XiabuXiabu Investment Thesis / Amir Dov

Abstract

XiabuXiabu (HKG:0520) is a Chinese Hot-Pot fast-casual restaurant chain, operating ~550 restaurants in mainland China. It is currently on-track with management's plan to operate 1,000+ restaurants by the end of 2018 while due to the overall weakness in China it trades for multiples that reflect practically no future growth. This might be a unique opportunity to jump on board with a business that enjoys rapid growth, scalable business model and solid profit margins, while paying attractive, "value-stock", prices (4.9x EV/EBITDA, 5.1x EV/OCF).

There are actually two main reasons for XiabuXiabu's depressed stock price. The first is the overall weakness in China and EM in general, and the other is the deceleration in top-line growth rates. This deceleration derives from Same-Store-Sales (SSS) decline, while new restaurants are still being opened at a 20% annual rate.

SSS growth is in decline in recent years and has actually decreased for the first time in H1-2015. This is a broad-industry decline that is probably due to the economic slowdown in China. However, there are reasons to believe this trend is about to change:

1. Comps. data point to Q3 improvement - while XiabuXiabu doesn't report quarterly earnings, some other Chinese fast-casual/fast-food chains (Yum & Ajisen Ramen) saw their SSS numbers improve in Q3 2015 (XiabuXiabu has performed significantly better among this peer group in the past).
2. Direct Initiatives - XiabuXiabu was launching both a breakfast menu as well as a home delivery service during H2 2015, with the clear goal of returning to SSS growth and expanding both services into 2016.
3. Long-term Macro trends (mainly urbanization) still favorable for QSR industry despite overall slowdown. Additionally, in the US, the QSR industry has been pretty resilient to past recessions.

Given the pace of new restaurant openings, a stabilization in SSS should result in a top-line growth of ~20% per annum in the next 3 years. If SSS growth is back to low single digits (2%-3% as I expect) - we should see top line growth of 25%-29% p.a.

To achieve the 1,000 restaurants target, management doesn't plan to expand overseas. In fact, it doesn't even expect to expand to Hong-Kong, Macau or Southern China at this point. The market is big enough for it to double restaurant count while staying in the northeast, northwest and central China (for the sake of the argument, California has 325 Chipotle locations with a population of 39m. Hebei province, including Beijing and Tianjin, has a population of about 108m and only 282 XiabuXiabu restaurants).

Additionally, XiabuXiabu is committed to pushing for high-growth rates due to its 32% shareholder - General Atlantic, which bought its stake in 2012 supposedly for a similar price the company currently trades for.

When IPO'd in Dec 2014, XiabuXiabu was growing top-line at 20%+ per annum. It traded for 15.0x EV/EBIT which was still a discount to the US fast-casual peers. Since then growth decelerated and outlook for China became more bearish, hence the company currently trades for 7.5x EBIT and 4.9x EBITDA. Both are significantly lower than its American peers, who do not share the same compelling Macro outlook in the longer term (urbanization, wage growth, personal consumption growth & untapped QSR market in China).

Even after recent declines, fueled by a 40% drop in Chipotle's share price, American Fast-Casual peers (CMG, Shake Shak, Zoe's Kitchen, Panera, Noodles & Co. and the Cheesecake factory) are still trading for 18x EBITDA and 34x EBIT on average (however, it's very likely that they are overvalued).

Little Sheep, XiabuXiabu's largest Hot-Pot competitor in China, was sold to Yum! Brands in 2011 for valuation multiples approximately 2.5x higher than XiabuXiabu's current valuation (Appendix A details the comparison).

XiabuXiabu reports CAPEX needed for a new location to be Rmb 1.2m on average. Combining this metric with the number of new locations opened during the last 3 years, we can see that maintenance CAPEX is very low - probably lower than 2% of revenues. The lack of in-restaurant central kitchens (since Hot-Pot is about DIY) also makes the business very asset-light, resulting in ROE of over 30% in 2012-2014, with peers ranging from 12% (in China) to 18% (globally/US).

Cash flow has historically been stronger than earnings. The company reports Net Cash from Operations, which is cash from ops minus taxes paid plus interest received (Xiabu has always had a net cash position so there are no interest payments). Net Cash from Operations have been growing at a 22% annual rate since 2011, reaching Rmb 315m in 2014 (reflecting a 5.1x multiple measured against EV).

