THE NELSON EXCLUSIVE

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About Your Editor

Brian Nelson is the president of equity research and ETF analysis at Valuentum Securities.

He is the architect behind the company's research methodology and processes, developing the Valuentum Buying Index rating system, the Economic Castle rating, and the Dividend Cushion ratio. Mr. Nelson has acted as editor-in-chief of the firm's Best Ideas Newsletter and Dividend Growth Newsletter since their inception.

Before founding Valuentum Securities in early 2011, Brian worked as a director at Morningstar, where he was primarily responsible for training and methodology development within the firm's equity and credit research department. Prior to that position, he served as a senior industrials securities analyst covering aerospace, airlines, construction, and environmental services companies.

Before joining Morningstar, Mr. Nelson worked for a small capitalization fund covering a variety of sectors for an aggressive growth investment management firm in Chicago. He holds a Bachelor's degree in finance and a minor in mathematics, magna cum laude, from Benedictine University. Brian has an MBA from the University of Chicago Booth School of Business and also holds the Chartered Financial Analyst (CFA) designation.

Highlights:

Brian is frequently quoted in the media and has been a frequent guest on Nightly Business Report, Bloomberg TV, CNBC, and the MoneyShow.

Mr. Nelson is very experienced valuing equities, developing discounted cash-flow models used to derive the fair value estimates for companies in the equity coverage universes of two independent investment research firms, including Valuentum.

Brian worked on a small cap fund and a micro-cap fund that were ranked within the top 10th percentile and top 1st percentile within the Small Cap Lipper Growth Universe, respectively, in 2005.

Mr. Nelson led the charge in developing Morningstar's issuer credit ratings, creating and rolling-out one of the firm's proprietary credit metrics, the Cash Flow Cushion.

Value and Momentum Within Stocks, Too

Valuentum released a study on its Valuentum Buying Index ratings! To download the paper in PDF form:

https://www.valuentum.com/downloads/20170729/download

Study of Individual Time Series of 20,000+ Valuentum Buying Ratings

Value and Momentum Within Stocks, Too

An Introduction to the Valuentum, the Value-Timing and the Ultra-Momentum Factors

Brian Nelson, CFA
Tatiana Dmitrieva
Kris Rosemann

First Version: July 2017

Abstract

We studied the individual time series of 20,000+ Valuentum Buying Index ratings across two data sets spanning Valuentum's inception (2011) through mid-June 2017. Stocks with the highest Valuentum Buying Index ratings (10, 9-10) significantly outperformed stocks with the lowest Valuentum Buying Index ratings (1, 1-2) immediately following such readings, and the relative outperformance was sustained for extended periods of time thereafter (estimated 12-24 months). We call the outperformance of the highest Valuentum Buying Index ratings relative to the lowest Valuentum Buying Index ratings the Valuentum factor. The Valuentum Buying Index showed a tendency to sort a universe of undervalued stocks on timeliness (9-10 less 8), with higher-rated undervalued stocks outperforming lower-rated undervalued stocks ("value traps"), and the Valuentum Buying Index showed a tendency to sort a universe of overvalued stocks on momentum (2 less 1), with higher-rated technical/momentum stocks ("ultra-momentum") outperforming lower-rated technical/momentum stocks. The outperformance of the highest-rated stocks (10 less universe) supports the hypothesis that stocks with the greatest number of relevant, unique and compensated factors within them may be key levers of sustained fund and portfolio outperformance. In general, cohorts of stocks with higher Valuentum Buying Index ratings outperformed cohorts of stocks with lower Valuentum Buying Index ratings in both data sets, though the signal was less strong in middle ratings (3-8) than at outliers or extremes, as designed and as expected. This paper showcases the efficacy of the stock-selection methodology, the Valuentum Buying Index, and may lay the foundation for evolving academic literature regarding the Valuentum, the value-timing and the ultra-momentum factors. The Valuentum Buying Index is a unique fundamentally-based and forward-looking methodology, differentiated from quantitative multi-factor models that may employ various historical value, momentum and timing dynamics.

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Brian Nelson, MBA Booth School of Business, University of Chicago, formerly Director of Training and Methodology Development at Morningstar, is President of Equity Research and ETF Analysis at Valuentum, an independent investment research publisher serving individual investors, financial advisors, and institutional money-managers. Special thanks to Tatiana Dmitrieva, Data Scientist at Valuentum, Kris Rosemann, Head of Data and Associate Investment Analyst at Valuentum, Elizabeth Nelson, Chris Araos, and to the dozens of analysts and colleagues at Morningstar and Driehaus Capital Management for the thoughts and comments during the past several years that ultimately shaped this analysis, making this paper possible.

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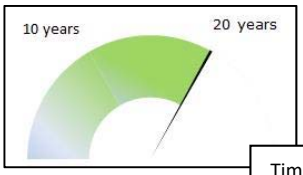


Time Horizon: Long-term

NATIONAL RETAIL PROPERTIES
NYSE:NNN

National Retail Properties (NNN)

"With 28 consecutive years of annual dividend increases, National Retail Properties is in an exclusive club of only four REITs and less than 90 US public companies. The confidence to increase our guidance and raise our dividend was driven in large part by the fact that our portfolio remains extremely healthy. Our broadly diversified pool of over 2,650 primarily small-box single-tenant properties remains over 99% occupied. Our tenants typically operate large regional and national businesses that focus on customer services, customer experiences and e-commerce resistant consumer necessities. We have very little exposure to apparel or other retail concepts that are getting negative headlines these days." – Jay Whitehurst
President & CEO, National Retail Properties 2017 second quarter conference call

Thesis

This month's income idea comes from the coveted list of Dividend Aristocrats, a select group of S&P 500 stocks with at least 25 consecutive years of annual dividend increases. National Retail Properties is one of only five real estate investment trusts (REIT) to make the list, and it has the fourth-longest streak of consecutive dividend increases among all REITs. 2017 marked the 28th consecutive year of an annual dividend increase for the REIT. When it comes to dividend track records, National Retail Properties ranks near the very top, and its dividend payout ratio was 70% of AFFO as of the second quarter of 2017, suggesting room for continued dividend hikes moving forward.

