

Calculating Incremental ROIC's

Corner of Berkshire & Fairfax – NYC Meetup

October 14, 2017

Fred Liu, CFA
Managing Partner

Hayden Capital, LLC
79 Madison Ave, 3rd Floor
New York, NY. 10016

Disclaimer

The information and statistical data contained herein have been obtained from sources, which we believe to be reliable, but in no way are warranted by us to accuracy or completeness. We do not undertake to advise you as to any change in figures or our views.

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact.

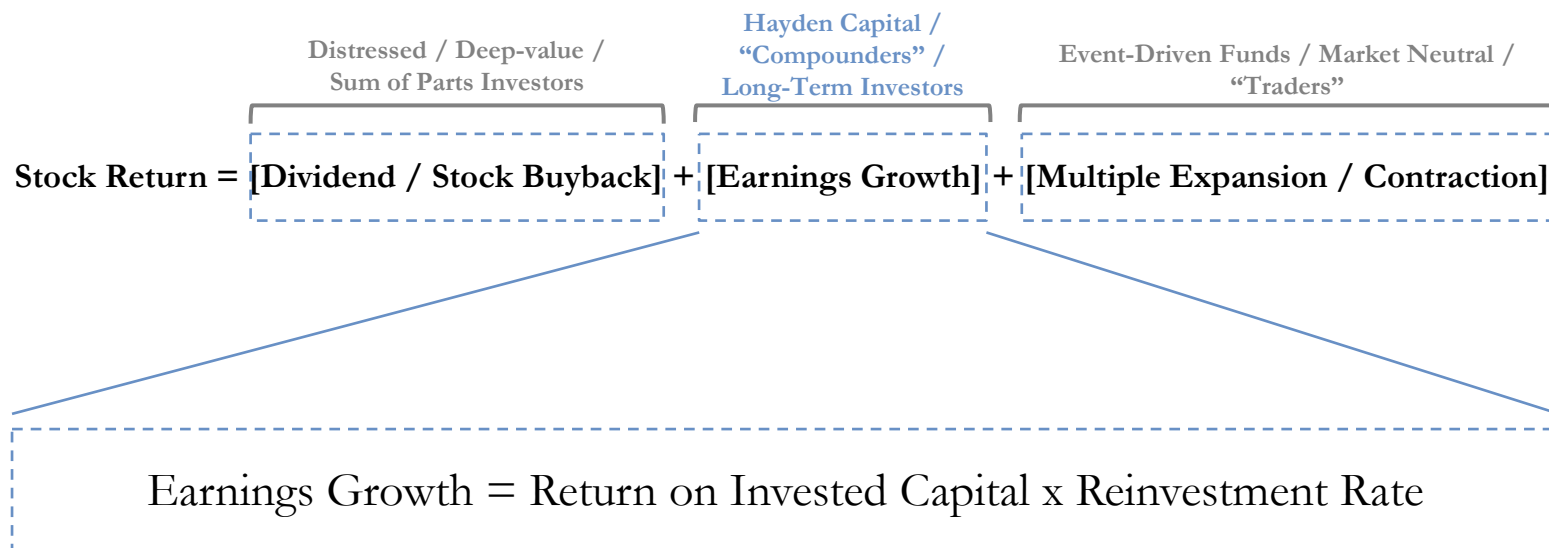
The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. The securities discussed within do not represent all the securities purchased, sold or recommended for client accounts. There is no assurance that any securities discussed herein will continue to be held. It should not be assumed that any of the securities discussed were or will be profitable, or that the investments decisions Hayden makes in the future will be profitable.

Hayden Capital is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy, investment process, stock selection methodology and investor temperament. Our views and opinions include “forward-looking statements” which may or may not be accurate over the long term. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

Clients should let Hayden Capital know if financial situations or investment objectives have changed or whether they prefer to place any reasonable restrictions on the management of their account(s) or modify any existing restrictions. All investments contain risk. You should carefully consider your risk tolerance, time horizon, and financial objectives before making investment decisions.

These materials shall not constitute an offer to sell or the solicitation of an offer to buy any interests in any account managed by Hayden Capital LLC (“Hayden Capital”) or any of its affiliates. Such an offer to sell or solicitation of an offer to buy will only be made pursuant to definitive subscription documents between Hayden Capital and an investor. We, any officer, or any member of their families, may have a position in and may from time to time purchase or sell any of the above mentioned or related securities.

