

Red Robin Gourmet Burgers Inc.
RRGB - \$78.11 – NasdaqGS

Recommendation: Sell Short

Reasons For Short Sale Recommendation

- **Stock price up 62% from low one year ago.**
- **Revenue up only 14% year over year.**
- **Very little traffic growth.**
- **Revenue growth coming from increased prices, ASP's and more stores.**
- **2015 2Q revenue missed estimates by \$4.7 million.**
- **Remodeling stores and loyalty program not increasing traffic.**
- **2015 1Q EPS boosted by 6 cents on gift card breakage.**
- **Slowing consumer spending and increased healthcare costs and wages next year to weigh on all restaurants.**

Financials

52 – Week Low 10-13-20014	\$47.45	Book Value/Shr (mrq)	\$27.78
52 – Week high 8-5-2015	\$95.00	Diluted Earnings/Shr (ttm)	\$2.71
52- Week Change	36.50%	Diluted Earnings/Shr mrq)	\$0.78
Daily Volume Avg.	264075	Sales/Shr (ttm)	\$87.53
Market Capitalization	\$1.11B	Cash/Shr (mrq)	\$1.60
Shares Outstanding	14.31M	Price/Book (mrq)	2.81
Float	13.98M	Price/Earnings (ttm)	28.78
Profit Margin (ttm)	3.14%	Price/Sales (ttm)	0.89
Operating Margin (ttm)	5.17%	Revenue (ttm)	\$1.24B
Return on Assets (ttm)	5.45%	EBITDA (ttm)	\$136.47
Return on Equity (ttm)	10.23%	Debt/Equity (mrq)	36.71
Operating Cash Flow (ttm)	\$134.85M	Shares Short 8-31-2015	1.57M
Leveraged Free Cash Flow (ttm)	-\$1.67M	% of Float Short	11.26
Total Cash (mrq)	\$22.61M	Short Ratio	4.08

(ttm) = Trailing 12 months, (mrq) = Most recent quarter, M = Millions, B = Billions, m = Thousands

RED ROBIN GOURMET BURGERS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

(Unaudited)

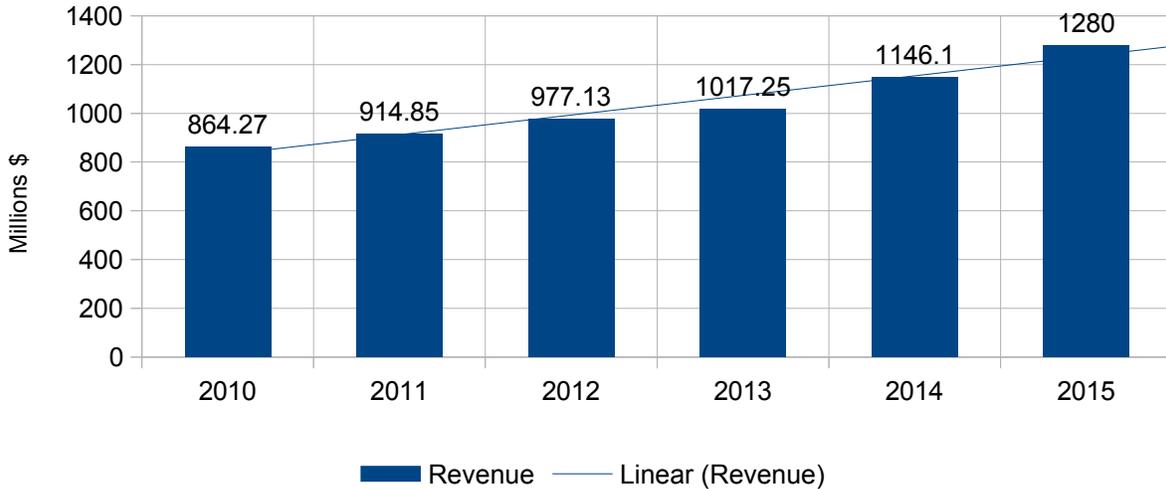
	Twelve Weeks Ended		Twenty-eight Weeks Ended	
	July 12, 2015	July 13, 2014	July 12, 2015	July 13, 2014
Revenues:				
Restaurant revenue	\$ 288,704	\$ 251,818	\$ 677,213	\$ 586,813
Franchise royalties, fees, and other revenues	4,275	4,315	10,667	9,804
Total revenues	292,979	256,133	687,880	596,617
Costs and expenses:				
Restaurant operating costs (excluding depreciation and amortization shown separately below):				
Cost of sales	71,665	63,689	169,615	147,909
Labor	93,513	82,572	217,869	193,493
Other operating	35,356	31,022	81,940	71,619
Occupancy	23,210	18,618	53,357	42,900
Depreciation and amortization	17,260	14,120	40,263	33,006
Selling, general, and administrative expenses	34,126	30,320	82,187	72,743
Pre-opening and acquisition costs	1,369	2,326	2,324	4,439
Total costs and expenses	276,499	242,667	647,555	566,109
Income from operations	16,480	13,466	40,325	30,508
Other expense:				
Interest expense, net and other	904	475	1,964	1,149
Income before income taxes	15,576	12,991	38,361	29,359
Provision for income taxes	4,410	3,521	10,630	7,945
Net income	\$ 11,166	\$ 9,470	\$ 27,731	\$ 21,414
Earnings per share:				
Basic	\$ 0.79	\$ 0.66	\$ 1.96	\$ 1.49
Diluted	\$ 0.78	\$ 0.65	\$ 1.94	\$ 1.47
Weighted average shares outstanding:				
Basic	14,142	14,312	14,134	14,335
Diluted	14,311	14,528	14,322	14,565

