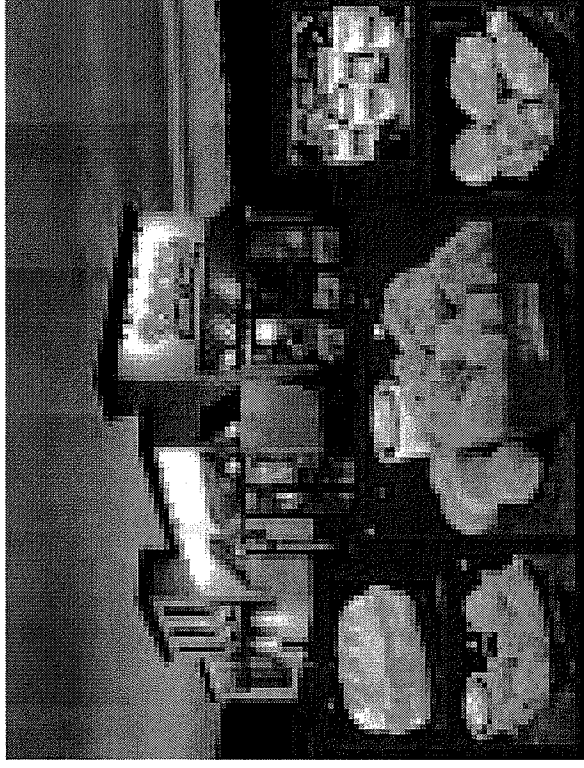

Case Study (& A Long Idea): AFC Enterprises (AFCE)



AFC Enterprises (AFCE): Background

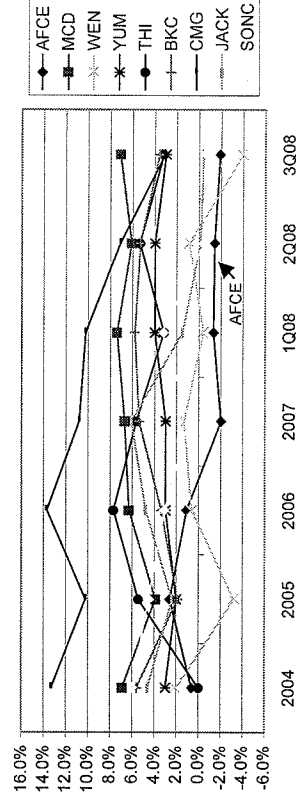
- AFC Enterprises operates the Popeye's Chicken & Biscuits Quick Service Restaurant (QSR) chain. There are currently 1,905 Popeye's restaurants throughout the world, mostly in the U.S. Southeast. AFCE has ~10% share of the U.S. QSR chicken market, #3 behind KFC (34%) and Chick-Fil-A (15%).
- The stock showed up on two screens I ran on 11/6/08: my regression based screen (in this case, EV/EBITDA), and a ROIC vs. earnings yield screen.
 - High EVA spread of 16.8%.
 - Easy to understand business model.
- From 11/6/08 (when I ran the screens) through 1/9/09, AFCE was up 19.5%, vs. a 3.0% decline in the Russell 2000 Index.

