THE REED REPORT

COMPANY SPOTLIGHT – DOMINO'S PIZZA

9/1/2017

Business Overview

Domino's Pizza (NYSE: DPZ) is the second largest pizza restaurant chain in the world with more than 13,800 locations in over 85 markets. The company generates revenues and earnings by selling food, equipment, and supplies to franchisees primarily in the U.S. and Canada, operating a number of their own stores, and charging royalties to its franchisees. Royalties are an ongoing percentage of sales fees for use of the Domino's brand marks. In the international markets, Domino's grants geographical rights to the Domino's Pizza brand to master franchisees. These master franchisees are charged with developing their geographical area, and they may profit by sub franchising and selling ingredients and equipment to those sub-franchisees, as well as by running their own stores.

Previous Quarter

On July 25, 2017, Domino's reported second quarter 2017 results. EPS (earnings per share) was $1.32 which beat estimates by $0.09 and revenues were $628.6 million which beat estimates by $14 million. Domino's reported strong domestic same store sales growth (SSS) of 11.2% for company owned stores, and 9.3% for franchised stores, both above consensus estimates. However, international SSS were 2.6%, below Wall Street estimates of 5.2% and Domino's own long term guidance range of 3% to 6%. On the conference call, CEO Patrick Doyle said the slowdown was driven primarily by their Europe region, the U.K. in particular, and the issues are known and fixable. Another issue was operating margin decreased to 30.7% from 31.4% in the prior-year quarter. The decrease was driven by higher insurance expense (car insurance for the drivers), higher transaction-related expenses and increased labor costs. Domino's stock sold off 10% the same day it reported earnings as investors were not pleased with their second quarter performance.

Growth Opportunities

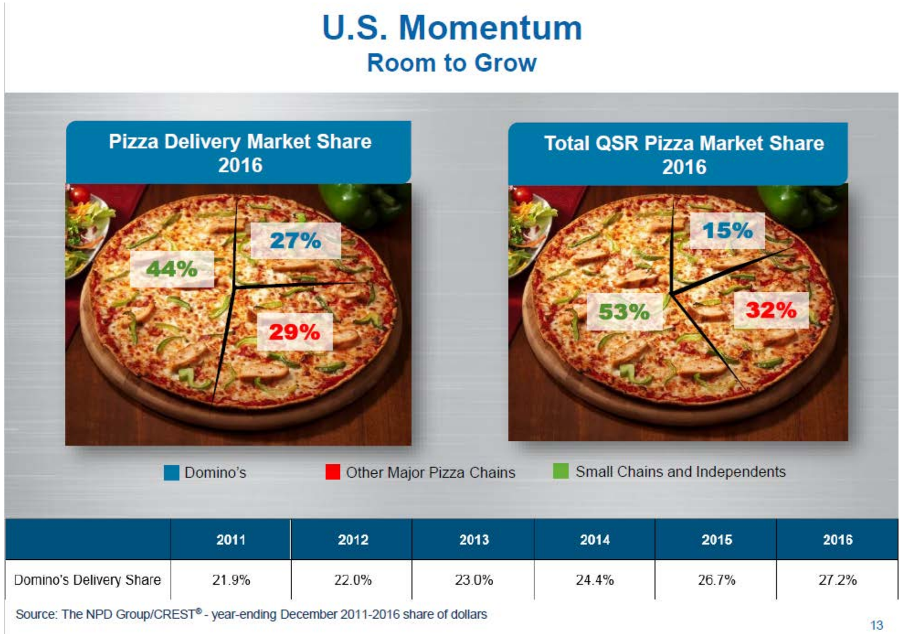
On January 12, 2017, Domino's held an Investor Day where management announced their 3-5 year outlook for the company. They expect an annual average of 3% to 6% same store sales growth, 6% to 8% store growth, and 8% to 12% global retail sales growth. They plan to achieve these goals by capitalizing on their technology platform, delivery expertise, and franchise model which has led to strong performances in their domestic and global segments over the past few years.

