I have a position in this security at the time of posting and may trade in and out of this position. This is not a recommendation for anyone to purchase or sell this stock. Please do your own research.

Overview

Flanigan's Enterprises ("BDL") is an off the radar microcap restaurant / bar concept and liquor store, with significant hidden value and an attractive earnings profile. Valuation is complicated due to the company's multiple earnings streams, a messy corporate structure, and no investor outreach (press releases, conference calls). While on the surface BDL may seem appropriately valued at 7.7x LTM Proportional EBITDA, this does not account for several factors.

- Significant non-restaurant related real estate
- Capital light earnings stream from franchise & management business
- Pending contractual step-down in minority interest payments
- Downside protection from restaurant real estate and defensive nature of liquor operations.

The founding family owns 54% of the stock and has historically reinvested cash back into the company.

Business Overview

<u>Restaurant Operations</u>

BDL's core business is the ownership and operation of 18 Flanigan's Seafood Bar and Grill, a south Florida casual restaurant and bar. If you have ever spent any time in the Miami area you have most likely seen this logo.

Now I must admit that this is not the place that would typically appeal to me. Perhaps serendipitously I ended up going to one at 2am for a friend's post-post-wedding party. What I found can best be described as a non-corporate version of Buffalo Wild Wings. Tables full of chatty 20-something year olds ordering drinks and tasty albeit greasy bar food (is there any other kind?). Needless to say, I was pleasantly surprised with the experience. I've since gone back at a more respectable hour and can say that the overall quality of food and service was good.

Restaurants range from 90 to 235 seats per unit. The company does not report same store sales so we have to rely on revenue per average store. Growth has been strong, consistently in the MSD range. Also note that these operations were quite resilient during the GFC most likely due to their lower price point.

$'000	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	LTM
Units	13	14	16	16	17	17	17	18	18	18	18	18	18

Per Store													
Food	$2,628	$2,818	$2,727	$2,675	$2,688	$2,703	$2,879	$2,998	$3,156	$3,464	$3,609	$3,718	$3,829
Bev	$609	$649	$633	$637	$689	$695	$780	$856	$946	$1,064	$1,138	$1,138	$1,180
Total	**$3,237**	**$3,467**	**$3,360**	**$3,311**	**$3,377**	**$3,398**	**$3,659**	**$3,854**	**$4,103**	**$4,528**	**$4,747**	**$4,855**	**$5,009**
Growth													
Food	3.4%	7.3%	(3.2%)	(1.9%)	0.5%	0.6%	6.5%	4.1%	5.3%	9.7%	4.2%	3.0%	6.1%
Bev	5.9%	6.6%	(2.5%)	0.6%	8.2%	0.9%	12.2%	9.7%	10.6%	12.4%	7.0%	(0.1%)	7.6%
Total	**3.9%**	**7.1%**	**(3.1%)**	**(1.5%)**	**2.0%**	**0.6%**	**7.7%**	**5.3%**	**6.5%**	**10.4%**	**4.8%**	**2.3%**	**6.4%**

Note: Company operates on a September year end. LTM growth rate is presented as an annualized figure.

With beverage sales accounting for 24% of total revenue, it is understandable why the company boasts gross margins of 65%.

It is important to note that BDL does not fully own all of these locations. 8 units are structured as LLC's whereby BDL owns 100% of the GP and some percentage of the LP. While this is incredibly advantageous to the company, it creates a little confusion. More on this later.

Liquor Operations

BDL owns and operates 9 liquor stores under the Big Daddy's Liquors name with the same bearded man as the logo. 6 of the units are free-standing while the remaining 3 connected to an existing restaurant operation. Stores are required to own a Beer, Wine, and Liquor License (3DPS, 3CPS, 3BPS, 3APS, 3PS) which runs on a quota system in Florida - a new license is only granted for every 7,500 increase in county population. I've spoken with several regional brokers and understand that licenses typically transact between $150 and $200k.

The company does not report same store sales, but with no unit growth, it doesn't really matter. Surprisingly this segment comped worse during the GFC, a counter-intuitive fact which I have a hard time explaining. Nonetheless, operations have been equally as strong with MSD growth over the past several years.

