Zombie Stock #8 – More Cash Burners to Sell

Given the market's rebound, investors may be feeling FOMO and consider rushing back into some of the meme stocks or once popular "growth" stocks. Instead, we recommend caution.

Shake Shack (SHAK: $52/share) is the newest addition to our zombie stocks list, a list of companies that will face challenges as easy/cheap access to capital dries up. Other zombie stocks include Carvana (CVNA), Freshpet (FRPT), Peloton (PTON), Snap Inc. (SNAP), Beyond Meat (BYND), Rivian Automotive (RIVN), and DoorDash (DASH).

Zombie Companies with Little Cash Are Risky

Companies with heavy cash burn and little cash on hand are risky investments in any market, but especially now as IPOs, preferred stock, secondary, and high yield debt issuances have all but dried up in 2022[1]. Figure 1 shows the zombie companies most likely to run out of cash first, based on free cash flow (FCF)[2] burn and cash on the balance sheet over the trailing-twelve-months (TTM).

Figure 1: Danger Zone Picks with <2 Years' Worth of Cash on Hand: TTM Cash Burn[3]

Company	Ticker	Interest Coverage Ratio	Months Before Bankruptcy
Freshpet Inc	FRPT	-13.1	1
Tilray Brands Inc	TLRY	-2.7	1
Carvana Co.	CVNA	-3.0	3
Peloton Interactive Inc.	PTON	-33.3	3
Sweetgreen Inc	SG	-1487.1	9
Rivian Automotive Inc	RIVN	-119.4	10
Beyond Meat Inc.	BYND	-54.9	10
Affirm Holdings Inc.	AFRM	-5.9	14
LivePerson Inc.	LPSN	-4.9	14
Snap Inc.	SNAP	-46.8	14
GameStop Corporation	GME	-157.3	18
MongoDB Inc	MDB	-30.1	18
Bumble Inc.	BMBL	-4.5	19
Wayfair, Inc.	W	-29.5	20
Allbirds Inc	BIRD	-183.6	20
Robinhood Markets	HOOD	-120.8	20
Shake Shack, Inc.	SHAK	-11.5	23
Cloudflare Inc.	NET	-5.4	24

Sources: New Constructs, LLC and company filings.
To calculate "Months Before Bankruptcy" we divided the TTM FCF burn, excluding acquisitions, by 12, which equals monthly cash burn. We then divide Cash and Equivalents on the balance sheet as of the most recent 10-Q or 10-K by monthly cash burn.

[1] As Brian Pellegrini of Intertemporal Economics notes in a recent research note.
[2] We exclude the impact of acquisitions to free cash flow in our analysis throughout this report.
[3] Each company in Figure 1 has, negative interest coverage ratio (EBIT/Interest expense), negative FCF over the TTM, less than 24 months before it needs more capital to subsidize the cash burn rate, and been a Danger Zone pick.

Figure 2 shows the zombie companies we found based on analyzing cash burn over the past two years versus cash burn over the TTM.

Companies such as WeWork Inc. (WE), AMC Entertainment (AMC), DoorDash (DASH), and Uber Technologies (UBER) are not in Figure 1 because their TTM cash flow is much better than the 2-year average. Because free cash flow can be very lumpy in any given year, taking a longer, i.e. 2 year, view helps us find more companies at risk of running out of money to fund their operations.

Figure 2: Danger Zone Picks with <2 Years' Worth of Cash on Hand: Avg FCF Burn Past 2 Years

Company	Ticker	Interest Coverage Ratio	Months Before Bankruptcy
WeWork Inc.	WE	-5.2	1
DoorDash	DASH	-326.7	18
AMC Entertainment	AMC	-0.9	20
Uber Technologies	UBER	-3.1	21

Sources: New Constructs, LLC and company filings.
To calculate "Months Before Bankruptcy" we divided the 2-year average FCF burn, excluding acquisitions, by 12, which equals monthly cash burn based on the company's average annual cash burn over the past two years. We then divide Cash and Equivalents on the balance sheet as of the most recent 10-Q or 10-K by monthly cash burn.