Corporate Profile
National Retail Properties is a real estate investment trust investing in long-term single tenant net-leased retail properties across the US. As of the end of 2016, the REIT owned 2,535 properties with aggregate gross leasable area of more than 27 million square feet in 48 states. It was founded in 1984 and is headquartered in Orlando, Florida.

Key Statistics	
Last Close	$40.50
52-week range	$36.45-$52.27
Market Cap	$6 B
Avg Daily Vol (30 wks)	1,214,970
Annual Dividend Yield	4.69%
Trailing Dividend Payout Ratio	138%
Trailing P/FFO	17.2
Debt/EBITDA (TTM)	4.8x
Credit rating	(BBB+/Baa1/BBB+)

Importantly, National Retail Properties also boasts an investment grade credit rating (BBB+/Baa1/BBB+), which is supported by low leverage ratios relative to its peers. Such a feature is an important one in the REIT space, given the dependence of the business model on access to new capital via the debt and equity markets. The image on the following page shows National Retail Properties' debt-to-EBITDA (on a trailing twelve month basis) ratio as of the first quarter of 2017, and the measure sat at 4.8x as of the end of the second quarter of 2017.

In addition to its low leverage balance sheet strategy, National Retail Properties works to maintain well-laddered debt maturities. As of June 30, 2017, the REIT has a weighted average debt maturity of 6.1 years, and after $250 million in debt matures in 2017, it has no material debt maturing until 2021. In total, less than $252 million in debt will mature through 2020, all of which can currently be refinanced at lower interest rates. Its low leverage balance sheet with long duration debt maturities lowers its exposure to changing interest rates, to a degree, as does the REIT's limited amount of floating rate debt, which sat at ~$215 million as of June 30, 2017.

Image Source: National Retail

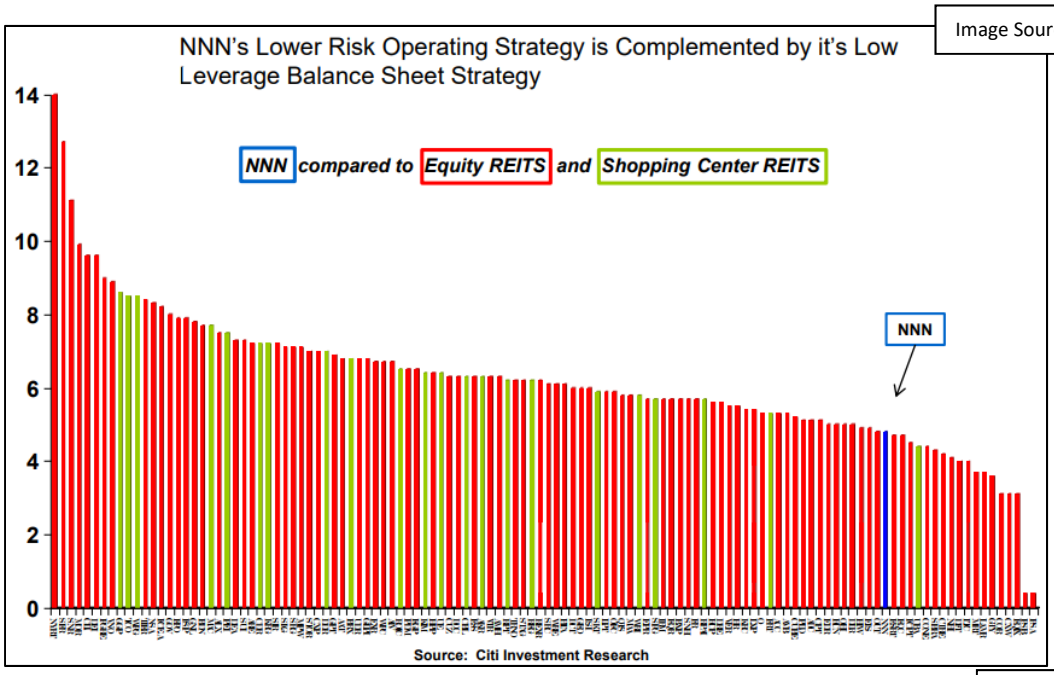
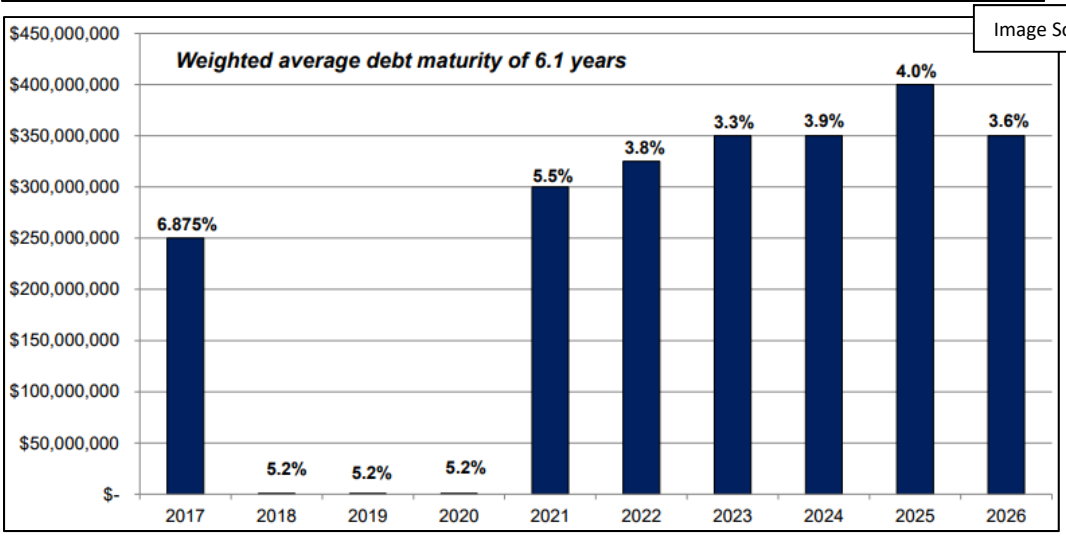


Image Source: National Retail



National Retail Properties' historically attractive acquisition capitalization rates (7.9% since 2010, 6.9% more recently) should help it combat the current rising interest-rate environment as well. In general, a higher cap rate allows for a higher amount of spread compression--between cap rates and the cost of capital--before acquisitions become unattractive.

