

## Arcos Dorados Holdings Inc (ARCO) Memo

<b>Name:</b> Garrett Hynson	<b>College/School:</b> CLAS	<b>Year:</b> 3 <sup>rd</sup> Year
-----------------------------	-----------------------------	-----------------------------------

### Important Company Financial Data

Ratios, financial statement data, projections, etc.

- Price (as of 11/30/2012 close): \$12.25
- 52 week range: 10.53 – 22.99
- P/E (Trailing/Forward): 22.1/13.5
- P/B: 3.7
- P/S: 0.7
- P/CF: 10.7
- PEG: 1.33
- Yield: 1.95%
- Market Cap: 2.6 Billion

### Thesis / Key Points

- The Latin American market has tremendous potential for growth. Brazil has seen great growth, although this has slowed somewhat recently, and hosting the World Cup and Olympics in 2014 and 2016 should be catalysts for continued expansion. Mexico is booming as well, and other areas in the region, particularly in the Caribbean, maintain stable, growing GDPs through sectors such as tourism.
- Arcos Dorados' limited saturation in the market leaves great expansion opportunity. The company currently operates McDonalds in twenty countries, from Mexico to Chile, and owns 1,880 restaurants. The total population of its markets is over half a billion people, with a total GDP of almost 5 trillion dollars, and growing at a much faster rate than that of the United States. In the United States, there are 12,804 McDonald's restaurants, or one for less than every 25,000 people. In Arcos Dorados' markets, this figure is one restaurant for approximately every 266 thousand people, or a penetration rate that is less than 10% of that in the US for McDonald's per person. If Arcos Dorados' markets were to pull even with the US market in terms of saturation, it would have approximately 20,000 restaurants. Obviously, this is not something that will happen overnight, or even in the next few years. But as Latin American growth continues, Arcos Dorados will be able to open more and more McDonalds in the future, leading to organic growth outside of simply growing comps. The franchisee's limited saturation of the market presents a great growth opportunity.
- Arcos Dorados same-store comparable sales growth, or "comp" growth rates, are tremendous. In Q2 2012, these were over 11.5%, which is essentially unheard of in the restaurant industry. The next closest competitor in terms of comps was Chipotle – at just 8%. The average industry-wide for the quarter was just 3.34% – meaning Arcos Dorados' comps were over 3 times the industry average. This is widely considered perhaps the most important metric in the restaurant industry, as comps show that a business has growing power beyond simply opening new locations. The fact that Arcos Dorados' comps are so high speaks volumes about its business – it clearly has a lot of room for growth, and must be appealing in the minds of customers as it is clearly not only able to retain them but to grow its customer base.
- Arcos Dorados is vastly undervalued compared to the McDonalds' franchise as a whole. McDonalds has a market capitalization of \$87.9 billion, as of its Friday close. Arcos Dorados has a market capitalization of just \$2.6 billion – less than 3% of McDonald's same metric. However, it makes up 5.5% of McDonald's revenue. If its market cap were to increase in line with this metric, Arcos Dorados would see over an 80% jump. Clearly, this segment of McDonalds' business is undervalued when compared to the business as a whole. This likely reflects the risks presented in investing in a franchisee, as well as those associated with emerging markets. However, it does not seem to reflect the benefits and higher growth rate that are associated with emerging markets.
- Arcos Dorados pays a dividend, and with earnings growth, could grow its dividend substantially in the future. It initiated the dividend back in 2011, and has never raised it. However, the payout ratio stands at only about 44% - leaving Arcos Dorados room to grow its dividend, particularly if earnings can grow.

### Misperception

- **Growth in Brazil and other countries is fading, and the fastest growth has already passed for many of Latin America's emerging markets. Although growth in Brazil has slowed, there are several catalysts for the country. Hosting both the World Cup and Olympics within the next ten years is sure to improve growth rates. The large oil reserves off the coast should also be a boon to economic growth if they can be tapped into effectively.**
- **Arcos Dorados' growth is slowing – growth looks to have faded and this paints a less bright future for the company. Shares were hammered after the most recent quarterly report, as it was reported that revenues fell by 2.2% year-over-year. However, it seems that many investors missed the larger, and more important point, which is that on an organic basis, revenues increased 11.6%, and comps were up 6.5%. These are the metrics investors must be looking at – not just absolute metrics.**