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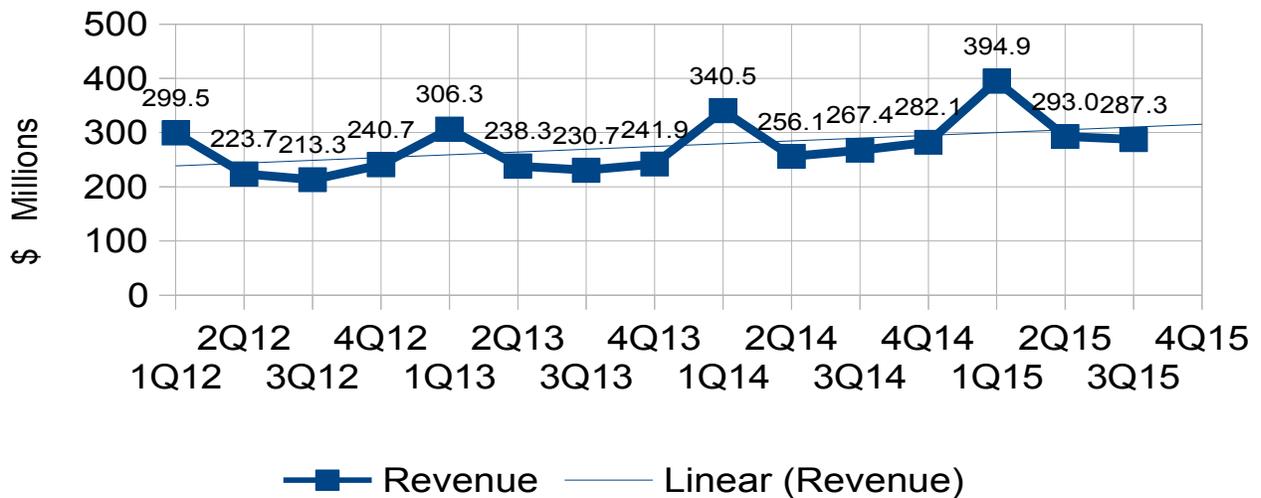
RRGB Revenue

2010 To 2015 Est.



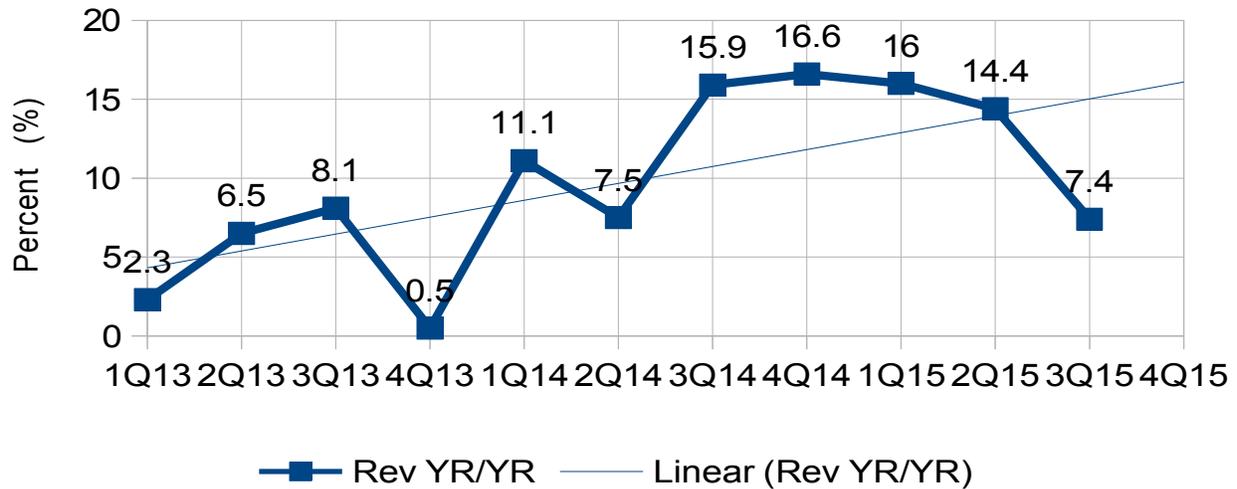
RRGB Revenue

April 2012 To October 2015 Est.



RRGB YR/YR Revenue Growth

April 2013 To October 2015 Est.



Revenue Growth

Red Robin (RRGB), has been growing yearly revenue in the mid teens percent for the last several quarters. **We believe that future revenue growth will be below this trend and be closer to nine or ten percent going forward.**

The main problem with RRGB is that there is very little traffic growth. They have been making their revenue numbers by raising menu prices, getting customers to spend more and adding stores. **We believe that this is a flawed strategy. The single most important restaurant metric in our opinion is how many customers are walking through the door.** Raising prices masks weak customer traffic flow. It is a temporary help, but leads to less traffic which leads to more price increases which leads to even less traffic which....

It is far better to have 15 percent more customers come through the door than it is to have flat traffic and gouge your customers more and more for an average burger. People notice

ever increasing restaurant bills, and vote with their feet. They come once a month instead of twice.

The main question to ask is why is customer traffic not increasing? There are four answers:

1. **The Economy:** When the U.S. goes into a recession, the first thing people do is cut back on eating out. RRGB has been and will again be hurt by this. In November 2005, RRGB was at \$54 per share, three years later in November 2008, RRGB was at \$12 per share, **a decline of 78 percent!** It had little to do with what RRGB did or did not do. **People just cut back.**
2. **Poor Service:** When you go out to eat you expect good, fast, friendly service.
3. **Food:** You expect good hot food when you are paying for it.
4. **Value:** You expect a fair value for the amount of food and quality of the food you are buying. There are a lot of other restaurants to choose from.

Since RRGB is having great difficulty generating increased traffic, despite remodeling stores and having a loyalty program, they must not be delivering some combination of the above four reasons.

