Tim Hortons mania at a boil

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Up and down Bay Street, telephones are ringing. Brokers are answering them, and regretting it.

"ABC Securities, John speaking."

"John! It's Marty."

"Uh . . ."

"From Musquodoboit Harbour. I'm the second cousin once removed of the guy who was the best man at your wedding."

"Um . . ."

"I split my pants doing the Macarena."

"Ah, Marty! Right. That was eight years ago."

"Whatever. Listen, I was reading about this **Tim Hortons** IPO, and I want a piece of it. I'll open an account and everything. I want ten thousand bucks' worth, okay?"

"I don't think I can . . ."

"Seriously, John. I mean, this has got to be the greatest business in the world. How much does it cost them to make a cup of coffee? Like, 15 cents? What are the profit margins on that?"

"You know, uh, a lot of people want . . ."

"I know you won't let me down, buddy. I'll send you a cheque next week, okay? Gotta go." (Click.)

News stories about the Hortons deal say that parent company **Wendy's International** is "selling" a minority interest of the beloved doughnut chain. A more accurate version would say, "beating back investors with a stick." The underwriters' order book runneth over.

One broker at RBC Dominion Securities, the top Canadian brokerage firm on the deal, says he has been fielding scores of inquiries. Not this week. Not last week. "Since October," he said.

With a maximum of 33.4 million shares to be sold, and most of it going to U.S. funds, and most of the rest going to Canadian institutions, there's little hope for the humble retail investor. In other words: Like Marty, you ain't gettin' any. You might as well accept it, and figure out at what price it's still worth buying once it starts trading.

Fortunately, the task is easier with Tim Hortons than with most new issues. The company is highly profitable, spits out geysers of cash flow, and has minimal debt. Management, led by chief executive officer Paul House, is experienced and capable. The brand name is unassailable in Canada. This is a stock Warren Buffett would own, except that he didn't get rich by buying mania IPOs.

So valuation is the only question, and the key to Tims true worth is how much growth it can deliver in the United States. Every spare patch of urban land in Canada now seems devoted to serving crullers -- there's one store in this country for every 12,500 people.

Applying the same ratio would get you 23,000 U.S. outlets, which of course is ridiculous. But there seems plenty of room to go up from the current total of about 300. Threequarters of them are in three border states -- Michigan, Ohio and New York; there are only a few stores in Massachusetts and Pennsylvania and none in Minnesota or North Dakota. Wendy's management has set a goal of 500 stores by the end of 2008.

CNBC screamer Jim Cramer might think Tim Hortons is "not a growth story," but then, he's certifiably Mad.

Despite solid sales, Tim Hortons is still unprofitable in the U.S. -- it reported $4.3-million in operating losses last year. That may seem ominous, but most of the outlets are quite new. Even with those startup losses, the company should produce $269-million in free cash flow this year, according to **Veritas Investment Research.**

That works out to about $1.39 a share, post-IPO, which is our starting point. What kind of growth should you anticipate? Does 8 per cent seem reasonable? If they can get the U.S. stores working, that may be too conservative. But assume that free cash flow grows at that rate for the next five years, after which its slows to the rate of the economy -- let's say 3 per cent.

The final piece of the puzzle is the discount rate, which is really just what you think you could earn by putting your money in another investment with similar risk -- say, 9 per cent, a good long-term average for a developed nation's stock market.

Discounting the cash flow at that rate gives you a value of about $29.50 per Tim Hortons share. **Veritas** analyst **Peter Holden** figures that's about what the existing business is worth; at that price, you're getting an option on the new stores for free. The IPO range is $25 to $27. Wendy's is not being greedy here.

You can fiddle with the numbers to produce any value you want, of course. If you believe Tims is less risky than most equities, and will grow faster than 8 per cent, you can easily justify $37 or $38 a share. Pay more than that, though, and you are starting to make some rather optimistic assumptions about what Tim Hortons can achieve in the U.S. (A better way to play it might be to buy Wendy's itself, which is likely to spin out the rest of its Hortons stake to shareholders in the next year.)

None of this is to say Tims stock won't go to $40, $45 or higher in the days and weeks after it hits the market on Friday. That sort of thing can happen when emotions overrule reason, and when the investing public thinks it has spotted a sure thing.