

El Pollo Loco
NYSE: LOCO
Recommendation: BUY



Company Data

| | |
|-------------------|----------|
| Price..... | \$18.89 |
| Market Cap..... | \$688.7M |
| P/E..... | 23.92x |
| EV/EBITDA..... | 14.70x |
| Price Target..... | \$22.05 |
| Upside..... | 16.7% |

Investment Thesis

We recommend a buy on El Pollo Loco (LOCO) with a target price of \$22.05 and an implied upside of 16.7%. El Pollo Loco is a California-based restaurant chain specializing in “LA Mex” food products, which is a healthy spin on traditional Mexican cuisine.

We believe strong macro tailwinds, paired with an experienced leadership team and dedication to customer satisfaction, make LOCO an attractive investment opportunity. Currently, in the United States, shifting eating habits towards healthier foods and changing demographics due to Hispanic population growth, creates positive tailwinds that LOCO is positioned to capitalize off of. Furthermore, as COVID-19 has accentuated operational efficiency, LOCO’s restaurant structure has evolved and adapted. Finally, LOCO’s relatively new leadership team, which is comprised of all tenured food-service executives, will guide LOCO to sustainable growth and expansion.

Two-Year Performance

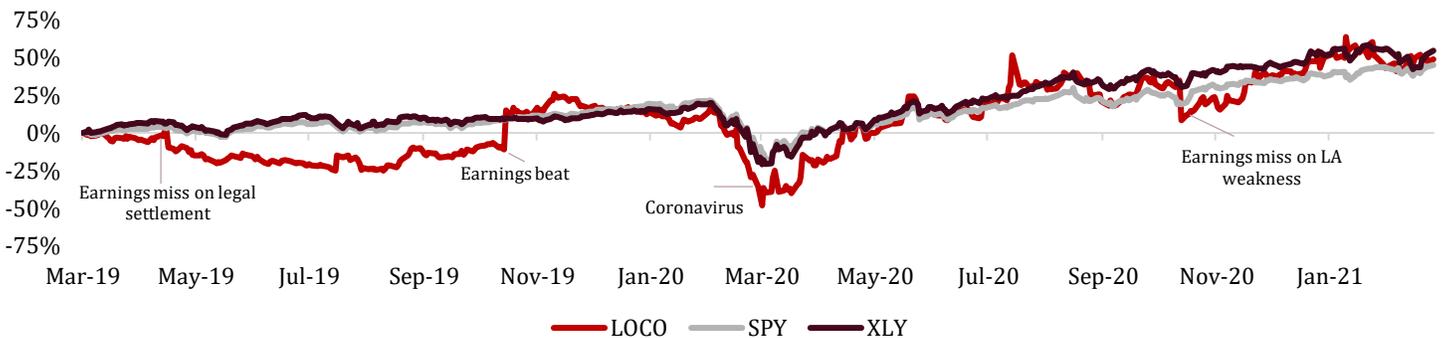


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Business Overview

LOCO is a limited-service restaurant (LSR), meaning it aims to provide the food and dining experience of a fast-casual restaurant at the speed, value, and convenience of a quick-service restaurant (QSR). LOCO specializes in Mexican and LA-style fresh, never frozen chicken dishes that it has coined as “LA-Mex”. LA-Mex focuses on combining the culinary tradition of Mexico with the healthier lifestyle of LA. LOCO has 479 system-wide restaurants located in California, Arizona, Nevada, Texas, Utah, and Louisiana. 80% of system-wide restaurants are in California, and more specifically 60% of system-wide restaurants are in LA. For company restaurants, 73% are in LA, giving LOCO significant exposure to the economy of the Greater LA area.

End Market Overview

Fast-casual retailers are adjusting end markets due to COVID-19. ~91% of off premises U.S. restaurants sales were through drive-thru and carry out transactions. As sales shift towards drive-thru, takeout, and curbside pick-up, retailers are adjusting to a little-to-no interaction model. In addition, fast food customer demographics are changing, with over 75% of millennials consuming fast food on a given day, up ~15% from their Gen X counterparts. Of the millennial’s who are causing a fast-casual boom, ~23% of millennials identify as Hispanic, making millennials one of the most diverse generations in U.S. history. This is resulting in an expanded palate of the younger generation, forcing retailers to adjust their menus and offerings to fit customer’s changing needs.