Why Should We Care About ROIC's and Reinvestment Rates?



“Investing is an Art, not a Science”

- 1. Many of the examples given here are theoretical. Often you won't have all the information necessary to do the calculations – especially not down to the \$0.01.*
- 2. This is simply a framework to think about these issues. It's your job as an investor to fill in as much of the gap as possible, to hopefully see the bigger picture.*

Reinvestment Rate

Reinvestment Rate: How Much Is The Company Investing In Itself?

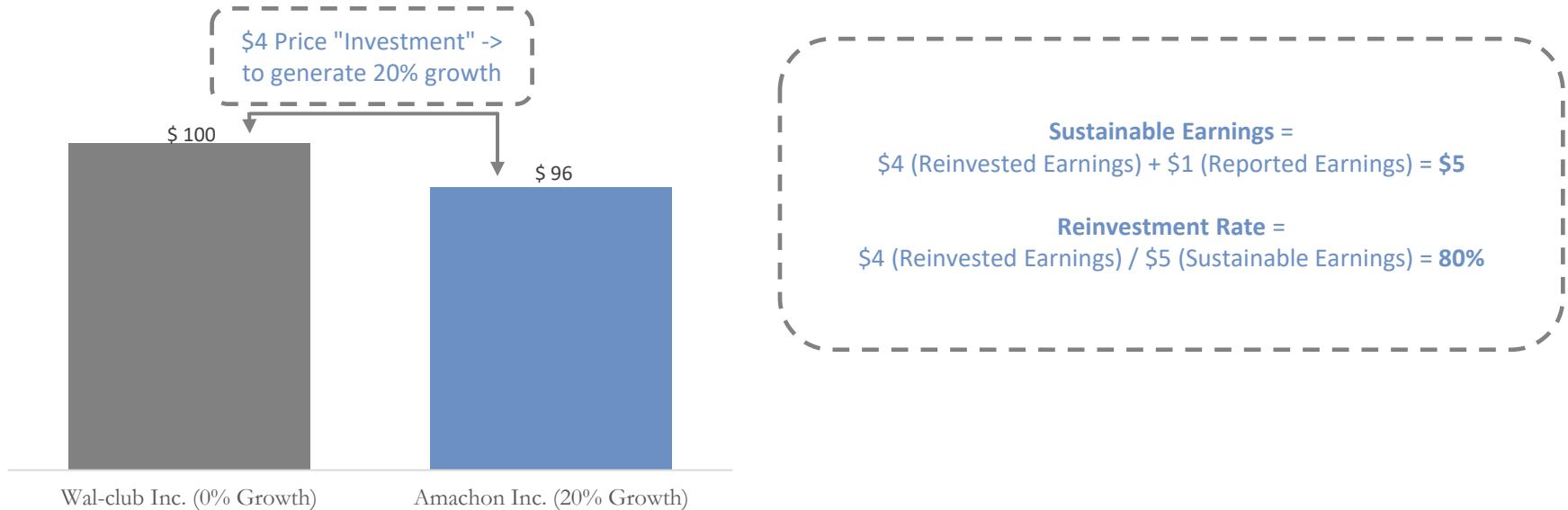
Reinvested Earnings = Sustainable Earnings Power – Reported Earnings

Reinvestment Rate = Reinvested Earnings / Sustainable Earnings Power

- Sustainable Earnings Power is what the business would theoretically earn if it stopped growing.
- There no set “formula” for calculating this. It’s going to be industry & business model dependent.
 - For example, a commodity business may structurally only earn it’s cost structure difference vs the next most efficient competitor.
 - Alternatively, a one-of-kind, mission-critical software provider (think Microsoft in 90’s) has enormous pricing power.
 - They could raise prices up to the point where new customers = lost customers.
 - For the last marginal customer in this scenario, the Price = Customer’s Marginal Utility

Commodity Retail Businesses

\$ Earned



Reinvestment Rate: How Much Is The Company Investing In Itself?

- **The better the reinvestment opportunities, the higher the reinvestment rate should be.**
 - If a company has unlimited opportunities to earn 50% returns, management better be plowing every cent back into the company, and reporting \$0 EPS (assuming investments are expensed).
 - Note: Some companies have a high return project, but limited capacity.
 - A new factory may cost \$5M, with 50% returns. But the business generates \$20M a year... what do you do with the other 15M?
 - Assuming the other 75% is returned, that's only 12.5% growth.
 - Lots of opportunities to deploy capital are just as important as the Return on Invested Capital.

