Why Shake Shack's IPO Should Be As Popular As Its Burgers

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Summary

- Burger and shake restaurant chain Shake Shack is preparing for an IPO.
- Shake Shack offers investors growth potential, proven leadership, and strong customer appeal.
- Its responsible approach to growth and other less visible factors are also attractive.

Customers are used to lining up for Shake Shack, the New York City-based burger and shake chain of fast casual restaurants. Soon investors will also probably want to join the queue to take a bite of the chain when it launches its upcoming initial public offering.

Rumors have valued Shake Shack as high as $1 billion, which represents 50 times the company's projected earnings of about $20 million this year. On the one hand it seems unbelievable that a small, regional restaurant chain could be valued at that level. But not so much when compared to El Pollo Loco Holdings Inc. (NASDAQ:LOCO), which raised $123 million in July and now trades at about 60 times projected 2014 earnings, and Zoe's Kitchen Inc. (ZOES), which held an IPO in April and now enjoys an forecasted 2014 P/E ratio of 400+.

Shake Shack certainly has the right combination of factors that suggest a very promising future. Among the most obvious is unit growth potential. The company operates approximately 50 units in several major metropolitan areas in the Northeast, and has a handful of restaurants outside of the U.S. in London, Dubai and Moscow. Other better-burger chains are far more developed, with Smashburger operating around 250 units and Five Guys Burgers and Fries with over 1,000. Although Shake Shack has stepped up expansion efforts, opening 35 units in the last 3 years alone, there is still plenty of growth opportunity before all the major metropolitan centers in the U.S. alone are home to the brand.

There's also customer fanaticism. The chain is too small to be tracked by the usual customer surveys, but the around-the-clock lines to get into a Shake Shack testify to widespread appeal of the brand. And its average U.S. store volume is around $4 million, more than twice that of McDonald's (NYSE:MCD) U.S. average. Moreover, the brand counts many celebrities as its fans, including U.S. President Barack Obama and actress Tina Fey, which means it is often the beneficiary of buzz and free media coverage.

Shake Shack is also an attractive company because of its leadership. It is owned by Union Square Hospitality Group, which also owns some of New York City's most iconic and long-standing fine dining options including Gramercy Tavern. USHG CEO Danny Meyer has a proven track record of operating popular, profitable restaurants, and he is admired by many business leaders especially those in the hospitality sector who study and try to imitate his management practices. Randy Garutti, with a hotel restaurant administration degree from Cornell University, worked his way up at Union Square Hospitality from general manager at its restaurants to lead Shake Shack as CEO. He and Meyer have a solid, long-standing working relationship -- and together they form a formidable leadership team.

Some other less visible and well-known reasons should make Shake Shack appealing to investors as well. First, Shake Shack's leadership takes a responsible approach to growth, both in terms of unit expansion and menu development.

Garutti explains that, unlike most chain operators, "We never talk in terms of 'units' or 'templates' or 'how fast can we go?' We talk about, 'What great community can we be part of? How can our other restaurants get better and busier in the process of opening another Shake Shack?'" They are careful about selecting unit locations and licensees in international markets, and work carefully to ensure quality supply from vendors in new markets. As such, Shake Shack is unlikely to fall into the growth trap, which in the past set back similarly fashionable chains like Krispy Kreme (NYSE:KND) and Boston Market.

Shake Shack is also careful not to expand its product offering too much. Its core menu features a limited selection of burgers, hot dogs, fries, shakes, and drinks -- just enough variety to appeal to a range of customers while keeping operational complexity and the number of items and ingredients in its kitchens to a minimum. Instead of feeding the new product drug like most fast feeders, it uses special events like a celebrity chef week and locally-inspired products to create news.

The internal culture at Shake Shack also positions the company well. It starts with its hiring practices. The company looks for staffers with a genuine sincere sense of hospitality and staffs new restaurants with a mix of new employees and emerging leaders from its existing ranks. Its employee pay, around $10/hour, is higher than most fast food companies. And it offers to full-time employees a generous bonus program and health benefits plus a 401(k) with matching contributions. As such, Shake Shack enjoys lower employee turnover, which lowers costs -- and delivers better customer service, which increases customer satisfaction.

Finally, Shake Shack derives its brand advantage from a superior customer experience. Although its products are tasty and its execution is solid, the brand has developed a loyal customer fan base because of its overall vibe. Its restaurants hop with energy, the employees create a fun, memorable experience, and each location works hard to connect with its local community through special menu items, locally-inspired architecture, and community programs like Shack's Track & Field Clubs. All these elements combine to create strong brand differentiation and a robust economic moat.

Of course, Shake Shack isn't without risks. Perhaps the greatest is the pressure to grow faster that its leaders will inevitably face from their new post-IPO stakeholders. But Garutti says that Shake Shack aspires to be "the 'anti-chain chain'" -- and because of that brand vision, executed across all of Shake Shack's customer touchpoints, Shake Shack is likely to satisfy investors' appetites.