This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
Accounting: Quality of Earnings Issues
Governance: Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals
Deception: Deception detection analysis

Darden Looks Most Vulnerable in Restaurant Group
Sector Notes: Darden Restaurants Inc. (NYSE:DRI)

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Introduction

Over the past year, some of our research has been notably focused on several different sectors where we have observed significant anomalous insider trading behavior. Beginning in mid and late 2008, for example, we covered several of the for-profit education companies, and then in early 2009 we noted and covered a significant pick up in meaningful trading among names in the “dollar store” group, certain other retailers, and in the restaurant group. In this issue of Sector Notes, we cover several of the restaurants that have just recently started to show some aggressive and/or uncharacteristic insider trading patterns.

Though it is true that a couple of the well-known restaurant stocks have had strong rallies off the November lows which would lead us to expect some profit taking by insiders, we suspect that some of these stocks have been lifted by the overall market rally and gotten ahead of themselves. Standing out the most in this regard is Darden Restaurants Inc., which has bounced more than 170% off its November low and in fact is approaching its all-time high. The problem is, that while the insiders were selling this rally aggressively (see the Insider Research Bulletin on 04/14/09), key metrics such as same store sales were continuing to trend in the wrong direction. In short, we have the stock price going one way, and the underlying fundamentals and insiders going the other. In this report we also cover the recent trading behavior at Chipotle Mexican Grill Inc. (NYSE:CMG) and Yum! Brands Inc. (NYSE:YUM). Our prior coverage of each of these stocks is summarized in the table below. Appendix A provides a complete list of restaurant names where we have observed recent anomalous trading behavior.

Date	Ticker	Headline	Insider trading	Accounting	Governance	Fundamentals	Deception
04/30/09	YUM	Research Watch List	✖				
04/30/09	CMG	Research Watch List	✖				
04/14/09	DRI	Insider Research Bulletin	✖				

Darden Restaurants Inc. (NYSE: DRI)

Introduction

DRI is the largest and best-known name in the causal dining segment, with a portfolio ranging from the affordable Italian food concept Olive Garden to high-end steakhouse Capital Grille. Since it reported 3Q09 earnings (quarter ended 02/22/09) after the close on 03/17/09, the stock has been on a tear and is up nearly 30% from the closing price the day the results were announced, and a whopping 172% from the closing price of $14.30 on November 21st when apparently investors thought the economy was about to collapse and the last thing anyone wanted to do was dine out. Of the restaurants in this sector update report, DRI has had the strongest come back, and in fact is within spitting distance of its all-time high closing price of $46.86 hit in July, 2007 when the economy was humming and consumers were wolfing down bowls of pasta, salad and bread sticks with abandon.

It's not that the results announced on 03/17/09 were that great; they just weren't as dismal as many had feared. Total sales from continuing operations were down slightly (-0.7%) to $1.8 billion. Excluding one-time integration costs, earnings were $0.78 or $.02 per share below the year ago period. Fairly aggressive new store openings were not enough to offset falling same restaurant sales, however. But management was quick to point out their same restaurant sales didn't fall as much as the industry average. Further, based on the better than expected results (which management primarily attributed to cost cutting efforts), the Company raised guidance above analyst expectations. Analysts responded with several upgrades, arguing that the Company's brand diversity makes it a more attractive play than even such competitors as Brinker International Inc. (NYSE: EAT) that are similarly hedged only with less variation in their cuisine offerings and menu price points, leaving DRI well positioned for an economic recovery. In the session following the release and conference call, the issue spiked 20% on four times the normal trading volume, making it the largest one-day percentage price gain in Company history.

