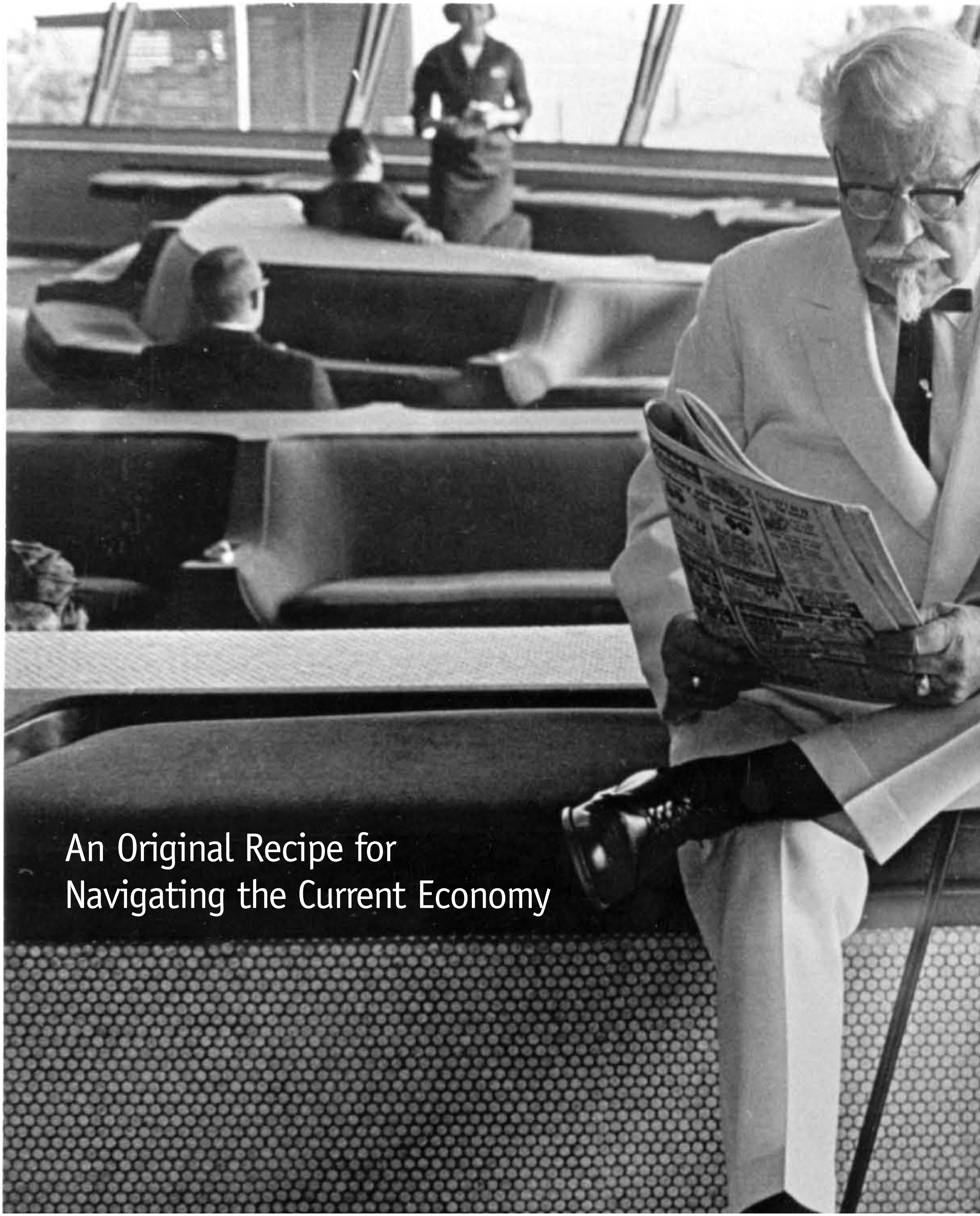
