# Minutemen Equity Fund

RESEARCH REPORT

Texas Roadhouse (NASDAQ: TXRH)

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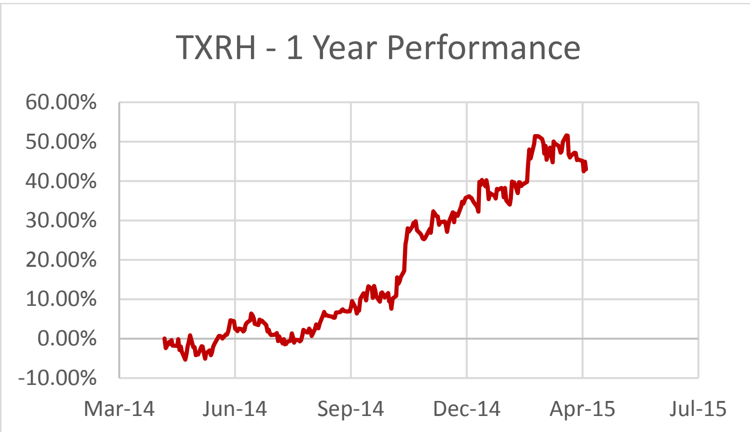
Company Name (Texas Roadhouse)
Ticker: (NASDAQ: TXRH)
Price: ($35.87)
Recommendation: BUY

## OVERVIEW




| | | | |
|---|---|---|---|
| Market Cap | 2.5B | EV/EBITDA | 13.03 |
| P/E *TTM* | 29.33 | EV/SALES | 1.57 |
| P/E *Forward* | 21.06 | Avg. Volume | 691,473 |
| P/B | 4.12 | Beta | 0.7 |
| D/E | 0.08 | Target Price | $43.28 |

### Investment Summary

Texas Roadhouse has produced consistent, stable, and even predictable growth over the last five years. We believe this is a direct result of the Company's focus on employee satisfaction, unique atmosphere, and local community engagement.

**Stable Growth** - Texas Roadhouse has consistently opened just under 30 restaurants for the past three years and has stable, high comparable sales growth. Combined with diligent margin efficiency practices, this has led to a strong capital position.

**Employee Satisfaction** – The Company's performance-based incentive model requires that all managers be invested in positive bottom-line results for the restaurants they oversee, aligning their interests with those of the shareholders. In addition, Texas Roadhouse has an advantage over other chains due to the fact that many are only open in the evenings, providing a higher quality of life for employees and therefore is more able to retain talent.

**Unique Atmosphere** - Texas Roadhouse's competitive advantage is its lively and fun atmosphere. The rustic southern-style decor paired with line-dancing staff is unique to Texas Roadhouse, and the Company has worked hard to maintain this theme throughout all company and franchise restaurants as it has grown.

**Local Engagement** - Each restaurant is committed to its local community by participating in numerous events including local fundraisers. The Company markets locally only, and purchases produce, dairy and alcohol from local suppliers. Though it is a chain restaurant, Texas Roadhouse is focused on being the neighborhood go-to, unlike its competitors.

## Industry Analysis

Texas Roadhouse is part of the chain restaurant industry, which saw annual growth of 2.4% from 2010-2015 and is expected to grow at an annual pace of 1.7% from 2015 to 2020. The industry profit margin is 5.1%, but is estimated to be slightly lower for chain restaurants serving meals with an average price in the range of $15 and $25 per customer. The industry is heavily dependent on consumer spending and consumer confidence. Over 50% of revenue is attributable to the first and second quintile of income earners in the United States, so the industry as a whole relies on households earning $100,000 or more in income annually for a large portion of profits.

As wages account for 32% of revenue in a typical restaurant, the industry is labor intensive and very responsive to wage changes and government policy surrounding employment. Cost of food is generally 28-32% of revenue, so the industry is also dependent on supply costs. The industry is in the mature lifestyle stage and faces intense competition. There is a current trend for consumers to choose restaurants that offer fast-paced service over more expensive and slower full service restaurants. Therefore, the chain restaurant industry faces competition from the larger food service industry, particularly from fast food chains and less service-oriented retail food locations that have the ability to cut costs and reduce prices more quickly. There is also a consumer trend toward healthier lifestyle choices, meaning restaurants with menus that are perceived to be healthier have a competitive edge.

