April 27, 2018

Dear Fellow Investors,

Adestella gained 9.4% in the first quarter of 2018. Our long holdings produced an 11.4% return, in large part due to a transformational acquisition announced by one of our larger positions in mid-March. Meanwhile, our short book ended the period with a 0.3% loss, and currency fluctuations had a negative 1.7% impact. The Fund finished the quarter with gross exposure of 156% and net exposure of 85%. Of this net total, international holdings now comprise about 47%.

The first quarter saw a return to volatility and the end of the nine quarter streak of positive returns for the S&P 500. Strong gains in January were erased in the following months as investors turned their focus first to long-time risk factors (such as the prospect of higher interest rates) and then to new ones (such as the implications of tariffs and potential trade wars). This led the indices to their first 10%+ pullback since early 2016. However, as I have noted in prior quarters, these developments are essentially immaterial to Adestella. Our performance will ultimately be driven by the success of our business holdings, and not by the timing of interest rate increases or VIX spikes. Accordingly, so long as the underlying economy is strong (as it currently is), I am not concerned with the mark-to-market fluctuations that consume the attention of many market participants and financial media sources.

An updated performance summary is as follows:

	1Q 2018	Since Inception[1]
S&P 500	-1.00%	45.31%
Vanguard Total World Stock ETF	-0.50%	28.87%
Russell 2000	-0.18%	35.16%
HFRI Equity-Hedge (Total) Index	0.71%	19.92%
Adestella Investment Management[2]	**9.39%**	**97.12%**

**all index returns include reinvestment of dividends*

[1] Adestella began operations in the third quarter of 2014.
[2] Time weighted returns on a gross basis

Only Shades of Gray

The nature of complex dynamic systems is such that their components can interact with each other in many different ways depending on their state and context. Often, the interplay between some of these various pieces is so small or subtle that it cannot be measured in an accurate and timely way. However, the codependency of the different parts of the system means that even a very small change in one input can lead to a massively different output elsewhere. This phenomenon is commonly known as the butterfly effect, a name derived from the metaphorical example of the enormous impact that a mere flap of a butterfly's wings can exert on the path of a developing tornado.

As the above example suggests, this effect is commonly found in the field of meteorology – no matter how many times an analyst sees a similar pattern of cloud structure, temperature, pressure, etc., he cannot be certain whether or not it will rain at all, much less exactly where. The same holds for rarer and more severe types of events – even with significant advances in technology, hurricane path predictions today are off by an average of 100 miles.[3] There are simply too many variables – down to minuscule details such as the way in which individual water particles coalesce – that preclude perfect foresight in these manners. Another complex dynamic system with inherent unpredictability is the stock market. The interplays between economics, geopolitics, industry environments, company specific actions, and sentiments are endless and make the idea of certainty a pipe dream. Decisions can thus never be black and white, only somewhere in between.

Given this reality, an investor needs to be able to think in and deal with probabilities. In *Superforecasting: the Art and Science of Prediction*, authors Dan Gardner and Phillip Tetlock recount a comment made by famous psychologist Amos Tversky about the way in which most people deal with probabilistic situations. He commented that most people only have three settings: "gonna happen", "not gonna happen", and "maybe." Combining this with the discussion above, this implies that the forecast for any stock can be boiled down to one word: "maybe".

Of course, simply concluding "maybe" for everything is not helpful in building an investment portfolio. That is why I spend a significant amount of time studying valuations, industry structures, competitive positioning, etc. to better gauge the likelihood of a company's success. Doing so allows us to fine-tune our predictions from "maybe" to "likely." Then, we insist on a margin of safety by adding only the best ideas, with the highest likelihood of success, to the portfolio – thereby positioning ourselves for satisfactory returns no matter how the metaphorical butterfly moves.

The lack of certainty and probabilistic nature of the stock market has another important implication: the importance of asymmetry. By investing in situations where the risk-reward is skewed in our favor, we can make sure we earn more on our successful investments than what we lose on our failures. No matter how much research we do, we will be wrong on some ideas – likely winners are not always winners. Yet, when netted out, this approach should generate an attractive return over time. For example, if we invest only in situations that have the potential to double our money, we only need to be right two thirds of the time to generate a 33% return (even assuming our unsuccessful investments were

[3] See https://www.economist.com/blogs/economist-explains/2016/06/economist-explains-10 for more detail

a total loss). Of course, not every opportunity offers that type of return potential – but most don't present that level of risk either. If we can identify situations where there is some sort of downside protection that would limit our maximum potential loss (say to 20%) while maintaining the same upside, we could be correct just over 40% of the time and still generate a 30% return.

Things are always more complicated in the real world, so the details will change. Fortunately, the favorable math equations won't. That's why I always prioritize an examination of risk-reward profiles when examining an idea, looking for things like large valuation disconnects or hidden assets that could potentially create asymmetry. One current holding for which I believe the odds are currently favorably skewed in our favor is Diversified Restaurant Holdings (SAUC), the topic of this quarter's appendix.

Snowball Effect: On the Benefits of Constant Learning

The snowball effect refers to processes that have small significance initially but build upon themselves over time to eventually become much larger and more meaningful. While the concept is well known in value investor circles, as it relates to the power of compounding money over time, I believe its applications are perhaps less often appreciated (but just as important) in the context of personal development.

Everyone knows that to improve at anything, you need to practice. But time constraints and the potential frustration that comes with slow progress is enough to dissuade many people from attempting at all. However, even small amounts of effort can have a significant impact over time. For example, if one can improve on a particular skill or task at a rate of just 1% per day, he or she will be about 38x better at it by the year's end. Perhaps the rate will be faster for a beginner, and it will certainly be slower for an expert, but in any case the power of consistent gradual improvement is enormous.

This snowball effect is the reason that I continually endeavor to learn new things about companies, industries, and the economy. It's also why I try to read some sort of nonfiction every day: as I briefly discussed in my previous letter, investing is a multi-disciplinary field in which having a latticework of knowledge can prove to be beneficial in ways you don't necessarily expect. Some days, the advancements are so small as to be nearly imperceptible, but I continue nonetheless knowing that these days of small improvement will eventually combine to form meaningful progress.