However, such the contracting spread dynamic highlights the necessity for disciplined acquisitions moving forward, particularly after considering National Retail Properties' exposure to the challenged retail environment. The REIT's acquisition strategy includes purchasing properties directly form tenants, which it believes produces more efficient pricing and better initial returns.

Such a strategy also allows for each deal to be individually structured based on the situation at hand, and tenants are less likely to sign a long-term lease (National Retail's initial lease terms are generally 10-20 years) on a store in which it has relatively little confidence. As of the end of the second quarter of 2017, its weighted average remaining lease term was 11.5 years, and only 6% of leases will expire through the end of 2019. The REIT's leases are also generally net leases in which the tenant takes on the risk of all property costs and expenses related to maintenance and operations such as utilities, property taxes, and insurance.

National Retail Properties has also been able to maintain relatively high occupancy rates with less volatility through the course of the economic cycle. From 2003 through the second quarter of 2017, the REIT's occupancy never fell below 96.4% (low mark established in 2009), while the REIT industry average was never above 93.5%. National Retail's average occupancy over the time period was an impressive 97.9%, and at the end of the second quarter of 2017, it was an even more impressive 99.3%.

Image Source: National Retail

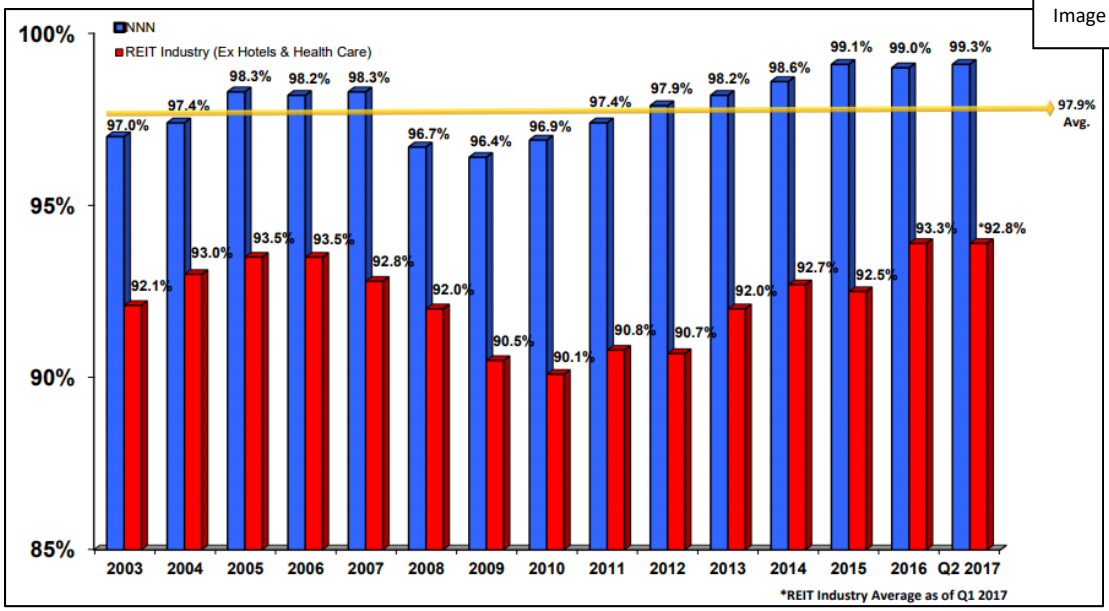


Image Source: National Retail

	Properties	% Base Rent
Sunoco	125	5.2%
Mister Car Wash	96	4.2%
LA Fitness	29	3.8%
Camping World	34	3.4%
AMC Theatre	20	3.3%
Couche-Tard (Pantry)	86	3.3%
7-Eleven	77	3.2%
GPM Investments	96	2.7%
Bell American (Taco Bell)	115	2.6%
SunTrust	109	2.5%
Chuck E. Cheese's	53	2.4%
BJ's Wholesale Club	8	2.2%
Frisch's Restaurant	74	2.1%
Gander Mountain	12	2.1%

However, as the traditional retail operating environment continues to face material pressure from the proliferation of e-commerce, such strong occupancy rates are almost certain to be negatively impacted. We view this as the most material risk to the long-term dividend strength of National Retail, though the payout will likely not be challenged in the foreseeable future. For example, the REIT's thirteenth largest tenant Gander Mountain, which had accounted for just over 2% of its base rent, recently filed Chapter 11 bankruptcy.

Image Source: National Retail

Rent Coverage	
Range	1.1x -- 6.0x
Average	3.1x
Weighted Average	3.4x
Fixed Charge Coverage	
Range	0.9x -- 4.8x
Average	2.2x
Weighted Average	2.2x

National Retail's tenant diversification does help mitigate some tenant-specific risk as no one tenant accounts for more than 5.2% of its total base rent. Its tenant coverage metrics are also solid, with weighted average rent coverage coming in at 3.4x as of the second quarter of 2017. The REIT also has a reasonably diverse tenant base in terms of lines of trade represented. Convenience stores, which might be more resistant to the "Amazon effect" than most of traditional retail, are its highest weighting at ~17%. We're not particularly fond of its exposure to restaurants, which actually represents a higher percentage of annual base rent when combining full and limited service concepts. This space is also susceptible to new delivery- and online-based business models that have become more and more common of late as the US consumer becomes increasingly digitally-focused.

