

TH International Ltd. (NasdaqCM: THCH)

TH International Ltd. (Tims China) is the parent company of the exclusive master franchisee of Tim Hortons coffee shops for Restaurant Brands International Inc. (RBI) in mainland China, Hong Kong, and Macau. THCH offers freshly brewed coffee, tea, and other beverages; freshly baked goods; sandwiches; and sides. The company launched its first coffee shop in China in February 2019 and has grown to more than 900 stores. The company utilizes an operating model that includes company-owned stores and franchise-operated locations, of various location size formats.

COMPANY HIGHLIGHTS

* TH International Ltd.: A Differentiated Offering in China's Coffee Market

* **Differentiated Product Offering:** We think that Tims China is well positioned to fill the role of a differentiated player in the market by providing strong value for money compared with premium players in the market, while offering a locally adapted food menu. We view favorably its expansion of food orders, which has accounted for more than 50% of transactions in recent quarters and we think supports improving store-level EBITDA margins that reached an all-time high over 10% in 2Q 2024, even as a price war among several industry players has contracted sales growth across the market to date this year.

* **Investment Phase Largely Completed:** THCH has completed much of its investment toward building an infrastructure, including a scalable supply chain and technology system that can support the target footprint in an efficient and economically optimized manner. The company has been able to reduce costs across multiple categories, enabling the achievement of corporate-level positive EBITDA in 2Q 2024, which we view as being a few quarters earlier than expected. We also see the recent divestiture of its nascent Popeyes restaurant business, which had been seeing signals of increasing local competition, easing capital investment obligations over the coming years.

* **Poised to Accelerate Net Location Growth:** At present, there are more than 900 Tims locations across more than 70 cities in China, and THCH has previously cited a target of more than 2,500 locations by 2026. We expect much of this growth to come from an accelerating subfranchise model. Over the past several quarters, the company has been pruning underperforming company-owned stores, consistent with its long-term planning, and recently cited approximately 3,600 potential locations in its franchise pipeline. Thus, we expect new store openings to be back end weighted to the 2025/2026 range and see the company as poised to accelerate store expansion, under the "asset light" franchise model.

* **Solid Financial Position:** As of June 30, 2024, THCH had RMB253.2 million (\$34.8 million) in cash and deposits and had net debt of approximately RMB990.3 million (\$136.3 million). In June 2024, it raised more than \$60 million in operating capital from the sale of its Popeyes restaurant business and the issuance of convertible notes. We think these moves, combined with the elimination of Popeyes-related investments, positive corporate-level EBITDA, and modest capital requirements moving forward, put THCH on solid footing to weather near-term challenges to its business and execute on its Tims expansion strategy.

* **Fair Value:** Based on our enterprise value (EV)/revenue analysis, we see a fair value of \$1.50 per share.

COMPANY/INDUSTRY BACKGROUND

THCH is the parent company of the master franchisee and licensed operator of Tim Hortons coffee shops, one of the largest coffee, donut, and tea restaurant chains in the world, in mainland China, Hong Kong, and Macau. In June 2024, the company sold its nascent Popeyes brand restaurant business, which had 14 active locations, to RBI, the global owner of the Tim Hortons brand. The company opened its first coffee shop in February 2019 and had 907 total stores as of June 30, 2024, consisting of company-owned/-operated and franchised Tims China stores.

Over the past few quarters, the company has pruned underperforming stores while opening new locations under its franchise model. Year-to-date in 2024, the company has added 5 net locations, opening 50 franchised locations while closing 45 company-owned locations. As a result, the percentage of company-operated stores has declined to 63% as of June 30, 2024, compared with 69% at the end of 2023.

Tims China has targeted a total footprint of more than 2,500 profitable stores in 2026, and we expect this growth to be back end loaded, as the company focuses on achieving profitability through the acceleration of its subfranchise model in smaller locations and then resuming expansion in company-owned formats. As of mid-2024, the company has cited more than 3,600 applications received, which we see suggesting robust demand for new store expansion. Consistent with trends since inception, we expect the fourth quarter to be the most active one for new store openings.