$'000	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	LTM
Units	9	9	9	9	9	9	9	9	9	9	9	9	9
Per Store	$1,450	$1,420	$1,369	$1,404	$1,433	$1,460	$1,468	$1,466	$1,534	$1,685	$1,740	$1,871	$1,984
Growth	10.5%	(2.0%)	(3.7%)	2.6%	2.1%	1.9%	0.6%	(0.2%)	4.7%	9.9%	3.3%	7.5%	12.4%

Gross margins have consistently been 30%.

Franchises

In addition to its owned and operated stores BDL franchises 5 Flanigan's Seafood Bar and Grill, 3 of which also have a Big Daddy's Liquor attached or nearby. BDL receives 3% of gross restaurant sales and 1% of gross liquor sales, as well as an advertising reimbursement of 1.5%-3.0% of gross sales.

While per unit revenue growth has grown at a healthy clip, the company did acquire two of its franchises which obviously brings down total revenue growth.

$'000	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	LTM
Rev	1,114	1,134	1,066	1,126	1,076	1,023	1,133	1,237	1,261	1,537	1,584	1,592	1,629
Growth	13.2%	1.8%	(6.0%)	5.6%	(4.4%)	(4.9%)	10.8%	9.2%	1.9%	21.9%	3.1%	0.5%	4.7%
Units	7	7	6	6	5	5	5	5	5	5	5	5	5
Rev/Unit	$159	$174	$178	$188	$196	$205	$227	$247	$252	$307	$317	$318	$326
Growth	13.2%	9.6%	1.8%	5.6%	4.2%	4.6%	10.8%	9.2%	1.9%	21.9%	3.1%	0.5%	4.7%

Restaurant Management

This is where things get interesting.

As mentioned before BDL owns a minority LP stake in 8 LLCs for which it owns 100% of the GP. As the GP, BDL is entitled to receive 3% of gross sales which is similar to the franchise structure. BDL also receives 50% of all distributions once the LPs get their money back. This GP income is deserving of a high multiple as it is capital light and can never result in a loss. Importantly, both the 3% royalty and the 50% of profits are hidden within BDL's reported financials as the company consolidates these into restaurant operations and reduces net income by non-controlling interest.

Another interest fact is that minority interest should fall (both as a percentage of earnings and on an absolute basis) as BDL reaches 100% return of capital for all of its LLC. As an example, last year BDL achieved 100% return of capital for its Miami LLC for which it only owned 5.0% of the LP. Going forward non-controlling distributions for this entity will fall from 95% of capital distributed to 95% x 50% = 47.5%. Someone taking a cursory look at BDL might assume that non-controlling interest would be about 30-35% of post-tax income, the rate it has averaged over the past several years. But during this period 3 LPs have reached 100% and 2 more are getting close (91% and 70.5% returned to date).

In order to estimate a normalized level of non-controlling interest, I calculate a revenue split based on the number of seats under the wholly owned and LLC structures. To determine the appropriate margin I start with reported restaurant operating income and back out franchise revenues. Historically this has run around 9%. 100% Owned units should have a higher margin than LLC units because of the 3% fee that the later bears. Through some simple algebra we can determine that non-controlling interests pre-fees should represent ~26% of operating restaurant earnings – or just 13% after the 50% GP split. This compares favorably to last year's percentage of 22% (i.e. at current levels minority interest will fall by 40%).

100% Owned vs LLC	100% Owned	LLC Structure	Total
Seats	1,675	1,526	3,201
% of Total	*52%*	*48%*	*100%*
EBITDA Margin	10.4%	7.4%	9.0%
Revenue (@ $100)	$52	$48	$100
EBITDA	$5	$4	$9
% of Total EBITDA	**61%**	**39%**	**100%**
LP Ownership	**BDL**	**Others**	**Total**
Proportional Seats	503	1,023	1,526

% of Total	*33%*	*67%*	*100%*
% of Total EBITDA	**13%**	**26%**	**39%**

<u>All Other</u>

BDL has several other non-core investments, the largest of which is its non-core real estate portfolio. In 2011 the company spent $6.1mm to acquire a 19k square foot shopping center along with a 5k square foot Flanigan's restaurant property which it leases to an LLC. The company receives additional lease income from owning a franchised store as well as 3rd party use of some vacant property. All in the BDL receives $600k of rental income.

There are also various small but stable revenue streams including $150k a year from an investment made into a strip club in Atlanta, ~$225k a year from managing an independent restaurant in Florida, and ~$50k a year from an LP investment into a non-GP controlled Flanigan's LLC.

