



AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

Decision Finality & Domino's Pizza

It's late summer in San Diego and you're spending the day at the Del Mar Racetrack. You're not much of a gambler but the sun, the cocktails, and the excitement of the crowd puts you into the betting mood. Again, you're not much of a gambler so you're only going to place a \$2 bet on the next race to "get a taste of the action."

While you're in line I ask you how well you think your horse will do? You hedge your answer and say you think it'll do well but you're not sure and that you're just having a little fun.

What do you think your answer will be if I asked you this same question right after you placed the bet? *

Instead of hedging, you'll be far more certain that your horse is a winner because you placed a bet. You added finality to your decision.

Decision Finality

According to the cognitive dissonance theory, you become far more certain you are right about something if you can't undo that decision.

Cognitive dissonance is a mental state of tension. It occurs when we hold two ideas, attitudes, beliefs, or opinions that are psychologically inconsistent with each other. We need to reconcile these two inconsistent beliefs to make us feel better.

You're not the type of person that frivolously throws money away, but you just gambled on a horse race. You need to self-justify these two conflicting actions and the one you decide on is increased confidence in your horse winning. You're not throwing money away; you are going to get it back and more.

For this reason, if you're considering a major purchase do not ask someone who recently bought the same item if it is the right thing to do. They need to reduce their own cognitive dissonance. They will try to convince you that the major purchase is the absolute right thing to do. Do this instead.

Therefore, if you want advice on what product to buy, ask someone who is still gathering information and is still open-minded. And if you want to know whether a program will help you, don't rely on testimonials; get the data from controlled experiments. - From [Mistakes Were Made \(but Not by Me\)](#)

Decision Finality & Investing

There are two ways we add finality to our investment decisions. The first and most obvious one is the act of buying a position. We're no longer in the betting line. We placed our bet. We probably think our investment is more of a sure thing than it is.

The second way we add finality is through this letter. We are putting our title as "expert" on the line by writing about why we think a stock is a good investment. If we're wrong about an investment, we're prone to compound the mistake to protect our ego.

But when an expert is wrong, the centerpiece of his or her professional identity is threatened. Therefore, dissonance theory predicts that the more self-confident and famous experts are, the less likely they will be to admit mistakes.

From [Mistakes Were Made \(but Not by Me\)](#)

Prevention

How can we prevent ourselves from falling into these traps?

First, our day job is not one of public prognostication. So, there is little risk of ruining our public perception. We're OK with being wrong and we'll admit it.

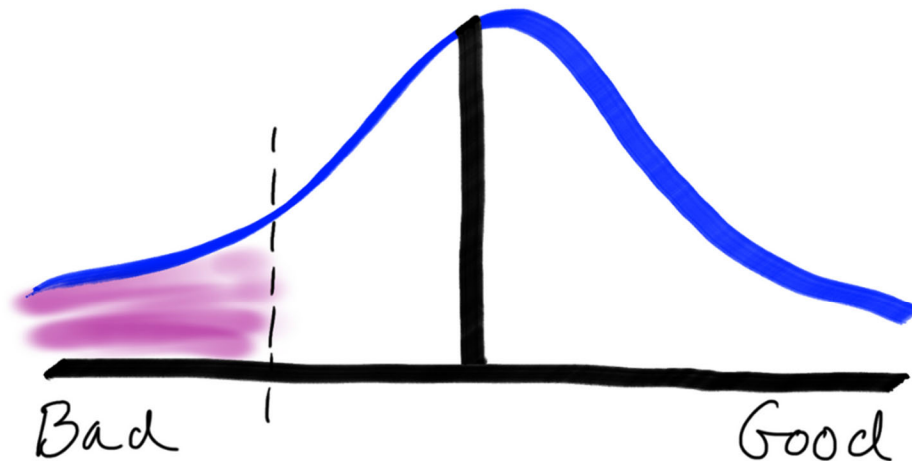
Second, before investing in a new position we outline the main risks to our investment thesis and what would need to happen to

make us say we were wrong. The tough part is then recognizing things went wrong. Regularly reviewing our investment thesis can provides an opportunity to see if things are going as planned

Third, we need to avoid the confirmation bias trap. If a well-known large investor has the same position as us, it's OK for us to listen to their opinions and to agree with them but we need to be aware that they too are subject to self-justification. So, like the advice above, we need to listen more to those that are still researching and gathering information about our position and give more weight to what they have to say, good or bad.

