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DANGER ZONE 8/16/21

After 2Q21 Earnings, This Food Concept Stock Remains Overvalued by 70%+

We're reiterating a Danger Zone pick that recently reported calendar 2Q21 earnings. Despite beating top line estimates, this business lacks differentiation and looks increasingly unlikely to achieve the profits implied by its stock price. Shake Shack (SHAK: $90/share) is in the Danger Zone.

Learn more about the best fundamental research

We leverage more reliable fundamental data, proven in The Journal of Financial Economics[1], with qualitative research to highlight these firms whose stocks present poor risk/reward.

Shake Shack Has 70%+ Downside

We put Shake Shack in the Danger Zone in June 2019. Since our original report, the stock has outperformed as a short vs. the S&P 500 by 18%. After strong revenue growth in 2Q21, investors may think Shake Shack is a good investment. However, when we look below the surface, we find that Shake Shack continues to look overvalued.

What's Working for the Business: Given the unprecedented economic shutdown across the globe in 2Q20, it should be no surprise Shake Shack reported impressive YoY revenue growth in 2Q21. Revenue jumped 104% YoY and same-shack sales increased 53% YoY, which actually came in slightly below consensus estimates of 55%.

On a non-GAAP basis, Shake Shack's adjusted EBITDA improved from -$8.8 million in 2Q20 to $21 million in 2Q21, although investors should note Shake Shack's adjusted EBITDA removes real costs of doing business, such as stock-based compensation, and is a poor representation of the firm's true profits.

Going forward, Shake Shack expects sales growth to continue at a rapid pace, with the midpoint of 3Q21 guidance implying a 51% YoY revenue growth rate.

What's Not Working for the Business: Any bull case about Shake Shack's "growth story" ignores that consumers were spending less at locations even before the pandemic. Average weekly sales fell from $96,000 in 2016 to $79,000 in 2019, before plummeting to $58,000 in 2020. In 2Q21, Shake Shack reports rising weekly sales of $72,000, which fail to top 2019 weekly sales.

Furthermore, Shake Shack has a long history of driving same-shack sales through price increases, rather than an increase in consumer interest. While 2Q21 saw a 62% YoY increase in guest traffic, we don't have to look far to see that in 1Q21, guest traffic was down 12% YoY while price and sales mix was up 18% YoY. If Shake Shack cannot get customers to return well above pre-pandemic levels, we see no realistic way to justify the expectations baked into its stock price.

Beyond consumer interest, Shake Shack's focus on differentiation in a commoditized burger/fast casual industry remains costly, the firm has not achieved any economies of scale, and its profitability ranks nearly last amongst its many competitors, highlighted in Figure 1.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, proven by professors at Harvard Business School & MIT Sloan and featured in The Journal of Financial Economics.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Figure 1: Shake Shack's Competition is Formidable

Company	Ticker	NOPAT Margin	Invested Capital Turns	ROIC
Domino's Pizza	DPZ	15%	3.8	57%
Wingstop, Inc.	WING	18%	2.0	36%
YUM! Brands	YUM	28%	1.1	30%
Papa Johns International	PZZA	6%	3.2	20%
Starbucks Corporation	SBUX	14%	1.3	18%
McDonald's Corporation	MCD	36%	0.4	16%
Jack in the Box	JACK	22%	0.7	15%
Chipotle Mexican Grill	CMG	10%	1.4	13%
Texas Roadhouse	TXRH	8%	1.6	13%
Restaurant Brands International	QSR	29%	0.3	8%
Bloomin' Brands	BLMN	7%	1.0	7%
Darden Restaurants	DRI	10%	0.8	7%
El Pollo Loco Holdings	LOCO	9%	0.7	6%
The Wendy's Company	WEN	17%	0.3	6%
Del Taco Restaurants	TACO	7%	0.5	4%
Brinker International	EAT	3%	1.1	4%
Denny's Corporation	DENN	8%	0.4	3%
The Cheesecake Factory	CAKE	3%	1.0	2%
Shake Shack	**SHAK**	**0%**	**0.9**	**0%**
Cracker Barrel Old Country Store	CBRL	0%	1.2	0%
Red Robin Gourmet Burgers	RRGB	-5%	0.8	-4%

Sources: New Constructs, LLC and company filings.

Shake Shack's food and paper costs, labor and related expenses, other operating expenses, and occupancy and related expenses were 80% of revenue in the first half of 2021, which is up from 76% over the TTM and 69% in 2016.

Total expenses, which also include general & administrative, depreciation and amortization, pre-opening costs, and impairments and losses on disposal of assets are 102% of revenue in the first half of 2021, which is up from 90% of revenue in 2016. In other words, as Shake Shack expands, its business is more costly to run.

In some ways, the fast casual restaurant boom reminds us of early days in the craft beer industry. There are many different concepts fighting for a slice of the market. However, the big difference for the fast casual industry is that the large national/global firms would rather replicate your offerings than buy the firm. The larger firms have a long history of being able to quickly and easily introduce competing products. In other words, the acquisition premium, or hope for a white knight buyer, is low for Shake Shack.

