annual Information Form
[6] LSIF Estimates
[7] Cara Operations Limited 2016 Management Discussion and Analysis
[8] Wikipedia Article Titled: "List of Canadian restaurant chains"
[9] IBISWorld US Fast Food Restaurants Industry Report
[10] IBISWorld US Fast Food Restaurants Industry Report
[11] LSIF Conversation with MTY's CFO, Eric Lefebvre

The appeal of MTY contributing to the consolidation of the North American market is the economies of scale that come with this trend (mentioned above: sourcing economies of scale, centralized administrative and marketing initiatives, etc.). The average profit margin of a fast food restaurant is estimated to be 5.3%, but can be significantly improved through scale. For example, IBISWorld estimates that "…profit margins at company-operated restaurants can be as high as 15% to 20% due to the large economies of scale the organization has access to".[12] I believe it makes economic sense for smaller franchises to be acquired by larger players, as the margin leverage they will see will improve franchisee's profitability.

In conclusion, I believe the North American food franchising market is supportive of further consolidation, and I believe MTY will be able to apply their model of buying small, private, second-rate companies for cheap prices to create value for shareholders. It is likely that MTY will be able to acquire ~3 companies per year in the future, as this is the number that they have averaged for the last number of years. In the supplemental financial model, it is assumed that MTY deploys $60M of capital per year for four years on M&A in the NPV per share analysis (mentioned above). It is difficult to assess if this point is being priced into the stock, but much of the coverage on this company does not address M&A opportunities, or the value that this company creates through this process. Therefore, it is plausible to conclude that an investor can gain an edge in the market by considering acquisitions in the company's valuation.

2.3 Investment Thesis III: Investors Overstating Organic Business Weakness

Much of the coverage of MTY Food Group mentions how weak their organic business seems. For example, MTY has reported flat or *slightly* positive/negative SSSG for the last 13 quarters. Additionally, they have been closing many more stores than they have opened recently, shown below in Figure 4:

Figure 4 – MTY's franchise location count, with net additions per year

	2010A	2011A	2012A	2013A	2014A	2015A	2016A	2017A
Franchisee Forecast								
Franchisees, Opening	1,550	1,701	2,233	2,179	2,565	2,691	2,695	5,599
Additions	191	127	129	155	145	120	182	260
Closures	(129)	(85)	(207)	(102)	(175)	(258)	(301)	(454)
Acquired	95	494	14	338	167	149	3,062	(18)
Franchisees, Closing	1,701	2,233	2,179	2,565	2,691	2,695	5,599	5,402
Net Additions	**62**	**42**	**(78)**	**53**	**(30)**	**(138)**	**(119)**	**(194)**

On the surface, one can see why MTY's organic business appears weak on an absolute basis, as well as relative to competitors. However, careful analysis of these key metrics show that the results are not as poor as they may seem, and an appreciation of this point may give an investor an edge in the market.

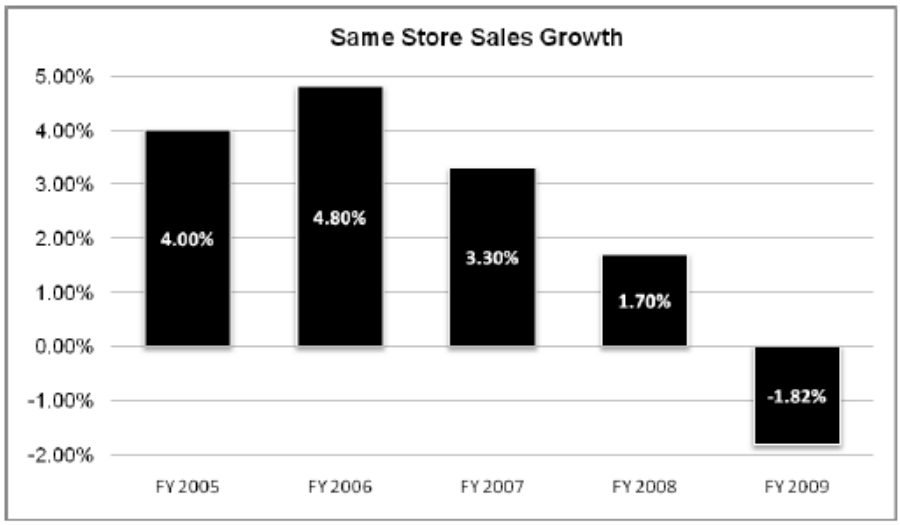
2.3.1 *A Closer Look at the SSSG Metric*

After speaking with MTY's CFO, it became apparent that some of the companies that MTY acquires end up being a drag on SSSG, despite the fact that the actual transactions are positive NPV. The main reason for this is because MTY is often acquiring lower-quality companies which still have underperforming locations in their portfolio. The end result is that there is likely slight downward pressure on SSSG from new acquisitions (once they are included in the SSSG calculation one year after the deal. When asked if this is true, Mr. Lefebvre indirectly confirmed that this phenomenon occurs (he was careful not to be definitive in his answer, but alluded to this being true).