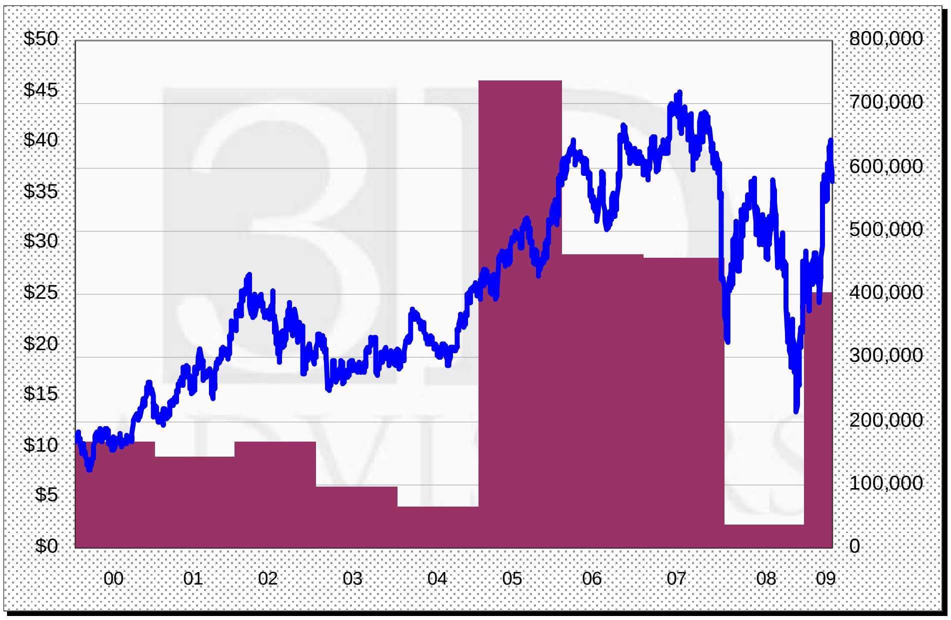
Insider trading behavior contradicts bullish analyst and investor expectations

But if analysts and management are so bullish, why have Darden executives been selling their stock at pace well above their historical norm? Three days after the 3Q09 results were announced and the share price surged, insiders started selling a large number of shares compared to their historical behavior and the sales have persisted right up to this report date, as 393,395 shares with a market value of $14.1 million have been sold by 10 different insiders (mostly key operating officers and division heads). As is shown in Figure 1 below, the number of shares traded through just the first 4 months of 2009 is already approaching the total number of shares sold in 2007, when the stock achieved its all-time high.

While we cannot claim this has been unprecedented profit taking, it has indeed been a rare convergence of this management team that has included record volume for several sellers. Be advised, this is not a holdings reductions story. Because of the infrequency with which this management team sells and the stock holding requirements that have been in place for more than 10 years, DRI executives have amassed sizeable stock and options holdings. Suffice it to say, however, that we feel the insider signals here, from a historical perspective, warrant attention from our clients. The last time

Darden insiders sold in-step was during a three week span in September and October of 2007, right around the closing of the RARE Hospitality acquisition. In that period eight execs and directors, including four who participated in the recent round, dumped 427,000 shares as the issue traded right around its all-time high of $47. Partly due to the acquisition (and also a weaker dollar), Darden lowered its fiscal 2008 EPS expectations by 73% just ten weeks after the last insider sale. The shares immediately lost 21% on the news and would find a bottom at $20 by January, as nearly 57% of the issue's value had evaporated since the insider sales just a few months earlier.

Figure 1. DRI Daily Stock Price, 01/03/00 through 05/01/09 (Blue Line and Left Scale) and Annual Number of Shares Sold by Insiders (Red Bars and Right Scale; 2009 is through 05/01/09). Source: Reuters and DRI SEC Filings.



As we alluded to earlier, this trading profile does not hinge on lofty holdings reductions. Instead we have nine of the Company's fourteen Section 16 executives executing medium-volume sales of which some were record trades. We can certainly appreciate a measured degree of profit taking after a $13 to $40 rally, but a convergence of this many insiders right after the earnings release does not signal a high degree of confidence on their part that the shares can hold these prices.

Take for example President and Chief Operating Officer **Andrew Madsen**, a typically reserved seller who had executed only two sales larger than 1,000 shares since becoming a Section 16 insider back in 2002. In the last three months he has already carried out three sales larger than 18,000 shares for a grand total of 68,000. This was in addition to taking an early election of his FlexComp retirement plan phantom stock ($565,000) in April. Similarly, Senior V.P., General Counsel **Paula Shives** had sold 42,000 in two trades during her first ten years as a registered insider but has become much more active this year, using three sales to distribute almost 100,000 shares. She has monetized more options in the last few months than she stands to gain from those scheduled to become exercisable in the next two years.