In our view, underpinning the opportunity for THCH is a market that is undergoing a generational shift in consumer preferences to coffee drinking from what was historically only a tea-drinking culture. According to the United States Department of Agriculture Foreign Agricultural Service, per capita annual consumption of coffee in China in 2020 was only 19 cups, compared with 628 cups in the United States and 494 cups in Japan. Subsequently, according to China Briefing, China's coffee market grew by 31% in 2021, which compares favorably with a mature international growth rate of only 2%.

Despite this growth, we see the market as still being in its early stages of development and offering lots of white space for future growth. We are encouraged by initiatives of the Chinese government to support this expanding development. In October 2022, coffee cultivation and production were included in the government's Catalogue of Encouraged Industries for Foreign Investment. Starbucks entered the Chinese market in 1999 and had more than 7,300 locations in China as of mid-2024, mostly in larger formats. Over the past decade, Luckin Coffee has surpassed Starbucks, with more than 18,500 stores as of mid-2024.

Over the past several quarters, however, the industry has seen pricing pressures, as the entrenched market players including Luckin and Cotti have sacrificed margin for revenue and unit growth expansion. We expect this pricing trend to be transient in nature, given the impact on corporate profitability, but see potential for this to accelerate the overall customer expansion of the category. Under this scenario, we see Tims China's product differentiation, driven by a higher level of orders including food items compared with its peers, to drive customer adoption and market share growth.

In June 2024, Tims China sold its Popeyes restaurant business to RBI, which had licensed the brand in China in early 2023. Since opening its first store in August 2023, THCH had opened 14 locations. Despite our positive long-term demand outlook for the Popeyes brand in China, we see the decision to divest as financially prudent, given signals of increased competition in the local market and the company's prioritization on driving profitability in the core Tims business.

INVESTMENT THESIS

In our view, the company has completed much of its investment toward building an infrastructure that can support the targeted footprint. Over the past few years, it has established the Tims China brand through the opening of a base of primarily large-scale, company-owned stores, as well as by building out a scalable supply chain and technology system that can accommodate additional store growth and brand additions over time. We view positively that THCH's supply chain focuses on sourcing fresh ingredients from suppliers that have a Global Food Safety Initiative certificate, a widely recognized food safety standard.

We see the company executing on a high return on investment strategy building upon investments already made. We expect the focus of future store growth to center around densification of established areas, both through subfranchising and smaller format locations. We view this strategy favorably, given the limited capital investment required and the enhanced profitability due to the scalability and higher margin of the franchising model.

We note that leading franchise partners include leading convenience store chain Easy Joy (a subsidiary of oil and gas company China Petroleum & Chemical Corp.) and real estate company Century 21, which are already well established and vetted, thus lowering THCH's execution risks. We expect many new store locations in high-traffic locations, including gas station convenience stores, subway stations, and others that can accommodate smaller formats, all of which will utilize THCH's supply chain, technology systems, and menu boards and benefit from lower labor burdens.

We see THCH benefiting from investments in developing locally relevant and product-tested menus, which we believe have been key for Western brands to achieve success in China. These menus also focus on innovation, as THCH introduced more than 100 new products in 2023, nearly split between food and beverage categories, and has announced a goal of a new beverage or food product every two-to-three weeks.

Although coffee is the largest revenue driver at Tims China locations, we are encouraged by the growth in food-included orders, which has exceeded 50% of all orders since the fourth quarter of 2023. We think this has also contributed to store-level adjusted EBITDA margins that have been resilient during the challenging market environment and reached an all-time high of 10.3% in the second quarter of 2024.

We note that freshly prepared food on the menu represents another area of differentiation compared with its peers. To that end, we are encouraged by recently completed renovations to nearly 300 of its locations, which enable customers to see its made-to-order, fresh food being prepared. We also see the variety of store formats enabling smaller locations with varied food and seating options, in contrast to chains such as Starbucks, which is largely concentrated in larger store footprints.

