TRINITY CAPITAL
INVESTMENT BANKING

4th Quarter 2013
Restaurant Industry
Commentary

What's Inside This Commentary

Same-Store Sales Discussion and Analysis 1
Same-Store Sales Data 2
To IPO or not to IPO: That is the question... 4
The Barbell Economy: A Challenge for Casual Dining 5

Same-Store Sales Discussion and Analysis

During the fourth quarter of 2013 ("Q4 2013"), the restaurant industry maintained positive momentum in same-store sales, which is impressive as it continues to comp over positive results from the prior two years. In fact, the industry reported its fifteenth consecutive quarter of same-store sales gains. It should be noted, however, that traffic has slowed or declined within many prominent chains, so the gains can likely be attributed to price increases opposed to increased customer visits.

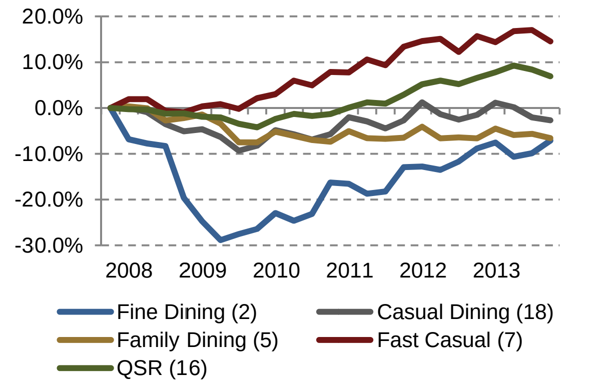
In fine dining, the companies we track were up from 2012 by an average of 5.5% for Q4 2013. It is important to note that despite 16 consecutive positive quarters, fine dining sales remain more than 5% below pre-recession levels (see cumulative Same-Store Sales graph). Nonetheless, these gains represent real momentum given the last three years' positive results.

In casual dining, the concepts we follow were down an average of 0.1% for Q4 2013. This is the second consecutive quarter that the casual dining segment has posted negative same-store sales results. According to Knapp-Track, casual dining guest counts were down 2.0% in October, 1.8% in November and 5.2% in December. In fact, Knapp-Track has reported negative guest counts in 23 of the last 29 months. We expect to start seeing more positive guest count numbers in the coming months as the segment comps over two-plus years of negative numbers. The family dining concepts we track reported an average decrease in same-store sales of 0.2% during Q4 2013.

The fast casual segment continued its positive momentum with another positive quarter after a minor setback in the first quarter of 2013, when the segment suffered its first same-store sales decline since Q2 2009. The segment was up 2.0% for Q4 2013. The fast casual segment continues to produce positive same-store sales results despite comping over nearly four years of strong growth.

In the QSR segment, 12 of the 16 concepts we track were positive during the fourth quarter of 2013 while the segment was up an average of 1.6%. The coffee/snack segment had another strong showing in the third quarter, up an average of 2.6% with Starbucks leading the way, up 5.0%, followed by Dunkin Donuts at 3.5%.

Cumulative Same-Store Sales Change by Segment



Source: Restaurant Research LLC, Capital IQ, Technomic and company filings

The year ended on a negative note for the restaurant industry as December was plagued by severe winter storms (Knapp Track reported that guest counts were down by 5.2% for the month) and a shortened shopping season due to a late Thanksgiving. The late Thanksgiving hurt same-store sales for those segments that typically have lower weekly sales due to that holiday, such as casual dining and fine dining. Furthermore, the late Thanksgiving meant that the holiday shopping season was shortened; thus, there was one week less of people eating out while shopping. Although same-store sales were positive for the year, the restaurant industry sustained its third consecutive year of decreased customer traffic.

The rough winter continued to affect most of the country in January and February of 2014, so we expect to see lower same-store sales and traffic numbers in the first quarter as well. Restaurant operators must continue to focus on operations and hold their collective breaths as the industry awaits the return of the customer.

Contributing Editor Josh Brannan is a Vice President for Trinity Capital.

