



# Consumer Sector Spotlight: Restaurant Footprint Expansion Opportunities

Artisan Partners Growth Team

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Insights

For Institutional Investors Only—Not for Onward Distribution

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Understanding the health of the global consumer is essential to forecasting economic growth, considering that consumer spending contributes nearly 70% of US GDP. While we cannot precisely predict the onset of a recession, we are less interested in businesses dependent on economic growth as the primary driver of their fundamental improvement. Instead, we focus on identifying high-quality franchises exposed to secular trends and internal drivers resulting in multi-year profit cycles irrespective of fluctuations in the economic backdrop.

Within the domain of consumer spending, we look for businesses that possess a powerful combination of a compelling value proposition, significant potential for increased market penetration via new store expansion and superior store-level economics return profiles as the recipe for success to creating economic value.

## The Fast-Casual Restaurant Industry

Market penetration success stories are not uncommon within the consumer sector. In this context, we delve into the restaurant industry, which is inherently complex due to the nature of its offerings: perishable items consumed on demand necessitating precise inventory management, complex supply chains, and packaging solutions that preserve food quality for takeout and delivery. Therein lies the opportunity.

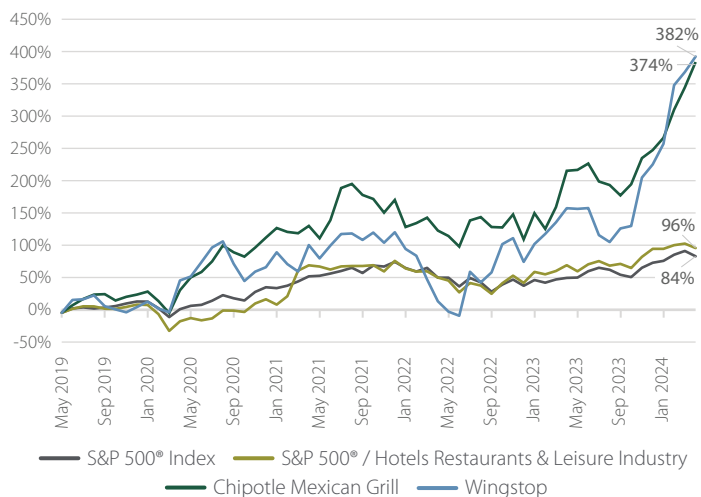
To be sure, there is no shortage of restaurants in the marketplace. The industry is intensely competitive. As analysts, our task is to scrutinize the unique value proposition of each company. What drives consumer preference? Is it solely the flavor, or does a narrative around quality ingredients appeal to health-conscious customers? Additionally, we must consider whether the pricing aligns with the consumer's perceived value. A company that offers a widely appealing product at an attractive price can achieve substantial growth, especially given the frequency of meal consumption - breakfast, lunch and dinner, seven days a week, all year round.

Despite an intensely competitive landscape, fast-casual restaurants can be highly profitable. These businesses are increasingly benefiting

from enhanced accessibility and convenience, a trend accelerated by the pandemic, with the advent of delivery services like DoorDash and Uber Eats.

In this analysis, we will focus on Chipotle and Wingstop. Each of these companies has cultivated a unique consumer value proposition and has significant runway remaining for high-return store expansion. However, each company utilizes a uniquely successful business model to create value.

Trailing 5-Year Total Returns (%)



Source: Artisan Partners/ S&P/FactSet, as of 30 Apr 2024. Past performance does not guarantee and is not a reliable indicator of future results.

## Store Economics

A strong consumer value proposition is vital for driving robust consumer demand. However, the key to generating economic value lies in two essential areas: (1) deploying an operational model that not only satisfies consumer demand but does so with enough efficiency to produce appealing profits at the individual store level, and (2) formulating a store expansion strategy that optimizes capital efficiency. This means the cost of constructing or opening a new store should be at a level where the

