TRINITY CAPITAL
INVESTMENT BANKING

Restaurant Industry Commentary
&
Q3 2017 SSS Update

What's Inside This Commentary

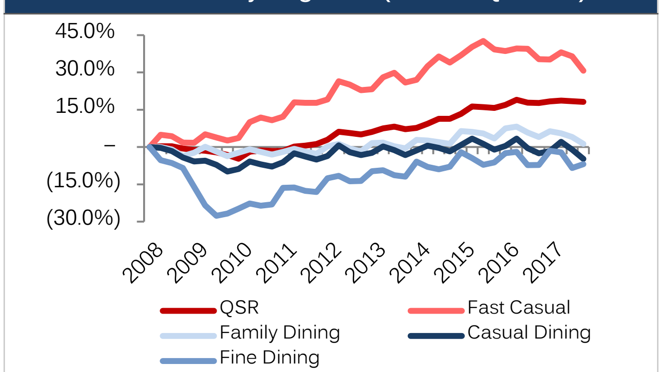
Published: February 2018

Same-Store Sales Discussion

During the third quarter of 2017 ("Q3 2017"), the restaurant industry saw mostly weak same-store sales ("SSS") results. On average, restaurant same-store sales decreased 1.5% year-over-year ("YOY") in Q3 2017. Of the 64 companies we follow, only 21, or 33%, enjoyed positive same-store sales growth. Data over the last several quarters have showed a consistent slowdown for the industry. Q3 2017 extended the streak of industry SSS decreases to six quarters.

QSR: As the chart below illustrates, QSR continued to be a bright spot in the restaurant industry in Q3 2017, with 14 of the 23 concepts we track turning in positive same-store sales growth. The segment as a whole was up 0.4% YOY, continuing its steady growth. Mexican concepts led the segment at 3.6% growth as Taco Bell (+3.0%) and Del Taco (+4.1%) both turned in strong results. Chicken concepts continued to struggle in Q3 2017 and were down 3.7% on average, led by another large decrease at Pollo Tropical (-10.9% following -7.7% in Q2) and a third consecutive negative quarter for Popeye's (-2.6%). Domino's strong performance continued for yet another quarter – its +8.4% growth was the *second worst* result of the past 12 quarters.

Indexed SSS by Segment (2007 to Q3 2017)



Source: Restaurant Research LLC, Technomic and company filings

Fast Casual: Q3 2017 saw the fast casual segment turn in a decrease of 3.4% for its seventh consecutive quarter of SSS decreases after 26 quarters of SSS increases from Q3 2009 to Q4 2015. Pie Five's losses continued to accelerate as the pizza concept posted a 17.3% decrease, its sixth consecutive double-digit decrease. After bouncing back from five consecutive quarters of sales declines in Q1 2017, Chipotle (+1.0%) lost momentum on yet another food safety issue. Excluding Chipotle, only El Pollo Loco (+1.7%) posted a positive comp. Even Shake Shack – after sizzling same-store sales performance following its IPO in January 2015 – turned in a third consecutive quarter of negative comps.

Family Dining: Struggles for the family dining segment continued in Q3 2017 as four of the six concepts we track posted SSS decreases. After 11 quarters of growth for the segment as a whole, this marks the fourth consecutive quarter of decreases. Chuck E. Cheese has seen a steady decline in same-store sales performance over the past two years – going from +6.0% in Q1 2016 to -6.9% in Q3 2017.

Casual Dining: Downward trends in casual dining accelerated in Q3 2017 as SSS declined 2.4% YOY. Of the 24 concepts we follow, 17 experienced sales declines for the quarter. Taco Cabana (-12.6%) suffered the biggest loss, followed by Applebee's with a 7.7% decline for its ninth consecutive quarterly decrease. On a positive note, steakhouse chains, Texas Roadhouse and LongHorn, along with Olive Garden, posted SSS growth and have now produced growth for 12+ quarters in a row.