To give a specific example, the Country Style acquisition is one that compressed SSSG versus the rest of the organic business. In MTY's 2009 MD&A, the company presents a table with annualized SSSG from 2005-2009 (Figure 5):

[12] IBISWorld US Fast Food Restaurants Industry Report

Figure 5 – SSSG from 2005-2009



The SSSG figure was quite strong prior to 2009. However, MTY stated that the credit crisis' effects played a role in the decline of SSSG in 2009. One would have assumed that this metric would return back to near-historical levels once the economy recovered post-2009. Consistent with this assumption, in 2011 MTY reported SSSG of 3% for all brands excluding Country Style and their frozen dessert concepts (the frozen dessert brands were weak due to colder weather that year). Including these two brands, SSSG was only 1.3%. SSSG was 56% lower (1-(1.3%/3%)) when Country Style and the frozen dessert brands were included, yet country style only accounted for 10% of revenue that year.[13] MTY stopped disclosing which brands were a drag on SSSG after this year, so it is unfair to assume for certain that this is occurring. However, the severity of the differential of SSSG with and without Country Style, as well as the fact that Mr. Lefebvre alluded to this occurring makes it probable that this has been occurring ever since acquisitions became a large driver of value creation post-2008.

Furthermore, Mr. Lefebvre said they must honour the franchise agreement when they acquire a company, and thus cannot simply close any poor performers immediately.[14] Depending on the duration of the franchise agreement, there could be underperforming locations in the portfolio for a number of years which drags down SSSG. However, once franchise renewal time comes around, he said they are not afraid to close locations. Since MTY has been "perpetually" acquiring companies, this SSSG phenomenon has possibly been occurring since MTY decided to make acquisitions a large piece of their capital allocation strategy.

This illustrates how MTY's acquisition model of buying lower quality companies is likely a drag on a key investor metric, despite the fact that the Country Style deal was still NPV positive (outlined in Investment Thesis I).

Since acquisitions are not integrated into the financial model (rather they are assessed on an NPV per share basis and added to the implied share price of the organic model), the franchise and corporate sales per restaurant growth rate are higher than the SSSG metric has historically been. Franchise restaurant sales grow an average of 2.5% for the discrete period (which is in-line with inflation and thus a fairly conservative estimate), and corporate restaurant sales grow from 1.5%-2% over the same period.[15] The justification for the lower corporate growth rate is that corporate stores are typically locations that MTY has taken over because they are challenged by various market conditions. These estimates do not seem unreasonable because i) acquisitions are not being modeled; ii) the SSSG metric is likely lower than the organic business actually is. Furthermore, as Investment Thesis I outlined, the return

[13] LSIF Estimates
[14] LSIF Conversation with MTY's CFO, Eric Lefebvre
[15] Bloomberg Estimates

on capital is greater when MTY buys companies than it is by improving SSSG. The conclusion of these two points is that MTY's share price may be inefficient due to an overemphasis by investors on low reported SSSG.

2.3.2 *High Store Closures Illustrate MTY's Operational Discipline*

It seems as though investors are also concerned with the high number of store closures in the recent five years; MTY has been net negative in their organic store openings for the last 5/6 years. Understandably, at face value this would point to weakness in the organic business. However, there are a few points that one needs to consider further when assessing this data point.

First, when a business has such a large number of stores in its portfolio like MTY does (5,402 as of year end December 2017), there will always be underperforming stores that need to be closed. MTY's CFO discussed the high number of store closures, saying that MTY would, "[…] prefer to have 1 excellent store than 4 bad stores". Additionally, the stores they are closing are generally much weaker in terms of financial performance than the stores they are opening. For example, the average monthly sales for the stores that were closed was ~$17,400, while the average monthly sales for the stores that were opened was ~$27,200, or 36% higher.[16] This says a great deal about how operationally focused MTY's management team is, specifically related to only keeping high quality locations in the portfolio. Furthermore, MTY's willingness to close underperformers improves the overall profitability of the business, and thus the returns they earn.

2.3.3 *Attractive Model for Franchisees*

Another important point to consider is how attractive the franchise model is for MTY's franchisees. In order for MTY's organic business to continue to grow and prosper, it is important that they can continue to attract franchisees to open new locations. Below is an analysis of the financial profile of what opening a franchise location looks like.

MTY will provide any prospective franchisees with a "Franchise Disclosure Document" (FDD). The FDD outlines much of the initial capital investment, as well as the details regarding leases, franchise rights, etc. Appendix 2 details the specific start-up costs. On average, it would cost a franchisee roughly $500,000 to open a "full" franchise location. This can either be paid to MTY as a lump sum, in a series of payments, or MTY can build the franchise for the franchisee and then be paid back over the course of the franchise agreement.

Additionally, the financial returns for a franchisee are attractive. A franchisee of a full location (i.e. food court, street location, movie theatre, etc.) could take home roughly $100,000 of pre-tax income (assuming the owner works in the store). This implies a 6 year payback, at an 11% IRR. Restaurant franchising has been especially popular with immigrants, and one can see why this is the case. Franchising a restaurant does not require a formal education, and MTY provides extensive support and training to franchisees. A franchisee gets access to a well-known brand, and can run their own business with less risk than starting from scratch. Appendix 3 provides a model of what a typical franchise location's profit and loss statement, as well as what their expected ROI could look like.