We don't think the economy is very strong, **there are a record number of people not in the workforce.** Consumer spending is projected to decline. This is a major problem for ALL restaurants. From the NY Fed Survey: **“But over the coming year, household spending growth expectations plunged to 3.5 percent in July, from 4.3 percent the previous month, hitting the lowest since the survey began in mid-2013** thanks in part to respondents over 40-years old and those with lower levels of education”. Consumer spending jumps around a lot over the short term. We think it is going to weaken in 2016. **Many consumers are going to be hit with double digit increases in their now mandatory health care premiums.** An average family that gets hit with a \$150-\$200 monthly increase in their health care insurance premium, WILL cut back on going out to eat.

We have a RRGB about 8 miles from our house. When it opened the first year there was always a wait to get in, 10-20 min. Today, at the same restaurant, there is never a wait, you

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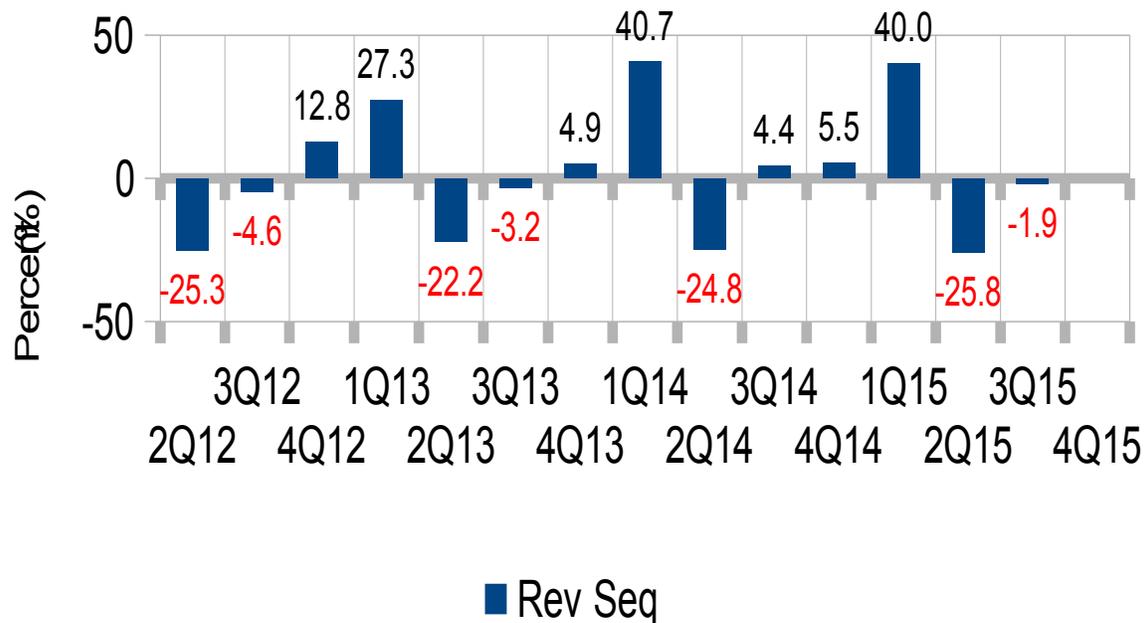
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get right in, its about half to three quarters full on a Saturday night. The service is friendly but slow. The last two times we went there it was not busy, but it took forever to get our food which was only warm, not hot. We have not been back since.

The food is in our opinion, not gourmet. It is a typical restaurant burger, its not bad, but nothing to get excited about either. Value is where they are probably having trouble. Every time I go there, they have a new menu, which means that they have raised prices. When you raise prices, the service can't be slow, the food can't be only warm or people will not come back. So obviously RRGB is having problems executing on these issues or their traffic would be growing.

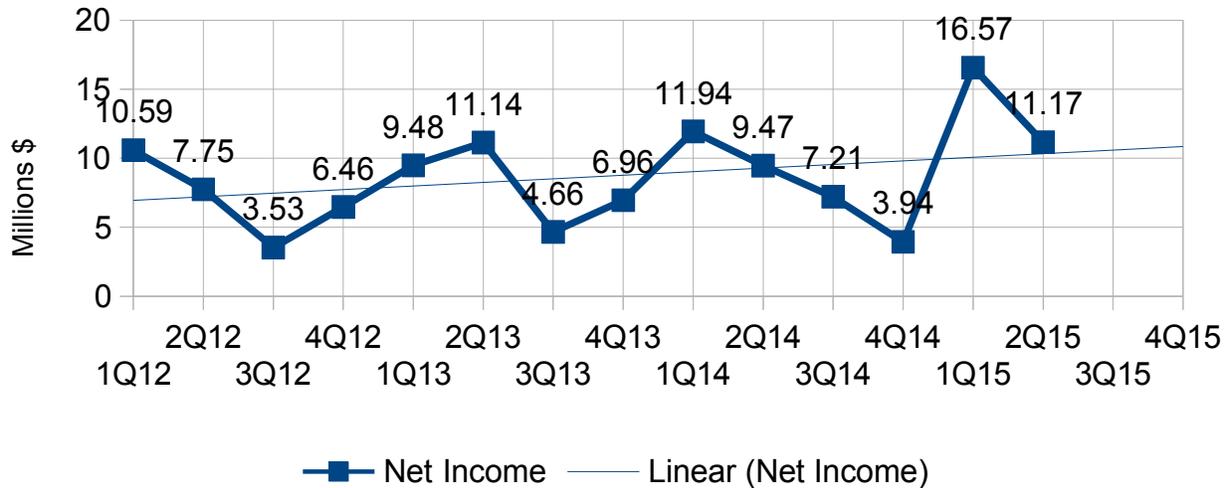
RRGB Sequential Revenue Growth

July 2012 To October 2015 Est.