The domestic market is somewhat saturated; therefore, many companies are expanding into emerging and high growth countries. Some potential success factors for restaurant chains are the ability to franchise operations, make fast adjustments to changing regulations, control stock on hand, maintain proximity to key markets, quickly adopt new technology, and have access to multi-skilled and flexible workforce. Marketing and technology are becoming increasingly important for restaurant chains, particularly among younger markets.

## Products and Services

Texas Roadhouse focuses on consistency, quality, freshness, and speed of preparation across all restaurants with its menu. Management inspects every entrée to confirm that it meets guests' orders and standards of quality, appearance, presentation, and uniformity. All food is tested for compliance with FDA and USDA guidelines. Texas Roadhouse offers a focused range of 60 entrees and 90 total menu items. Each time a new menu item is introduced, an old one is cut out. The restaurant is adapting to the health-conscious public by offering gluten-free choices, vegetarian choices, and detailing nutritional information on the menu. The menu is also family friendly, as it offers a kids menu that features smaller portions and lower prices. The menu offers a wide variety, serving ribs, fish, chicken, pork, vegetable plates, hamburgers, salad, and over ten steak options. All meals are customizable and begin with a bucket of peanuts and buttered rolls. Most restaurants also offer a full bar featuring regional and local beer brands, wine, and margaritas. Alcohol comprised 11% of total sales in 2014.

To ensure excellent service, Texas Roadhouse conducts regular customer surveys and employs third party individuals who are part of the “secret shopper program” to randomly visit and review restaurants. The Company is making a continuous effort to reduce customer wait time. Texas Roadhouse strives for a casual atmosphere that appeals to broad range of the population. Juke boxes featuring country music, buckets of peanuts, and various décor all contribute to the southern comfort atmosphere.

Average price per guest check at Texas Roadhouse was $16.02 in 2014, which is less than key competitors such as Olive Garden, Buffalo Wild Wings, and Longhorn Steakhouse. Texas Roadhouse prices are heavily dependent on supply, particularly beef, so large changes in cost of food sold could impact the Company’s profits and pricing strategy. To help reduce the impact of changing supply costs, Texas Roadhouse tries to qualify more than one supplier for all key food items. Major menu items are all available at short notice from different suppliers. The Company has annual contracts for beef with 4 suppliers, but could face supply shortages and higher costs to secure adequate supplies if one of these parties failed to properly fulfill the contract. Food supplied is shipped directly to individual restaurants, as there is no central warehouse for food.

## Location and Ownership

Texas Roadhouse owns 372 domestic restaurants and franchises 70 domestic restaurants, totaling to 442 domestic locations. The restaurants are in 49 of the 50 states: 51 in Texas, 25 in Ohio, 20 in Pennsylvania, 17 in North Carolina, and 16 in Florida. The fact that 17% of domestic restaurants are located in Texas exposes the Company to some regional risk. Texas Roadhouse owns no foreign restaurants, but has franchises in 9 locations abroad in UAE, Saudi Arabia, Kuwait and Taiwan. The Company is planning to expand internationally with franchised restaurants. This past year, 26 new restaurants were added, bringing the current total restaurants to 451. Locations are distributed largely by population and income per capita. Chain restaurants are heavily centered in Southeast, West and Mid-Atlantic regions due to population distribution and size.

Domestic franchises pay a $40,000 initial franchise fee plus a renewal fee specified in each individual contract. About 4% of gross sales from franchise restaurants is paid to Texas Roadhouse (the exact portion is defined in the franchise agreement). International franchises have very different terms, but the fact that the only international locations are franchises reduces currency exposure as well as invested capital. Revenue from franchises accounts for only 0.9% of total revenue.

## Marketing

Texas Roadhouses utilizes an efficient and strategic marketing plan that focuses on creating a unified brand through local and in-restaurant marketing. The marketing strategy is to be a neighborhood destination that encourages frequent visits from repeat customers and exposes new customers to the brand. Texas Roadhouse does not run any national advertisements, which reduces selling and administrative costs and makes advertisements more focused. The Company does community-based marketing to generate specific awareness based on local atmosphere. This includes employing local marketing representatives to create local campaigns and community events, and weighing the costs and benefits of each effort. Additionally, social media is utilized to promote events and awareness about the restaurant. The use of popular country music artists in a monthly campaign has also proven to be a successful technique to increase restaurant traffic.