Fine Dining: The fine dining segment saw mixed results with SSS growth of 0.3% on average, despite negative comps from three of five concepts we track. Fine dining sales have yet to fully recover to pre-recession levels and are still below 2007 sales. A 1.6% decline broke Ruth's Chris's streak of 29 consecutive quarters with positive comps, while Sullivan's bounced back and led the segment with a +7.7% increase after trailing the segment in the last quarter.

Restaurant industry performance was generally lackluster through three quarters of 2017. Always in a highly competitive space, restaurant operators now find themselves facing a rapidly shifting technological and cultural landscape. Those who innovate – while also maintaining focus on the fundamentals of quality, service and cleanliness – should continue to prosper in this changing environment.

Contributing Editor Aaron Edwards is an Associate at Trinity Capital.

Same-Store Sales Data

	FY 2014	FY 2015				FY 2016				FY 2017		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
QSR												
Chicken												
Bojangles	7.0%	7.9%	4.4%	4.1%	0.6%	2.0%	0.2%	0.8%	2.4%	(1.7%)	(1.4%)	(2.2%)
Church's	3.6%	2.8%	(2.6%)	(4.8%)	(4.6%)	(4.2%)	(2.5%)	(1.8%)	(1.3%)	(1.0%)	0.2%	N/A
KFC	6.0%	7.0%	3.0%	0.0%	3.0%	1.0%	2.0%	6.0%	4.0%	2.0%	2.0%	1.0%
Pollo Tropical	7.7%	6.4%	4.3%	4.2%	0.4%	0.0%	(1.4%)	(1.0%)	(4.0%)	(6.7%)	(7.7%)	(10.9%)
Popeye's	10.7%	7.0%	7.9%	5.6%	2.0%	1.1%	0.0%	1.5%	3.0%	(0.4%)	(3.3%)	(2.6%)
Mean	**7.0%**	**6.2%**	**3.4%**	**1.8%**	**0.3%**	**(0.0%)**	**(0.3%)**	**1.1%**	**0.8%**	**(1.6%)**	**(2.0%)**	**(3.7%)**
Coffee/Snack												
Baskin Robbins	9.3%	8.0%	3.4%	7.5%	4.4%	5.0%	0.6%	(0.9%)	0.9%	(2.4%)	(0.9%)	0.4%
Dunkin Donuts	1.4%	2.7%	2.9%	1.1%	1.8%	2.0%	0.5%	2.0%	1.9%	0.0%	0.8%	0.6%
Jamba Juice	4.9%	5.0%	(5.9%)	6.6%	5.4%	(2.1%)	4.2%	(1.1%)	(2.2%)	(5.8%)	0.0%	N/A
Starbucks	5.0%	7.0%	8.0%	9.0%	9.0%	7.0%	4.0%	4.0%	3.0%	3.0%	5.0%	2.0%
Tim Horton's	4.1%	8.9%	7.0%	4.3%	5.8%	5.8%	5.9%	4.5%	3.6%	(0.1%)	(0.8%)	0.3%
Mean	**4.9%**	**6.3%**	**3.1%**	**5.7%**	**5.3%**	**3.5%**	**3.0%**	**1.7%**	**1.4%**	**(1.1%)**	**0.8%**	**0.8%**
Mexican												
Del Taco	N/A	7.7%	6.0%	5.6%	5.8%	3.2%	3.3%	6.7%	5.5%	4.2%	7.1%	4.1%
Taco Bell	7.0%	6.0%	6.0%	4.0%	4.0%	1.0%	(1.0%)	3.0%	3.0%	8.0%	4.0%	3.0%