Add Darden's Chairman and Chief Executive, **Clarence Otis Jr**., to the list of insiders making their largest historical sales this year. Otis monetized 60,000 options on 01/05/09 that were set to expire five months later, selling the shares at $28. He followed this trade, which matched the sum of the shares sold in all his past dispositions, with a 35,525-share sale on 03/20/09. This sale, which involved the monetization of non-expiring options (June 2010), occurred after the shares rallied to $34 on the heels of the 3Q09 earnings report. Two restaurant presidents, **David Pickens** (Olive Garden) and **Kim Lopdrup** (Red Lobster) each made his largest-ever sales since the last earnings release as well. Despite DRI's trading at prices 25% below those associated with his last sale in September 2007, Pickens doubled his prior selling volume with a 46,000-share sale on 03/20/09. Lopdrup, whose only prior trade in the last five years was a 1,000 share open-market purchase in December 2007 at $27, now has reversed course by selling 33,000 shares on 05/01/09 at $36.

Same Restaurant Sales and Guest Visit Data

Analysts seem to be expecting, and the current DRI share price certainly reflects, that we will soon see a return to positive economic growth and that worries over jobs, house values and retirement funds will abate and consumers will be eager to dine out after a period of hunkering down during the height of the economic storm. While that is a hopeful scenario, there is no evidence in the available DRI data that turn around has yet begun. For instance, as shown in the table below, the percentage change in y/y same restaurant sales continued to trend downward in the most recent quarter, and turned negative for the first time at Olive Garden, the Company's flagship brand that accounts for 46% of total sales. Even though it is a much smaller portion of total sales (3.4%), the rate of decline in same restaurant sales at The Capital Grille doubled from the prior quarter, from -8.7% to -19%.

Y/Y Percent % Same Store Sales	1Q09 (08/24/08)	2Q09 (11/23/09)	3Q09 (02/22/09)
Olive Garden	2.4%	0.8%	-1.4%
Red Lobster	-3.7%	0.3%	-4.6%
Longhorn Steakhouse	-4.9%	-5.7%	-5.4%
Sub – Total	Not Reported	Not Reported	-3.2%
The Capital Grille	-8.6%	-8.7%	-19.0%
Bahama Breeze	-3.7%	-8.0%	-8.8%
Total – All	Not Reported	Not Reported	Not Reported

During the 3Q09 conference call, the very first analyst question was on whether management saw any sign that consumers were starting to dine out again. The question is lengthy and the CEO really doesn't answer it, but he does make a statement that seems to contradict the data [bolding in CEO quote is ours]:

> **Analyst:** Thanks. Congratulations on a great quarter, guys. I wanted to ask you about what you see going on in calendar 2009 to date. Obviously the two-year deterioration and one year deterioration in same-store sales in January and February

isn't quite what it was in the fourth quarter…And I am wondering what you think is causing that slowing of same-store sales decline industry wide, and perhaps for you?...Even things like movie going is up. And perhaps we are getting some sort of level where casual dining is a cheap entertainment, almost a trade down in that sort of way. But again more like speculating because it seems not that bad. So any sort of thoughts about that would be helpful.

Clarence Otis, Chairman and CEO: This is Clarence. I will start and it is -- it is difficult to say with certainly. So a lot of what we are about to say is really theory as much as anything else. We do think, as we look at the fourth quarter last year, we are looking at an environment that as a lot of people have said was unprecedented in a lot of ways. So when you think about the financial crisis, you think about the wealth deterioration, how quickly it happened, our sense is that people hit the pause button and said I need to really hunker down and understand what is going on here. Stability started to come back in a little bit as we got past what, at this point appears to be the worst of the concern about the basic financial institutions, deposits, those sorts of things. And so we think some of that got past, even though the job loss continued and the headlines around job loss were there. I think people felt it wasn't this crisis that they were unfamiliar with. We were back to economic cycle sorts of things. So we think people hunker down a lot.

It culminated in December where sales really fell off a cliff not just in casual dining but across every consumer category. **And we think as people got a little bit more confident that we started to see them return in January and February**. What we have seen also in prior recessions is that as people get their moneys around the fact that we are in a slow down and it is going to last for a while, they tend to make that decision about the big ticket item and putting those off, cars and appliances and those sorts of things. And as a consequence of that, they started to treat themselves with the smaller ticket items. And in the past that has included movies for sure but also dining out. We think a lot of that was going on. And that explains a little bit of the pattern. I don't know if other people have other things to add.

Despite the hopeful, though qualified optimism ("…it is difficult to say with certainty"), the data from the most recent quarter seem to contradict the statement highlighted above.