Fourth, instead of competing to be the smartest investor out there, we focus on trying to avoid doing the dumb thing.

If decisions were a bell curve, dumbest on the left and smartest on the right, we want to eliminate the left tail. We hope that by eliminating the dumb stuff we increase our odds of doing the right thing.



Trying to be the smartest person also puts our reputation further on the line. It creates larger incentives to not admit our mistakes and it could lead us to make costly investment mistakes with your money. We're surrendering to the idea that other people are much smarter than us. This reduces how much of our ego gets in the way of our investment process.

We don't chase story stocks. We don't invest in turnaround or distressed companies. We do not get involved in complicated corporate restructurings. Instead, we focus on investing in industry-leading companies with high returns on invested capital. We want companies with a competitive advantage that are in a secular growth trend. And then we want to pay a reasonable price for them.

We will be wrong at times. By constricting our investment choices, we're lessening our ability to make a dumb decision. Hopefully, we increase our chances of positive investment outcomes.

The subject of this letter is a perfect example of this type of company.

**This scenario is from the book [Mistakes Were Made \(but Not by Me\)](#) by [Carol Tavris & Elliot Aronson](#)*

Dividend Stock in Focus

Domino's Pizza (DPZ): \$335.72

Price as of May 10, 2022

Pizza is the perfect food. It's a complex taste with the perfect blend of fat, sweet, and rich foods. Cheese provides the fat. Pizza sauce is sweet. And meat toppings provide the richness.

Pizza's taste complexity is enhanced by two chemical reactions, Caramelization and the Maillard reaction. When pizza bakes, the natural sugars in its toppings and dough start to brown and caramelize. The Maillard reaction is the amino acids and sugars in high protein foods like cheese and pepperoni reacting with each other.

If that wasn't enough, pizza is packed with glutamate. When you taste something savory, you're tasting glutamate. The more savory the food, the more we crave it. Our tongue is loaded with

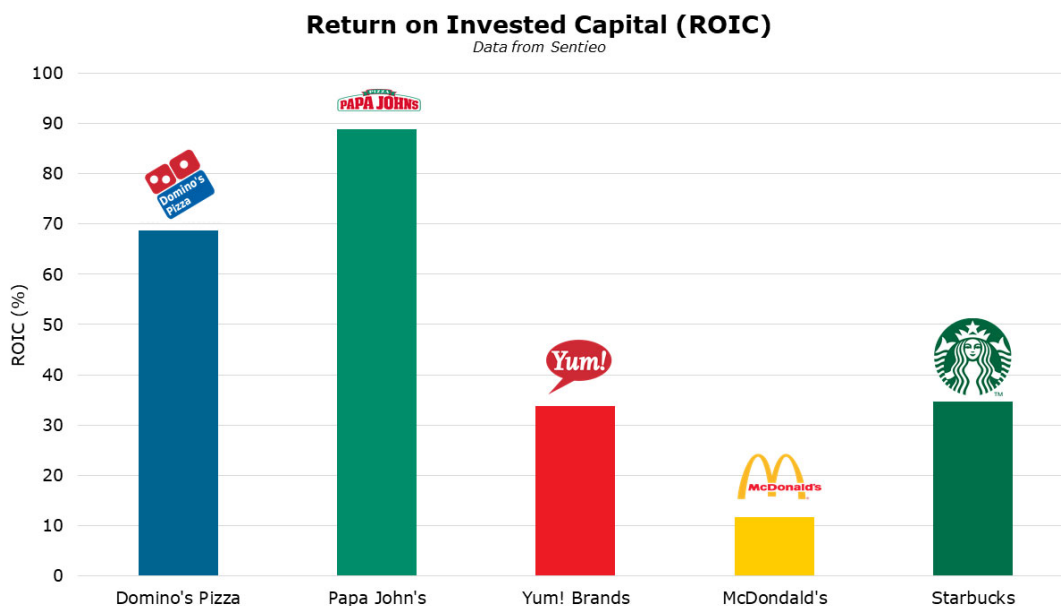
sensors for glutamate ions. When glutamate hits our tongue, it activates our reward system. We get a rush of dopamine causing us to want to eat more pizza.