We also view THCH's use of mobile and digital technologies as supporting its growth amid China's use of mobile devices in daily routines. Since 2020, digital ordering has increased from 64% to over 80% of all transactions, including delivery and mobile ordering for self-pickup, reaching 86.5% in the second quarter of 2024.

In addition, the Tims app is prominently featured across the digital ecosystem to facilitate this trend for increased digital ordering and marketing on vertical service platforms, including Eleme and Tmall, and social media platforms, including WeChat, Weibo, Weixin, Xiaohongshu, and TikTok.

Despite challenging revenue growth year-to-date, we view positively the robust growth in monthly average transacting customers, which increased by 12% year over year to 3.1 million. In addition, loyalty members, which tend to spend considerably more than nonmembers, expanded

to 21.4 million, representing 45% growth. We note that the company had approximately 2 million loyalty members at the end of 2020. Thus, we see room for additional growth among its registered customer base as the company continues to scale its operations.

RECENT DEVELOPMENTS

Tims China shares trade on the Nasdaq Capital Market under the symbol THCH. In 2023, THCH shares declined by 37%, compared with a 24% increase for the S&P 500. Year-to-date in 2024, the shares have fallen 64% compared with a 16% increase for the S&P 500.

In August 2024, THCH reported second-quarter 2024 results, which saw an 11% decline in total revenues (6.6% decline for the first half of 2024) but an all-time high in store-level EBITDA at 10.3%. The second quarter marked the company's eighth consecutive quarter of positive adjusted store-level EBITDA. The company also announced that Tims China surpassed 21 million registered loyalty club members, representing 45% year-over-year growth.

In June 2024, Tims China sold its Popeyes China business to RBI for cash proceeds of \$9 million (equivalent to an enterprise value of \$15 million) and secured \$50 million in financing through the issuance of convertible notes.

On May 31, 2023, THCH announced that it was added to the MSCI China All Shares Small Cap Index.

EARNINGS & GROWTH ANALYSIS

We forecast that THCH will post revenues of approximately RMB 1.54 billion for 2024 (approximately \$216 million at current exchange rates) and RMB 1.69 billion (\$237 million) for 2025, which would represent a 2% decline and 10% growth, respectively. We expect near-term revenue growth to be challenged by the pricing environment in China's coffee market, as well as the pruning of company-owned stores and the transition to a majority of new stores falling under the franchise model.

The company ended the second quarter of 2024 with 907 stores, approximately 63% company owned and operated, down from 69% at the end of 2023. Over the next two-to-three years, we expect most new store openings to be subfranchised and expect that franchised locations will surpass company-owned stores as the company executes its strategic expansion program.

Thus, we see this shift slowing the rate of top-line growth but enabling an accelerated path to profitability, as the company will receive a largely expense-free percentage of gross revenues of franchised units in perpetuity.

While THCH reported 7.6% same-store sales growth in 2023, this trend has turned negative in 2024, which we attribute to macroeconomic pressures in China and pricing dynamics in the coffee market, which we expect will be transient. We expect future results to reflect improvements in efficiency, as THCH leverages its supply chain and infrastructure, which is largely built out at this stage.

In terms of operating margins, we are encouraged by prospects for THCH to reduce its cost burden as a percentage of revenues moving forward, as costs shift to franchisees, as well as smaller format locations, which can generate favorable growth and profitability from inception. We expect its company-owned store sales to become more profitable as its fixed costs are spread across a wider corporate footprint.

For 2024, we expect operating expenses to comprise 97% of revenues, compared with 105% in 2023. We expect this figure to decline further, to 93% of revenues, in 2025. The

company has seen reduced food and packaging, rental, and labor costs as a percentage of revenue. We project adjusted EBITDA store-level margin expansion to 10% for 2024, up from 4.9% in 2023, and 15.2% in 2025, boosted by fewer store-opening-related costs. Corporate-wide, we project adjusted EBITDA of -2% in 2024, despite a -15.4% margin in 1Q 24, and 1.5% in 2025.

