

July 31, 2018

Let's all go to the lobby;  
Let's all go to the lobby;  
Let's all go to the lobby  
To get ourselves a treat.

Delicious things to eat;  
The popcorn can't be beat.  
The sparkling drinks are just dandy;  
The chocolate bars and nut candy.  
So let's all go to the lobby  
To get ourselves a treat.  
Let's all go to the lobby  
To get ourselves a treat.



- Technicolor Refreshment Trailer No. 1, Filmack<sup>1</sup>

Dear Client,

Despite another interest rate hike in June by the Federal Reserve that raised the target federal funds range to 1.75-2.00%, along with plenty of increased tariff talk and (some) implementation by the Trump administration, the investment world was relatively calm in the second quarter of 2018. Three of the four primary asset classes were up for the period: stocks, long-term Treasury bonds, and commodities were all up, while gold was down. As a side note, the decrease in gold offers an interesting counter to the fear of accelerating inflation from wages and what some say is a capacity-constrained economy.

Fears that seemed to be building in the first quarter plateaued, though did not go away. Credit spreads climbed at a decelerating rate and the percentage of stocks above their 200-day moving average increased from a recent low of 40% back above 50%.

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<sup>1</sup> <http://www.filmack.com/products/ClassicLobbyA.htm>

Some of the first quarter's volatility did persist and created a few opportunities. During the second quarter, we initiated positions in two new individual securities: IMAX Corporation and Zoe's Kitchen.

### **IMAX Corporation (IMAX)**

We purchased shares in IMAX Corporation (IMAX) on May 1 at just under \$22 per share. IMAX provides systems to both movie theaters and studios enabling the development and viewing of very large format, ultra-high-definition films. In an era where consumers focus on the "experience," IMAX elevates a trip to the theater. An IMAX film is bigger and brighter than the traditional theater and thus, when moviegoers seek to leave home (and Netflix) more are choosing to see a movie on an IMAX screen and are willing to pay up for that experience.

As well as being trend-right, IMAX has a business protected from competitive threat. There is a network effect in place that, over time, enhances IMAX's business strength: the more theaters that show IMAX films, the more studios want to produce IMAX movies. In addition, the more movies available in IMAX, the more theater owners want to offer IMAX screens. Finally, IMAX still has a long runway for growth. It is an international phenomenon and growth in China (and other emerging markets) has been and should continue to be strong. Today, IMAX has just over 1400 theaters, but sees an opportunity to reach as many as 2855.

Given IMAX's niche, the stock traded as high as \$43 per share in June of 2015. Since then, weaker IMAX global box office numbers combined with a large base of new, but not yet fully productive, theaters in China diminished investor enthusiasm. From our perspective, the decline offered an opportunity to invest in a strong business franchise.

With regard to box office sales, the pattern looks very similar to 2011 when blockbuster movies were similarly weak. After hitting a low of \$13 per share in October 2011, when the blockbuster movie cycle eventually rebounded, IMAX share price followed until it reached the \$43 per share high in 2015. The past few years, IMAX Global box office was similarly challenged. It fell from a high of \$985mm in 2015 to \$966mm in 2016 and \$977mm in 2017. But, the first two quarters of 2018 already show a rebound. In the just reported second quarter of 2018, IMAX global box office reached \$343mm, up 27% over the previous year's second quarter.

Per-theater sales are still lower in China as the theater buildout continues to outpace demand. However, while challenged in China, the global per screen average increased in the second quarter of 2018 to \$263k from \$238k in the previous year. Despite the lower numbers in China, demand for IMAX theaters remains high: theater backlog increased to 635 from 580 a year ago. A rebound in China per theater sales will continue to take time, but there is evidence in the age cohorts that as a theater matures its sales increase substantially.

As the blockbuster cycle turns and China's theaters continue to mature, we think IMAX shares can climb above \$30. In addition, given the runway to add theaters, IMAX could prove an investment that compounds for many years.

### **Zoe's Kitchen (ZOES)**

On June 8, we initiated a position in Zoe's Kitchen (ZOES) at just under \$9.50 per share. Zoe's is a small, fast-casual, Mediterranean-inspired restaurant concept. Today, there are 251 locations. We think Zoe's has ample room for growth. For comparison, more mature fast-casual concept Panera Bread has over 2000 locations.

When we made our purchase, Zoe's had recently announced first quarter results after the close on May 24. Total revenue was up 12.7%, but the more important same store sales number was down 2.3% (both statistics are on a year over year basis.) This was the fourth quarter of down same store sales in the last five quarters, a "no-no" for a growth concept, and investors were panicking. The next day the stock fell 40% and closed at \$8.65 per share. While that one-day move lower was extreme, the stock was already on a downward trend. When same store sales were strong, the stock had traded as high as \$46 per share in July 2015 as investors modeled in years of store-level growth and a massive expansion in unit count. That 80% decline is what happens when years and years of growth embedded in a stock price all-of-a-sudden come into question.

Despite the recent spate of same store sales challenges, we believe \$9.50 is a compelling price for a strong franchise that is aggressively moving to address issues. We were able to purchase Zoe's at a price close to "replacement cost." At \$9.50 per share, Zoe's enterprise value was just slightly higher than the net buildout cost per location. We purchased Zoe's shares at the equivalent of \$800k per each of the 251 existing locations. In comparison, Zoe's pays approximately \$750k net to buildout a new location and about \$50k in "pre-opening" (primarily labor) costs.

Further, unit economics remain healthy. While lower than historical numbers (and what we think possible in the future), current store-level margins are a respectable 16.5%. Corporate expenses mask store-level profitability – the corporate team is currently sized for growth and absent a path to rapidly adding significantly more stores, there is too much overhead.

A restaurant-specialist, activist-investor now controls over 16% of the stock. Additionally, the board and management team responded quickly to develop a strategy to stem same store sales declines. Critically, the firm has expressed a willingness to review "all strategic alternatives" (code word for explore a sale of the company). This type of rapid response is unusual. We believe one of two things will happen quickly: either sales will improve based on several

initiatives and the company will resume growth and leverage the corporate overhead or, the company will sell its profitable 251 units to a larger entity that can leverage its existing corporate infrastructure across a bigger footprint. In either case, we think the stock is worth \$15-20 per share. Like IMAX, there is a significant runway to add additional stores. Therefore, if same store sales improve and growth returns, Zoe's could also be an investment that compounds for many years.

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While volatility has diminished since the first quarter, financial assets remain expensive by many historical comparisons and that creates a system easily prone to disturbance. We remain focused on balancing our efforts – on one hand, continuing to seek out new opportunities such as IMAX and ZOES, and on the other hand watching important signals such as credit spreads and market breadth in order to be ready to batten down the hatches when appropriate.

Have a wonderful rest of your summer and be sure to enjoy a fresh, Mediterranean meal at Zoe's followed by a big, loud, action-packed summer movie on an IMAX screen!

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

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Sincerely,  
*Grey Owl Capital Management*  
Grey Owl Capital Management, LLC

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