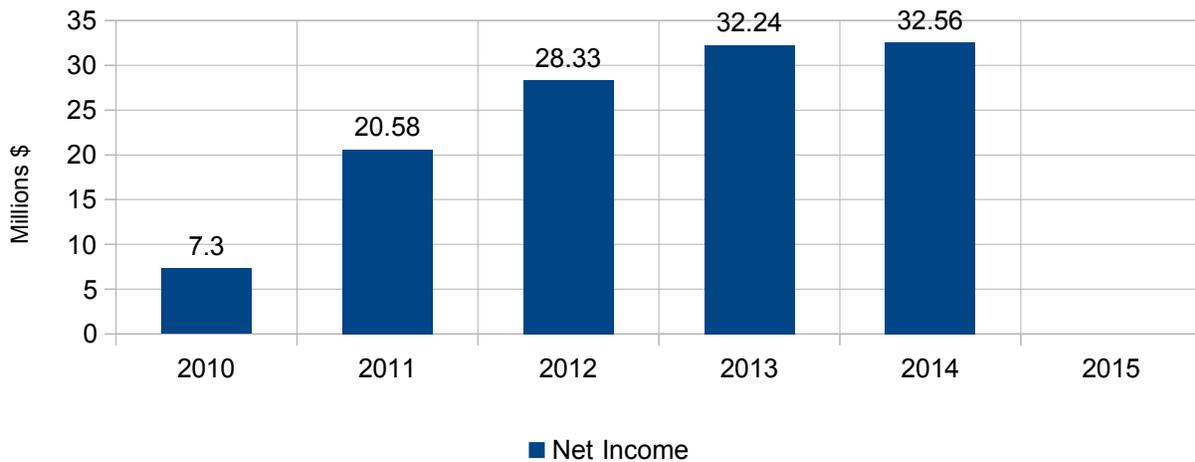
RRGB Net Income

April 2012 To July 2015



RRGB Net Income

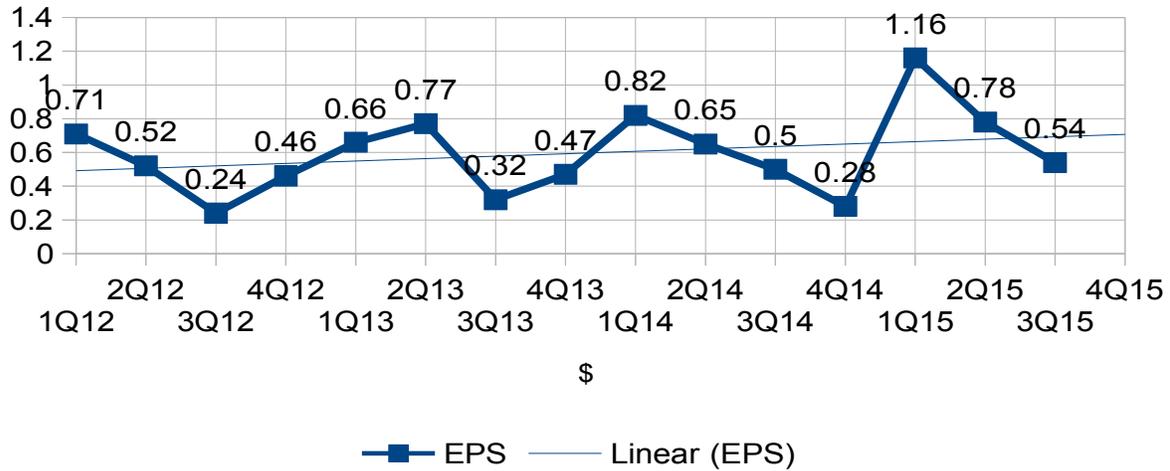
2010 To 2014



Growth in net income has slowed.

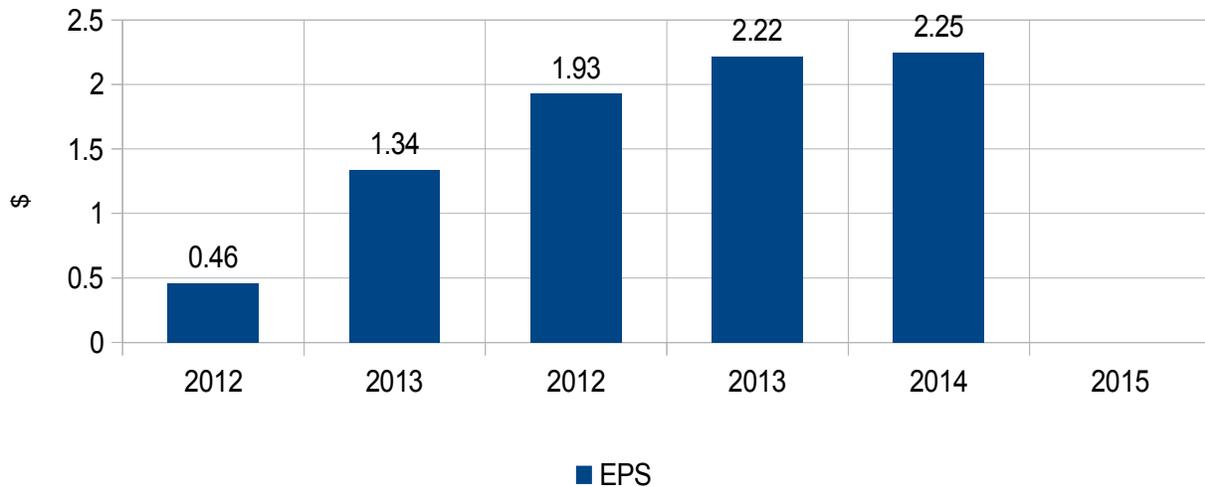
RRGB Earnings Per Share

April 2012 To October 2015 Est.



