SHAK: NYC IS NOT THE CENTER OF THE UNIVERSE

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We are adding **SHAK** to the **Hedgeye Best Ideas** list as a **SHORT**.

THE SHORT REPORT

For the most part, the **SHAK** growth story (business model) is predicated on the view that what works well in NYC will work well in the rest of the world.

In our view, when it comes to operating a small cap growth restaurant company, NYC is not the center of the universe. Just ask the management team at DFRG.

SHAK priced its IPO on January 29, 2015 at $21 per share, while raising about $121 million. The primary use of the proceeds were to pay down debt and pay out a distribution to the original owners of the concept, including Union Square Hospitality Group, Danny Meyer, Leonard Green & Partners, and Select Equity Group. The remaining proceeds were kept on the balance sheet as cash to help fund future growth. Following the IPO, Danny Meyer owns roughly 21% of the company, while minority investors Leonard Green and Select Equity Group own 26% and 12%, respectively.

The bull case for the stock centers on the brand's unique beginnings and its "cult-like" status, which sets it apart from other better-burger operators. The company has guided the street to sustained, long-term EBITDA growth of +20%. This growth is expected to be driven by +20% domestic unit growth, execution on existing agreements for overseas licensed growth, low single digit SSS, and modest operating leverage.

At $47 the stock is reflecting a performance that assumes multiples of the aforementioned guidance. What the stock is not reflecting is the inevitable reality that, at the end of the day, it is just a restaurant company and the "cult-like" status will not last forever. We've seen many "cult-like" companies come and go and the vast majority of these stories have ended poorly.

THE BASICS OF THE CONCEPT ARE STRONG

Average check at **SHAK** runs between $14-15 per transaction. This is a significant premium to most QSR burger chains and even other fast casual concepts:

- **HABT** average check is $7.50
- **PNRA** average check is $9.50
- **ZOES** average check is $10.00
- **CMG** average check is $10.00

Unlike the other concepts, **SHAK** has an alcohol component, as beer and wine currently make up around 3% of sales. Having liquor on the menu makes the concept more attractive for the dinner daypart. Currently, the mix at **SHAK** is around 50/50 for lunch and dinner.

According to management, Shake Shack is a modern day roadside burger stand, serving a classic American menu of premium all-natural, formal, and anti-biotic free burgers, hot dogs, crinkle-cut fries, shakes, frozen custard, beer, and wine.

Shake Shack was founded by Danny Meyer's Union Square Hospitality Group and benefits from USHG's expertise and community building, hospitality, fine dining, restaurant operations, and the sourcing of premium ingredients.

Shake Shack officially opened its first restaurant in 2004 which, according to management, "immediately became a community gathering place from New Yorkers and visitors from all over the world."

As the story goes, in just 10 years, Shake Shack has become not only a beloved New York City institution, but a global phenomenon – an amazing claim for any restaurant company, but especially a burger chain. Management also points to "outsized media attention," "critical acclaim," and a "passionately devoted following" as to why it is so successful. It's difficult to question Danny Meyer's original version of Enlightened Hospitality and how that has guided the creation of Shake Shack's unique culture, but can that continue to be a point of differentiation in a rapidly growing chain?

Management describes Enlightened Hospitality as the virtuous cycle that's created when they choose to put their team first, care for each other, their guests, their communities, their suppliers, and ultimately, create strong returns for their investors.

Lastly, Shake Shack has aligned the company in a new category – fine casual. According to the company, fine casual couples the ease, value, and convenience of fast casual with the high standards of excellence in thoughtful ingredients sourcing, preparation, hospitality, and quality grounded in the company's founders' roots as a fine dining company.

NEW UNIT POTENTIAL & OPERATIONAL RISKS

To simplify the **SHAK** story, the only thing that will truly matter from here on out is the performance of new units.