Y/Y Percent % Same Restaurant Guest Counts	1Q09 (08/24/08)	2Q09 (11/23/09)	3Q09 (02/22/09)
Olive Garden	-0.3%	-1.8%	-3.5%
Red Lobster	-5.6%	-3.2%	-6.8%
Longhorn Steakhouse	Not Reported	Not Reported	-6.9%
The Capital Grille	Not Reported	Not Reported	Not Reported
Bahama Breeze	Not Reported	Not Reported	Not Reported
Total – All	Not Reported	Not Reported	Not Reported

The data above, taken from the last three SEC Form 10-Q filings, show same restaurant guest counts which is in some ways a better gauge of what is happening at each restaurant brand than same restaurant sales since the latter can be affected by menu changes and price increases. What is clear from the data, is that guest visits declined at an accelerated pace in 3Q09, which ended on 02/22/09, despite the CEO's statement that "we started to see them return in January and February".

The simple question we have at this time is whether there is enough evidence to indicate that Darden's fundamentals and operating metrics justify the issue's recent momentum. The insider behavior suggests to us we have not yet reached that point and one could argue that the shares, which are currently outpacing the industry index and S&P by more than 35% on the year, have been bid up by investors on the strength of a single earnings report. It is very possible we are seeing the earliest stages of improving consumer confidence and guest traffic, but to us management has quietly sent its warning that the recent stock price gains are not supported by any such progress.

Chipotle Mexican Grill Inc. (NYSE: CMG)

Introduction

The industry insiders who have managed to attract the most attention with their trading behavior in the past few weeks include those at Chipotle Mexican Grill Inc. The rare and aggressive sales by managers of the 'fast-casual' Mexican food restaurant operator in the aftermath of the Company's first quarter earnings release have caught the attention of the mainstream media. The stock sales seem to have hit a nerve within the sell-side community as well, as suggestions of related lack of CMG management confidence have surfaced. Suffice it to say, we have never known the sell-side to truly understand the significance insider selling may imply. Our past experience has been that most analysts from "this side" would rather turn a head away from any potential negative interpretation of such selling lest they expose themselves to the pain of downgrading a company that they previously had been cheerleading for. The fact that some now seem to have found the conviction to comment on the selling is interesting to us as it could very well provide justification for coming negative changes in their opinion.

Company description and explanation for sales inaccurate

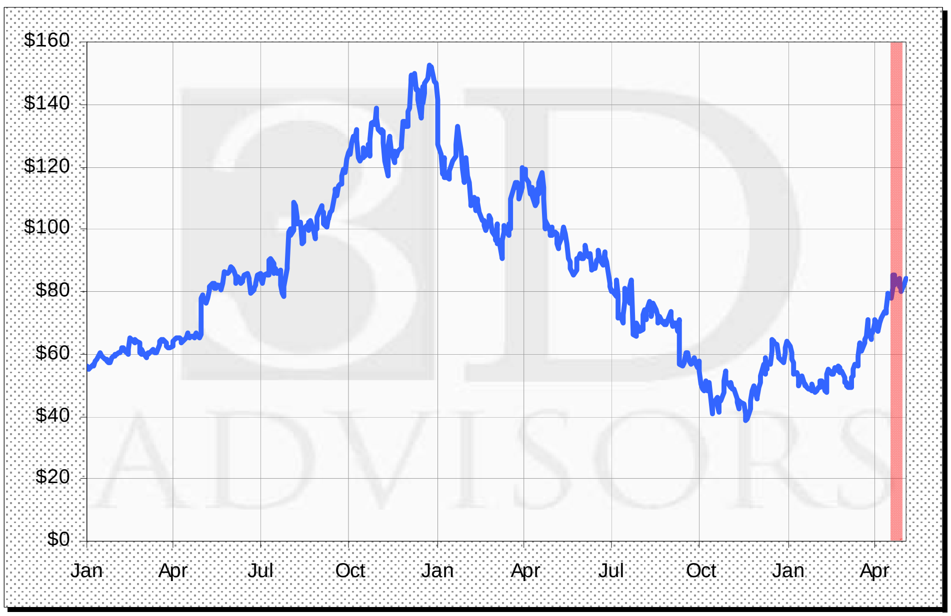
All told, eight insiders cashed in a total of 216,000 shares beginning on the first day a trading window opened (04/24/09) following the release of 1Q09 earnings through 05/01/09 (see Figure 2 below). The insiders' $83 average sale price marks a 130% premium to the issue's low set during the third week of November when the S&P first bottomed; nevertheless, $83 is still a far cry from Chipotle's all-time high of $155 set in December 2007. A Company representative downplayed the timing of these sales, pointing out certain options issued at the time of their January 2006 initial public offering just became exercisable. Not only did he intimate the latest sales involved only these particular newly-vested options, but also proclaimed the executives continue to have substantial exposure to Company shares. We would like to address some of these points while also providing some additional color on the recent trades.

