A Special Situation at Steak n Shake

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I learned of H. Kevin Byun and his recently launched hedge fund, Denali Investors, through the value-investing grapevine. Upon learning that his fund focused on special situations, I thought it'd be fun to pick his brain about one of his favorite ideas. The following is an interview I conducted with Kevin.

Emil Lee: Can you give us a little background about yourself and your firm?

H. Kevin Byun: I manage Denali Investors, which is a value-based investment partnership. The firm invests with a concentrated, focused approach, meaning typically five to 10 best ideas, to build a diversified portfolio. I started Denali after graduating from Columbia Business School, which I attended specifically for the Value Investing Program. Before that, I was in investment banking for more years than I care to remember.

Lee: Can you explain your investing framework?

Byun: The framework is straightforward in that we look for ideas that have highly skewed risk-reward ratios. For every unit of risk, the compensation must at least offer five units of reward.

Notice that risk is considered first -- protect the downside. We consider risk a permanent impairment of capital, NOT beta, the typical definition of risk. This seemingly insignificant difference gives us a big structural advantage to the market. Value and high beta are not necessarily mutually exclusive. Also, we are able to take a long-term view, another critical but perhaps underappreciated difference.

Lee: How did you get interested in one of your special-situation picks, **Steak n Shake** (NYSE: SNS)?

Byun: [A year ago], I created a database of about 60 restaurants that allowed me to rank across various metrics, to get an apples-to-apples comparison. As a result, Steak n Shake came across my radar. I found that it was at the top of my list in terms of optionality in the business model, meaning there was (1) a ton of underlying value in assets; (2) a largely company-owned unit base; (3) underperformance in operational metrics; and (4) [it was] fairly under-saturated. My view was that action on any of these fronts would unlock substantial embedded value.

Lee: How do you go about valuing a restaurant company?

Byun: In my view, there are four major drivers to restaurant value. (1) Asset backing -- generally meaning real estate. The spectrum ranges from fully leased to fully owned land and buildings. (2) Franchise mix -- what portion of the unit base is company-owned versus franchised? The spectrum ranges from fully franchised to fully owned units. (3) Operational performance -- is the business making money at the store (four-wall) level and at the corporate level? There is a wide spectrum of operational performance. (4) Saturation percentage -- how many units should the concept have? Is this a 20-unit company in which saturation is 50 units, or 5,000?

After having done the deep dive on the company, I realized that as a non-activist investor, that value could be embedded in the company indeterminately. Therefore, I came to the conclusion, albeit reluctantly, that things might not change for a long time and therefore decided to pass on the opportunity back in 2006.

Lee: But now, is there is a catalyst that may unlock shareholder value?

Byun: Interestingly, the situation changed recently. This summer, an activist investor cut from the same cloth as Buffett, Munger, Graham, and Dodd became involved. Although we have not spoken, I believe Sardar Biglari's thesis has similar underpinnings as my analysis from last year. His track record of unlocking and creating value is absolutely wonderful. That he is involved, has requested two seats on the board, and owns close to 10% of the company gives me comfort that proactive steps will be taken to unlock embedded value. I feel it is worth mentioning that the stock was compelling to me last year at $16 to $18 per share. Now the stock is around $10 to $11 per share, and I recently built a position.

Lee: What do you think the company is worth?

Byun: Well, when I do a bottom-up, unit-level analysis and add the various parts of the value drivers together, I get to at least $20 per share as a floor valuation. I believe realistically there is much more value to the upside, into the $30s, but that is gravy in my view. Most of the unlocking of value is weighted in the asset backing and franchise mix, with a contribution from potential operational improvements and additional units. I don't necessarily want to get into all the numbers. I will say that one can get to a high level of granularity in relevant data, and that data shows that this situation is very attractive given the underlying value. Depending on certain management actions, this value could be recognized gradually, or in a stairstep fashion.

Lee: How do you feel about the competitive landscape, especially Steak n Shake compared to other 24-hour diners like **Denny's** (Nasdaq: DENN) and **IHOP** (NYSE: IHP)?

Byun: Restaurants are a brutally competitive business, so it is foolhardy to assume away the very real competitive threats posed by the likes of Denny's, **Carl's Jr.** (NYSE: CKR), or my grandma's cooking. After all, eating is close to a zero-sum game, as we don't go to more than one place for lunch, right?

The demographic set that enjoys a STEAKBURGER and a shake are ones that are unlikely to change their habits soon. Same goes for the sets of people that frequent other concepts. So I feel there is actually significant upside potential in terms of top-line unit-level performance, as well as unit expansion from the current unit base, given a much higher saturation potential and [the] travel-ability of the concept.

Lee: What are the risks involved with this position?

Byun: Well, in these embedded-value scenarios, actions of the management are key. There is an outcome band which, on the downside, can include circling the wagons, a scorched-earth policy, poison pills and puts, or other destructive behavior. Realistically, I don't see this being the case here, but rather more likely the opposite.

Also, as with any business, there are risks at every point in the revenue cycle and the expense cycle. You have looming recessionary concerns. Since we are dealing with the main product being food, I'll point out that any restaurant with a significant beef and dairy component is necessarily correlated to cows.

But fundamentally, the thesis remains that the catalysts for SNS are largely agnostic to the market, and the unlocking of embedded value, via the value drivers above, is a matter of decision-making at the executive level.

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