

# DRI: Expectations of Hope and Change

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LONG LIST		TRADE	TREND	TAIL	SHORT LIST		TRADE	TREND	TAIL
<b>LONG</b>					<b>SHORT</b>				
<b>YUM</b>	Yum! Brands*	-	✓	✓	<b>SHAK</b>	Shake Shack*	-	X	X
<b>CMG</b>	Chipotle Mexican Grill	✓	✓	✓	<b>DFRG</b>	Del Frisco's Rest. Group	X	X	-
<b>WEN</b>	The Wendy's Company	-	✓	✓	<b>NDLS</b>	Noodles & Co.	X	X	-
<b>LONG BENCH</b>					<b>CHUY</b>	Chuy's Holdings	X	X	-
<b>LONG</b>					<b>MCD</b>	McDonald's Corp	X	X	✓
<b>JACK</b>	Jack In The Box	-	✓	✓	<b>DRI</b>	Darden Restaurants	X	-	✓
<b>PLKI</b>	Popeyes Louisiana Kitchen	-	✓	✓	<b>SHORT BENCH</b>				
<b>ZOES</b>	Zoe's Kitchen	✓	-	✓	<b>SHORT</b>				
					<b>PLAY</b>	Dave & Busters Ent.	-	X	-
					<b>HABT</b>	Habit Restaurants	-	X	-
					<b>CBRL</b>	Cracker Barrel	X	X	✓
					<b>CAKE</b>	The Cheesecake Factory	-	X	-

\*Denotes Hedgeye Best Idea

Bench = timing is not right, or research is in progress.

DRI is up 10% this year and up 30% over the past twelve months.

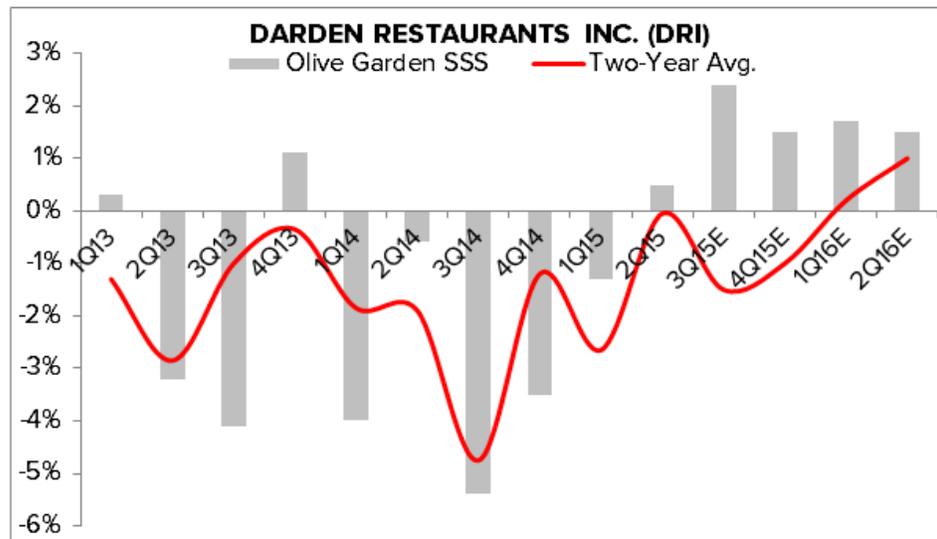
Now the team must deliver on what the stock is intimating is happening – and we don't think that's likely.

DRI is set to report earnings on Friday, March 20<sup>th</sup>. It will be an important call for newly appointed CEO, Gene Lee. He needs to show the investment community what type of leader he will be and how he will turn Darden back into the great company it once was.

The street is looking for 3Q15 EPS of \$0.84, up +31% from a disastrous 3Q14. This would be a nice performance for the new CEO to talk about on his first earnings call. While 4Q15 will be equally as easy from a comparison standpoint, it's not all about the numbers here. It's important to remember that the casual dining industry is currently in an upswing, which compares quite favorably to conditions a year ago. Our fear is that this industry-wide upturn is masking continued weakness in the Olive Garden business. To allay these concerns, we must see how the changes at Olive Garden will lead to sustainable, increased profitability for the organization.