Domino's was one of the first major restaurant chains to invest heavily in technology which has now become its competitive advantage. The key is they offer a variety of ways for customers to place an order. This includes ordering through a mobile device, tablet, smartwatch, Amazon Echo, Google Home, Ford Sync, Samsung Smart TV, Twitter, Facebook Messenger, and text message. Many of these methods require that you are a member of Domino's Piece of the Pie Rewards program. This is a loyalty program that provides special offers to its members and allows them to save their favorite order and payment information for a quick checkout. Once you place an order, you are able to track it using the app or receive updates on your mobile device. The Domino's app has been a huge success. 60% of the company's sales come from the app and it is rated higher on ITunes and Google Play than Papa John's and Pizza Hut's apps. The convenience of ordering on the app has been a big hit with millennials since so many of them are glued to their mobile devices and hate talking on the phone. As Domino's continues to invest into technology, I believe they will stay ahead of their competition and continue to drive sales growth.

Lately, there has been a shift in the restaurant industry to delivery. Consumers now place more value on their time and this has led to a decrease in overall restaurant traffic. Companies are responding by providing carryout and delivery services. McDonald's, Buffalo Wild Wings, Wingstop, Wendy's, Cheesecake Factory, and Chipotle are all testing or offering delivery. GrubHub recently acquired Yelp's food delivery service, Eat24. This creates the largest network of online and mobile food ordering in the U.S. as consumers will be able to order from 75,000 restaurants. This shift seems like it could mean trouble for Domino's but management isn't too worried. On the second quarter conference call Domino's CEO Patrick Doyle said "a lot of these delivery services are finding out very quickly that delivery is a lot harder than they thought it was going to be." He goes on to say "For it to work, it's got to work for the driver, it's got to work for the restaurant, it's got to work for the company providing that service, and it's got to work for the customer. There's got to be value creation for all four of those parties to have a successful delivery business. And I think that there's still a lot of learning going on in this space around how difficult it is to make all of that work. Fortunately, we have 57 years of learning around how to make delivery efficient on food, and our advantages there seem to be holding up very, very well." He also mentioned that they are not seeing any affects from the increase in delivery offerings on their business. The majority of their same store sales growth this quarter came from more transactions rather than higher prices. As the food delivery market grows, I expect Domino's market share to grow along with it.

Over 97% of Domino's stores are owned and operated by franchisees. Since the business is comprised of delivery and carryout services, the stores are smaller and less expensive to build than other restaurants. Domino's smaller menu size and supply chain centers which provide everything from food to equipment makes store operations for franchisees simpler and more efficient. This allows franchisees to grow their business rapidly and recoup their initial investment on average within 3 years. As of January 1 2017, the average domestic franchisee owned and operated six stores and had been in the franchise system for over 17 years. Four franchisees own more than half of the total international stores. Domino's profits off of the franchise royalty fees and supply chain sales which is used to invest back into new products, technology, supply chain center, pay down debt, dividends, and stock repurchases. Domino's has built a franchise model that is beneficial to franchisees, the company, and most importantly shareowners.

Domino's domestic (United States) segment is comprised of 5,438 stores and accounts for 49% of global retail sales. Since 2010, Domino's has recorded the highest same store sales growth among the top 10 quick service restaurants. This includes major brands such as Starbucks, McDonald's Panera, and Pizza Hut. Average store EBITDA (earnings before interest, taxes, depreciation, and amortization) has gone from $67K in 2010 to $133K in 2016. This has resulted in accelerating store growth. Domino's has opened 183 net new stores in the past year versus 96 during the same period in 2015. Despite this store growth, Domino's domestic segment still has plenty of room to grow. According to the NPD Crest, Domino's owns 27% of the pizza delivery market and 15% of the total quick service restaurant pizza market. Refer to the graphic below for more details **(Source: Domino's August 2017 Investor Presentation)**.



Domino's international segment is comprised of 8,779 stores in 85 developed and emerging markets and accounts for 51% of global retail sales. The most recent quarter marked the 94th consecutive one of positive same store sales growth. Over the last 20 years, international same store sales have averaged 5.8% and was above that the last 4 years. This success had led to rapid store growth as more than half of the international stores are held by four public companies; Domino's Pizza Enterprises Ltd., Domino's Pizza Group PLC, Jubilant FoodWorks Ltd., and Alsea SAB de CV. Store count has grown by 3,605 over the last five years, higher than Pizza Hut and Papa John's. Domino's is #1 or #2 in pizza delivery in their largest 15 international markets. Also, they see potential for an additional 5,200 stores in these markets alone. According to NPD Crest, the international pizza market is $85 billion and expected to grow 3% to 4% annually to $103 billion by 2020. There is plenty of runway left for growth for Domino's international segment.