To be sure, the regular application of effort does require some time and discipline – hence why shortcuts like cramming before an exam or buying into a "get rich quick" scheme have and will maintain the illusion of attractiveness. But for those with patience and a longer-term time horizon, the effects of modest but consistent exertion can be terrific. Thus, my goal has been to position both myself and Adestella to be able to take advantage of them, and it will continue to be going forward. If we succeed, I expect we may be able to create a rather formidable snowball over time.

Outlook

So far the investment environment of 2018 has been quite different than 2017. Year to date, there have been 31 days in which the S&P 500 had a move of more than 1% – more than three times as many as we had in the entire 2017 calendar year. While we may not see that same elevated level of volatility during the rest of the year, I would guess that we won't return to the historically depressed levels of last year either. In any case, it is likely investors will continue to overweight and overreact to short-term data points and market noise, hopefully providing us with occasional opportunities to transact at favorable prices.

Conclusion

When I started writing these quarterly update letters last year, my goal was to crystalize my thinking on investment ideas and strategies and then to share it in a manner than would be useful to current and prospective investors alike. On this front, I believe we made a good start in 2017, and I hope that this letter marks the beginning of a continuation of that progress in 2018 – given the aforementioned snowball effect, I think we have a decent shot! I look forward to providing you with another update on Adestella this summer.

"He who stops being better stops being good."

- Oliver Cromwell

Best Regards,

Andrew Jakubowski

Appendix A: Diversified Restaurant Holdings (SAUC) Investment Thesis

Introduction

Diversified Restaurant Holdings (SAUC) is one of the largest franchisees of the Buffalo Wild Wings (BWW) brand, with 65 locations primarily in the Midwestern and Southeastern regions of the US. The company has been on my radar for quite some time now. I owned shares towards the end of 2016, around the time that SAUC announced it would run a strategic alternatives process for its subscale "better burger" chain Bagger Dave's (BD) to focus on its core BWW operations (and thereby making its corporate name a misnomer). I exited the position as the stock ran up last spring upon the completion of that process, but I have continued keeping tabs on it since. And, as the stock continued drifting lower and lower in the latter half of 2017, I began watching ever more closely. I finally reentered the position last December, shortly after the announcement of one particularly exciting piece of news that I believe remains underappreciated even today. I was early – the stock has mostly continued to drift downward since my initial purchases – but I have continually added to the position in recent months, and I now believe the company to offer a very attractive risk-reward proposition.

Company and Situation Background

SAUC was founded in 1999 by restaurant operator Michael Ansley, with a view toward franchising a group of restaurants in a concept he felt had a lot of potential – Buffalo Wild Wings Grill & Bar. That year, Ansley opened his first BWW franchise in Sterling Heights, Michigan (not far from the firm's current headquarters in Southfield, MI). The company continued adding units throughout the Midwest in the years that followed, including locations in Indiana, Illinois, and Missouri. They had reached double-digit units across these four states by 2004 when they further expanded into Florida, which became their second largest market. SAUC's efforts were overwhelmingly successful, leading to a bevy of awards over the years, such as BWW's operator of the year (2000), highest single unit sales (2003 and 2006), and IFA Franchisee of the Year and Multi-Unit Franchisee of the Year (2007). From 2010 to 2015, the strong performance continued – units, revenues, and EBITDA all grew between 27-31% on an annualized basis, and the company posted 20 consecutive quarters of same-store sales (SSS) growth. Towards the end of this period (May 2015), SAUC acquired another 18 units in the St. Louis area, its first major M&A transaction.

However, a couple factors conspired to stop SAUC's momentum in 2016. First, following years of solid performance, traffic declines led to persistently negative SSS figures across the casual dining space.

Restaurant Industry Commentary and Q3 2017 SSS Update

TRINITY CAPITAL
INVESTMENT BANKING

Same-Store Sales Data (Cont.)