Same-Store Sales ("SSS") Data

	FY 2011				FY 2012				FY 2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Fine Dining												
Fleming's	11.4%	9.9%	10.1%	0.3%	5.4%	6.8%	10.1%	4.0%	5.4%	2.0%	4.2%	4.9%
Ruth's Chris	5.2%	5.8%	2.6%	7.7%	3.7%	6.0%	5.9%	5.4%	6.6%	4.6%	4.2%	5.5%
Mean	**8.3%**	**7.9%**	**6.4%**	**4.0%**	**4.6%**	**6.4%**	**8.0%**	**4.7%**	**6.0%**	**3.3%**	**4.2%**	**5.2%**
Casual Dining												
Applebee's	3.9%	3.1%	-0.3%	1.0%	1.2%	0.4%	2.0%	0.9%	-1.3%	1.3%	-0.4%	-0.3%
Benihana	5.6%	6.0%	6.4%	7.0%	4.8%	4.5%	-	-	-	-	-	-
BJ's Restaurants	7.8%	6.9%	6.5%	5.1%	3.3%	4.4%	2.3%	3.0%	-0.4%	0.0%	-2.2%	-2.7%
Bonefish	9.6%	10.2%	7.4%	5.9%	6.2%	2.1%	3.5%	1.0%	0.5%	0.2%	-2.7%	0.9%
Buffalo Wild Wings	2.4%	3.9%	4.8%	7.1%	8.1%	5.4%	6.0%	6.7%	1.9%	4.0%	4.3%	4.0%
Carrabba's Italian Grill	3.9%	4.8%	6.3%	3.5%	4.3%	1.5%	1.0%	-0.4%	-1.7%	0.3%	0.0%	0.9%
CEC Entertainment	1.1%	-2.0%	-6.3%	-3.6%	-4.2%	-2.4%	-2.3%	-2.9%	1.6%	2.9%	-2.1%	-1.3%
Cheesecake Factory	2.1%	2.3%	0.8%	2.7%	2.6%	2.1%	2.9%	1.3%	1.6%	0.9%	1.0%	1.1%
Chili's Grill & Bar	-3.0%	2.1%	1.7%	1.4%	4.6%	2.2%	2.8%	1.0%	-1.1%	-0.6%	-1.9%	0.2%
Dave & Buster's	5.3%	1.9%	2.7%	-0.9%	-0.3%	5.4%	5.4%	3.7%	1.8%	-0.9%	-0.9%	-
Famous Dave's	3.0%	-1.2%	-0.1%	3.6%	-1.6%	-0.6%	0.2%	-6.0%	-1.8%	3.8%	-2.3%	-1.1%
Granite City	3.8%	3.5%	3.0%	4.0%	1.9%	1.5%	2.5%	4.5%	2.7%	2.5%	0.4%	0.6%
LongHorn Steakhouse	6.1%	6.0%	4.8%	6.7%	3.8%	3.0%	2.2%	-0.8%	-1.6%	3.5%	3.2%	2.9%
Maggiano's	3.4%	5.7%	3.5%	2.8%	3.9%	1.9%	0.9%	0.6%	0.4%	0.2%	0.6%	0.9%
Olive Garden	0.0%	0.0%	-2.9%	-2.5%	2.0%	-1.8%	0.3%	-3.2%	-4.1%	1.1%	-4.0%	-0.6%
Outback	4.3%	1.8%	6.0%	3.6%	5.3%	2.3%	4.5%	5.3%	2.5%	2.8%	-0.3%	1.1%
Red Lobster	0.1%	3.8%	10.7%	6.8%	6.0%	-3.9%	-2.6%	-2.7%	-6.6%	3.2%	-5.2%	-4.5%
Red Robin	2.1%	2.9%	2.1%	4.5%	1.0%	1.2%	0.6%	1.4%	1.4%	3.6%	5.4%	3.7%
Ruby Tuesday	-1.2%	-0.1%	-4.1%	-4.2%	-5.0%	-4.6%	1.9%	0.3%	-2.8%	-3.1%	-11.4%	-7.8%
Taco Cabana	2.0%	4.5%	5.3%	2.7%	6.1%	4.5%	1.8%	6.8%	2.0%	1.1%	1.8%	-2.9%
Texas Roadhouse	4.5%	4.3%	3.9%	5.6%	6.2%	4.6%	3.9%	4.5%	3.7%	4.7%	2.9%	2.5%
Mean	**3.0%**	**3.0%**	**2.6%**	**3.2%**	**3.3%**	**1.6%**	**2.0%**	**1.3%**	**-0.1%**	**1.6%**	**-0.7%**	**-0.1%**
Family Dining												
Bob Evans	1.2%	-1.8%	-1.5%	1.6%	-0.6%	1.0%	1.0%	1.6%	0.0%	-0.6%	-1.9%	-1.8%
Denny's	-1.7%	2.0%	0.9%	1.6%	2.4%	0.8%	0.4%	1.7%	-0.7%	0.6%	1.2%	0.9%
Frisch's Big Boy	0.2%	0.5%	0.0%	0.4%	1.7%	-1.7%	-0.2%	-1.7%	-0.9%	1.0%	-0.1%	-3.6%
IHOP	-2.7%	-2.9%	-1.5%	-1.0%	-0.5%	-1.4%	-2.0%	-2.6%	-0.5%	1.9%	3.6%	2.4%
Luby's	3.5%	-0.6%	3.5%	2.2%	2.2%	1.1%	2.4%	0.2%	-0.1%	1.0%	2.4%	1.2%
Mean	**0.1%**	**-0.6%**	**0.3%**	**1.0%**	**1.0%**	**0.0%**	**0.3%**	**-0.2%**	**-0.4%**	**0.8%**	**1.0%**	**-0.2%**