Technical Analysis

Below is the YTD chart for Domino's as of 8/31/2017 (**Source: Yahoo Finance**).

As you can see from the chart, there has been 3 big selloffs in the stock this year. The first one was in early April after an analyst from M Science warned that Domino's first quarter same store sales would be below consensus. I took advantage of this pullback and purchased the stock. It turned out this analyst was wrong as same store sales beat consensus that quarter. The second selloff was in early June after an analyst from Longbow Research said the stock was overvalued and their checks showed that sales for the second quarter may be below consensus. The third selloff was after they reported second quarter earnings. So far all of them have looked like buying opportunities for long term investors.

Based on Domino's price to earnings ratio (P/E ratio) price/earnings to growth ratio (PEG ratio), the stock is expensive. As of August 31, 2017, Domino's P/E ratio is 35.59 and its PEG ratio is 1.97. A PEG ratio above two is considered expensive. The good news is Domino's P/E is the lowest it's been in a year. Yes, there is concern about international sales after the last quarter and rightfully so. But I don't believe it should be trading this low on a P/E basis. As I've mentioned before, the problem with stocks with high valuations is if the company reports results that do not meet expectations, the stock can easily go down 5% to 20%. In some cases, the downward move is justified. In others, it is an overreaction by shareholders who are just riding the stock higher and sell at the first sign of a reversal. I believe this situation with Domino's is the latter scenario.

Financial Statement Review

Since I invest in growth companies, I primarily focus on the year over year change in revenue and margins when reviewing an income statement. For the first half of 2017, revenues are up 15.3% and operating margins are down 0.3%. The reasons for the slight decline were mentioned in the previous quarter section above. Refer to the income statement below for more details (**Source: Domino's Pizza 2nd Quarter 2017 Press Release**).

Domino's Pizza, Inc. and Subsidiaries
Condensed Consolidated Statements of Income
(Unaudited)

	Two Fiscal Quarters Ended			
(In thousands, except per share data)	June 18, 2017	% of Total Revenues	June 19, 2016	% of Total Revenues
Revenues:				
Domestic Company-owned stores	$ 225,975		$ 194,278	
Domestic franchise	162,304		137,826	
Supply chain	778,657		674,954	
International franchise	85,892		79,459	
Total revenues	1,252,828	100.0%	1,086,517	100.0%
Cost of sales:				
Domestic Company-owned stores	176,224		146,550	
Supply chain	689,943		600,912	
Total cost of sales	866,167	69.1%	747,462	68.8%
Operating margin	386,661	30.9%	339,055	31.2%
General and administrative	157,760	12.6%	136,641	12.6%
Income from operations	228,901	18.3%	202,414	18.6%
Interest expense, net	(49,855)	(4.0)%	(50,880)	(4.7)%
Income before provision for income taxes	179,046	14.3%	151,534	13.9%
Provision for income taxes	50,836	4.1%	56,822	5.2%
Net income	$ 128,210	10.2%	$ 94,712	8.7%
Earnings per share:				
Common stock – diluted	$ 2.58		$ 1.86	
Dividends declared per share	$ 0.92		$ 0.76	

When I look at Domino's balance sheet, the first thing that pops out is the $2.2 billion in long term debt. It started in 1998 when Bain Capital obtained the company through a leveraged buyout. Bain Capital took out over $700 million worth of debt against Domino's assets and purchased stock from the shareholders so they could take the company private. In 2004, Domino's came public again through an IPO. When the debt from the leveraged buyout became due in 2007, Domino's refinanced the debt and took out additional debt in the amount of $1.7 billion. The debt was used for a special dividend of $13.50 and investing back into the business. Domino's refinanced their debt two more times, once in 2012 and in July of this year. This recent refinancing lowered their weighted average borrowing rate from 4.6% to 3.8% as well as their principal payments in 2019 and 2020 of $878.5 and $488.0 million to $19 million in each of those years. The proceeds are being used to pay the $910 million remaining balance on the 2012 debt and a $1 billion accelerated share repurchase program. Domino's debt is rated by Standard & Poors credit agency as BBB+ which is the top rating in the restaurant industry for whole business securitizations. Their goal is to keep their debt to EBITDA ratio between 3 to 6 and after the deal it is at 5.9. As long as Domino's can keep this ratio in their desired range and continue to grow their operating cash flows, I don't believe the debt is an issue to be overly concerned about. Refer to Domino's balance sheet and statement of cash flows for more details (**Source: Domino's Pizza 2nd Quarter 2017 Press Release**).