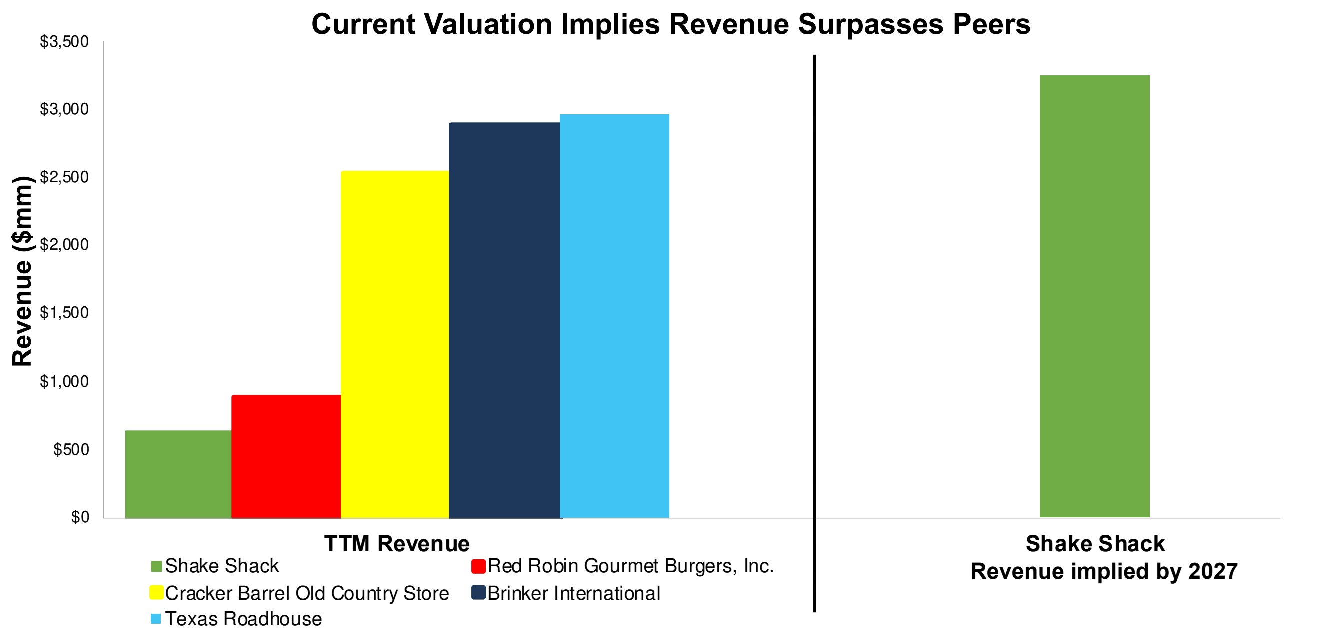
Shake Shack Priced to Surpass Bigger & More Profitable Industry Peers: To justify its current price of $90/share, Shake Shack must:

- improve its net operating profit after-tax (NOPAT) margin to 10% (equal to Chipotle's TTM margin and well above Shake Shack's 0.1% TTM margin or 6% 2019 margin), and
- grow revenue at a 30% CAGR through 2027 (nearly 3x projected industry growth through 2027).

In this scenario, Shake Shack would generate $3.9 billion in revenue in 2027, which is 5x its TTM revenue and 6x its pre-pandemic 2019 revenue. At $3.2 billion, Shake Shack's revenue would surpass industry peers such as Red Robin Gourmet Burgers (RRGB), Cracker Barrel Old Country Store (CBRL), Brinker International (EAT), and Texas Roadhouse (TXRH). See Figure 2 for comparison of Shake Shack's implied revenue in this scenario to its peers.

We think it's overly optimistic to assume Shake Shack will reverse years of margin deterioration (even before COVID-19, NOPAT margin fell YoY in 2017, 2018, and 2019) while also growing revenue three times as fast as the overall industry. In a more realistic scenario, detailed below, the stock has large downside risk.