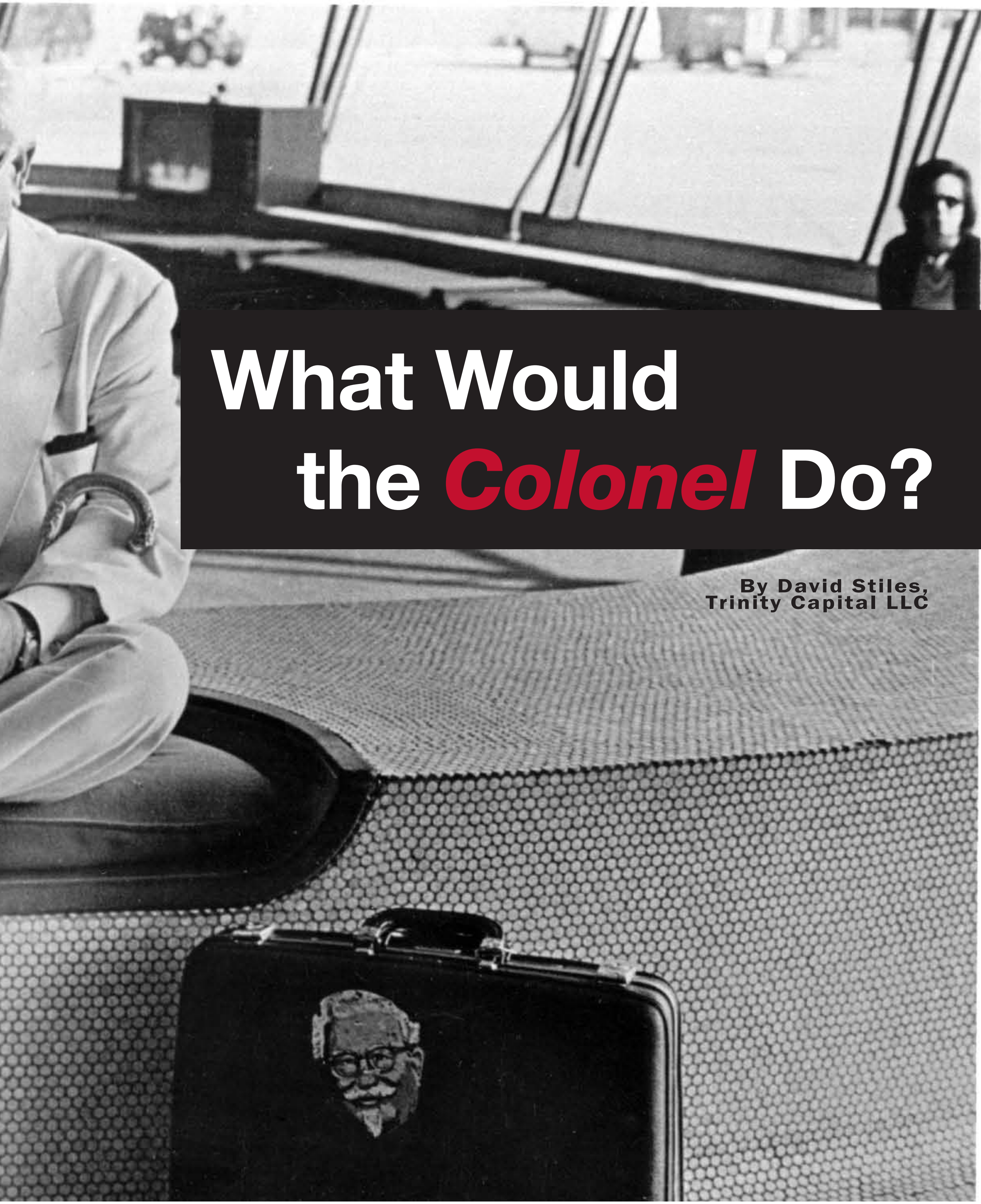