First, let's deal with the options the Company maintains had just become exercisable. These were granted on 01/25/06 with a $22 strike price and cliff vested (100%) on 01/25/09. They were fully exercisable when CMG's insider trading window opened on 02/13/09, two business days after the release of 4Q08 earnings. Contrary to

CMG's commentary, the sales occurring in late April could have occurred three months earlier. That said, however, we simply do not buy CMG's justification for the selling as having been motivated by vesting of the options involved. Our experience has shown that it is usually significant when insiders sell all related shares immediately upon the vesting of options. The fact that some CMG insiders chose to wait a few months before acting only adds a timing flair to the event.

What's more, contrary to Company suggestion that all the shares recently sold came from the newly-vested options series, 74,000 of 216,000 shares (34%) sold after the earnings release actually represented directly-held common stock along with a few thousand shares acquired from the exercise of separate option series. So, not only did the timing of the trades seem quite discretionary, but the related insiders clearly tapped into their common stock holdings to augment profits as well.

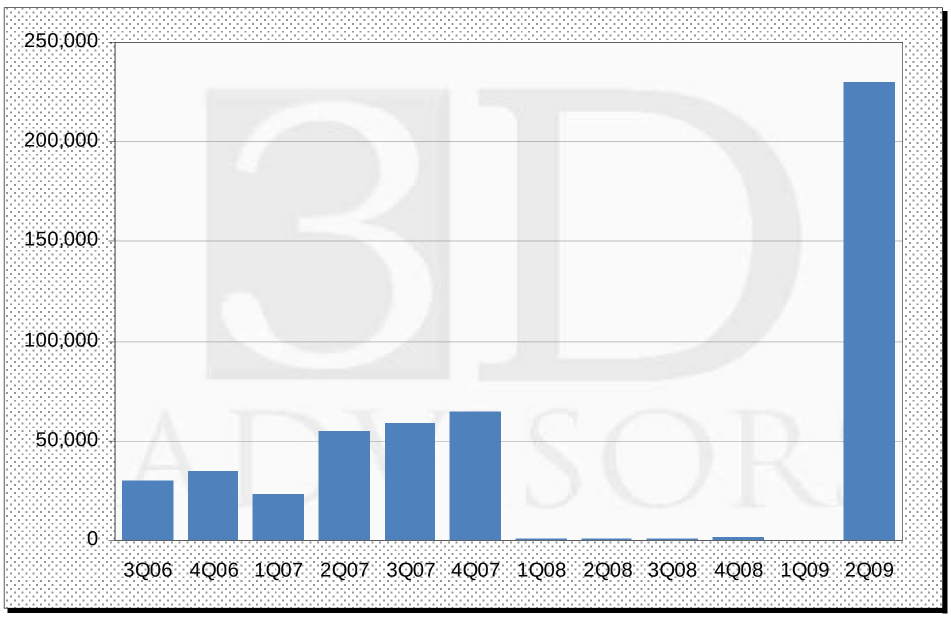
Figure 2. CMG Daily Closing Price, 01/03/07 through 05/05/09. Red shaded area is where 8 insiders sold 216,000 shares. Source: Reuters and CMG SEC Filings.



The Company also justified these sales by contending the executives have "substantial investments in the stock". To this we would argue that the zero actionable holdings (common stock and vested options) of one of Chipotle's top five executives, Restaurant Support Officer **Robert Blessing**, following his 28,007 share sale on 04/24/09 hardly meets the substantial designation. Then there is the activity of new Co-CEO **Montgomery "Monty" Moran**, who was appointed to his new role in January. Moran vested in 80,000 options and 15,000 restricted shares in the first quarter, all of which he monetized immediately upon the opening of the post-earnings release trading window on 04/24/09. The 95,000 shares, which he sold for $6.7 million, accounted for 93% of his Class A holdings though he does own another 153,000 of the less liquid Class B shares. Even more interesting, with regards to his activity, is that Moran traded under a 10b5-1 sales plan from 04/15/09 to 04/23/09, distributing a total of 14,000 shares. The Form 4 filed for his 04/24/09 trade indicates 36,000 of the 95,000 shares sold during that session were also part of this 10b5-1 plan, which suggests he sold the remaining shares outside of his plan.