As we have covered in great lengths in the past, REITs are susceptible to rising interest rates in more ways than

Image Source: National Retail

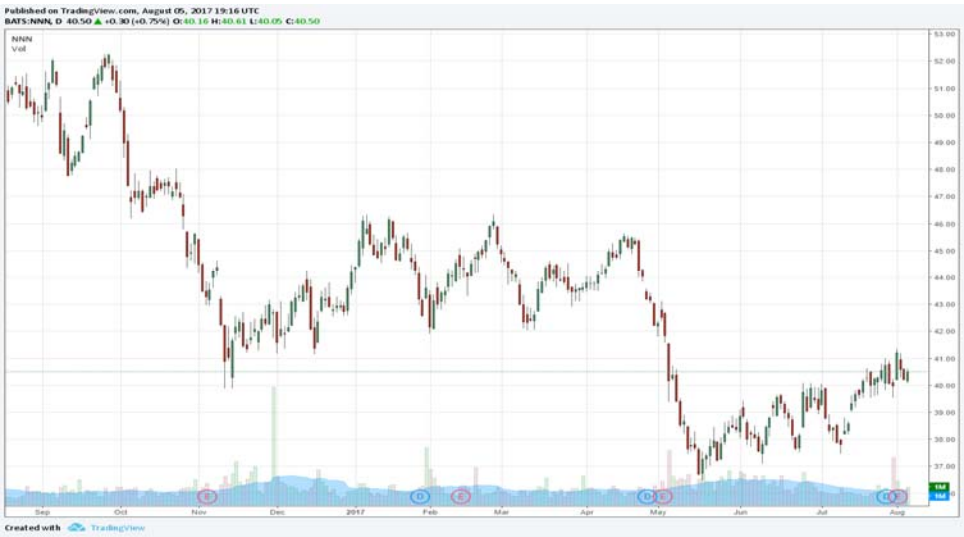
	Top 10 Lines of Trade	% of Annual Base Rent[1] 2016	2015	2014
1.	Convenience stores	16.9%	16.7%	18.0%
2.	Restaurants - full service	11.8%	11.0%	9.1%
3.	Restaurants - limited service	7.5%	7.2%	6.5%
4.	Automotive service	6.6%	7.0%	7.2%
5.	Family entertainment centers	5.8%	5.6%	5.1%
6.	Health and fitness	5.7%	3.8%	3.9%
7.	Theaters	4.9%	5.2%	5.2%
8.	Automotive parts	3.9%	4.2%	4.7%
9.	Recreational vehicle dealers, parts and accessories	3.4%	3.6%	3.1%
10.	Banks	3.1%	3.4%	3.7%
	Other	30.4%	32.3%	33.5%
		100.0%	100.0%	100.0%

(1) Based on annualized base rent for all leases in place as of December 31 of the respective year.

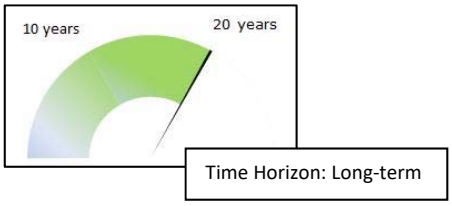
cap rate spreads and rising debt service costs. Equity prices of REITs often face pressure in the event of rising interest rates as the yield spread between US Treasury bond yields and REIT dividend yields narrow. For the time being, National Retail's dividend yield of ~2.9% is more favorable for income-minded investors than the ~2.3% yield on the 10-year US T-bill.

An interesting dynamic is also at play with National Retail Properties is its presence in a number of real estate-focused ETFs. The REIT lists Vanguard (15.5% of common stock), BlackRock (10.6%), Invesco (6.9%), and State Street (7.2%) as the largest holders of its shares. A reasonable argument can be made that such a dynamic could help support the price of its equity as ETFs continue to find favor among investors. Some of the largest ETFs in terms of assets under management list National Retail as a holding, including the Vangaurd REIT ETF (VNQ), iShares US Real Estate ETF (IYR), iShares Cohen & Steers REIT ETF (ICF), and SPDR Dow Jones REIT ETF (RWR).

All-in, we expect National Retail Properties to continue being a compelling income idea for readers to consider. While risks are present in its long-term outlook, we think its disciplined acquisition strategy, historically attractive acquisition cap rates, and dedication to its investment-grade credit rating will serve it well in combatting such risks. Shares are currently trading at ~16.4 times the midpoint of 2107 FFO guidance, a mark that was recently raised following a strong second quarter report.



Kris Rosemann contributed to this article.



Wingstop (WING)

"Chairman and CEO Charlie Morrison stated, "The comparable restaurant sales momentum that began late in the first quarter strengthened as we moved through the second quarter. As expected, our national TV and digital advertising is growing awareness of our 'category of one' brand. Despite higher wing prices, Adjusted EBITDA increased 18.0% and diluted EPS rose 28.6% during the second quarter, outpacing top-line growth." Morrison concluded, "The strength of our overall business and the cash flow that we generate have positioned Wingstop to initiate a regular dividend only two years after our initial public offering. This return of capital to our shareholders demonstrates our commitment to shareholder value and underscores our confidence in future performance." – Wingstop's second-quarter press release, August 3, 2017

Thesis

The Dallas-based, mostly-franchised chicken wing restaurant chain will say it's not in the 'wing business' but instead that it is in the 'flavor business'--and its recent fundamental trajectory has been nothing short of hot and spicy. We've traditionally viewed Wingstop (WING) as Buffalo Wild Wings' (BWLD) smaller cousin, but given some of the troubles at the latter, our attention on the wing space has now shifted in part to the former. Unlike Buffalo Wild Wings, Wingstop operates much smaller restaurants, often 1,350 to 1,800 square feet. Wingstop has an estimated carryout rate of 70%-75%, meaning that with average unit volume of just over $1.1 million, it boasts one of the highest sales-per-square foot measures in the industry. The company dubs itself "The Wing Experts," as all it does is "wings, sides and fries," and we think Wingstop's recent success may be in part causing some of the troubles at its larger cousin, B-Dubs.

Corporate Profile

Wingstop is one of the largest and fast-growing franchisors in the US. The company was founded in 1994 and is one of the pioneers behind the concept of wings as a "center-of-the-plate" item. It offers customers more than 10 flavors on its bone-in or boneless chicken wings, seasoned fries and a variety of sides--cumulatively accounting for 90%+ sales. Wingstop's initial public offering was in 2015.