Company	Description	Value Proposition	Business Model
Chipotle	Restaurant chain that specializes in Mexican food, such as burritos, tacos, and bowls.	Chipotle offers a comparatively healthier option than other fast-food chains given it provides 53 fresh ingredients that can be used to customize customer orders prepared on site.	<b>Owner Operator:</b> Chipotle maintains complete ownership and control over in-store operations and the expansion of new stores. This hands-on approach, while demanding in terms of capital and management, positions the company to fully reap the benefits of high returns when executed successfully.
Wingstop	Restaurant chain specializing in fresh, cooked-to-order chicken products, including wings, sandwiches, and side orders.	Wingstop products offer a strong value for the money for consumers. Furthermore, the company's previous focus on chicken wings limited consumer frequency. However, it recently introduced the chicken sandwich, which we believe will increase consumer frequency, is benefitting from increased convenience (digital/delivery) and increasing scale is leading to higher advertising spend to drive consumer awareness.	<b>Franchise:</b> Wingstop controls brand development along with establishing a repeatable process for franchisees to build, open and operate Wingstop locations. The franchisor business model depends upon franchisees investing their own capital to open new stores. In exchange, Wingstop earns a percentage of the revenues from these franchises in addition to payments to support functions such as advertising. This business model is asset-light for the franchisor (Wingstop) with margin profiles that are typically superior to an owner-operator model.

profit generated by each store, when compared to the build cost, results in an attractive return on the capital invested in opening that store. Thus, reinvesting cash flow from ongoing operations into new store openings becomes the most judicious allocation of resources.

**Chipotle** spent an average of \$1.2M in development and construction costs per new restaurant in 2023 and expects these numbers to be consistent in 2024. Once a new store is fully operational, average unit revenues are expected to be ~\$3M and operational costs per store average 76% of revenues (meaning operating margins are 24%). This revenue and operating margin profile implies \$720K in expected annual operating income, a 60% cash-on-cash return and a payback period of ~20 months.

**Wingstop** targets an initial investment of \$480K. Once a new store is fully operational, average unit revenues are expected to be \$1.8M and the company targets a 70% cash-on-cash return and a payback period of less than 2 years, even after incorporating the 6% royalty fee and 5% advertising fee that franchisees pay.

	Chipotle	Wingstop
Up-Front Costs	\$1.2M	\$480K
Average Unit Revenues	\$3M	\$1.8M
Operating Margin	24%	Not disclosed
Operating Income (Revenue X Operating Margin)	\$720,000	Not disclosed
Cash-on-Cash Return (Operating Income / Up-Front Costs)	60%	70%
Franchise Fee + Advertising Fee	0	11%
Implied Payback Period	<2 Years	<2 Years

Source: Chipotle and Wingstop 2023 Annual Reports.

These less than 2-year payback periods highlight the attractive economics of these business models. Both companies have created operations that have generated high returns and, importantly, are easily replicated, allowing for high-return market penetration potential. These high returns can create a self-funding flywheel where the highest and best use of capital from existing operations is investing in new stores.

## Store Expansion Progress and Outlook

Given the demonstrated demand for each of these restaurant concepts and the attractive economics of launching new stores, we believe these companies will continue to march toward their market penetration aspirations. Using company reports, each is still relatively early in its expansion plan. Coincidentally, both companies are targeting a total addressable market size of 7,000 stores but are taking different paths to reach their targets. Taking a closer look at some of the details surrounding each company's plans:

**Chipotle** is currently at ~3,400 stores, with the vast majority within the United States, and is targeting an annual unit growth rate of 8-10%. Importantly, the company continues to innovate as it grows with the recently launched Chipotlane, an efficient, drive-through operating model that should drive even higher cash-on-cash returns. In 2023, 238 of the 271 new restaurants included a Chipotlane. The company is also focused on expanding its presence outside of the US and will focus on accelerating growth in Canada and expanding at a measured pace in Europe.

**Wingstop** is currently at ~2,200 stores, and management believes there is a significant opportunity to continue to expand both domestically and internationally. Within the United States, 56% of stores are located in Texas, California, Illinois, and Florida. The company will focus on growing within these high-brand-awareness markets while attempting to broaden out to new markets through investments in advertising and promotional activity. At the end of 2023, Wingstop had 288 international locations. The company believes that the restaurant operating model translates well internationally based on the small real estate footprint, simplicity of operations, the universal and broad appeal of chicken and the ability to customize its wide variety of flavors to local tastes.

While it is an important part of our thesis, these footprint expansion plans need to be incorporated alongside a broader mosaic of fundamental factors. For instance, what is each company doing to drive same-store sales growth? With Chipotle, we mentioned the Chipotlane earlier as one of the efforts management is taking to drive operational efficiencies during peak periods of demand. For context, the company is achieving low-20s transaction counts during peak 15-minute intervals, but management believes high-20s to low-30s is attainable. This would drive meaningful improvements in same-store sales.