Valuation

Due to the net cash position and the negligible maintenance CAPEX needs, I believe an EBITDA multiple will be most appropriate in order to value the company. I've used a 10x EV/EBITDA multiple on 2018 EBITDA, which is about 22% lower than the multiple paid by Yum! Brands for Little Sheep in 2011, and 80% lower than the American peer group of fast-casual chains. To arrive to the 2018 EBITDA figure, I used the following assumptions:

- Management meets the 1,000 restaurants target by 2018.
- SSS growth averages 2% per annum in 2016-2018.
- EBITDA margin improves modestly, from 14% in 2014 to 15% in 2018.

The above assumptions result in a 2018 EBITDA of Rmb 730m, and a valuation of Rmb 7.3b, 180% higher than today's market cap (excluding assumed ~3% dividend yield along the way).

Main Risks / Open Questions

- **Severity of China's economic slowdown -** since there are a lot of unknowns at this point, it's hard to predict where the economy will be in 2-3 years. Change in urban disposable income will probably the most important indicator for this matter.
- **Barriers to entry aren't very high** - XiabuXiabu differentiates itself on ingredients quality, not on being the cheapest Hot-Pot around. It basically makes its moat (if one exists) harder to protect.
- **Beijing area vs. rest of China** - historically, margins in Beijing have been higher than in other regions (mainly Shanghai). This was due to lower seat turnover, probably deriving from a more competitive environment. There remains a question whether XiabuXiabu can replicate the success it had in Beijing in other parts of China.
- **Forex** - for non-Chinese investors - a major Yuan devaluation is not unrealistic.

Catalysts:

- **Return to SSS Growth -** this should result in 20%+ top-line growth and push margins and valuation multiples upwards.
- **Yum! Brands separation of China division -** planned by the end of 2016 and could attract more attention to the sector from western investors.

Additional in-depth Notes

General - XiabuXiabu / Hot-Pot / Chinese Fast-Food

- XiabuXiabu is a hot-pot restaurant chain in China (mainly North-East China). As of June 30, 2015, it had 499 restaurants, all of them operated by the company (no franchisees).
- About 50% of the chain's locations are in the Beijing metropolitan.
- According to management's announced plan, they should have over 1,000 running restaurants by the end of 2018. This plan was initially announced in 2014 and was repeated in their latest filing. It also seems reasonable considering the pace they've been opening restaurants so far. Management also stated a 120 new restaurants target in 2015. They only opened 47 in H1, so we'll see if they are able to ramp up the pace to 73 in H2 (we're probably standing around 550-570 locations as of YE 2015).
- Hot-Pot is a very popular type-of-meal in China. It's basically a bubbling cauldron of broth in which diners cook meat and vegetables themselves (since food cooked in a soup is usually a bit dull in taste, the real deal in a lot of Hot-Pot places are the sauces. Chains like XiabuXiabu offer huge variety of sauces).
- Hot-Pot restaurants can be either part of a chain like Xiabu and Little Sheep, or just a traditional stand-alone Hot-Pot location, which is usually more expensive and intended for family gathering, groups of friends, etc.
- The biggest chain in the nation is probably Little Sheep, which was acquired by Yum! Brands in 2011. It had 430 locations about a year ago when Xiabu had 394, so I'm assuming it's still bigger. But it also seems that XBXB is growing faster (Little Sheep had 300 locations when it was acquired in 2011 while XBXB had less than 200), so it makes sense that they're about the same size now. The 3rd largest chain is probably Hai Di Lao with approximately 100 locations.
- However, XBXB claims it approaches a more upscale market than Little Sheep, hence classify themselves as "fast-casual" while little sheep is "a fast-food chain that is owned by a fast-food giant." I couldn't find Little Sheep's average spending per customer in their

old reports, but XBXB stands at Rmb 45 or $7, which is about 2x the price of an average KFC / McDonalds' meal.

- Why would you go to a XBXB or a Little Sheep rather than a traditional Hot-Pot?
    - Price - traditional Hot-Pot seems to be more expensive.
    - Speed - traditional Hot-Pot are more suited for a long multi-participant dinner.
    - Consistency - same reason you'd walk into a McDonald's - you know what you're getting pretty much any time anywhere.