Key Statistics	
Last Close	$32.28
52-week range	$24.74-$33.42
Market Cap	$935 M
Avg Daily Vol (30 wks)	500,404
Trailing P/E	215.2
Net Debt (LFY)	$147 M
Net Debt/EBITDA (LFY)	4.6x

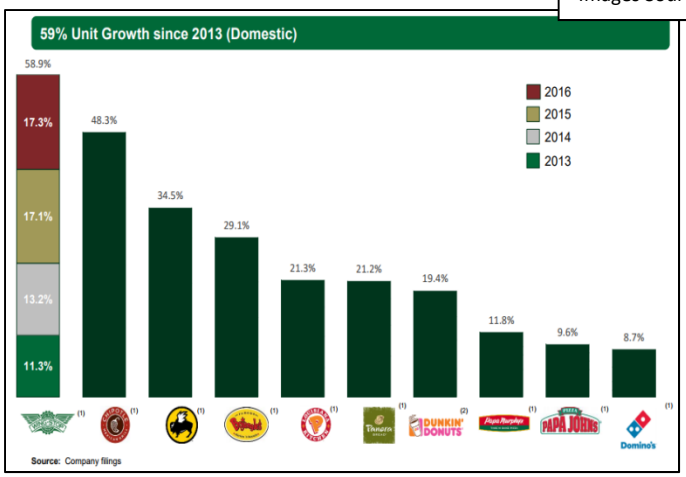
Where other restaurant chains are struggling for any number of reasons, 2016 marked Wingstop's 13th consecutive year of same-store-sales growth, as it also grew units by 18%, amounting to 153 new openings on a net basis. The restaurant and bar segment is a crowded one and may be another reason why Buffalo Wild Wings hasn't been performing up to par lately, but Wingstop's carry-out niche coupled with its engagement with millennials may in some ways better capture our original thesis across wing-focused restaurants, or that which originally attracted us to Buffalo Wild Wings in the Best Ideas Newsletter portfolio. Wingstop's domestic and international growth opportunities, for example,

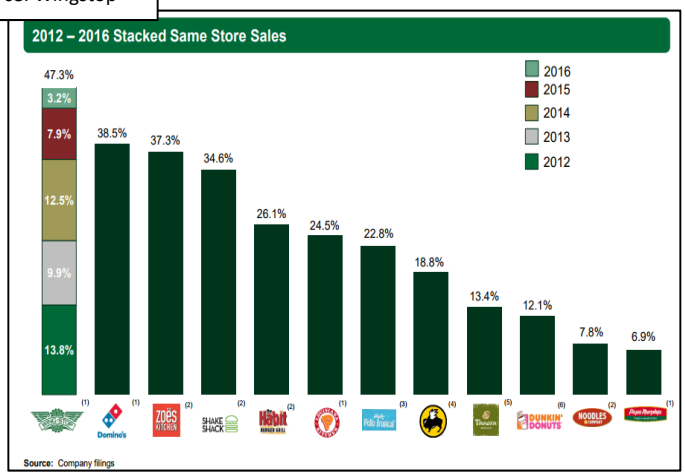
are phenomenal, with management estimating potential in the US alone at 2,500 (it has ~950 at present). On a non-US basis, it has ~90 restaurants in a handful of countries (the majority of non-US units are in Mexico), suggesting a long runway of opportunity, and management has noted it continues to receive "significant franchisee interest."

Image Source: Wingstop

Wingstop is an interesting contrast to the short-idea consideration in this August edition of the Nelson Exclusive, as while both ideas are tied to fickle consumer behavior, Wingstop may in some ways be viewed in a class by itself. During the past 3 years, for example, Wingstop has experienced a compound annual growth rate for unit development, system-wide sales, revenue, and adjusted EBITDA of 18%, 20%, 14%, and 21%, respectively. On an aggregate basis, Wingstop has put up unit development rates better than other fast-growing entities, including Chipotle (CMG), Buffalo Wild Wings, Bojangles (BOJA), Popeyes (PLKI) straight on down the line (see image). The company also has one of the best, if not the best, stacked same-store sales trends among its peer group, better than even highest-rated Economic Castle Dominos (DPZ), Zoe's Kitchen (ZOES), and Shake Shack (SHAK), among many others (see image). What an incredible combination Wingstop currently showcases with respect to both unit development and comparable-store sales, respectively, as the slides below show.

Images Source: Wingstop





From our perspective, Wingstop's business model is in the sweet stop of the restaurant space, positioned nicely to continue to capture industry-wide trends. For starters, its online sales of 20% of total is more than three times that of the fast-casual industry average of 6% (about half of its restaurants generate more than 20% of revenue from the online channel so this number has the potential to go higher). Approximately 50% of its orders are placed over the phone, and the company's ticket prices tend to be a few dollars above the industry average leaving a bit more room for sales to fall to the bottom line. Our general take-away is that franchisees like what Wingstop has to offer, too. Management recently noted that unlevered year-2 cash-on-cash returns are running north of 50% (its domestic system average). From where we stand, the company's business model has been proven across much of the US, with restaurants in almost every state, and its "flavor craver audience" won't be going away anytime soon. We like its long-term goals.

Images Source: Wingstop

Wingstop has a lot of good things going for it, but there are always risks. First, the restaurant space remains intensely competitive, and new concepts are sprouting up all the time. Chicken wing prices and staff size changes can cause volatility among its franchisee's operations and its company-owned restaurants (only 21 out of 1,000+). To give some perspective, for example, a 10% increase in bone-in wing costs would have increased cost of sales by $0.7 million for fiscal 2016 (management is targeting net income between $20.9-$21.2 million for fiscal 2017). Execution across its growth initiatives, both domestically and internationally, is another area to watch very closely. With companies that are growing as rapidly as Wingstop, keeping the ship on course will take a tremendous amount of effort by the executive team.

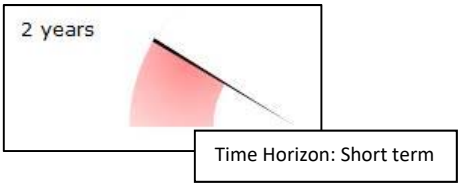
The company holds a net debt position of $135+ million at the end of the second quarter. Wingstop's net debt to its trailing 12-months adjusted EBITDA is running at ~3.5-4x, but we'd expect a fast-growing concept such as Wingstop to be investing heavily--so we're not as concerned about its leverage at the moment as we would be for a mature restaurant chain. The company's executive team doesn't seem to be that worried either, as just two years after becoming a public company, it has already initiated a regular dividend ($0.07 per share). The company also paid a special dividend of $2.90 per share in July 2016. As for tail-risk, the prospect of a pandemic spread of avian flu is one that comes to mind, but the company has been able to navigate such events successfully to date. We view bird-flu scares as more transitory setbacks, not permanent conditions, in any case.