It is no wonder [why we crave pizza and we eat large amounts of it](#).

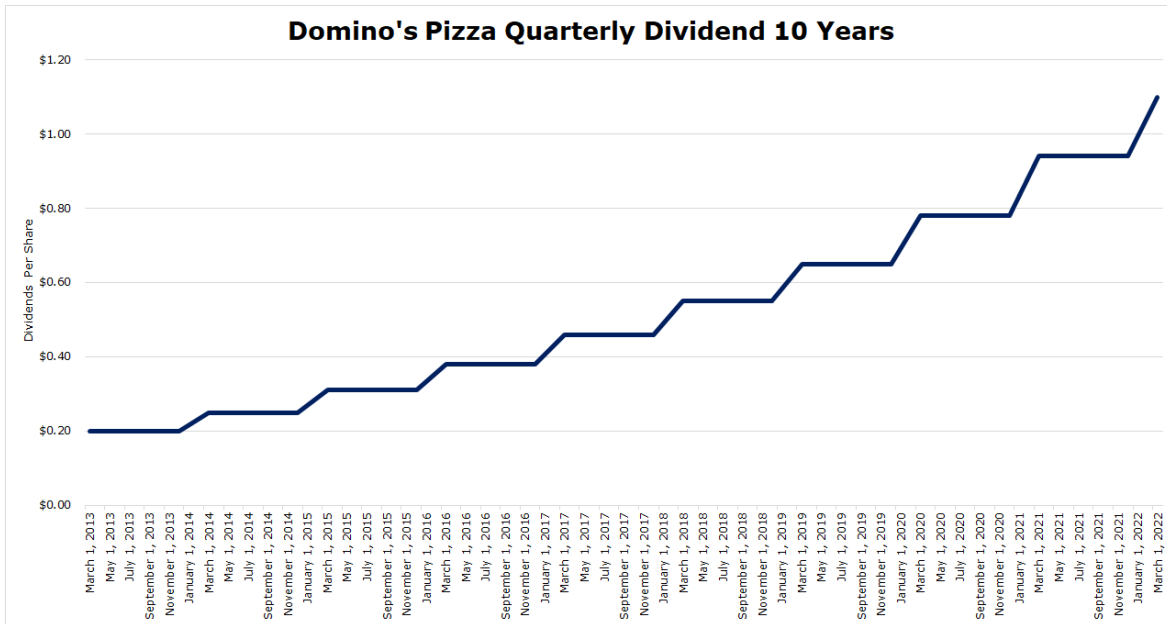
In the United States, 350 slices are eaten every second, while 40 percent of Americans eat pizza at least once a week.

Pizza is also the perfect food for delivery. It's flat, stackable, and built to withstand the rigors of a car ride.

A delivery-focused pizza business feeding our insatiable pizza demand should have high sales per square foot and high ROIC. Domino's Pizza does.



Dividend History



Domino’s Pizza has compounded its quarterly dividend at 18.6% over 10 years and 19% over the last 5 years.

Dividend Safety

Dividend Payout Ratio < 60%?	27.30%	✓
Cash Dividend Payout Ratio < 60%?	21.19%	✓
FCFE Coverage Ratio > 100%?	218.28%	✓
Debt to Equity < 1.00?	(1.22)	?
Interest Coverage > 2.00?	3.91	✓

