STOCKTRADES PREMIUM COMPANY SUMMARY

A&W ROYALTY INCOME FUND

AW.UN

UPDATED MAY 9, 2024

NOTE: DAN IS LONG AW.UN

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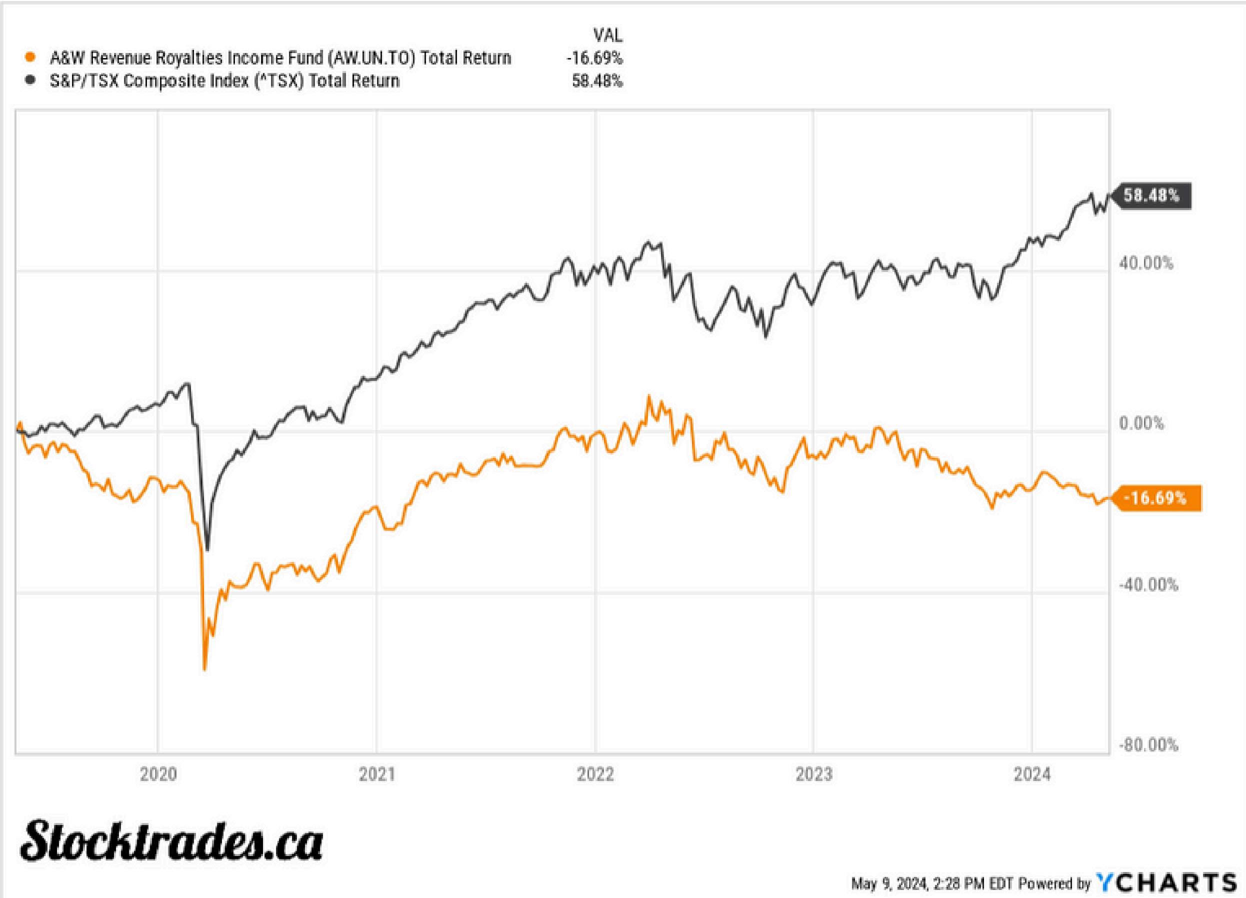

A&W Revenue Royalties Income Fund is a limited purpose trust established to invest in A&W Trade Marks Inc, which through its ownership interest in A&W Trade Marks Limited Partnership owns the A&W trade-marks used in the A&W quick service restaurant business in Canada. It has granted A&W Food Services of Canada Inc, a license to use the A&W trade-marks to market Root Beer in cans and bottles to the retail grocery trade as well as its acts as a franchisor of hamburger quick-service restaurants in Canada.

Of note, as a royalty company, our screeners are not accurate at predicting its dividend safety or its future growth. As such, both ratings are N/A.

OUR GROWTH SCORE: N/A

Sector: Consumer Cyclical

Industry: Restaurants

Current Price: $29.55

OUR DIVIDEND SAFETY SCORE: N/A

Stock Type: Income

Our Risk Rating*: Moderate

1 Year Price Target: $45

*Our Risk Rating: Our opinion of the overall risk an investment presents. Can be shown as Defensive (DEF), Moderate (MOD), or Aggressive (AGG). By no means is this an indication of future potential gains or lower volatility.