All in, we think Wingstop has the potential to do for wings what Domino's has done--and is doing for--pizza. From an enthusiastic executive team, an exciting concept, distinctive menu offerings, compelling unit economics to attract franchisees, a lower-risk and capital-light business model that has been proven to be portable across much of North America, Wingstop is a rare aggressive growth idea that has not become too extended on a technical basis in the current overheated stock market of mid-2017 (see chart on next page). Though our highlighting of Wingstop in the August edition of the Nelson Exclusive is based on its standalone prospects, we wouldn't be surprised if the company is eventually acquired by a larger rival in the years ahead, perhaps B-dubs, as the restaurant space may seek to rationalize and optimize profits over the long haul. Wingstop is one for your radar!

Image Source: Wingstop

(in thousands)	Year ended December 31, 2016	December 26, 2015	December 27, 2014
Consolidated Statements of Income Data:			
Revenue:			
Royalty revenue and franchise fees	$ 57,071	$ 46,688	$ 38,032
Company-owned restaurant sales	34,288	31,281	29,417
Total revenue	91,359	77,969	67,449
Cost and expenses:			
Cost of sales	25,308	22,219	20,473
Selling, general and administrative	33,840	33,350	26,006
Depreciation and amortization	3,008	2,682	2,904
Total costs and expenses	62,156	58,251	49,383
Operating income	29,203	19,718	18,066
Interest expense, net	4,396	3,477	3,684
Other expense (income), net	254	396	84
Income before income taxes	24,553	15,845	14,298
Income tax expense	9,119	5,739	5,312
Net income	$ 15,434	$ 10,106	$ 8,986
Consolidated Statement of Cash Flows Data:			
Net cash provided by operating activities	$ 22,166	$ 13,047	$ 14,370
Net cash provided by (used in) investing activities	(2,056)	(1,915)	(363)
Net cash provided by (used in) financing activities	(27,050)	(10,165)	(7,457)
Net increase (decrease) in cash and cash equivalents	$ (6,940)	$ 967	$ 6,550

Short Consideration



Del Frisco's Restaurant Group (DFRG)

Thesis

Restaurants across the US are struggling to continue bringing in new guests. According to Black Box Intelligence, May 2017 marked the fourth consecutive month of comparable store sales declines, which have largely been driven by lower traffic counts. Perhaps most troubling for the industry is that unemployment levels are near historic lows, and the general health of the economy has not led to the operational strength one would expect for the discretionary-spending fueled restaurant industry.

Corporate Profile
Del Frisco's Restaurant Group owns and operates the Del Frisco's Double Eagle Steak House, Sullivan's Steakhouse, and Del Frisco's Grille restaurant chains. Each concept offers steaks, along with other menu selections and an award-winning wine list. As of the end of 2016, it operated 53 restaurants in 24 states and the District of Columbia. The company was organized in 2006 and is headquartered in Southlake, Texas.

Not only are top-line pressures present in the full-service restaurant space, so too are margin-contracting forces. The rising wage pressures have high labor-intensive full-service restaurants struggling to maintain margin performance, and many restaurants are working to improve the guest experience via new technology and other differentiating factors, which only further increase spending at the restaurant operating level. Price increase initiatives across the space have been used in an attempt to buoy comparable restaurant sales, but value-conscious consumers have taken notice that the less labor-intensive grocery store industry has been able to keep costs relatively lower, making eating out an increasingly less attractive proposition in terms of value.

Not only are potential restaurant-goers impacting traffic numbers by being increasingly value-focused, but the "Amazon effect" of online ordering, delivery, and other digitally focused business models are placing increasing levels of pressure on traditional restaurant chain operators. Consumers may prefer the convenience of delivery and ease of use of online ordering over a typical sit down meal at full-service restaurant. Fast causal restaurant chains are appealing to the convenience factor in consumers while also avoiding the health stigma related to fast food restaurants, at least to a degree. We feel that traditional, full-service restaurants will have a higher level of difficulty adjusting to the changing trends in US foodservice than other concepts.

This month's short idea consideration, Del Frisco's Restaurant Group, is a prime example of all of the aforementioned pressures coming together. Unlike Wingstop, for example, Del Frisco's has experienced negative comparable restaurant sales in each of the last two years (2015-2016), and it recently lowered its expectations for 2017 comparable restaurant sales to fall by 1%-2% compared to 2016 levels (was a range of -0.5%-0.5%). Management expects comp trends to pick up in the fourth quarter of the year as a result of a marketing campaign rollout and new menu implementation, but we warn that these initiatives are fraught with execution risk.

The company plans to help reverse its comps woes via menu price hikes, a move we're not particularly fond of as it does not speak of sustainability, especially as we continue to march forward in the current economic upswing. We would expect Del Frisco's higher end offerings--the average check at its Del Frisco's Double Eagle Steak House, Sullivan's Steakhouse, and Del Frisco's Grille chains in 2016 were $115, $64, and $48,

respectively-- to experience material pressure in the event of an economic downturn, especially if management continues to implement a price-hike strategy in an attempt to drive sales growth as traffic continues to shrink.

Del Frisco's is also expecting, and has begun to see, some impact from the aforementioned margin-pressuring factors. In fact, these pressures were key to the lowering of its 2017 EBITDA margin and adjusted EPS guidance. Beef price inflation, which accounts for roughly one-third of Del Frisco's food and beverage costs, is expected to impact results as management is forecasting a 6%-8% increase for the full year, and wage pressures will be ongoing. The company's restaurant operating costs will also face pressure from its plans to continue upgrading guest touch points and the build out of new talent and professional fees across its business. The quest for differentiation, a key to traffic increases, is not cheap or easy and welcomes execution risk.