Source: Restaurant Research LLC, Capital IQ, Technomic and company filings

SSS Data (Cont'd)

	FY 2011				FY 2012				FY 2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q3
Fast Casual												
Chipotle	12.4%	10.0%	11.3%	11.1%	12.7%	10.2%	4.8%	3.8%	1.0%	5.5%	6.2%	9.3%
Cosi	1.7%	-0.2%	-3.0%	2.6%	7.5%	-0.5%	-0.7%	-3.9%	-4.5%	-2.7%	-3.6%	-4.6%
Einstein Noah Bagel	-0.4%	0.2%	0.7%	1.2%	1.1%	1.3%	0.2%	1.4%	-0.6%	0.7%	-1.4%	0.1%
Panera Bread	3.3%	3.9%	4.4%	4.4%	6.3%	5.9%	5.8%	4.9%	3.3%	3.7%	1.3%	1.1%
Qdoba Mexican Grill	6.0%	5.1%	4.3%	3.8%	3.0%	2.1%	3.3%	1.0%	-1.5%	1.3%	2.0%	2.3%
Steak n Shake	4.3%	4.9%	5.3%	5.5%	5.5%	4.8%	2.9%	3.8%	1.3%	0.3%	4.2%	3.0%
Tim Horton's (US)	4.9%	6.4%	6.3%	7.2%	8.5%	4.9%	2.3%	3.2%	-0.5%	1.4%	3.0%	3.1%
Mean	**4.6%**	**4.3%**	**4.2%**	**5.1%**	**6.4%**	**4.1%**	**2.7%**	**2.0%**	**-0.2%**	**1.5%**	**1.7%**	**2.0%**
QSR												
Chicken												
KFC	1.0%	-5.0%	-3.0%	-1.0%	2.0%	1.0%	4.0%	4.0%	4.5%	3.0%	-4.0%	-5.0%
Pollo Tropical	13.5%	10.7%	7.9%	7.8%	9.4%	7.8%	7.0%	8.3%	3.8%	6.4%	6.5%	7.0%
Popeye's	3.9%	0.5%	1.7%	5.9%	8.1%	8.4%	6.8%	6.4%	0.5%	4.3%	5.1%	0.3%
Mean	**6.1%**	**2.1%**	**2.2%**	**4.2%**	**6.5%**	**5.7%**	**5.9%**	**6.2%**	**2.9%**	**4.6%**	**2.5%**	**0.8%**
Coffee/Snack												
Caribou Coffee	4.3%	4.6%	4.1%	5.6%	2.5%	2.8%	3.5%	-	-	-	-	-
Dunkin Donuts	2.8%	3.2%	6.0%	7.4%	7.2%	4.0%	4.0%	3.2%	1.7%	4.0%	4.2%	3.5%
Jamba Juice	2.2%	4.3%	3.3%	7.7%	12.7%	5.7%	2.5%	0.6%	1.3%	1.7%	-3.4%	0.3%
Krispy Kreme	7.0%	2.5%	4.0%	8.3%	2.1%	5.4%	6.8%	7.5%	11.4%	10.0%	3.7%	1.6%
Starbucks	7.0%	8.0%	10.0%	9.0%	8.0%	7.0%	7.0%	7.0%	7.0%	9.0%	8.0%	5.0%
Mean	**4.7%**	**4.5%**	**5.5%**	**7.6%**	**6.5%**	**5.0%**	**4.8%**	**4.6%**	**5.4%**	**6.2%**	**3.1%**	**2.6%**
Mexican												
Taco Bell	0.0%	-5.0%	-2.0%	-2.0%	6.0%	13.0%	7.0%	5.0%	6.0%	2.0%	2.0%	1.0%
Mean	**0.0%**	**-5.0%**	**-2.0%**	**-2.0%**	**6.0%**	**13.0%**	**7.0%**	**5.0%**	**6.0%**	**2.0%**	**2.0%**	**1.0%**
