Part 2: The effect of consumer behaviour on 'Quick Service Restaurants' with Rosie Malcolm, Head of Franchises

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Rosie Malcolm, Head of Franchises
Jennifer Herbert, Key Account Manager - Listed Funds

Jennifer Herbert:

Hello and welcome to our investment insights series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios.

My name is Jennifer Herbert, Key Account Manager at Magellan, and over the next 10 minutes, I'll be talking to Magellan's head of franchises, Rosie Malcolm, about our current views on the quick-service restaurants we hold in the portfolio. Thanks for joining us, Rosie.

Rosie Malcolm:

Thank you, Jen.

Jennifer Herbert:

Rosie, Magellan is an investor in the restaurant giants, including Starbucks, McDonald's, and Yum! Brands. How did Magellan think about its investment in these businesses as covid-19 started to spread?

Rosie Malcolm:

So, Jen, it's really interesting because these companies generally perform in a pretty defensive manner, particularly when we see these kinds of downturns. And we knew pretty early on that covid-19 was going to be different because in some way, shape or form, they were going to have to probably close some portion of their operations. And so that was quite different as we went into this.

But there are really kind of four big-picture questions that we thought through. Firstly, what were governments going to do to the restaurants? And by that, I mean, were they going to force them to close completely? Maybe it was just the drive-through, or could they keep the drive-through open? Could they do take-out? Would they have to close the dine-in? Could people operate with gloves? So it was, what were they actually going to do? And it was different for every country around the world.

The second point was what were the governments going to do for the restaurants? So in some cases in Europe, for instance, we saw governments prepared to pay the wages for workers at the restaurants. And that made a big difference to, say, a McDonald's franchisee, or a Yum! Brands franchisee in terms of their ability to keep going during this downturn.

The third thing, though, was after you consider that, what would customers be prepared to do? What would the clients be prepared to do? Let's say the drive-through was open; would people want McDonald's or someone else cooking their food for them in this environment?

And then lastly, the big question was how long was this going to go on for? And so there were a lot of permutations and combinations in terms of how this could play out. And so, what we really did is sat back and thought about did these companies have the operating flexibility, and the financial flexibility to sort of pivot, to move, to get around, and to be able to kind of work through this, what was going to be a very choppy training environment.

And, ultimately, it was difficult to see that exact path forward. But when we looked at all of these companies and the commonalities between them, and this is sort of in line with how Magellan thinks about its investments generally, but what we had were some very strong brands, no one was going to forget that you go to McDonald's and buy burgers just because they weren't dropping past the big Ms every day. It has a strong management team, a reputation for being focused on cleanliness and sanitisation. And that, obviously, in this environment was very important. And the other thing its' done was invest in technology. So, McDonald's had purchased Dynamic Yield, which helps in the drive-through in terms of making that move more quickly, and a range of other investments that these companies have made just around technology, which is important. So, these were the commonalities to help them move through this.

Then, the differences were there were circumstances for all the different companies. So, for instance, Yum! Brands and McDonald's in the US, about 95% of those stores are equipped with a drive-through, so that really matters. And, in fact, even before covid-19 about

70% of their sales came from that drive-through. And so, they had a way of getting that product to customers, even if the dine-in was actually closed, so that was important.

On the other side, Starbucks, only just over 50% of its stores were equipped with a drive-through. And so it's in a different position, but Starbucks actually did not have a lot of debt on its balance sheet relative to the others. And so it had a bit more financial flexibility so we felt okay about that.

Now, Yum! Brands had a lot more leverage but, at the same time, Yum! Brands has three brands to it, so it's Pizza Hut, KFC, and Taco Bell, so it had a bit of flexibility there. And it also didn't have a big breakfast business. And we found that the breakfast business because people are not going to work, they're not in that usual routine, that particular day part has suffered a bit more than others. Now, McDonald's – it didn't have quite as much leverage as Yum! Brands. It did have the breakfast, but it had the drive-through. And so, there was a whole range of different things to contend with as I looked at each individual name but, overall, that strong brand, the management teams, investments in technology, and some level of financial flexibility is what we thought meant that they would be able to work through this pretty difficult operating period.

Jennifer Herbert:

That's really interesting. So has everything panned out the way that you thought it would?

