The "Domino" Effect

Our short thesis on Domino's in 10 minutes or less – or your pizza's free.

Quick Review of Domino's

- Founded in 1960, over 12,500 locations in 80 markets across the world
- U.S.: 4,816 franchise stores, 384 company owned || International: 7,330 franchise model stores
- Up over 500% in the past five years
- Major push for technology over last couple of years during reworking of their business
- Recapitalized balance sheet in 2015 by issuing $1.3 bn in fixed notes, retiring $551M in debt

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Key Components of Short Thesis

- Our short thesis is a combination of several supplemental factors combined with what we feel to be a robust valuation of Domino's and its entire sector that could cause up to 34% downside in coming quarters
- Key pressure points for Domino's
  - Company is doing a poor job allocating capital, essentially ignoring debt to buy back stock at valuations nearing 30x 2016 earnings
  - Emphasis on wage hikes and recurring issues like company's wage violation history in NY
  - Eventual rising cost of commodity prices – cheese, pork & oil
  - Higher multiple than main peer Papa John's (PZZA) despite lower growth forecast & lower FCF yield
  - At 2.6%, the company's FCF yield significantly lags peers
  - Entire sector under pressure with recent industry components' earnings misses
  - Major balloon payments coming in 2019 & 2020 when debt matures

Quick Review of Recent Results

- Submitted our research to Sohn contest around April 22, DPZ ~$138
- Company reported earnings on 4/28/16; shares traded down to ~$120
  - Reported EPS of $0.89, missing consensus estimates by $0.09
    - EPS benefitted $0.09 from the company's lower share count. In fact, net income was down year over year for the quarter.
    - EPS benefitted $0.09 from improved operating results.
    - **<u>EPS pressure of -$0.07 came from increased interest expense on $2.2 billion debt.</u>**
    - EPS pressure of -$0.03 came from currency headwinds .
    - Interest expense increased to $5.8M as result of recapitalization.
    - Net income pressure, according to mgmt., due mostly to interest expense.
  - Revenue of $539.2M missed consensus estimates by $6.4M.
  - Company addressed labor costs on conference call, though not in its press release.

Management Admits Labor Rate is Already an Issue

Quotes from Q1 2016 Conference Call 4/28/16:

- “The operating margin in our company-owned stores decreased to 24.6% from 26.2%, driven primarily by <u>higher labor rates</u>, transaction-related expenses, and increased depreciation from our pizza theater reimaging program.”
- “As far as the company-owned store margin, if I heard you right, really, the biggest thing going against us there is more <u>labor rate</u> than anything else.”
- “Our higher interest expense, primarily as a result of our higher debt balance, negatively impacted us by $0.07.”

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Continued Wage Violations Show Reliance on Low Labor Costs

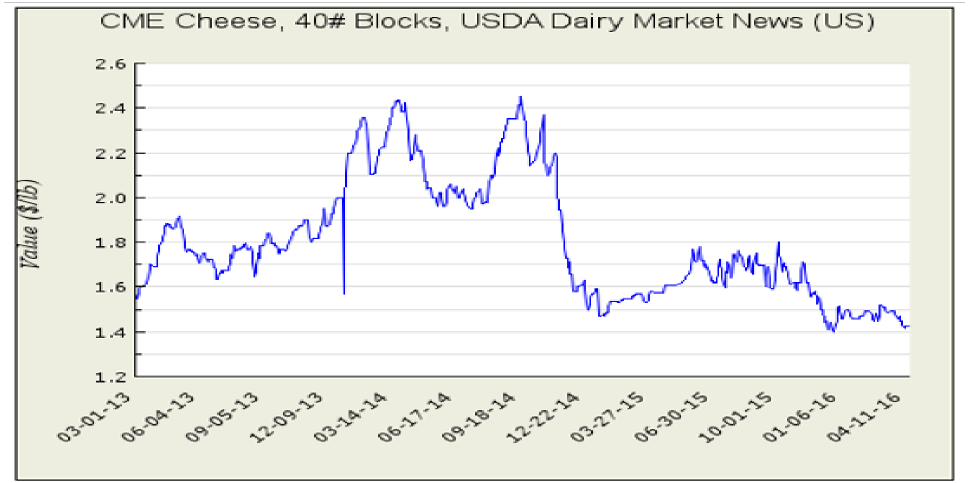
- The notion of $15 minimum wage has been constantly brought up by both Democratic candidates who, if elected, could push through legislation necessary to make the change and drastically impact costs for businesses.