## Arcos Dorados Holdings Inc (ARCO) Memo

### VAR

- I have talked to people who live in Latin America (specifically in Arcos Dorados' markets) and they cite McDonalds as a well-respected restaurant with a similar quality of food and service in their home markets as in the United States. This is important, as for many restaurants; the experience is far different in international markets than it is in the United States. For example, I visited a Subway in Vietnam, and the experience was vastly inferior to what one would find in a Subway in America. There were not as many different kinds of bread, cheese, or meat, and the quality of the food was subpar as well. It is very important that the quality of Arcos Dorados' McDonalds does not deteriorate, or the restaurant's image and reputation will be damaged.
- Analysts seem to share my sentiment that Arcos Dorados is misunderstood on a currency basis, and that its organic growth is not being viewed fairly because currency fluctuations have hurt revenue marks on an absolute basis. They agree that this was the reason for the collapse in share price after the earnings announcement, and that its subsequent rebound has been due to investors realizing the truth reflected in organic growth as opposed to absolute metrics.

### How It Plays Out

Arcos Dorados continues to ride the growth of the Latin American market. Comps continue to grow, and the company continues its expansion plan, increasing the number of stores in its markets, and perhaps expanding into some of the countries it is not currently in – such as Paraguay and Bolivia. The saturation rate also continues to grow, as company expansion rates exceed the population growth rates of its particular markets. Arcos Dorados dividend continues to grow as well, and eventually moves from a growth to a value stock. The stock gives MII a significant presence in emerging markets, which I believe it is currently lacking.

### Risks / What Signs Would Indicate We Are Wrong?

- Arcos Dorados is only a franchisee – McDonalds still controls much of the business, and the franchisee could be subject to any adverse decisions McDonalds decides to make. Changes in the menu could adversely affect it, as could changes in McDonalds franchising policy or overall strategy.
- The company is headquartered in Buenos Aires, Argentina – a country that has been known to be very hostile to business. Cristina Fernandez de Kirchner, Argentina's president, has been unfriendly to large businesses during her tenure, even nationalizing certain companies. Argentina's economy has struggled, in no small part thanks to Kirchner's policies, and we must be wary of any radical steps she could take should Argentina continue to have economic problems.
- Slowing growth would be very detrimental to the business. Right now, Arcos Dorados is still looking to grow into its full valuation, particularly when using metrics such as price-to-book. It is also using profits from its growth to finance further growth, and a slowing of growth would interrupt this cycle of expansion.
- Continued appreciation of the dollar against Latin American currencies. This has affected Arcos Dorados revenues and profits recently, and was the main catalyst for its decline following its reporting of Q3 earnings. If the dollar continues to appreciate against Latin American currencies, it will erode the positive growth Arcos Dorados has maintained.

### Signposts / Follow-Up

- Comparable Store Sales Growth: Comps have been strong recently, we should expect them to consistently hold above 5%
- Valuation of Latin American currencies: The dollar has strengthened versus Latin American currencies recently, we should look for a slowed appreciation or even a possible depreciation
- New Store Openings: Arcos Dorados has opened 333 stores in the last 5 years. New store growth must continue, and we should look for this especially in countries where Arcos Dorados currently lacks a presence. This will help supplement comps as another source of growth
- GDP Growth in major Latin American countries, such as Brazil

### Company Description

ARCO is the largest franchisee of McDonalds restaurants and is the sole franchisee in Latin America and the Caribbean. It operates McDonalds, McCafes, and Dessert Centers in twenty countries, including Mexico, Brazil, Argentina, Chile, Ecuador, and other large Latin American and Caribbean markets. The company operates 1,880 restaurants, of which 74% are company operated, and 26% are franchised. It is headquartered in Buenos Aires, Argentina, and employs approximately 90,000 people.