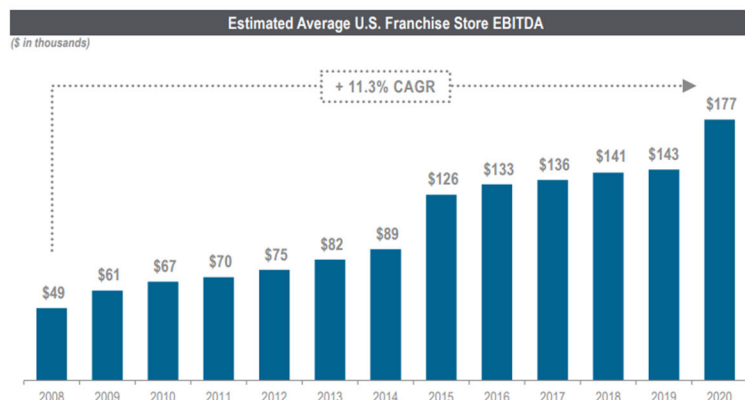
Domino's passes every item on our dividend safety checklist. The negative Debt to equity ratio is not a concern. Like Home Depot, Domino's Pizza consistently repurchases its shares. Domino's has repurchased so many shares that the Retained Deficit line item on its balance sheet—where Domino's records its treasury stock repurchases—is so large it creates negative equity.

Catalysts for Price Appreciation and Dividend Growth

Unit Economics

The average cost to build out a Domino's store is between \$300,000 and \$350,000. The average store earns between \$1-1.3 million in revenue and the average store generates \$177,000 in EBITDA.

INDUSTRY-LEADING FRANCHISE STORE PROFITABILITY



Note: Estimated average U.S. franchise store EBITDA is an internal company estimate based on unaudited results self-reported by U.S. franchise owners.

DPZ INVESTOR PRESENTATION 17

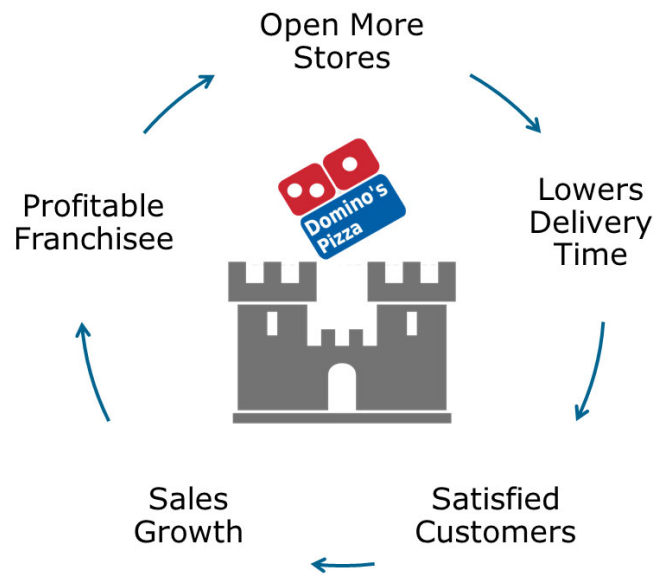
From Domino's Q3 2021 Investor presentation

A franchisee most likely financed the build out of their store and will have to pay interest. They'll have to pay taxes too. So, actual free cash flow gets closer to \$125,000 per store. A cash-on-cash return between 35-40%. With these returns, it takes about 3-4 years for a store to pay back the original cost. And this is not accounting for sales growth.

Potential franchisees want to be a part of Domino's and current Franchisees want to open more stores. Domino's leverages this demand to build more stores and to execute its "fortressing" strategy.

Fortressing

Fortressing is Domino's term and strategy for growing same-store sales. You can think of it as Domino's flywheel. If an area has one Domino's store and, based on internal data, that store is reaching capacity, management will approach the franchisee about opening another store nearby. The initial thought is that this will cannibalize the previous store's sales. But the opposite happens, same store sales actually increase. The reason for this is diagramed below.



The profitability of each store increases because of:

- Increased incremental carry-out orders
- Lower delivery times decreased delivery costs
- Drivers are busier and make more tip money, lowering employee turnover
- Costs can be spread across multiple stores

Fortressing also creates a barrier to entry to competitors and protects the returns on investment for the franchisee. The following image is from [Domino's UK 2018 investor presentation](#).