PROS

- Fund is not exposed to the expenses of running restaurants
- One of Canada's fastest growing restaurants
- Extremely loyal franchise base
- Has increased royalty sales in 21 of 22 years
- Exceptional marketing platform
- Has the strongest climate change and environmental impact plan of all quick service restaurants
- The company's business model actually stands to benefit from inflation

CONS

- The company is relatively unknown, covered by only one analyst
- The company, although for only a short period of time, did cut its distribution due to the pandemic
- The company's dividends are non-eligible, meaning it should be tax-sheltered
- The income strategy of the fund may put pressure on its price while fixed-income options remain attractive
- Same store sales growth is slowing due to a tighter consumer. A&W's food is not cheap

OVERALL THESIS

To understand A&W Royalty a little better, we must first know the structure of the company's business. The royalty is a "top line" company, meaning that it takes royalties off the sales of A&W restaurants before the restaurants themselves deduct any expenses and claim any earnings. A&W Royalty's structure is quite simple. It takes the gross sales of the restaurants in the royalty pool, and takes 3% of that. From there, it takes out the fund expenses and taxes, and the remaining capital left over is for distributions to shareholders.

The benefit of this type of royalty system is that A&W Royalty is not exposed to one-off expenses or significant capital events, besides slowing sales. If a restaurant or multiple restaurants have capital expenses or issues that result in a higher amount of expenses, A&W Royalty takes its share of sales before those expenses are factored in, impacting the profitability of the restaurants but not A&W Royalty. This makes the company an outstanding option in an inflationary environment, as although inflation deteriorates earnings, as long as it doesn't get to the point where it starts impacting sales, A&W would benefit from higher inflation as revenue increases.

However, the reason we like it doesn't end with the company being inflation-resistant. It's also posting outstanding growth, which is another reason we like AW.UN in this environment. We'll speak more about the fund's overall growth throughout this report.

The overall thesis for A&W Royalty is a strong blend of growth and income without exposure to the daily expenses or issues in the restaurant sector through a company like Restaurant Brands International, for example.

POTENTIAL RISKS

Although this is an inflation-resistant business, it is far from inflation-proof. A&W's products are far from cheap. If inflation were to continue to rise, we could see people opt-out of quick service restaurant dining. In this situation, we could see revenue dip and because AW.UN is a top-line royalty company, this would ultimately impact the distribution for current holders.

Inflation could also potentially hit the fund in another area, sales and administrative expenses. Although this is a small portion of the fund's overall expenses, higher wages, and higher administrative expenses due to rising costs would have an impact on the funds distributable cash

Beta	**1.07**
Alpha	**-1**
Our Risk Rating	**Mod***
Max Drawdown	**60.6%**

The fund also depends on the overall growth of the A&W brand. While it is one of the fastest growing quick service restaurants in the country today, if that growth slowed A&W Royalty would be impacted. Along with this, because of its resiliency and strong brand recognition, the company does trade at a premium valuation to other royalties. If growth were to slow, the fund may face a valuation reset by the market.

And finally, the company is looked at as a defensive income play. As such, when fixed income rates on things like GICs and bonds become more attractive, the risk of investing in equity over a bond or GIC may not be worth it to investors, which will put pressure on A&W's unit price.

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VALUATION

	TTM	5 Year Average	Industry Average
P/E	15.40	19.83	5.23
P/S	9.29	11.45	1.12
P/B	2.02	2.60	6.07
P/FCF	14.06	15.03	5.52
PEG Ratio (FWD)	N/A	N/A	N/A

It's important to note that the industry averages listed above are for the entire restaurant industry. So, this would include companies like Restaurant Brands International (TSE:QSR) which have much different business structures and thus different valuations.

At first, it would seem that a royalty company could be tricky to evaluate. However, considering A&W's net income is going to be the bulk of the cash flow it distributes to shareholders, the price-to-earnings ratio is a pretty accurate representation.

Right now, the fund is trading at only 15.40 times trailing earnings. As you can see from the chart above, this is a large discount to its typical valuation over the last 5 years. This is primarily due to the fact fixed income has now become more attractive. If an investor can get 5.5% through a GIC, they may feel the risk of owning a stock is not worth the additional yield A&W offers. However, as long-term investors, we aren't worried too much. For one, it is one of the fastest-growing royalty companies in the country and has become the 2nd largest burger restaurant and one of the largest franchises in Canada.

This is ahead of some notable names such as Dairy Queen, KFC, and Boston Pizza. Considering there are few analysts covering this company in terms of earnings or sales projections, along with the fact the fund doesn't provide hard dollar earnings or revenue outlooks themselves, the only thing we really have to go off of is trailing earnings against historical averages. And as we've mentioned, it's undervalued relative to its 5-year average which is to be expected in this type of environment.

