Tortilla Mexican Grill

Elevator Pitch

The UK's largest fast-casual Mexican chain generating over 30% ROCE per location selling at just 7x five-year median CFFO.

Introduction

Tortilla Mexican Grill was founded by Brandon Stephens as a business school project in 2007. It is now the largest fast casual Mexican restaurant chain in the UK with over 82 locations across UK, Ireland, and the Middle East. Tortilla offers a subway-like customisable food option with healthy, fresh, convenient, and consistent food (having been prepared off-site) to the under-35's it so frequently serves having captured their minds with its 12m+ followers across its social media influencer base. This combination results in a customer experiencing the joy of Tortilla every 6 seconds.

Tortilla offers loyalty rewards, £3 burrito Fridays, free lunch for first customers when a store opens, 2-for-1 deals for a couple days post-opening and primarily seeks stores in high footfall areas. Nothing unusual for a company who competes for share-of-bellies, but Tortilla is amicably placed in universities, shopping centres, as well as the UK's busiest airports and railways. Tortilla's particular offering can be a quick lunch on the go for city workers or a sit-down dinner after a day of shopping. This decreases the probability of 'dead time' that: (a) restaurants may experience during the day; (b) grab-and-go lunch spots may experience after work; or (c) sit-down locations within transport hubs may experience given typical food preparation times.

Business

Tortilla is private-equity backed (Paul Campbell, 2009; Quilvest, 2011) and operates a capital-light model enabling them to scale to 4x the size of its next largest competitor, Barburrito and grow stores at almost twice their rate. Tortilla recently acquired Chilango for £2.75m thus fortifying its geographical strength. They are taking advantage of wobbly economics and a post-covid demise to increase dominance and strengthen their business whilst taking advantage of favourable rents with significant discounts. The covid-induced downturn significantly hindered Tortilla's competitors causing Barburrito, Chilango, El Mexicana, and Benito's Hat to either go into administration, enter a CVA, or close several locations.[1] Even Nando's, Pret A Manger, and Yo! Sushi closed 10%, 17% and 28% of their UK locations, respectively. Despite this, Tortilla increased their number of restaurants by 58% from 2019 to today.

In its quest for growth, Tortilla has identified several target locations in the UK[2] and a Europe-wide whitespace report identified the potential for over 300 units across 26 metropolitan areas and 9 different countries.[3] Tortilla has set out to amass just 45 of 121 potential sites in the next 5 years.[4] If they have an equivalent hit rate outside of the UK this would translate to over 100 stores (1/3 of the 320 potential sites) across 9 countries equating to 11 locations per country. Given that they currently have 28 in London alone this significantly underestimates Tortilla's potential. In addition, Tortilla has launched three pivotal partnerships with: (a) Merlin Entertainments – operator of top attractions and theme parks[5]; (b) Chartwells – university operator with plans to open 14 - 16 sites on a franchise basis within the next 5 years; and (c) SSP Group – contract foodservice company with 180 airports and 300 railway stations across 35 countries. Outside of the UK, Tortilla have planned expansion into Ireland and planning documents estimate approximately 250 guests per day on average. Assuming a £10 transaction per customer suggests ~£1m in sales per annum.

Tortilla's central hub enables them to lower food costs with fewer than 40 ingredients, improve consistency, and reduce staff required (both based on quantity and skill-level). This allows them to offer a premium healthy option at reduced costs with a focal point being under 35s (representing 75% of customer base) with ¾ of them being repeat customers. This has enabled them to grow at triple the rate of the market with 16% LFL revenue growth (CGA peach coffer index[6]: 5%) despite travel strikes around their primary hubs. Moreover, CACI highlighted that customers are moving to Tortilla from other brands largely driven by incentives e.g. no messing around with proportions / quality / pricing / or ingredients. This is driven entirely by the leadership of Tortilla who have continually shown time after time, year after year, that they will forego price action and growth for quality and consumer preservation.

Tortilla exited 2022 5% cheaper than Barburrito and 10% cheaper than Chipotle. Since then, the cost-of-living crisis, Ukraine, extreme hedging costs, abnormal running costs, a huge uptick in protein costs, staffing cost increases, and an array of other things have occurred. Despite this, Tortilla enters 2023 doubling their value relative to Barburrito (now 15% cheaper) and retaining their value to Chipotle. Tortilla have done this despite their burritos providing customers with 15% more calories in their regular-sized offerings. This shows that Tortilla is more resilient and more immune to the burden's others in the market face. They will also continue to build through continuous self-funded roll-out and are reluctant to raise debt given current debt capital markets. This management team is very prudent and are not in a rush; they have proven their cool-mindedness time and time again having previously decided to halt rollouts as rents became unfavourable and, more recently, not hedging energy as the costs outweighed the benefits.

