MTY Food Group – A Case Study of a 100-Bagger

CHIP MALONEY MARCH 26, 2015 BLOG, EDUCATIONAL 33 COMMENTS

In late 2003, I had been investing in microcaps for about 3 years when I came across a small microcap company called MTY Food Group that was trading on the TSX Venture Exchange. At the time, MTY had a market cap of under $5 million. Incredibly, $1 invested in MTY stock in 2003 would go on to be worth $100 by 2013.

So how did MTY management achieve this, and could an investor have foreseen this multi-bagger potential at the start of the run?

With some hindsight bias, let's go back to 2003 and look at the circumstances that led to this incredible investment opportunity. In early 2003, MTY Food Group was then known as iNsu Innovations. INsu consisted of two divisions – a profitable fast food restaurant franchisor, as well as an unprofitable technology business. On April 10, 2003, MTY announced they would be divesting their unprofitable technology business to focus on the fast food restaurant franchising business, and they announced the name change to MTY Food Group to symbolize their focus on the franchising business. The annual results from 2002 had just been released and buried in the footnotes to the financial statements were the segment results, and the fast food franchising division had earned $.07 in the previous year, doubling earnings over the previous two years. Since the collapse of the tech bubble, the unprofitable technology division had been masking the profitable fast food franchise business. So from now on, the profitable franchising business would start to show through in the financial statements.

On April 17, 2003, Stanley Ma was appointed President of MTY. Ma was the entrepreneur who started the company's very first restaurant concept Tiki Ming – Chinese Cuisine in 1987 as a recent immigrant to Canada. Ma was a fanatic about the fast food franchising business. He had previously been the Chairman of the company with it's unsuccessful foray into the tech business, but now he was stepping in to lead the company in it's expansion of the fast food franchising business. He had guided the accretive acquisition of four fast food franchise concepts over the previous three years.

On Sept 25, 2003, Stanley Ma purchased 3.1 m shares or 20% of shares outstanding for $.25 per share from two large shareholders. The total cost was $.8 million (to be paid over 5 years in installments) to bring his shareholdings to 4.3 million shares or 29% of the total outstanding shares. Ma was now heavily incentivized to make this business a success.

On Oct. 24, 2003, MTY announced they had earned 3.5 cents per share for the third quarter. Revenues were up 20% year on year, but without the unprofitable technology division, earnings had rocketed up 178%. The restaurant franchising business had very little seasonality, and so an astute investor could annualize this quarter's results to come up with an approximate forward EPS number of 14 cents EPS.

Throughout the summer and fall of 2003, there was a fair amount of liquidity in the stock, and a small investor could have acquired a decent sized position between 25 and 35 cents.

At this point in 2003, the stars were lining up for this to be a very good investment. Here were the key reasons why:

1). Q3 2003 had just shown massive growth in revenues and earnings per share quarter on quarter and year on year. In relation to run-rate EPS, the shares at 30 cents were trading at an absurd valuation of 2X forward earnings, not even factoring in the 30 cents per share of excess cash.

2). MTY was a cash cow with high gross margins in the 70% range, EBITDA margins in the 35% range, and was growing organically with a capital light business model.

3) The franchise business had very high returns on invested capital (greater than 60%) with the ability to reinvest incremental capital at similar high rates. In other words, MTY was generating substantial cash flows, and because it didn't have to reinvest that cash back into the business, it was plowing it into acquiring more fast food franchising concepts at similar high returns, which would lead to rapid earnings growth if continued.

4). MTY was run by an owner operator who was incentivized to run the business to maximize growth and profitability over the long term, and who was a fanatic about the business.

5). The business had a durable competitive advantage. There were two sources to the competitive advantage. First, MTY owned regional fast food restaurant brands that were very strong in Eastern Canada. In a mall setting, eating decisions are made in a few seconds, so brand recognition is important. Secondly, and more importantly, MTY's customers (the franchisees) had large switching costs. The initial franchise fee to start an MTY location is $25,000 to $40,000. In addition, the capital investment to build out a location for a new MTY franchise is between $150,000 and $450,000. If a franchisee wants to switch restaurant brands, they would need to rip out all the signage and equipment, and pay another franchisor another franchise fee as well as make another capital investment into equipment and signage. So unless the customer went bankrupt, they would probably continue to pay MTY a monthly royalty.