Zombie Companies with Little Cash Flow Potential Are Riskier

The companies most at risk of seeing their stock prices go to $0 have poor underlying business models, which was overlooked while many of these names soared during the 2020-2021 meme-stock frenzy. Stock frenzies tend to end when credit dries up, forcing financial leverage to decline and asset prices to stop rising. We think that much needed unwinding process is currently playing out.

Overvalued Zombie Stocks Are the Riskiest

Stock valuations that embed high expectations for long-term profit growth add more risk to owning shares of zombie companies facing short-term distress. With these stocks, overvaluation risk is stacked on top of short-term cash flow risk.

Below, we'll take a closer look at Shake Shack, its cash burn, and how much further its stock could fall.

Shake Shack (SHAK: $52/share)

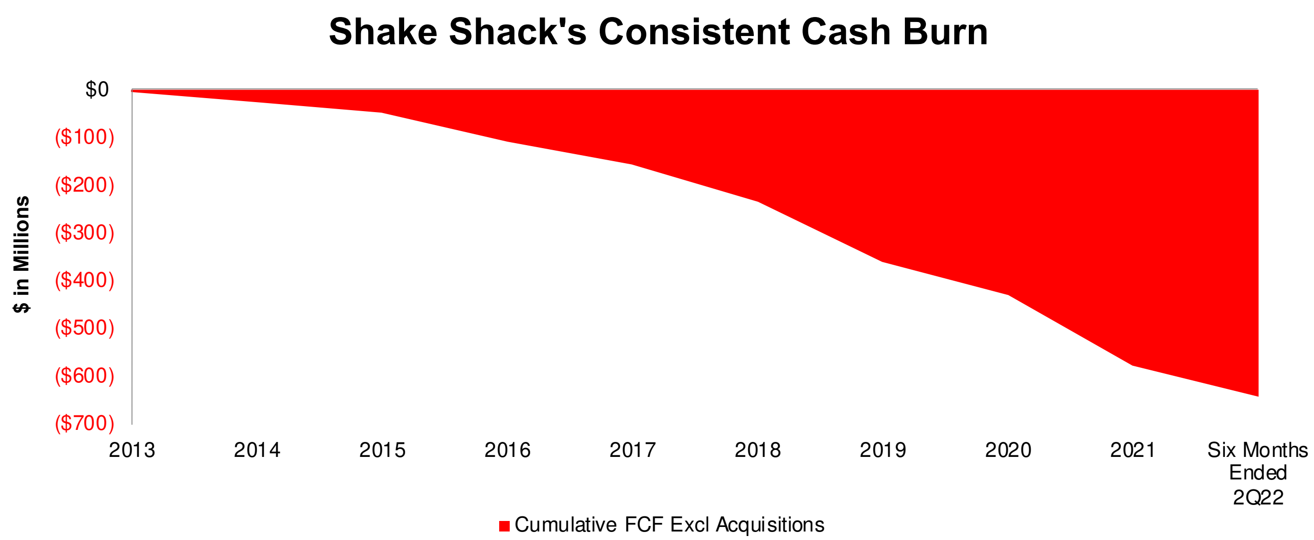
We put Shake Shack in the Danger Zone in June 2019, and the stock has outperformed the S&P 500 as a short by 66% since then. Even after falling 50% from its 52-week high, 28% YTD, and 27% from our most recent report in February 2022, we think the stock has more downside. Our prior reports on Shake Shack are here.

Shake Shack has failed to generate free cash flow since going public in 2015. Since 2012 (earliest available FCF data), Shake Shack has burned through $643 million in FCF, per Figure 3.

The cash drain at Shake Shack shows no signs of slowing as the company burned through $187 million in FCF excluding acquisitions over the TTM ended 2Q22. With just $358 million in cash and cash equivalents at the end of 2Q22, Shake Shack's cash balance could only sustain its cash burn for another 23 months after 2Q22. Raising additional capital to fund this cash-burning business would likely come at a high cost. Shake Shack's severe cash crisis, along with competitive challenges, puts the company's stock at significant risk of declining to $0 per share.