	FY 2014	FY 2015				FY 2016				FY 2017		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Casual Dining												
Applebee's	2.8%	2.9%	1.0%	(0.5%)	(2.5%)	(3.7%)	(4.2%)	(5.2%)	(7.2%)	(7.9%)	(6.2%)	(7.7%)
Bahama Breeze	(0.6%)	3.2%	1.8%	1.8%	2.4%	9.9%	4.7%	3.9%	2.6%	0.5%	1.4%	1.2%
BJ's Restaurants	1.2%	3.2%	0.5%	2.3%	0.7%	0.6%	(0.2%)	(3.4%)	(2.2%)	(1.3%)	(1.4%)	(1.7%)
Bonefish	0.7%	0.9%	(4.6%)	(6.1%)	(5.4%)	(2.7%)	0.9%	1.7%	(1.9%)	(0.8%)	(2.6%)	(4.3%)
Bravo! Cucina Italiana	(3.9%)	(1.7%)	(2.1%)	(3.1%)	(5.2%)	(4.1%)	(8.4%)	(8.0%)	(7.5%)	(2.9%)	(1.1%)	(2.7%)
Brick House Tavern	5.7%	5.4%	2.8%	(0.7%)	(2.8%)	(4.5%)	(6.3%)	(8.9%)	0.0%	0.0%	0.0%	0.0%
Brio Tuscan Grille	(4.2%)	(1.0%)	(1.6%)	(3.8%)	(4.3%)	(2.1%)	(6.4%)	(3.7%)	(4.3%)	(1.9%)	(0.9%)	(7.4%)
Buffalo Wild Wings	5.5%	6.5%	3.3%	2.6%	1.0%	(2.0%)	(2.3%)	(1.7%)	(4.0%)	0.6%	(1.2%)	(2.3%)
Carrabba's Italian Grill	0.3%	1.9%	0.9%	(2.0%)	(4.0%)	(2.0%)	(4.8%)	(2.1%)	(2.3%)	(3.8%)	0.4%	(2.8%)
Cheesecake Factory	1.4%	4.2%	2.8%	2.2%	1.1%	1.7%	0.3%	1.7%	1.1%	0.3%	(0.5%)	(2.3%)
Chili's Grill & Bar	4.2%	2.2%	0.1%	(1.1%)	(2.1%)	(3.6%)	(1.8%)	(1.3%)	(3.2%)	(1.7%)	(1.7%)	(3.0%)
Chuy's	3.8%	1.9%	N/A	4.2%	3.2%	3.2%	1.0%	0.3%	(1.1%)	(0.7%)	(0.1%)	(2.1%)
Dave & Buster's	10.5%	9.9%	11.0%	8.8%	6.0%	3.6%	1.0%	5.9%	3.2%	2.2%	1.1%	(1.3%)
Famous Dave's	(2.4%)	0.1%	(3.3%)	(3.6%)	(5.2%)	(6.1%)	(4.3%)	(3.8%)	(4.7%)	(4.8%)	(3.2%)	(1.5%)
Joe's Crab Shack	(4.5%)	(3.8%)	(4.0%)	(6.6%)	(2.9%)	(1.3%)	(6.8%)	(6.5%)	0.0%	0.0%	0.0%	0.0%
Kona Grill	3.1%	2.2%	1.0%	1.6%	3.2%	3.6%	2.5%	0.7%	(4.1%)	(4.3%)	(5.3%)	(7.2%)
LongHorn Steakhouse	2.6%	5.4%	5.2%	4.4%	2.6%	5.2%	2.2%	0.6%	0.1%	0.2%	3.5%	2.6%
Maggiano's	2.3%	0.1%	(0.1%)	(1.7%)	(1.8%)	0.2%	(1.7%)	(0.6%)	(0.8%)	1.6%	0.5%	(2.6%)
Olive Garden	2.2%	2.2%	3.4%	2.7%	2.8%	4.9%	2.4%	2.0%	2.6%	1.4%	4.4%	1.9%
Outback	6.4%	5.0%	4.0%	0.1%	(2.2%)	(1.3%)	(2.5%)	(0.7%)	(4.8%)	1.4%	0.3%	0.6%
Red Robin	4.3%	3.8%	3.6%	3.7%	(1.6%)	(2.2%)	(3.2%)	(3.3%)	(4.4%)	(1.5%)	0.5%	(0.1%)
Ruby Tuesday	(1.0%)	(0.3%)	(1.7%)	0.6%	0.8%	(3.1%)	(3.7%)	(2.7%)	(4.1%)	(4.0%)	(1.6%)	(5.8%)
Taco Cabana	6.1%	3.8%	5.6%	4.8%	3.3%	1.7%	(3.8%)	(4.1%)	(3.5%)	(4.5%)	(4.7%)	(12.6%)
Texas Roadhouse	6.8%	8.7%	8.0%	7.0%	4.4%	4.3%	4.2%	3.4%	1.4%	3.2%	4.0%	4.5%
Mean	**2.2%**	**2.8%**	**1.6%**	**0.7%**	**(0.4%)**	**0.0%**	**(1.7%)**	**(1.5%)**	**(2.0%)**	**(1.2%)**	**(0.6%)**	**(2.4%)**

Despite managing to grow its average check over the period, SAUC was not immune to the traffic pressures and posted over 3% declines in SSS for both 2016 and 2017.

Second, the price of chicken wings (which represent BWW's largest cost-of-sales item) reached record highs towards the end of 2016 and remained there for the entirety of 2017.

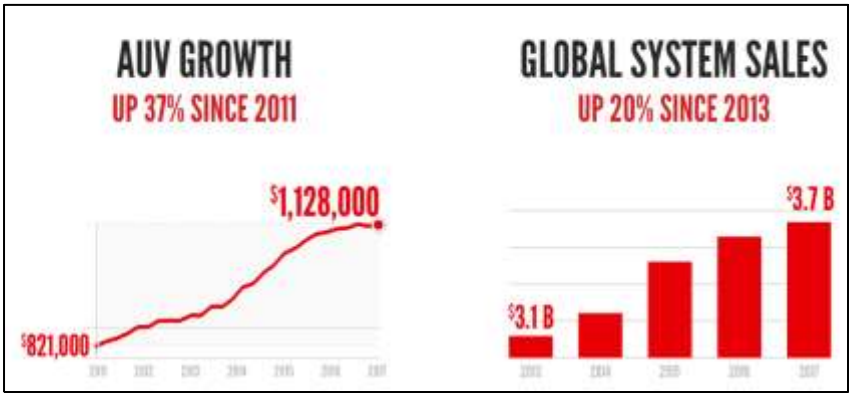
This combination of falling sales and rising costs could not be fully offset by corporate belt-tightening, and as a result, SAUC's margins began to fall. By year-end 2016, the stock had already fallen over 80% from its 2013 peak. The shares' roller coaster ride continued in early 2017, when a wave of optimism following the spinoff of Bagger Dave's caused SAUC's market value to more than triple in the first half of the year. However, as weak monthly industry traffic data rolled in, this soon gave way to fears of negative operating leverage and debt levels, causing the stock give up nearly all its gains by the end of the year. The bearish trend has continued so far in 2018, with SAUC hitting a low of $1.25 last week (a 65% decline from May 2017 highs).

While there was perhaps too much optimism from shareholders in early 2017, I now believe the pendulum of sentiment has swung too far in the other direction. Moreover, I think the seeds for the catalyst that will eventually cause it to swing back were sown last November, when Buffalo Wild Wings announced it was selling itself to private equity firm Roark Capital Group. While seemingly unappreciated by most, I believe this deal will prove to be a game-changer for SAUC, as I'll discuss in the following section.

Key Investment Points

1. **New ownership group with proven track record of success.** An investment in SAUC today is largely a bet on the jockey, so it's worth examining the purchaser and its executives in detail. Following the acquisition of BWW by Roark Capital Group, the brand and its strategy are under the control of Inspire Brands (a wholly owned subsidiary of Roark that handles its restaurant investments). Inspire is led by Paul Brown, the former president of Hilton Worldwide who was brought to the firm in 2013 to attempt a turnaround of Arby's, which Inspire had purchased in 2011. By all accounts, this was a difficult task – the year before Roark's purchase, a JP Morgan analyst called Arby's performance "amongst the worst in modern history." Incremental improvements had been made in 2011 and 2012, but they were largely due to discounts and promotions that were not a sustainable source of sales and cash flow growth.

