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INVESTORS' DIARY

Fast footwork puts Foodex out front

By Patricia Anderson

CORNINESS MAY just be an occupational hazard in the fast food industry. One remembers the smashing dinner put on by McDonald's Restaurants of Canada in February and the goofy tee-shirts and hats then given the pinstripe-suited Bay St. gents. One recent broker's report expounding the virtues of Foodex Systems Ltd. (Ponderosa) even included a coupon, courtesy of the company.

But while the sophisticated turn a cool eye to hokey gimmicks and exaggerated friendliness, such sober investment houses as Merrill Lynch and Wood Gundy are coming out with reports on the fast-food industry and the profit potential of certain of its components.

A company catching the eye of numerous analysts lately is Foodex. This may be because management has decided to do some loud talking about the company. Some analysts say they were rebuffed when seeking information and interviews back when the company's earnings weren't as buoyant as they are now.

"I don't care if people call it hokey," says Harold Schneer, the quick-talking man largely responsible for the Ponderosa steak house presence in Canada. He's president of Foodex, which operates the 85-unit Ponderosa chain under license from Ponderosa System Inc. of the U.S. "No one can argue about the profitability," he adds. He says that as a man poised to repeat the Ponderosa coup with a chain of beer-and-pizza restaurants — Frank Vetere's Pizzeria & Tavern.

Pizza Power

Schneer has few doubts about the pizza operation. Pizza is one of the fastest growing segments of the fast food market. Pilot units were opened 3½ years ago in Toronto and have exceeded planned revenues and profits. Schneer is quietly eyeing the U.S. market even as the plans for Canada go into operation.

Foodex had some people worried in 1974 when profitability of the operation, which includes a 62.1% interest in Gibraltar Pari-Mutuel Inc., a U.S. subsidiary, declined from 42¢ a share to 35¢ a share. Skeptics were treated to a reverse of this trend last year when earnings bounced back to 64¢ a share. First-quarter results this year show 15¢ a share, more than double the 7¢ earned last year.

Of the $69 million in revenue last year, $38 million came from the Ponderosa division, the remainder from the race-track operation and various other small interests. Although Gibraltar contributed $936,820 of the $2.8 million reported net income, Schneer says that he would sell at the "right price," an obvious answer from a man who

Schneer and Vetere see eye to eye. 'If you can't make a chain of it — sell it.'

states corporate policy: "If you can't make a chain of it — sell it."

Schneer says the 1974 setback is not likely to be repeated. One problem then was supply and price of meat — a problem, Schneer says, that was eliminated with the opening last year of the $1 million meat plant. Management made a decision early in 1974 to absorb most price increases, rather than to suffer volume declines and loss of market share. During the year, margins fell from 23% to 15% at the store level. In hindsight, this was a wise decision as many of the Ponderosa units were new and had not yet built up clienteles.

The move gained credence when the 1975 results began to roll in, with the final figures for the Ponderosa division showing an increase in profit of 138%, against a revenue increase of 41%.

Schneer and his executive vice-president, Frank Vetere (yes, there really is a Frank Vetere!), make a formidable team. They were both involved with the Red Barn operation, a chain of fast-serve hamburger restaurants that were popular in the late 1960s. Schneer sold out at the top; since then, the company has fallen on harder times. Before that, Schneer was a franchisee for the U.S. Mr. Donut chain.

His experience as a franchisee is perhaps responsible for the decision to forego the franchise route right back in 1971 when Ponderosa first started in Canada. This meant a postponement of the tremendous growth affordable by franchising, but also eliminated much trouble now being experienced by U.S. franchisors particularly.

"The first day you're in business with a franchisee, he figures he doesn't need you," Schneer says by way of explanation. More and more franchise operations are increasing their numbers of company-owned units.

However, company-owned restaurants, although more profitable, have their own problems: employee motivation. This, management has tackled with profit-sharing plans and decentralized decision-making.

A decision was also made early in the game to emphasize ownership of land and buildings. This has been accomplished to the extent of 55% ownership of the units operating, but has also created heavy debt commitments.