Mean	**7.0%**	**6.9%**	**6.0%**	**4.8%**	**4.9%**	**2.1%**	**1.2%**	**4.9%**	**4.3%**	**6.1%**	**5.6%**	**3.6%**
Pizza												
Domino's	11.1%	14.5%	12.8%	10.5%	10.7%	6.4%	9.7%	13.0%	12.2%	10.2%	9.5%	8.4%
Papa John's	4.1%	6.5%	5.5%	3.0%	1.9%	0.1%	4.8%	5.5%	3.8%	2.0%	1.4%	1.0%
Papa Murphy's	N/A	5.6%	4.5%	1.4%	(3.1%)	(3.0%)	(4.0%)	(5.8%)	(7.8%)	(5.0%)	(4.3%)	(4.1%)
Pizza Hut	0.0%	(1.0%)	1.0%	0.0%	2.0%	5.0%	1.0%	(2.0%)	(4.0%)	(7.0%)	(3.0%)	0.0%
Pizza Inn	6.4%	6.0%	0.2%	(1.1%)	(1.7%)	(2.2%)	0.3%	0.2%	(1.2%)	0.1%	(9.5%)	1.4%
Mean	**5.4%**	**6.3%**	**4.8%**	**2.8%**	**2.0%**	**1.3%**	**2.4%**	**2.2%**	**0.6%**	**0.1%**	**(1.2%)**	**1.3%**
Sandwich												
Arby's	4.9%	9.7%	7.6%	9.6%	5.5%	5.8%	3.7%	2.4%	3.1%	1.6%	3.7%	N/A
Burger King	4.2%	6.9%	7.9%	5.2%	2.8%	4.4%	(0.8%)	(0.5%)	1.8%	(2.2%)	3.0%	4.0%
Jack in the Box	4.4%	8.9%	7.3%	6.2%	1.4%	0.0%	1.1%	2.0%	3.1%	(0.8%)	(0.2%)	(1.0%)
McDonald's	(1.7%)	(2.6%)	(2.0%)	0.9%	5.7%	5.4%	1.8%	1.3%	(1.3%)	1.7%	3.9%	4.1%
Sonic Drive-In	8.5%	11.5%	6.1%	4.9%	5.3%	6.5%	2.0%	(2.0%)	(2.0%)	(7.4%)	(1.2%)	(3.3%)
Wendy's	1.7%	3.2%	2.2%	3.1%	4.8%	3.6%	0.4%	1.4%	0.8%	1.6%	3.2%	2.0%
Mean	**3.7%**	**6.3%**	**4.9%**	**5.0%**	**4.3%**	**4.3%**	**1.4%**	**0.8%**	**0.9%**	**(0.9%)**	**2.1%**	**1.2%**
Mean Total QSR	**5.3%**	**6.3%**	**4.2%**	**4.0%**	**3.2%**	**2.3%**	**1.6%**	**1.7%**	**1.2%**	**(0.3%)**	**0.5%**	**0.4%**
Fast Casual												
Chipotle	16.1%	10.4%	4.3%	2.6%	(14.6%)	(29.7%)	(23.6%)	(21.9%)	(4.8%)	17.8%	8.1%	1.0%
El Pollo Loco	7.6%	3.5%	1.3%	0.0%	1.8%	0.7%	2.4%	1.6%	(1.3%)	(0.3%)	2.9%	1.7%
Fuddrucker's	0.2%	2.1%	0.2%	1.7%	1.3%	0.0%	(1.0%)	(0.8%)	(1.6%)	(1.1%)	(0.9%)	(3.6%)
Noodles & Company	1.3%	0.9%	0.1%	(0.9%)	(1.1%)	(0.1%)	(1.0%)	(0.7%)	(1.3%)	(2.0%)	(3.4%)	(3.5%)
Panera Bread	3.0%	0.7%	1.8%	2.8%	2.3%	4.7%	2.3%	1.7%	0.7%	2.6%	N/A	N/A
Pie Five	16.9%	9.5%	6.7%	1.5%	(1.6%)	(4.0%)	(12.0%)	(14.7%)	(17.4%)	(15.8%)	(16.2%)	(17.3%)
Potbelly	3.7%	5.4%	4.9%	3.7%	3.7%	3.7%	1.7%	0.6%	0.1%	(3.1%)	(4.9%)	(4.8%)
Qdoba Mexican Grill	14.0%	8.3%	7.7%	6.6%	1.5%	2.1%	0.6%	0.8%	(1.0%)	(3.2%)	0.5%	(2.1%)
Shake Shack	7.2%	11.7%	12.9%	17.1%	11.0%	9.9%	4.5%	2.9%	1.6%	(2.5%)	(1.8%)	(1.6%)
Zoe's Kitchen	7.8%	N/A	5.6%	4.5%	7.7%	8.1%	4.0%	2.4%	0.7%	(3.3%)	(3.8%)	(0.5%)
Mean	**7.8%**	**5.8%**	**4.6%**	**4.0%**	**1.2%**	**(0.5%)**	**(2.2%)**	**(2.8%)**	**(2.4%)**	**(1.1%)**	**(2.2%)**	**(3.4%)**