Pizza												
Domino's	-1.4%	4.8%	3.0%	6.8%	2.0%	1.7%	3.3%	4.7%	6.2%	6.7%	5.4%	3.7%
Papa John's	6.1%	0.4%	5.3%	1.7%	1.1%	5.7%	2.5%	5.2%	1.6%	3.4%	1.8%	6.6%
Pizza Hut	-3.0%	-2.0%	-3.0%	6.0%	5.0%	4.0%	6.0%	-1.0%	-1.0%	-2.0%	-1.0%	-4.0%
Mean	**0.6%**	**1.1%**	**1.8%**	**4.8%**	**2.7%**	**3.8%**	**3.9%**	**3.0%**	**2.3%**	**2.7%**	**2.1%**	**2.1%**
Sandwich												
Burger King	-6.0%	-5.3%	-0.3%	-2.0%	4.2%	4.4%	1.6%	3.7%	-3.0%	-0.5%	-0.3%	0.2%
Carl's Jr.	-0.4%	2.1%	2.0%	2.0%	1.7%	2.6%	5.5%	2.6%	2.9%	-	-	-
Hardee's	5.7%	9.6%	2.5%	1.8%	6.1%	2.6%	3.6%	2.3%	1.1%	-	-	-
Jack in the Box	0.8%	4.7%	5.8%	5.3%	5.6%	3.4%	3.1%	1.9%	0.1%	0.1%	-1.4%	1.9%
McDonald's	2.9%	4.5%	4.4%	7.1%	8.9%	3.6%	1.2%	0.3%	-1.2%	1.0%	0.7%	-1.4%
Sonic Drive-In	1.2%	3.9%	-0.5%	0.1%	3.5%	2.8%	2.3%	3.0%	1.3%	0.1%	5.9%	2.2%
Wendy's	0.0%	2.3%	0.9%	4.4%	0.7%	3.2%	2.8%	-0.5%	0.7%	0.3%	3.1%	2.9%
Mean	**0.6%**	**3.1%**	**2.1%**	**2.7%**	**4.4%**	**3.2%**	**2.9%**	**1.9%**	**0.3%**	**0.2%**	**1.6%**	**1.2%**
Mean Total QSR	**2.5%**	**2.6%**	**2.7%**	**4.3%**	**5.1%**	**4.7%**	**4.2%**	**3.6%**	**2.5%**	**3.1%**	**2.3%**	**1.6%**

Source: Restaurant Research LLC, Capital IQ, Technomic and company filings

To IPO or not to IPO: That is the question…

For many years now, the dream of an initial public offering ("IPO") has generally meant wealth, prestige and success for the lucky few restaurant concepts. In terms of dollar volume, while 2013 was the biggest year for IPOs in over a decade, 2014 is on pace to double that mark. Recent IPOs have received higher valuation multiples, often reaching 12x to 14x, relative to the 8x to 10x achieved in an M&A process. So, when examining exit (liquidation) alternatives, it is no surprise that a number of restaurant owners have recently pursued IPOs rather than a sale through an M&A process.