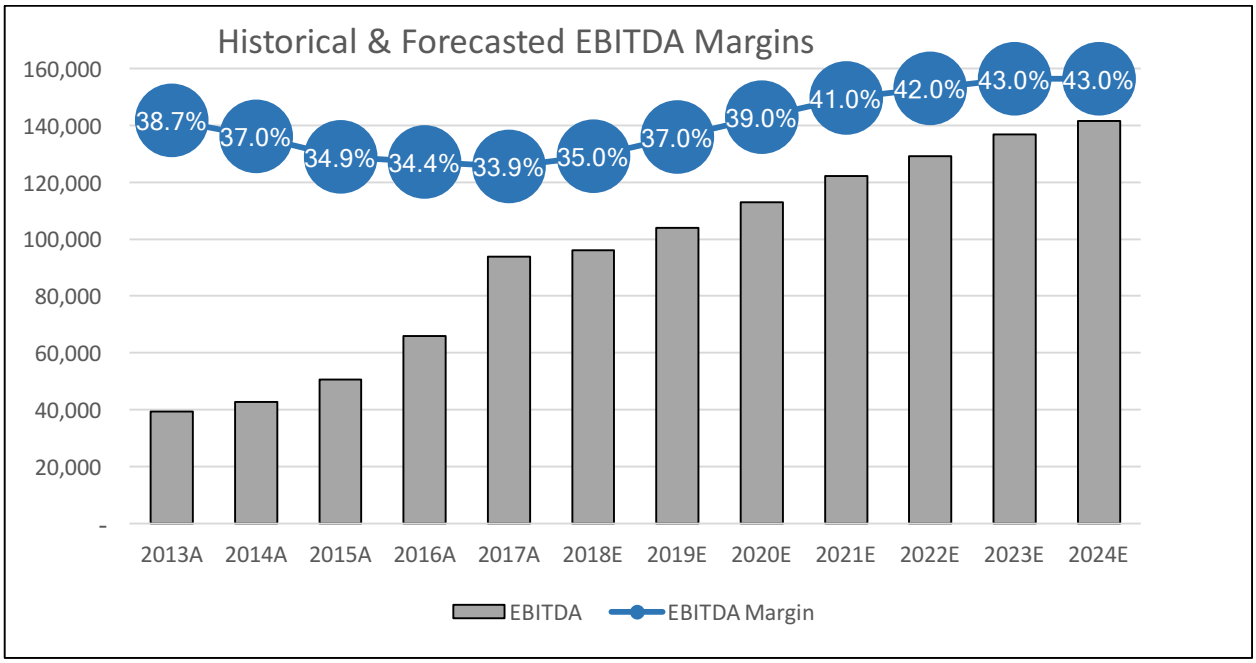
This point was meant to illustrate that the MTY model is attractive to the franchisees, and that it is highly likely that there will always be people looking to open franchises.

[16] MTY Food Group 2016 Management Discussion and Analysis

2.4 Margin Analysis: MTY Historically & Competitor's Margins

MTY's EBITDA margins are a primary driver of the valuation, and are explicitly forecasted in the model. Figure 6 below outlines MTY's historical EBITDA margins, as well as the forecast going forward:

Figure 6 – Historical and Forecasted EBITDA Margins



The justification for the margin improvement is as follows: first, the organic model assumes no further acquisitions. Given this, it is assumed that MTY will close poorly performing stores (which drag on profitability), and will thus see margin improvement. Second, MTY's CFO alluded to the fact that their margins have been depressed recently due to the high number of corporate stores they have inherited with recent deals (corporate stores typically earn 8% EBITDA margins versus >35% for franchised locations). The assumption going forward is that these will improve slightly or be sold off. In the financial model, it is assumed that MTY only adds 3-4 new corporate stores per year, which is much lower than historical averages. Given this slower corporate store addition, it is reasonable to state that margins will improve over time.

Figure 7 below is a comparison of other QSR franchisor's EBITDA margins relative to MTY. One can see that MTY has historically earned much higher margins than the average, though their peer companies have caught up in the recent past.

Figure 7 – EBITDA Margins of MTY Food Group vs. Competitors

Peer EBITDA Margins	2009	2010	2011	2012	2013	2014	2015	2016	2017
Domino's Pizza (DPZ US)	15.2%	16.0%	17.1%	18.2%	18.8%	19.1%	19.8%	19.9%	20.3%
McDonald's Corp (MCD US)	35.4%	36.3%	36.8%	36.6%	36.8%	35.0%	34.2%	37.6%	47.8%
Restaurant Brands Int'l Inc (QSR US)					51.1%	20.8%	33.9%	44.4%	41.9%
Wendy's Co (WEN US)	8.4%	14.0%	11.6%	11.1%	13.5%	20.1%	22.9%	30.6%	27.8%
CARA Brands (CARA CN)					9.6%	22.6%	32.6%	29.0%	
Average	**19.7%**	**22.1%**	**21.9%**	**22.0%**	**26.0%**	**23.5%**	**28.7%**	**32.3%**	**34.5%**
MTY Food Group Inc (MTY CN)	41.5%	38.6%	32.2%	36.3%	38.7%	37.0%	34.9%	34.4%	33.9%

2.5 Management Alignment and Compensation

This section outlines the key members of the management team, how they are compensated, and how aligned they are with shareholders. There is also a portion detailing how the CEO and COO initially acquired their shares in MTY Food Group Inc.