   Despite the size of the challenge, Brown has succeeded beyond anyone's expectations. Since Brown became CEO in late 2013, Arby's has grown SSS for 16 consecutive quarters (and likely 18 by now – I only have data up to Q2 2017). Unit volumes have steadily expanded, allowing the company to generate record sales in 2017 despite having 42 fewer locations than it did when Brown took over.



Even more important than the results, though, (at least for a prospective SAUC investor) is the process that Brown and his team used to achieve them. So how did the company manage to pull this off? There's been quite a bit written about Arby's turnaround), but a few frequently mentioned things stand out to me as particularly important:

1.) **Brand re-energization via improved communication, internally and externally.** In his first six months on the job, Brown visited over 50 Arby's locations and spoke to over 1,000 employees about what they would do differently if they were in charge of the company. Spending time listening and visiting sites instead of immediately dictating changes allowed him to improve morale and discover unique ideas and frequent pain points on the unit level. Simultaneously, Arby's revamped its brand persona to great effect both on social media and television.
2.) **Consistent menu innovation.** Upon Brown's CEO appointment, Arby's immediately stepped up the pace of new menu item releases from about two per year to twelve. Some of these immediately had a major impact, such as the Smokehouse Brisket that lifted sales by a double digit percentage upon its release in 2013. Even today, the company continues to release unique new products to generate buzz and drive sales – for example, in 2016 the company released a venison sandwich in markets where hunting is popular to celebrate the start of the deer season, and it was a huge hit. In 2017, Arby's rolled out the venison product nationwide and added a new elk offering.
3.) **Commitment to analytics.** Brown has said his strategy for Arby's was inspired by the book *Moneyball*, which describes how a small market team managed to compete with and defeat richer organizations by using analytics to find overlooked players with strong potential. Realizing his company would never have resources comparable to McDonald's (such as a large ad budget to push new products), Brown pivoted Arby's towards making decisions more on the basis of hard data and proprietary research than on qualitative judgments. Accordingly, the company developed a consistent, data-driven process of testing new menu items – introduce the product at a discount to get people to try it, and then remove the promotional

pricing and see how it fares. If the item can continue earning 3-6% of total sales, it remains on the menu; if not, it's gone. This has proved to be a high hurdle: to date only about four of thirty have managed to pass the test.

Now, I realize that quick service and casual dining restaurants have important differences in areas such as customer demographics and menu variety. And, there have certainly been plenty of instances in which high-profile new CEOs failed to replicate their prior successes at a different company. But there are two reasons why I believe the probability of success is very high here. First, Brown is not a lifelong QSR executive who will be trying to fit the only strategy he knows into something new; recall he arrived at Arby's from the hotel industry and had no prior experience with restaurants. Second, examining Roark's playbook at Arby's, I believe most pages can be effectively transferred to a restaurant with the style and format of Buffalo Wild Wings. In fact, each of the three process keys listed above seems readily applicable to BWW as well:

1.) Improved communication – the site visits and stakeholder collaborations are easily replicable and appear to be off to a good start (see following section). BWW also has plenty of room to improve its brand perception (its net promoter score is currently negative) and engagement (as one data point, BWW has about 15% fewer Twitter followers despite having published 36% more Tweets).
2.) Menu innovation – given the wider scope of BWW's menu, this could arguably be easier to accomplish here than it was at Arby's. New signature sauce or seasoning options are a ripe area for experiment, and there is a pipeline of potential crossover items from Arby's menu as well. New management appears to have already gotten underway on both these initiatives – in February, BWW trialed a new sauce that was a hybrid of Arby's famous Horsey sauce and BWW's Asian Zing sauce in several New York locations.
3.) Commitment to analytics – while the percentage of sales threshold may change slightly, the process of introducing new items at a discount and then gauging performance without promotional pricing to see whether they should stay can easily be transferred. The improved measures of item cannibalization from the release of new products and regional taste preferences that Roark brought to Arby's should be able to be implemented here as well.

I also realize that corporate BWW is not the same as SAUC, and there may be some differences with company-owned versus franchised locations. But Arby's is also a heavily franchised concept (67% of total US locations), and it's clear that those franchise owners think highly of Brown – 97% now say they believe in the company's long term potential, up from only 67% in 2013. So far, SAUC management appears to have a similarly positive view:

David Gregory Burke
President, Chief Executive Officer & Director, Diversified Restaurant Holdings, Inc.

A

There are a lot of initiatives as you can imagine. Roark has a stellar track record with these types of situations and time is of the essence as you can imagine with them. So, that said, they're very prudent in how they do things, there's going to be zero shooting from the hip or instinctive decisions, but – so, there's going to be – I look at this through the lens that there's going to be short-term benefits, mid-term and longer-term benefits. And you have to kind of categorize all these.

Short-term benefits are going to be, the low-hanging fruit is going to be looking at all of our contracts, leveraging their scale, their current scale, leveraging the future scale that they've already alluded to as Inspire builds up. So, that definitely can happen relatively quickly, contracts with larger suppliers.

And then mid-term, a lot of the strategies – we're already making changes as we speak, okay? We're testing some new value propositions. In fact, we're starting on this week. It's an everyday value for the weekend that we've never really tried before. So, I'm highly encouraged by that and strategically what they're doing and how their putting the data behind and how they're testing it and how they're rolling it out, it's very refreshing.

And then longer term, obviously, this is more strategic in nature in understanding the position of Buffalo Wild Wings and how that's going to change, looking at things like the menu, looking at the food, the quality of the food, just every – the entire brand, right, and all the elements of the brand, how we go to market, the creative side of it, et cetera. Those are longer-term proposition. Those aren't going to happen overnight, nor would you want them to happen overnight.