Macro Tailwinds Driving Demand

LOCO will benefit from the macro tailwinds of healthier lifestyles, an unrealized TAM, and the COVID-19 economic downturn. LOCO is well-positioned to benefit from healthier customer eating habits as it is an LSR focused on healthy, authentic cuisine. Americans are sourcing and eating healthier food with ~70% of Millennials saying they would pay more for healthier and better-quality food options. Additionally, almost ~39% of Americans are eating more vegan foods. LOCO has differentiated itself as a LSR by focusing on the health and dietary inclusion of their Mexican cuisine. Its authentic menu options with strong Hispanic influence also positions LOCO to benefit from the tailwinds of an unrealized TAM. We believe the 3% annualized Hispanic growth within the U.S. will increase LOCO's customer base for authentic LA-Mex cuisine. Although U.S. border states already account for ~50% of Hispanic population, recent Hispanic growth is dispersed across the U.S., providing a growing customer base that will complement LOCO's aggressive expansion plans. LOCO's resilient business model and low-cost quality meals will attract new customers as the economic downturn has shrunk customer budgets, and consumer spending has shifted to value and essentials.

Evolution of Customer Satisfaction

LOCO is continually evolving its practices to best meet customer's changing needs. LOCO's relaunch of its loyalty program has driven loyalty-related sales up by 3% from 4Q19 to 4Q20. We believe this growth will continue as LOCO opens new locations and increases its overall customer base. LOCO has also created its own recipe for vegan chicken, allowing it to service the 15% of Americans who do not eat chicken-based products. With customers in mind, LOCO is also increasing its operational effectiveness by creating

double drive-thrus, drive-thru only restaurants, and GPS enabled pick up. LOCO's goal is to reduce wait times by 50%, which would allow for 2x more customers per day to be serviced.

Experienced Leadership with Focus on Franchise and Partnership Growth

LOCO's new partnership with Organic has positioned the company to increase digital sales to 30% of total sales over the next three years. In 2020 alone, LOCO's e-commerce business grew 3x in size and is projected to keep growing alongside the global e-commerce CAGR of ~14.7% from 2020-2027. LOCO also utilizes a franchise-based growth strategy that requires a comparatively minimal capital commitment and is aimed at generating both strong cash flow as well as high returns on invested capital. Balancing franchise ownership expertise with local market familiarity, we believe that LOCO will achieve its expected 5% annual unit expansion in the U.S. by 2023. This is in addition to its wide-ranging growth strategy to open 140+ restaurants in Western U.S by 2026.

Catalysts

1. Announcement of New Franchisees
2. New Marketing Targets Different Demographics
3. Increase in Food Consumption Awareness
4. Faster than Expected Economic LA Rebound

Risks

1. 2016 Franchise Lawsuit
2. LA & CA Economy
3. Tepid Reception in New Markets
4. Overpopulation of FCRs and QSRs

Comparable Company Analysis

Given LOCO's relative value to peers despite higher margins and what we believe to be better expansion opportunities, LOCO is the most attractive peer. We expect once LOCO finds success in expanding markets, we could see EV/EBITDA multiple expansion, bringing it closer in line with Chipotle (CMG) yet still at a considerable discount. LOCO consistently has a higher ROIC and ROE than peers as well as a lower P/E ratio. On all fronts, except size, CMG is LOCO's largest competition but, as articulated in our thesis points, we do not see this inhibiting LOCO's growth.

Valuation

Using a Discounted Cash Flow model and a conservative EV/EBITDA multiple of 14.7x for the base case, we found an implied upside of 16.7% and a targeted share price of \$22.05. For the bear case, we found an implied upside of 7.9% and a targeted share price of \$20.39. For the bull case, we found an implied upside of 29% and a targeted share price of \$24.36. To arrive at our different outputs, we carefully considered revenue and franchise expansion assumptions as well as multiple expansion. For our potential 3-year price target, we arrived at an upside of 36.4% and a targeted share price of \$25.77 for the base case. We attributed this growth largely to EV/EBITDA multiple expansion that falls in line with the historic trends of competitors, management guidance, as well as our own research. We were conservative with our assumptions as we understand there is additional risk due to LOCO's future success being reliant on franchise expansion and an economic rebound in Los Angeles and California.