MTY's current CEO is Stanley Ma, who has been Chairman of the Board since 1997, and President and CEO since 2004. He founded the first MTY restaurant, "Le Paradis du Pacifique" in 1979, and expanded the business to other lines such as IT and security equipment. Once he realized that the franchising business was very lucrative, he decided to sell off the other lines and focus exclusively on franchising. Through organic growth and acquisitions, he has grown the company to where it is today. He currently owns 23% of all shares outstanding, and is paid a $390,000 base salary.[17] Claude St-Pierre has been the COO since 2012, but was Secretary of MTY since 1996. He owns ~2.5% of shares outstanding, and is paid a base salary of roughly $190,000.[18]

MTY pays their managers quite a modest salary, have not awarded options or any other equity-based compensation since 2005, and have not paid bonuses in the recent past. All of the named executive officers combined are paid a total of $1.3M per year, which is quite low for a corporation of this size. It is difficult to assess management's alignment with shareholders when many of them do not own substantial amounts of stock (with the exception of Ma and St-Pierre). When asked about the lack of options awarded to the management team, MTY's CFO said they did not want to dilute existing shareholders' stock by issuing options, though they considered it.[19] This statement says a lot about how aware this management team is of shareholder value maximization. Additionally, the fact that Ma owns such a large amount of stock and employs his family in the company further aligns him with shareholders. The MTY management team does not communicate extensively with investors, (they do not do presentations or conference calls), and appear to just be very focused on operating the business effectively.

One thing that is interesting about MTY is how Stanley Ma and Claude St-Pierre first acquired their shares in the company. In 2001, investors allegedly "let" the management team reprice their stock option purchase prices.[20] Looking at subsequent insider transactions since this date, Stanley Ma and Claude St-Pierre purchased large amounts of shares in 2003. Stanley Ma purchased 3.1M shares at $0.25 per share in a private transaction, and Claude St-Pierre was awarded 465K shares at $0.25 each.[21] These transactions are what allowed Ma to get such a large stake in MTY, as he previously only owned 3% of the company. Typically, these option repricing programs are unfair to investors as they allow management to acquire previously underwater stock options very cheaply. This is the only instance of MTY's management operating "unethically" or not in favour of shareholders, but is still worth noting.

In conclusion, MTY's management team seems aligned with shareholders through stock holdings and/or modest salaries. The company seems thoughtful with respect to value creation in favour of shareholders, and are very focused on running the business. Furthermore, MTY's track record of maximizing shareholder wealth should not be overlooked, as this company's total shareholder return over its time as a public company has been 18% annualized (vs. 7% for the TSX).[22]

3. Base Case Forecasts

3.1 Revenue Forecast

Over the discrete period of seven years (2018-2024), sales are forecasted to grow at an average of 2.6%. This is the result of individual forecasts of royalties, sale of goods, and the other segments. This section outlines how each revenue line is being forecasted. MTY reports their system sales (this is the total sales that all of the franchisees generate), as

[17] MTY Food Group 2016 Proxy Statement
[18] MTY Food Group 2016 Proxy Statement
[19] LSIF Conversation with MTY's CFO, Eric Lefebvre
[20] MTY press release dated May 23, 2001
[21] SEDI Insider Transactions
[22] Bloomberg Estimates

well as the sales generated from corporate locations separately. Subtracting the corporate sales figure from the system sales gives the total franchisee sales, which have then been forecasted separately from corporate sales.

3.1.1 *Royalties*

Royalties are forecasted to grow at an average of 2.3% from 2018-2024. This implies that this segment will make up ~42% of the revenue mix (it has historically been ~40% of revenue).

The method that is used to forecast the royalties that MTY will collect from franchisees is the traditional sales per store model for retailers. This section was forecasted in two parts, with the first being franchisee sales per restaurant growth and the second being the net new franchise locations opened in the period. These two numbers drive the total franchisee sales, which MTY then collects a royalty from. The following function denotes how this figure is derived:

$$Total\ Franchisee\ Sales = Franchisee\ Sales\ per\ Restaurant * Average\ Store\ Count\ in\ Period$$

Franchisee sales per restaurant is growing using a growth rate of 2.5% for years 2018-2024, with net new franchise location additions of (60) in 2018, zero in 2019, 10 in 2020, increasing by 10 per year to 50 in 2024. This is meant to reflect high store closures from the last few years of deals, and then improving figures going forward when acquisitions are not included.

To calculate the amount of royalties that MTY collects from its franchisees, a royalty rate of 5.2% was applied to the total franchisee sales (5.2% * total franchisee sales). 5.2% is approximately the average that this figure has been in the past.

3.1.2 *Sale of Goods, Including Construction Revenue*

This segment includes corporate location sales, renovation & construction revenue, and processing revenue. In this segment, corporate sales have been modeled separately from the other components. The method for forecasting corporate sales is the same as franchisee sales (above), using a growth rate in sales per corporate restaurant, and net new store additions. The financial model forecast has MTY adding three to four corporate locations per year for the foreseeable future.

