ARAMARK (ARMK)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

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<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>47 - 10</td>
<td>Suitability:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Cap (mil):</td>
<td>6,463</td>
<td>Price Target ($) :</td>
<td>24</td>
<td>Q1</td>
<td>0.62A</td>
<td>0.62A</td>
<td>0.38E</td>
</tr>
<tr>
<td>Shares Out (mil):</td>
<td>252.4</td>
<td>L-Term Rev. Gr Rate Est:</td>
<td>3%</td>
<td>Q2</td>
<td>0.45A</td>
<td>0.26A</td>
<td>0.33E</td>
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<tr>
<td>Float (mil):</td>
<td>249.1</td>
<td>L-Term EPS Gr Rate Est:</td>
<td>9%</td>
<td>Q3</td>
<td>0.47A</td>
<td>(0.63)E</td>
<td>0.35E</td>
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<tr>
<td>Avg. Daily Vol (mil):</td>
<td>4.75</td>
<td>Debt/Cap:</td>
<td>71.5%</td>
<td>Q4</td>
<td>0.68A</td>
<td>0.14E</td>
<td>0.57E</td>
</tr>
<tr>
<td>Dividend ($) :</td>
<td>0.44</td>
<td>ROE:</td>
<td>3.5%</td>
<td>Total</td>
<td>2.22A</td>
<td>0.39E</td>
<td>1.63E</td>
</tr>
<tr>
<td>Yield (%):</td>
<td>1.7</td>
<td>FY P/E</td>
<td></td>
<td>FY 2019A</td>
<td>11.5x</td>
<td>65.7x</td>
<td>15.7x</td>
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<tr>
<td></td>
<td></td>
<td>EPS (Cal)</td>
<td></td>
<td>2020E</td>
<td>0.15E</td>
<td>1.70E</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>P/E (Cal)</td>
<td></td>
<td>2021E</td>
<td>11.5x</td>
<td>NM</td>
<td>15.1x</td>
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Company Description

ARAMARK (ARMK) is the third-largest global provider of outsourced food and facilities services to business and industry, education, healthcare, sports and leisure and corrections end markets with a heavy concentration in North America. The company is also North America’s second-largest uniform rental and career apparel provider.

Revenue Profile

Aramark Revenue and EBIT by Segment, F2019

Competition

Food & Support Services: Primary-Compass Group (CPG-LON), Sodexo (SW-PAR); Secondary-RentoKill (RTO-LON), MITIE Group (MTO-LON), ABM Industries (ABM), ISS A/S (ISS-CSE)

Uniform and Career Apparel: Cintas (CTAS), UniFirst (UNF), hundreds of regional competitors

Quick Summary

Activist turnaround story, but COVID matters more now. The prior "bull" thesis was underpinned by an activist investor creating value through management upgrade, growth investments, and consideration of strategic options. These actions are on hold until COVID passes. That said, even pre-COVID, it was clear structural changes were going to take time with hopes for better revenue growth coming at the expense of margins. Ultimately, improving ARMK’s service model and resulting customer retention rates is the greatest fundamental opportunity; this fact is not new. Perhaps more importantly for the near term, potential for bigger portfolio changes, including a uniform sale/spin transaction, appear less likely/imminent now, in our view.
- **Defensive platform (in theory).** A "normal" economy would typically allow ~10% EPS growth potential and reliable FCF generation with ARMK’s valuation at a substantial discount to peers. This has been the bull case since the IPO with execution of the plan inconsistent, and hoping for a different future, post COVID.

- **Recent results.** ARMK pre-announced F2Q20 results given COVID with revenue trending down ~50% in April with decremental margins holding stable at ~20%, a pretty good outcome actually. FCF expectations were more materially hit than we expected, however. Offsetting, previously announced balance sheet actions take liquidity concerns off the table, with flexibility to respond to COVID challenges. Variable cost structure helps and revenues should (eventually) recover.

