SIRE LINE CAPITAL MANAGEMENT
Investment Review
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Investment Review by
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YUM! BRANDS, INC.
A Growth & Cash Machine

When searching for suitable investments for our portfolios, Sire Line Capital looks for high-quality businesses that I.) are simple to understand, II.) have a consistent operating history and favorable long-term prospects, III.) are managed by honest and able managers whose interests are aligned with ours and IV.) can be purchased at a significant discount to intrinsic value. In other words, we want to pay a reasonable price for predictability and quality. We believe we have found that in YUM! Brands (YUM).

I. Simple to Understand

YUM is the world's largest restaurant company with over 37,000 stores in more than 110 countries operating under such brands as KFC, Pizza Hut and Taco Bell, as well as others. In October of 1997, PepsiCo spun-off its restaurant division under the name TRICON Global Restaurants. In 2002, the company changed its name to YUM! Brands.

The concept of a quick-serve restaurant business is relatively simple and straightforward. You build four walls and a roof, you attach a brand name to the outside and sell food and drinks to customers on the inside. The company generates revenue primarily from two sources: Company-operated stores and collections of franchise royalties and fees from franchisees. Of the company's 37,000 total units worldwide, 21% are operated by the company and 79% are operated by franchisees, unconsolidated affiliates and licensees.

II. Consistent Operating History and Favorable Long-term Prospects

YUM has consistently experienced above-average growth and profitability. Even during the recent economic weakness the company has been able to perform better than most. Over the last five years the company has generated average earnings growth of approximately 13% (Table #1):

Table #1

Financial Results	2004	2009	CAGR
Rev./share	$14.77	$22.43	**9%**
Op. Inc./share	$1.87	$3.44	**13%**
Net Income/share	$1.21	$2.22	**13%**

Source: Company reports, SLC analysis
Note: CAGR = compounded annual growth rate.

This above-average growth has not come at the expense of lower profitability. In fact, returns on invested capital have improved from 26% to 32% over this time (Table #2):

Table #2

Profitability	2004	2009
Return on Total Inv. Capital	26%	32%

Source: Company reports, SLC analysis

It is safe to say that these returns are well above the firm's cost of capital. These returns are among the highest in the industry—or any industry for that matter. Even after adjusting for operating leases, which can be quite substantial for restaurants, YUM is at the top of the list (Table #3):

Table #3

ROIC-Adjusted for Leases	2009
YUM	**23%**
McDonald's	19%
Chipotle	18%
Tim Horton's	18%
Starbucks	17%
Burger King	14%

Source: Company reports, JPMorgan

So how does YUM do it? When most Americans think of KFC, Pizza Hut, Long John Silver's and A&W, they think of old, worn-out, low-quality restaurant brands. While this is largely true in the U.S., it is not the case internationally. Outside of the U.S., KFC and Pizza Hut are both strong, high-quality competitors in most

markets. This is an important point as the non-U.S. business has increasingly become a larger part of the story for YUM. Just ten years ago, the non-U.S. part of the business accounted for approximately 22% of total operating income. Today it accounts for over 60%.

YUM's crown jewel, which has mostly been responsible for the rapid change in the company's profile, is its China Division. As you can see in Table #5, YUM's business in China has tripled over the last five years:

Table #5
($'s in millions)

YUM's China Segment:	2004	2009
Revenue	$ 1,120	$ 3,682
Operating profit	**$ 205**	**$ 602**
Restaurant margin	22.0%	21.0%
# of stores	1,431	3,400
# of cities	280	600

Source: Company reports, SLC analysis

This rapid growth in China, coupled with refranchising activities (selling company-operated stores) and slower growth experienced in YUM's more mature U.S. business, means that the company's China operations will soon pass its U.S. operations in terms of contribution to total income. Table #6 shows that YUM's China business accounted for only 16% of total operating income in 2004 vs. the U.S. at 59%. Today, just five years later, China accounts for over one-third of total income while the U.S. has dropped to 37%:

Table #6

% of Total Operating Profit	2004	2009
U.S.	59%	37%
Int'l	26%	28%
China	**16%**	**35%**

Source: Company reports, SLC analysis

And this trend can continue well into the future as YUM's opportunity for further expansion in China remains large. Here are some important observations:

- A total population of over 1.3 billion with a large and growing middle class of roughly 300 million people.
- Above-average GDP growth.
- A culture which has chicken as its primary protein source (read: KFC is more popular than McDonald's).
- YUM has built its own distribution system to supply its stores and to ensure that product quality remains high.
- YUM is already entrenched in China having launched operations there over twenty years ago.
- China is an underpenetrated market: YUM has 2.5 units per million people in China vs. 60 in the U.S.
- There are less than 6,000 western quick-serve restaurants in China vs. 165,000 in the U.S.
- Besides McDonald's, there are no other global competitors of any relevance in the market.
- YUM has a large and growing lead over McDonald's.