Earnings Growth Drivers

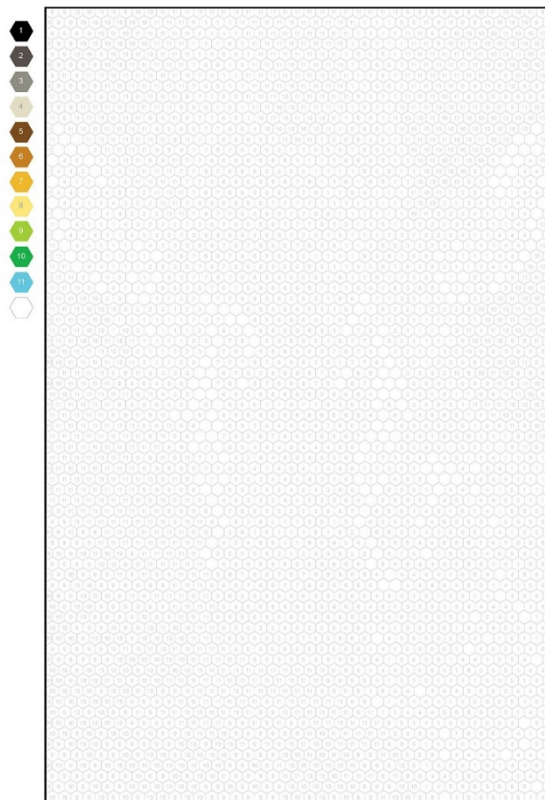
Illustrative Example

	Year 1	Year 2	Year 3	Year 4	Year 5
Capital Reinvested					
Prior Year Earnings		\$ 20	\$ 23	\$ 27	\$ 32
x Reinvestment Rate		80%	80%	100%	100%
= Addl Capital Reinvested		\$ 16	\$ 19	\$ 27	\$ 32
Earnings Growth					
Existing Capital		\$ 100	\$ 116	\$ 135	\$ 161
+ Reinvested Earnings		16	19	27	32
= Total Capital Investment	\$ 100	\$ 116	\$ 135	\$ 161	\$ 194
x Return on Inv. Capital	20%	20%	20%	20%	20%
= Earnings	\$ 20	\$ 23	\$ 27	\$ 32	\$ 39
<i>memo: Growth Y/Y - Earnings</i>		16.0%	16.0%	20.0%	20.0%

Incremental Return on Invested Capital

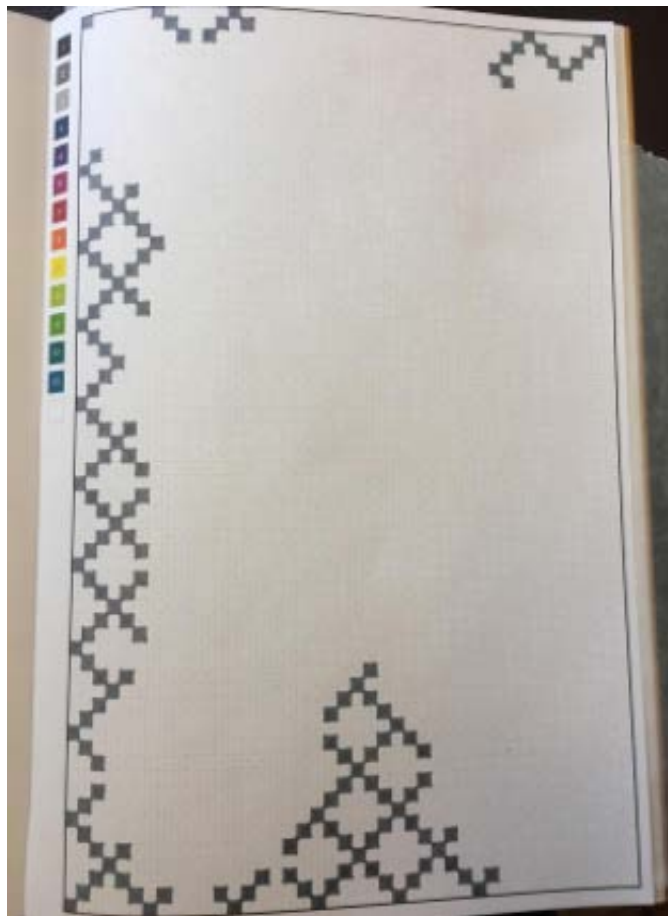
Start with a Framework / Thesis (i.e.. a blank sheet of paper)

