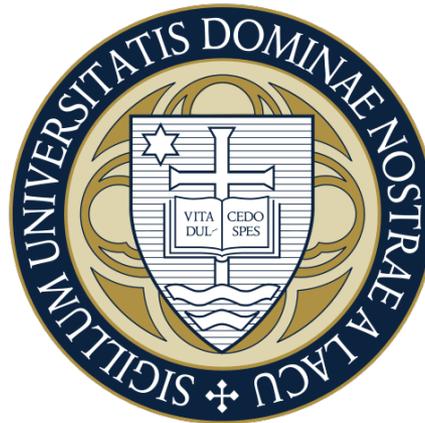


# Notre Dame Investment Club

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Shake Shack - **Buy**

11/2/2021

*Benjamin Norris, Sean Santos, Oliver Bernasek*





# Overview of Investment Thesis

## Recommendation:

Shake Shack (NYSE: SHAK) is fundamentally undervalued; the considerable decline of the share price since early 2021 (as a result of lower than expected post COVID consumer demand) offers a strong discount to future growth oriented Shake Shack. We recommend the Investment Club initiates a long position in the stock.

## Rationale:

While the consumer discretionary restaurant landscape remains incredibly competitive, we still believe the stock is a great buy. The market is not adequately pricing in the future growth prospects, the impact of drive-through stores, and continued growth of sales through Shake Shack's new online platform, which offer superior unit economics.

- 1 Expansion of Domestic Company-Operated Shacks will drive revenue growth
- 2 Transition and addition of drive-through Shacks will dramatically increase unit sales
- 3 Huge momentum through Shake Shack's digital platform will drive better profitability

Base Price Target: **\$94.04**  
33.1% upside from current price



# Shake Shack Overview

Shake Shack is a regionally concentrated fast casual restaurant chain which is differentiated by its exceptional in-person dining experience, unique limited time offerings, and alcohol service.

## Shake Shack Overview

- Shake Shack, founded in 2004, is an American fast-casual operator and franchiser with a strong domestic presence concentrated in the North East and California
- Shake Shack owns and operates 183 domestic “Shacks,” and has 128 licensed “Shacks”
- Shake Shack offers a uniquely “premium” and “engaging” experience for diners thanks to limited high-quality menu, superior dining rooms, regularly refreshed seasonal limited time offerings, and alcohol offerings for 21+ guests.

## Management



**Randy Garutti**, Chief Executive Officer & Director

- Served as COO from 2010-2012 prior to serving as CEO and a director
- Former Director of Operations for the Union Square Hospitality group



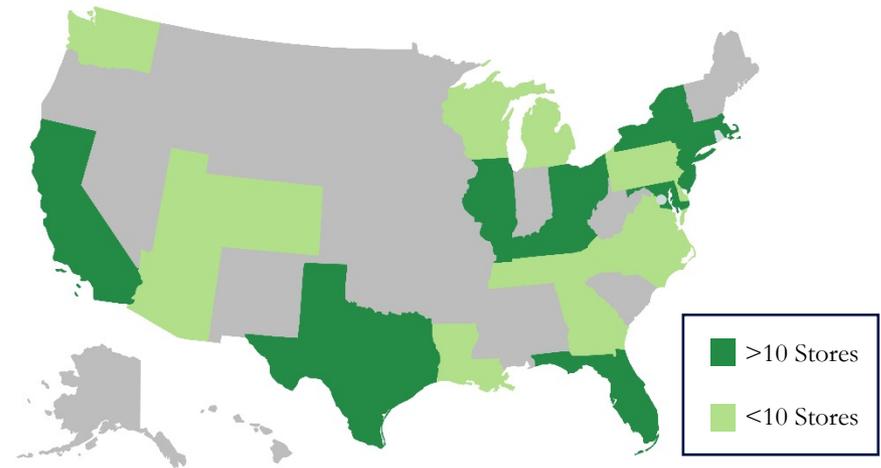
**Katie Fogerty**, Chief Financial Officer