Arcos Dorados Holdings Inc (ARCO) Memo

(Page of Exhibit/s)

McDonald's

Exterior



Interior



McCafé

Interior



Menu Items



Dessert Centers

View



Menu Items



NUMBER OF RESTAURANTS <sup>(1)</sup>		
Brazil	691	37%
SLAD	556	30%
NOLAD	496	26%
Caribbean	137	7%
	1,880	100%

# We Operate and Sub-franchise Restaurants

Operator business model



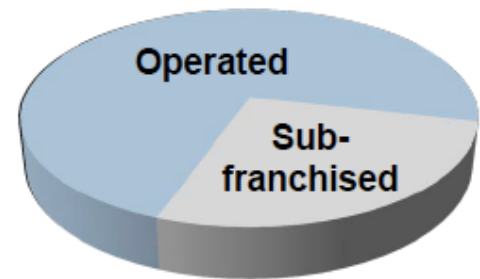
## COMPANY OPERATED RESTAURANTS

Revenues from restaurant sales

- Royalty fee
- Costs related to running the business

Operating Results

73%



## SUB-FRANCHISED RESTAURANTS

Revenues from rental income

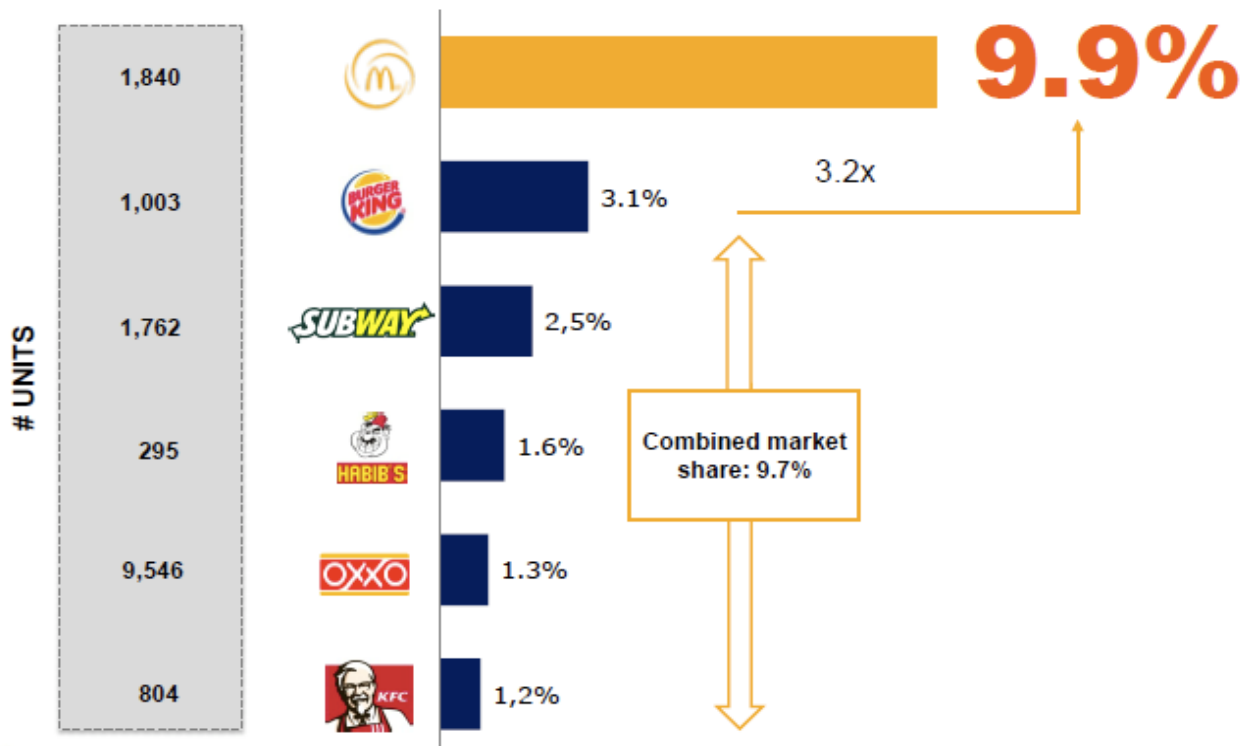
- Rental fee (related to real estate)