A growth rate of 2.5% was then applied to the other components of this segment (i.e. renovation & construction and processing revenue) for all future years. This implies that sale of goods makes up ~33% of the revenue mix, which is approximately what it has historically averaged.

3.1.3 *Other Revenue Segments (Franchise and Transfer Fees, Rent, Other Franchising Revenue, Other)*

These segments of the business are much smaller than the royalties and sale of goods, and thus a simple growth rate was used to forecast these. The royalties' growth rate that the above method implies was applied to these line items. On average, they are growing ~2.3% for the forecast period. The "Other" line is being forecasted as flat.

Figure 8 below outlines the forecasted revenue by segment and year-over-year growth rates by segment:

Figure 8 – Revenue Segment Forecast in Terms of Absolute Dollars and Growth Rates

Year	2018E	2019E	2020E	2021E	2022E	2023E	2024E
Segments							
Royalties	118,081	120,357	123,482	126,924	130,703	134,841	139,360
Franchise and Transfer Fees	11,036	11,249	11,541	11,863	12,216	12,603	13,025
Rent	2,306	2,350	2,411	2,478	2,552	2,633	2,721
Sale of Goods, including construction revenues	89,635	93,112	96,694	100,384	104,430	108,851	113,409
Other Franchising Revenue	40,675	41,459	42,536	43,721	45,023	46,449	48,005
Other	12,710	12,710	12,710	12,710	12,710	12,710	12,710
Total Revenue	274,443	281,238	289,374	298,080	307,636	318,087	329,230

Year	2018E	2019E	2020E	2021E	2022E	2023E	2024E
Royalties Growth Rate	-0.5%	1.9%	2.6%	2.8%	3.0%	3.2%	3.4%
Franchise and Transfer Fees Growth Rate	-0.5%	1.9%	2.6%	2.8%	3.0%	3.2%	3.4%
Rent Growth Rate	-0.5%	1.9%	2.6%	2.8%	3.0%	3.2%	3.4%
Sale of Goods Growth Rate	-0.9%	3.9%	3.8%	3.8%	4.0%	4.2%	4.2%
Other Franchising Revenue Growth Rate	-0.5%	1.9%	2.6%	2.8%	3.0%	3.2%	3.4%
Other Growth Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

3.2 Margins

3.2.1 EBITDA Margins

Section 2.4 outlined the margins of MTY Food Group Inc. historically, as well as relative to peers. The base case forecast has margins improving from 35% in 2018 to 43% in 2024. This justification for this increase was outlined above.

3.4 Other Model Assumptions

3.4.1 Working Capital

I) Accounts Receivable – When forecasting this line item, the metric "Days Sales Outstanding" was used. The equation is outlined below:

$$Days\ Sales\ Outstanding = \frac{Accounts\ Receivable\ in\ period\ n}{Sales\ in\ period\ n} * Days\ in\ period\ n$$

46 days was used as the forecasted average with no deviations over the forecasted period. This is approximately how quickly they have been able to collect their receivables in the past. The financial model is not incredibly sensitive to this assumption due to the low working capital balance in this business.

II) Accounts Payable – This line item is similar to accounts receivable. The equation for "Days Payable Outstanding" is denoted below:

$$Days\ Payable\ Outstanding = \frac{Accounts\ Payable\ in\ period\ n}{Cost\ of\ Goods\ Sold\ in\ period\ n} * Days\ in\ period\ n$$

250 days is used as the forecasted average with no deviations. This line item fluctuates quite a lot, so it is difficult to find an average to use, but the model is not very sensitive to this assumption.

III) Inventory - "Inventory Days" is the metric used to forecast this line, which is similar to Days Sales Outstanding, except has "Inventory in period n" in the numerator. An average of 6 days was used to forecast this line, as this has been the historical average.

IV) Loans Receivable, Prepaid Expenses and Deposits, Deferred Revenue – these three working capital items were forecasted as a percent of revenue at 1%, 1.2%, and 7.5% respectively. These numbers are based on an average that was taken from historical figures.

MTY's working capital balance has historically been quite small as they run a very asset-light business. Additionally, there were years in the past where the change in working capital was negative, and thus a source of funds. This is likely the case because MTY can stretch their suppliers with their scale, but get paid quickly due to the small size and low bargaining power of their franchisees. In the projections, there are multiple years where the change in working capital is negative, but this is a normal phenomenon for a business such as MTY.

3.4.2 Capital Expenditures

Food franchising is typically not a very capital intensive business, and MTY Food Group is no different; CAPEX has generally been ~1% of revenue. For a capital intensive business such as a manufacturer, a more detailed CAPEX forecast would be warranted. However for MTY, CAPEX was modeled as 22% of the opening PP&E balance in the period. This yields CAPEX values that are 1% of revenue, which is consistent with historical values.

3.4.3 *Depreciation and Amortization*

Depreciation is modeled as a percent of the opening property, plant and equipment balance. Historically, depreciation has been under 1% of revenue, and is therefore not a large factor affecting this company's valuation. This business is very capital-light, as they do not own any of the franchisee properties (they are leased), and have minimal head office requirements. Depreciation is modeled as 20% of the opening PP&E balance for the duration of the projection period.