While the company has put up its HQ for sales, they should be eager to sell more assets that that. Our guess is that management will hold out a significant "number" of carrots to the investment community. Given that a hedge fund manager is the Chairman of the Board, we expect to hear a smartly crafted message of hope and change.

The hope side of the equation will be conveyed by a positive tone about the trends at Olive Garden. For 3Q15, the street is expecting +2.5% same-store sales growth, which would represent a 190 bps sequential acceleration from 2Q, but a 150 bps slowdown on a 2-year basis. Importantly, +2.5% same-store sales growth would lag the industry, which would imply that Olive Garden continues to lose market share. They must deliver a strong message about the future of the brand, because we haven't heard one yet.



Sources: Company Filings; Consensus Estimates

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On the change side of the equation, there is a significant amount that can be accomplished, such as selling its corporate HQ.

**Other changes we want to see include:**

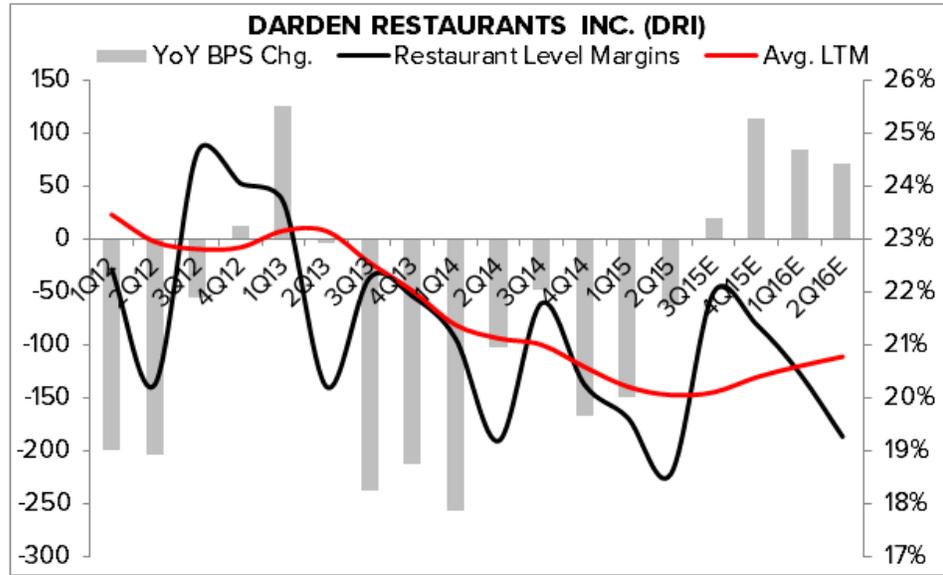
- Cutting new unit capital spending
- Commentary about non-core asset sales
- Further cost cutting
- The future of Olive Garden remodels
- 3 to 5 year plan to improve margins by 300-400 bps
- What the future of Olive Garden will look like
- The evolving culture of the company

We don't expect to hear much on these fronts and think management's overall message will fall short of lofty expectations. For this reason, we believe the stock is far ahead of itself. Until we see a material change in the fundamentals of the business, this will continue to be the case.

**Since the Board meeting last October:**

- Short interest has decreased from 12% to 3%
- FY15 EPS estimates have increased from \$2.25 to \$2.31
- NTM P/E has increased from 22x to 25.5x
- The average sell-side price target has increased from \$59 to \$65
- The percentage of buy ratings has increased from 26% to 35%

Given the industry-wide pickup, we think DRI will be able to hit the numbers in 2H15. But FY16 EPS estimates of \$2.61 look aggressive, particularly considering the massive improvement in restaurant level margins the street is baking in over the next three quarters. The 3Q15 print will be indicative of future results. If Darden doesn't show restaurant level margin growth in the quarter, it will be safe to assume that estimates for such aggressive expansion moving forward are likely to disappoint.



Sources: Company Filings; Consensus Estimates

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We'd be short DRI given the massive run in the stock that has not been supported by a change in the fundamentals of the business. We have fair value at \$56 to \$58.

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