So, I'm – okay, couldn't be more excited, to be frank. Just it's refreshing, seeing what they've done with Arby's, as from an Inspire Brand standpoint, nothing but great things to say about their new leadership team and really looking forward to some of the changes coming down the pipeline.

Jeremy Hamblin
Analyst, Dougherty & Co. LLC

Q

Yeah. I have to agree. At the Arby's transformation, my 20-plus years in the business, one of the most remarkable I've ever seen for a brand that I thought was dead. So, it certainly provides a lot of optimistic outlook here.

I believe this is particularly important since it appears as though franchisees were viewed as something of an afterthought under the prior leadership (quote below is from CEO in same earnings call transcript)

But that being said, there's really no – nothing's really been telepathic whether we're going to go through any type of drastic change and capital requirements as a result of potentially any change out there, I really don't see that happening there. And I can say that just because of the tone and the conversations we've had with a lot of the leadership team, and the fairness, the transparency, and the way they view the franchise or franchisee relationship as a true partnership in the truest sense. And that, in it of itself, is highly refreshing to me.

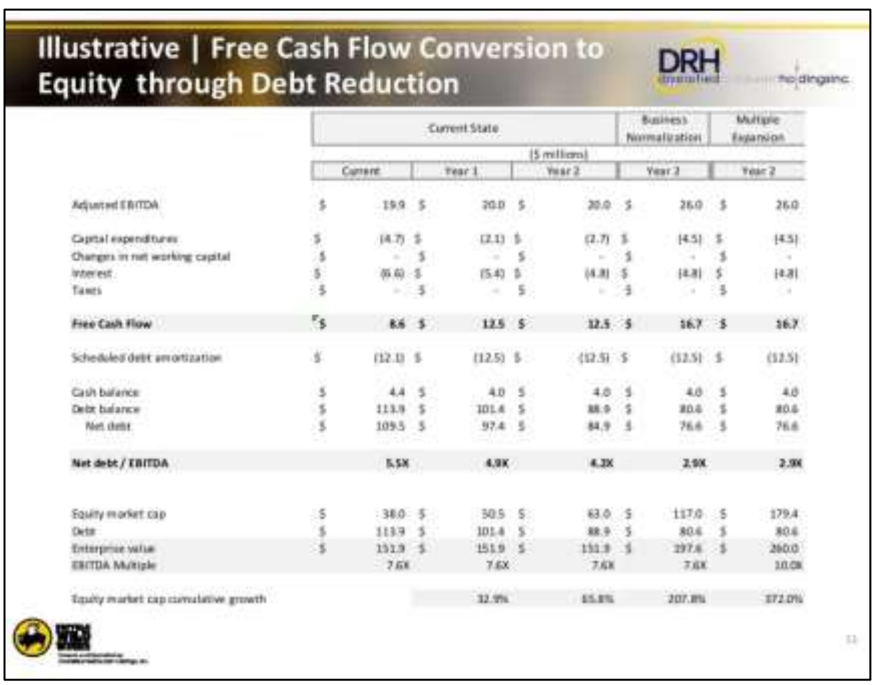
2. **Chicken wing prices normalizing from elevated 2016-2017 levels.** Record demand and an aggressive promotional environment drove chicken wing prices to their highest levels ever beginning in the fall of 2016. Not surprisingly, this increase squeezed the margins of wing joints like SAUC, who were unable to pass the full cost increase on to customers. From 2014 to 2017, wings as a percentage of the company's cost of sales increased from 18.4% to 24.7%, causing gross margins to decline each year. When combined with slowing sales growth (which limited the positive impact from corporate cost reductions), this caused EBITDA margins to drop from 21.2% to 17.1% over the three-year period.

   The good news is that in a commodity industry such as chicken, things always mean-revert. As anyone who ever took an economics course knows, higher prices incentivize producers to increase supply. As supply increases faster than demand (as buyers counteract the price increase via substitutes, etc.), prices are pushed down until a market clearing price is found. That process now appears to be well underway in for chicken wings now – following a year or so of record prices, they began falling steadily in fall 2017 and are now at their lowest levels in several years (see chart below).

3. **Operating leverage due to capital structure and cost cuts creates attractive risk-reward proposition.** Highly-levered companies trading at cheap multiples and generating significant free cash flow can often be sources of interesting investment opportunities. If the company's cash flow stream is sufficient to service interest payments and pay back principal, value will gradually be transferred from the debt holders to the equity holders. As a further benefit, as leverage metrics fall, investors will often award the stock a higher multiple. Such situations can be likened to a "public LBO," as the use of debt financing and focus on cash flows is very similar to the strategies employed by many private equity firms, and they have been a source of profitable investments for me in the past.

   SAUC seems to be aware of this as well – in a recent presentation, they even made the comparison themselves:

Leverage is a double-edged sword, but if handled carefully, one can use it to his advantage. The combination of potential debt reduction, profitability improvement, multiple expansion, and EBITDA growth could be explosive if things fall into place here – SAUC's own illustrative example (from the same presentation) shows how the company could potentially be a 5-bagger within two years:



Illustrative | Free Cash Flow Conversion to Equity through Debt Reduction

($ millions)	Current State			Business Normalization	Multiple Expansion
	Current	Year 1	Year 2	Year 2	Year 2
Adjusted EBITDA	$ 19.9	$ 20.0	$ 20.0	$ 26.0	$ 26.0
Capital expenditures	$ (4.7)	$ (2.1)	$ (2.7)	$ (4.5)	$ (4.5)
Changes in net working capital	$ -	$ -	$ -	$ -	$ -
Interest	$ (6.6)	$ (5.4)	$ (4.8)	$ (4.8)	$ (4.8)
Taxes	$ -	$ -	$ -	$ -	$ -
Free Cash Flow	**$ 8.6**	**$ 12.5**	**$ 12.5**	**$ 16.7**	**$ 16.7**
Scheduled debt amortization	$ (12.1)	$ (12.5)	$ (12.5)	$ (12.5)	$ (12.5)
Cash balance	$ 4.4	$ 4.0	$ 4.0	$ 4.0	$ 4.0
Debt balance	$ 113.9	$ 101.4	$ 88.9	$ 80.6	$ 80.6
Net debt	$ 109.5	$ 97.4	$ 84.9	$ 76.6	$ 76.6
Net debt / EBITDA	**5.5X**	**4.9X**	**4.2X**	**2.9X**	**2.9X**
Equity market cap	$ 38.0	$ 50.5	$ 63.0	$ 117.0	$ 179.4
Debt	$ 113.9	$ 101.4	$ 88.9	$ 80.6	$ 80.6
Enterprise value	$ 151.9	$ 151.9	$ 151.9	$ 197.6	$ 260.0
EBITDA Multiple	7.6X	7.6X	7.6X	7.6X	10.0X
Equity market cap cumulative growth		32.9%	65.8%	207.8%	372.0%