We project diluted net loss per share of RMB1.97 (\$0.28) in 2024 and net loss per share of RMB1.22 (\$0.18) in 2025, using a recent renminbi-to-dollar exchange rate of 0.14. On an adjusted basis, we forecast net loss per share of RMB 1.62 (\$0.23) in 2024 and RMB 1.00 (\$0.14) in 2024 and 2025, respectively.

FINANCIAL STRENGTH & DIVIDENDS

Our financial strength rating for THCH is Low-Medium. As of June 30, 2024, the company had cash and deposits of RMB253.2 million (approximately \$34.8 million), down from RMB611.5 million (\$86 million) at the end of 2022, primarily due to the expansion of its business and store network, partially offset by an increase in bank borrowings. Cash use also included a true-up payment to investors under a previous equity support agreement (ESA).

In June 2024, Tims China secured up to \$65 million in aggregate funding from its founding shareholders, Cartesian Capital Group LLC and RBI, which included \$50 million in three-year convertible notes (\$40 million issued at closing). As part of the transaction, Tims China sold its Popeyes business to RBI for cash consideration of \$9 million, reflecting an enterprise value of \$15 million, and Tims China extinguished the deferred consideration due to former shareholders of Popeyes China via issuance of a \$15 million convertible note. Previously, in March 2024, Tims China had entered into new promissory note borrowing agreements for \$20 million with Cartesian Capital. (These notes were tendered in consideration for \$20 million of the new three-year convertible notes mentioned above.)

As of June 30, 2024, THCH had a negative working capital position of RMB597.7 million (\$82.2 million), which translates into a current ratio of 0.45, which compares favorably to 0.3 in the prior quarter. The company's net debt, with approximately 32% short-term borrowings and 68% long-term convertible notes, is approximately RMB990.3 million (\$136.3 million).

With the divestiture of the Popeyes business, which was at an early stage and would have required significant operating capital over the coming years, we expect THCH's balance sheet to improve moving forward. We see the achievement of positive corporate-level EBITDA several quarters ahead of our estimate beginning to reflect the leveraging of Tims China's supply chain across a store base that shifts to new franchised store locations. Such operations carry little investment requirement and expense exposure, while providing a percentage of those restaurants' gross sales to THCH.

Net cash used in operating activities in 2023 was RMB196.1 million (\$27.6 million), which is more than 30% narrower than the net cash used of RMB286.9 million (\$41.6 million) in 2022, as the company continued to expand its corporate store footprint. During the first half of 2024, company operations generated positive RMB5 million in cash, compared with cash used of RMB 85.1 million in the same period in 2023.

In 2023, net cash provided by investing activities was RMB60 million (\$8.4 million), compared with net cash used of RMB705.2 million in 2022, which was impacted by a collateral account balance invested in U.S. Treasury bonds through an ESA collateral account that holds the underlying assets. In the first half of 2024, net cash used by investing activities totaled

RMB28.7 million, compared with cash provided of RMB64.2 million in the same year-ago period.

Net cash provided by financing activities in 2023 was RMB80.3 million (\$11.4 million), compared with net cash provided in 2022 of RMB827.2 million, with former-period results driven by net proceeds from ESA investors, private investment in public equity investors, and bank loan drawdowns. For the first half of 2024, financing activities used RMB11.8 million, compared with cash provided of RMB28.6 million in the same period in 2023.

In September 2022, in connection with its IPO, THCH issued 22.9 million warrants, consisting of 17.25 million public warrants (at a strike price of \$11.50), and 5.65 million private placement warrants. In June 2023, the company completed an exchange of all of these public and private warrants for 5.42 million common shares.

THCH does not pay a dividend, and we do not expect the company to initiate such a program in the foreseeable future.

MANAGEMENT

Yongchen Lu has been THCH's chief executive officer since its 2018 inception and a director since September 2022. Mr. Lu served as the chief financial officer of Burger King China from November 2012 to April 2018 and previously was China representative for Cartesian Capital Group, a global private equity firm. Mr. Lu is a certified Six Sigma Black Belt and holds a bachelor's degree in international finance from Shanghai Jiaotong University and an MBA from Tuck School of Business at Dartmouth College.