- Joined as CFO in June 2021
- Previously, served at Goldman Sachs as VP & Lead Equity Analyst for the restaurant sector

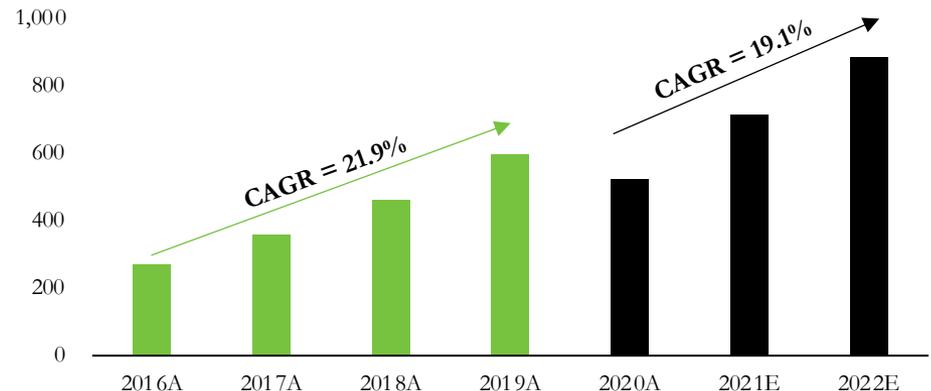
## Growth Plan Summary

- Shake Shack plans to expand further into the Midwest and South, two regions less effected by the healthy eating headwinds on the coasts
- The company plans to add Drive-Thru’s to all new stores and some existing locations to boost per-store sales and improve unit economics
- Shake Shack has been aggressively re-vamping its digital platform, which has already boosted digital sales by 17% in Q2.

## Geographic Breakdown (Domestic)



## Revenue (\$mm)





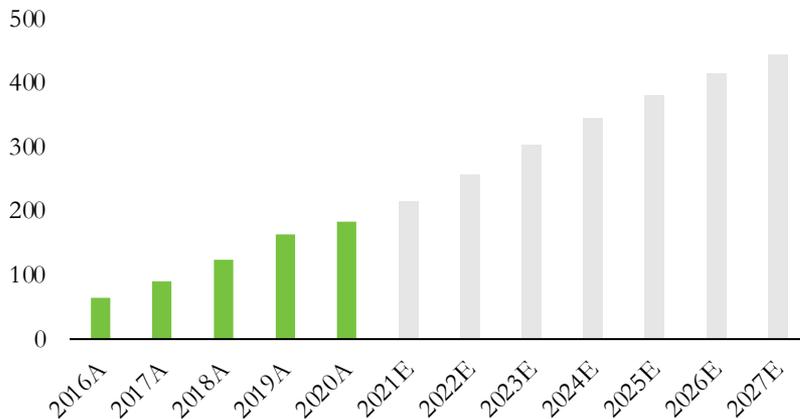
# Growth Story & Digital Evolution

Shake Shack's growth strategy hinges on boosting both same-store sales and unit economics by offering an improved digital platform and by adding Drive-Thru's to its new stores as it expands

## Growth Story & Management Commentary

- Since the first Shack in 2004, growth has been cautionary as the focus has been on quality
- Shake Shack has always focused on premier indoor dining experience, but guest preferences have shifted since COVID
- Drive-Thru's are now what guests demand
  - Management claims new Shack locations are going to have the same fundamental experience -- beautiful patios, building design, and customer service
- Management target is 450 Domestic-Company Operated Shacks by 2027
  - The plan is currently for all new Shacks to have Drive-Thru's
  - Old Shacks will be periodically transitioned to Drive-Thru's