SPLITTING IS AN ECONOMICALLY RATIONAL CHOICE



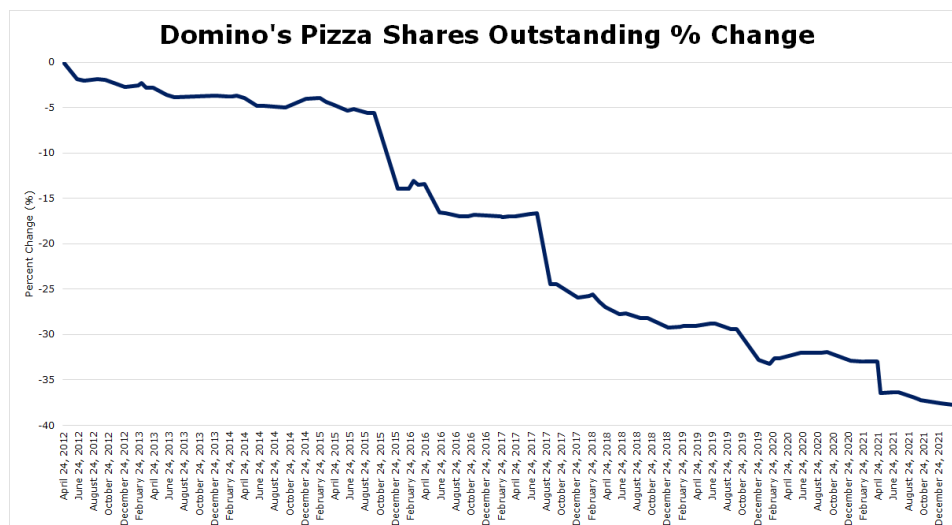
- In a perfect world, a store could make steady state EBITDA and ROIC at maturity...
- ...but high returns attract competition
- Significant risk of value loss from not fortressing
- Splitting increases EBITDA, protects ROIC longer term, and significantly enhances capital value

Fortressing protects the returns of its franchisees and their profitability. Franchisees want to open more stores which grows Domino’s global store count, it prevents competitors from moving in, and it increases system wide sales and cash flow.

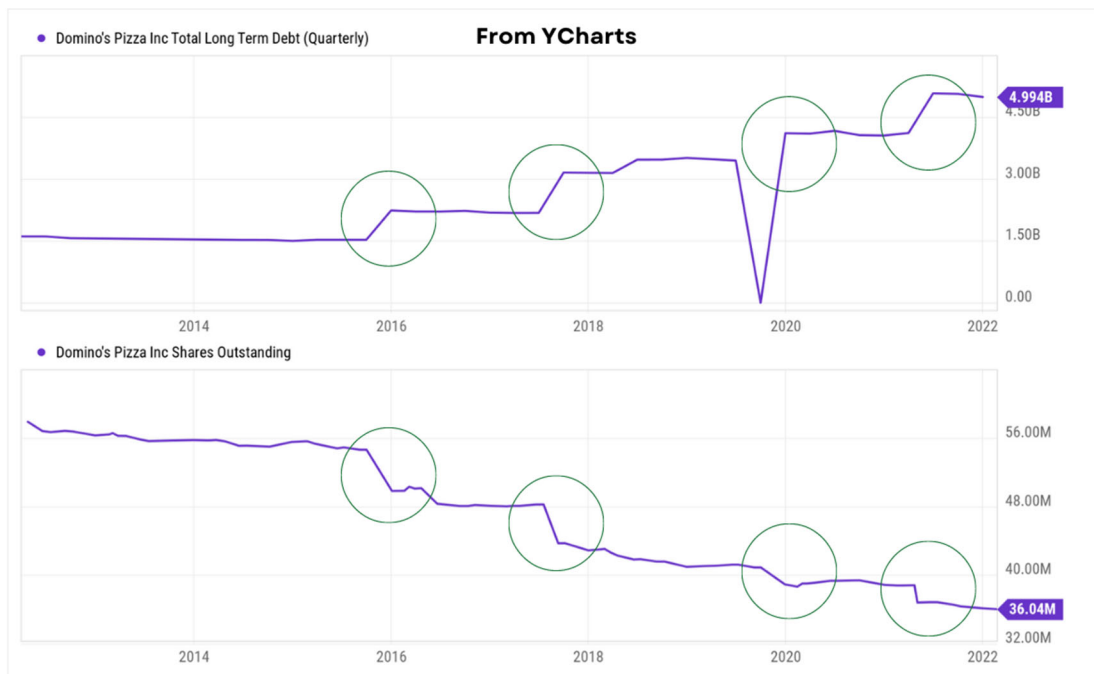
Leveraged Recap & Repeat

Companies can return capital to shareholders through dividends and through share buybacks.

