Do insiders think $DFRG sell-off is a rare opportunity?

It's pretty rare these days to find a U.S. stock that simply no one has heard of or taken a look at. When I stumble on a stock, the first thing I do is search my email to see if I've emailed anyone about it and then check VIC and Sumzero to see if it's been written up on one of those sites, and it's astonishing how rare it is that the stock hasn't been mentioned in one of those three places. So, increasingly, all investors are using the same tools to look at the same stocks (at least in the U.S. markets; foreign markets seem less picked over from my seat but me and most of the people I talk to might just have a U.S. bias).

Despite the fact we're all fishing in pretty much the same pools and using basically the same valuation skills, investors somehow manage to put together completely different portfolios. In general, I find those differences are built by investor preferences / tendencies to look at stocks with specific characteristics or situations. For example, I know some investors who spend most of their time looking at forced selling (from index kickouts, or dividend cuts, or tiny spin offs) while others might spend more time looking at in the deep value territory (stocks with particularly low P/E) or looking at "simpler" industries they can understand (mainly consumer focused companies). So even though we all have the same investable universe, each individual investor ends up with a unique portfolio that generally has some common themes running through it depending on the type of stocks they are looking at.

Increasingly, the common theme through my portfolio is the company and/or company insiders are doing something that shows they think shares are undervalued (normally repurchasing stock or buying stock on the open market). And Del Frisco's (DFRG; disclosure: long a bit) certainly checks both of those boxes.

Some background: DFRG is a stock I've followed for a while, so I won't recount a ton of history here. It owns three different steakhouse chains that operate 52 restaurants in total. The company first popped up on my radar when Fidelity National (FNF) acquired >10% of the company because FNF had a history of taking stalled restaurant chains private. The acquisition never played out, and late last year the DFRG's CEO resigned, likely pushed out by two activist investors who wanted the company to pursue a sales process.

Under the new CEO, things seemed to be going well. Same store sales (SSS) started to stabilize, and the company made some investments (redesigning the menu, investing ~$3m into a consultant study) that were supposed to help drive SSS growth in the back half of the year as well as prepare them to resume opening new locations in FY18 and beyond. However, the company's Q2

results were an absolute train wreck, and they caused the company to pull back on their full year projections as well as push off some of their growth initiatives (particularly their Sullivan's franchising project).

Ok, so that background is a bit simplified but enough for these purposes. At today's share price of ~$14.25, DFRG is trading for ~7x LTM EBITDA and around 10-11x unlevered FCF (EBITDA less my estimate of maintaince capex). I loosely follow a few restaurants and while that valuation is on the lower of where peers trade, that's honestly pretty justified given DFRG's current SSS deterioration and lack of growth (most peers are opening some new units at attractive IRRs).

So DFRG trades at the lower end of peers and current earnings trends aren't great. And restaurants are a notoriously fickle and difficult industry, so it's not like you're buying a long term compounder at a fair to cheap price. So, if DFRG isn't that cheap and the industry isn't great, what is there to like about DFRG?

Great question, and it brings us back to the opening of this write up: insiders doing something that shows shares are undervalued. Under DFRG's prior CEO, Del Frisco's had a stock repurchase authorization but was very conservative in acting on it, repurchasing $6.3m in shares in FY14, $3m in FY15, and $2.2m in YTD in FY16 until his "retirement". That's changed in a big way under the new CEO, who has made clear he thinks returning cash to shareholder through share repurchases represents a shareholder friendly way to put capital to work. The new CEO started in late November, and the company immediately bought back $2.5m of stock in December 2016 (more than the company had bought back YTD under the old CEO). That's continued into FY17, with the company buying back ~$30m of stock (~7.3% of shares outstanding) in the first two quarter of the year; on top of those repurchases, the company highlighted buying another ~540k shares (~2.5% of shares) QTD in Q3. In total, the company has repurchased ~10% of their shares since the new CEO took over less than a year ago. That's a tremendous amount of repurchasing, and all of it was done at a price well above today's levels (between $16.50-$18/share).