## Domestic-Company Operated Shack Growth



## Digital Evolution

- Shake Shack's proprietary app and modern platforms are meant to heighten crucial guest experience
- Digital assets include in-Shack pickup, Shack Track, curbside pick-up, integrated kiosks, and new delivery partnerships with Uber
- The app and superior digital guest experience help with knowing customers and facilitating engagement
  - LTO advertisement and promotion are integrated throughout the app
- On Monday November 1<sup>st</sup>, Truist Securities upgraded SHAK to a buy rating citing the "acceleration of digital sales and improved delivery performance"

## Key Digital Stats



Since the pandemic began, 2.4 million new digital users (up 17% from 2021 Q1)



Average weekly sales were \$72,000 in Q2 2021, growing substantially in each month of the quarter and from each previous quarter



Total digital sales represent 47% of Shack sales in Q2 of 2021 (includes third-party delivery orders)



# Post-COVID Environment

Shake Shack suffered a loss in per-store sales due to COVID-19 and regional headwinds. COVID recovery along with the offering of a new digital experience will increase per-store sales.

## Suburban

### Performance

- 50% of shacks are in suburban locations
- Suburban sales stayed flat in 2020, and surpassed pre-COVID levels in 2021
- Suburban areas are expected to be “majority of growth” – Randy Garutti, Shake Shack CEO

### Suburban Drivers

- Suburban areas tend to have far more consistent and reliable numbers because the customers live nearby
- Shake Shack’s main mission, Stand For Something Good, target high involvement within the community: partnering with local artists, hosting fundraisers, and community meal donations

## Urban

### Performance

- Urban locations account for the rest of total shacks, however, they have not recovered from pre-COVID performance
- Historically, 60% of sales were derived from urban locations, but are down 31% from 2019 same-store sales

### Urban Drivers

- Urban performance is directly tied to the population, traffic, and tourism near each shack
- Tourism and conferences have had a large hit since COVID, and have not recovered to previous sizes which have halted the recovery of Urban locations – this tourism is anticipated to recovery by early 2022

## Digital Experience

### Digital Interface

- Shake Shack invested in an app and website for omnichannel capabilities
  - New ordering experience and digital experience
- Added capabilities of gathering customer data, which didn’t exist pre-COVID

### Delivery

- The new website was designed to improve the ordering function, especially on mobile devices, where there were many issues
- Shake Shack partnered with UBER to lower off-premise costs and improve efficiency



# Introduction of Drive-Thru's

Although Shake Shack differentiates itself through offering great in person experiences, adding Drive Thru's would allow the company to expand the scope of its consumer base and boost per store revenues by roughly 28%

## Drive-Through Successes

Companies				
Sales from Drive Throughs	90%	50%	65%	65%
Summary	<ul style="list-style-type: none"> <li>Wendy's was able to sustain growth throughout COVID, resulting in a 2.2% increase in revenue</li> <li>Wendy's ranks 6<sup>th</sup> in overall drive through experiences and has operated with drive throughs since 1970</li> </ul>	<ul style="list-style-type: none"> <li>Starbucks had an 11% decrease in revenue during COVID, primarily due to the closing of in-store dining</li> <li>With the help of drive throughs, Starbucks was able to have a 24% recovery in 2020</li> </ul>	<ul style="list-style-type: none"> <li>McDonald's had a similar experience as Starbucks, where there was a 10% decline in revenues throughout COVID but a quick 18% recovery in revenues</li> <li>Revenue is back to 2019</li> </ul>	<ul style="list-style-type: none"> <li>KFC's same-store sales fell 7% during COVID</li> <li>COVID recovery has resulted in same-store sales to come close to 2019 levels</li> <li>KFC ranks 16<sup>th</sup> in overall drive through experience, correlated to slower recovery</li> </ul>

## Shake Shack Drive-Through Synergies

Target Market	<ul style="list-style-type: none"> <li>Industry tailwinds are leading consumers to quality dining experiences, but some are too busy to dine-in. The addition of drive-throughs would increase Shake Shack's TAM, especially as it moves into regions dominated by traditional fast food players.</li> </ul>
Average Upside	<ul style="list-style-type: none"> <li>Drive throughs on average are able to raise sales by roughly 28% and offer better unit economics compared to in-person dining</li> </ul>