Over the last 10 years Domino’s has bought back over 37% of its shares outstanding.

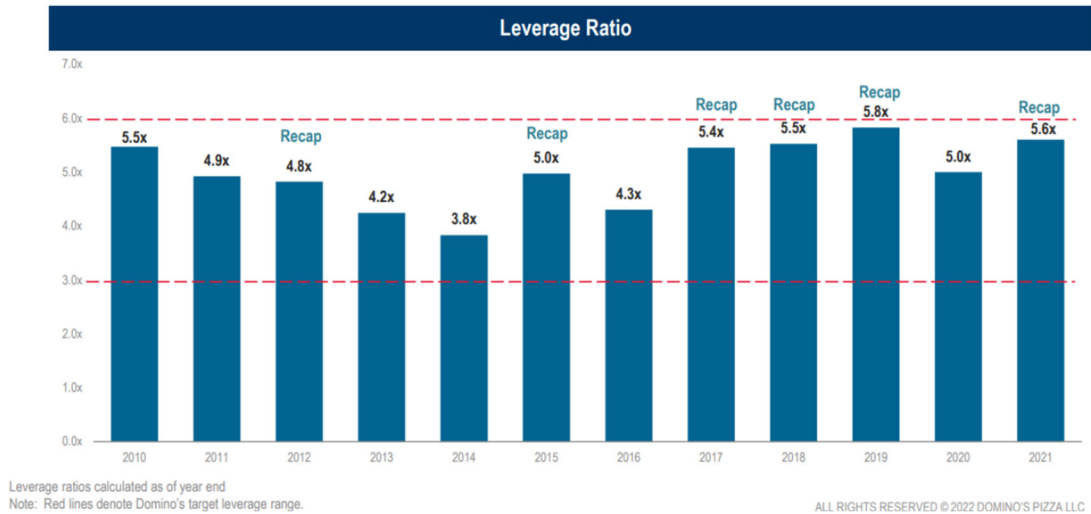


Domino's Pizza issues debt to buy back shares. This process is a leveraged recapitalization. Domino's operates an asset-light franchise business model. This type of business model produces consistent cash flow, and our insatiable pizza demand drives its growth. This allows management to conduct a leverage recapitalization every few years.



If Dominos' leverage ratio remains within its target range, management will use its balance sheet to retire more shares.

Combined With Leverage...



Companies sometimes use share buybacks to signal to the market that their shares are undervalued. Domino's Pizza is not doing this. Management is targeting an optimal capital structure and taking a systematic approach to their share buybacks.

Most CEOs are bad at capital allocation. They initiate buybacks when their stock is up and suspend buybacks when their stock price is down. Domino's management is relying on their balance sheet to dictate when they'll return capital to shareholders. It removes their bias, and it creates a consistent predictable process.

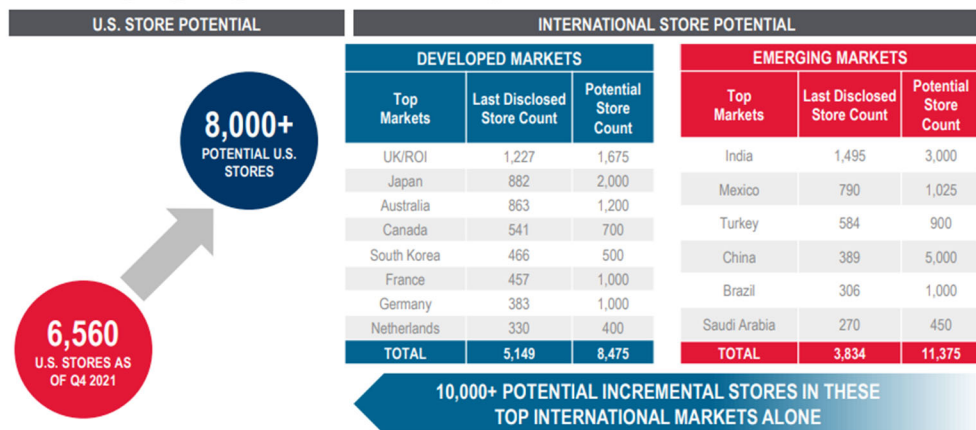
The downside to this approach is management will miss the opportunity to buy back larger amounts of shares when their stock is cheap.