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

Same-Store Sales Data (Cont.)

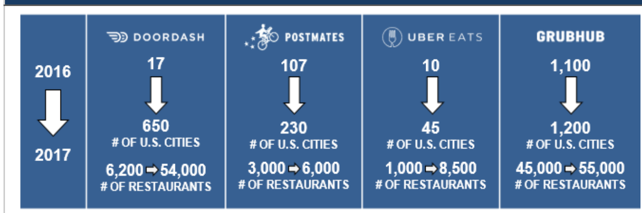
	FY 2014	FY 2015				FY 2016				FY 2017		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Family Dining												
Bob Evans	3.8%	2.1%	(0.3%)	(3.2%)	(3.6%)	(3.0%)	(2.0%)	(2.2%)	(2.6%)	(3.9%)	N/A	N/A
Chuck E Cheese	(1.4%)	(5.0%)	3.0%	0.7%	1.3%	6.0%	2.6%	3.7%	(1.6%)	(2.8%)	(3.8%)	(6.9%)
Cracker Barrel	7.9%	5.2%	3.8%	2.5%	0.6%	2.3%	3.2%	1.3%	0.6%	(0.4%)	(0.8%)	0.2%
Denny's	4.7%	7.2%	7.3%	6.1%	2.9%	2.5%	(0.5%)	1.0%	0.5%	(1.1%)	2.6%	0.6%
IHOP	6.1%	4.8%	6.2%	5.8%	1.4%	1.5%	0.2%	(0.1%)	(2.1%)	(1.7%)	(2.6%)	(3.2%)
Luby's	0.2%	3.1%	(1.0%)	0.2%	1.2%	3.1%	(0.2%)	0.0%	(2.2%)	(4.4%)	(2.5%)	(4.5%)
Steak n Shake	2.9%	6.0%	4.8%	3.0%	3.6%	1.8%	(0.7%)	0.2%	(0.4%)	(3.3%)	(3.1%)	(2.2%)
Mean	**3.5%**	**3.3%**	**3.4%**	**2.2%**	**1.1%**	**2.0%**	**0.4%**	**0.6%**	**(1.1%)**	**(2.5%)**	**(1.7%)**	**(2.7%)**
Casual Dining												
Applebee's	2.8%	2.9%	1.0%	(0.5%)	(2.5%)	(3.7%)	(4.2%)	(5.2%)	(7.2%)	(7.9%)	(6.2%)	(7.7%)
Bahama Breeze	(0.6%)	3.2%	1.8%	1.8%	2.4%	9.9%	4.7%	3.9%	2.6%	0.5%	1.4%	1.2%
BJ's Restaurants	1.2%	3.2%	0.5%	2.3%	0.7%	0.6%	(0.2%)	(3.4%)	(2.2%)	(1.3%)	(1.4%)	(1.7%)
Bonefish	0.7%	0.9%	(4.6%)	(6.1%)	(5.4%)	(2.7%)	0.9%	1.7%	(1.9%)	(0.8%)	(2.6%)	(4.3%)
Bravo! Cucina Italiana	(3.9%)	(1.7%)	(2.1%)	(3.1%)	(5.2%)	(4.1%)	(8.4%)	(8.0%)	(7.5%)	(2.9%)	(1.1%)	(2.7%)
Brick House Tavern	5.7%	5.4%	2.8%	(0.7%)	(2.8%)	(4.5%)	(6.3%)	(8.9%)	0.0%	0.0%	0.0%	0.0%
Brio Tuscan Grille	(4.2%)	(1.0%)	(1.6%)	(3.8%)	(4.3%)	(2.1%)	(6.4%)	(3.7%)	(4.3%)	(1.9%)	(0.9%)	(7.4%)
Buffalo Wild Wings	5.5%	6.5%	3.3%	2.6%	1.0%	(2.0%)	(2.3%)	(1.7%)	(4.0%)	0.6%	(1.2%)	(2.3%)
Carrabba's Italian Grill	0.3%	1.9%	0.9%	(2.0%)	(4.0%)	(2.0%)	(4.8%)	(2.1%)	(2.3%)	(3.8%)	0.4%	(2.8%)
Cheesecake Factory	1.4%	4.2%	2.8%	2.2%	1.1%	1.7%	0.3%	1.7%	1.1%	0.3%	(0.5%)	(2.3%)