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[1] Shortavocado - VIC, 2022

[2] London – 21; Suburbs – 10; Transport Hubs – 13; and outside of London – 23.

[3] AIM Admission Document

[4] Legal documentation stage: 7. 'Heads of Terms' stage: 8.

[5] Chessington, Thorpe Park, Alton Towers, Legoland, and Warwick Castle.

[6] "Coffer Peach Business Tracker" (benchmark for the UK hospitality sector growth)

In 2019, Tortilla partnered with SSP partnership which has enabled them to offer franchised locations at London Euston, Gatwick (2021) and Leeds Motorway (2021) with the possibility of a further 8 sites over the next 5 years. They launched a new franchise with Compass group and franchise income grew 112% in FY22. Over 2022, Tortilla opened 10 sites, 3 delivery kitchens, and 16 franchise stores with all new openings delivering 56% ROCE and already at 83% of investment case mature sales levels. Moreover, their store openings in Gatwick and Bristol airport outperformed all previous incumbents showing that this is not simply a game of 'location, location, location' but rather 'reputation, reputation, reputation'…

Tortilla aims to continue building a stronghold in the UK by exploring healthcare and motorway services and European markets as there is *"an exciting opportunity to capitalise on our position as the largest burrito business in Europe".* A sweetener if you like is Tortilla's cloud kitchens which require a sub £50k initial outlay and are generating a normalised return of £100k representing a 200% ROIC.

<u>Why does this opportunity exist?</u>

1) Tortilla is small. Ultimately, it is a ~£50m 'burrito joint' in the tiny island that is the United Kingdom competing with the global behemoth that is Chipotle.
2) Tortilla's revenues went from ~£35m pre-COVID to ~£50m post-COVID which many may attribute to COVID-induced sales. However, they were only available on Deliveroo whilst now being available on Just Eat and Uber Eats too and have continued their post-lockdown growth into 2022 and are on track to do so again in 2023.
    a. In 2022 revenues were up a further 20% since this last 'post-COVID checkpoint' – when will people realise the COVID tailwinds only last so long and this is simply good old-fashioned growth…
3) Macroeconomic climate: gas, electricity, fuel, and inflation are eating more of consumer's earnings and government stimulus adds fuel to the fire thus investors may seek companies with a longer history of slow and safe earnings.

<u>Valuation</u>[7]

Tortilla is currently trading at 6x TTM CFFO and 11x average pre-COVID FCF with gross margins consistently above 75% for the last 5 years. Tortilla have never closed a location, demand a minimum hurdle rate for new locations of 30% ROCE, and have enough cash to self-fund all future investment. Tortilla being priced below PP&E suggests not only a decline in the economy but a complete obliteration of human taste buds.

A simple comparable analysis of LEON's sale to the ISSA brothers for £100m with just 71 stores could, albeit imprudently, suggest a double in Tortilla's market cap. Another somewhat haphazard approach is the comparable analysis of Chipotle's ~3,000 stores trading at 4-5x revenues. Using Tortilla's pre-COVID revenues of ~£34m would suggest a market capitalisation 3x greater than current levels using a 4.5x PS ratio. Assuming Tortilla will never have the prowess to command a 4.5x PS ratio – rather just 2.25x – would result in a ~66% return on investment despite using a denominator far below current levels and excluding any future growth. Using current revenues would result in 5.5x and 3x return on investment as revenues are up 20% overall pre vs. post-covid (16% like-for-like).

Another approach is to explore Chipotle's trajectory. Chipotle grew from 16 locations in 1998 (when McDonalds invested) to over 3,000 today [CAGR: 24%] and boasts a market cap of ~$45bn. Tortilla hit 16 locations in 2013 thus 10 years down their 25-year 'Chipotle Cruise' has seen locations grow at 32% CAGR putting it on track to hit 3,000 stores in the next 15 years. More conservatively, assuming Tortilla's growth trajectory declines to 16% (taking its average to below Chipotle's 24%) it will have amassed a store count of ~500 by 2035 representing ~1/6th the opportunity size of Chipotle. This suggests that Tortilla would grow to: (a) the size of Nandos; (b) 1/3 the size of McDonalds, UK; and (c) 1/5 the number of UK-based Subways. Hardly an Icarus-like expectation. These 500 locations at the minimum return management expect from their latest Chilango stores (£1m across 8 stores .:. £125k per store) would equate to future free cash flow equal to Tortilla's current market capitalisation. Therefore, whichever multiple you wish to attach to this free cash flow approximates the return you ought to expect over the next 13 years. For clarity, at a 10x multiple of free cash flow, this would equate to an 18%+ compounded annual growth rate. At 15x, this would exceed 22%.