There are currently 63 Shake Shacks worldwide, with about 49% of the store base company-owned. Most of the franchised stores are operated internationally, the majority of which are in the Middle East. Going forward, management is targeting at least ten company openings a year, and wants to triple its domestic footprint over the next five years. This translates to +32% and +27% domestic growth in 2015 and 2016, respectively. This would put **SHAK**'s growth rate at the highest in the industry and significantly above the more mature fast casual players that are growing in the +8-14% range.

Despite only having 63 units, management believes that Shake Shack "has become a beloved global brand with a power reaching multiples beyond [its] size." Ah, a classic New Yorker's view of the world. During the 4Q14 earnings call, CEO Randall Garutti went on to say, "The excitement we create during our openings and the ongoing connection we have with our fans through an intensive social media strategy, graphic design, and unique collaborations have together powered our voice and created a truly dynamic connection with our loyal Shack fans."

Remember, Shake Shack is in the nascent stage of growth with a business model that is largely based on how New Yorkers view the brand. With 63 units, and only 13 in the same-store sales base (new units take 24 months to enter the base), management believes it has covered all of the bases. Its "versatile real estate model is built for growth, already proven throughout the country in varied formats: in urban, suburban, mall, train stations, airports, and even ballparks." With roughly half of its units in the US, it's difficult to imagine that management believes they have it all figured out. The runway for growth can be a lot smaller than most imagine and there is significant room for operational risk along the way.

NEW UNIT METRICS ARE THE KEY TO THE SHORT THESIS

As we've said before, performance in NYC is not indicative of future performance anywhere else. In 2013, company stores ran at average unit volumes of $5 million, the highest among publicly traded fast casual players. The high average unit volumes are primarily driven by seven Manhattan stores, which average around $7.4 million per store. Importantly, these stores generate restaurant level margins in the 30% range. With new units only costing $2.6 million to build (prior to rent), they tend to generate spectacular results with a 2.8x sales to investment ratio and 80% cash-on-cash returns.

Alas, it's all downhill from here!

Outside of Manhattan, the average **SHAK** generates about $3.8 million in sales, with store margins in the 20% range, despite being at a much earlier stage of growth and having a significantly smaller portfolio size. The difference in margins is primarily due to the high brand awareness and operating efficiencies in Manhattan, where the company can leverage its increased penetration and distribution scale. The non-Manhattan stores cost $2.2 million to build in 2013, resulting in a 1.7x sales to investment ratio and 35% cash-on-cash returns.

Yet, we believe investors should expect even lower returns in the future. Going forward, management is targeting new unit volumes of $2.8-3.2 million, roughly 40% lower than the current $5 million system average. Additionally, the company is targeting restaurant level margins in the 18-22% range which, at an initial investment of $1.9 million, would yield a 1.5x sales to investment ratio and 30-33% cash-on-cash returns.

This is where the bull vs bear debate begins – and ends. The **SHAK** bulls argue that the guidance for new unit returns is too conservative and that they underestimate consumers' appetites for an engaging lifestyle "cult" brand.

The **SHAK** bears, such as us, argue that new units in disperse markets typically experience lower average unit volumes and opening-related inefficiencies, such as higher labor costs. In addition, we question whether or not there has been enough investment in G&A to have the necessary resources to work through these inefficiencies by the second or third month.

The bottom line is that, for us, there is a very good probability that **SHAK** begins opening up some new units that fall short of the street's expectations. In fact, this almost always happens in concepts like this. Trading at $48.50 and with a market cap over $1.7 billion, it's clear that the stock doesn't properly reflect this risk.