Bulls will argue that such spending is necessary for Shake Shack to differentiate its business in a commoditized burger/fast casual industry. However, as we've noted in prior reports, such spending has not created any economies of scale or the sustainable profits required to make the company a good investment (not just a nice place to eat). If bulls believe the company is spending to differentiate itself, the results show a failure in execution.

Figure 3: Shake Shack's Cumulative Free Cash Flow Since 2013



Sources: New Constructs, LLC and company filings.

Profitability Remains Near Industry Lows

Beyond consumer interest, Shake Shack's focus on differentiation in a commoditized burger/fast casual industry remains quite unprofitable. The firm has not achieved any economies of scale, and its profitability ranks nearly last amongst its many competitors, highlighted in Figure 4.

Figure 4: Shake Shack Profitability Vs. Competitors: TTM

Company Name	Ticker	NOPAT Margin	IC Turns	ROIC
Domino's Pizza	DPZ	14%	3.8	52%
Wingstop, Inc.	WING	19%	2.1	39%
YUM! Brands, Inc.	YUM	27%	1.2	32%
Papa Johns International	PZZA	7%	3.2	22%
Starbucks Corporation	SBUX	13%	1.6	21%
McDonald's Corporation	MCD	37%	0.5	18%
Chipotle Mexican Grill	CMG	11%	1.4	16%
Texas Roadhouse	TXRH	8%	2.0	15%
Jack in the Box	JACK	20%	0.7	14%
Darden Restaurants	DRI	12%	1.0	11%
Bloomin' Brands	BLMN	7%	1.2	9%
Cracker Barrel Old Country Store	CBRL	6%	1.6	9%
Brinker International	EAT	6%	1.5	9%
Restaurant Brands International	QSR	28%	0.3	8%
Denny's Corporation	DENN	12%	0.5	6%
El Pollo Loco Holdings	LOCO	8%	0.7	6%
The Wendy's Company	WEN	15%	0.4	6%
The Cheesecake Factory	CAKE	4%	1.2	5%
Shake Shack, Inc.	**SHAK**	**1%**	**1.0**	**1%**
Red Robin Gourmet Burgers	RRGB	0%	1.1	1%

Sources: New Constructs, LLC and company filings.

As we've noted before, the fast casual restaurant boom reminds us of early days in the craft beer industry. There are many different concepts fighting for a slice of the market. However, the big difference for the fast casual industry is that the large national/global firms would rather replicate your offerings than buy them. The larger firms have a long history of being able to quickly and easily copy and introduce competing products. In other words, the acquisition premium, or hope for a white knight buyer, is low for Shake Shack.

Shake Shack Still Priced to Surpass Bigger & More Profitable Industry Peers

Below, we use our reverse DCF model to analyze the expectations for future growth in cash flows baked into Shake Shack's current share price and show that it could fall 79%+ further.

To justify its current price of $52/share, our model shows that Shake Shack would have to:

- improve its NOPAT margin to 8% (equal to El Pollo Loco's TTM margin and well above Shake Shack's 1% TTM margin or 6% pre-pandemic 2019 margin), and
- grow revenue by 20% compounded annually through 2031 (1.7x projected industry growth through 2026).

In this scenario, Shake Shack would generate $4.4 billion in revenue in 2031, which is 5x its TTM revenue and over 7x its pre-pandemic 2019 revenue. At $4.4 billion, Shake Shack's revenue would 3.6x peer Red Robin Gourmet Burgers (RRGB) and 54% of Chipotle's (CMG) TTM revenue.

We think it's overly optimistic to assume Shake Shack will reverse years of margin deterioration, especially amidst rising inflation and labor costs while also growing revenue 1.7x as fast as the overall industry. Additionally, companies that grow revenue by 20%+ compounded annually for such a long period are "unbelievably rare", making the expectations in Shake Shack's share price even more unrealistic. In a more realistic scenario, detailed below, the stock has large downside risk.

79%+ Downside if Consensus is Right

We review an additional DCF scenario to highlight the downside risk if Shake Shack's revenue grows more in-line with consensus estimates.