Revenues

- Since 2011 (earliest financial information), revenue grew 30% per annum until 2014 or 25% p.a. until 2015 if we're using the most recent estimates for FY2015 revenues.
- However, it has been slowing pretty rapidly recently - growing only 16% in 2014 and estimated to grow ~10% in 2015.
- While the number of locations shows relative consistant growth of around 20% p.a., the headwind in the last 18 months was a decline in Same Store Sales.
- SSS growth has been declining alongside China's economic slowdown, and turned negative in H1 2015. It has gone from 10.5% growth in 2012, to 2.8% in 2013, 1.5% in 2014 and -3.3% in H1 2015.
- **SSS decline wasn't specific to XiabuXiabu, it was all across the industry and if anything, it seems that Xiabu was one of the less severe cases (Ajisen-Ramen reported 10% SSS decline in Mainland China in Q2, while Yum! Brands suffered 4 straight quarters of SSS decline in China).**
- *(side note: given that most fast food chains showed a decline in SSS during H1 2015, mostly sharper than XBXB's 3.3%, the 6.5%-7% GDP reported growth numbers seem odd. As far as I can tell these are recession-type numbers).*
- There is however some light at the end of the tunnel and some reasons to believe SSS will go back to growth in the next 12 months:
    - **Breakfast**: Targetting a return to SSS growth, Xiabu started serving breakfast in selected restaurants in H2 2015.
    - **Takeout & Delivery**: By the end of 2015, Xiabu should have had 17 restaurants participating in the takeout and delivery services, with the idea of further expansion (if successful) to more restaurants in 2016.

    - **Macro**: In the US, the QSR industry has been resilient to past recessions. There's no reason to assume this will not be the case in China, even if the economy gets even messier in the near-term
    - **Comps:** XBXB doesn't release quarterly reports/updates, but other Chinese peers do. Yum! Brands which has by far the biggest fast-food business in China actually reported a Q3 SSS growth after 4 straight quarters of declines. Ajisen Ramen, which operates the largest fast-casual business in China (about 20% larger than XBXB), saw SSS decline a bit narrowed in Q3 compared with Q2 (however still a huge 9.2% decline in mainland China).
- *Caveat re Yum! Brands: November figures actually took a dive following an improved Sep & Oct, so it could mean the trend is turning negative again.*
- I expect the breakfast initiative especially to have an impact on SSS numbers in 2016, but obviously Macro is going to be the biggest factor going forward.
- *A reminder: given the pace of opening new restaurants, once SSS stabilize we should see top line growth of more than 20% once again. If SSS growth is back to low single digits (2%-3% as I expect) - we should see top line growth of 25%-29% p.a.*

Expenses / Operating Profit

- Management reports "restaurant-level operating profit" which is a non-GAAP metric and hence should be taken with a grain of salt.
- Reported margin for this metric has been around 19%-21% but most recently (H1 '15) declined to 18.4% due to the decrease in SSS.
- Restaurant Level Operating Profit has been growing at a 32% CAGR in 2011-2014. It is expected to remain flat or grow in low single digits in 2015 as the decline in SSS should mitigate most of the profit from new locations.
- Operating Margins averaged 9.5%-10.0% in recent years, and expected to fall to around 8% in 2015. Again, this is mainly due to SSS decline.
- While the trend seems not to favor Xiabu, I believe the 2015 slowdown is the main reason this opportunity exists in such an attractive pricing. Current multiples (at a HKD 2.90 share price) are:
    - EV / 2015 EBITDA - 4.9x
    - EV / 2015 Restaurant Level Operating Profit - 3.2x
    - EV / 2015 Operating Profit - 7.5x

- The American fast-casual comps I've looked into (Chipotle, Shake Shak, Zoe's Kitchen, Panera, Cheesecake Factory and Noodles & Co.) average 17.9x EV/EBITDA, 34.1x EV/EBIT and 10.5x EV / Restaurant Level Profit (they were pushed higher by Shake Shak's crazy valuation but even w/o Shake Shak it's 13.9x/28.6x/7.8x).
- I think that in a 3+ years timeframe Xiabu has a significantly more favorable macro environment to grow its business in (number of locations + pricing due to wage rise in China). Hence I would pay more for Xiabu than for any of the above (besides Chipotle maybe).
- The 19%-21% restaurant level operating margin is still a bit lower than most American fast casual chains who average 23%, but Xiabu makes up for most of it with relatively low overhead (G&A + D&A) so operating margins are in-line with the American peers average.
- Looking at the restaurant level cost-structure, Xiabu actually spends less than most peers on staff cost, mainly due to the lack of in-restaurant central kitchen (since it's a DIY thing). This allows Xiabu to spend more on fresh and superior raw materials, as it claims to differentiate itself from most peers by the quality of products. Indeed, Xiabu spends ~40% of revenue on raw materials & consumables, which is significantly higher than Chipotle's 33%, Ajisen's 30%, or the broad industry average of 31%.
- The company has a highly centralized procurement process (>90% via central procurement). it has also been able to keep food cost from rising as fast as their retail price. The central procurement process should result in better COGS when scaling.
- *Side Note: Ajisen Ramen, the Japanese-style fast-casual chain mentioned earlier, is actually even cheaper than Xiabu at current levels, trading for 2.9x EBITDA and 2.1x Restaurant level profit. It is very likely that it will be as good, if not better investment as Xiabu in the next few years. The reasons I ultimately chose to invest only in Xiabu are the following:*
    - *Ajisen practically failed to grow its business in the last few years, growing on average at only 2.5% in the last 3 years (2012-2015).*
    - *The lack of return-targeted big shareholder (like General Atlantic) made me worry they will be no real force to push management for acceleration in growth rates.*