Peter Yu has been THCH's chairman since its 2018 inception and is a managing partner of Cartesian Capital Group. He was previously the founder, president, and CEO of private equity firm AIG Capital Partners Inc. (AIGCP), which became a leading international private equity firm, with more than \$4.5 billion in committed capital, under his leadership. Prior to founding AIGCP, Mr. Yu served President Bill Clinton as director of the National Economic Council, the White House office responsible for developing and coordinating economic policy. Mr. Yu is a graduate of Harvard Law School and served as president of the *Harvard Law Review* and as a law clerk on the U.S. Supreme Court.

As of June 30, 2024, affiliates of Cartesian Capital Group owned approximately 50% of the outstanding ordinary shares. Other prominent investors include Tencent Holdings Ltd. (12.5%), Sequoia Capital China (8.3%), and RBI.

As of August 2024, THCH's board of directors consisted of eight members. We note that the sale of the Popeyes China business granted RBI the right to appoint two directors to Tims China's board.

RISKS

Risks to an investment in THCH include intense competition and the potential for pricing dynamics impacting sales and margins in China's coffee shop and food and beverage industries; sensitivity of inflation rates to the prices of commodity inputs to its products, labor, and transportation; reliance on continued favorable macroeconomic trends toward consumer discretionary spending on the out-of-home coffee and food categories; the need to continually develop new products that are accepted by its customers; and disruptions to its supply chain and technology systems. We also anticipate equity dilution over the coming years as recently issued convertible notes are converted to common shares.

VALUATION

With a recent stock price falling below \$1 per share and a market capitalization around \$100 million, representing a decline of approximately 70% over the past 52 weeks, we do not see THCH's valuation accurately reflecting its long-term growth potential in China's coffee market.

While we expect the near-term valuation to be hampered by the current market dynamics in China, which have seen unfavorable same-store sales trends and declining revenues for THCH amid a price war across the industry, we see the rapid expansion of its own loyalty program to over 21 million members and the robust franchise interest from more than 3,600 applicants as underappreciated by investors. We think that robust growth trends, including improving store-level EBITDA growth, differentiation from more than 50% of orders including food, and most transactions being conducted electronically are likely to improve THCH's financial results and, in turn, investor sentiment over time.

We expect expansion of the store footprint, for which the company has set a target of more than 2,500 locations in 2026, to be back end loaded, with most of the new locations coming from subfranchisees through established groups and being smaller in format, which should promote strong store launches in high-traffic locations and an accelerated path to profitability.

As such, we expect a growing operational footprint to ease concerns over Tims China's balance sheet and its cost structure over the coming years, with the achievement of positive corporate-wide EBITDA in 2Q 2024 likely to serve as validation of its model and the profitability potential for the business. Moving forward, although we see revenue growth challenged over the near term due to unfavorable market dynamics in China and moderating under a subfranchise-driven model compared with the company-owned model over the longer term, we expect operating margins, operating cash flows, and profitability to all improve, supporting a more sustainable growth trajectory.

We value THCH in comparison with the leading public coffee companies operating in China. Primary players Starbucks (EV/2024 consensus revenue of 3.5-times) and Luckin Coffee (1.3-times) average 2.4-times as a group. We have removed Yum China Holdings Inc. from our group, given THCH's recent sale of its Popeyes restaurant business.

Since we expect THCH to grow at an attractive rate moving forward as it implements its subfranchise model with a prioritization on profitability, we value the company at a modest discount to this average, reflecting the balance sheet overhang and the still early stage of its footprint expansion efforts.

Thus, we apply a multiple of 2.2-times our 2024 revenue estimate of RMB1.54 billion. After adjusting for net debt and assuming a fully diluted share count of approximately 230 million, we arrive at an EV/revenue derived fair value of \$1.50 per share. (Steve Silver, Argus Research Analyst)