Say When

Tim Hortons is one of Canada's great growth stories. To be a great stock it will have to keep up the pace.

Robert Thompson, National Post
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It's a typical mid-winter morning at Gary O'Neill's Tim Hortons restaurant on Mountain Road in Moncton, N.B. Outside, the snow is falling, and the cars are lined up at the drive-thru as people stop by to pick up their morning coffee on the way to work. Indoors, the regulars are clustered around the tables, chatting over their doughnuts and double-doubles. One of them, a middle-aged man, notices O'Neill behind the counter and calls out a greeting. On this morning, however, he offers more than the typical salutation. "In March," the man announces, "I'm going to own part of this store!"

O'Neill laughs. As one of Tim Hortons' largest and most successful franchisees -- he opened his first Tim's franchise here more than 30 years ago and today owns 40 restaurants across Canada and in the United States -- he's heard that comment a lot in recent weeks. Everybody, it seems, is angling to get a piece of Canada's coffee-and-doughnut king when it goes public later this month or in early April in what's likely to be this country's investing event of the year. "There's a lot of talk about the IPO from everyone I run into. Everyone has something to say about it," O'Neill says. "My customers are all asking where they can buy shares."
That interest is hardly surprising. With RRSP earnings swollen from the boom in energy and commodity prices, Canada's Main Street investors no doubt feel fat and confident these days. And who among them wouldn't want a bit of Tim's? With more than 2,800 outlets in Canada and the U.S. -- generating revenue of US$1.2 billion for its corporate parent, Wendy's International, in 2005 -- the chain is one of this country's most exciting growth stories. It may not be as high-flying as, say, Waterloo's Research In Motion. Then again, no one's got a patent on the doughnut.

The value of Tim Hortons -- or at least the perception of value -- lies in more than its network of restaurants and drive-thrus linking communities from Whitehorse to Conception Bay. More important is Tim's place on the cultural landscape; its ties to the national pastime, its mythic back story and its resoundingly folksy brand. In this country, Tim Hortons is more than a fast-food chain. It's an institution that satisfies Canadians' appetite for national identity as much as their taste for hot coffee with milk and sugar. For that reason, an investment will be more than a business move. To many, it will also be an act of patriotism. "There's going to be an emotional attachment to this one, even if investors don't really know a lot about how Tim Hortons functions," notes Adrian Mastracci, president of KCM Wealth Management in Vancouver. "Some people are going to buy this just because it's Tim's."

And that may be a problem -- especially for investors who think they understand the business because they see the morning coffee lineups. While no one questions Tim's phenomenal success, its best years as a growth company may be over. Analysts warn that it may be reaching the saturation point in Canada, and that the brand hasn't made major inroads in the U.S.-- its largest potential market -- since opening its first American franchise in 1985. The question today "is whether historical growth indicates future growth," says **Peter Holden**, an analyst with **Veritas Investment Research** in Toronto. "Canada, if not tapped out, is pretty full. And while their marketing in Canada has been great, I don't know how well it's going to translate into the U.S."

This doesn't mean the Tim's IPO is going to be a bust. Far from it. But investors should think carefully before shelling out. Even Ron Joyce, the ex-cop and early Tim's partner who created its business model, is steering clear of the IPO. Demand, he says, means shares will likely be fully valued when they hit the market, leaving little room for profit.

Tim Hortons resonates with Canadians thanks, in part, to its down-home branding and marketing. The restaurants are active at the grassroots level in their support of community sports and recreation programs, a tribute to company founder and namesake Tim Horton, a star defenceman for the Toronto Maple Leafs who was killed in a car accident in 1974. Nationally, the chain promotes itself as a friendly neighbour with advertising campaigns featuring customers, such as Lillian, the gentle grandmother from Lunenberg, N.S., who walks up a hill every day, rain or shine, to visit her local Tim's outlet and get her coffee fix.

Business at Tim's may have been almost that folksy in the mid-1960s, when Horton and Joyce were plotting how to break their little coffee chain out of its original Hamilton neighbourhood. But it had become a serious regional outfit with 40 franchises by the time of Horton's death. And it was big business when Joyce, who bought Horton's share of the firm after his death, sold to Wendy's in 1996 in a share-based deal valued at $600 million.

The company that Joyce sold to Wendy's, called TDL Group Corp., bears little resemblance to the restaurants Canadians have grown accustomed to seeing on their street corners and TV screens. It is, in fact, a holding company that handles the franchising, wholesaling, marketing and real estate business that lies behind the network of independently owned franchise restaurants. But if the heart of the brand lies in those restaurants, the money's been in TDL. And so, it wasn't long after the sale that it became Wendy's chief profit driver. Joyce continued to work for TDL under Wendy's, and over the next 10 years, he and chief operating officer Paul House put the company through a massive expansion. They more than doubled the number of franchises and, in 1998, moved into the lunch business with soups, sandwiches and chili.