RRGB Earnings Per Share

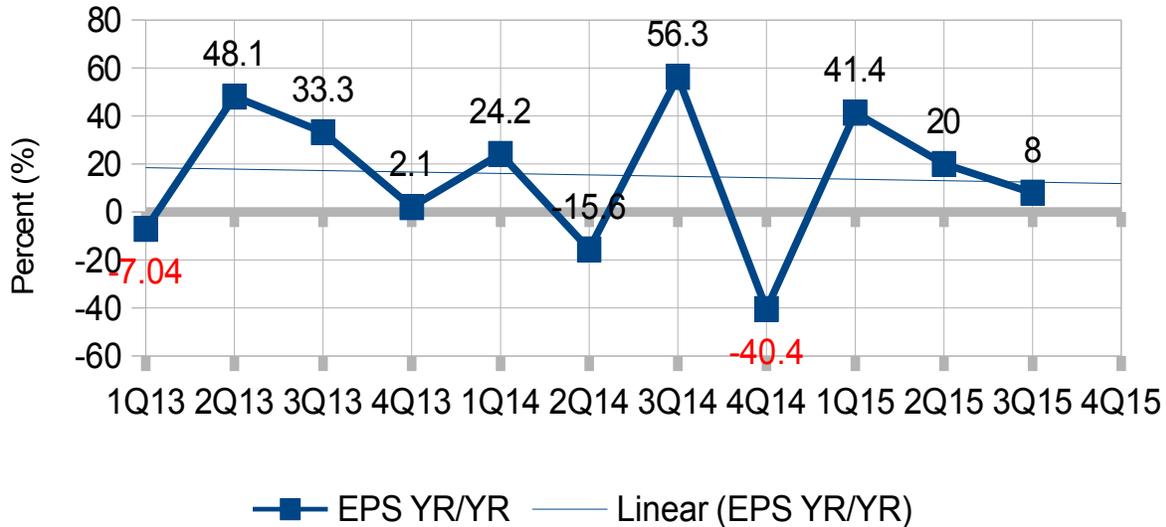
2012 To 2015



Same story with earnings per share, slowing.

RRGB EPS YR/YR Growth

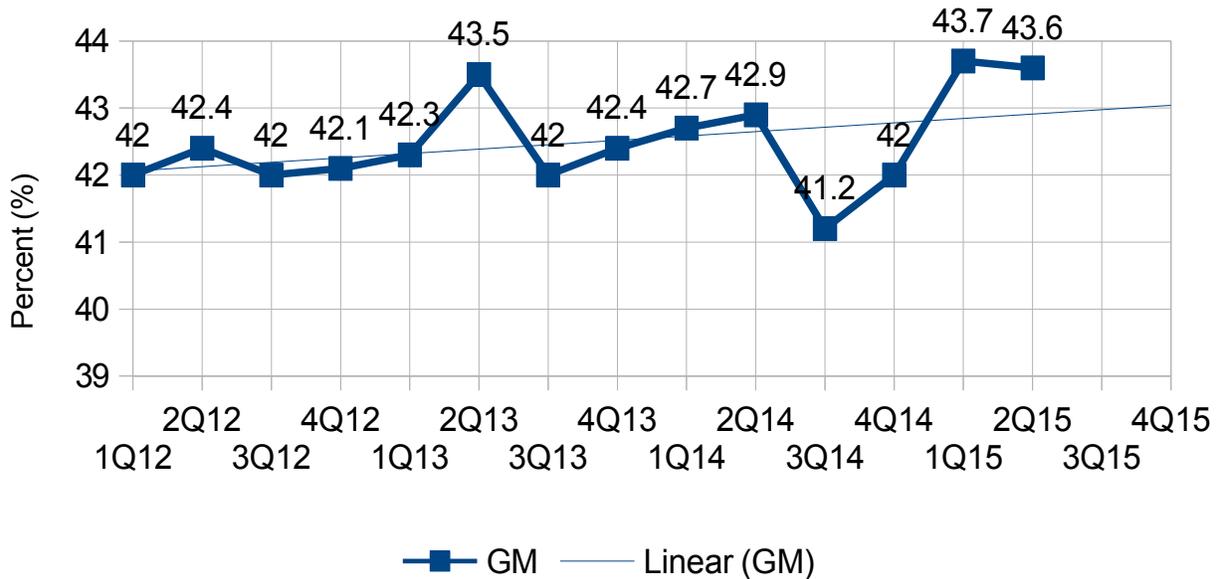
April 2013 To October 2015 Est.



Year over year earnings per share growth has been trending lower for two years. We expect this to continue.

RRGB Gross Margin

April 2012 To July 2015



RRGB gross margin has held up, mostly do them increasing their menu prices by 3 to 4 percent every year. While this is a positive for gross margin, it is a negative (higher prices), for their customers. Customers have noticed the increased prices and are coming less frequently. Even with the price increases, gross margin trend line has only increased one percent in 3 years. Given the higher clamor for an increased minimum wage all over the country and the company already at the high end for pricing in its niche, we would expect gross margin to decrease in the future.