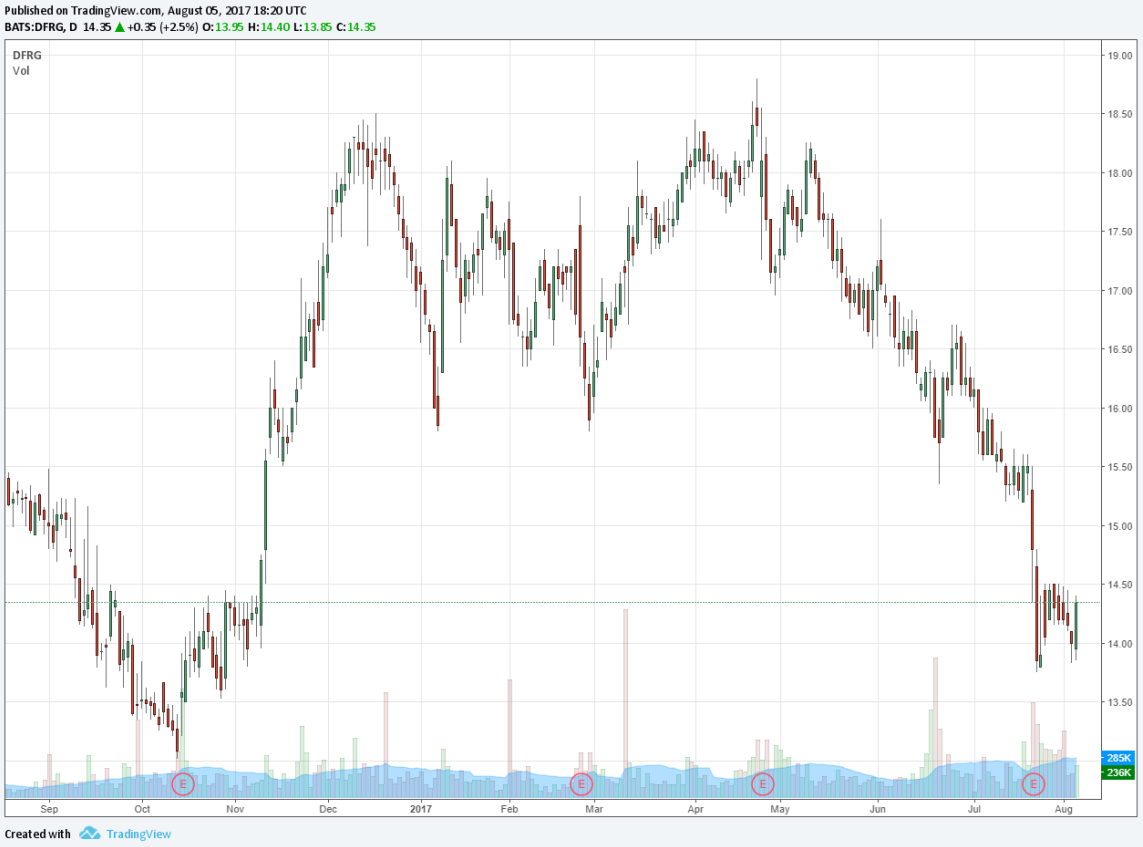
A look at Del Frisco's financials does little in the way of inspiring confidence, though we note that it has been able to sustain top-line growth in recent years thanks to new restaurant openings. However, free cash flow has been less than ideal, coming in negative in 2014 and 2015 before jumping to ~$13 million in 2016 only to drop back into negative territory through the first half of 2017. The company's balance sheet health has deteriorated thus far in 2017 as well, as its cash balance fell to ~$2 million in June from ~$15 million at the end of 2016 while its long-term debt balance rose to ~$23 million from nothing. This debt load represents a very benign net debt-to-restaurant-level EBITDA ratio of 0.5x, but we view the increase in debt as a sign that internally generated cash flows are not enough to appropriately build and transform the business at this point in time. We also have concerns over the effectiveness of its menu price initiatives to reverse such a trend.

Del Frisco's also depends materially on the performance of its Del Frisco's Double Eagle Steak House New York City location, which accounted for 11%, 12%, and 13% of its total revenue in 2016, 2015, and 2014, respectively. Such concentration opens the firm up to abnormal risks unique to the New York City restaurant industry. Though we would not actively anticipate such risks materially impacting its business, it is yet another negative mark against a business model that is facing mounting pressure. Despite the confluence of these risks, Del Frisco's continues to trade at rather lofty earnings multiples, or roughly 18.4 times the midpoint of its recently lowered adjusted EPS guidance for 2017. The chart below summarizes the company's guidance adjustments compared to 2016 actual results.

Image Source: Del Frisco's

($ in millions ex. per share)	2016 Actual	2017 Previous Guidance	2017 Updated Guidance
Comparable restaurant sales growth	-0.8%	(0.5%) - 0.5%	(2%) - (1%)
Cost of sales (as a % of revenue)	28.2%	27.8% - 28.2%	28.0% - 28.4%
Restaurant-level EBITDA margin	21.3%	21.1% - 21.4%	20.5% - 21.0%
G&A spend	$25.9	$26.6 - $28.0	$27.1 - $28.5
Tax rate	27.7%	29% - 31%	26% - 28%
Adjusted EPS	$0.83	$0.82 - $0.86	$0.76 - $0.80
Capital expenditures	$36.7	$32.8 - $33.8	$28.0 - $30.0

All things considered, Del Frisco's equity price may continue to experience pressure in the near term as works to improve its fortunes, and its recent revisions to 2017 guidance across the board speaks to the troubles its business is facing. Multiple secular trends are working against its attempted re-invigoration of comparable restaurant sales, and we don't think it is out of the woods yet. We're taking a short-term perspective with this short idea consideration, but the prospects of a long-term recovery are not attractive, from our point of view.



Kris Rosemann contributed to this article.

July 1, 2016

Inaugural Letter to Members

Dear Valued Member,

Welcome! You are one of a very limited number of members that will ever bear witness to the pages that follow.

The launch week of the Nelson Exclusive coincided with news that Britain has voted to leave the European Union. The decision, while sending the European banks tumbling violently, does little to muddy the context setting the background of the inaugural edition of this publication.