- Investing and “data-point” analysis is similar to coloring. You’re simply trying to fill in the dots (i.e. piece together knowledge) to see the end picture.
- For example, you think it *could* be a “wolf” (it’s what the directions say), but you’re skeptical... There’s no way to find out, until you start coloring.
- (*“Wolf” in this case = an attractive business*)



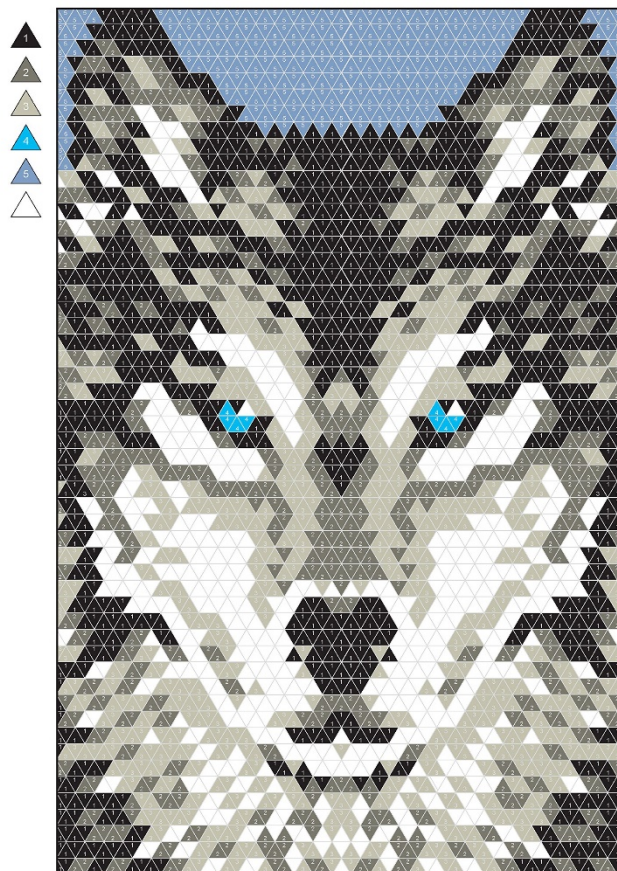
Find Data-points that Confirm or Deny the Thesis (i.e. Fill In The Dots)

- The picture's starting to come together... there's some sort of shape, but it's still not clear.
- Some dots are outside the framework, but the majority seem to fit the outline.
- *Why's that look like a Giraffe though??*



Hey, There It Is! You Were Right! It's a “Wolf”.

- Turns out it's a “Wolf” after-all!... It just took some work to fill in the dots and test the thesis.
- *Note: In investing, it's often too late to wait till the picture is complete. It will be obvious to everyone else by that point too.*
- *To get an edge, start coloring earlier than other people, collect more “dots” than other people, and invest when the picture is 80% filled in and you're confident in the final outcome.*



**Astute readers will notice the last three pictures aren't the same... just checking that you're paying attention.*

A Case Study: YUM China

Is YUMC Getting Higher Returns?