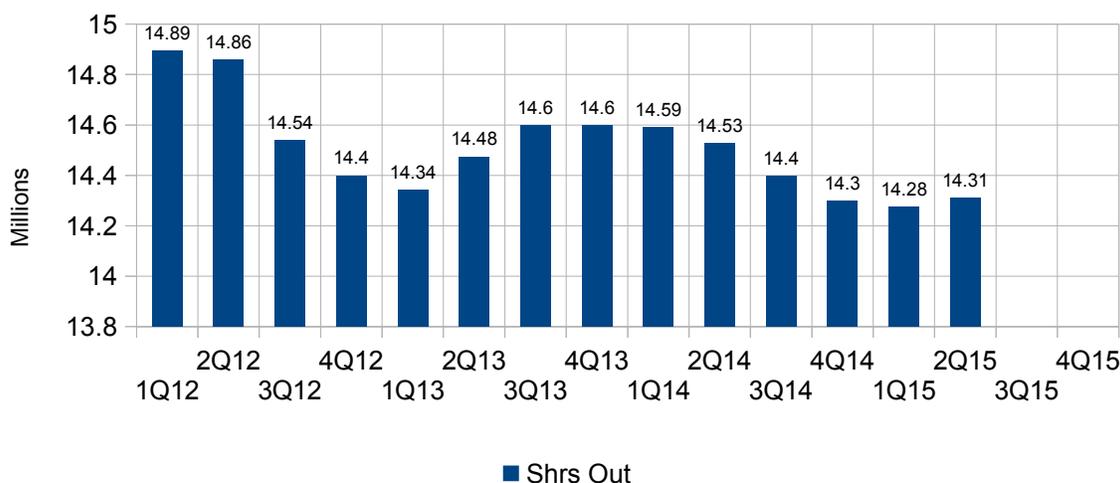
RRGB Operating Income

April 2012 To July 2015



RRGB Shares Outstanding

April 2012 To July 2015



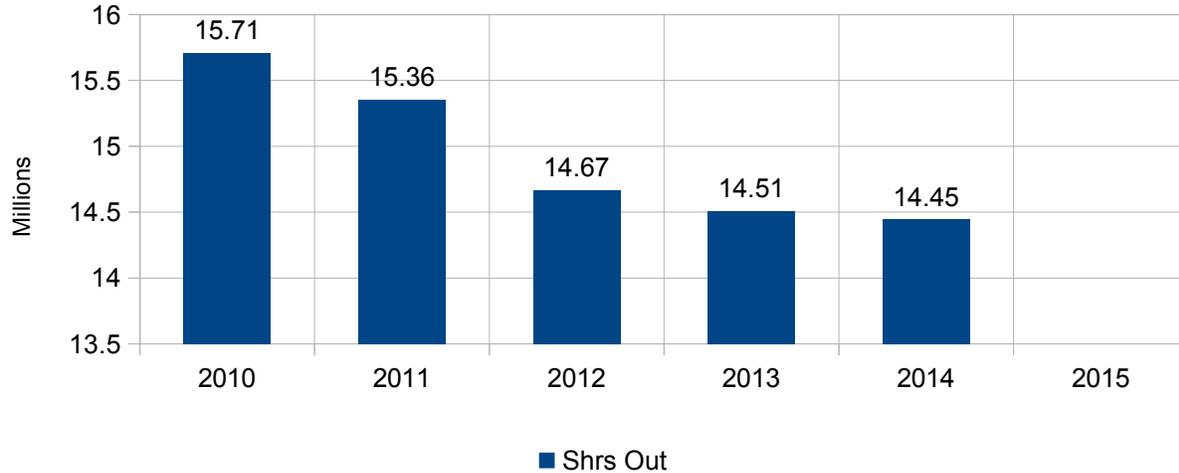
Earnings per share have been helped by share buybacks.

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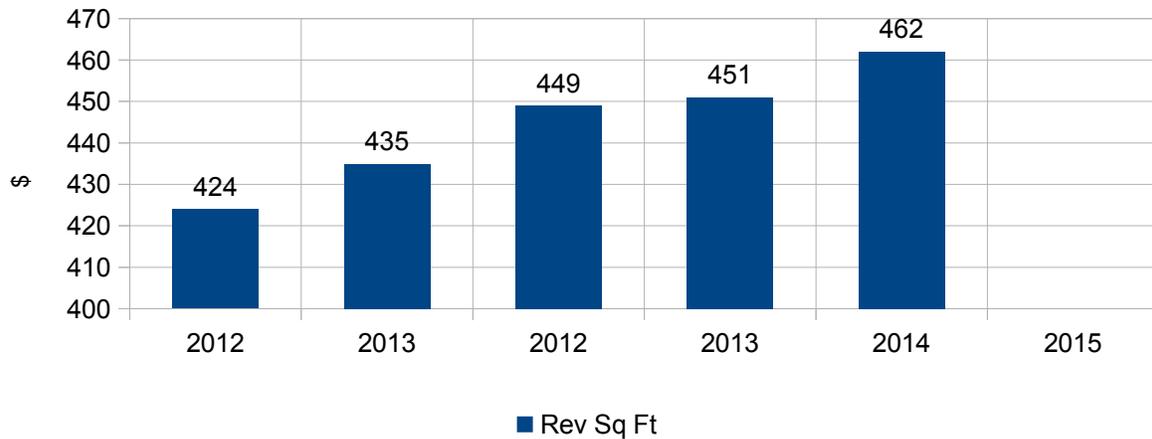
RRGB Shares Outstanding