Although same store sales growth is slowing due to a weaker consumer here in Canada, we feel the issues will be transitory and A&W should see some tailwinds in terms of increased spending in combination with lower policy rates making royalties more attractive.

COMPETITOR ANALYSIS

	AW.UN	PZA.TO	BPF.UN
P/E	**15.40**	**14.11**	**13.9**
P/S	**8.87**	**10.89**	**7.95**
P/B	**1.92**	**1.49**	**1.2**
P/FCF	**13.45**	**13.98**	**10.31**

We must look at the overall growth trajectory of these royalties to better assess the competition. And when we do, we can see that AW.UN is best in class by a wide margin. Pizza Pizza and Boston Pizza have struggled to keep up with A&W regarding distribution growth. This is primarily because the underlying businesses aren't really growing. Pizza Pizza is certainly turning it around as of late. Still, due to multiple years of mediocrity, we will need the royalty to string together some strong results on a consecutive basis before we give it the title of a full-blown turnaround. The best part is A&W Royalty is one of the cheapest royalty companies in the country today.

When we own a royalty company, we want to see same-store sales growth, along with more restaurants being added to the royalty pool. In the case of Pizza Pizza, its royalty sales have effectively flatlined for half a decade now, much like Boston Pizza. And before Pizza Pizza added a relatively small net restaurant growth in 2022 and 2023, it had undergone 3 straight years of declining restaurants in its royalty pool. Pizza Pizza grew its restaurants by 4.6% from 2010 to 2021. Over that same timeframe, A&W Royalty grew restaurants by 45%.

As mentioned, Pizza Pizza is amid a turnaround, and its operations are doing well. As a result, its valuation has gotten ahead of A&W Royalty. It's hard to deny the attractiveness of A&W Royalty at these levels, especially because outside of the COVID-19 pandemic, its operations have been unphased for decades.

DIVIDEND ANALYSIS

Annual Dividend	Payout Ratio (EPS)	5 Year Dividend Growth %	Dividend Growth Streak
$1.92	114%	2.78%	0

A&W Royalty hit a big milestone a year before the COVID-19 pandemic. That is, it became a Canadian Dividend Aristocrat. In 2019, it raised the distribution for the fifth straight year, the milestone needed to achieve Aristocrat status. Unfortunately, the COVID-19 pandemic squashed that achievement relatively quickly as the fund was forced to suspend its distribution amid significant uncertainty. With nearly 1/3 of its restaurants shut down during the height of the pandemic, A&W stopped distribution payments for 3 months. However, that distribution was quickly reinstated, and the fund made up for lost payments via a special dividend in late 2020. Fast forward to 2021, and the company made three increases to the distribution as same-store sales growth continued to grow at a double-digit pace. Before the COVID-19 pandemic, this was a royalty fund that had grown the annual distribution from $1.404 in 2015 to $1.881 in 2020. This is a 34% increase in 5 years, an outstanding pace from a royalty company and one of the best in the country.

The company currently pays out $1.92 per share, a high watermark. We had expected the company to come through with another distribution raise in Fiscal 2023, but it failed to do so. This might result from their yield already topping 6.0% as investors switch from high-yield stocks to guaranteed income. Either way, the distribution is well covered, and there is a path to growth if it continues to add restaurants to the pool and drive strong same-store sales growth. The company's payout is currently sitting at 114%. However, this is simply due to the timing of tax events for the company and we will see it normalize moving forward.

A note about the dividend from A&W. It is not an eligible dividend. As such, it should be tax-sheltered if possible. The dividends paid by A&W are not eligible for the dividend tax credit.

RECENT EARNINGS

You won't see our typical estimates chart in our reports here. This is because only one analyst covers A&W and has not made any future growth predictions. Also, A&W avoids making any hard dollar estimates themselves.

A&W looks like it is starting to see the impacts of a weaker Canadian consumer. It is important to keep in mind that this company is purely exposed to Canada, and the impacts of rising rates and less consumer spending are reflected in the company's same-store sales growth.

Same-store sales growth came in at 0.6%, relative to the 6.1% witnessed in the first quarter of 2023. The decline in quick-service restaurants is not unique to A&W. We're seeing Restaurant Brands International's Burger King segment slow materially as well, as the company is seeing low single-digit same-store sales growth and declining restaurant counts in the segment.

Because of this slowing growth, the company's royalty income increased by low single digits, and distributable cash fell by 1%~.

On the bright side, the company continues to open more restaurants, adding 10 more to the royalty pool, which now sits at 1,047. General and admin expenses also declined by 5% year over year, which helped alleviate some of the pressures from slowing growth.

There is little doubt that A&W needs interest rates to come down to garner more interest from investors as a royalty company. It also needs rates to decrease to encourage more consumer spending and a return to quick-service restaurant activity.

We believe that when interest rates decline, the company will have numerous tailwinds pushing higher results. At this point in time, one must simply be patient.

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