AFC Enterprises (AFCE): Key Investment Considerations

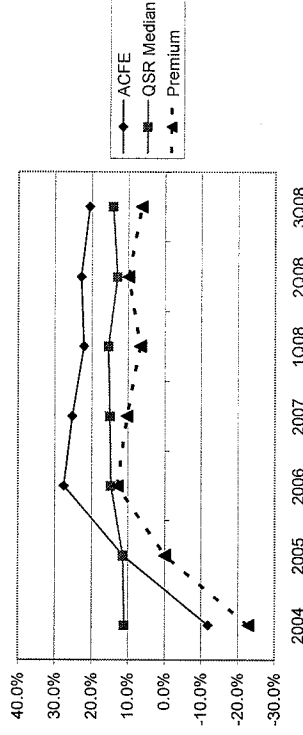
First, the bad news

- Stock price has underperformed its peers since 2003.
- AFCE's same store sales have fallen into negative territory the last couple of years. Several key competitors (MCD, BKC) added chicken products to their menus, and aggressively lowered their prices. AFCE countered by lowering its prices, but that did not lead to a significant increase in store traffic. Instead, it helped reduce same store sales.
- Lower SSS in turn have decreased AFCE's operating margin premium over the market.
- Drastically higher corn prices since early 2006 have squeezed operating margins as well.
- AFCE is highly leveraged. Current debt/cap ratio is 153%, but their debt/EBITDA ratio of 2.8x poses no real problems. Management is committed to paying down debt, and I expect debt/EBITDA to fall to 1.7x exiting 2013.

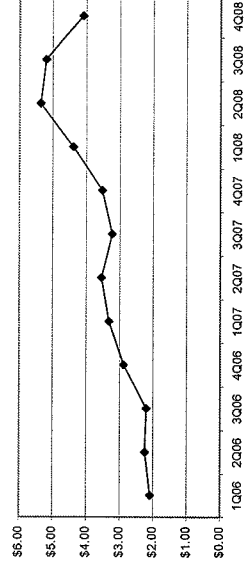
Global QSR Y/Y Same Store Sales Trends



AFCE Operating Margins



U.S. Corn Prices (\$/bushel)



Sources for all graphs: Company reports, CME

AFC Enterprises (AFCE): Key Investment Considerations (Con't)

Management is taking positive steps to turn around declining SSS

- Hired a new CEO in 11/07. She used to run KFC's domestic operations, and prior to that, was responsible for successfully introducing new products at Domino's Pizza.
- Introduced an expanded menu in August 2008 that fills key gaps in their product offerings. New items address the value (read: inexpensive) and boneless (chicken tenders & nuggets) segments that led to success at its competitors. The Dollar Menu was vital to MCD's success in 2008.
- Initiated a new national cable advertising campaign in October 2008. AFCE's franchisees are paying more than 95% of the total costs.
- Early results are encouraging. In the 3 weeks since their national advertising strategy began, AFC's SSS beat the chicken QSR category by 1.7%. Management reported a noticeable uptick in store traffic at the end of the 3Q, and my store checks in Florida and Virginia seem to confirm this.
- MY DCF MODEL ASSUMES A RETURN TO YY SSS OF JUST POSITIVE 0.6%-0.7% STARTING IN 2010, WELL WITHIN THE COMPANY'S REACH, ESPECIALLY CONSIDERING THE UPSIDE FROM INTERNATIONAL STORES.

AFC Enterprises (AFCE): Key Investment Considerations (Con't)

Corn prices are likely headed lower

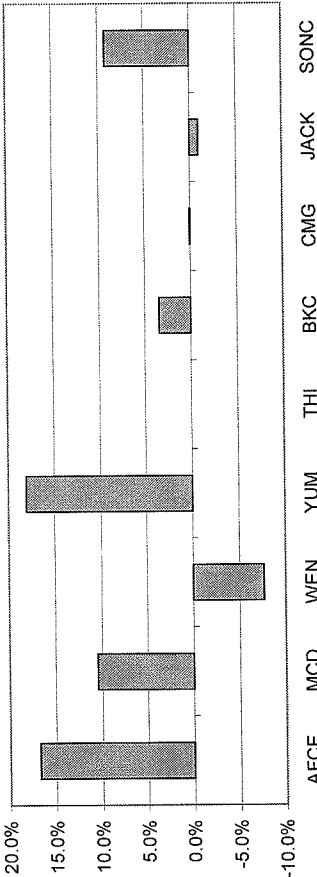
- 40% of AFCE's COGS are chicken, and chicken prices are in turn driven 65% from corn costs.
- The current CME 2009 corn futures strip calls for a 10% Y/Y decline in average corn prices. Management stated the company is largely hedged for 2009, but lower corn prices would help in the out years. AFCE's chicken contracts are cost plus, so lower corn prices = lower COGS.
- Since 1Q06, AFCE's stock price has shown a 49% R-square (and a 0.7 coefficient correlation) to corn prices, so lower corn prices should help boost the stock, all other things held equal.
- Longer-term, I would not be surprised to see the Obama administration reduce ethanol requirements for gasoline, which should reduce the price of corn even more. Existing ethanol policy created a surge in the demand for corn, which took away acreage from other crops, and helped drive other key agriculture prices higher. This issue has been masked by the current recession, but it remains a long-term concern, and I believe it will be addressed within the next 2-4 years.
- ***Lower corn prices would lower AFCE's direct COGS at its remaining company owned stores, but more importantly, it would improve unit economics for the franchisees, which in turn should lead to more unit openings.***