While I believe certain aspects of management's illustrative calculations are too aggressive – in my valuation below I assume lower multiples and a slower normalization process – I do strongly agree that there is the potential to eventually multiply one's money here and that the risk-reward is very favorable near current prices.

Management

I've already discussed the new management team of BWW in detail, but it's worth repeating that I believe they are truly exceptional and ideal for the task at hand. Their long-term orientation and focus on driving sustainable growth rather than on next quarter's numbers should ultimately prove highly beneficial both to BWW and SAUC (and its shareholders).

In terms of SAUC, insiders own nearly half of the company, so they're aligned with shareholders. The current CEO David Burke is the former CFO, who was promoted in October 2016 when founder Michael Ansley stepped away from day-to-day operations to become the chairman of the board. I view Burke as a solid manager who has been forced to navigate a difficult industry environment. And, more importantly, he and his team seem fully on board with Inspire's turnaround plans (see transcript excerpt above).

Valuation

SAUC trades at a large discount to casual dining peers, despite its results reflecting similar industry headwinds and additional margin pressures from increased COGS. Even assuming all capex for is maintenance, SAUC currently trades under 4x FCF, which I view as far too punitive, especially since its current conditions are likely near or at the trough.

Company Symbol	Company Name	MV (USD)	EV (USD)	LTM P/E	NTM P/E	LTM EV/ EBITDA	NTM EV/ EBITDA	LTM P/CF	LTM P/FCF	EV/ uFCF	EV/ Sales	EBITDA Margin	Net Debt / EBITDA
BJRI	BJ's Restaurants, Inc.	999.6	1,138.7	23.3	26.3	10.1	9.5	9.7	22.0	25.0	0.91	10.9%	1.24
BLMN	Bloomin' Brands, Inc.	2,165.3	3,164.8	23.8	16.3	8.1	8.2	6.4	14.3	56.2	0.74	9.2%	2.54
BBRG	Bravo Brio Restaurant Group, Inc.	61.2	99.3	n/a	n/a	3.8	n/a	3.6	11.7	24.7	0.19	6.5%	1.44
EAT	Brinker International, Inc.	1,767.7	3,126.5	14.6	10.4	7.2	7.6	5.9	9.3	13.2	1.04	13.7%	3.03
CAKE	Cheesecake Factory Incorporated	2,395.5	2,508.1	15.9	18.7	9.7	10.1	10.0	20.1	19.1	1.10	11.3%	0.44
CHUY	Chuy's Holdings, Inc.	457.2	448.4	15.9	23.5	9.8	10.4	11.6	n/a	-145.8	1.27	11.3%	-0.19
DRI	Darden Restaurants, Inc.	10,858.9	11,689.1	22.5	16.5	12.6	10.2	14.5	17.7	25.2	1.67	12.8%	0.93
PLAY	Dave & Buster's Entertainment, Inc.	1,729.9	2,077.4	15.0	15.8	7.0	7.6	8.0	45.4	220.1	2.09	25.9%	1.18
DIN	Dine Brands Global, Inc.	1,290.8	2,540.5	n/a	13.4	12.4	11.5	13.7	17.2	-9.5	3.56	34.0%	6.08
DAVE	Famous Dave's of America, Inc.	53.4	53.4	n/a	19.8	18.6	8.2	17.1	19.6	-13.9	0.71	5.6%	0.00
FRGI	Fiesta Restaurant Group, Inc.	530.1	603.0	n/a	29.8	9.6	9.2	8.9	n/a	-10.9	0.87	9.1%	1.16
RRGB	Red Robin Gourmet Burgers, Inc.	789.3	1,048.1	26.3	21.7	7.6	7.4	6.3	10.0	22.7	0.72	10.0%	1.87
TXRH	Texas Roadhouse, Inc.	4,367.6	4,280.9	33.2	24.9	13.6	13.3	16.9	31.0	66.5	1.70	13.5%	-0.31
	Average	**2,112.8**	**2,521.4**	**21.2**	**19.8**	**10.0**	**9.4**	**10.9**	**19.6**	**22.5**	**1.27**	**13.4%**	**1.49**
	Median	**1,290.8**	**2,077.4**	**22.5**	**19.2**	**9.7**	**9.4**	**9.7**	**17.2**	**22.7**	**1.04**	**11.3%**	**1.18**
SAUC	*Diversified Restaurant Holdings*	*33.4*	*143.0*	*285.2*	*12.4*	*7.2*	*6.4*	*2.5*	*3.9*	*11.1*	*0.86*	*12.0%*	*5.51*

To crosscheck the results (as I was concerned these figures could be inflated by larger companies), I also made a set of smaller cap restaurants with positive FCF and similar margin profiles; the results proved to be quite similar.