Chili's Grill & Bar	4.2%	2.2%	0.1%	(1.1%)	(2.1%)	(3.6%)	(1.8%)	(1.3%)	(3.2%)	(1.7%)	(1.7%)	(3.0%)
Chuy's	3.8%	1.9%	N/A	4.2%	3.2%	3.2%	1.0%	0.3%	(1.1%)	(0.7%)	(0.1%)	(2.1%)
Dave & Buster's	10.5%	9.9%	11.0%	8.8%	6.0%	3.6%	1.0%	5.9%	3.2%	2.2%	1.1%	(1.3%)
Famous Dave's	(2.4%)	0.1%	(3.3%)	(3.6%)	(5.2%)	(6.1%)	(4.3%)	(3.8%)	(4.7%)	(4.8%)	(3.2%)	(1.5%)
Joe's Crab Shack	(4.5%)	(3.8%)	(4.0%)	(6.6%)	(2.9%)	(1.3%)	(6.8%)	(6.5%)	0.0%	0.0%	0.0%	0.0%
Kona Grill	3.1%	2.2%	1.0%	1.6%	3.2%	3.6%	2.5%	0.7%	(4.1%)	(4.3%)	(5.3%)	(7.2%)
LongHorn Steakhouse	2.6%	5.4%	5.2%	4.4%	2.6%	5.2%	2.2%	0.6%	0.1%	0.2%	3.5%	2.6%
Maggiano's	2.3%	0.1%	(0.1%)	(1.7%)	(1.8%)	0.2%	(1.7%)	(0.6%)	(0.8%)	1.6%	0.5%	(2.6%)
Olive Garden	2.2%	2.2%	3.4%	2.7%	2.8%	4.9%	2.4%	2.0%	2.6%	1.4%	4.4%	1.9%
Outback	6.4%	5.0%	4.0%	0.1%	(2.2%)	(1.3%)	(2.5%)	(0.7%)	(4.8%)	1.4%	0.3%	0.6%
Red Robin	4.3%	3.8%	3.6%	3.7%	(1.6%)	(2.2%)	(3.2%)	(3.3%)	(4.4%)	(1.5%)	0.5%	(0.1%)
Ruby Tuesday	(1.0%)	(0.3%)	(1.7%)	0.6%	0.8%	(3.1%)	(3.7%)	(2.7%)	(4.1%)	(4.0%)	(1.6%)	(5.8%)
Taco Cabana	6.1%	3.8%	5.6%	4.8%	3.3%	1.7%	(3.8%)	(4.1%)	(3.5%)	(4.5%)	(4.7%)	(12.6%)
Texas Roadhouse	6.8%	8.7%	8.0%	7.0%	4.4%	4.3%	4.2%	3.4%	1.4%	3.2%	4.0%	4.5%
Mean	**2.2%**	**2.8%**	**1.6%**	**0.7%**	**(0.4%)**	**0.0%**	**(1.7%)**	**(1.5%)**	**(2.0%)**	**(1.2%)**	**(0.6%)**	**(2.4%)**
Fine Dining												
Fleming's	3.4%	3.0%	3.2%	(0.6%)	(0.3%)	1.3%	(0.8%)	(1.9%)	0.2%	(2.9%)	(1.3%)	(1.0%)
Ruth's Chris	5.0%	2.8%	4.2%	3.3%	3.2%	3.1%	1.5%	2.1%	0.0%	0.7%	2.9%	(1.6%)
Capital Grille	5.0%	6.1%	4.4%	7.2%	1.5%	5.3%	3.7%	(1.2%)	1.2%	0.9%	0.5%	2.0%
Del Frisco's Grille	4.9%	2.3%	1.0%	(1.4%)	(4.5%)	5.3%	(2.0%)	(1.4%)	2.7%	(0.9%)	(3.2%)	(5.4%)
Sullivan's	1.7%	4.8%	(3.0%)	1.2%	(1.8%)	(1.8%)	(2.9%)	(3.2%)	0.9%	1.1%	(5.2%)	7.7%
Mean	**4.0%**	**3.8%**	**2.0%**	**1.9%**	**(0.4%)**	**2.6%**	**(0.1%)**	**(1.1%)**	**1.0%**	**(0.2%)**	**(1.3%)**	**0.3%**

