DEL FRISCO'S REPORTS Q4 & NEW GUIDANCE - BUY, SELL, OR HOLD ?

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CONCLUSION:

Back on 11/27/18, our conclusion, in part: "we think it is, at the very least, a possibility that corporate cash flow improvements will not take place as projected. Store expansion plans would need to be adjusted....overall, we think DFRG from this price could work out well if operations improve as projected. Also, there are still hundreds of billions of dollars out there looking for a home....even with the apparent risks...the debt burden could become critical if the operational improvement is delayed, and successful integration of newly acquired concepts has been a flawed assumption many times in the past. For our money, we hesitate to be short DFRG, especially because of the takeover possibility, but the downside risk is too substantial for us to be comfortable on the long side."

We stand by the above conclusion. Readers, for more background, can refer back to our previous writeup.

RECENT RESULTS

We most recently wrote about DFRG back in December. As a result of their company changing acquisition of Barteca, with the two dynamic concepts, Bartaco and Barcelona Wine Bar, Del Frisco's had taken on about $300M of high interest (over 9%) debt. They were, naturally, optimistic about the outlook. Setting aside the expectations at that point for calendar '18, which was largely concluded, management was looking out further to 2021.

The guidance for 2021 was annual revenues of $700M, at least $100M of adjusted corporate EBITDA (This is not "free cash flow" when you are carrying $300M of 9% debt). However, Net debt would be reduced to 2.50-3.0x, which would not require much paydown, no more than $50M, but would be a lot more tolerable than the 8x based on trailing adjusted EBITDA of 35M for the TTM of 12/31/18. So it all depends on building the EBITDA return to the $100M level, from $35M in '18. (Adjusted EBITDA was down 9.8% in Q4 and 3.2% for all of '18.) They were going to get there by 2021 with 10-12% revenue growth, comp increases of 0-2%, maintaining strong store level margins, G&A cost leverage, adjusted EBITDA growth of 15% annually. They were planning capex of $50-60M in '19, which would obviously require an immediate improvement, unless further debt were somehow added.

Activists investors have been attracted to this situation, Engaged Capital in particular has placed a representative on the Board of Directors as chairman of the transaction committee which is reviewing strategic options. It has been reported that some investors believe the company is worth more as two separate entities. With an enterprise value of approximately $550M, or 15.7x trailing twelve months EBITDA, investors are obviously betting on the potential of EBITDA increasing to something like the $100 M projectionfor 2021. The current enterprise value of $550M would obviously be 5.5x, but it would be three years from now that the $100M would be in the rear view mirror. Should that happen, an enterprise value of a reasonable 10x, or $1B, less $300M of debt which could still be in place, would put the stock at almost three times the current value. That's called the power of leverage, and tells you why activists are interested.

However, it gets back to execution at the store level. In Q4 and in calendar '18, store level Adjusted EBITDA was down at Del Frisco's Double Eagle, Del Frisco's Grille, and Corporate. Bartaco and Barcelona's Q4 and YTY comparisons were not shown. In Q4 and calendar '18, traffic and sales were lackluster at Double Eagle and the Grille, generally flat sales with traffic down a little, improving a touch in Q1'19 but not enough to improve margins (as we see it). Bartaco had store level EBITDA of 20.4% in Q4 and 24.6% for the year, Barcelona had Q4 EBITDA of 21.9% inQ4 and 22.4% for the year. We don't know whether Q4 is a relatively strong quarter for these two concepts, but Q4 was obviously weaker than the first nine months in terms of EBITDA. These two concepts are running positive comps in the low to mid single digits, but that is not enough to build margins a lot. Even Bartaco and Barcelona are not immune to higher labor and occupancy expenses. One specific change of plans: capex for '19 was reduced to $25-35M, down about 50% from the previous plan of $50-60M, *which we predicted.* Adjusted Ebitda for '19 i s now projected at $58-66M, which, after $28M of debt service , without taxes, would only leave $25-35 for capex unless debt were added.

Focusing on the longer term, management explained the relatively lackluster Q4, had a number of reasonable rationalizations and indications of pending improvement, and maintained their previous optimism. The previous guidance has been largely maintained. Q4 delivered an Adjusted EBITDA (we always feel that quotation marks should be put around Adjusted, but we'll just capitalize it) pretty much in line though toward the lower end of expectations. In addition to the guidance for 2021, management has added expectations: "by the end of 2023, we are targeting generation on annual basis of at least $800M in consolidated revenues and $130M in Adjusted EBITDA. To achieve these long term targets, we need to satisfy the following key annual goals:" and they reiterated the YTY growth parameters previously indicated. If they meet 2021 objectives, 2023 will look pretty reasonable.

An important element of this equation is the progress at Bartaco and Barcelona Wine Bar. Since YTY comparative numbers are not provided, and will not be for at least the next two quarters, there is limited transparency in this regard.

Conclusion: Provided at the beginning of this article