I'm a self-confessed big fan of repurchases, but you could probably construe a new CEO coming in and doing a bunch of repurchases a lot of different ways. Maybe the activist pressure makes him feel like he needs to rapidly buy back shares regardless of the share price or his view of the underlying value (and, given he was aggressively buying shares between Q2 close and reporting Q2 results that caused the stock to dive, there is some validity to this argument!). Maybe the fact that DFRG is generating a lot of FCF right now (again, a lot of their growth capex is on pause right now) makes him feel like he needs to put cash to work. Maybe he truly feels that the shares are undervalued and repurchasing them is a great way to generate shareholder value. At a minimum I look at a company retiring shares that quickly as an encouraging sign.

But what really interests me about DFRG today is that insiders have really

stepped up to the plate in the wake of the big sell-off post Q2 earnings with some aggressive insider purchasing. The CEO has bought ~20k total shares in two separate transactions, a director stepped in for another 12.2k shares, the CFO hit the open market 3 times for ~18k shares in total, and even the Culinary VP got involved for 7.2k shares. That is a lot of insider purchasing!

A common argument I hear about insider purchases is that it's a small piece of an insider's overall wealth or comp. I can certainly understand that argument, but I don't think it holds any weight here. The CEO is taking home $600k/year in salary and just spent ~$200k buying DFRG shares on the open market. That feels like a pretty significant signal to me, but maybe you feel differently given he also qualifies for a ~$600k/year target bonus and has spent time at a private equity firm before (so maybe he's got a lot of outside wealth). Ok, let's look at what the CFO did- his salary is ~$300k, and he just spent $250k buying stock on the open market. Or consider the culinary VP's purchase. He's been with Del Frisco's since 2006 and, as far as I can tell, has never made an open market purchase. Then this month he spends ~$100k to buy 7.2k shares on the open market to bring his total share ownership to 10.8k shares (his other shares seem to have been acquired through options). That seems like a pretty powerfully bullish sign, particularly when you start thinking about what he probably makes yearly (I would guess he makes ~$200k/year all in?) and how much of that he put into an open market purchase.

Maybe a cynic will interpret this as management going on tilt- they bought a bunch of shares with the company's money during the Q, the stock went down, and now they're doubling down with their own money. I can understand that explanation, but I'm just not that cynical. To me, this seems like the company thought they were doing well by shareholders by buying back shares earlier this year, and when the stock traded below those levels everyone on the management team got excited about the opportunity and greedily started buying shares. Again, maybe I'm reading too much into it, but I find it really interesting that a member of the management team who has been with them for over a decade would chose now to make his first open market purchase and do so in a big way relative to his comp.

So it's a pretty simple thesis here: the industry isn't great, but the stock looks cheap and a variety of insiders are pounding the table in a ton of ways that signal the stock is undervalued.

Odds and ends

- One nice thing about Del Frisco's: restaurants are notoriously finicky, but I feel like there's a bit more stability to the brand / steakhouses than something like a Bravo Brio (high end Italian). Maybe that's just me developing creating a story in my mind, but I feel like once a Ruth's or a Del Frisco's is established in a market it's much less prone to fading to irrelevance than other restaurant types.

    - Perhaps countering that "lack of fad" stability: this is a high end steakhouse, so there's certainly some economic sensitivity here.
- The CEO has a bunch of background with private equity firms, and many of the restaurants he previously worked at were involved in M&A. DFRG also used to be owned by private equity firm Lone Star. I would not be surprised if a buyout was the end game here.
- I've long thought there was room from Del Frisco's to improve their restaurant level margins, as both the overall company and each of the individual brands have seen their restaurant level margins deteriorate since 2014. This is pretty simplistic, but a combo of boosting restaurant level EBITDA margins from their current ~21% levels to 22.5% (roughly in line with 2014 levels) while holding SG&A flat and giving the whole company an 8x multiple gets you to a ~$20 stock, with additional upside if they can profitably open a few new units.
- While I love the idea of a company repurchasing tons of shares, I will admit that DFRG spending ~$3m to hire Bain to do a customer analysis strikes me as insanity capital allocation wise. Maybe as an ex-consultant I'm negatively biased to consultants, but I just can't understand how a ~$300m market cap company can justify spending that much money on a customer study.