# Competitive Landscape

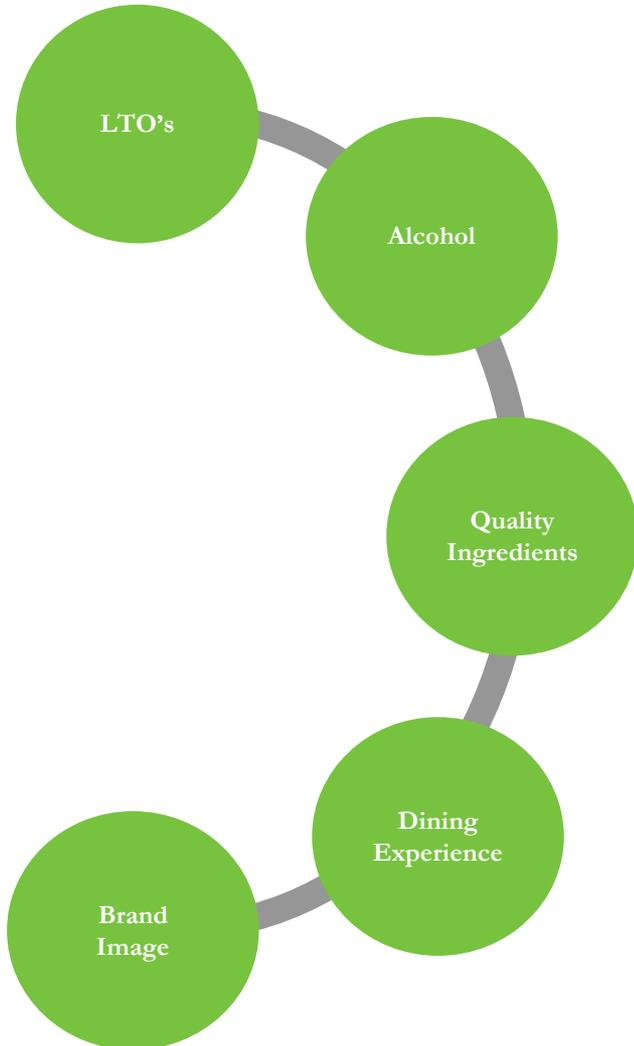
Shake Shack's gross profit margins far exceed comparable companies in the fast casual space. By offering Drive-Thru's it has the opportunity to bite into the consumer base of traditional fast food players.

	Fast Casual	Casual	Fast Food	Healthy Fast Food/Casual																
Characteristics	<ul style="list-style-type: none"> <li>Large focus on a premium dining experience</li> <li>Newer segment, extremely fast growth</li> <li>Highly cyclical as a result of higher quality food with premium pricing</li> <li>Market composed of a few key players regional players</li> <li>Hard hit by Covid-19 due to reliance on in person dining experience to drive engagement</li> </ul>	<ul style="list-style-type: none"> <li>Dying segment dominated by legacy players</li> <li>Lower margins due to need for wait staff, table service</li> <li>Generally do not offer drive through, limited options for takeout and delivery</li> <li>Extreme reliance on in-person dining led to the bankruptcy of multiple major players during COVID-19</li> </ul>	<ul style="list-style-type: none"> <li>Largest and most competitive segment</li> <li>Limited growth, market is extremely saturated by over-franchised players</li> <li>Generally offer in person dining, but most sales are generated by drive-thru's and takeout</li> <li>Highly impacted by labor shortage due to 24/7 model</li> </ul>	<ul style="list-style-type: none"> <li>Emerging segment due to growing consumer health consciousness</li> <li>Extremely segmented, no dominant players nationally</li> <li>Major fast food players are attempting to pivot into this segment with new branding and healthy offerings</li> <li>Highest-margins on food due to a consumer willingness to pay a "health premium"</li> </ul>																
Major Players																				
Gross Margin %	<table border="1"> <caption>Gross Margin % Data</caption> <thead> <tr> <th>Company</th> <th>Gross Margin %</th> </tr> </thead> <tbody> <tr> <td>Noodles and Co</td> <td>~20%</td> </tr> <tr> <td>Chipotle</td> <td>~15%</td> </tr> <tr> <td>Shake Shack</td> <td>~45%</td> </tr> <tr> <td>McDonald's</td> <td>~55%</td> </tr> <tr> <td>Subway</td> <td>~10%</td> </tr> <tr> <td>Sweetgreen</td> <td>~15%</td> </tr> </tbody> </table>						Company	Gross Margin %	Noodles and Co	~20%	Chipotle	~15%	Shake Shack	~45%	McDonald's	~55%	Subway	~10%	Sweetgreen	~15%
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# Competitive Advantages