Also selling during this stretch was Chief Development Officer **Rex Jones**, who cleared out his July 2010 options and most of the newly-vested January 2013 series, along with nearly all of the Class A shares held in his wife's trust. The 18,333 shares he sold between 04/24/09 and 05/01/09 for an average price of $84 accounted for 60% of his Class A holdings (his wife's trust still owns 4,000 Class B shares). Finally, Chief Financial Officer **Jack Hartung** monetized 20,000 of his January 2013 options and 14,000 common shares, including all 9,200 held by his wife. These dispositions, which occurred at prices 40% below his last sales in November 2007, erased nearly 40% of his household's actionable holdings.

Figure 3. Shares Sold Quarterly by CMG Insiders. Source: CMG SEC Filings.



At this point, valuation seems to be the most logical motivation for this spirited profit taking despite the Company's best spin efforts. With a forward price-to-earnings multiple of 28, Chipotle is the most expensive stock (by a wide margin) of any restaurant company with a market capitalization greater than $500 million. Although the Company does boast some of the highest sales and earnings growth estimates in the group, we believe the insiders' actions demonstrate even they have doubts the current valuation is warranted in the current economic climate.

Another indication the insiders see the Class A shares as being richly priced is the fact they have thus far sold only their Class A and held onto their Class B shares. A recent Wall Street Journal article suggested the Class B shares, which are convertible on a one-for-one basis and trade at 16% discount to the Class A shares, are the more sound investment of the two. The Journal might very well be on to something, judging from the insider behavior and the fact the Company has been repurchasing only the Class B shares, which do trade at a lower multiple to their Class A counterparts.

Same restaurant sales growth continues to slow

CMG has done quite well since fiscal 2005, growing in excess of 20% per year on a sequential basis. Although same restaurant sales have also done quite well, the 2008 SEC Form 10-K highlights that “new restaurants have contributed substantially to our restaurant sales growth.” Furthermore, the 10-K states that “we expect our comparable restaurant sales increases in 2009 to be in the low single digits driven primarily by menu price increases implemented in the fourth quarter of 2008…Due to fluctuations in consumer spending as a result of economic uncertainty, potential traffic declines as a result of our recent menu price increases and variability in prior-year comparisons, we could experience rapid and large changes in our comparable restaurant sales trends during the year.”

This last bit of disclosure signals that we may really see a bit of volatility in sales and same restaurant sales growth in 2009. In fact, same restaurant sales have been facing a slowing trend since the 2Q08 as shown in Figure 4 below. Same restaurant sales in 1Q08 were reported at 10.2%, in 2Q08 they fell to 7.1%, 3.1% in 3Q08, and 3.5% in the 4Q08 and to 2.2% by the 1Q09.

Figure 4. CMG Same Restaurant Sales Growth. Source: CMG SEC Filings.

<u>Yum! Brands Inc. (NYSE: YUM)</u>

Introduction

It is a given that the investor community and financial media tend to take notice anytime a company’s chief executive unloads $82 million worth of shares. This was certainly the case when Yum! Brands’ Chairman and Chief Executive **David Novak** sold 2,415,504 shares just days after the Company reported an 8% decline in first quarter sales, although profits came in better than expected due to its international operations. The Company’s sell-side supporters were quick to downplay Novak’s activity and the

Company took the party line that his activity, which involved his largest (volume and value) trades to date, covering one-third of his actionable holdings, was just routine estate planning. Never ones to take a company's trading explanations at face value, we point clients to the consistent signals coming from Novak's supporting cast (not to mention the other names in the restaurant group) to provide confirmation that we are witnessing anything but routine diversification efforts.

10b5-1 trading plan abuses

Looking beyond the Novak sales, seven other YUM executives collectively distributed 351,834 shares in April and May at an average price of $33.60. The volume itself is not without comparison as exactly one year earlier, insiders sold a like amount after that period's 1Q08 earnings release. The difference, however, is that earlier round came at all-time high prices ($40) which were more than 20% higher than those accepted recently. Additionally there are also clear signs a number of executives have altered their 10b5-1 trading plans while also increasing their normal selling volume.

