Should You Add Some Gluten to Your Portfolio?

One of Benjamin Graham's favorite instructional methods was to have his students pick two stocks to compare and contrast. Usually he would pick two companies next to each other in the alphabet, such as General Mills and General Motors, or perhaps two companies in the same industry, such as General Dynamics and Lockheed Martin.

Today we will perform that same exercise on two companies in the same industry, and which have headquarters that are less than 20 miles apart. The industry is Quick Service Restaurants (QSR), the metropolitan area is Denver, yet somehow neither company in today's comparison is Chipotle Mexican Grill, probably the most famous QSR concept to come out of the Denver area. However, neither company's products are in the height of fashion right now, because both rely rather heavily on gluten-based ingredients.

Bagels vs. Noodles

The first company is Einstein Noah Restaurant Group, operator of various bagel chains, the most famous of which is Einstein Bros. Bagels. Their ticker, appropriately enough, is BAGL. It operates about 850 restaurants in 42 states, and the company was founded in 1993.

The second company is Noodles & Co., operator of noodle-themed restaurants (anything from mac and cheese to pad thai) with another appropriate ticker symbol (NDLS). They have a little less than 400 locations in 29 states, and the company started in 1995.

So, which stock would you rather buy?

We're certain you did not fall for that and actually provide an answer, because of course you would demand to have more information than that before coming to an investment conclusion. So let's take a closer look at these two companies, and see if we can gain any further insights.

Growth

The world is a dynamic place, and surely these companies have not always had the same number of restaurants over the course of time. While BAGL has about 850 locations right now, just a few years ago they had less than 700. The average annual growth in number of locations over the last four years has been about 6%.

However, over that same four-year period, overall revenue at BAGL has increased only 1.5%, from a little over $400 million to $434 million last year. How is that possible? Well, if the number of locations has been growing faster than the overall revenues for the company, that can only mean one thing: revenue on a per-store basis has actually been declining. For BAGL, its sales per store has been going down about 4% each year for the last four years.

Noodles & Co. has been growing its store base, as well, but at a faster rate: about 13% each year for the last four years. They've gone from less than 250 locations to now closer to 400. Overall revenues, though, have increased by 16%, which means that sales per store has also been going up, to the tune of about 3% each year.

So now that you know about the growth trajectories of the two companies, which one would you choose to invest in?

Profitability

You're too smart for us, once again. Because you refused to answer that question, too, didn't you? Before you commit to an answer, you'd like to know more about the economics of these companies.

So let's look at their profitability. We know about their revenue, so now we need to look at their expense structure. Each company has to buy its food ingredients, prepare them, pay its employees to serve them to customers, pay rent on its locations, and so on. At the end of the day, what's left over before non-operating items such as interest expense and taxes goes by the self-explanatory name of Operating Income.

If you calculate a company's Operating Income as a percentage of its Revenue, you are looking at its profit margin. Software and Internet-related companies generally have high operating margins (see Google's 24%), while industrial and commodity-related businesses are generally lower (see Alcoa's 4%).

BAGL's and NDLS' operating margins are in the same ballpark, though BAGL's ~6.0% is about 25% better than NDLS' ~4.7%.

Now we have a pretty good picture of the current state of the companies, their growth trajectories, and their profitability. Do we have enough information to make an investment decision?

Valuation

We can't get anything past you. Of course, you are going to insist on knowing the prices of the stocks and how those relate to the business fundamentals we've outlined above.

At the time of this writing, both BAGL and NDLS have recently touched new 52-week lows. That is, their share prices were at their lowest points at any time in the previous year. Since then, the stocks have recovered a little bit: BAGL is up 6.5% from its recent low, and NDLS is up 3.0%. However, they are both quite far from their record highs: BAGL would need to increase 22% to regain its highest stock price, and NDLS would need to increase 75%.

With both stocks so close to their recent lows, and with so much apparent headroom to get back to their highest points, does that make them good values? Should an investor rush out to buy both of them? Let's dig a little deeper to find out whether that would be prudent.

BAGL is currently selling for about $15 per share, and there about 18 million shares of the company, meaning that the stock market is ascribing a value of $275 million to the stockholders of the company. However, BAGL is not owned only by its stockholders. In addition to its shares of stock, BAGL has quite a bit of net debt outstanding, $120 million of it in fact. Adding that to the $275 million in stockholder value gives a total enterprise value of close to $400 million.

NDLS is currently selling for about $28 per share, and there are about 31 million shares of the company, meaning that the stock market is ascribing a value of about $875 million to the stockholders of the company. NDLS has a bit of net debt, too, but only about $5 million, meaning that its total enterprise value is about $880 million.

We've thrown a lot of numbers at you so far. Let's take a step back and look at the most pertinent ones in a side-by-side table, to see how our two companies stack up:

	BAGL	**NDLS**
Enterprise Value (EV)	$400 M	$880 M
Locations as of 12/31/13	852	380
2013 Sales	$434 M	$351 M
2013 Operating Profit	$28 M	$14 M
EV / Location	$462 K	$2,309 K
EV / Sales	0.9x	2.5x
EV / Oper. Profit	14x	62x

BAGL has a little more than twice as many locations as NDLS, and its operating profit is twice as high. However, the stock market is ascribing a total value to NDLS more than twice as high as to BAGL. Probably this is because it has been achieving a higher growth rate in its number of locations and in its sales per location.

BAGL's valuation is much lower than NDLS', both on a per-location basis and in terms of a multiple of its sales and profits. So an investor has to decide: bet on the down-trodden BAGL, with its declining sales-per-store, at what appears to be a bargain price? Or pay a steep price to hitch a ride on NDLS' high-growth wagon, which is currently small but growing by leaps and bounds?

But Wait, There's More

While the above information is certainly necessary to take into account when analyzing these two companies, it is not completely sufficient. There are several other pieces of data an investor would want to take under advisement before committing any of his or her capital.

For instance, BAGL pays its shareholders a dividend of about 3.4% each year, while NDLS does not pay any at all. Also, in the unlikely event of a bankruptcy, debt holders get their money back before stock holders do. BAGL's relatively high debt load (its debt as a percentage of its enterprise value is 35% compared to NDLS' 1%) should give an investor pause. Also, BAGL franchises out about half its locations, while NDLS actually owns 84% of its stores. Finally, an investor might want to know who else is on his side. Superstar investor David Einhorn owns over 30% of BAGL, while private equity outfit Catterton Partners still owns nearly 30% of NDLS following its recent IPO.

Conclusion

To make a long story short, evaluating individual companies as potential investments should be an arduous and time-consuming task. After all, we are putting at risk our hard-earned money, in the hopes that the stock we eventually select will not only preserve our capital but also grow it over time. So be sure to look before you leap, and may all your investments be good ones.

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