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

The Restaurant Industry's Fastest Growing Segment – Delivery

With the emergence of third-party food delivery service apps like Grubhub, Uber Eats, DoorDash and Postmates, more people than ever before are ordering dinner from the comfort of their homes. Today, delivery customers have a wide array of restaurants to choose from to go along with the convenience of ordering from their couch. The adoption of the various delivery platforms is widespread and has taken the industry by storm. In order to effectively compete in today's technology-focused and demanding economy, restaurant operators need to be nimble and adapt to the changing environment. The chart below shows the rapid expansion of third-party delivery providers last year.

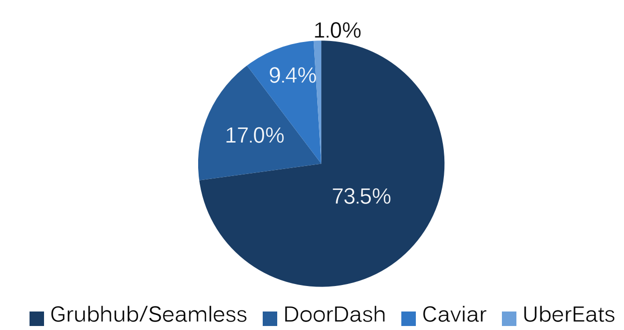
Third-party Delivery Services



Source: Technomic

Virtually every type of cuisine, not just the pizza and Chinese segments that are historically associated with delivery, is available at the touch of a button or swipe of a finger. The digital delivery era has afforded consumers with unfettered access to any food that they may crave, usually within an hour. The demand for food delivery and its convenience has contributed to the quick rise of numerous third-party delivery providers. Today, there are a handful of major players competing for your business.

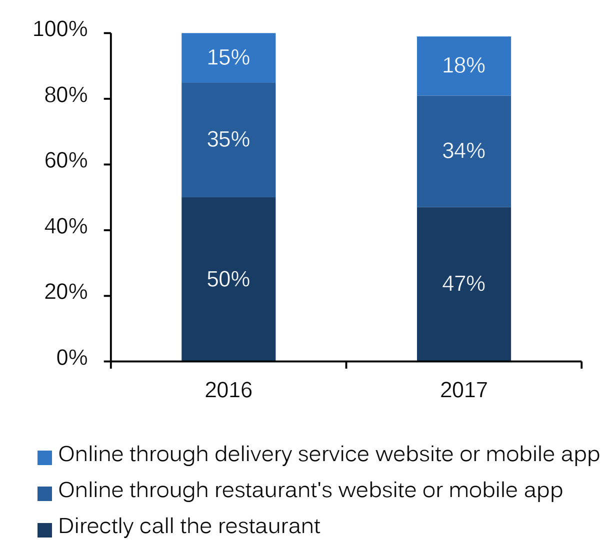
Restaurant Delivery Market Share



Source: Bloomberg

The foodservice delivery market can be broken down into three categories: 1) phone orders, 2) online orders directly through the restaurant's website and 3) online orders through a delivery service provider. As demonstrated in the chart below, more than half of all delivery orders were made online for the first time in 2017, with online orders through delivery services taking market share from the other channels. We believe this trend will continue and restaurants not traditionally associated with delivery will benefit from this incremental sales channel.