Within the restaurant, Texas Roadhouse communicates with customers via a permission-based loyalty program and the use of special offers and holiday offers. The Company's eight week holiday gift card campaign has led to a large increase in profits and could continue to drive growth in the future through the attraction of new customers. Furthermore, the realization of unspent gift card credit works to increase margins.

## Financials

Texas Roadhouse has maintained consistent growth over the past four years, each year a mirror image of the year before. Revenue growth has hovered between 10% and 13% year over year, reflecting the fact that Texas Roadhouse consistently opens just under 30 stores each year and is focused on driving growth through frequent customer visits. Restaurant cost of food for 2014 was roughly 35%, just over the 28-32% industry average. This is due to the fact that each Texas Roadhouse buys from local suppliers. However, the Company's cost of labor sits at 29% of sales, below industry average. Labor expenses increased from 2013 and are projected to increase in 2015 as a result of the Affordable Care Act, which will place a new population of employees under the Company's healthcare plan. General and administrative costs decreased from 2013 to 2014 and are held relatively low as the Company does not have any national marketing campaigns. The Company's profit margin for 2014 was 5.4%, above industry averages for casual dining with average check per customer between $15 and $25. In addition, the Company has maintained consistent cash levels at around $86 million since 2010 and currently has $50 million in debt. Its debt-to-equity ratio is only 0.08, demonstrating its excellent capital position.

Notable in the DCF, the Company has negative working capital for multiple years. This is a result of deferred gift card revenue and high inventory turnover.

Average unit volume, or the average sales per restaurant, in 2014 was $4.4 million, up from $4.0 million in 2012. Comparable sales grew at 4.7% in 2014, up from 3.4% the year before. The average cost to open a new store was $5.1 million for 2014, up from $4.1 million in 2013. This is the result of land purchases made in expensive locations such as Alaska and NYC. Therefore, management expects 2015 averages to be $4.7 million. In addition, the Company has already purchased or entered into contract for all properties necessary for the restaurants to be opened in 2015. Five of these new restaurants will be Bubba’s 33, a new chain the Company has added to its portfolio. In 2014, $124 million was spent on capital expenditures, up by about $10 million from the previous year due to refurbishments. This expenditure was a strategic decision made by management to expand restaurants that are close to meeting maximum capacity. Net cash increased in lockstep, more than covering expenses; it rose to $192 million in 2014 from $174 million in 2013. It is expected that capital expenditures will increase again in 2015 to $135-$145 million for additional openings of 25-30 stores, and net cash from operating activities will exceed this. The Company will therefore continue to pay a dividend, which was recently raised to $0.17.

## Management

The CEO and founder of Texas Roadhouse, W. Kent Taylor, is a dedicated executive with over 25 years of experience in the restaurant industry and a 94% approval rating on Glassdoor. He receives an annual salary of $525,000 plus an incentive-based bonus. A Compensation Committee on the Board of Directors oversees his compensation. Taylor also has a minority interest in over 10% of franchised restaurants. We believe this is indicative of his dedication to the brand and the company; he is invested in maintaining a high quality brand and reputation through excellent food and service.

All management positions of individual restaurants are compensated with a salary and a performance based bonus. The bonus is a percent of restaurant profits before tax. This encourages management of each individual restaurant to be focused on bottom-line results, incentivizing them to grow the business and to keep an eye on margins. In addition, management is trained in every position in the restaurant, which allows each restaurant to maintain a high level of efficiency, especially during busy times.

## Risks

1. The current consumer trend could switch to faster, convenient locations versus full-service restaurants.
2. Same store sales could stop increasing at such a high rate because restaurant capacity could be reached.
3. A higher cost of labor can negatively impact bottom lines.
4. Supply costs, particularly beef, could increase, resulting in tighter margins.