The treatment of amortization charges that this business incurs needs slightly more attention than usual. Specifically, since MTY has acquired such a large number of companies, they have built up a balance of acquisition-related intangible assets that are not economic. In other words, the amortization charges that MTY takes on their intangible assets are not real "costs" of doing business, and thus should not be considered a cash outlay. For example, MTY has $69M worth of "Franchise and Master Franchise Rights", and $63M of "Trademarks" within the intangible assets balance. The Franchise and Master Franchise Rights amount is related to acquisitions, and the trademarks amount is an indefinite life intangible. As such, I do not believe either of these balances are material costs.

Amortization is forecasted as a percent of the opening intangible assets balance in the period, with 4.5% being used as the value. This is not included in the DCF valuation, so the precision of this metric is not overly important. This is not being included in the FCF calculation because much of the amortization charge comes from acquired intangibles which, again, are not a cost of doing business. Therefore, *additions* to intangible assets are not being forecasted, and thus the amortization charge this company takes is not treated as a recurring cost in the FCF calculation.

3.4.4 *Income Taxes*

A tax rate of 26% is used as the forecasted rate in the future.[23] MTY's CFO implied this would be a reasonable estimate to use as the effective tax rate, as it incorporates a blend of both Canada and US tax rates. Given that MTY is gaining more exposure to the US, the new tax reforms being implemented should be favourable in terms of lowering their effective tax rate.

3.4.5 *Terminal Growth Rate*

A terminal growth rate of 2.5% is used in the terminal value calculation, which is based on an estimate of average U.S. inflation over the last fifty years.[24]

3.4.6 *Weighted Average Cost of Capital*

MTY's cost of equity is based on the CAPM model, with the following assumptions:

- A risk-free rate of 2.5%, based on the interest rate on a 5-year US Treasury Bond;[25]
- LSIF standard equity risk premium of 7.0%;
- Beta of 0.89[26]

MTY's after-tax cost of debt is derived from the following assumptions:

- A pre-tax cost of debt of 4.5%;
- An effective tax rate of 26%

Given these inputs, the cost of equity is 8.7% and the after-tax cost of debt is 3.4%. MTY's capital structure is 83% equity, 17% debt, which yields a weighted average cost of capital (WACC) of 7.8%. MTY's business is generally

[23] LSIF Conversation with MTY's CFO, Eric Lefebvre
[24] "Long Term U.S. Inflation", Tim McMahon
[25] Bloomberg Estimates
[26] Bloomberg Estimates

low risk (as they assume very little franchise specific risk and simply collect a royalty on revenue), and as such, this low WACC is justified.

4.0 DCF Valuation

4.1 Scenario 1 – Base Case

Scenario 1 is the valuation of MTY Food Group Inc. with the base case forecasts outlined in section 3. Key assumptions include:

- 60 franchise restaurant closures in 2018, zero in 2019, and an increase of 10 new openings annual until 2024 with 50 new openings per year;
- Franchise sales per restaurant growth rate of 2.5% over the discrete period;
- 3 corporate stores opening per year, growing revenue per store at 1.5% in 2018, and 2% from 2019-2024;
- A royalty rate of 5.2%;
- Non-restaurant sale of goods growth rate of 2.5%;
- EBITDA margins improving from 36% in 2018 to 43% in 2024;
- Terminal growth of 2.5%

Valuation - Scenario 1	
PV Forecast Period	845,075
PV Terminal Period	861,854
Enterprise Value	1,706,930
Less: Debt	227,202
Add: Cash	56,453
Equity Value	1,536,181
Diluted Shares Outstanding	21,374
Implied Share Price	$ 71.87
Current Price	$ 51.14
Margin of Safety	*41%*

4.2 Scenario 2 – NPV per Share of Acquisitions

Scenario 2 is the valuation of MTY Food Group Inc. with the above base case forecast assumptions, but includes the NPV per share of explicitly modeling future acquisitions by MTY. In addition to the base case assumptions from above, key assumptions include:

- $60M of capital deployed per year;
- Targets operating at a 30% EBITDA margin;
- Average deal multiple of 6.6x EBITDA;
- Revenue growth of 3% for 5 years, 30% EBITDA margins improving to 34% within 5 years

Scenario 2 - Implied Share Price With Acquisitions	
Organic Share Price	$ 71.87
NPV of Acquisitions	104,822
Shares Outstanding	21,374
NPV Per Share	$ 4.90
Implied Share Price	$ 76.77
Margin of Safety	*50%*

4.3 Scenario 3 – Bull Case

Scenario 3 is the valuation of MTY Food Group Inc. with bull case forecasts. Key assumptions include:

- Net franchise location openings of 20 in 2018, increasing by 10 per year to 70 net franchise location openings in 2024;
- Franchise sales per restaurant growth rate of 3% over the discrete period;
- 4 corporate store openings per year, growing revenue per store at 2% from 2018-2020, and 2.5% in 2021-2024;
- A royalty rate of 5.2%;
- Non-restaurant sale of goods growth rate of 2.5%;
- EBITDA margins improving from 35% in 2018 to 45% in 2024;
- Terminal growth of 2.5%