Growth of Online Orders for Food Delivery



Source: AlphaWise, Morgan Stanley Research

In order to remain competitive, restaurant operators need to be mindful of the impact delivery orders can have on operations and overall brand implications. Product development, logistics, packaging and third-party delivery relationships all need to be carefully managed in order to develop a winning delivery strategy. Any missteps with delivery could negatively impact a customer's perception of the brand.

A challenge facing operators today is how to rethink and redesign their menu offerings and restaurant footprint to optimize a delivery component. When the majority of restaurants were built, no one anticipated the off-premise volume that restaurants are seeing today. Operators that invest in the proper technological infrastructure, reconfigure store layout to be conducive to delivery, and create menu offerings that travel well, will be best positioned to succeed.

From a logistics and cost standpoint, working with third-party delivery service providers makes things easier than doing it in-house; however, it does come at a price. Third-party delivery services typically charge fees of anywhere from 15% to 30% of sales. Also, whichever third-party company is chosen also becomes the main touchpoint for the customer and in effect, carries the brand flag. This can be troublesome because if anything goes wrong, the blame will undoubtedly fall on the restaurant regardless of fault.

We believe delivery will play an increasingly larger role and provide restaurants with much welcomed incremental off-premise revenue. Execution will be of paramount importance in order to deliver a high quality product to today's demanding customer.

Contributing Editor Howard Lo is a Managing Director at Trinity Capital.

Government Policy's Increasing Impact on Business

Each passing year brings more regulation, taxation and market impact from local, state and federal governments to middle-market business owners, but never before have we seen the government impact middle-market businesses – like restaurants – with the frequency and magnitude seen over the past several years. Since 2008, there has been a steady drumbeat of regulatory activity, such as wage and hour rules, minimum wage increases, development regulation, ADA compliance and the like, all while the Fed implements tightening monetary policy tools to slow down the economy. Therefore, a keen understanding of current politics and government policy is becoming a necessary tool for running profitable restaurants.

The new federal tax bill has severely limited deductibility of state income tax, significantly increasing the tax bill for restaurant owners in high state income tax venues. These developments have materially impacted restaurant P&L statements and underscore the increase in government influence on the industry. On a positive note, the expectation of the Tax Reform Bill and anticipation of the new tax regulations contributed to a 25% increase in major market indices as evidenced by the following chart.

Dow Jones from Election Day to Tax Bill Passing

Source: Capital IQ

Federal, state and local governments are leaving longer-lasting fingerprints on restaurant businesses by passing multi-year minimum wage increases. Some jurisdictions were sorely in need of a boost to the minimum wage; however, many states passed multi-year legislation (detailed below) which may present delayed financial challenges for restaurant operators. For example, California's multi-year minimum wage increases may be digestible in the plan's early years, but if a recession accompanies a period of significant statutory wage increases, then restaurant cash flow may be significantly impaired.