Investments

Over the last 10 years BDL has made significant investments into the business with capex totaling $47mm vs. $24mm of D&A. On a cursory look these investments may be underappreciated as a portion do not run through the cash flow statement because they are non-cash items (purchases in exchange for debt). It appears that most of the additional capex relates to investments designed to grow the business.

$mm	Fiscal Year	Growth Capital
$6.1	2012	Purchase of shopping center & nearby restaurant property (leased to LLC)
$2.9	2013	Purchase of two parcels next to existing combo restaurant & liquor (100% Owned). Will use one for parking (previously leased) and one will lease out to 3rd party.
$2.5	2017	Purchase of vacant land next to existing restaurant.
$1.8	2011	Purchase of existing combo restaurant & liquor property (100% Owned).
$1.7	2010	Purchase of existing restaurant property (100% Owned).
$1.5	2015	Purchase vacant land next to existing combo restaurant & liquor (100% Owned). Will build separate building to move liquor store.
$1.4	2010	Purchase of existing restaurant property (100% Owned).
$1.3	2017	Construction of standalone liquor store on existing property.
$1.3	2014	Purchase of existing restaurant property (leased to LLC).
$0.6	2017	Construction of catering kitchen.
$0.2	2010	Acquired franchise via asset acquisition.
$21.2	**Total**	**Growth Capital**

Since most of these investments are designed to improve their existing core operations, it would be inappropriate to add them back as non-core value. Nonetheless, it is important to examine pre-tax returns on invested capital to ensure that the company is deploying capital appropriately.

$'000	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	LTM
Pre-tax ROIC	11.7%	13.0%	12.1%	14.5%	20.2%	14.2%	14.2%	17.0%	22.6%	25.7%	23.2%	18.1%	20.0%

As the table shows, BDL is currently operating at a respectable 20% pre-tax ROIC. Recent levels are a bit depressed as 2017 was a big investment year with $4.4mm of growth capex vs 2016 invested capital of $29.3mm.

Book Value

Downside valuation is supported by book value of $33.5mm ($18.04/sh). This figure does not account for certain mark to market adjustments. The three most obvious are:

- Liquor licenses: at $175k per license the market value of $1.6mm exceeds BV of $0.6mm. $1.0mm delta.
- Shopping Center: at $300/sq foot the market value of $7.1mm exceeds the purchase price of $6.1mm (BV likely lower due to 7yrs of depreciation). $1.0mm delta.
- Corporate Office: at $175/sq foot the market value of $1.8mm exceeds the purchase price of $0.9mm (BV likely lower due to 19yrs of depreciation). $0.9mm delta.

These three items would bring BV/sh up to $19.55 (72% of the current price). But keep in mind that BDL has made multiple investments into real property in the Miami area over the past 10 years, so there likely other assets that are undervalued on the books.

Valuation

At $27.00 BDL has a market cap of $50mm with a tiny amount of net debt. If we just back out the non-core real estate value at $8.9mm (7% cap rate, $275/sq foot) and the strip club investment at $1.2 (8x CF), the EV falls to $41mm. Using a normalized non-controlling interest level BDL is currently valued at 4.7x proportional EBITDA and 9.0x earnings. This is entirely too low for a stable business with a long history of positive comps, not to mention that a large slug of earnings come from capital light and less volatile revenue streams. At 7.5x EBITDA / 15.0x EPS BDL would be worth $40.00 (+48%).

Alternatively, we can look at the company on a sum of the parts in order to independently give credit to the franchise and GP management ops. This would yield a price of $45.00 (+67%). I did not break out the 3% royalty paid from LLCs to BDL from owned restaurant operations in order to avoid giving credit from shifting profit from one pocket to the other.

$'000	EBITDA	Multiple	Value
Owned & LP Interest in Restaurant / Liquor	9,553	7.5x	71,648
Less: Non-controlling EBITDA	(1,453)	7.5x	(10,894)
GP Management Split	1,453	10.0x	14,525
Franchise	1,703	14.0x	23,840
Strip Club	150	8.0x	1,200
Other Investments	280	5.0x	1,400
Non-Core Real Estate	610	14.6x (7.0% yield)	8,896
Corporate	(2,923)	8.7x (weighted avg)	(25,486)
Total	**9,373**		**84,320**
Net Debt			(243)
Equity Value			**83,835**
Per Share			**$45.00**

Valuation

- Inability to manage wage inflation
- Proliferation of online liquor distribution
- Significant Miami real estate exposure may lead to mark to market losses on pull back