Shake Shake's dominance in the level of consumer experience it offers will allow it to become a top fast-food/fast casual player as it begins an aggressive expansion into the South and Midwest.



## Competitive Advantage Details

### Limited Time Offerings (LTOs)

- Shake Shack operates an Innovation Kitchen that is responsible for menu development
- LTO's include popular Hot Chick'n and Featured Shakes
- Exclusive LTO Offerings (i.e. Black Truffle Menu)

### Quality Ingredients

- Roots in fine dining influence quality ingredients at all locations
- All-natural and hormone and antibiotic-free meat
- Superior ingredients and culinary partners keep guests coming back

### Alcohol

- Alcohol is served at the majority of domestic locations
- ShackMeister Ale and featured Wine items heighten in-store dining experience
- High profit margins

### Dining Experience

- Original and upbeat and relaxed ambiance at all Shacks
- High quality environment encourages guests to stay and enjoy experience
- Innovative drive-through Shacks will continue this characteristic

### Brand Image

- Shake Shacks superior community engagement, digital evolution, and culinary innovation keeps guests coming back and heightens overall brand image
- Colorful logo and marketing allows company to stand out in relation to competitors
- Strong ESG efforts through employee benefits and supply chain commitments solidifies Shake Shack as a brand of the future



# Risks and Mitigation

## Risks

### Declining Per-Shack Sales

- Per-Shack sales have been in decline since 2017, accelerated by COVID-19
- Caused primarily by no drive-thru option, increased competition, and geographic concentration

### Rising Labor Costs & Churn

- Due to the ongoing labor shortage, wages have risen substantially in the food service sector
- Employee churn levels are at all time highs, reducing efficiency and adding significant new employee training costs

### Geographic Concentration

- Exposed to regional economic downturns, especially given the price point of Shake Shack's menu
- Exposed to health headwinds which are most pronounced in costal regions

## Mitigation

### Drive Thru's, Expanded LTOs, COVID-19 Recovery

- Addition of Drive Thru's to new stores will dramatically increase per-store sales
- Revamped seasonal LTO offerings will drive higher per store sales
- Pent-up demand for in person experiences after COVID-19