Broader stock market valuations are at frothy levels, and interest rates continue to hover near all-time lows. The investment-decision landscape is more complicated today than ever before for all types of investors, from those seeking long-term capital appreciation to those that are targeting certain income goals. Cyclicals today are trading at peak multiples on peak earnings, and even consumer staples equities have reached valuation levels that may be more appropriate for aggressive growth equities, not mature operators. *Said differently, the market has laid down the gauntlet.*

The next few years in the markets may be among the most difficult witnessed since the Great Recession. Even a broader market pullback 20% from current all-time highs wouldn't be abnormal given that the collective market valuation of S&P 500 companies has effectively tripled from the March 2009 panic bottom. The launch of the Nelson Exclusive in such conditions can be considered perilous as broader market performance inevitably will act as ballast to the returns of ideas surfaced. In this spirit, I want to remind you that not all ideas in this publication will be successful, and some that are eventually may encounter tough sledding over extended periods of time. As a swimmer cannot achieve his best time swimming against the current, a stock selector cannot achieve his best performance in a down market. Regardless, the value placed on a steady hand during challenging times is priceless.

Let's first cover what the Exclusive is and then we'll talk about what it is not. As you know, the Valuentum investment coverage universe is vast, and what we're seeking to deliver in this publication is ideas that fall outside its reach. We're breaking down the traditional barriers of equity coverage to identify underfollowed gems across the investing spectrum, delivering in each monthly edition one idea for income investors, one idea for readers seeking long-term capital appreciation, and a bonus idea for those looking for a "short" consideration (1). Underfollowed doesn't mean obscure, however, and the ideas that we're targeting will be investable ones, avoiding thinly-traded instruments and penny stock "traps." We'll clearly define our expected time horizon for each consideration, and where applicable, we'll update our theses in subsequent editions. We'll keep score, tracking performance over time.

Let's talk about what the Exclusive isn't. The Exclusive does not constitute individual investment advice, and the ideas within it are not personal recommendations. Each of you reading should always work with your

personal financial advisor who knows your individual goals and risk tolerances. I do not. Only you and your personal financial advisor know what's best for your life circumstances. The personal financial advising markets and what we do at Valuentum via financial publishing are two different verticals in the same industry, but they are different nonetheless. I just want to be very clear about this because I can never tell you to buy or sell anything at any time, even if this may be what you want. It's not that I don't have conviction in my work – it's the rules of the business.

Within the twelve editions of the Nelson Exclusive each year, we'll be highlighting in total 36 ideas for consideration with varying investment parameters. That's a lot. Depending on the time horizon set forth with each idea, fantastic performance might mean a success rate of 60%, great performance might be 55%, average performance might be 50%, while anything below that mark may constituent a poor showing. Obviously, I'm aiming for a 100% success rate, but I also have to be realistic. The great Joe DiMaggio may have hit safely for 56 consecutive games in the last baseball season before the United States was thrust into World War II, but he "only" hit .357 that year. That season of '41, the great Ted Williams would be the last player to hit .400, meaning that one of the best hitters in baseball…ever…was still called out ~60% of the time.

The greatest investors face a similar paradigm. Stock selection is a process where there will be homeruns and strikeouts. You know me. The Exclusive is not a "get-rich-quick" product, and you should keep a close eye on your wallet if you encounter anyone promising anything of the sort. In the inaugural edition of the Nelson Exclusive, I'm going to take 36 swings – they are going to be hard and through the zone, and I'm not going to pull my shoulder out or take my eye off the ball. Market conditions are expected to be stormy in coming years as "reversion-to-the-mean" dynamics rain down, and a crafty lefthander with great "stuff" may be on the mound, but we're stepping up to the plate and digging in.

Batter up!

Sincerely,

Brian Nelson, CFA
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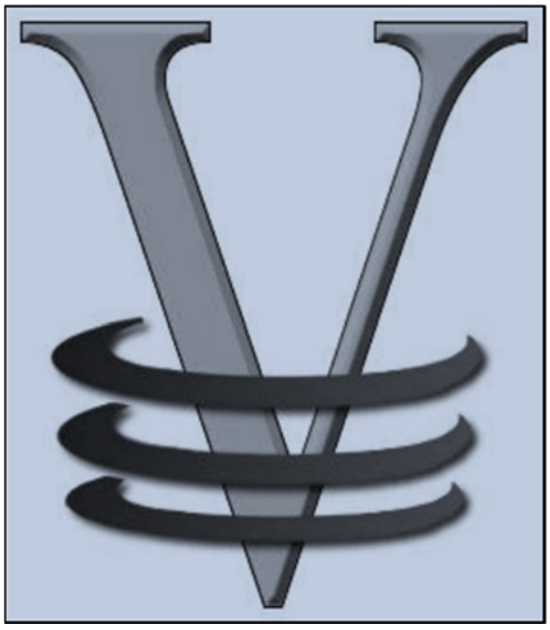

P.S. On a very personal note, I wanted to thank you for your continued support. Without you, neither the Nelson Exclusive publication nor Valuentum would exist. This fact is not lost on me. I thank you deeply.

The Nelson Exclusive: Volume 2, Issue 8

The Nelson Exclusive is published monthly. Contact us at info@valuentum.com for more information.

(1) From the SEC's website: A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor. Short sales are normally settled by the delivery of a security borrowed by or on behalf of the investor. The investor later closes out the position by returning the borrowed security to the stock lender, typically by purchasing securities on the open market.

Investors who sell stock short typically believe the price of the stock will fall and hope to buy the stock at the lower price and make a profit. Short selling is also used by market makers and others to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security. If the price of the stock rises, short sellers who buy it at the higher price will incur a loss.

Brokerage firms typically lend stock to customers who engage in short sales, using the firm's own inventory, the margin account of another of the firm's customers, or another lender. As with buying stock on margin, short sellers are subject to the margin rules and other fees and charges may apply (including interest on the stock loan). If the borrowed stock pays a dividend, the short seller is responsible for paying the dividend to the person or firm making the loan (Source: SEC https://www.sec.gov/answers/shortsale.htm)

Short selling is not for all types of investors, and readers should consult their personal financial advisor that understands their individual goals and risk tolerances before considering any investment or any strategy. Potential losses for an investor engaging in a short selling strategy are theoretically infinite.

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