Domino's Pizza, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(Unaudited)

(In thousands)	June 18, 2017	January 1, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 52,243	$ 42,815
Restricted cash and cash equivalents	161,685	126,496
Accounts receivable	151,641	150,369
Inventories	37,664	40,181
Advertising fund assets, restricted	116,158	118,377
Prepaid expenses and other	41,512	17,635
Total current assets	560,903	495,873
Property, plant and equipment, net	137,793	138,534
Other assets	83,101	81,888
Total assets	$ 781,797	$ 716,295
Liabilities and stockholders' deficit		
Current liabilities:		
Current portion of long-term debt	$ 305	$ 38,887
Accounts payable	104,620	111,510
Dividends payable	22,648	619
Advertising fund liabilities	116,158	118,377
Other accrued liabilities	107,781	134,305
Total current liabilities	351,512	403,698
Long-term liabilities:		
Long-term debt, less current portion	2,180,518	2,148,990
Other accrued liabilities	52,838	46,750
Total long-term liabilities	2,233,356	2,195,740
Total stockholders' deficit	(1,803,071)	(1,883,143)
Total liabilities and stockholders' deficit	$ 781,797	$ 716,295

Domino's Pizza, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

		Two Fiscal Quarters Ended		
		June 18, 2017		June 19, 2016
(In thousands)				
Cash flows from operating activities:				
Net income	$	128,210	$	94,712
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization		19,773		16,756
Losses on sale/disposal of assets		345		247
Amortization of debt issuance costs		2,714		3,133
Provision for deferred income taxes		3,581		1,775
Non-cash compensation expense		9,633		8,617
Other		204		16
Excess tax benefits from equity-based compensation		(16,906)		(34,852)
Changes in operating assets and liabilities		(32,468)		(20,951)
Net cash provided by operating activities		115,086		69,453
Cash flows from investing activities:				
Capital expenditures		(25,230)		(25,045)
Changes in restricted cash		(35,189)		73,505
Other		519		1,861
Net cash provided by (used in) investing activities		(59,900)		50,321
Cash flows from financing activities:				
Proceeds from issuance of long-term debt		—		10,000
Repayments of long-term debt and capital lease obligations		(9,766)		(39,878)
Proceeds from exercise of stock options		3,884		10,848
Excess tax benefits from equity-based compensation		—		34,852
Purchases of common stock		(12,721)		(224,139)
Tax payments for restricted stock upon vesting		(4,911)		(3,036)
Payments of common stock dividends and equivalents		(22,280)		(19,099)
Net cash used in financing activities		(45,794)		(230,452)
Effect of exchange rate changes on cash and cash equivalents		36		(466)
Change in cash and cash equivalents		9,428		(111,144)
Cash and cash equivalents, at beginning of period		42,815		133,449
Cash and cash equivalents, at end of period	$	52,243	$	22,305

Recommendation

Domino's credits their success over the past few years to their value equation. They do not sell the cheapest products. Instead, they provide an overwhelming amount of benefits to justify their prices. Some of the benefits that they offer to consumers and franchisees include their technology platform which makes ordering very convenient, efficient delivery service at a time where more people are staying home, and a loyalty program which gives the members the opportunity to earn rewards such as free pizza, stock, or even a portion of a store's profits. This is why Domino's has averaged double digit sales and earnings growth and increasing store growth since 2013.

The thing to consider when it comes to Domino's stock is risk versus reward. They had disappointing international sales in the second quarter but overall sales were still good. It's 18% off its high of $221.58. The stock bounced at $175 in early April so that becomes a level of support. Due to the restructuring of their debt, Domino's did not buyback any stock in the second quarter. In early August, the company authorized a $1 billion stock repurchase plan. In the first quarter, their average buying price was $160 which becomes more support. These two levels of support minimize the downside risk. If I didn't already own the stock I would be a buyer at $180 or less.

Disclosure: I am a Domino’s shareholder.