- According to our research, New York and 12 additional states are considering wage increases before end of 2016.

- The chain has been fined by New York State already for wage violations on multiple occasions:
  - New York State has fined Domino's for wage violations multiple times already. A 2014 investigation resulted in a $450,000 penalty against 23 locations. Attorney General Eric Schneiderman described it as a pattern of "illegally chiseling at the pay of minimum-wage workers." One year later, another 29 New York locations paid a $970,000 settlement for the exact same thing. Schneiderman appealed directly to Domino's executives this time, saying, "My message for Domino's CEO Patrick Doyle is this: To protect the Domino's brand, protect the basic rights of the people who wear the Domino's uniform, who make and deliver your pizzas.“

- Domino’s is currently being sued for paying workers less than minimum wage.
  - Riad Kucher, who worked at five Domino's locations between 2014 and 2016, is suing the pizza chain for what he asserts are **"systemic wage violations."** His lawsuit, filed by the employment-litigation firm Wigdor, alleges he and hundreds of fellow employees weren't paid proper wages, and were forced to work more than 20 hours per week off the clock, bringing their hourly pay to sub-minimum wage.

Benefits from Commodity Prices Will Eventually Shift Directions



- Both cheese and pork are near 3 year lows.

Our Assumptions Are Less Optimistic Than Those of Analysts

- Our projections indicate that DPZ's CAGR for net income and EPS will decelerate.
- We expect EPS to grow to $4.78 in 2019, a CAGR of 8.34% vs 2011-2015 when the company grew EPS by a CAGR of 19.35%.
- Our model assumes 7% revenue growth vs 7.7% avg the last 5 years.
- Our model accounts for an increase in labor costs.

	Geo Estimate	Analysts Estimate
2016 EPS	**$4.00**	$4.09
2017 EPS	**$4.17**	$4.85

(dollars in millions, except per share data)

	Fiscal 2016 (calendar 2015)		Geo Estimate Calendar Years 2016		2017		2018		2019	
Income statement data:										
Revenues:										
Domestic Company-owned stores	$ 396.9	17.9%	$ 419.3	17.7%	$ 444.5	17.5%	$ 471.2	17.3%	$ 499.4	17.1%
Domestic franchise	272.8	12.3%	294.6	12.4%	315.2	12.4%	337.3	12.4%	360.9	12.4%
Domestic stores	669.7	30.2%	714.0	30.1%	759.7	29.9%	808.5	29.7%	860.4	29.5%
Supply chain	1,383.2	62.4%	1,480.0	62.4%	1,591.0	62.6%	1,710.4	62.8%	1,838.6	63.1%
International franchise	163.6	7.4%	177.2	7.5%	189.6	7.5%	202.9	7.5%	217.1	7.4%
Total revenues	2,216.5	100.0%	2,371.2	100.0%	2,540.3	100.0%	2,721.7	100.0%	2,916.0	100.0%
YOY growth %	*11.2%*		*7.0%*		*7.1%*		*7.1%*		*7.1%*	
Cost of Sales:										
Domestic Company-owned stores	299.3	75.4%	322.9	77.0%	346.7	78.0%	372.2	79.0%	399.5	80.0%
Supply chain	1,234.1	89.2%	1,324.6	89.5%	1,431.9	90.0%	1,539.3	90.0%	1,654.8	90.0%
Total cost of sales	1,533.4	69.2%	1,647.5	69.5%	1,778.6	70.0%	1,911.5	70.2%	2,054.3	70.4%
Operating margin	683.1	30.8%	723.7	30.5%	761.7	30.0%	810.1	29.8%	861.7	29.6%
General and administrative expense	277.7	12.5%	291.7	12.3%	309.9	12.2%	329.3	12.1%	349.9	12.0%
Income from operations	405.4	18.3%	432.0	18.2%	451.8	17.8%	480.8	17.7%	511.8	17.6%
Interest income	0.3	0.0%	1.1	0.0%	1.1	0.0%	1.1	0.0%	1.1	0.0%
Interest expense	(99.5)	-4.5%	(105.0)	-4.4%	(110.0)	-4.3%	(115.0)	-4.2%	(120.0)	-4.1%
Income before provision for income taxes	306.2	13.8%	328.1	13.8%	342.9	13.5%	366.9	13.5%	392.9	13.5%
Provision for income taxes	113.4	5.1%	122.1	5.1%	127.6	5.0%	136.5	5.0%	146.2	5.0%
Net income	$ 192.8	8.7%	$ 206.0	8.7%	$ 215.3	8.5%	$ 230.4	8.5%	$ 246.7	8.5%
Earnings per share:										
Common stock – basic	$ 3.58		$ 4.12		$ 4.30		$ 4.60		$ 4.92	
Common stock – diluted	$ 3.47		$ 4.00		$ 4.17		$ 4.46		$ 4.78	
Weighter average shares o/s - basic	53.8		50.0		50.1		50.1		50.1	
Weighter average shares o/s - diluted	55.5		51.5		51.6		51.6		51.6	