We're OK with its systematic approach. As long as they remain consistent.

International Growth

Domino’s Pizza still has plenty of room to grow in the U.S. and other developed markets. But emerging markets, like China, are the main driver of Domino’s future store growth.

Leveraging Significant Runway For Future Growth & Scale



U.S. store potential represents management's internal estimate based on review of Company data; Australia (including New Zealand), Japan, Netherlands, Germany and France store counts as of DPE H1'22 earnings (February 23, 2022); India as of JURLFOOD Q3'21 earnings (February 2, 2022); UK/ROI as of DOM FY'21 earnings (March 8, 2022); Turkey as of DPEU H1'21 earnings (September 7, 2021); Mexico as of ALSSF Q3'21 earnings (October 26, 2021); All other markets based on non-public master franchisee disclosure approval (coinciding with DPZ Q4'20 earnings (in mind). Potential for additional international stores based on management estimates of respective international master franchisees.

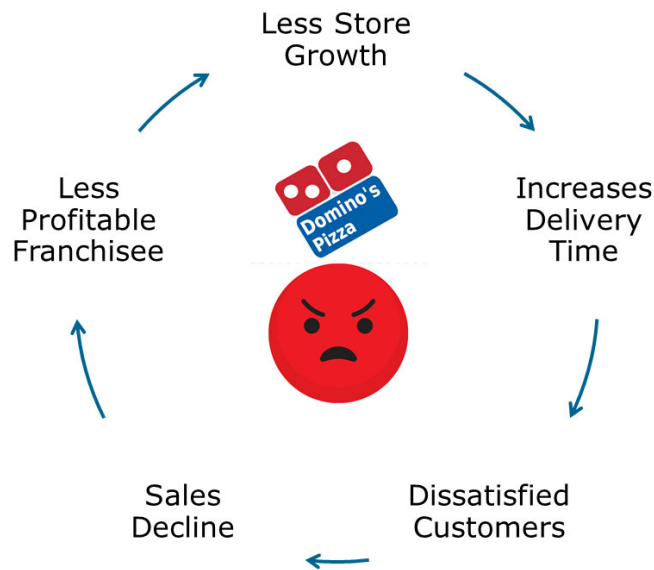
Emerging market growth is also one of the bigger immediate risks that we discuss below.

Risks

Lack of Drivers

Restaurants of all shapes and sizes are having trouble filling open job positions. With unemployment rates so low and so many open job positions across all industries, former restaurant workers are finding more lucrative opportunities elsewhere. Domino’s is having trouble filling delivery positions.

Putting this through the flywheel framework. A lack of drivers increases delivery time. This leads to dissatisfied customers and declining sales. Franchisees are less profitable and don't want to open more stores. Which leads to lower total store growth.



Something that seems minor, like fewer drivers available, can lead to big issues as it cascades through their "flywheel". These short-term issues can cause us to overvalue Domino's Pizza as it harms its future cash flow.

Domino's is offering discounts on carryout orders to combat their driver shortage and to keep customers happy. But people want their pizza delivered. That's the main reason to order Domino's. If they must drive to go get it themselves, then why not order from any other restaurant that offers carryout?

Covid

Most of the developed Western world is reducing their Covid restrictions if they haven't removed them already. If a more lethal and infectious variant circulates around the world, countries might impose lockdowns and restrictions on gatherings again.

Domino's benefits more from an open economy and large social gatherings. What food do you buy to please a large crowd? Pizza of course.

There will be some short-term headwinds with people going out more instead of ordering a pizza at home. But eventually we expect domino's same store sales growth trends to revert to pre-pandemic levels once the novelty of dining out again wears off. As Jerry Seinfeld said, [once you're out it's time to get back](#).