SAME-STORE SALES ARE DECELERATING WITH INCREASED UNITS

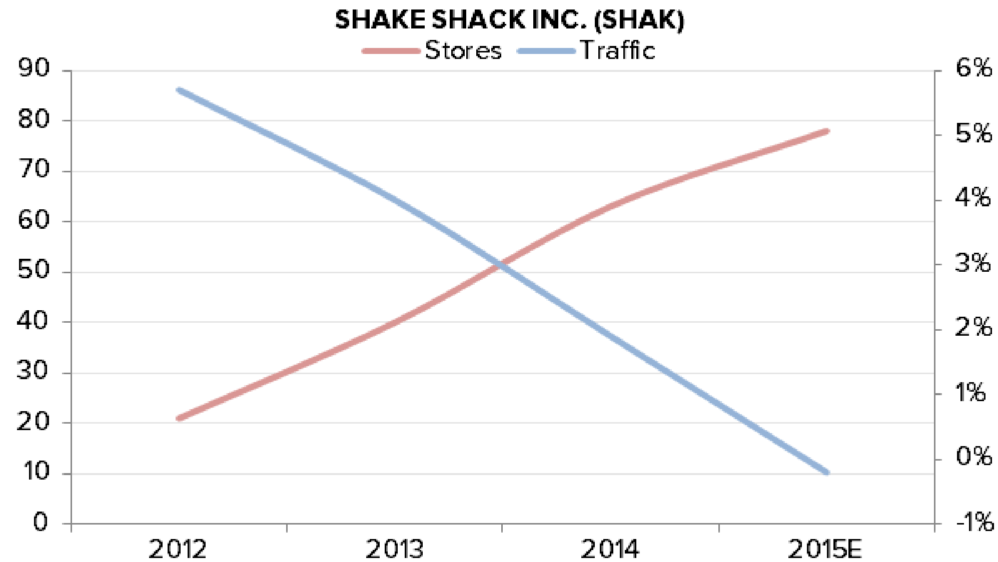
A lot of the day-to-day volatility in the stock will revolve around same-store sales numbers, but as we just discussed, the true health of the concept will be determined by the performance of new units. In reality, due to the limited number of stores in the base, same-store sales are far from a significant metric. In 2012, with only five stores in the base, same-store sales ran +7.1%, with traffic +5.7%, and ticket +1.4%. In 2013, the comp base grew by +60% to eight, and same-store sales decelerated to +5.9%, with traffic +4%, and ticket +1.8%.

It's not surprising that as the base of stores has grown, same-store sales trends have decelerated. For 2014, same-store sales were +4.1%, with traffic +0.5%, and ticket +3.6%. Recently, management has aggressively raised prices, versus what we've typically seen from them in the +1-2% range per year. In September 2014, and again in January 2015, management took menu pricing of +4.5% and +6%, respectively, in order to offset increased beef inflation. This increase brought the price of a regular Shackburger up over $5.00. For 2015, the street is modeling same-store sales growth of +3.9%, which assumes comps run above +4.5% through the first three quarters before they normalize to +1.9% in 4Q15.

In the most recent quarter, traffic was up +1.7% and is a number that must be watched very closely moving forward. Negative traffic, or even a slowdown in traffic, could be a serious concern for bulls on the stock.

To sum it up, traffic has decelerated as unit growth has accelerated:

- In 2012, traffic was +5.7%
- In 2013, traffic was +4.0%
- In 2014, traffic was +1.9%
- In 2015, traffic is estimated to be -0.2%



Source: Company Filings HEDGEYE

This isn't a very good trend for a "cult" concept that is in the nascent stage of an aggressive expansion plan.

SHAK currently trades at 128x NTM EV/EBITDA, a staggering multiple for any restaurant company. While we think the operating characteristic and principals involved are deserving of a premium valuation, this multiple suggests nirvana — and that doesn't exist in the restaurant space.

Investors are already baking in:

- A total domestic opportunity beyond 450 stores
- Outsized returns at new non-Manhattan Shacks
- Accelerated new international growth opportunities
- Operating leverage
- Flawless execution

The market is valuing **SHAK** at $27 million per system-wide store versus the average store generating approximately $3.5 million in revenues. This compares to **CMG**, which trades at $11.2 million per store. If **SHAK** can execute at a **CMG** level and grow into that valuation, it would trade at around $20 per share.