Recommendation: Don’t Buy **Target Price until (12/27/2016): $95**

1. Reasons for the Recommendation

One of the most important reasons why we don’t want to buy Yum is the growth prospects of the company in the US, where YUM gets about 35 % revenues. The reasons why domestic growth prospects are not looking good are because the company has failed to adapt their menu to increasingly health conscious consumers. Although the company has added some new “healthier” dishes, the offers are not good enough to convince consumers. Even though consumer spending is expected to rise, YUM will not be able to take full advantage of it because more and more people want to spend their extra money on more premium to-go food.

Another negative in the US market for YUM is their decision to not grow their company in Texas, Super Chix. Super Chix is a restaurant that was going to compete against Chick Fill A. In our opinion this is not a strong move on YUM’s part. Although YUM has opened a second Super Chix location within Texas no decision has been rendered regarding expansion of this brand, and no information has been made public of the overall performance of each of the two Super Chix locations. Thus, as the Super Chix franchise can provide growth for YUM, it has not been clear if YUM is moving forward with this brand in the future. They needed a new trendy restaurant to interest the newer generation who likes to focus on good quality food and healthier menu options. A new approach would help the company to increase domestic sales again.

Another issue is the operating margin for both US and China operations. The operating margin from restaurants in China went from 20 % in 2010 to 14.5 % (2014). For worldwide operations it dropped from 16 % to 11 % in the last four years. YUM Brands operating margin is below all competitors within the industry, which had operating margins between 20 and 30 % in the last years. YUM had little but constant sales growth, but with a decreasing margin in all the years, analysts certainly have to question if the company will be able to regain profitability in the future again or if the tough competition will tighten the margin further.

The sales growth of the company mainly happened because of the opening of 1400 restaurants in China and India. However, same store sales declined since 2011 in all their divisions mostly due to the increased competition of restaurants, which provide healthier food options in the US, and local competition in Asia. Furthermore, the company had issues with suppliers in China for the last two years, which had a big impact on their sales growth. YUM now needs to rethink their supply chain in order to gain the trust of consumers in China gain. As this process can take some time, we expect YUM to grow their sales double digits in the next two years, but only because they plan to open lots of new stores in Asia where the market is not saturated yet. We also anticipate that the same store sales growth will get back to low single digit growth in Asia.

A good return will also depend on the management’s ability to learn from their mistakes. Wrong acquisitions and restaurants at the wrong locations led to big impairments in recent years. Also, despite being aware that premium food is getting increasingly popular, the management has not yet tried to introduce healthy products or maybe even new store concepts across the US. If the management is aware of their wrongdoing in recent years and tries to get ahead of competitors like McDonalds, YUM will have better growth than we now expect. However, management decisions are hard to forecast and history shows that it is difficult for the company to adapt to new trends and rely on old “traditions” too long.

2. Company Analysis

Company Description:

Yum Brands Inc. consists mostly of KFC, Taco Bell, and Pizza Hut. Yum is one of the largest restaurant chains with stores all over the globe. As of 2014 around 70% of their profits come from stores other than in the United States. When it comes to emerging markets yum brands is leading the competition. According to the company, Yum has twice as many restaurants (15,000) in emerging markets compared to there nearest competitor. The restaurants are operated by Yum or by independent franchising. Yum is currently housed in over 125 countries and has more than 41,000 restaurants throughout these countries.

Revenue Mix:

In 2014 Yum produced over $13bn in revenue. Yum gets its revenue primarily through there three restaurant chains, KFC, Taco Bell, and Pizza Hut. The franchising costs for these three companies supply capital for Yum Brands. As mention above Yum is a global company. Since Yum began in 1997 it has increased its foreign profits by 50%. Now in 2014 almost 70% of their profits come from foreign markets.

SWOT Analysis:

When it comes to Yum's strengths one of them is the three concept companies KFC, Taco Bell, and Pizza Hut. These are three very large and well-known restraint chains with a strong fallowing. Another strength they have is them being the number one leader in new and emerging markets (related to the number of restaurants and sales).

A weakness that Yum has is the market that they compete in is highly saturated and contains a lot of substitutes. There are a lot of fast food restaurants across the globe that offers the same types of food. There are also endless amounts of substitutes for any food industry.

Opportunity that Yum has is emerging markets, new food trends, and checkout or payment options. Yum can capitalize on new food trends that arise. The company has introduced new items on the menus of their franchises in the past and it has just started to test new healthy menu options in some Taco Bell and KFC restaurants. There are also new trends when it comes to payment options such as online and apple pay. People want to have more convenient ways to pay for food and with different payment systems the company could abolish lines in the restaurants. For example people could order and pay the meal on their mobile before entering the restaurant. This saves time and incentives customers to order additional items if promotions are added to payment systems.