If we assume Shake Shack's:

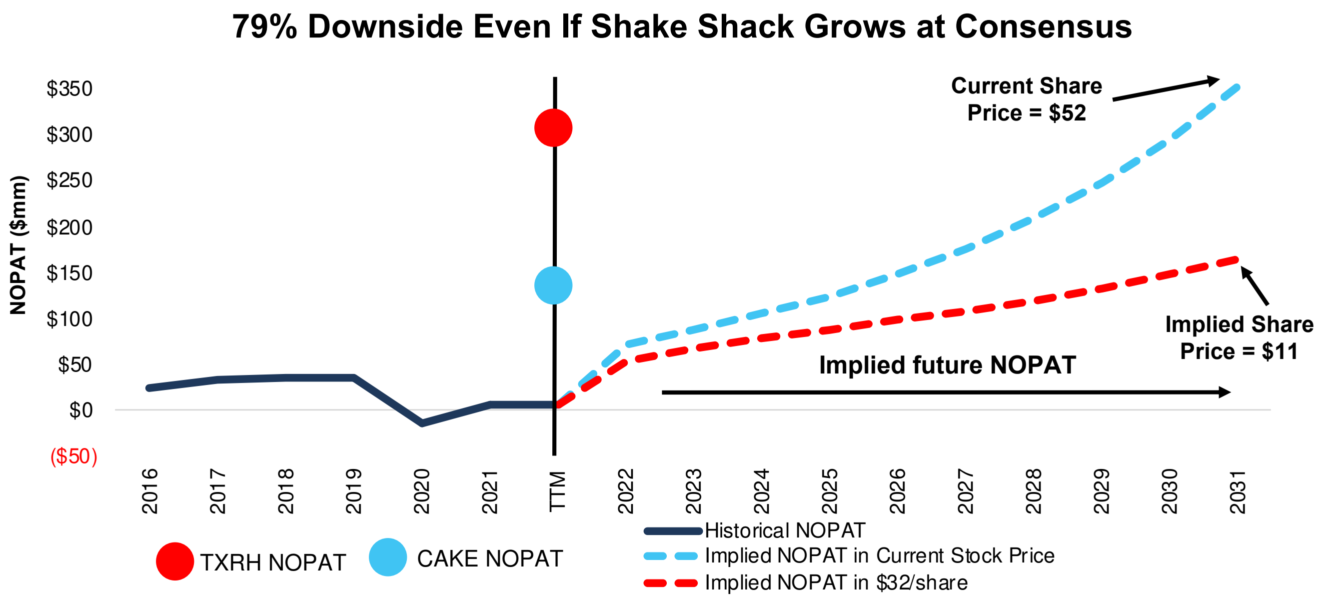
- NOPAT margin improves to 6% (equal to pre-pandemic 2019 level),
- revenue grows at consensus rates in 2021 2022, and 2023, and
- revenue grows 11% a year in 2024-2031 (equal to industry growth rate from 2022-2026), then

the stock is worth $11/share today – a 79% downside to the current price. This scenario still implies Shake Shack's NOPAT quadruples from the highest level in company history (2019).

If Shake Shack fails to improve margins (likely given that labor costs are expected to weigh on profitability) or grow revenue at consensus rates, the downside risk in the stock is even higher.

Figure 5 compares Shake Shack's implied future NOPAT in these three scenarios to its historical NOPAT. For reference, we include the TTM NOPAT of peers Texas Roadhouse (TXRH) and Cheesecake Factory (CAKE).

Figure 5: Shake Shack's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings.

Each of the above scenarios assumes Shake Shack's YoY change in invested capital is 9% of revenue in each year of our DCF model, given the firm's expansion plans. Such an estimate could prove conservative but allows us to create best-case scenarios that demonstrate how high expectations embedded in the current valuation are For context, Shake Shack's change in invested capital averaged 23% of revenue from 2016-TTM and invested capital grew 23% compounded annually from 2016-2021.

This article originally published on August 10, 2022.

Disclosure: David Trainer, Kyle Guske II, Matt Shuler, and Brian Pellegrini receive no compensation to write about any specific stock, style, or theme.

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Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

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Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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