Fact: Growth = SSS Growth (old stores)+ New Store Count Growth

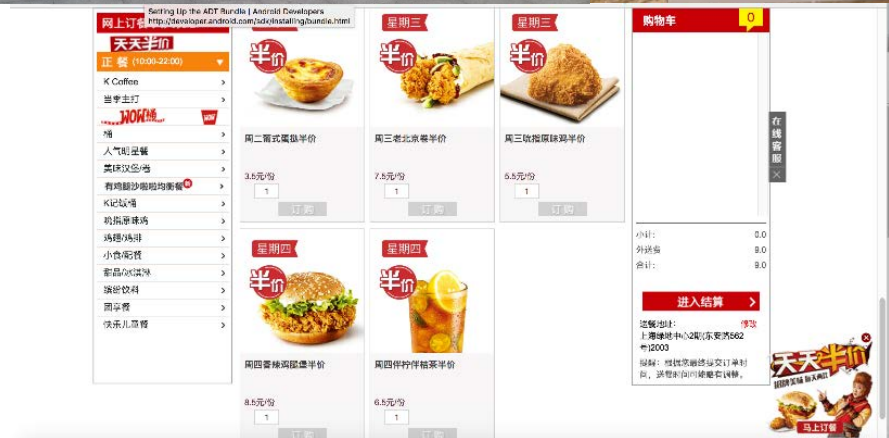
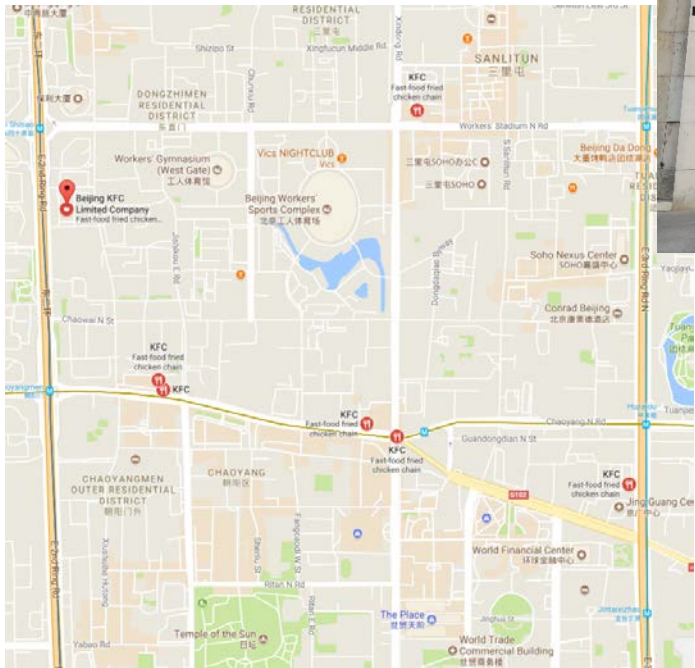
Thesis: New Stores are more profitable than old stores. i.e. Incremental ROIC > Historical ROIC

Question: How can you gain confidence ROIC will inflect up?



Collect A LOT of Data

Store IRR		
Year	2015	2016
New Store Openings	282.00	251.00
x Avg. Capital Spending/ New Store	0.77	0.73
= Capital Spending on New Stores	215.75	183.98
memo: % of Capital Spending on New Stores	83.3%	83.3%



... Then Put The Pieces Together

Realized the most attractive business is KFC Delivery. It's all about that Unit Economics.

- Delivery fee is largely a pass-through for direct orders (excl. platforms like Ele.me, Meituan Waimai, etc)
 - Confirmed by triangulating last-mile courier salaries, and competitor comments. ~RMB10 per order
- Square footage required for delivery is minimal
 - Found size indications for new stores vs old stores online. On average 10% smaller, with a larger section devoted to delivery prep.
 - Also confirmed by the company stating average store square footage is reduced 2% a year.
- Average delivery ticket is TWICE that of eat-in.
 - Stated by management, and makes logical sense. When ordering delivery, often it's for a group of friends.

Unit Economics						
	KFC		Pizza Hut		YUMC	
	Eat-in	Delivery	Eat-in	Delivery	Eat-in	Delivery
Company Sales (in MM)	1,753.00	204.00	650.00	156.00	2,403.00	360.00
Avg. Ticket Size	4.44	8.88	15.54	14.80	5.50	10.74
Transaction Volume (# of Tickets in MM)	394.82	22.97	41.83	10.54	436.65	33.51
memo: % of Company Sales	89.6%	10.4%	80.6%	19.4%	87.0%	13.0%
Food and Paper/ Ticket	1.25	2.49	4.45	4.23	1.59	3.10
Payroll and Employee Benefits/ Ticket	1.01	1.01	3.40	3.40	1.31	1.31
Occupancy and Other Operating Expenses/ Ticket	1.38	2.63	5.47	2.41	1.81	2.62
Restaurant Expense/ Ticket	3.64	6.14	13.32	10.05	4.71	7.03
Restaurant Profit/ Ticket	0.80	2.74	2.22	4.75	0.79	3.71
memo: % Expenses Split	89.6%	10.4%	80.6%	19.4%	87.0%	13.0%
memo: Restaurant Margin	18.0%	30.8%	14.3%	32.1%	14.4%	34.5%
G&A/ Ticket	0.15	0.29	0.77	0.73	0.35	0.68
Closure and Impairment Expenses, net/ Ticket	0.02	0.04	0.15	0.15	0.03	0.07
Other (Income) Expense, net/ Ticket	(0.12)	(0.25)	-	-	(0.06)	(0.11)
EBIT/Ticket	0.76	2.66	1.30	3.87	0.47	3.07
memo: % Restaurant Expense	89.6%	10.4%	80.6%	19.4%	87.0%	13.0%
memo: EBIT Margin	17.1%	29.9%	8.3%	26.2%	8.5%	28.6%
Tax	0.18	0.62	0.30	0.91	0.11	0.72
NOPAT/ Ticket	0.58	2.03	0.99	2.96	0.36	2.35
memo: Effective Tax Rate	23.5%	23.5%	23.5%	23.5%	23.5%	23.5%
memo: NOPAT Margin	13.1%	22.9%	6.4%	20.0%	6.5%	21.9%

