Rev/Employee: $75.99 k **Number of Employees: 23,100** **Avg ROIC: 28.86%** **Leisure**

PZZA: Missing Leadership Ingredients

We think the recent CEO change and pending CFO departure at Papa John's signals lower returns for investors in 2018. In January, former COO and long-time employee Steve Ritchie (42) took over as CEO following November's announcement of downward financial guidance and unspecified needed future operational spending. Chairman & Founder of Papa John's John Schnatter (55) stepped down as CEO for the second time in his career last month and this week, CFO Lance Tucker (47) resigned, effective March 2nd (he will become the new CFO of Jack in the Box restaurants). New CEO Ritchie says he will detail Papa John's new tactical plans in late February which we think will entail significantly higher SG&A expenses. We think PZZA has benefited from a strong marketing strategy that has avoided many significant long term investments. We think that past capital allocation may come to hurt the new CEO's ability to execute and improve operating margins. The Board's August '17 announcement of a $500 million share repurchase and commensurate fourth quarter increase in debt has precariously leveraged PZZA's balance sheet with variable rate debt tied to LIBOR. Chairman Schnatter still owns 27% of the Company which will increase to over 35% of the shares outstanding at the conclusion of the share repurchase, but we note that Chairman Schnatter netted over $49 million in net proceeds at the end of 2016.

New CEO Ritchie has a good marketing strategy in place that we expect he will stick to this year but we worry about the highly leveraged capital allocation he also inherits. We think CEO Steve Ritchie is well qualified to lead Papa John's 3,400 domestic and 1,600 international franchises, having worked his way up from the store level in 1996 to COO in 2014 and then President in 2015. However, his ability to deliver improved financial returns is dubious with deferred infrastructure costs, higher marketing expenses, and now a new CFO to put in place by the end of next month. Founder & Chairman Schnatter told investors in November that "..over the next several quarters, we will be experimenting with a number of new initiatives, and we'll be making significant investments across the business that we believe will position us for another prolonged period of solid, sustained growth." The following month, the Chairman told his investors that Steve Ritchie would take over in January and the resignation of CFO Lance Tucker was disclosed this week. The good news is that Tucker is leaving for a positive reason, to become the new CFO of Jack in the Box restaurants, but PZZA's acknowledgement that it has hired a headhunter to conduct a formal search without a named successor suggests a shallow bench. The CFO is also departing at the early stages of a 5k restaurant wide site upgrade program, similar to one substantially completed last year by DPZ. We think Schnatter's second term (starting in 2011) as CEO was a good one (see our prior profile). He grew Papa Johns' sales by focusing on improving the quality of ingredients and not charging initial franchise fees, but Schnatter's fast growth strategy relied heavily on a leveraged growth model and PZZA's NFL marketing partnership, at the expense of POS infrastructure and other important investments. We note Domino's has spent heavily on IT since 2009 (see our DPZ profile here) and it has leveraged technology to build a more sustainable business model. Domino's is increasingly outpacing Papa John's in domestic comparable sales widening to a 900 basis point gap in 2017 from 600 basis points in both 2016 and 2015. Pizza Hut, which is also generating flat sales, is investing in IT and improved delivery systems setting the stage for increasing price competition in 2018. Schnatter and Ritchie have relied heavily on former CFO Lance Tucker since 2011 and he will be missed. International head Jack Swaysland remains a key driver in new sales and has delivered 7 consecutive years of positive comps but incremental growth may be tougher versus DPZ. Chief Marketing Officer Brandon Rhoten has been with PZZA almost a year and we like that he has a strong background in digital marketing platforms. Prior he worked at Wendy's since 2011, starting as Head of Digital Marketing before becoming VP of the marketing group. We like the CMO's plan to reduce dependency on NFL spending but note it will be expensive. Rhoten has told investors "..we're changing the game. We're investing in infrastructure, investing in tools, in agency partners so that moving forward we don't have to play the media tonnage game." Mike Nettles has been the Chief Information and Digital Officer for 18 months and also is likely to have ambitious spending plans for 2018. He has a strong background as the former VP of Enterprise Architecture and IT Strategy at Panera Bread from 2012-16.