- *From conversations I had with several local Chinese, Ajisen seem to fall out of favor in recent years while Xiabu is still pretty trendy.*

- *With that said, it's pretty ridiculously priced and if it falls further I might be tempted to open a small position there as well.*

Cash flow & Balance Sheet

- Cash flows have been historically stronger than earnings. The fast-food business is a cash machine and it is apparently no different in China than in the US
- Net cash from operations, which is cash from ops minus taxes paid plus interest received (Xiabu has always had a net cash position so there are no interest payments) has been growing at a 22% annual rate since 2011.
- Net cash from operations were Rmb 315m in 2014 (reflecting a 5.1x multiple measured against EV). In fact, the net cash from operations generated in the last 4 years (2011-2014) is about 55% of current EV.
- The balance sheet is stacked with cash, also generated from operations but mainly from the late 2014 IPO. As of June 2015, cash & short term investments were Rmb 1,195m ($182m) which is now about 45% of market cap. According to the prospectus, the cash would be gradually deployed in the next 3-4 years in:
  1. Increased pace of opening new locations (165 new locations planned in 2018 alone).
  2. The construction and opening of two additional logistics and production centers in Beijing and Shanghai (they currently have only one - in Beijing). These centers should be able to support additional 800 new restaurants bringing total capacity to >1300.
- To be honest, given the current cash generation from operations, I don't think they'll need so much cash to open new locations. We'll probably soon see an increase in the dividend (currently yielding ~2.9%) and hopefully they won't do anything stupid with the cash in the meantime.
- The lack of in-restaurant central kitchen also makes Xiabu's business very CAPEX-light. They hardly need any expensive assets to operate the business and hence ROE has been above 30% in 2012-2014 with peers ranging form 12% (in China) to 18% (globally/US).

- Maintenance CAPEX is extremely low. Xiabu's average investment in a new location is Rmb 1.2m. They don't provide breakdown for CAPEX spending but if we take this 1.2m figure and look at the entire CAPEX spend in the last 3 years - even if we assume all other CAPEX is maintenance CAPEX (i.e. zero allocation to the building of production & logistics facilities) it's still ranging between 2.2%-2.6% of revenue.

Rmb (m)	2013	2014	H1 2015
Total Capex	119	126	45
New restaurants	64	58	47
Capex p/ new restaurant	1.2	1.2	1.2
Total CAPEX on new restaurants	77	70	56
Other CAPEX	42	56	-11
As % of Revenue	2.2%	2.6%	<0%

- In fact, the real number is probably closer to the 2013 figure than the 2014 one, as the company has spent a lot of time and money on some of the restaurants that needed to be refurbished before the IPO. Approximately 20 restaurants were closed for refurbishments in the period before and slightly after the IPO, to get them up to the required health & cleaning standards (this is also the reason less new restaurants opened in 2014 than in 2013).

Management / Shareholders

- Kuang-chi Ho (51) is the executive chairman and owner of 42% of the business. He's a taiwanese citizen and has founded XiabuXiabu in 1998 in Beijing. He doesn't serve as the CEO since 2013 but he is still responsible for "formulating the overall development strategies and business plans of the Group". Considering what he achieved with Xiabu so far, he seems very competent. I also like the fact that he welcomes and partner with western PE firms (General Atlantic bought their share in 2012 from another PE).