2010 To 2014



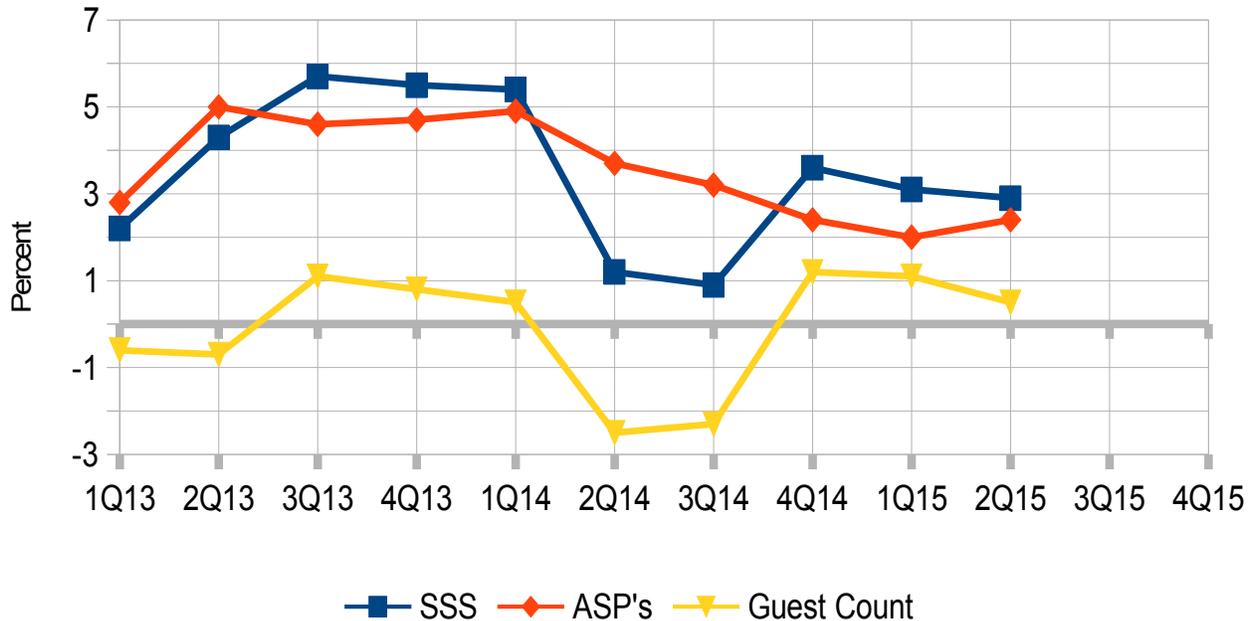
RRGB Revenue Per SQ FT

2012 To 2014



RRGB Same Store Sales

= Avg Selling Price + Guest count



RRGB's same store sales have declined 50 percent in two years, from 6% to 3%.

Guest count has been at or below 1 percent for 10 quarters in a row. If you really want to drill down and ask, what is this company's true growth rate? It is less than one percent. This stock should trade at a discount to other restaurants and the market.

ASP's is where ALL the growth has come from. But this is “bad” growth. In the short term it helps the same store sales growth, but in the long run it drives customers away.

The only way RRGB can increase revenue is to raise prices, get customers to spend more and open more stores, which is exactly what they are doing. But they can only raise prices so much before their guest count really tanks. They are planning on opening about 17 stores in the second half of 2015 which is 4 percent growth.

It's troubling that RRGB began a Brand Transformation Initiative in 2012, yet guest count grows at 1 percent or less, sometimes negative. From the 10Q:

Brand Transformation Initiative. In 2012, we began investing in our brand transformation program to enhance our service, menu, food presentation, and other guest experiences. Key elements of the **restaurant remodel** associated with our brand transformation include greater separation of the bar and family dining area, and new exteriors including signage. **We completed 31 restaurant remodels during the second quarter 2015 towards our goal of completing 150 in fiscal year 2015. We anticipate having a total of 295 restaurants conforming to the new brand standards by year end 2015,** including new restaurant openings.

Marketing. Our Red Robin Royalty™ **loyalty program operates in all of our U.S. Company-owned Red Robin restaurants and has been rolled out to most of our franchised restaurants.** We engage our guests through Red Robin Royalty with offers **designed to increase frequency of visits** as a key part of our overall marketing strategy. We also inform enrolled guests early about new menu items to generate awareness and trial. Our media buying approach is designed to achieve greater continuity with less time off air between televised advertising windows. In addition, we use digital, social, and earned media to target and more effectively reach specific segments of our guest base. Our “Million Reasons” advertising campaign features a female spokeswoman to appeal to our core target of female decision-makers and create continuity of branding across individual advertisements and media.

So, over 50 percent of the restaurants have been transformed and they all have the loyalty program yet the guest count is at less than one percent! We believe that their strategy of raising prices is turning off people that have tight budgets. We believe that this will get even worse in 2016.

If the guest count turns negative next year, which we think it will, and they raise prices one or two percent, you will have zero same store sales growth.

RRGB has opened 4 stores in the first six months of 2015. They plan on opening 17 more in the second half, for a total of 21. They ended 2014 with 514 total stores, **so they are**

opening stores at a rate of 4 percent per year. Four percent more stores in 2016 plus zero percent same store sales growth is 4 percent growth!

Management is guiding to 12 percent revenue growth and 3 percent SSS growth for the remainder of 2015. RRGB missed revenue estimates in the 2015 second quarter by \$4.7 million. We believe that there could be more misses coming.

Investors are expecting 12 to 15 percent growth going forward and we think that they will be disappointed. The stock price was \$48 in October of 2014. It's now \$78, yet revenue growth is slowing and now down to 12 percent. If the stock price grew at the same rate as revenue it would be \$55.

Paying near 30 times earnings (28), for a company with 1 percent (at best) customer growth and 4 percent more stores per year does not make much sense to us. With 521 total stores now, finding good future locations will become more and more difficult. Also, to keep growing new store openings at 4 percent, they have to open more and more stores every year. The U.S already has enough restaurants. In the next downturn, same stores sales will plunge and new store openings will come to a halt.