### Best-in-class employee retention programs

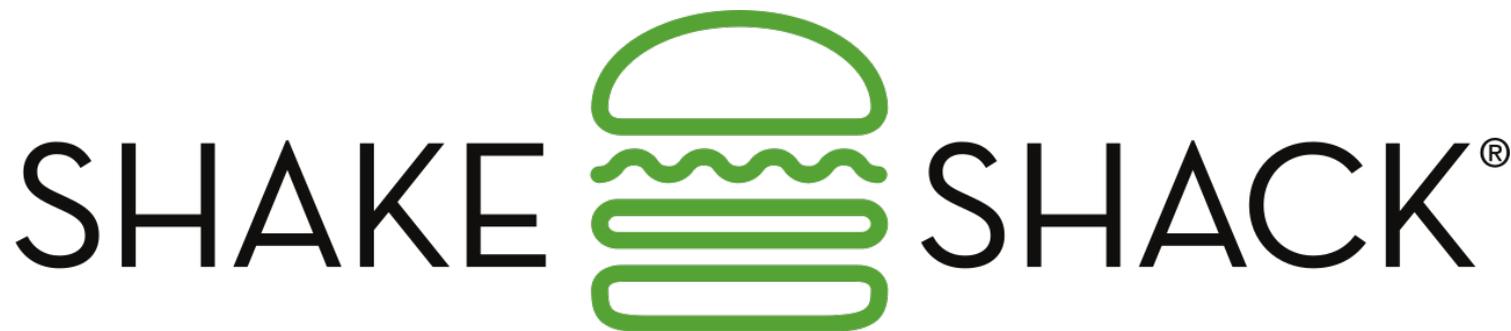
- Strong contribution savings plan offers employees a 50% company match up to 5% of compensation for retirement savings
- Employee benefit programs such as a four day work week, health care, and high wage floors make it easier to hire and retain employees

### Geographic Expansion

- Expansion into new regions will allow Shake Shack to lower its exposure to regional economic trends
- Expansion into less health conscious regions (Midwest & South) help mitigate impacts of health tailwinds



# Final Recommendation



## Low Case:

Price Target: **\$68.21**

Downside: **-3.5%**

## Base Case:

Price Target: **\$94.04**

Upside: **33.1%**

## High Case:

Price Target: **\$123.17**

Upside: **74.3%**

### Recommendation:

Shake Shack (NYSE: SHAK) is fundamentally undervalued; the considerable decline of the share price since early 2021 (as a result of lower than expected post COVID consumer demand) offers a strong discount to future growth oriented Shake Shack. We recommend the Investment Club initiates a long position in the stock immediately.

### Key Catalysts:

Shake Shack's ability to extend its exceptional brand image into new geographic locations with different consumer preferences is the key catalyst to its growth story. Furthermore, our valuation hinges on LTOs and Shake Shack's new digital platform continuing to drive higher per store sales.



 Notre Dame  
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Appendix



# DCF - Base

DCF Analysis	2016A	2017A	2018A	2019A	2020A	2021E	2022E	2023E	2024E	2025E	2026E
<b>Revenue</b>	268.5	358.8	459.3	594.5	522.9	671.9	919.0	1,457.9	1,727.5	1,986.0	2,251.3
% Growth		33.6%	28.0%	29.4%	(12.1%)	28.5%	36.8%	58.6%	18.5%	15.0%	13.4%
(-) COGS	161.1	218.3	280.9	377.4	361.7	467.0	621.8	904.8	1,063.4	1,222.5	1,385.8
(-) Operating Expenses	65.0	84.4	116.8	149.7	146.1	174.1	209.8	302.3	327.8	342.1	362.5
<b>EBITDA</b>	42.3	56.1	61.6	67.4	15.1	30.9	87.5	250.9	336.4	421.4	502.9
% Margin	15.8%	15.6%	13.4%	11.3%	2.9%	4.6%	9.5%	17.2%	19.5%	21.2%	22.3%
(-) D&A	(14.5)	(21.7)	(29.0)	(40.4)	(48.8)	(55.9)	(66.8)	(78.5)	(89.4)	(98.8)	(107.6)
<b>EBIT</b>	27.8	34.4	32.6	27.0	(33.7)	(25.0)	20.6	172.4	246.9	322.6	395.3
% Margin	10.4%	9.6%	7.1%	4.5%	(6.5%)	(3.7%)	2.2%	11.8%	14.3%	16.2%	17.6%
Effective Tax Rate	39.7%	38.5%	22.2%	6.2%	20.0%	26.5%	26.5%	26.5%	26.5%	26.5%	26.5%
(-) Tax on EBIT	11.1	13.3	7.2	1.7	0.0	-	5.5	45.7	65.4	85.5	104.7
<b>NOPAT</b>	16.8	21.2	25.4	25.4	(33.7)	(25.0)	15.2	126.7	181.5	237.1	290.5
(+) D&A	14.5	21.7	29.0	40.4	48.8	55.9	66.8	78.5	89.4	98.8	107.6
(-) Capital Expenditure	(54.4)	(61.5)	(87.5)	(106.5)	(69.0)	(72.7)	(100.2)	(133.5)	(107.3)	(108.7)	(107.6)
(-) Change in NWC	86.2	8.2	(22.2)	(48.5)	(32.7)	33.9	(62.8)	(53.7)	(55.2)	(36.1)	(35.8)
<b>Unlevered Free Cash Flow</b>	\$ (10.4)	\$ (55.3)	\$ (89.3)	\$ (86.7)	\$ (7.9)	\$ (81.0)	\$ 18.0	\$ 108.4	\$ 191.2	\$ 254.7	
Growth rate			430.5%	61.4%	(2.9%)	(90.9%)	928.6%	(122.3%)	500.9%	76.4%	33.3%
Period						0.2	1.2	2.2	3.2	4.2	5.2
<b>PV of UFCF</b>						\$ (7.7)	\$ (72.7)	\$ 14.8	\$ 81.3	\$ 131.0	\$ 159.5