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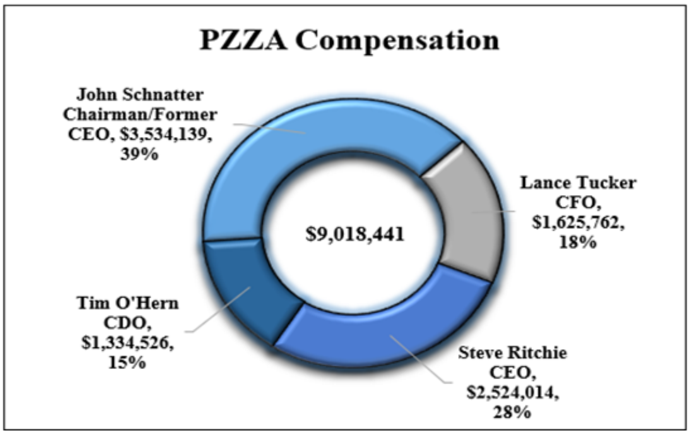

The executive pay plan at PZZA has always been a strength with modest cash and big incentives. The Board has not yet disclosed new CEO Ritchie's pay plan (deeming it an internal promotion and not a material contract). As CEO, Schnatter was paid $900k in salary, $874k in bonus, $1.2 million in options, $500k time vesting equity and $100k in performance equity in 2016. In 2016, Schnatter's bonus target was lowered to 77% of salary from 90% and the other executives have a 75% of salary bonus target. We note favorably that Chairman Schnatter has kept his total annual pay at $3.5 million for the last three years with over half of that in equity. We like the bonus metrics which are based 45% on operating income, 10% on domestic units, 15% on international units, 15% on domestic comparable sales and 15% international comparable sales. In 2016, only the international metrics came in below plan and overall the bonus paid out at 125% of target. The LTIP uses stock options, equity vesting ratably over three years and to a lesser extent performance equity. In 2016, each senior executive got $100k in performance equity covering 2016-18 based on good metrics comprising 50% on global units, 30% on domestic comparable sales and 20% on international comparable sales. The Board has not announced a pay change for the promotion of Steve Ritchie and we do not expect a significant change other than a raise and potentially a special equity grant. In 2016 as President and COO, he made $2.5 million with a $777k salary, $740k bonus, $450k in stock options, $450k in time vesting equity and $100k in performance equity. CFO Tucker was paid $1.6 million with 38% equity based.

Because of the founder's large equity stake, insider ownership is high at 30%. Founder & Chairman Schnatter beneficially owns about 9.9 million shares (28%) which we note could move meaningful higher following the completion of the planned stock repurchase plan. We would like to see CEO Ritchie increase his ownership following his promotion and expect some type of special equity grant. He currently owns 63k shares or $3.7 million. As President, he was required to own 3 times salary or $2.5 million and Chairman Schnatter as CEO was required to own 5 times salary or $4.5 million. Executives have five years to meet a new required ownership level. CFO Tucker owns 48k shares or $3 million. The company has 1.5 million outstanding stock options with an average exercise price of $46.58, and while some are now underwater, we think they provide good alignment with shareholders. Chairman Schnatter did not sell any meaningful amount of stock in 2017, however he did sell $49 million between August and October 2016 when the stock was in the high 70s. CEO Ritchie sold $800k in May 2017 and $2 million in the second half of 2016 following option exercises.

We worry higher operating expenses may offset expected benefits from the new lower corporate tax rate. CFO Tucker lowered PZZA's full year 2017 guidance meaningfully in November by reducing comparable sales estimates a full 2% to flattish expectations and revising the projected debt ratio range to 2.5 to 3.5x from 1.5 to 2x. We also note negatively that unit growth has now slowed to 3-4% in 2017, in contrast to Domino's planned 6-8% unit growth. The outgoing CFO has told investors that 2018 CapEx is unlikely to differ much from 2017's $55 million because the operating plan is to run technology and infrastructure spending through the P&L. In August 2017, CFO Tucker announced an aggressive share repurchase plan of $500 million, or over 20% of the market capitalization, to be paid for with approximately $100 million in annual FCF plus four-year variable interest rate financing. The buybacks supplement PZZA's modest dividend and change what had been modest 2x EBITDA leverage. To help finance the repurchase in the third quarter, the CFO has entered into a new $1 billion financing agreement with a $400 million term loan (that repaid $300 million on the prior $500 million revolver) and added a $600 million revolver that has not yet been drawn on but will likely push debt to EBITDA to the 3.5x range this year. In Q3 '17, the CFO repurchased $88 million of stock bringing the YTD amount to $122 million. About $485 million remains on the authorization, which it plans to complete by early to mid-2019. The interest rate on the new debt is based on

LIBOR plus 75 to 200 basis points based on the Company's leverage ratio. The term loan requires $5 million quarterly payments and is due in 2022.

Fiduciary concerns remain with the Chairman at Papa John's. Schatter has a number of related transactions including an aircraft company that Papa John's paid $732k for services. Chairman Schnatter's wife owns one franchise in Louisville and CEO Ritchie and CDO Timothy O'Hern together own eight franchises in Wisconsin. In addition, CEO Ritchie and CDO O'Hern's wives both work for Papa John's.