Ark Restaurants (ARKR)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Ark Restaurants - business

- Ownership and operation of restaurants and bars in the United States:
  - 22 restaurants and bars:
    - 7 facilities in New York City; 3 in Washington, D.C.; 7 in Las Vegas, Nevada; 2 in Atlantic City, New Jersey; 1 at the Foxwoods Resort Casino in Ledyard, Connecticut; and 1 in the Faneuil Hall Marketplace in Boston, Massachusetts
  - 22 fast food concepts and catering operations

Ark Restaurants – business (cont'd)

- Started NYC. Shift to non-NYC -> Florida, casinos, etc.
- Two NYC restaurants flooded and closing due to lease expiration
- Some restaurant expansion: Clyde Frazier's Wine and Dine, NYC, reorg @ NYNY in Las Vegas
- Some underperforming restaurant closures: lease expirations, food court @ MGM casino @ Foxwoods
- Our restaurants generally do not achieve substantial increases in revenue from year to year, which we consider to be typical of the restaurant industry. To achieve significant increases in revenue or to replace revenue of restaurants that lose customer favor or which close because of lease expirations or other reasons, we would have to open additional restaurant facilities or expand existing restaurants. There can be no assurance that a restaurant will be successful after it is opened, particularly since in many instances we do not operate our new restaurants under a trade name currently used by us, thereby requiring new restaurants to establish their own identity.

Ark Restaurants – Misc thoughts

- What can go wrong?
  - Recession
  - Good locations going out of lease with worse terms of renewal or no renewal
  - Overspending on long term leases for bad concepts/locations
  - Low margins may turn negative due to food cost, healthcare cost increase, insurance cost increase, minimum wage increase, etc.

Ark Restaurants - Misc thoughts

- Opportunities:
  - Long time restaurant operator
  - Successful concept?

Strategic considerations

- Moat (*switching costs*, *habit*, *low cost*):
  - What are the moats? Locations only, no brand power
  - What does it take to sustain the moats? N/A
  - Bargaining power of suppliers/customers? Some power of lessors
- Is it a low risk business? Medium risk.
- Is there high uncertainty? Medium uncertainty.
- How capital intensive is the business? Not really.
- Future growth – Unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Perhaps understated due to past recession

Checklist

- 1. Can I in one sentence say exactly what the company does?
- 2. Operating cash flow higher than earnings per share?
- 3. Free Cash Flow per share higher than dividends paid?
- 4. Debt to equity below 35%?
- 5. Debt less than book value?
- 6. Long Term debt less than 2 times working capital?
- 7. Is the debt to EBITDA ratio less than 5?
- 8. What are the debt covenants?
- 9. When is the debt due? All at the same time?
- 10. Are pre-tax margins higher than 15%?
- 11. Free cash flow margin higher than 10%?
- 12. Does the cash belong to the company?
- 13. Current asset ratio greater than 1.5?
- 14. Quick ratio greater than 1?
- 15. Growth in Earnings Per Share?
- 16. EBIT / Assets > 20%
- 17. Management shareholding > 10%?
- 18. Altman Z score > 3?
- 19. Piotroski F-Score of more than 7?
- 20. Is there substantial dilution?
- 21. What is the Flow ratio (Good < 1.25, Bad > 3)

Management

- I don’t usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Piotroski Score

Only applicable to Graham Cos – N/A to ARKR

1. Net Income: Bottom line. Score 1 if last year net income is positive.
2. Operating Cash Flow: Better earnings gauge. Score 1 if last year cash flow is positive.
3. Return On Assets: Measures Profitability. Score 1 if last year ROA exceeds prior-year ROA.
4. Quality of Earnings: Warns of Accounting Tricks. Score 1 if last year operating cash flow exceeds net income.
5. Long-Term Debt vs. Assets: Is Debt decreasing? Score 1 if the ratio of long-term debt to assets is down from the year-ago value. (If LTD is zero but assets are increasing, score 1 anyway.)
6. Current Ratio: Measures increasing working capital. Score 1 if CR has increased from the prior year.
7. Shares Outstanding: A Measure of potential dilution. Score 1 if the number of shares outstanding is no greater than the year-ago figure.
8. Gross Margin: A measure of improving competitive position. Score 1 if full-year GM exceeds the prior-year GM.
9. Asset Turnover: Measures productivity. Score 1 if the percentage increase in sales exceeds the percentage increase in total assets.

- Total: / 9

Is it a good business?

- 10 year history of profits
- ROE:
  - 2010: 7 2011:4 2012: 17
- Margins
  - 2010:2 2011:1 2012:4
- 3 year sales growth 5%, earnings growth 28%
- No dilution
- Strong balance sheet
  - Cash >> debt
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - ~= ROE

Is it a good business? Cash flow

- Good 2012 cash flow:
  - 2012 7M earnings, 13M operating cash flow, 5M FCF (FCF = OCF – capital expenditures)
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? - Buffettology calculations

- ROE 15%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $17M
- Equity in 10 years = Equity*$(1+ROE)^9$ = $115M
- Market cap = 17M x P/E (15) = $258M
- Rate of return = 15% after tax (calculations omitted)

- 9 year earnings growth: 5%. Assuming 5% earnings growth: 10% share price growth.

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of 5.5M (FCF ~5M)
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $53M current valuation
  - 5% growth for 5 years, leveling after that
    - 15% discount -> $44M current valuation
  - 10% growth for 10 years, leveling after that
    - 15% discount -> $67M current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 5.5M / (55M-6M) = 11%
- What makes up the margin of safety? Valuation
- Is there a sufficient margin of safety? No.

Is business cheap? - Graham investment considerations

- N/A for ARKR – included for completeness
- 1.7 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)