# DCF - Base Output

Terminal Value: Perpetuity Growth Method	
2026 Unlevered FCF	254.7
Perpetual Growth Rate	2.7%
Implied 2027 Unlevered FCF	261.6
WACC	9.4%
Terminal Value (as of 2027)	3,895.5
Discounting Factor	6.2
Discounted Terminal Value	2,229.8
Implied EV/2026 EBITDA	5.3x

Terminal Value: Exit Multiple Method	
2027 EBITDA	\$ 502.9
Terminal Multiple	12.0x
Implied 2026 EV	6,034.8
WACC	9.4%
Discounting Factor	6.2
Discounted Terminal Value	3,454.3

Enterprise Value and Equity Value		
	PGR	EV/EBITDA
Sum of Discounted Cash Flows	306.1	306.1
Discounted Terminal Value	2,229.8	3,454.3
Enterprise Value	2,535.9	3,760.5
Less Debt	243.0	243.0
Plus Cash, Short Term Investments	595.8	595.8
Equity Value	3,374.7	4,599.3
Weighted Average Diluted Shares Outstanding	45.0	45.0
Share price	\$ 74.99	\$ 102.21
Current share price	\$ 70.65	\$ 70.65
Upside/downside	6.1%	44.7%

Blended Implied Share Price	
Perpetuity Growth Method	\$ 74.99
Exit Multiple Method	\$ 102.21
Blended Share Price	\$ 94.04
Upside/downside	33.1%



# DCF - Base Sensitivity Analysis

		Blended Implied Share Price				
		WACC				
		7.0%	8.0%	9.0%	10.0%	11.0%
Perpetuity Growth	1.5%	\$ 94.95	\$ 80.77	\$ 70.48	\$ 62.70	\$ 56.62
	2.0%	\$ 102.19	\$ 85.64	\$ 73.92	\$ 65.23	\$ 58.55
	2.5%	\$ 111.04	\$ 91.38	\$ 77.90	\$ 68.11	\$ 60.70
	3.0%	\$ 122.10	\$ 98.28	\$ 82.53	\$ 71.39	\$ 63.12
	3.5%	\$ 136.32	\$ 106.71	\$ 88.01	\$ 75.18	\$ 65.86