**Investment Thesis**

The call: Too much COVID uncertainty and too much financial leverage keep us Neutral-rated. Revenues trending down ~50% and an uncertain path to both timing and robustness of re-opening (particularly for key customers in Education and Sports) keeps us on the sidelines, especially considering above average leverage and softer cash flows. Fortunately, ARMK has been able to limit margin pressures (decremental margins of 20% are still painful however) and cash flow damage as well as shore up its balance sheet to position the company to weather the storm. Still, it’s unclear how ARMK’s relative competitive position will fare through this. The prior thesis underpinned by an activist investor creating value through management upgrade, growth investments, and consideration of strategic options is therefore on hold until things settle back down.

Beneficiary of outsourcing trend. ARAMARK’s customers have increasingly outsourced non-core business functions, a trend we expect to continue, with ~50% of ARAMARK’s addressable market still self-performed. In most cases, ARAMARK can provide immediate cost savings for its customers and enhance the overall service quality of the function. As customers increasingly solicit single-source providers, we believe ARAMARK is well positioned to gain share as one of the industry's largest providers in a highly fragmented market.

A cash flow story. Limited working capital needs, capex at ~3.25% of revenue, and (generally) consistent, recurring revenue underpin the business model lending ARAMARK to cash flow oriented investors. Despite still high leverage, management eventually will target ~3.0-3.5x post COVID. We wouldn't be surprised to see a dividend cut and we don’t expect usage of its buyback program either, however.

Uniform rental offers some operating leverage. ARAMARK is also the second-largest uniform rental provider in North America. However, the company has lost share over the past several years as it has placed more emphasis on expanding its food and support services business. Nevertheless, the uniform segment generates higher operating margins for ARAMARK with strong free cash flow, over a higher fixed asset base, offering some operating leverage. Strategic opportunities here, perhaps.

**Risks & Caveats**

Highly competitive market with only modest barriers to entry. The Food and Support Services business is highly competitive and does not require much capital investment. While scale, brand, and reputation certainly give ARAMARK an edge in this segment, especially with larger client contracts, pricing still weighs heavily in the client’s decision making process. More deeply penetrated verticals (such as sports/entertainment and B&I) see greater relative price competition versus less-outsourced verticals (education/healthcare).

Contract structure often puts risk to ARAMARK. ARAMARK operates its Food and Support Services businesses using three contract frameworks. Profit and Loss Contracts and Profit Sharing Contracts (~75% of FSS revenue) are the most typical contract types within this segment. While these contracts have some differences, they are similar in that ARAMARK bears the total profit risk for services rendered. The third contract type is the Client Interest contract where ARAMARK earns a "fee" for its services while the client bears the revenue and expense risk. Contract structure is therefore a risk that may otherwise be overlooked.

Food inflation and/or minimum wage raises could increase costs. A significant portion of ARAMARK’s revenue is U.S. based, where the majority of employees are variable hour employees. Higher labor costs (minimum wage increases or other factors) could pressure margins as could general food inflation (representing ~20-25% of COGS).

**Supplemental Information**

**Aramark Valuation Chart**

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<tr>
<th>F2Q20 Multiples</th>
<th>Forward P/E</th>
<th>Forward EV/EBITDA</th>
</tr>
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<tbody>
<tr>
<td>Historical Range</td>
<td>10.4x-48.3x</td>
<td>7.3x-14.9x</td>
</tr>
<tr>
<td>Historical Average</td>
<td>17.4x</td>
<td>11.4x</td>
</tr>
<tr>
<td>$24 Price Target Assumes:</td>
<td>13.9x</td>
<td>8.5x</td>
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</table>

*Source: Baird research*
Appendix - Important Disclosures and Analyst Certification

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Covered Companies Mentioned
All stock prices below are the 5/18/2020 closing price.

Cintas Corporation (CTAS - $236.43 - Neutral)
UniFirst Corporation (UNF - $170.53 - Outperform)
(See recent research reports for more information)
1 Robert W. Baird & Co. Incorporated makes a market in the securities of ARMK, CTAS and UNF.

10 Robert W. Baird & Co. Incorporated and/or its affiliates have been compensated by UniFirst Corporation for non-investment banking-securities related services in the past 12 months.

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