Putting the pieces together... Delivery margins are 76% HIGHER than eat-in (30% vs. 17%)!

Conclusion: Delivery Is A Much Better Business

Takeaway: Investors in YUMC should cheer for new initiatives that encourage delivery orders.

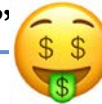
New Stores Openings are the primary use of capital.

- Company stated goal of **TRIPLING** store count over the next 20 years (5.6% CAGR).
- 83% of capital generated goes towards opening new stores.
- = **Investors need to understand new store unit economics, to evaluate this company.**

Overall, the company currently earns ~30% ROIC on each store opened (3 - 4 year payback period). **BUT, delivery is a ~56% ROIC business.**

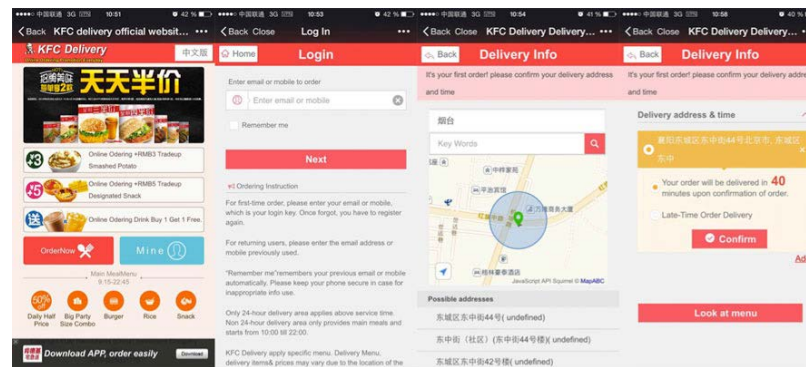
- Delivery is only 10% of store sales today.
- As delivery business grows, so too will the company's ROIC.

Whenever KFC launches promos to encourage customers to order online... investors should be going “WOOOOOOOOOOOOOOOOOOOOOOOOOOOOOOO”



KFC Online Order Promotions

Official KFC WeChat Account



But This Is Just One Small Piece of The Puzzle...

1. How much can delivery grow to?
2. What are the most effective methods to promote delivery? New Customer Discounts? Advertising?
3. How can you make delivery costs cheaper? Drones & their unit economics?

Many More “Dots” To Fill In...

Remember... Trust, BUT Verify

- **Everyone's allocating capital.**
 - Clients give money to fund managers.
 - Fund managers give capital to Companies & the management teams.
 - Management teams invest capital into new projects with (hopefully) high returns.
- **We're not going to calculate the exact ROIC or earning growth % the company will achieve next year.**
 - Even if the information were knowable and public, there's not enough time in the day to calculate every single project a company embarks on (think Amazon).
- **We're simply trying to get 80% of the way there.**
 - The goal is to evaluate if management is someone we want to partner with & that the strategy makes sense.
 - Out of 100 different projects, we may evaluate the top 5 - 10 of them.
 - If these 5 - 10 projects are all proven to be attractive, 25% ROIC projects, then that gives us more confidence that management is smart, and thinking about capital allocation in the right way.
 - On the other hand, if our analysis starts showing all these projects to be 2% earners, RUN AWAY!

For More Information
Contact Us:

Fred Liu

Managing Partner

Hayden Capital

79 Madison Ave, 3rd Floor

New York, NY. 10016

Email: fred.liu@haydencapital.com