Yum! Growth with Global Flavor

By Marc Hogan

Nothing whets Wall Street's appetite like a positive earnings surprise. On Oct. 11, Yum! Brands (YUM) reported a 12% jump in third-quarter profit, beating analyst expectations. and raised its full-year earnings forecast. Shares of the Louisville (Ky.) fast-food chain operator climbed to a 52-week high a day later, before settling at $59.08, up 8.2%.

Some traders may have even stopped by a Yum location on their lunch break, since the company's restaurants are seemingly everywhere. Spun off from Pepsico (PEP) in 1997 and formerly known as Tricon Global, the company owns and operates more than 34,000 quick-service restaurants worldwide, including such chains as KFC, Pizza Hut, and Taco Bell. More than 11,000 of those stores are in its international division.

Yum's exposure to overseas markets should keep profits cooking despite a slowing U.S. economy, some analysts say. At the same time, lower gasoline prices and strong branding initiatives could help Yum's domestic stores withstand a tougher consumer outlook. Ongoing stock buybacks and dividends may also support the shares.

STRONG CASH FLOW. For the third quarter, Yum posted earnings of 83 cents per share, ahead of analyst estimates of 75 cents. The company also lifted its earnings guidance for 2006 to $2.89, for growth of 14%, from its prior forecast of at least $2.83. "The power of our global portfolio and international scale and growth makes us not your ordinary restaurant company," said David Novak, Yum's chairman and chief executive, in an Oct. 12 conference call.

Following the earnings announcement, Goldman Sachs (GS) raised its earnings estimate and price target for Yum stock. "We continue to believe companies that offer global diversification, strong free cash flow, and flexible capital structure remain the best investment opportunities in the restaurant industry," Goldman Sachs analyst Steven Kron, who has a buy rating on the stock, wrote in an Oct. 11 report. (Goldman has an investment banking relationship with Yum.)

International business has already given Yum's performance a boost. Third-quarter operating profits rose 26% in the company's expanding China division and 22% in other international areas, compared to 1% U.S. profit growth. The strong earnings report came the same day another fast-food giant, McDonald's (MCD), raised its third-quarter profit outlook due in part to rebounding sales abroad (see BusinessWeek.com, 10/12/06,"A Golden Month for the Golden Arches").

MAINLAND MOMENTUM. The nearly 1,700 KFC restaurants in mainland China represent a key growth opportunity for Yum, according to industry observers. “It’s a very large and increasingly affluent market,” says Malcolm Knapp, president of New York consultancy Malcolm M. Knapp and founder of the Knapp-Track casual-dining research service. “They really have their act together there, and that should just continue.”

Yum isn’t stopping there. In the conference call, Novak announced plans to open 14,000 Taco Bells in mainland China. Along with a proposed 2,000 Pizza Huts and various other locations, Novak projected a total of 20,000 Yum restaurants in mainland China, though he did not provide a schedule.

Yum’s shares are up 33.6% from their 52-week low, reached Aug. 1. The rebound comes as the large-cap Dow Jones industrial average hit new all-time highs. Yum’s stock price jumped 3% on Oct. 4, amid a restaurant-sector rally on strong September sales reports. Two weeks earlier, the company said it expected a 2% decline for the month in U.S. same-store sales, a key retail metric, but a 10% gain in its international division.

MORE SHARE BUYBACKS. In addition, Yum has taken steps aimed at increasing shareholder value. On Sept. 14, the company’s board approved an additional $500 million stock buyback, on top of another $500 billion authorized in March, and also approved a dividend of 15 cents a share. The share repurchases will reduce share count by 6% this year, following a 2% reduction last year, Novak said. Stock buybacks can boost per-share earnings by reducing shares outstanding (see BusinessWeek.com, 8/28/06, “Buyback Binge: Bane or Boon?”).

Merger-and-acquisition activity has also nudged Yum shares toward their current highs. On Sept. 12, Yum said it completed a buyout of the remaining 50% of its British Pizza Hut joint venture from partner Whitbread. The deal was valued at $184 million, plus $25 million of assumed debt.

While Yum has enjoyed growth internationally, trends have been softer for its U.S. restaurants. On Oct. 12, UBS (UBS) lowered its estimates for fourth-quarter earnings and for same-store sales (sales of units open at least a year), citing slower sales. Nevertheless, UBS analyst David Palmer has a buy rating on the stock. (UBS makes a market in Yum securities.)

Still, the company’s recent U.S. troubles shouldn’t offset its upbeat outlook over the long haul, some analysts say. “We are confident in the international business long term, and we believe the problems faced by the U.S. business can be fixed through more aggressive promotional and brand management efforts," says JP Morgan (JPM)analyst John Ivankoe in an Oct. 11 note. Ivankoe has an overweight rating on the stock. (JP Morgan has an investment banking relationship with Yum and makes a market in its securities.)

However, some analysts express concerns about Yum's valuation. Indeed, the stock was fairly valued ahead of the latest gains, according to Cowen analyst Paul Westra, who has a neutral recommendation on the stock. (Cowen seeks to do business with companies covered in its reports.)

Yum still must solve the challenges facing its U.S. restaurants, and Novak's bold plans for China will certainly meet obstacles, as well. Still, the company's exposure to this growing market could be a good option for investors nervous about a slowing domestic economy.