AFC Enterprises (AFCE): Key Investment Considerations (Con't)

Returns on invested capital remain among the highest in the QSR industry

- Even with the recent reduction in its operating margins, AFCE is number two in EVA spread, just behind industry leader YUM.

QSR EVA Spreads as of 1/11/09



Source: Company reports

Moving to a 100% franchise model

- AFCE currently earns 90+% of its operating margins from franchisees, and plans to sell its remaining 56 stores within the next two-three years.
- Franchise stores tend to earn operating margins that are 300-500 basis points higher than company owned restaurants.
- The sales should bring in \$15-\$20 million, which the company plans to use to pay down debt.

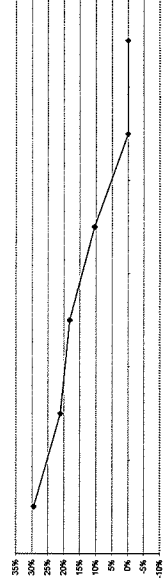
AFC Enterprises (AFCE): Key Investment Considerations (Con't)

The market is likely underestimating AFCE's potential overseas

- International SSS have been positive every quarter since 4Q06, and were 7.4% in 3Q08. Overall, international SSS averaged 2.3% between 4Q06-3Q08, vs. (2.3%) for domestic stores over that time period.
- The overseas store count has been flat since 1Q06, but the major reason is that stores in Korea fell from 154 in 2005, to 116 in 2006, and 104 in 2007 because a single franchisee there was having financial problems. The number of stores overseas is now set to grow.
- On a "pro-forma" basis, the overseas net store count should continue to grow at 20-25 per year, which is all I am modelling. This could prove to be too conservative an estimate.
- Domestically, management has identified another 3500 possible expansion locations.

Other Positives

- Negative cash conversion cycle. AFCE has almost no inventory to speak of, and all sales are point of purchase, so it has been able to generate cash from working capital. That also helps its ROIC.
- Steadily bought back shares the last few years, but has temporarily suspended the buyback to focus on paying down debt. Still authorized to purchase another \$19 million in stock, which management would do if the stock price fell enough.
- Lower U.S. gasoline prices could help counter negative effects of U.S economy.
- No unionized labor.
- Earnings momentum has slowed the last few quarters, so the stock could be in more of a position to pop on a favorable earnings beat.



Source: FirstCall

AFC Enterprises (AFCE): Key Investment Considerations (Con't)

Valuation Looks Compelling

- My DCF analysis suggests a fair market value of \$6.25, roughly 29% upside.
- Price Implied Expectations assumes negative future growth, but confirms stock is trading well below intrinsic value.
- The market is pricing in future annual free cash flow declines of 11.3%, but I expect the company to achieve positive annual growth of 2%-4%.
- PEG ratio just 0.55.
- I am not a huge fan of multiple analysis. But for completeness, I point out that AFCE is currently trading at 7.8x TTM EPS, and 5.6x EV/EBITDA, both below their respective 5-yr median levels of 12.6x and 7.9x. Returning to those levels would translate into a stock price range of \$8.50-\$9.00.

Risks

- The U.S. economy continues to struggle well into 2010.
- AFCE's new product offerings lead neither to increased store traffic, nor to an improvement in same store sales.
- The pace of international expansions slows.
- One domestic franchisee represents 11% of total company revenue.