Company Symbol	Company Name	MV (USD)	EV (USD)	LTM P/E	NTM P/E	LTM EV/ EBITDA	NTM EV/ EBITDA	LTM P/CF	LTM P/FCF	EV/ uFCF	EV/ Sales	EBITDA Margin	Net Debt / EBITDA
BJRI	BJ's Restaurants, Inc.	999.6	1,138.7	23.3	26.3	10.1	9.5	9.7	22.0	25.0	0.91	10.9%	1.24
BOJA	Bojangles', Inc.	519.8	660.6	7.5	19.9	9.3	10.9	10.3	11.3	7.9	1.09	13.0%	1.98
BBRG	Bravo Brio Restauran...	61.2	99.3	NA	NA	3.8	NA	3.6	11.7	24.7	0.19	6.5%	1.44
TACO	Del Taco Restaurants...	412.5	578.0	8.6	17.1	8.6	7.8	7.6	67.6	22.0	1.38	14.3%	2.45
LOCO	El Pollo Loco Holding...	365.3	450.0	45.2	13.4	7.9	7.5	6.5	22.6	-81.3	1.18	14.3%	1.50
DAVE	Famous Dave's of Am...	53.4	53.4	NA	19.8	18.6	8.2	26.2	16.7	-13.9	0.71	5.6%	0.00
JAX	J. Alexander's Holdin...	172.0	186.3	23.9	20.3	8.2	7.1	9.5	18.0	32.8	0.68	9.1%	0.40
FRSH	Papa Murphy's Holdin...	85.7	178.9	NA	16.9	9.4	8.5	11.4	7.9	18.3	1.55	10.1%	4.92
PBPB	Potbelly Corp.	310.1	285.1	NA	33.1	7.9	7.6	6.9	43.2	-17.9	0.66	8.2%	-0.71
RRGB	Red Robin Gourmet ...	789.3	1,048.1	26.3	21.7	7.6	7.4	6.3	10.0	22.7	0.72	10.0%	1.67
RUTH	Ruth's Hospitality Gro...	788.6	834.6	26.6	18.7	12.3	11.7	13.0	14.1	34.0	1.72	15.9%	0.68
Average		**414.3**	**501.2**	**23.1**	**20.7**	**9.4**	**8.6**	**10.1**	**22.3**	**8.6**	**0.98**	**10.7%**	**1.43**
Median		**365.3**	**450.0**	**23.9**	**19.8**	**8.6**	**8.0**	**9.5**	**16.7**	**22.0**	**0.91**	**10.1%**	**1.44**
	SAUC	*33.4*	*143.0*	*285.2*	*12.4*	*7.2*	*6.4*	*2.5*	*3.9*	*11.1*	*0.86*	*12.0%*	*5.51*

As mentioned in the previous section, there is a lot of operating leverage here – and it doesn't require much to go right in order to kick in. In my model, I assume that it takes the company until 2020 to retain the level of sales it achieved in 2016. This assumes a -1% SSS decline and no new stores in 2018, and then 1% SSS growth for 2019 and 2020 with just one new opening each year (recall Arby's produced 8% and 4% SSS growth with this team in its second and third years, respectively). I hold corporate costs at the same percentage of sales in 2020 as management's implied guidance for 2018 (although the percentage is likely to go down if sales increase).

	2015	2016	2017	2018	2019	2020		2017	2018	2019	2020	
Total Sales	172.5	166.5	165.5	163.8	165.4	167.1		-0.6%	-1.0%	1.0%	1.0%	YoY SSS growth
x Corp. Costs as % of Sales	8.9%	5.7%	5.3%	4.8%	4.8%	4.8%		<-- percentages lower after 2015 due to BG spinoff				
Corp. Costs	15.4	9.5	8.8	7.9	8.0	8.0		<-- mgt. estimate for 2018				

I increase store EBITDA margins by 1.3%, which can be accomplished solely by chicken wing prices returning to 2016 levels (they're now lower than that) and gives no credit to the potential for Roark store productivity initiatives.

	2015	2016	2017	2018	2019	2020					
Existing BWLD Units (at beg	42	62	64	65	65	66	2017	2018	2019	2020	
x AUV	2.92	2.64	2.56	2.54	2.56	2.59	-2.9%	-1.0%	1.0%	1.0%	SSS growth
Sales	123	164	164	165	167	171					
x Store EBITDA Margin	19.2%	19.4%	17.1%	18.4%	18.9%	19.4%	*<-- ~1.4% improvement over 2017 can be accomplished solely by chicken wing prices returning to 2016 level*				
Store EBITDA	23.5	31.8	28.1	30.4	31.5	33.2					
New BWLD Units	20	2	1	0	1	1	<-- mgt. guidance for 2018				
x AUV	2.98	2.70	2.65	2.62	2.65	2.67	2017	2018	2019	2020	
Run-Rate Sales	59.6	5.4	2.6	0.0	2.6	2.7	-2.0%	-1.0%	1.0%	1.0%	SSS growth
- Est. Ramping Adjustment	29.4	2.7	1.3	0.0	1.3	1.3	0.5	Implies avg. store opened halfway through year			
Actual Cumulative Sales	30.2	2.7	1.3	0.0	1.3	1.3					
x Store EBITDA Margin	18.0%	19.1%	17.0%	17.5%	18.0%	18.5%	<-- factors in lower contribution in initial year				
Store EBITDA	5.4	0.5	0.2	0.0	0.2	0.2					

In terms of cash flow, I assume consistent levels of D&A and a return to normalized capex levels (around $4.5 M per year). This leads to FCF generation of $15-16 M a year (even if we deduct all capex as maintenance), which I apply toward reducing the company's debt balance.

	2015	2016	2017	2018	2019	2020						
NI	0.6	1.8	0.1	2.7	4.6	6.6						
+ D&A	16.6	14.7	13.1	13.4	13.6	13.7	2017	2018	2019	2020		
- Maint. Capex	11.4	9.4	4.7	1.3	4.5	4.5	100%	100%	100%	100%	of total capex	
FCF	5.8	7.1	8.5	14.9	13.7	15.8	22.1%	CAGR				

To these figures I apply a 7x EBITDA multiple, below the peer median and SAUC's long-term average.