Figure 5. YUM Daily Closing Price, 01/03/07 through 05/05/09. Red shaded area is where 7 insiders sold 351,834 shares. Source: Reuters and YUM SEC Filings.

Topping the list of aggressive 10b5-1 activity is Senior V.P. and Chief Public Relations Officer **Jonathan Blum**, who ended his two-year streak of monthly 8,000-share 10b5-1 sales by trading outside his ongoing sales plan to monetize 25,000 options on 04/24/09 that were not set to expire for four years (January 2013). It is clear, based on the Form 4 filing and also the next trade filed in May, that Blum did in fact execute an out-of-plan disposition to profit on the first quarter earnings surprise, which consequently jeopardizes the safe harbor protection afforded by his plan.

By no means are we brushing off the huge Novak sale by focusing on less-recognizable officers. We have always maintained the behavior of the frontline operating execs holds just as much (and many times more) significance than that of the chief officers. And in this case, the mainstream media has failed to pay attention to what we feel are the most important clues the actions of these players are emitting.   As an example, **Greg Creed**, the President and Chief Concept Officer of Taco Bell and **Christian Campbell**, the Company's General Counsel and Chief Franchise Policy Officer, had each traded unvaryingly under individual sales plans through 3Q08. Creed, whose average 10b5-1 sale for nearly two years was 3,800 shares, resurfaced on 04/24/09 with a 13,180-share disposition. You have to go back to September 2007 to find him selling at lower prices. Campbell's trading plans triggered 42 sales over the last five years, with an average share count of 28,000 per trade. We immediately took notice when he too took advantage of the 1Q09 earnings rally, selling 75,000 shares on 04/24/09 at $34. This was his largest single disposition since registering as a Section 16 insider back in 1997. And finally, while there were other sellers making record sales during this post-earnings period, there is one slightly older trade we feel needs to be addressed (below).

KFC to the rescue?

YUM followers are aware the KFC brand has not only been a drag on the Company's domestic performance, but is now being counted on as a significant revenue driver over the second half of the year. YUM has made a significant investment in its new Kentucky Grilled Chicken offering, which involved years of market testing and the installation of ovens in all 5,200 U.S. stores, not to mention providing financial assistance to franchisees for the ovens. The executive credited for this entire endeavor (including multiple praises by CEO Novak on the 1Q09 conference call) is **Roger Eaton**, who was being groomed for the Chief Operating Officer position and even took the job briefly before being reassigned in June 2008 to head up KFC. Thus far, his tenure has been shaky with KFC contributing to continued U.S. division same-store comp and revenue declines.

With the extraordinary expectations for the new grilled chicken offering, it stands out that Eaton went outside of his ongoing 10b5-1 plan (the plan has, in the past, sold only converted phantom stock he elected to receive) to sell 82,000 shares for $2.4 million on 02/09/09. Although Novak's strongly-worded proclamation on the latest conference call that he is, "Absolutely convinced we're doing the right stuff in the U.S. and there is no doubt in my mind that we will get through this year and be stronger and better as we go into 2010", his trading actions and those of his lieutenants diminish the credibility of his articulated confidence.

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Appendix A: Summary of Recent Restaurant Group Activity

Company	Market Cap	Short Interest	# Sellers Last 90 Days	Selling Volume Last 90 Days	Average Quarterly Selling Volume	Notes
Brinker International (EAT)	1.82B	7.5%	3	227,530	71,590	CEO Brooks and EVP Diener clear out options two quarters before expiration; No reductions.
California Pizza Kitchen (CPKI)	366.8M	19.8%	3	93,581	10,355	Two named execs make largest-ever sales; SVP Sugueti clears out all common, which was bought through ESPP.
Darden Restaurants (DRI)	5.19B	9.3%	9	378,569	79,735	Record selling volume by a number of key operating officers; Third largest round of sales in 15 years.
Yum! Brands (YUM)	16.30B	2.4%	8	2,858,015	445,390	CEO Novak's largest-ever sale; SVP Blum trades outside sales plan; Unusually large 10b5-1 sales by a number of execs.
Panera Bread (PNRA)	1.70B	30.0%	11	118,005	13,987	Insiders clearing out mix of expiring and non-expiring options; Reductions between 50% and 70% for key officers.
Chipotle Mexican Grill (CMG)	2.60B	1.40%	8	230,375	25,541	Largest round of sales since Jan-06 IPO; Insiders sell more than they exercise for; Reductions between 30% and 100%.