Profitability of Sub-franchised Restaurants

27%

\*Royalty Payments = collected and paid to McDonald's Corporation

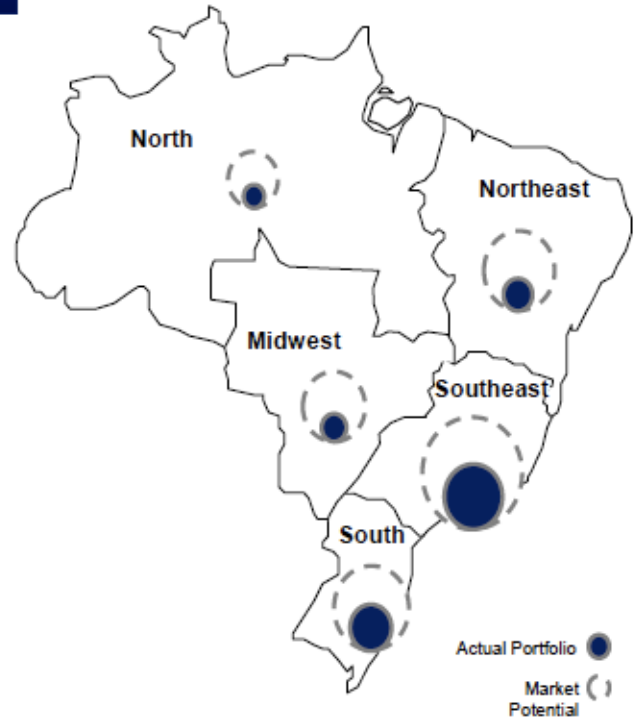
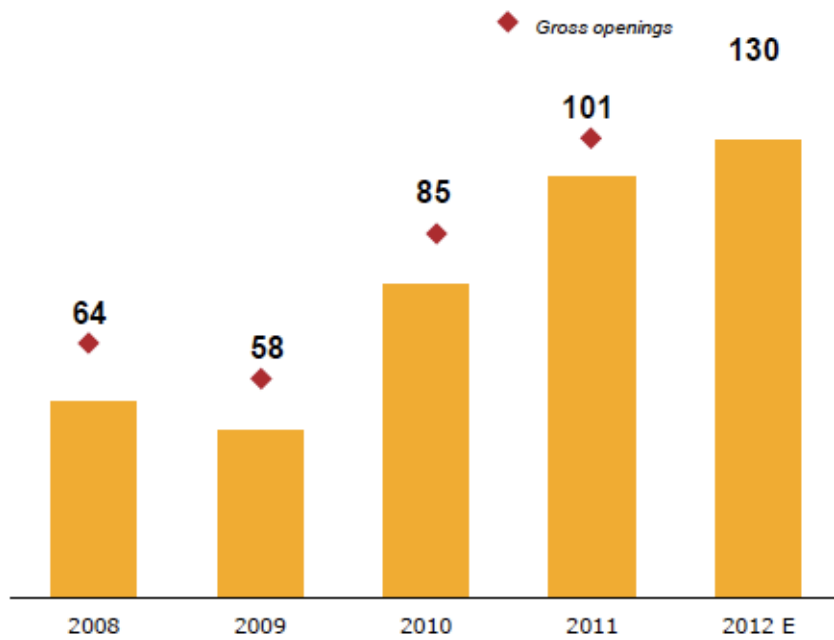
## MAJOR FAST FOOD RESTAURANTS IN LATIN AMERICA: 2011 MARKET SHARE



## Arcos Dorados Holdings Inc (ARCO) Memo

(Page of Exhibit/s)

### Accelerating new openings in the region



Restaurants (End of period)				
2008	2009	2010	2011	2012 E
1,640	1,680	1,755	1,840	

### Improving economic conditions

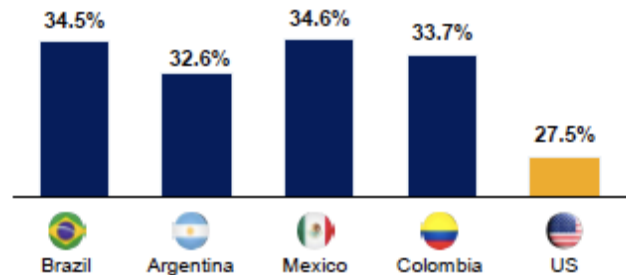
#### Changing socio-economic profile in Brazil

(mm individuals and % population)



### Young and growing population

#### % of Population between 15-34 years



### GDP per capita (PPP) growth

#### 2006-2011 CAGR (%)