On this last point, KFC had a 600 restaurant advantage over McDonald's in Mainland China in 2004. Today, that lead has expanded to 1,550. It will be tough for anyone to catch YUM in China as they are opening nearly two new restaurants each day. I think General Nathan Bedford Forrest would be proud of the company's "Get There First with the Most" strategy.

Another very successful division for the company is the YUM Restaurants International (YRI) segment, which excludes the U.S. and China. This segment accounts for approximately 28% of total income for the company and is growing at an above-average rate. Per share operating earnings for the segment have grown at a 13% compounded annual growth rate over the last five years. The company uses mostly a franchise business model in this segment with roughly 85% of the stores being managed by a franchisee or licensee. The franchise business model results in high profit margins, low capital intensity and plenty of free cash generation.

The largest opportunity in the YRI segment, which has similar stats to that of the China segment, is India. With over one hundred restaurants today, the pattern of store growth resembles that of the YUM-China business on a 10-year lag. India and other attractive markets

should help drive above-average growth for this segment well into the future.

Back to the U.S. business. It would be wrong to say that this segment is all subpar. Taco Bell, with nearly 6,000 restaurants and accounting for over 60% of the U.S. segment, is a high-quality brand that generates attractive average unit volumes (sales per store) and profitability, with plenty of opportunities for further expansion.

To sum up, when you separate the good from the bad, you are left with only about 15% of total income coming from subpar brands (KFC-U.S., Pizza Hut-U.S., Long John Silver's/A&W-U.S.) and approximately 85% of total profits coming from YUM-China, YRI and Taco Bell-U.S. (and this is expected to increase to 90% by 2012). These are all very high-quality brands/segments that generate attractive returns on capital and have above-average growth opportunities.

III. Managed by Honest and Able Managers Whose Interests are Aligned with Ours

I have had the opportunity to visit with this management team on several occasions and something that I have heard them repeat over and over again about the U.S. business is that their stores have to "Earn the right to own." What they mean by that is if a company-operated restaurant is not achieving a certain target for return on invested capital, it should be sold to a franchisee so that the company's capital can be extracted and reallocated in a more efficient way. This is the kind of thing we want to hear from management. Now let's see if their actions are as good as their words.

Table #7 is a cumulative summary of the company's cash flow statement for the last five years. As you can see in the table, the company has generated $7.35 billion of cash flow from operations since 2005 (line 1). Of that, management reinvested approximately half ($3.7 billion) back into the business in the form of capital expenditures (line 2). This would be money spent on building new restaurants, buying equipment, etc. Management didn't go out and make any expensive acquisitions as they only spent $124 million in this area (line 4). The next two lines (5 & 6) show the cash that has been extracted by refranchising activities (stores that did not "earn the right to own") and closing unprofitable stores. These actions "freed up" over $1 billion of additional cash, resulting in a total of $4.7 billion available for either debt reduction, dividends or share repurchases (line 7). After issuing $1.2 billion of debt (line 8), management had almost $6 billion available to return to shareholders (line 9). All told, this management returned over $5.7 billion to shareholders over the last five years (line 12).

Table #7
(in millions)

	Cumulative Cash Flows: 2005-2009	Total	Line
	Cash flows from operations	$7,346	1
-	Capital expenditures	3,697	2
=	Free Cash Flow (FCF)	3,649	3
+	Acquisitions	(124)	4
+	Disposal of fixed assets	300	5
+	Refranchising activities and other	893	6
=	FCF before financing activities	4,718	7
+	Issuance of debt	1,238	8
=	FCF available for div. & repurchases	5,956	9
	Cash Dividends Paid	**1,224**	10
+	**Stock Repurchases**	**4,490**	11
	Total Returned to Shareholders	**5,714**	12

Source: Company, SLC analysis

In other words, for each share of stock that you would have purchased on January 1, 2005, you would have received almost half of your original investment in the form of dividends and repurchases within the first five years (Table #8):

Table #8	2005-2009	
Total returned to shareholders	$ 5,714	in millions
Total returned to shareholders	$ 10.70	per share
Stock price on 1/1/2005	$ 23.50	initial investment
$'s returned as a % of investment	**45%**	

Source: Company, SLC analysis

We know that they have been returning value to shareholders, but what about the earnings that are being retained in the business? If management is allocating capital efficiently, each dollar of retained earnings should translate into at least one dollar of equity market value over a long period of time. By looking at the statement of shareholders' equity in the company's annual report we can see that retained earnings have increased by approximately $2.7 billion over the last ten years (from a $1.7 billion deficit in 1999 to $1 billion surplus in 2009). Meanwhile, the

company's total equity market value increased roughly $10.7 billion over this time (from approximately $6.2 billion at the end of 1999 to $16.9 billion at the end of 2009). This means that for every $1 retained by management, they have produced roughly $4 in market value. Not many companies can claim this kind of performance over the last 10 years.