The conservatism of Tortilla's management is also represented in their admission document which estimates their sector at a couple hundred million whereas the US represents over $60bn. With 1/5th the population of the US, this would result in at minimum a multi-billion-dollar addressable market. Should Tortilla gain just 1% of this UK market (assuming 0% success in the EU) this would be a $122m opportunity. Normalising against GDP instead of population would result in an $80m market cap representing at minimum a 74% return on investment. Finally, Latin Limited Service is just 1% of the UK limited-service market whereas Mexican cuisine is ~10% of the US market therefore should the UK's total addressable market increase 10x over time and Tortilla's market share decrease to just 10%, Tortilla's share would increase four-fold.

<u>Catalysts</u>

- New store openings
    - Expected to open 10 sites and 3-5 delivery ghost kitchens (this year; fully self-funded)
    - All new openings delivered 56% ROCE and already @ 83% of investment case mature sales level

[7] Disclaimer: This analysis excludes any details on royalties from Tortilla franchises. Consider this a right-tail gift.

- Chilango store revenue recognition
    - Acquired 8 locations from Chilango for less than replacement cost [£2.75m] with the expectation of sales to be down 20% for a few years despite now being 15% higher than 2019; currently expected to generate £1m p.a.

- European Success
    - Francesca Tiritiello has been hired to drive European franchising
        - Francesca is the Managing Partner and Co-Founder of Kikkirossi which focuses on international brand and franchise development. She has experience in M&A and strategic planning and was the CFO of YUM! Restaurants covering 1,100 restaurants across 27 countries. Francesca's experience and connections across France, Germany, and the Netherlands, will help Tortilla infiltrate European areas with European whitespace already examined.

- Motorway expansion
    - Conversations with Welcome Break over Franchising on motorways
        - Welcome break have 44 motorway services and 31 hotels and over 85m customers each year[8]

- University Sites
    - Tortilla expects to have 14 university sites franchised in the next 5yrs. Its current university sites generate between £5k - £8k per week therefore these new sites alone will generate over £4m p.a. for Tortilla.

- Technological Advances
    - Andrew Brooks (formerly at Wholefoods) has been hired as Tortilla's head of IT to find ways of increasing speed during peak hours with the use of kiosks and delivery prep.

- Governance
    - Richard Morris, CEO, built Loch Fyne from 2 to 39 locations in just 10 years compounding revenues at 62% p.a. taking EBITDA from -£100,000 to +£3.7m

<u>Risks</u>

- Economic Downturn
    - Tortilla showed during COVID their flexibility reducing cost of sales almost 75% as revenue declined by 66%. Further, their lean structure whereby COGS only represents 25% of Sales enables them to be agile.
    - No dividend distribution or excess capacity given their centralised hub which can effectively manage declines in demand, and boast a low-cost workforce given the fact they do not need high-skilled labour to cook – at all.
    - Tortilla purposefully slowed its rollout in 2017 and 2018 as rents in the property market became overheated thus reduced their investments until it seemed more prudent; this is a smart management that are not in a rush and who will not pander to shareholders with short-term horizons.
    - They have already responded to strenuous market conditions by updating pricing, driving operational efficiencies, and partnering with Uber Eats and Just Eat (as well as their initial partnership with Deliveroo) to prevent alienating consumers who prefer individual platforms thus capturing a wider market.

- Weaker Consumer
    - Assuming an economic decline, will students stop attending higher education? No. Will they take on less debt to do so? No. Are they likely to become anti-social? No. As such, Tortilla's arrangement with Chartwells makes them amicably positioned to have at least 16 university-based locations with a robust consumer.
    - value concept with materially lower overhead and utility costs relative to the competition.

- Icarus
    - Tortilla received significant government assistance as well as significantly reduced rents, CapEx assistance, offers on buildings etc. that are soon to diminish and more likely, disappear.

- Insider Ownership
    - 75% of shares not publicly held thus offering relative stability, however, may also provide a swift change in the stock price should they depart.

- Valuation
    - The stores may not be worth what Tortilla paid given a significant recession/depression and decline in the property market; and/or
    - It may be true that the pessimists are correct in that Tortilla's cash flows have been boosted by what is a post-COVID, pre-recession, consumer glut.

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[8] Acquisition of a Majority Stake in Welcome Break (investis.com)