We believe, however, the restaurant IPO story frequently starts well, but does not always end well. There are many reasons for this, but chief among them is the stock market uses discounted cash flow models to value equities, which means significant, consistent unit and same-store sales growth is a prerequisite for success. When growth slows, the stock market will usually punish companies. Therefore, as restaurant owners assess whether to pursue an exit through an IPO or through a private sale, we advise that the primary determining factor is the liquidity objective of the existing shareholders, followed by the growth potential of the concept.

The M&A vs. the IPO

While IPO valuations are frequently significantly higher than in a sale process, it is important to note that an M&A sale process can provide a full monetization for the seller upon completion of the transaction, whereas an IPO generally provides sellers only 25% or so. Subsequent to an IPO, companies have to market a series of follow-on equity offerings in order to realize the value of the 75% unsold shares, a process that often requires a period of several years. If the stock market is not cooperative, sellers could find themselves in a position where follow-on equity offerings are not feasible or not attractively priced. This makes the value of remaining shares subject to the vagaries of the economy, stock market, restaurant sector, geography, concept and, finally, the operating performance of the restaurants. With the exception of perhaps the last two, these items are beyond the control of the management team and should give pause to anyone who dismisses an M&A process without careful consideration.

The Successful IPO vs. Those That Have Struggled

After the liquidity objective of the existing shareholders has been determined, the financial profile and long-term growth of the company will determine the most suitable sale process. IPOs make sense for a concept that is profitable, growing rapidly and will require significant debt and equity capital to fund future expansion initiatives. A concept that meets these criteria will generally be rewarded by the stock market, the most evident example of this being Chipotle Mexican Grill. Chipotle was adding approximately 100 new units per year when it decided an IPO in 2006; as such, an IPO was the best strategy to fund ongoing growth. Chipotle continues to achieve meteoric growth with new unit and system-wide sales increases of more than 12% and 17%, respectively, in 2013. Needless to say, Chipotle not only completed a successful IPO, but has also enjoyed exponential growth in share price since then.

If, however, we look at restaurant IPOs that occurred around the same time as Chipotle, there are several examples where one could reasonably argue a private sale would have been the better strategy. Carrols Restaurant Group's share price declined roughly 25% from its IPO price within the first eight months and continued to decline until it lost approximately 90% in value. Carrols' share price today is almost 50% below its IPO price. Morton's Restaurant Group's share price declined nearly 20% from its IPO price within the first five months and settled about 70% below the IPO price before being acquired. Lastly, Einstein Noah Restaurant Group's share price has remained below its IPO price for all but approximately three months out of its nearly seven year history on the public exchange.

There are a number of factors that may have contributed to the poor stock performance following the IPOs of the three companies noted above, not the least of which is the Great Recession. Nevertheless, these examples demonstrate that if the main objective of a restaurant owner is near-term monetization of a significant portion of their equity ownership, then speculating on the future performance of the stock market and pursuing an IPO is a less appropriate path.

Other IPO Caveats

Another word of caution on IPOs: they are very time-consuming, expensive and require broad regulatory compliance. This commonly means a company may need to change its auditor, upgrade its legal counsel, engage one or two more C-Suite executives and prepare for much greater transparency in business operations. Frequently, a company's operating agreements, supply contracts and other principal documents will need to be filed and disclosed, and therefore be available to friend and foe alike. Similarly, loan documents and other information associated with a company's capitalization, such as shareholder loans, insider stock holdings and compensation will be public as well. In essence, once the IPO is completed, management's life will change dramatically as the steward of an SEC-regulated public company.

