THE SUBWAY ACQUISITION AT YEAR ONE: US SUBWAY CONDITIONS NOT IMPROVING

A little over a year ago, the Subway franchisor entity, Doctor's Associates Inc. was finally able to get itself sold to ROARK, the huge private equity group. With one of the longest M&A cycles–9 months-- known in the restaurant space, and with over 70 investors signing and looking at the Book either not being interested or bidding too low, a floor purchase price of $8.995 billion plus another $600 million in terms of earnout was finalized[1]. There was a valuation gap between seller and buyer, hence the earnout, based on future cash flow performance. The EBITDA multiple was not announced, but the best belief is that it was in the 11-12X range. See REUTERS below:

Buyout firm Roark sets conditions to clinch $9 bln-plus Subway deal-sources | Reuters

Subway was a family-owned sub shop since 1965 and experienced powerful unit growth in the 1985-2014 era but has deaccelerated since 2015. Both US and International unit closures occurred, with appx. 7,000 US unit closings through 2023. The co-founder and 49.9% partner, Fred Delucia indicated that 'we would expand units we couldn't and then close units'. There is international expansion potential of course, but the US has to produce the vast majority of the EBITDA necessary to service the debt. Subway is now paying debt service.

The problem is that US Subway conditions are not getting any better. While sales/per unit (AUV) were said to be up in 2023, recently the SSS was confirmed to be down 10-15%, depending on region. While a whole new sandwich platform in the US was developed in 2023, Subway discounted the new items immediately. Currently, every sandwich is discounted via a $6.99 LTO national app offer. While discounting is common in US QSR operations, Subway has always been a heavy discounter. The current offer discounts the whole menu at one time, which is very unusual. To counter franchisee angst, we understand that Subway Corporate is noting there is no variable labor or OPEX associated with discounted sales, to justify the low selling price. [That notion is incorrect]. See the New York Post report:

Exclusive | Subway soda war forces owners to choose Pepsi over Coke or risk losing franchises

It seems that Subway's brand stewardship has been plagued with bad assumptions for decades. One was the assumption that there were no limits on expansion. That has been proven to be false. Another is that its true competitor is McDonald's [due to their extensive number of US units]. And that they had to operate at a similar price point.

[1] Half of the proceeds went to the estate of founder Peter Buck and is not available for restaurant operations and investments.

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That is of course impossible due to different raw material costs [Subway protein raw material and other costs are way above McDonald's and the other QSRs.] Another is the flawed assumption that labor costs nothing in doing marketing analysis.

Not surprisingly, Subway continues to be in warlike conditions with its franchisees. Subway has not operated even one company unit for decades and has no skin in the game. John Chidsey, the CEO since 2018, last year threatened franchisees and told them to go. Chidsey had a very poor record at Burger King 10 years earlier; when it was purchased by 3G Capital at the time, they noted very poor brand management in that era. In 2008-2011, Burger King Corporate and Burger King franchisees engaged in one of the largest conflicts of all time, which ended only after Chidsey and the executive group were terminated after the acquisition. Chidsey's same attitudes seem to be at work at Subway. The highly effective prior CEO of Popeye's and one of the architects of its turnaround, Cheryl Bachelder, noted once, 'A world-class franchise brand cannot be at war with its franchisees'.

We won't know until next spring as to the net number of US units that have closed. We do know a 25-unit multi-unit franchisee closed up in the Pacific Northwest just in August. The problem is Subway unit AUVs are so low, always 40-50% or less versus its direct peers. It has very low unit EBITDA on average, mid-single digits at best, and does not provide enough to cover expenses and debt service. The low EBITDA is a vestige of concept development flaws over the years.

Implications: Along with more small US business franchisee failures, ROARK may well have trouble with the debt service of the $8.995 billion deal. If US units close, franchisor royalties, marketing, and supply chain rebates will be affected. ROARK can throw incremental money at it from other funds. But that was not the goal of the investment, was it? Subway securitized its debt to other debt holders in 2024, expanding the pool of investors watching these developments.