Figure 2: Shake Shake's Implied Revenue vs. Its Peers



Sources: New Constructs, LLC and company filings

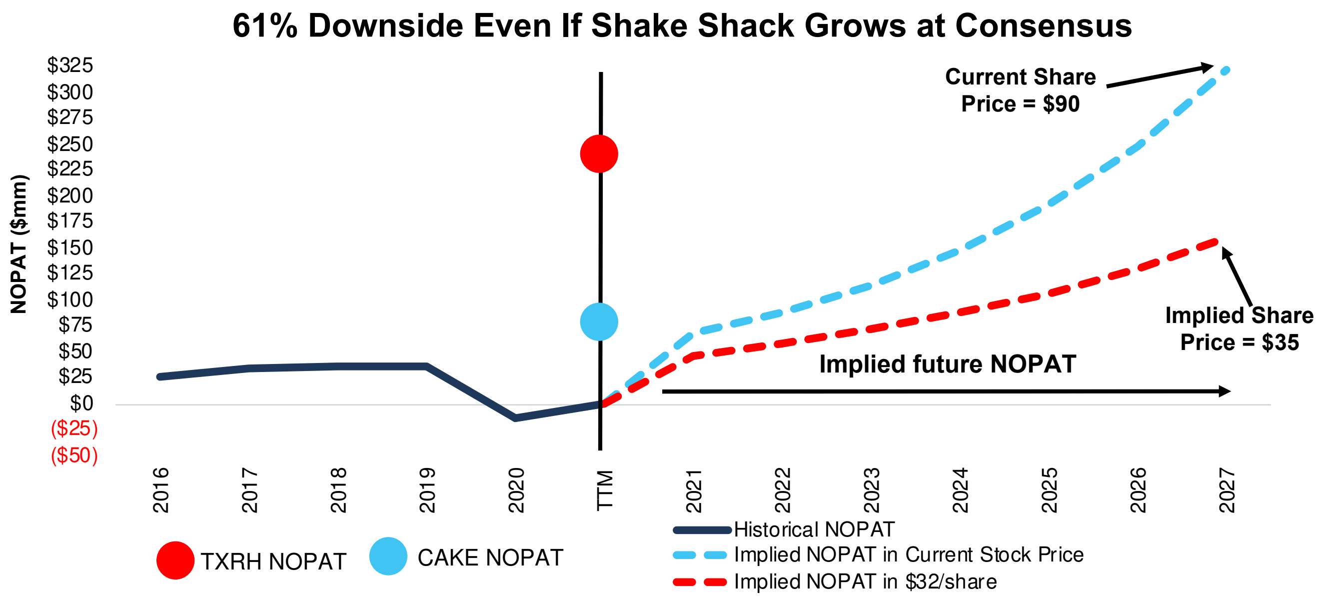
SHAK Has 61%+ Downside if Consensus is Right: if we assume Shake Shack's:

- NOPAT margin improves to 6% (equal to pre-pandemic 2019 level) and
- revenue grows at consensus rates in 2021, 2022, and 2023 and
- revenue grows 22% a year in 2024-2027 (continuation of 2023 consensus estimates), then

the stock is worth $35/share today – a 61% downside to the current price. This scenario still implies Shake Shack's NOPAT quadruples from 2019 levels (highest in company history). If Shake Shack fails to improve margins (likely given that labor costs are expected to weigh on profitability) or grow revenue at consensus rates, the downside risk in the stock is even higher.

Figure 3 compares the firm's historical NOPAT and implied NOPATs for the two scenarios we presented to illustrate just how high the expectations baked into Shake Shack's stock price remain. For reference, we include the TTM NOPAT of peers Texas Roadhouse and Cheesecake Factory (CAKE).

Figure 3: Shake Shack's Historical vs. Implied NOPAT



Sources: New Constructs, LLC and company filings.

There's 70%+ Downside If Revenue Growth Slows After 2024 If we instead assume revenue growth slows beyond 2023, Shake Shack's stock has even more downside. In this scenario, Shake Shack's:

- NOPAT margin improves to 6% (equal to pre-pandemic 2019 level) and
- revenue grows at consensus rates in 2021, 2022, and 2023 and
- revenue grows 22% in 2024 (continuation of 2023 consensus), 20% in 2025, and 15% in 2026 and 2027, then

the stock is worth $27/share today – a 70% downside to the current price.

Each of the above scenarios assumes Shake Shack's YoY change in invested capital is 9% of revenue in each year of our DCF model. For context, Shake Shack's invested capital averaged 19% of revenue from 2016-TTM and invested capital has grown 19% compounded annually since 2016.

Other Danger Zone Picks That Recently Reported Earnings

Figure 4 shows other Danger Zone picks that have recently reported their calendar 2Q21 earnings along with their relative performance.

Figure 4: More Danger Zone Picks That Recently Reported Earnings: Through 8/13/21

Company	Ticker	Earnings Date	Out (under)performance as Short vs. S&P 500
Zynga Inc.	ZNGA	8/5/21	11%
AMC Entertainment	AMC	8/9/21	45%**
Compass Inc.	COMP	8/9/21	31%*
Squarespace Inc.	SQSP	8/9/21	16%*
Coinbase Global	COIN	8/10/21	39%*
Bottomline Technologies	EPAY	8/10/21	39%
Airbnb	ABNB	8/12/21	42%
DoorDash Inc.	DASH	8/12/21	14%*

Sources: New Constructs, LLC
Performance measured from the date of publication of each respective report linked in the table. Performance represents price performance and is not adjusted for dividends.
*Measured from the opening price on the day of each firm's IPO.
** Focus List Stocks: Short performance

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

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Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, style, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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