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Levered with Low FCF Yield and Questionable Use of Capital

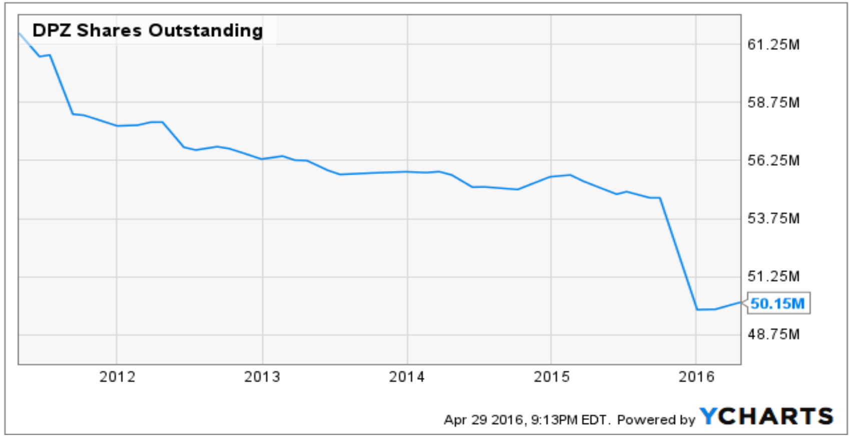
FCF Yield w/ PE Compared to Peers

	Free Cash Flow Yield	2016 Forward P/E
DPZ	**2.6%**	**29.4**
PZZA	5.6%	24.4
JACK	5.3%	19.5
DRI	8.4%	18.1
MCD	4.2%	23.1
BWLD	3.4%	23.8

- Considering debt burden, cash flow is easily most important part of the business.
- Company's decision to not service debt immediately and rely on future cash flows should be handicapped in its multiple.
- FCF yield is alarmingly poor compared to peers.
- Competitor Papa John's (PZZA) has a far better FCF yield and lower PE, and analysts have PZZA growing its EPS at a higher rate than DPZ over the next 5 years. source: Capital IQ via Yahoo Finance)
- With a big debt burden and a FCF yield of 2.6%, it leaves the company little room for increased interest expense.
- This type of "financial engineering" has been publicly denounced by savvy investors like Carl Icahn, who point to buybacks and the high yield debt market as looming catastrophes.

Considering Debt Burden, Are Share Buybacks and Dividends the Best Use of Cash?

- Lowered share count has contributed to increased EPS over last 5 years
- Company has spent $1.5 billion returning capital to shareholders over the last 5 years
- Essentially, growing debt is funding buybacks at a PE near 30X
- In coming quarters, will this strategy of avoiding the debt while buying back stock near 30X P/E make sense?
    - We don't believe it does since Domino's is a negative equity company with little to fall back on in terms of FCF yield



DPZ Cash Used Share Buybacks and Dividends

	Share Buybacks	Dividends and Equivalents Declared	Total
2011	$ 165,000,000	$ -	$ 165,000,000
2012	88,200,000	187,000,000	275,200,000
2013	97,100,000	44,200,000	141,300,000
2014	82,400,000	55,300,000	137,700,000
2015	738,600,000	66,500,000	805,100,000
Totals	$ 1,171,300,000	$ 353,000,000	$ 1,524,300,000

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Buybacks and Dividends Certainly Benefit Management

	Share Buybacks	Cost per Share	Total Cost	Options Exercised	Cost to Acquire Shares Exercised	Exercise Price	Proceeds from Exercise of Options	Net Cost to Acquire Shares Issed Upon Exercise of Options
2011	(6,414,813)	$ 25.72	165,000,000	3,773,763	97,067,661	$ 8.88	33,511,015	63,556,646
2012	(2,472,863)	$ 35.67	88,200,000	938,669	33,479,657	$ 9.55	8,964,289	24,515,368
2013	(1,666,435)	$ 58.27	97,100,000	928,464	54,099,833	$ 10.22	9,488,902	44,610,930
2014	(1,151,931)	$ 71.53	82,400,000	939,340	67,192,927	$ 9.56	8,980,090	58,212,837
2015	(6,152,918)	$ 120.04	738,600,000	428,433	51,429,357	$ 11.70	5,012,666	46,416,690
	(17,858,960)	$ 65.59	1,171,300,000	7,008,669	303,269,435	$ 9.41	65,956,963	237,312,472

We note that while the company was funding share buybacks and dividend payments with debt, executives were exercising options as DPZ's share price rose.