6). The business had a long runway of growth. In 2003, MTY's market share was a fraction of the total quick service restaurant franchise market in Canada, not even considering the U.S.

7). There was little risk of obsolescence. Unless shoppers and office workers abandoned food courts, this business would be around for many years.

8). The restaurant franchise royalty business was a very stable business with recurring revenues that would grow throughout the economic cycle and MTY had a perpetual option on any growth in a franchisee's revenues. Because MTY was paid, depending on the brand, 4.5-6% of a franchisee's revenues, any growth in the franchisee's same store sales resulted in growth in MTY's royalty stream.

9) MTY had a very tight share structure with around 15 million shares outstanding, and the company had bought back 5% of shares outstanding in the previous year. In other words, they treated their shares like gold.

So in essence, at 30 cents, you were buying a great business at 2X forward earnings, with a Fort Knox balance sheet.

Here's what happened to MTY from 2003 to 2013:

	Revenues (mill)	EPS	# of locations	Share Price
2003	$11.50	$0.10	260	$0.34
2004	$15.50	$0.19	420	$2.50
2005	$18.62	$0.27	527	$3.85
2006	$22.40	$0.33	784	$6.40
2007	$30.53	$0.48	825	$12.63
2008	$34.24	$0.52	1023	$7.34
2009	$51.50	$0.64	1570	$9.15
2010	$66.90	$0.81	1727	$14.40
2011	$78.50	$0.84	2263	$15.30
2012	$96.20	$1.15	2199	$22.25
2013	$101.40	$1.34	2590	$34.34
Growth	7.8 X	12.4X	9 X	100 X

Between 2003 and 2013, MTY launched 5 new restaurant concepts, and acquired another 19 restaurant franchise concepts, which added 2029 locations to it's franchise network. Except for a small sale of shares, all these acquisitions were financed out of cash flow.

As you can see in the above table, over 10 years, MTY increased it's share price by one-hundred fold.

Earnings per share grew by a factor of 12.4X. But if the company only grew earnings by 12.4X, how did the stock grow 100X? The answer lies in the price to earnings (P/E) multiple expansion. Investors in MTY went from paying roughly 3.5X earnings when it was left for dead in 2003 to a more optimistic 26X earnings in 2013.

So how did I do on this investment you may ask? The answer is I didn't make a single dollar of profit on it. I was paralyzed by two behavioral biases that prevented me from buying shares. The first was that I had anchored onto the price of 25 cents that Stanley Ma had paid for his 3.1 million shares, and was unwilling to up my bid to the $.30 ask. The other bias that paralyzed me was recency bias. I had just read Kathryn Staley's excellent book The Art of Short Selling, and there was a chapter on the Jiffy Lube franchise failure, and I saw that MTY was on the hook for leases if it's franchisees failed, so I was hesitant to pay up for the shares. Short story is I never bought any shares, even though there were multiple opportunities along the way to make 2X, 5X, or 10 X my money all the way up.

The painful lessons I learned from this experience were:

1. A large part of the return on a multi-bagger will come from performance of the business and earnings per share growth. However, if you pay a very low multiple for a great business, you can really juice your returns because you get a double whammy from earnings growth and the P/E multiple expansion.
2. When all the stars line up, swing for the fences. Make these rare opportunities a significant part of your portfolio because they don't come around very often.
3. Buy right and sit tight. When you own a great company with great management, hold on for the ride.
4. Be cognizant of behavioral biases. They can cost you a lot of money in missed opportunities.
5. At least I don't feel as stupid for missing this 100 bagger as the two large shareholders who sold Stanley Ma 20% of the company for 25 cents a share, to be paid back in installments over five years.

The moral of this story is that the investor who has the ability to find great stocks but does not buy them has no advantage over the investor who has no idea how to find them. The next time you find a stock like MTY Food Group, back up the truck and load up.

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ABOUT THE MICROCAP SUPERSTAR AUTHOR

Chip Maloney

Twitter

Chip Maloney is a Canadian-based private investor and has been investing primarily in non-resource Canadian microcaps for 15 years. His investment style could be summed up as GULP (Growth at an Ultra Low Price). When he is not doing investment-related reading, you can find him running, biking, skiing or spending time with his wife and daughter.