Debt/equity ratio for 1975 stood at 1.09, which is down from the 1.4 figure of the year before. Management claims that by mid-1980 the Ponderosa division will have no debt.

Still, Wood Gundy's Dave Graham begins his recent report on the company, pointing out this financial risk. Debt as a percentage of total invested capital is 61%. A more comfortable figure would be 45%. Most of that debt is bank loans. In response, management points to real estate values which have increased since purchase. Accounting methods are also not the most conservative, with pre-opening costs deferred for a 60-month period from a unit's opening. Working capital is negative — all right as long as cash comes in right away, and costs can be deferred. (Scott's Restaurants had a negative working capital position until two years ago.) Foodex says it can spot cash problems quickly, through efficient internal control systems which deliver operating statistics for all units to senior executives' desks as early as the Monday of the week following.

Although the strategy now is to utilize the corporate machinery of the steak house operation for the pizzerias, initially the pizza units will be financed out of cash flow, and some lease-back arrangements will be used.

Growth is the catch-word for this company, which five years ago was little more than a corporate shell with diverse and confusing holdings which included everything from Ruby Foo's Chinese food restaurant in Montreal and the Honeydew restaurants to a hotel in Frobisher Bay and a dredging business. Enter the Schneer-Vetere team with the idea to link up with the Ponderosa chain in the U.S.

In fact, the Canadian team produced some "pretty fast dealing" by some accounts when it discovered the "Ponderosa" trademark unregistered in a number of countries, and proceeded to register them in its own corporate name. Not surprisingly, this produced a law suit in late 1974. This has been settled, with Foodex transferring all Canadian and other foreign trademarks to Ponderosa Systems in the U.S., in exchange for the exclusive right to use the Ponderosa name in Canada and reimbursement for all costs incurred in obtaining the rights.

Management raised some eyebrows also with its stock option plans. During 1975, the company issued options "to an officer" to purchase 75,000 of its unissued shares at $2.48 a share and cancelled previous options to purchase at prices between $6 and $8.34 a share. Prices in 1974 ranged from $6.25-$1.50, making the earlier plan anything but attractive. Recently, shares have been trading from $6.25-$4.90, making $2.48 look not too bad.

Future earnings growth should depend on how Frank Vetere's makes out. The pizza business has some advantages over steak outlets, where 40%-45% of the revenue dollar is eaten up by food costs. Also, there is not the dependence on one food commodity as there is with steak restaurants. Break-even levels are also lower in the Vetere operation, despite the higher labor costs associated with table service. Competition is mainly from local independents which don't have the advertising clout of a major chain.

Saturation Point

Ponderosa is scheduled to have about 90 units operating by yearend. The company estimates the saturation point to be about 125 units, so timing for the pizza chain is obviously right. One unit is slated for opening in Toronto early August. Indeed, Schneer says that the idea for the next chain is now being researched. (The idea is still a secret, but it shouldn't be too hard to guess.)

Management is obviously not adverse to risk — it is not a stock for the widows and the orphans of the world. Yet the Ponderosa division is outstepping the U.S. licensor with higher profit margins and higher per-unit sales. They are both, however, a long way off the king of the fast food trade, McDonald's, which nets a whopping 9% on company revenues (not systemwide sales). Ponderosa made 4.8% after taxes in 1975.

At $6.50, the shares are trading 7.6 times one analyst's estimate of 85¢ for 1976. This estimate, however, could be low. Second-quarter earnings are due out in early August. The price moved up 50¢ late last week on the strength of impending news about a clever promotional deal between Loblaws and Ponderosa (see p.). And although the deal will not affect earnings, the plychological effects were already felt by the market. Analysts are also speculating that second-quarter earnings will be higher than anticipated.

Foodex is 59% owned by Hambro Canada Ltd., which is a holding company with interests as diversified as merchant banking, real estate development and merchandising. Hambro is 48% owned by Hambros Ltd., London.

Foodex/Frank V's

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