- In 2015, when the company was repurchasing shares for ~$120, executives were exercising options ~$11.70
- During the 2011 - 2015 period, executives exercised options to acquire 7.0 million shares at an average exercise price of $9.41 generating $66.0 million proceeds for the company.
- The company's cost to acquire the shares issued upon the exercise of options averaged $65.59, totaling $303.3 million.
- The total cost of the shares acquired to cover those issued upon exercise of options was $237.3 million more than the proceeds received from executives exercising options.

2019 Isn't that Far Away

As the company recently stated in its Q1 2016 conference call, interest expense is an issue. In our view, it'll only get worse.

	2017	2018	2019	2020
2012 notes	$ 25,600,000	$ 25,600,000	$ 865,400,000	$ -
2015 notes	$ 13,000,000	$ 13,000,000	$ 13,000,000	$ 488,000,000
Total due	$ 38,600,000	$ 38,600,000	$ 878,400,000	$ 488,000,000

- Company has over $1.3 billion in debt payments due in 2019 and 2020.
- Even if the company delays its rollover by extending its debt obligation through refinancing , we believe it will be doing so in a higher interest environment, which will further put pressure on margins.
- Debt: "It isn't a problem…until it's a problem"

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The Entire Sector Has a Robust Valuation

As we can see from a basket of restaurant stocks that are in their mid to mature growth stages, multiple expansion (as it has been with the entire market) has been prevalent especially in the restaurant sector.

PE Estimates Based on Historical Data

(note these numbers are realative estimates for the full year period)

	2011 PE	2012 PE	2013 PE	2014 PE	2015 PE	2016 Est. PE	2017 Est. PE
MCD	16.6	14.8	16.2	18.7	24.4	23.1	20.7
PZZA	16.9	20.6	28.6	31.5	29.4	24.4	21.7
YUM	19.6	18.2	30.1	30.3	24.7	22.1	19.7
SONC	21.3	17.0	30.9	31.5	26.8	25.6	22.4
BOBE	16.8	15.1	n/a	39.1	55.1	23.6	21.1
CBRL	12.0	12.9	20.4	24.0	18.3	19.7	17.8
Average	***17.2***	***16.4***	***25.2***	***29.2***	***29.8***	***23.1***	***20.6***
DPZ	***17.6***	***21.9***	***27.3***	***32.7***	***32.0***	***29.4***	***24.8***

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There’s No Protective Moat Around Domino’s “Technology” Gimmicks

The company has done very well to reach customers through ease of use of their app and online ordering

BUT

- At it’s core, Domino’s is not a technology company; it's a company that makes its money from cooking and then delivering pizzas and other food items. It doesn’t deserve a technology-infused multiple.
- Everyone in the sector is going to catch up to Domino’s in terms of technology. Competitors can have apps and can model their technology based off of Domino’s success with a modest investment.
- Companies like GrubHub are focused solely on the business of ordering food online, and will continue to compete with DPZ.

- Domino’s, in our opinion, is more about marketing their technology “gimmick” and the brand instead of the food quality
- KEY THREAT: If we see a shift in taste and focus on food quality from millennials, it could negatively impact DPZ

Valuation

	PE of 20X	PE of 25X
Analyst 2016 estimates of $4.09/share	$ 81.80	$ 102.25
Our 2016 estimate of $4.00/share	$ 80.00	$ 100.00
Analyst 2017 estimates of $4.85/share	$ 97.00	$ 121.25
Our 2017 estimate of $4.17/share	$ 83.45	$ 104.31
High end	$ 121.25	
Low end	**$ 80.00**	

- We feel that a P/E of 20-25x on our financial model and analyst estimates is appropriate – and even optimistic – given the company's debt load. Applying 20-25X multiples to our 2016 estimate of fully diluted EPS of $4.00 implies a share price of $80.00 to $100.00 which is well below DPZ's recent trading price ~$120 .
- **Bottom line: DPZ could move as low as $80.00 within the next 4-8 quarters, giving it downside of up to 34%.**

Thank you for your time.

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