Wingstop has been generating strong same-store sales momentum due to several factors, including menu innovation, national branding efforts, the integration of a second delivery provider (Uber Eats), and an ongoing value-based bundling strategy. Importantly, this same-store sales increase has been traffic-driven (rather than by rising prices), which stands in stark contrast to many of its competitors.

Holding	Global Opportunities Strategy	Global Discovery Strategy	U.S. Mid-Cap Growth Strategy	U.S. Small-Cap Growth Strategy
Chipotle	■		■	
Wingstop		■	■	■

Holdings information as of 31 Mar 2024.

## Artisan Partners Growth Team

The following team members contributed to this report



**Matt Kamm, CFA**  
Portfolio Manager



**Roderick Brower**  
Head of Sustainable Investing, Analyst

### Investment Process Highlights

We seek to invest in companies with franchise characteristics that are benefiting from an accelerating profit cycle and are trading at a discount to private market value.

#### Security Selection

We seek to identify companies with franchise characteristics that are selling at attractive valuations and are benefiting from an accelerating profit cycle. We look for companies that are well positioned for long-term growth, driven by demand for their products and services, at an early enough stage in their profit cycle to benefit from the increased cash flows produced by the emerging profit cycle.

#### Capital Allocation

Based on our fundamental analysis of a company's profit cycle, we divide the portfolio into three parts. Garden<sup>SM</sup> investments are small positions in the early part of their profit cycle that will warrant a more sizeable allocation once their profit cycle accelerates. Crop<sup>SM</sup> investments are positions that are being increased to a full weight because they are moving through the strongest part of their profit cycle. Harvest<sup>SM</sup> investments are positions that are being reduced as they near our estimate of full valuation or their profit cycle begins to decelerate. We believe that adhering to this process increases the likelihood of delivering upside participation with downside protection.

### Broad Knowledge

We overlay security selection and capital allocation with the capability to invest opportunistically across the entire global equity spectrum. It is our goal to have broad knowledge of the global economy to ensure that we are able to find growth wherever it occurs. This capability extends from the design of our team, which leverages the broad experience of the portfolio managers and the deep expertise of the analysts on the team.

### Team Overview

We believe deep industry expertise, broad investment knowledge, a highly collaborative decision-making process and individual accountability are a powerful combination. Since the inception of the team in 1997, we have been committed to building a team of growth investors that retains these attributes and is solely dedicated to our process and approach.

#### Artisan Strategies Managed

- Global Opportunities Strategy
- Global Discovery Strategy
- U.S. Mid-Cap Growth Strategy
- U.S. Small-Cap Growth Strategy



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This summary represents the views of the portfolio managers as of 31 Mar 2024. Those views may change and the Strategies disclaim any obligation to advise investors of such changes. For the purposes of determining the portfolios' holdings, exposures are delta-adjusted at the issuer level and may include multiple securities of the same issuer. The holdings mentioned above comprise the following percentages of a representative account within the Composites' total net assets as of 31 Mar 2024: Artisan Global Opportunities Strategy: Amazon.com Inc 2.4%, Shopify Inc 1.3%, Artisan U.S. Mid-Cap Growth Strategy: Shopify Inc 1.8%, Etsy Inc 0.8%, Artisan U.S. Small-Cap Growth Strategy: Etsy Inc 0.9%. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities. Securities named in the commentary but not listed here are not held in the portfolio as of the date of this report.

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Our capital allocation process is designed to build position size according to our conviction. Portfolio holdings develop through three stages: Garden<sup>SM</sup>, Crop<sup>SM</sup> and Harvest<sup>SM</sup>. Garden<sup>SM</sup> investments are situations where we believe we are right, but there is not clear evidence that the profit cycle has taken hold, so positions are small. Crop<sup>SM</sup> investments are holdings where we have gained conviction in the company's profit cycle, so positions are larger. Harvest<sup>SM</sup> investments are holdings that have exceeded our estimate of intrinsic value or holdings where there is a deceleration in the company's profit cycle. Harvest<sup>SM</sup> investments are generally being reduced or sold from the portfolios.

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