Minimum Wage Increases in 2018 and Beyond

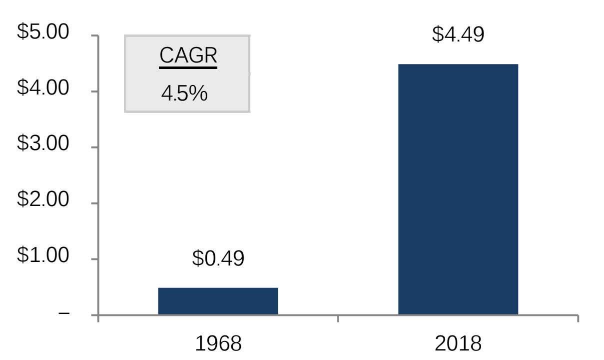
#	State	2018	2019	2020	2021	2022
1.	D.C.	$13.25	$14.00	$15.00		
2.	Washington	$11.50	$12.00	$13.50		
3.	California	$11.00	$12.00	$13.00	$14.00	$15.00
4.	Oregon	$10.75	$11.25	$12.00	$12.75	$13.50
5.	Arizona	$10.50	$11.00	$12.00		
6.	Vermont	$10.50				
7.	New York	$10.40	$11.10	$11.80	$12.50	
8.	Colorado	$10.20	$11.10	$12.00		
9.	Rhode Island	$10.10	$10.50			
10.	Hawaii	$10.10				
11.	Maryland	$10.10				
12.	Maine	$10.00	$11.00	$12.00		
13.	Michigan	$9.25				

Source: National Conference of State Legislature

The chart above excludes nine other states that increased minimum wage in 2017 but not in 2018. Furthermore, some municipalities – such as Seattle, San Francisco and Los Angeles – have enacted legislation that imposes a minimum in excess of state minimums.

So far, these increased labor costs have been passed on to customers through price increases, but restaurants will only be able to increase prices so much without losing traffic. Restaurant price inflation has outpaced overall inflation as demonstrated by price inflation of the Big Mac in the following chart.

Big Mac Price Inflation



Source: Business Insider

In addition to legislature raising minimum wages, the Courts have recently passed down decisions on wage and hour litigation which, due to new distinctions between hourly and salaried employees, materially increase labor costs. Operators need to be aware of upcoming wage increases and wage and hour litigation in order to limit the impact on profitability.

In response to the cataclysmic drop in business activity during the 2008 financial crisis, the Federal Reserve began purchasing assets such as Fannie Mae and Freddie Mac securities, AIG assets and common stock in GM and select US banks, while substantially cutting interest rates to near-zero for an extended period of time. Fast forward to today, the Federal Reserve is making efforts to slow down the economy and tame inflation by increasing interest rates (thereby restoring their policy tool of being able to lower interest rates in the next recession), reducing its balance sheet by selling off the aforementioned assets and securities and unwinding guarantees.

These recent activities slow or even undermine economic expansion by taking dollars out of the economy or redirecting them toward interest payments as opposed to growth. This again, highlights the tremendous influence the government has on middle-market businesses such as restaurants.

What are some things that restaurant operators could be doing to get ahead of the curve regarding some of the developments in government policy in the last several years? To begin, restaurant operators should create financial plans reflecting the realities of newly enacted legislation, Federal Reserve policy, interest rate movements and potential commodity cycles. Second, with the Fed all but promising to raise interest rates – Goldman Sachs forecasts the Federal Funds Rate to increase approximately 200 basis points over the next two years, from 1.4% at the end of 2017 to 3.4% by the end of 2019 – it makes sense for restaurant operators to carefully consider when to refinance their existing credit facility.

In making this decision, there are two primary strategic questions to keep in mind: 1) when does the facility expire, and 2) what will be the after-tax cost of the money? If interest rates are on a systemic, upward trend and you have a credit facility expiring in 24 months, it probably makes sense to explore refinancing now, giving you the benefit of five years of a known interest rate (net of hedges) and 60 months of additional time before maturity. If rates move materially higher and you wait to renew your facility, you may be looking at substantially higher interest payments for a long period of time. Of course, these considerations accompany other important factors operators should contemplate, such as documentation, covenants, recourse and flexibility.

There's always a danger in having government set policy on the cost side of the P&L while not being able to add anything to the restaurants' revenues. Restaurant operators should make themselves knowledgeable of recent and imminent government actions affecting the restaurant industry and have a plan in place to adapt their operating and financial strategies accordingly. Failure to do so can lead to missed opportunities and unnecessarily higher cost structures, undermining profitability and threatening the survivability of their businesses.

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