		Blended Implied Share Price				
		WACC				
		7.0%	8.0%	9.0%	10.0%	11.0%
Exit Multiple	10.0x	\$ 99.74	\$ 95.27	\$ 91.08	\$ 87.15	\$ 83.47
	11.0x	\$ 107.09	\$ 102.20	\$ 97.63	\$ 93.34	\$ 89.32
	12.0x	\$ 114.43	\$ 109.14	\$ 104.18	\$ 99.53	\$ 95.17
	13.0x	\$ 121.78	\$ 116.07	\$ 110.73	\$ 105.72	\$ 101.02
	14.0x	\$ 129.13	\$ 123.01	\$ 117.28	\$ 111.91	\$ 106.88



# Revenue - Base

Base	2016A	2017A	2018A	2019A	2020A	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Avg. Shack Sales	4.05	3.85	3.59	3.53	2.77	3.00	3.45	4.69	4.88	5.08	5.28	5.49
% growth		-5.0%	-6.6%	-1.9%	-21.5%	8.3%	15.0%	36.2%	4.0%	4.0%	4.0%	4.0%
Avg. Liscensing Revenue	0.18	0.18	0.16	0.18	0.13	0.18	0.18	0.18	0.19	0.19	0.19	0.19
% growth		-1.4%	-9.3%	8.7%	-27.3%	40.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Domestic-Company Operated Shack Sales	64	90	124	163	183	215	257	302	344	380	414	444
						644.2	885.6	1417.6	1679.3	1929.2	2185.9	2438.1
Liscensed Stores	50	69	84	112	128	153	183	219	259	302	344	381
Liscensing Revenue						27.7	33.4	40.4	48.2	56.8	65.4	73.1
<b>Total Revenue</b>						<b>\$ 671.9</b>	<b>\$ 919.0</b>	<b>\$ 1,457.9</b>	<b>\$ 1,727.5</b>	<b>\$ 1,986.0</b>	<b>\$ 2,251.3</b>	<b>\$ 2,511.2</b>



# Cost of Goods Sold - Base

Base	2016A	2017A	2018A	2019A	2020A	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Domestic Company-Operated Stores	64	90	124	163	183	215	257	302	344	380	414	444
Total Revenue	268.5	358.8	459.3	594.5	522.9	671.9	919.0	1,457.9	1,727.5	1,986.0	2,251.3	2,511.2
<b>Cost of Goods Sold</b>	<b>\$ 161.1</b>	<b>\$ 218.3</b>	<b>\$ 280.9</b>	<b>\$ 377.4</b>	<b>\$ 361.7</b>	<b>\$ 467.0</b>	<b>\$ 621.8</b>	<b>\$ 904.8</b>	<b>\$ 1,063.4</b>	<b>\$ 1,222.5</b>	<b>\$ 1,385.8</b>	<b>\$ 1,545.8</b>
Occupancy and Related Expenses	21.8	28.2	32.7	48.5	51.6	63.8	82.7	123.9	138.2	158.9	180.1	200.9
% margin	8.1%	7.9%	7.1%	8.1%	9.9%	9.5%	9.0%	8.5%	8.0%	8.0%	8.0%	8.0%
Food & Paper Costs	73.8	98.3	126.1	168.2	153.3	194.9	254.2	403.2	477.7	549.2	622.6	694.5
% margin	27.5%	27.4%	27.5%	28.3%	29.3%	29.0%	27.7%	27.7%	27.7%	27.7%	27.7%	27.7%
Labor & Related Expenses	65.5	91.7	122.1	160.8	156.8	208.3	284.9	377.6	447.5	514.4	583.1	650.5
% margin	24.4%	25.6%	26.6%	27.0%	30.0%	31.0%	31.0%	25.9%	25.9%	25.9%	25.9%	25.9%



# Same Shack Growth - Base

Base	2016A	2017A	2018A	2019A	2020A	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Domestic-Company Operated Shacks	64	90	124	163	183	215	257	302	344	380	414	444
% growth		40.6%	37.8%	31.5%	12.3%	17.5%	19.5%	17.5%	13.9%	10.5%	8.9%	7.2%
New Additions (net)		26	34	39	20	32	42	45	42	36	34	30