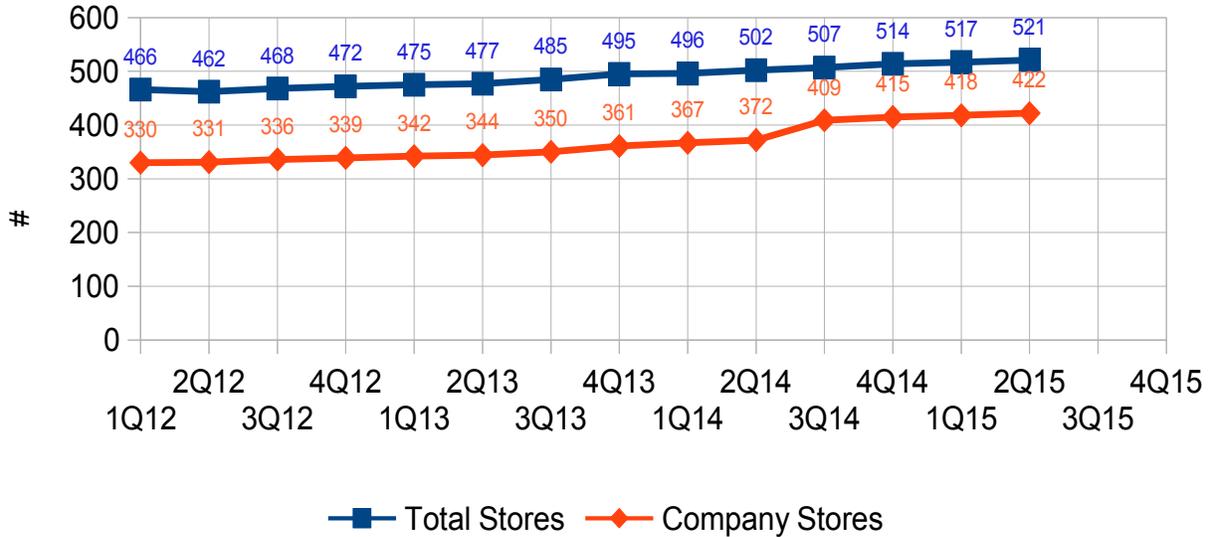
RRGB is also going to be negatively affected by the call for a higher minimum wage, as will every other restaurant. They have already raised their prices too much, **they can not pass along all the increased wage cost or their sales will plunge.** This will hurt margins.

RRGB will begin experimenting with ordering at the table on an iPad, no waitress needed, or at least fewer. This may or may not work. First there is the huge expense of ordering all the iPads. Second, people will break them and spill drinks on them and steal them. Third, they are bacteria traps. You will never go back to that restaurant if you get sick after eating there. Fourth, this is a sit down restaurant, not McDonalds. The customer wants to be waited on. Fifth, there is **less chance to up sell the customer for high margin drinks and appetizers.** Sixth, if I am doing all the work, do I still need to tip? A lot of people won't, which means your waitstaff will make a lot less money and will quit. Which will increase your labor costs for new hiring and training.

The flip side would be, if I don't need to tip, I will save 20% on my meal so maybe I go out to eat more. But, if I save a few bucks and now the service is rude and terrible, do I go back? **A lot of those increased ASP's are from the waitress getting you to buy a second drink or an appetizer. Getting rid of them may be penny wise and pound foolish.**

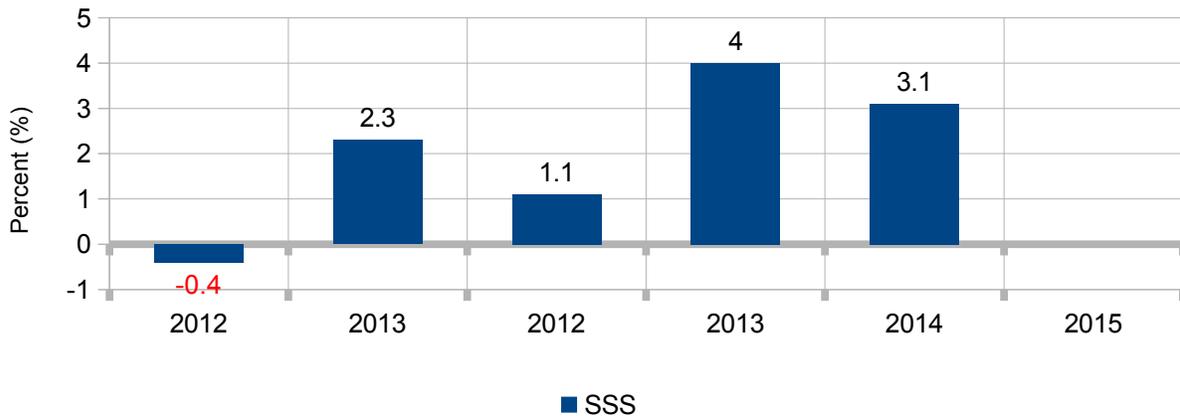
RRGB Stores

April 2012 To July 2015



RRGB Same Store Sales

2012 To 2014



Conclusion

Momentum investors had piled into this stock pushing it up from \$48 in October 2014 to over \$90 in August 2015. But then RRGB missed on revenues in the second quarter of 2015 and the stock sold off to \$78. It's hard to fathom why momentum investors would love a restaurant that has less than 1 percent traffic growth, but whatever. Now we are looking at a company that has remodeled half of its stores, installed a loyalty program and still guest count has been at or below one percent for ten straight quarters. **Maybe it is just a slightly overpriced casual restaurant chain, nothing special and nothing else.** It does not deserve to trade at almost 30 times earnings in our opinion. It is trading at 21 times 2016 earnings which are projected to increase 16 percent from 2015, and which are estimated to be up 21 percent. It is hard to see how they get there? 21 percent EPS growth this year and another 16% next year? When traffic growth is 1 percent? We believe investors are going to be disappointed in 2016. Look for more missed numbers. We have a short term target of \$60 and a longer term target of \$50-\$55. We strongly believe that guest count could turn negative in 2016. If that happens, RRGB will not make their numbers and we believe the stock price will sell off. If the U.S goes into a recession, the stock will go a lot lower than our price targets.

Sell.