AFCE Projected Financials



INCOME STATEMENT		2005	2006	2007	2008	2009	2010	2011	2012	2013
REVENUE ASSUMPTIONS										
Number of Company Owned Units		56	56	56	56	56	56	56	56	56
Number of Franchises (Dom & Int)		1,796	1,822	1,840	1,855	1,892	1,892	1,937	1,949	1,962
Openings		122	119	119	133.0	146.0	146.0	135.0	140.0	150.0
Closings		(95)	(113)	(101)	(99)	(102)	(123)	(123)	(127)	(138)
End of Year		1,796	1,822	1,840	1,855	1,892	1,892	1,937	1,949	1,962
Total # of Stores		1,828	1,905	1,911	1,925	1,939	1,939	1,949	1,962	1,975
Open/Close Ratio		1.28	1.23	1.18	1.12	1.10	1.10	1.10	1.10	1.10
Percentage of Franchises in U.S.		81.2%	82.5%	82.5%	81.0%	80.0%	80.0%	79.5%	79.0%	78.5%
Average Revenue Per Unit		\$1,482	\$1,322	\$1,307	\$1,268	\$1,230	\$1,193	\$1,193	\$1,157	\$1,123
Company Owned		\$0,043	\$0,046	\$0,046	\$0,046	\$0,046	\$0,046	\$0,046	\$0,047	\$0,047
Franchises		\$1,439	\$1,276	\$1,261	\$1,222	\$1,184	\$1,147	\$1,147	\$1,110	\$1,076
Y/Y Same Store Sales Changes		6.5%	9.0%	-7.8%	-5.3%	-3.0%	-3.0%	-3.0%	-3.0%	-3.0%
Domestic Company Owned		3.2%	-1.3%	-2.1%	-1.9%	0.0%	0.0%	0.0%	0.0%	0.0%
Domestic Franchise		-4.2%	-3.2%	1.1%	4.4%	4.0%	4.0%	4.0%	4.0%	4.0%
Int'l Franchise		-	-	-	-	-	-	-	-	-
Total Franchise		2.6%	1.1%	-2.0%	-1.7%	0.0%	0.0%	0.0%	0.0%	0.0%
Total System		2.6%	1.1%	-2.0%	-1.7%	0.0%	0.0%	0.0%	0.0%	0.0%
Y/Y Rev Changes		8.1%	22.7%	-1.1%	-27.5%	-61.9%	-94.5%	-100.0%	-100.0%	-100.0%
Sales by Company Operated Restaurants		6.6%	0.2%	2.5%	7.3%	3.0%	1.6%	1.6%	1.4%	1.6%
Franchise Revenues		1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Other Revenues		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Revenues		8.1%	17.7%	14.0%	8.8%	4.6%	3.1%	3.1%	2.9%	3.1%
Restaurant food, beverages, & packaging		20.6	21.3	27.6	19.5	7.3	0.4	0.4	0.4	0.4
Restaurant employee, occupancy, & other expenses		30.5	33.7	40.7	30.7	11.7	0.6	0.6	0.6	0.6
D&A		7.3	6.4	6.3	5.0	2.2	0.5	0.5	0.5	0.5
Gross Profit %		59.5%	59.2%	54.4%	63.7%	82.1%	98.5%	98.5%	98.4%	98.6%
SG&A		64.3	43.7	48.6	46.0	47.9	48.8	48.8	49.8	49.8
Advertising		3.2	3.3	5.6	5.7	5.9	6.1	6.1	6.2	6.2
R&D		1.2	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.5
Other		23.2	(2.7)	4.0	4.3	4.2	4.2	4.2	4.2	4.2
EBIT (Operating Income)		(6.9)	45.3	41.0	46.6	43.2	42.2	42.2	42.0	42.1
Operating Income %		-4.5%	29.6%	27.3%	24.4%	36.5%	42.7%	42.7%	42.6%	42.1%
Interest & Other Income		6.8	11.1	8.7	7.7	5.9	5.4	5.4	4.9	4.4
Interest Expense		-	-	-	-	-	-	-	-	-
Earnings from Unconsolidated Affiliates		-	-	-	-	-	-	-	-	-