There are many threats when it comes to Yum. One is raising food prices. If farmers raise their price this could affect the prices for Yum's fast food chains, which need to stay at competitive prices. Another threat is a trend in life style. A healthy life style trend can affect Yum in a big way being that majority of the food they provide is considered to be not a choice for a person trying to live a healthy life style.

3. Industry Analysis

Industry description:

Restaurants in the fast food industry rely on the convenience they bring to customers. The industry is known for quick service on site, via delivery or drive-thru. Companies in the industry operate either via a franchise system where the franchisee pays a royalty and a share of the revenue to the company or via company-owned stores. Yum operates most of their brands as franchised stores. Typical products the companies in the industry sell are burgers, sandwiches, pizza, pasta, fish as well as Mexican and Asian food. As consumers start to be increasingly health conscious, salads, smoothies and other healthy options are added to the menu of restaurants. Coffee and snack shops are not included in this industry.

The industry had revenues of 207.8 bn USD in 2014, where franchise fees are not included. The growth rate in the last five years was 1.2 % on an annual basis because the intense competition led to price wars. There are approximately 152 000 fast food restaurants in the USA. The industry is seen in a mature stage of the life cycle. In developed countries, the market is already saturated because of the high number of fast food restaurants and extensive franchising. Interesting enough, fast food restaurants have outperformed other competitors because consumers seem to value price and convenience. However, future success will depend on the ability of industry restaurants to adapt to the changing consumer preferences.

Key Drivers:

The success of fast food restaurants and firms in the industry relies heavily on consumer spending: If wages rise and people have more money to spend there is a high chance they are going to spend it on food. For example, during the crisis in 2008 consumer spending for food decreased almost 2 %. Consumer spending is expected to grow the next couple of years in the US and other developed countries – this could be a favorable environment for companies like Yum! to grow. Another key driver of the success of fast food restaurants is the healthy eating index, and if industry companies don't adapt to the trend of this index they won't grow as fast as other restaurants which offer healthier food options. Another important indicator is the consumer confidence index. If consumers are confident and secure about the future, they are more likely to spend money at luxury items, such as eating away from home. Another determinant of success are demographic trends that take place. Baby-boomers are the major group of customers for the industry, because they have the most money to spend.

Consumers are not the only driver of the industry; it is also exposed to the input side. The input side represents the raw materials of the industry, such as meat, wheat and other ingredients, which the restaurants need to prepare the food. When prices for agricultural products rise, restaurants need to change their prices as well or their profit margin will shrink. The agricultural price index can be a good indicator for the prices of the inputs of industry restaurants.

Competition:

The industry is highly competitive. Barriers to enter are not high, and trends for healthier food options let new competitors emerge. The concentration of the industry is also low. The top-4 players (McDonalds, Yum!, Subways, Wendy's) in the industry account for 36 % of the market. McDonalds, the biggest company has a market share of over 17 % in the US and 15 % worldwide. Yum! is the second largest company in the industry with 10 % domestic market share and 9.4 % worldwide. Local operated fast food restaurants, which don't belong to big multinational companies, account for the other three quarter of revenues. The trend of internationalizing has increased in the past couple of years because the market in the US has become too competitive and saturated. Industry restaurants, which increasingly go to Asia and other emerging markets, face moderate competition there.

Outlook:

The industry is expected to grow an annualized 1.9 % until 2020 in the US. This is due to the fact that economy is picking up and consumer spending is about to grow. Global growth is also very important for a company like Yum!. It is expected that global growth in fast food revenue will be 3.5 – 4 % annually the next five years. Especially Asian and South America will contribute to that growth. Much of the success of the industry will depend on the expansion to Asia in the next years. The market in Asia will be the biggest source of growth and profitability in the next decade because of the reason mentioned above, including a saturated market in developed nations, population growth, and growth of GDP. It will be also crucial for companies to adapt to the increasing health consciousness of consumers. Companies, which are ready to anticipate this trend, will have above average growth.

Appendix: Inputs into valuation using multiples

	2009	2010	2011	2012	2013	2014	2015F	2016F
Stock Price	36.56	51.33	59.3	74	78.3	82.49	84.14	95.49
Basic EPS	2.28	2.44	2.81	3.46	2.41	2.37	4.21	4.77
Sales	10836	11343	12626	13633	13084	13279	14806	16805
Sales/Share	23.1	24.19	27.45	30.23	29.53	30.6	34.12	38.72
P/E	16.04	21.04	21.10	21.39	32.49	34.81	20	20
P/S	1.58	2.12	2.16	2.45	2.65	2.70	2.47	2.47
Basic Shares Outstanding	469	469	460	451	443	434	434	434

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*

Source:

ibisworld.com
Fast food restaurants in the US
Global fast food restaurants
Chain restaurants in the US