Where Covid is still causing problems is in Southeast Asia, mainly China. China is still implementing a zero-Covid policy and China is a big source of growth for Domino's Pizza. City-wide lockdowns and quarantines hurt current sales and delay the opening of new stores. This will affect the expected timing of future cash flows. This will lower the present value of Domino's stock and make our current estimate of fair value too high. No matter how good a company is, if you pay too high a price, you'll generate poor returns.

Supply Chains & Inflation

Part of Domino's consumer appeal is its affordable pricing strategy. Pizza is cheap to make because its main ingredients are dough, pizza sauce, and cheese.

If the costs of its main ingredients rise, then Domino's faces a dilemma. Either raise prices to offset rising costs and lose sales. Or don't raise prices and sacrifice profitability and risk hurting your franchisees

The knock-on effect of Covid and the war in Ukraine is further supply chain disruptions and increased inflation. Ukraine and Russia are two of the top ten producers of wheat. You cannot take them off the global market without affecting global wheat prices.

Top Ten Wheat Producing Countries

- | | |
|-----------------------------|------------------------------|
| 1. China | 6. France |
| 2. India | 7. Pakistan |
| 3. Russia | 8. Ukraine |
| 4. United States | 9. Germany |
| 5. Canada | 10. Turkey |

We'll need to see how increased input costs are affecting Domino's current business, how management is handling the increased costs, and the reaction from its customers.

QSR is a competitive industry and consumers have many choices. A wrong move that alienates its core customers can have lasting effects on its business.

Valuation

The standard valuation tool is the discounted cash flow model. Make some forward projections about revenue, margins, and capex to derive future cash flows. Then discount them back to today, sum them, remove debt, and divide by shares outstanding to get a per share estimate of fair value. We arrive at a price of \$417 per share using the perpetuity method.

Terminal Value	
EBITDA Method	
Exit Year EBITDA	1,539,938.4
Multiple	20.0x
Terminal Value	30,798,767.6
Net Present Value	14,532,680.6
Perpetuity Method	
Unlevered Free Cash Flow	1,235,230.5
Growth Rate	3.5%
Terminal Value	29,731,709.9
Net Present Value	14,029,179.7

Discounted Cash Flow Total Valuation	EBITDA Method	Perpetuity Method
Total of Present Value of Cash Flows	6,285,032.9	6,285,032.9
Present Value of Terminal Value	14,532,680.6	14,029,179.7
Total Enterprise Value	20,817,713.5	20,314,212.6
Net Debt, Non-controlling interests, preferred secu	5,240,093.0	5,240,093.0
Equity Value	15,577,620.5	15,074,119.6
Share Count (millions)	36,138.0	36,138.0
Estimated Equity Value per Share	\$431.06	\$417.13

If we invert this process, we can determine what future the market is pricing in with today's share price. [Michael Mauboussin and his co-author Alfred Rappaport](#) call this Price Implied Expectations analysis, P.I.E. analysis. An appropriate name for analysis on a Pizza company.

The big concern is rising costs and margin erosion. The last big inflation scare was in late 2007 with rising energy and food prices. Domino's operating margin then was 14%. I'll use that as Domino's target margin rate. If I keep Domino's expected sales growth at 7%, I still can't arrive at today's price. Next, I adjust the expected revenue growth. If I take it down to 4%, I can arrive at today's market price.

Price-Implied Expectations (PIE) Inputs

Operating Value Drivers:

Sales growth rate		4.0%
Starting sales	\$	4,357.00
Operating profit margin		14.0%
Starting operating profit margin		18.0%
Incremental fixed capital investment rate		15.0%
Incremental working capital investment rate		10.0%

Other Value Determinants:

Cash tax rate		16.5%
Cost of capital		5.4%
Inflation		2.0%

Market Valuation Metrics:

Share price	\$	341.30
<u>Shares Outstanding</u>		<u>36.00</u>
Market Value of Equity		12,286.80
Debt	\$	5,070.00
Cash & marketable securities	\$	310.00

The market is expecting below consensus sales and Domino's margins to lose 400 basis points. If either one of these expectations do not happen, then the market is drastically undervaluing Domino's Pizza.

At today's prices we think Domino's Pizza is well worth these risks.