5. There is the possibility that the CEO and founder would step down after working with the company since 1993.

## Valuation

*($ in thousands, fiscal year end Dec. 31)*

| | |
|---|---|
| **Cost of Equity (CAPM)** | **7.64%** |
| Risk Free Rate (10 yr Treasury Rate) | 2.14% |
| Market Return Rate | 10.0% |
| Beta | 0.70 |
| | |
| **Cost of Debt** | **7.22%** |
| | |
| **WACC** | **7.59%** |
| Current Shares Outstanding* | 69.84 |
| Current Price | 36.02 |
| Total Debt* | 50.8 |
| Market Value of Equity* | 2,515.6 |
| Tax Rate | 32.0% |
| *in millions | |

| | | |
|---|---|---|
| **Terminal Value** | | **2,648** |
| Last year projected FCF | | 118 |
| LT CF Growth Rate | | 3.0% |
| WACC Discount Rate | | 7.59% |
| | | |
| **Gordon Growth Method** | | |
| WACC | | 7.59% |
| SUM FCF | | 340 |
| Terminal Value | | 2,648 |
| Enterprise Value | | 2,988 |
| Net Debt | | -35 |
| Equity Value | | 3,023 |
| Shares Outstanding | | 70 |
| **Value/Share** | **$** | **43.28** |
| ***Upside*** | | ***20.2%*** |

($ in thousands, fiscal year end Dec. 31)