In addition, to help better align management's interests with those of its outside shareholders, YUM has established stock ownership guidelines that require the top 600 employees to own shares in the company worth a multiple of their base salary (based on position). YUM executives own over 3% of the total shares outstanding.

This is clearly a management team that 1) has been returning substantial value to shareholders through dividends and share repurchases, 2) has been allocating capital efficiently through reinvestment and 3) thinks and acts like a shareholder.

IV. Can it be Purchased at a Significant Discount to Intrinsic Value?

A the beginning of 2010, YUM had an equity market value of $16.9 billion (483 million shares x $35 per share). Normalized free cash flow to equity shareholders was approximately $850 million, which resulted in a free cash yield of 5% ($850/$16,900 = 5%). This compared favorably to the risk-free rate of return for the 10-year Treasury bond of 3.85%. However, given the company's potential for continued above-average growth, an investor in YUM is likely to experience a return well above 5%. After factoring in volume growth of 4%-6% and inflation of 2%-3%, the total expected annual return for an investment in YUM could easily get into the double digits (5%+4%+2%=11%), assuming shares trade at a similar multiple of cash flow compared to January 1, 2010. This rate of return from such a strong consumer franchise business is extremely attractive to us in such an environment.

The calculation of intrinsic value is a little more difficult. We first focus on that data which is most reliable. At the end of 2009, the balance sheet showed the book value of equity to be just over $1 billion, or only $2 per share. This is far short of the current market value of $35 per share. For YUM, any valuation approach that focuses on the balance sheet (mostly tangible items), will be an extremely conservative estimate of intrinsic value because most of the value in a franchise business model comes in the form of intangible assets (brands, distribution systems, etc.), which are not found on the balance sheet. A better way to find the value of the intangible assets for a franchise business model is by looking at the earnings power of these intangible assets. In other words, we have to focus more on the income statement and the statement of cash flows.

Last year, YUM earned almost $1.3 billion in net operating profit after tax (NOPAT). To this, we add back depreciation of $600 million and subtract the change in working capital of approximately $50 million (YUM actually has negative working capital) and maintenance-related capital expenditures of roughly $300 million (roughly $40,000 per company-operated store). We don't subtract growth-related capital expenditures (money spent on new stores) yet because we first want to see what the company's existing assets (reliable data) are worth before we begin to factor in assumptions about future growth (less reliable data).

After making the adjustments to NOPAT, we are left with free-cash power of approximately $1.5 billion. In other words, YUM's tangible and intangible assets generated $1.5 billion of free cash flow in the most recent year. If YUM earned this same amount every year in the future, and if we assume the firm's cost of capital is 8%, the company would be worth approximately $19 billion:

$1.5 billion / (8% - 0%) = $18.8 billion

You can certainly debate the 8% cost of capital. However, I think it would be a mistake to say that YUM has a similar risk profile to that of an average company with little or no competitive advantages. That may be true for the 15% of YUM's business that is subpar. But it is certainly not true for the other 85% of the business that possesses an enduring consumer franchise and which is generating above-average returns and growth. This is the way I prefer to look at it: YUM-China today is the closest thing to a "McDonald's-U.S. in 1970" that I have ever found. In other words, if you could go back to 1970 and invest in McDonald's, would you? And how large would the risk premium need to be?

After subtracting net debt of $2.9 billion, we are left with an equity value of approximately $16 billion, or $33 per share (vs. a market value of $35 on January 1st).

This is not what we think the entire company is worth. Rather, this is a crude approximation of what we think the existing assets could be worth before factoring in heroic assumptions about future growth. As value investors, we are always trying to get something for free. In this case, we are trying to get the growth for free.

To make it a little more conservative we didn't adjust NOPAT for other growth-related expenses such as marketing, general and administrative expenses. For example, although the company has over 100 stores in India, they are still generating a loss in that market as they are spending ahead of the revenue that is to come with future expansion.

Finally, after incorporating a conservative amount of growth (mid-single digits) and including all growth-related expenses, Sire Line's estimate of total intrinsic value for YUM is somewhere in the range of $52-$58 per share—approximately 1.6-1.8x the value in a no-growth scenario. This "growth multiple" seems reasonable given the company's high returns and growth relative to its cost of capital. A value of $52-$58 per share implies an EV/EBITDA multiple of 12.5-14x, an EV/sales multiple of 2.5-3x and a forward P/E multiple of 21-25x. These values appear appropriate given recent private market transaction values for high-quality retail businesses.

How is it possible, you may ask, that there is such a wide margin between the company's market value and its intrinsic value? We believe YUM is the classic 80/20 case where most investors focus too much on the 20% of the business that is subpar rather than the 80% that consists of a valuable consumer franchise.

To conclude, YUM is very simple to understand, has generated consistent growth and profitability over time, owns a difficult-to-replicate consumer franchise in attractive markets around the world and is being managed by a capable team of executives whose interests are aligned with ours. Most importantly, the price is right!

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