Valuation - Scenario 3	
PV Forecast Period	944,770
PV Terminal Period	1,021,905
Enterprise Value	1,966,675
Less: Debt	227,202
Add: Cash	56,453
Equity Value	1,795,926
Diluted Shares Outstanding	21,374
Implied Share Price	$ 84.02
Current Price	$ 51.14
Margin of Safety	*64%*

4.4 Scenario 4 – Bear Case

Scenario 4 is the valuation of MTY Food Group Inc. with bull case forecasts. Key assumptions include:

- Net franchise location closures of 120, 100, 50, 50 in years 2018-2021 respectively, with zero openings per year for the rest of the discrete period;
- Franchise sales per restaurant growth of 1.5% for the discrete period;
- Zero corporate store openings per year, with revenue per corporate restaurant growing 0% in 2018, 1% from 2019-2021, and 1.5% from 2022 and beyond;
- A royalty rate of 5.2%;
- Non-restaurant sale of goods growth rate of 2.5%;
- EBITDA margins improving from 34% in 2018 to 40% in 2024;
- Terminal growth of 2%

Valuation - Scenario 4	
PV Forecast Period	678,222
PV Terminal Period	606,425
Enterprise Value	1,284,647
Less: Debt	227,202
Add: Cash	56,453
Equity Value	1,113,898
Diluted Shares Outstanding	21,374
Implied Share Price	$ 52.11
Current Price	$ 51.14
Margin of Safety	*2%*

5.0 Comparable Analysis

MTY Food Group is positioned as one of the most diversified food franchisors in the North American Market. Additionally, many of the below competitors are either much larger businesses or own a very small portfolio of brands. As a result, there are no directly similar competitors with respect to number of brands *and* size. Figure 9 below is a table of North American food franchisors, and related metrics:

Figure 9 – Comparables Table

			EV/EBITDA			Margins					
Company Name	Market Cap	Enterprise Value	LTM	Fwd 1 Yr.	Fwd 2 Yrs.	Gross	EBITDA	Operating	FCF Yield	ROIC	5 yr. rev. growth
Domino'S Pizza Inc	9,969	13,087	23.1x	20.6x	18.7x	31.1%	20.3%	18.7%	2.3%	101.7%	10.7%
Mcdonald'S Corp	128,113	155,185	14.2x	14.9x	14.3x	46.5%	47.8%	41.9%	2.8%	22.8%	-3.7%
Restaurant Brands In	26,013	37,062	19.3x	16.1x	15.0x	49.1%	41.9%	37.9%	10.1%	10.3%	
Wendy'S Co/The	4,075	6,658	19.6x	15.7x	14.4x	58.1%	27.8%	17.6%	4.1%	8.2%	-13.4%
Cara Operations Ltd-	1,834	2,243	12.5x	10.2x	9.5x	61.3%	23.2%	16.6%	6.5%	10.8%	
Median			***19.3x***	***15.7x***	***14.4x***	***49.1%***	***27.8%***	***18.7%***	***4.1%***	***10.8%***	***-3.7%***
Average			*17.7x*	*15.5x*	*14.4x*	*49.2%*	*32.2%*	*26.5%*	*5.2%*	*30.8%*	*-2.1%*
Mty Food Group Inc	**1,285**	**1,457**	**15.5x**	**12.1x**	**10.9x**		**33.9%**	**25.7%**	**7.9%**	**7.9%**	**23.5%**

MTY trades at a 3-4x discount on EV/EBITDA versus the competitors. Historically, this has been relatively consistent (MTY has traded at ~12x EBITDA for the last 5 years), though they were a much smaller business in 2013 ($600M market capitalization versus $1.3B today). Due to the fact that MTY's EBITDA and EBIT margins are generally much higher than competitors such as Wendy's or Cara Foods, as well as the fact that they earn a 65%+ return on tangible assets (net assets minus goodwill and intangibles at a 26% tax rate), the multiple discount is unjustified.

It is highly possible that the market awarded MTY a lower multiple for various reasons including: weak SSSG relative to peers, a lack of conference calls and presentation by management, MTY being a much smaller company, and that some of the portfolio brands are weak at face value. However, as was discussed above, many of these concerns seem unjustified and given these facts, the multiple seems low. However, even if the multiple does not expand to be in line with peers, much of this stock's upside will likely come in the form of EBITDA and FCF growth from either the business growing organically or through further acquisitions.

6.0 Conclusion

MTY Food Group Inc. is currently undervalued in the market due to an under-appreciation of the following points:

1. MTY earns a higher return on capital by acquiring companies than they would by focusing on improving SSSG or aggressively opening new franchise locations. SSSG is a key investor metric, but a focus on this understates MTY's ability to create value for shareholders;
2. The North American food franchising market is very fragmented, and MTY will continue to be able to deploy their acquisition strategy to earn high returns on positive NPV transactions. Investors typically do not model M&A, but this company has proven that this should be priced into the stock, and thus is a potential source of mispricing;
3. MTY's organic business is stronger than the SSSG metric may suggest, and the high number of store closures are not a sign of business weakness. Investors' concerns with organic business weakness could give an investor an edge in the market

In conclusion, this report recommends MTY Food Group Inc. as a **BUY**, with a target price of $72.00 ($77.00 including acquisitions) which implies an undervaluation of ~40%.