Other		(13.7)	34.2	33.3	36.7	37.3	36.9	37.1	37.7	37.7
Income Tax Expense		(5.3)	12.0	13.8	14.3	14.2	13.6	13.4	13.2	13.2
Net Income (Recurring)		(8.4)	22.2	23.1	19.8	22.4	23.1	23.2	23.8	24.5
Preferred Stock Dividends		-	-	-	-	-	-	-	-	-
Discops		(158.0)	(0.2)	23.1	19.8	22.4	23.1	23.2	23.8	24.5
Net Income to Common Shareholders		149.6	22.4	23.1	19.8	22.4	23.1	23.2	23.8	24.5
EPS (Diluted)		\$5.14	\$0.75	\$0.80	\$0.77	\$0.88	\$0.90	\$0.90	\$0.91	\$0.93
Pro Forma EPS (Diluted)		29.1	29.5	28.6	25.7	25.5	25.7	25.9	26.1	26.3
Common Shares		29.1	29.5	28.6	25.7	25.5	25.7	25.9	26.1	26.3
Diluted Shares		29.1	29.5	28.6	25.7	25.5	25.7	25.9	26.1	26.3
Tax Rate		38.7%	35.1%	37.4%	40.5%	39.0%	38.0%	37.0%	36.0%	35.0%
Dividend Per Share - Common		\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000
Expense Assumptions		34.2%	32.7%	34.1%	34.9%	34.0%	33.5%	33.0%	33.0%	33.0%
Food, beverages, & packaging as a % of co owned sales		50.6%	51.7%	50.9%	53.5%	53.5%	53.5%	53.5%	53.5%	53.5%
R&D as % of Sales		0.8%	0.7%	0.7%	0.8%	0.9%	1.1%	1.4%	1.5%	1.5%
SG&A as % of Sales		44.8%	28.6%	26.8%	29.0%	30.3%	39.8%	48.4%	49.5%	49.8%
Advertising as a % of Sales		2.2%	2.1%	4.1%	3.3%	3.9%	4.9%	6.0%	6.1%	6.2%
D&A as % of Sales		5.1%	4.2%	4.1%	3.3%	3.3%	1.8%	0.5%	0.4%	0.4%
Other as % of Sales		16.2%	-1.2%	-1.6%	-3.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Y/Y Changes (Model Checks)		7%	9%	0%	0%	-10%	-22%	-16%	0%	1%
Revenue		9%	9%	0%	0%	5%	5%	5%	5%	5%
R&D		-32%	3%	9%	8%	-5%	2%	2%	2%	2%
SG&A		-	-	-	-	-	-	-	-	-
CASH FLOW		2005	2006	2007	2008	2009	2010	2011	2012	2013
Net Income		-8.4	22.2	23.1	19.8	22.4	23.1	23.2	23.8	24.5
Less: Equity Earnings from Unconsolidated Affiliates		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
D, D, & A		7.3	6.4	6.3	5.0	2.2	0.5	0.5	0.4	0.4
Changes in Working Capital		-82.2	18.4	11.6	-4.0	-0.6	-0.5	-0.5	-0.5	-0.5
Deferred Taxes		9.3	2.2	-0.5	-1.0	0.0	0.0	0.0	0.0	0.0
Other		8.7	-0.7	4.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash Flow		-65.3	48.7	40.4	25.1	26.6	24.7	23.2	23.6	24.4
Less: Net Cap Ex (including acqs and divestitures)		3.3	12.0	10.1	-1.5	-3.9	2.4	2.4	3.0	3.0
Free Cash Flow		-68.6	36.7	30.3	26.6	30.5	31.0	20.8	20.6	21.4
EBITDA		0.4	51.7	52.5	47.3	48.5	45.4	42.7	42.4	42.5
Cash Flow/Share		-\$2.24	\$1.63	\$1.40	\$1.04	\$1.20	\$1.21	\$0.90	\$0.79	\$0.81
Free Cash Flow/Share		-\$2.36	\$1.23	\$1.05	\$0.75	\$0.98	\$0.99	\$0.80	\$0.70	\$0.73
Earnings Quality		77%	219%	175%	127%	119%	107%	100%	99%	99%