## Discounted Cash Flow Analysis

*Texas Roadhouse (TXRH)* *Consumer Discretionary* *Casual Dining Restaurants*

| | Historical Period | | | | | | | Projection Period | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Averages | 2015 | 2016 | 2017 | 2018 | 2019 |
| Sales | 934,100 | 995,988 | 1,099,475 | 1,252,358 | 1,410,118 | 1,568,556 | | **1,766,194** | **1,978,137** | **2,225,405** | **2,492,453** | **2,791,547** |
| *Total Change (YOY)* | | 6.63% | 10.39% | 13.91% | 12.60% | 11.24% | *10.95%* | *13%* | *12%* | *13%* | *12%* | *12%* |
| Cost of sales | 312,800 | 324,267 | 367,385 | 423,615 | 492,306 | 553,144 | | 600,506 | 672,567 | 756,638 | 847,434 | 949,126 |
| **Gross Profit** | **621,300** | **671,721** | **732,090** | **828,743** | **917,812** | **1,015,412** | | **1,165,688** | **1,305,571** | **1,468,767** | **1,645,019** | **1,842,421** |
| *Gross Margin* | 66.5% | 67.4% | 66.6% | 66.2% | 65.1% | 64.7% | *66.36%* | 66% | 66% | 66% | 66% | 66% |
| *SG&A* | 47,430 | 52,494 | 57,702 | 70,640 | 77,258 | 81,656 | | 0 | 0 | 0 | 0 | 0 |
| *Labor* | 276,626 | 293,022 | 326,233 | 367,763 | 411,394 | 459,119 | | | | | | |
| *Rent* | 20,018 | 21,361 | 23,150 | 25,797 | 28,978 | 33,174 | | | | | | |
| *Other operating costs* | 158,961 | 172,893 | 184,073 | 204,318 | 224,882 | 246,339 | | | | | | |
| *Pre-opening costs* | 5,813 | 7,051 | 11,534 | 12,399 | 17,891 | 18,452 | | | | | | |
| *Depreciation & Amortization* | 41,822 | 41,283 | 42,709 | 46,717 | 51,562 | 59,179 | | | | | | |
| **OpExp** | **550,670** | **588,104** | **645,401** | **727,634** | **811,965** | **897,919** | | *1,006,731* | *1,127,538* | *1,268,481* | *1,420,698* | *1,591,182* |
| **OpExp/Sales** | **59.0%** | **59.0%** | **58.7%** | **58.1%** | **57.6%** | **57.2%** | *58.14%* | **57%** | **57%** | **57%** | **57%** | **57%** |
| **EBIT** | **70,630** | **83,617** | **86,689** | **101,109** | **105,847** | **117,493** | | **158,957** | **178,032** | **200,286** | **224,321** | **251,239** |
| **EBIT Margin** | *7.56%* | *8.40%* | *7.88%* | *8.07%* | *7.51%* | *7.49%* | *7.80%* | *9.00%* | *9.00%* | *9.00%* | *9.00%* | *9.00%* |
| *Depreciation & Amortization* | 41,822 | 41,283 | 42,709 | 46,717 | 51,562 | 59,179 | | *53,215* | *54,279* | *55,364* | *56,472* | *57,601* |
| **EBITDA** | **112,452** | **124,900** | **129,398** | **147,826** | **157,409** | **176,672** | | **212,172** | **232,311** | **255,651** | **280,792** | **308,840** |
| **EBITDA Margin** | **12.04%** | **12.54%** | **11.77%** | **11.80%** | **11.16%** | **11.26%** | *11.71%* | **12.01%** | **11.74%** | **11.49%** | **11.27%** | **11.06%** |
| Taxes | 23,491 | 27,683 | 26,765 | 34,738 | 34,140 | 38,990 | | 50,866 | 56,970 | 64,092 | 71,783 | 80,397 |
| PP&E (gross) | 619,270 | 657,034 | 729,977 | 800,706 | 890,728 | | | 908,543 | 926,713 | 945,248 | 964,153 | 983,436 |
| PP&E (net) | 456,281 | 458,983 | 497,217 | 531,654 | 586,192 | 649,637 | *2.0%* | 597,916 | 609,874 | 622,072 | 634,513 | 647,203 |
| CapEx | 45,516 | 45,051 | 81,758 | 84,879 | 111,478 | 125,445 | | 107,625 | 109,777 | 111,973 | 114,212 | 116,497 |
| *Capital Expenditures (% PP&E net)* | *9.98%* | *9.82%* | *16.44%* | *15.97%* | *19.02%* | *19.31%* | | *18.0%* | *18.0%* | *18.0%* | *18.0%* | *18.0%* |
| *Depreciation & Amortization (% PP&E n* | 9.17% | 8.99% | 8.59% | 8.79% | 8.80% | 9.11% | | *8.9%* | *8.9%* | *8.9%* | *8.9%* | *8.9%* |
| Working Capital | -33,887 | 1,864 | -24,398 | -36,190 | -29,437 | -68,245 | | -35,324 | -39,563 | -44,508 | -49,849 | -55,831 |
| *Working Capial (% revenue)* | -3.63% | 0.19% | -2.22% | -2.89% | -2.09% | -4.35% | | *-2.0%* | *-2.0%* | *-2.0%* | *-2.0%* | *-2.0%* |
| Change in Working Capital | | 35,751 | -26,262 | -11,792 | 6,753 | -38,808 | | -5,887 | -4,239 | -4,945 | -5,341 | -5,982 |
| Unlevered Free Cash Flow | | 16,415 | 47,137 | 40,001 | 5,038 | 51,045 | | 59,568 | 69,802 | 84,532 | 100,138 | 117,929 |
| **Discounted Unlevered FCF** | | | | | | | | **55,366** | **60,303** | **67,876** | **74,736** | **81,806** |
| *Model Assumptions* | *WACC* | *7.59%* | | | | | | | | | | |
| Sales *(% YoY growth)* | | *6.6%* | *10.4%* | *13.9%* | *12.6%* | *11.2%* | *11.0%* | *12.6%* | *12.0%* | *12.5%* | *12.0%* | *12.0%* |
| COGS *(% revenue)* | *33.5%* | *32.6%* | *33.4%* | *33.8%* | *34.9%* | *35.3%* | *34.0%* | *34.0%* | *34.0%* | *34.0%* | *34.0%* | *34.0%* |
| OpExp *(% revenue)* | *59.0%* | *59.0%* | *58.7%* | *58.1%* | *57.6%* | *57.2%* | *58.1%* | *57.0%* | *57.0%* | *57.0%* | *57.0%* | *57.0%* |
| Depreciation & Amortization *(% PP&E r* | *9.2%* | *9.0%* | *8.6%* | *8.8%* | *8.8%* | *9.1%* | *8.9%* | *8.9%* | *8.9%* | *8.9%* | *8.9%* | *8.9%* |
| Capital Expenditures *(% PP&E net)* | *10.0%* | *9.8%* | *16.4%* | *16.0%* | *19.0%* | *19.3%* | *16.1%* | *18.0%* | *18.0%* | *18.0%* | *18.0%* | *18.0%* |
| Working Capial *(% revenue) (take from Bl* | *-3.6%* | *0.2%* | *-2.2%* | *-2.9%* | *-2.1%* | *-4.4%* | *-2.3%* | *-2.0%* | *-2.0%* | *-2.0%* | *-2.0%* | *-2.0%* |
| Tax Rate *(% EBIT)* | *33.3%* | *33.1%* | *30.9%* | *34.4%* | *32.3%* | *33.2%* | *32.8%* | *32.0%* | *32.0%* | *32.0%* | *32.0%* | *32.0%* |