Rosie Malcolm:

Well, it's been really interesting because if you look at Starbucks, for instance, Starbucks said, "Well, let's try and keep that takeout option open, and have people come in the stores, and pick up their coffee, and leave again." And it found people were just crowding the stores. It was amazing. When they had the opportunity of maybe dying, or missing out on is Starbucks they're like, "Well, we're definitely going to dice with death because there's no way we're going to give up on our Starbucks," which we love – that kind of consumer commitment to the product over the long term. But in the short term, it did mean that Starbucks just felt that the only responsible thing to do was to actually close those stores to that take-out.

And so, it did have a few drive-throughs, as I mentioned earlier. And even though we saw queues for that drive-through, like a line of cars going around the block twice, in some instances, it still wasn't enough to offset the lost sales from just the take-out and that regular customer coming in each morning. And so, its sales dropped by about 60% to 70%.

Jennifer Herbert:

That is extraordinary, the extent that people will go to to get their coffee fix. I guess it's not a bad thing for Starbucks and the longer term.

Rosie Malcolm:

Agreed. And we've seen Starbucks reopening its stores in the US last week. And so we'll start to see, hopefully, some of that demand start coming back through as these outlets reopen. We're watching that pretty closely.

Yum! Brands and McDonald's didn't have that same drop in the sales, so it was around 25% just because they had that drive-through business. And it's interesting, actually, Yum! Brands with those three brands, when we look at some of the credit card data that we track, it actually looks like a lot of these sales have come back almost back to where they were pre-covid-19, at least the credit cards, which is a great outcome for the company.

I think we're not seeing quite the same rebound in McDonald's as yet. And that's partly because of that breakfast business, that is a big part of the McDonald's revenue stream. And so, as people start to come back to work, and we see the economies reopen we expect to see that come back up. But right now there's a bit of a differential between the two companies in terms of how they're performing.

And then, I think the other thing that I mentioned earlier in terms of what are the potential variabilities and outcomes was how long was this going to go on for? And that was a little bit of a surprise as well. We're closely tracking what's happening in China. Obviously, the country started with covid-19 earlier than other parts of the world. And, ultimately, China had about three weeks of hardcore lockdown and because Starbucks don't have the drive-through there was a lot more of a drop in sales across all of these companies. And then these outlets reopened three months on, and these companies had reported last week and talked about same-store sales being down between 10% and 35% or so still. So, we're about three months away from when the stores all started to reopen and they're certainly all reopened now, and we're still seeing that drop in same-store sales. So, I think it's going to take a little longer than maybe we originally anticipated to reopen those stores or to get those sales volumes back to where they were.

On the positive side, what we are seeing is that it's got nothing to do with Starbucks themselves or Yum! Brands themselves. So, when I talk about that 10% to 35% down there's a real range across different stores. If you're a store in the city where people are back to work the sales are doing fine. It's more that there're some areas like an airport or a transportation hub, which haven't seen as volumes come back yet. And so that means that this is more of a short-term issue. As those things start to reopen, and hopefully that process continues, then we expect to see those sales come back. This is not permanent damage to those brands where people decide they no longer want to go to Starbucks, or Yum! Brands or McDonald's, so that's important too.

Jennifer Herbert:

So, what does the future look like for these quick-service restaurants?

Rosie Malcolm:

So I think that's a really good question. As we look at a number of the trends they were already in trend, but I think what's happened is that covid-19 has accelerated those trends. And so, things like downloading an app to order online, a lot more people have done that now because we've kind of been forced to. Because we can't use cash in covid-19, you have to kind of do everything online. So, I think we'll see an elevated level of mobile order and pay going forward relative to where we were before covid-19. So I think that's important.

I think it's increasingly important for these brands to connect with customers directly, either through a loyalty program or an email list, or some way of reaching out to them saying, "Look, the stores are open. You can come to this store; this other store might be closed.". That direct customer connection; the importance of that has been reiterated during this process.

It'll also be interesting ... So, there's a company in the US, and a lot of companies are thinking about this differently but, for instance, Nationwide Insurance is ahead of the curve and decided that it's just going to close all of its offices. So, they've got about 4,000 staff and said, "You know what? We're going to move to telecommuting permanently." So, in that environment, if more companies do that, that third place, so if you're stuck at home and you're not really talking to people, the ability to go to a coffee shop and just sit down and maybe get some human interaction – that might become more important in the future. So that's another trend that we're watching closing.

But, ultimately, as I think about it, the strength of the brands, the strength of the management team, and those investments in technology – that's what's going to be important for all these companies.