7.0 Appendices

*7.1 – **Appendix 1** – Analysis of Country Style Acquisition*

Despite the Country Style acquisition being less financially favourable than Manchu Wok, the deal still generated a high rate of return for MTY and was positive NPV, as shown in the below table:

MTY's Acquisition of Country Style

Country Style Transaction Analysis												
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Terminal
System Sales		94,000	96,820	99,725	102,716	105,798	108,972	112,241	115,608	119,076	122,649	
MTY Royalty		6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	
MTY Royalty in $		5,640	5,809	5,983	6,163	6,348	6,538	6,734	6,936	7,145	7,359	
EBITDA		2,087	2,149	2,214	2,280	2,349	2,419	2,492	2,567	2,643	2,723	
FCF	(13,811)	1,356	1,397	1,439	1,482	1,527	1,572	1,620	1,668	1,718	1,770	27,909
PV FCF	(13,811)	1,244	1,176	1,111	1,050	992	938	886	837	791	748	10,816
Cash-on-Cash Return		9%	9%	8%	8%	7%	7%	6%	6%	6%	5%	
IRR	15%											
EV/EBITDA Purchase Price	6.6x											
NPV	6,778											

Country style had 490 locations in the year that they were acquired, 114 of which were full service locations, while 360 were kiosk-style locations. MTY paid a total consideration of $13.8M for Country Style, which had $94M in system sales at the time of the deal.[27]

The assumptions in this model are similar to the ones in the Manchu Wok analysis, though the EBITDA/FCF conversion rate is slightly lower at 65% (which was the average in the year this deal was done).

*7.2 – **Appendix 2** – Franchise Start-Up Costs*

Initial Investment	Food Court	Street Location
Initial Franchise Fee	30,000	30,000
Electricity, Water, Gas, Phone, etc.	7,500	8,500
Store Design Fees and Plans	11,000	11,000
Permits	1,500	2,000
Landlord Capital Contribution	37,500	-
Store Construction, Leaseholds, Fixtures	185,000	270,000
Exhaust	32,500	50,000
Equiipment	82,500	87,500
Furniture	-	27,500
Signs	11,500	20,000
Menu Box	11,750	13,750
Working Capital	10,000	10,000
Other	49,700	49,700
Total Initial Investment (midpoints)	470,450	579,950

[27] Globe and Mail Article on MTY's acquisition of Country Style

*7.3 – **Appendix 3 -** Franchisee 15-year P&L Statement*

Franchisee P&L																	
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Terminal
Gross Revenue		750,000	772,500	795,675	819,545	844,132	869,456	895,539	922,405	950,078	978,580	1,007,937	1,038,175	1,069,321	1,101,400	1,134,442	
Fees:																	
Royalties		45,000	46,350	47,741	49,173	50,648	52,167	53,732	55,344	57,005	58,715	60,476	62,291	64,159	66,084	68,067	
Marketing		22,500	23,175	23,870	24,586	25,324	26,084	26,866	27,672	28,502	29,357	30,238	31,145	32,080	33,042	34,033	
Advertising		15,000	15,450	15,914	16,391	16,883	17,389	17,911	18,448	19,002	19,572	20,159	20,764	21,386	22,028	22,689	
Net Revenue		667,500	687,525	708,151	729,395	751,277	773,815	797,030	820,941	845,569	870,936	897,064	923,976	951,695	980,246	1,009,654	
Cost of Goods Sold		467,250	481,268	495,706	510,577	525,894	541,671	557,921	574,659	591,898	609,655	627,945	646,783	666,187	686,172	706,758	
Gross Profit		200,250	206,258	212,445	218,819	225,383	232,145	239,109	246,282	253,671	261,281	269,119	277,193	285,509	294,074	302,896	
OpEx		146,850	151,256	155,793	160,467	165,281	170,239	175,347	180,607	186,025	191,606	197,354	203,275	209,373	215,654	222,124	
Pre-Operating Income		53,400	55,002	56,652	58,352	60,102	61,905	63,762	65,675	67,646	69,675	71,765	73,918	76,136	78,420	80,772	
Gross FCF	(525,200)	53,400	55,002	56,652	58,352	60,102	61,905	63,762	65,675	67,646	69,675	71,765	73,918	76,136	78,420	80,772	1,273,717
Salary		40,000	41,000	42,025	43,076	44,153	45,256	46,388	47,547	48,736	49,955	51,203	52,483	53,796	55,140	56,519	
Net FCF	**(525,200)**	**93,400**	**96,002**	**98,677**	**101,427**	**104,255**	**107,162**	**110,150**	**113,223**	**116,382**	**119,629**	**122,969**	**126,402**	**129,931**	**133,560**	**137,291**	**1,273,717**
PV FCF	(525,200)	85,688	80,803	76,197	71,854	67,758	63,897	60,256	56,823	53,585	50,533	47,654	44,940	42,381	39,967	37,692	349,684
NPV	**704,511**																
IRR	**11.3%**																
Implied FCF Multiple	8.7x																