	2015	2016	2017	2018	2019	2020					
Store EBITDA	32.1	32.3	28.3	30.4	31.7	33.4		0.8%	CAGR		
- Add'l Corporate Costs	15.4	9.5	8.8	7.9	8.0	8.0					
Base EBITDA	16.8	22.7	19.5	22.5	23.8	25.4					
+ Pre-Open Costs	3.7	0.6	0.4	-	0.3	0.3		0.264	per new store		
Adjusted EBITDA	20.5	23.3	19.9	22.5	24.1	25.7		4.6%	CAGR		
x Multiple	7.0	7.0	7.0	7.0	7.0	7.0		7	EV/EBITDA	<-- 3 yr. median is 10x	
EV	143.4	163.4	139.1	157.3	168.4	179.7					
- ND	112.4	117.2	109.6	94.6	80.2	64.8					
MC	31.0	46.3	29.5	62.7	88.2	115.0					
÷ Shares	26.5	26.7	26.7	26.7	26.9	27.0		1%	annual dilution		
BWLD Value	1.17	1.73	1.10	2.35	3.29	4.26					
+ BG Value	0.52	0.56	-	-	-	-		0.7	BG EV/S		
Total Value	1.69	2.30	1.10	2.35	3.29	4.26					
Upside	*34.9%*	*83.9%*	*-11.6%*	*87.8%*	*162.9%*	*240.8%*					
IRR	*34.9%*	*83.9%*	*-11.6%*	*87.8%*	*62.1%*	*50.5%*					

This triangulates to about a 7.5x FCF multiple, also below the company's long-term average and by far the lowest of any company in my comparison set.

	2015	2016	2017	2018	2019	2020				
FCF/share	0.22	0.27	0.32	0.56	0.51	0.59	21.7%	CAGR		
x Multiple	7.5	7.5	7.5	7.5	7.5	7.5	7.5	P/FCF	<-- 3 yr. median is 8.9x	
Value	1.65	2.01	2.40	4.18	3.82	4.40				
Upside	*32.0%*	*60.5%*	*91.9%*	*234.2%*	*205.8%*	*251.9%*				
IRR	*32.0%*	*60.5%*	*91.9%*	*234.2%*	*74.9%*	*52.1%*				

The calculations above imply that even if its sales recovery is tepid and its EBITDA multiple fails to expand, SAUC could be worth around $4.25 by 2020. I believe that the potential length of the turnaround (recall Brown's comment that they're not rushed) could be part of the reason for the opportunity here. However, a $4.25 price in 2020 would still equate to a highly attractive 51% IRR.

Furthermore, based on Arby's trajectory, I believe there's a reasonable chance that we'll see a return to 2016 sales levels earlier than I've projected here.

Why Does This Opportunity Exist?

I believe there are several reasons why the opportunity in SAUC stock exists today:

- **Small capitalization with low free float.** SAUC's current market value is only $35 M, making it too small for many institutional investors. The problem is further exacerbated by the fact that insiders own over half of the shares, which reduces the average daily trading volume.

- **Limited investor following.** SAUC has only two sell-side analysts covering it, both from small shops. It also has only 1,022 followers on Seeking Alpha, which is below peers even after adjusting for market value differences.

- **Myopic focus on short term casual dining trends.** Aside from its brief period of buoyancy last spring following the BG spinoff, SAUC stock has seemed to be correlated to changes in industry trends. Investors are apparently more worried about next quarter's SSS numbers than about the longer term strategy of the new ownership group – something I think they may come to regret in the years ahead.

Risks & Their Mitigants

The risk that likely causes potential investors the greatest concern is the leverage profile of the company – currently, net debt/EBITDA stands at 5.5x. However, as discussed in the operating leverage section of the thesis, SAUC's debt is low cost (around 4%) and not due until 2020, providing ample time for a potential refinancing. Even under the unfavorable conditions of the past 18 months, they generated more than enough cash flow to cover all their financing obligations. Furthermore, given the high level of insider ownership here, management is certainly acutely aware of the risks they face in this regard.

Some investors may also be worried about the company's liabilities relating to Bagger Dave's – which has continued to struggle since being spun off and now has very limited equity value – and wonder how its failure could potentially impact SAUC. However, according to SAUC's latest 10-K, the only liabilities for which SAUC would be on the hook are 16 leases. These leases expire anywhere from this year to 2030 and carry a maximum potential liability of $8.4 M. However, SAUC has stated that it does not expect these liabilities to be material; given that it has thus far been able to find new tenants for 80% of the closed Bagger Dave's locations that have lease guarantees, I am inclined to agree. However, let's assume for a minute that the company is unable to find any sub-lessors in the future and is forced to bear all those rental costs. In this case, the annual drag to FCF would be $700k per year on average. Not only would SAUC still be solidly FCF positive at that level, the stock would still be very cheap – at current prices, it trades at 4.5x this pro-forma FCF.

Potential Catalysts

While I don't foresee a single hard catalyst that will cause the stock to re-rate, I think there are several regular data points that, if they exhibit a positive trajectory, could cause investor sentiment on SAUC to improve rapidly.

- **Casual dining trends improve.** A rising tide lifts all boats, so if we see a bounce-back in traffic for the segment I think sentiment will quickly change on SAUC. Given that the US consumer profile is still quite healthy, I think there's a reasonable chance that this occurs sometime in 2018.
- **Positive SSS from BWLD, showing evidence of Roark's successful plan implantation**. For the reasons outlined above, I have a lot of confidence in the new BWW management team and believe they are highly likely to be successful. What's more, they've shown their turnaround playbook can be executed regardless of the broader industry landscape – Arby's has posted consistent SSS growth in recent quarters even as industry traffic has declined. Thus, regardless of whether casual dining improves in the years ahead, I believe BWW (and SAUC as an extension) is well-positioned for anyone who can take a longer-term view.

Conclusion

Diversified Restaurant Holdings has operated under difficult conditions for the past 18 months, and the environment may remain tough this year as well. But at current prices, such sentiment is more than accounted for, while ascribing no value to the optionality that a terrific new management team and cost input declines should produce. Even with very modest assumptions about the timing and degree of turnaround, shares could be worth more than $4 and generate a 50%+ IRR by 2020. Thus, I believe the range and skew of outcomes is very attractive here, which makes SAUC a very appetizing investment opportunity indeed.

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