By 2005, Tim Hortons was Wendy's star. Although the hamburger chain had two and a half times as many outlets, its revenue, at US$2.4 billion, was only twice that of Tim's. And when investors looked at the bottom line, it was obvious that Tim's was on a breakaway. Its profit of US$279 million topped that of Wendy's by more than US$50 million.

Wendy's restaurants poor performance was the result of a rapid-growth strategy in its early years that left it with expensive corporate stores, an inefficient franchise system and a depressed share price. (Joyce, once one of Wendy's largest shareholders, dumped his shares in 2002, frustrated with their performance.)

A long-troubled company, Wendy's nadir arrived in 2004 when a woman from California claimed to have been served a severed finger in a bowl of chili. The claim turned out to be an extortion attempt. But by the time the truth was uncovered, the story had cost Wendy's an estimated US$2.5 million in lost sales and sent its shares to a 52-week low of US$36.73.

Sensing a mix of blood and opportunity in the water, several prominent hedge funds began taking advantage of Wendy's diminished share price. They bought positions in the company and, before long, were clamouring for Wendy's to spin off its doughnut partner so they could realize its value. Wendy's CEO Jack Schuessler acquiesced last July, committing to take 18% of Tim's public by the end of March or in early April. That wasn't good enough for one of the activist investors, Nelson Peltz, a corporate raider and head of the New York-based investment firm Trian Fund Management. In December, he announced that he had acquired a 5.5% stake in Wendy's and that he wanted the parent to spin off the coffee-and-doughnut chain in its entirety. For Schuessler, Peltz's demand was the straw that broke the camel's back. In January, he confirmed that Wendy's will spin off all of Tim Hortons. The first 18% will go, as planned, in the IPO. The remainder is to be distributed to Wendy's shareholders over the next nine to 18 months.

To casual investors, Tim Hortons may look to be a slam dunk. Its growth in Canada has certainly been stunning. But those who score the easy money off the IPO will likely be the hedge funds who've lobbied hardest for the spinoff. They'll benefit from the fact that shares in Tim's and shares in Wendy's, as separate companies, will be worth more than those of the combined entity. Wendy's International shares, for example, were trading at $55 in mid-February. Peltz, in SEC filings, says he believes that shares in an independent Tim's will be worth about US$32. He also believes that Wendy's can have a value of more than US$45 a share, assuming it follows his plan to fix its business model. Put those two figures together, and Peltz's investment, by his estimation, becomes worth at least US$77 for each pair of shares -- a profit of more than US$20 based on Wendy's mid-February share price.

New investors, on the other hand, will be betting on the continued growth of Tim Hortons' franchise network to drive its share price higher. Despite arguments that it's reaching the limits in Canada, company managers have said some room for expansion remains in urban centres. More important, however, are plans for the U.S. Tim's management was unable to comment for this article due to regulatory requirements for a "quiet period" leading up to the IPO date. But in earlier interviews and statements, executives have said they plan to double the number of Tim's stores in the U.S. to 500 by the end of 2007. That growth will be concentrated in the northeast, COO Paul House said in an interview with the fast-food trade journal QSR Magazine published last August. He also said Tim's growth will rest on the twin strategies of selling franchises, rather than opening corporate stores, and on promoting its "Always Fresh" brand promise. "We're doing what we do in Canada," House said. "It might take a while in a market where there's an established buying pattern. But we're persistent."

Persistence, in fact, may become the chain's most important asset in the years ahead. Tim Hortons has spent two decades trying to break into the U.S. Yet it's only since the sale to Wendy's that it has achieved any degree of success. On the upside, same-store sales -- a key measure of retail performance -- are increasing more rapidly in the U.S. than in Canada. Many individual franchises, however, are running only at the break-even level. Part of the problem has been that the Tim Hortons brand simply isn't recognized in the U.S., except perhaps in a handful of border towns. More significant, however, is the level of competition. In Canada, Tim's claims it has 70% of the coffee and baked-goods restaurant business. It may feel pressure here from successful company-run networks like Starbucks and lesser franchise chains like Country Style and Coffee Time. But the competition increases exponentially across the border. In the U.S., Tim Hortons must stand out not only among premium banners like Starbucks, but also veteran franchises such as Krispy Kreme and Dunkin' Donuts.

Adding to that issue is the fact that much of Tim's growth in Canada has come from using its brand power to enter the lunch market. In the U.S., it is an unknown going up against majorleaguers
such as McDonalds, Subway and Burger King. "Tim Hortons is going to have to fight all sorts of competitors they haven't battled with yet," says John LaForge, chief investment advisor with SRQ Capital in Sarasota, Fla. "Its growth trajectory will be very different in the U.S. than it has been in Canada."