- Yang Shuling (53) - the current CEO. She started in the company as an accountant when Xiabu was established and went up the ladder until she was appointed CEO in 2013. I couldn't really find anything interesting to say about her. She has about 13m options with different exercise prices - the largest tranche (7m options) is at Rmb 2.78 which is actually above the current share price (HKD 2.90 = Rmb 2.45).
- General Atlantic - they own about 32% of the business which they bought in 2012 for more or less the current share price. Their board director in Xiabu is Wei Ke, a Harvard graduate and former BCG consultant. He was previously with Actis, which is the firm General Atlantic bought its stake from - so I guess it's a good sign (he like what he saw).

Why is it so cheap?

1. **Growth concerns for China -** a very solid concern indeed. China could be up for major slowdown or even a recession. What I like about XiabuXiabu is that it is cash rich and a cash generating business, and that the government doesn't own a piece of it. I believe urbanization, personal consumption and average wage all have good chance to rise in the next few years even if China falls into recession.
2. **Heavy redemptions in Asian/Chinese funds/ETFs -** this is obviously a technical reason deriving from underweighting China/Emerging Markets in most financial institutions / money managers. if this is the case it's a great reason to buy the dip.
3. **Hot-Pot wasn't/isn't a big success in the US** - probably not going to be in the future (it's a taste thing), but if the US is large enough for 1,500 Chipotles, China is surely big enough for 1,500 XiabuXiabu locations (which is 3x of today, and that's before we look at Singapore, Hong-Kong, Taiwan etc.). Also, management has stated it has no plans to expand overseas. In fact, the current 1,000 restaurants plan doesn't even include Hong-Kong and Taiwan - only mainland China (and mainly north-east China). Just to get some proportions, California has 325 Chipotle restaurants with a population of 39m

people. Hebei province (including Beijing and Tianjin) has a population of about 108m and about 282 XiabuXiabu restaurants.

4. **Growth has materially slowed -** I've addressed that above and it's almost entirely due to SSS decline, as the opening of new restaurants were relatively steady at 20% per year. I do expect growth to

Valuation

Not a lot to say here. I do believe earnings will be much higher in a few years, and that multiples will also expand to a more reasonable 10x-12x EBITDA. I arbitrarily picked 2018 but it could be 2019 or 2020 - in any case it looks something like that

	Bear-Case	Base-Case	Bull-Case
SSS Growth (2016-2018)	0%	2%	3%
The 1,000 locations plan	10% below plan	5% below plan	On track
EBITDA Margin	13%	14%	15%
EV / EBITDA	8x	10x	12x
EV (Rmb)	4,292m	6,472m	9,019m
Share Price (Rmb)	4.01	6.06	8.43
Share Price (HKD)	4.77	7.20	10.03
Return (+3% Div. Yield)	71%	154%	252%
Annualized Return	20%	36%	52%

Appendix A - Comparison between XiabuXiabu and Little Sheep pre-acquisition by Yum!

This is solely anecdotal, since Yum! could have overpaid and expectations regarding China are probably different today than they were 5 years ago. But still it's a comparison between XiabuXiabu LTM figures and Little Sheep 2010 P&L, just before it was acquired for $587m.

	Little Sheep 2010	XiabuXiabu LTM June '15
Revenues	1,930	2,304
Y/Y Growth	22.7%	12.7%
3 Year CAGR	26.7%	17.9%
EBITDA	317	309
EBITDA Margin	16.4%	13.4%
Operating Profit	243	211
Operating Margin	12.6%	9.2%
Net Income	187.8	176
Net Margin	9.7%	7.6%
Acquisition Price / EV	3,859	1,643
Rev Multiple	2.0x	0.7x
EBITDA Multiple	12.2x	5.3x
EBIT Multiple	15.9x	7.8x
Net Income Multiple	20.5x	9.3x

Appendix B - XiabuXiabu vs. Selected Fast-Casual Peers

in USD (m)	Chipotle	Shake-Shak	Zoe's	Panera	Noodles & Co	Ajisen	XiabuXiabu
Restaurants	1,783	63	132	925	386	669	499
Restaurant Level Margin	27%	28.5%	21%	22.3%	20.5%	25.3%	19%
Operating Margin (GAAP)	17.4%	11.2%	3.1%	11.0%	3.2%	11%	8%
EBIT per Restaurant	662	1203	308	554	235	196	148
Market Cap	12,884	1,375	501	5,006	307	470	391
EV	11,925	1,305	507	5,142	365	226	212
EV / EBIT	15.0	61.5	72.4	17.4	25.2	4.7	7.5
EV / Rest Level Profit	9.6	24.1	10.7	9.2	3.9	2.1	3.2
EV / EBITDA	12.0	38.0	25.4	13.3	10.1	3.1	4.9