The Company Sale vs. the IPO

Determining the most suitable exit strategy for a particular company will depend on a variety of factors, but the first question to ask when contemplating a company sale versus an IPO is this: is this a growth funding strategy or an exit (liquidation) for the existing equity owners? If it's the former, IPOs will generally provide better outcomes, assuming the company's performance meets expectations and the market cooperates. If it's an exit strategy, a private sale provides sellers with a simpler, lower cost, less time consuming process and most importantly, a more immediate payout, which also means less ongoing uncertainty and risk. One rule of thumb that we believe very strongly is that if the level of uncertainty is greater than the level of certainty, it is advisable to get paid up front through a private sale than to speculate on a series of secondary stock offerings.

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The Barbell Economy: A Challenge for Casual Dining

While there are a number of positive U.S. economic indicators, casual dining restaurant sales continue to disappoint. U.S. GDP growth – an annualized rate of 2.6% was reported for 4Q 2013 – is positive, albeit somewhat lower than the average since World War II. The U.S. unemployment rate has fallen as new jobs have replaced those lost during the Great Recession. The stock market currently trades near its all-time highs, and interest rates remain attractively low. The manufacturing and housing sectors have improved. However, guest counts at casual dining establishments continue to decline. Knapp-Track released an estimate of a 3.6% decline in year-over-year traffic for March, and a 1.7% sales drop. This estimate represents the 18th negative sales month of the past 43 months and the 34th negative traffic month during that same period. In fact, casual dining traffic is down over 16% since January 2009 according to Knapp-Track.

Poor weather has negatively impacted restaurant traffic this year. However, we believe there are some other important trends creating challenges for casual dining chains. In particular, a large percentage of the population has not perceived the benefits of the apparently improving economy described above. A significant number of the new jobs created have been relatively low paying or part-time. The true shadow unemployment numbers, including “discouraged” workers, remain very high, and new job creation has not kept up with population growth (the Economic Policy Institute estimates a 7.3 million job shortfall). Only a small percentage of the population has benefited from the stock market increases as most Americans have less than $25,000 in total savings. As a result of these and other factors, a majority of consumers are very value-oriented, and many analysts believe the shrinking middle class has contributed to an extended shift to thrifty, if not frugal, spending habits. This hurts casual dining traffic.

The improving economy and stock market has helped wealthier Americans and contributed to positive sales growth at fine dining restaurants. At the same time, greater consumer interest in specific attributes of certain restaurants has led to increased spending for healthier foods, greater convenience, higher quality, enhanced experience, etc. Millennials (the 18-34 age group) are driving many of these newer consumer trends. In particular, they prefer fast casual concepts, which tend to offer a better value proposition (without having to pay a tip!), greater control over the food inputs and faster service.

The divergence in consumer spending has created a barbell-type economy with higher spending for value-oriented alternatives on one end and specialty and premium options on the other. The middle ground of relatively undifferentiated value, convenience, quality and/or experience is suffering and that is where most of the casual dining chains play. They don't offer the value or conveniences of limited service restaurants or the unique experience of fine dining establishments. In food retail, a similar phenomenon has occurred with higher sales increases at value stores and premium/specialty concepts than at traditional supermarkets or drug stores.

How have casual dining firms reacted? Several are trying to offer greater convenience with take-out stations, delivery and on-line ordering. Others are reformatting and refreshing their stores to enhance the consumer dining experience. Restaurants generally are offering more nutritious alternatives. Certain chains have stepped up their social media programs to attract younger diners. Some have essentially conceded the position and opened new fast casual formats.

While some industry analysts believe casual dining is in a systemic, permanent decline given the new normal of bifurcated consumer demands, we do not believe all casual dining chains are equal and feel strongly that certain operators will survive and thrive. The key ingredient remains never becoming complacent, never accepting the status quo. Rather, the winners will continually seek out ways to enhance their value proposition with a more appealing environment, higher quality and more interesting food, better and timelier service with reasonable prices. Successful chains will emphasize the pleasurable casual dining experiences of savoring meals, enjoying social interaction and receiving impeccable service, all of which cannot be duplicated by fast casual alternatives. Adopting new technology to control costs, speed up service and drive social media traffic will be important as well. For casual dining, the war has not been lost, but, in the current barbell economy, the battles to differentiate and justify one's relative dining experience will be challenging.

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