If Tim's is unable to meet investor demand for revenue growth through expansion of the chain, it may be compelled to demand more from franchisees, which may in turn affect the performance of the stores. The franchises are currently considered a good deal for the people who buy them. It costs between $420,000 and $450,000 to open a restaurant -- compared to Harvey's, which requires $550,000, or Wendy's, which can cost up to $600,000 -- a sum that covers start-up capital, furniture and equipment, support, training and the right to use trademarks. Better yet, the money comes back quickly. An average outlet earns revenue of US$1.7 million annually, according to Wendy's financial statements, while store owners say they earn operating margins around 16%.

Joyce says franchisee margins were even higher -- as much as 20% -- when he ran Tim's. "It was my philosophy to treat the franchise owners as partners." But now he worries that owners won't be able to sustain the current levels, which have already been under pressure in recent years. A publicly traded Tim's, he warns, could be forced to open more restaurants near existing ones or perhaps charge more for the services it provides to franchisees.

Franchise owners are also quietly expressing fears that they'll become the focus of new efforts to grow its bottom line. "I know a lot of store owners feel that way," says one franchisee, who asked not to be named. "They feel if the operating company comes under pressure, it'll start to squeeze the stores." Bob Gibson, consumer products analysts at Octagon Capital Corp., also warns that store owners may face new pressures following the IPO. "Investors," he cautions, "will make management look shorter term."

On the other hand, the chain could continue to grow in spite of the challenges it faces in Canada and the U.S. In his interview with QSR, House vowed to stay the course. "We've never left a market," he said. "We are too stubborn to leave. Forty years has proven to us that we might take a beating, but we'll get traction if we just keep doing it right." And House isn't alone his expectations. In SEC filings, Peltz says his analysis suggests the number of Tim Hortons restaurants has the potential to double, and he expects the chain's strong growth to continue until 2011.

Back in Moncton, even franchise owner Gary O'Neill is feeling pretty good. Unlike his customers, he's not wondering where he can buy stock; franchisees have the option of purchasing $30,000 worth of shares. Many haven't decided whether to opt in to the program, O'Neill says, but he's had no trouble with his decision. "Some owners haven't paid much attention to the IPO," he says. "But I think this could go very well. And I know there are other owners like me who would buy more shares if they could."

That said, shareholders like O'Neill and Peltz, or executives like House, are experts with deep understandings of the company. They will also benefit from the IPO in ways different from the exuberant rank-and-file. Hopefully, Main Street's brokers and financial advisers are reminding those investors: There's no promise you'll win when you roll up the rim.

WHO CAN BUY TIM'S SHARES?

You've seen lineups at the local Tim Hortons, and you believe there's a lot of growth left in the franchise. Now you're wondering how you can buy shares in Tim's when its parent, Wendy's International, spins off 18% of the company in an IPO, expected in the next few weeks.

Well, chances are you're out of luck. In a move that's left some analysts scratching their heads, Wendy's has decided that the majority of the Tim's IPO will take place in the U.S, even though the chain is far more popular here. "I think it was very short-sighted to focus on U.S. brokers," says Bob Gibson of Octagon Capital. "If they'd given this to more Canadian brokers, it would go out the door much faster."

Some shares will debut on the TSX, as RBC Capital Markets is one of the underwriters of the IPO, but it's unlikely they'll go to retail investors. So, if you want to buy into Tim's, you'll have to wait for shares to start circulating after the offering. If you really can't hang on, you can always buy shares in Wendy's, which will distribute the remainder of post-IPO Tim's to its shareholders over the next nine to 18 months. But that's a risky move -- Wendy's has only been able to dream of results like Tim's in recent years.

BREWING UP: Investors in Tim Hortons will be counting on continued growth to drive shares:

1964 Tim Horton opens first store in Hamilton with partner Jim Charade. Ron Joyce buys the franchise a year later

1967 Ron Joyce becomes full partner in Tim Donut Ltd.

1974 Tim Horton killed in car crash. Joyce buys Horton's share of business from family members a year later

1985 Tim Hortons opens first U.S. franchise in Amherstburg, N.Y.

1996 Ron Joyce sells Tim Hortons to Wendy's International Inc. for US$680 million. Joyce joins Wendy's management and receives 16.45 million shares in the company

1998 Tim Hortons expands menu and moves into lunch category with new line of sandwiches, soups, chili and bagels

2001 U.S. doughnut powerhouse Krispy Kreme challenges Tim's at home with plans to open 32 stores in Ontario, Quebec and Maritimes

2002 Joyce, recently retired from Wendy's, unloads his Wendy's shares, frustrated by the company's poor performance

April 2005 Krispy Kreme can't compete with Tim's. Canadian operations go bankrupt and assets are put up for sale

July 2005 Wendy's gives in to activist investors and announces plans to take Tim Hortons public