An Original Recipe for Navigating the Current Economy



What Would the *Colonel* Do?

By David Stiles, Trinity Capital LLC

Could one actually avoid writing a restaurant article these days without mentioning the economy in the first sentence? I guess not. For those of you easily bored by economics 101, fear not. We are about to take a thought-provoking journey that will hopefully illuminate a new perspective on how the current economy will impact your franchised restaurant business. The fact of the matter is that we continue to face unprecedented economic times. Following six consecutive years of expansion (18 years excluding the internet bubble), the pace of real GDP growth turned negative in the second half of 2008. The fourth quarter (Q4) of 2008 and Q1 2009 represented the first time since the Great Depression that the economy contracted more than 5 percent for two quarters in a row. Market analysts and the media have all offered strong opinions and are resigned to the notion that the economy is the worst in 70 years.

Recently, however, we have been bombarded with press releases suggesting that leading economic indicators are signaling the recession may be over as soon as today, not three to six months from now. Fed Chairman Ben Bernanke and U.S. central bank officials, some private-sector economists, and members of the Obama administration are all crowing that the economic news is indicating a near-term turning point. They are sounding so convincing that the recession will end soon that even we catch ourselves drinking the Kool-Aid. But then we say, "not so fast."

Therefore, if you are unsure about the direction of your near-term traffic count, sales and bottom line, the possible behavior of your current franchise lender, as well as what you may need to do to safely navigate these choppy waters, then follow us down a path that will prove invaluable.

Economic Indicators

OUR PERSPECTIVE ON economic recovery is based on extensive review of both leading and lagging economic indicators, in addition to data observations in the industry. We believe those who suggest there are strong signs of economic recovery are searching and clinging to any data offering a glimmer of hope. Believe us when we say that we want them to be correct. But fueling their argument, in part, are results from the economic release of the index of U.S. leading indicators, which rose in June for the third consecutive month. Seven of the 10 indicators in the report contributed positively to the index reading, while three indicators subtracted from it. Discerning whether the index reading allows one to conclude that we have turned the corner on this recession is actually very difficult. In any case, the economy is wreaking unprecedented havoc on franchise restaurant sales and traffic.

The seven positive indicators that have led pundits to express enthusiasm about a potential recovery are a steepening yield curve, decreasing jobless claims, increasing building permits, positive earnings by companies and rising stock prices, and longer factory workweeks. All of these variables provide evidence to economists that government efforts have eased the financial turmoil. In our mind, the jury is still out.

The widening spread between the short-term treasury bills and 10- and 30-year Treasury bonds (the steepening slope of the yield curve) provided the biggest boost to a positive index reading. However, the increase at the long end of the yield curve may have come by way of mounting speculation of an economic recovery, the difficulty in selling long Treasury bonds in this environment and the government stepping in to purchase Treasuries to stabilize the U.S. Treasury market.

Jobless claims may be decreasing, but each recently announced monthly unemployment rate seems to trump the prior 26-year high. Fifteen states are now reporting double-digit unemployment.

Companies reporting better-than-expected second-quarter earnings results have been providing some good news for the equity markets. However, nearly 40 percent of many companies' favorable earnings were due to aggressive budget slashing and cost cutting, which offset declines in revenue. Cutting costs only can be implemented to a certain point before it becomes degenerative to operations. Limitless cost cuts are not realistic and cannot be relied upon to continuously sustain positive earnings reports in the long run, particularly in the face of severely curtailed consumer spending.

As of July, housing starts increased for the second consecutive month. However, just as with restaurant reporting, abysmal same-store sales in a prior year eventually will lead to positive comps the next year. (Consider that housing starts fell more than 90 percent from their peak in 2007 and you can see why we are not overly enthusiastic about a modest bump in housing starts.)

Factory workweek hours were a positive contribution to the index, but the details are not persuasive. Manufacturing workweek hours for June only slightly increased, from 39.4 hours to 39.5 hours, and was actually down from 40.8 hours in June 2008. More telling is that the three components of the index which detracted from the reading were the M2 money supply (bank loans), which decreased; manufacturing orders, which decreased; and speed of delivery of merchandise from vendors to suppliers, which increased (meaning there is more capacity in the distribution system to allow for more speedy deliveries). All tolled, it seems to us that the signals of a turnaround may not be strong enough to draw any meaningful conclusion.

As far as financial turmoil waning, economists may sense that the Obama administration's aggressive intervention was "mission accomplished" for the time being. Yet, alarming news such as one of the franchise industry's leading small business lenders, CIT, narrowly escaping bankruptcy for now, continue to surface. We believe that economic data suggests another wave of economic pressure is unavoidable. A study of the trends in the economic indicators, particularly those to which the restaurant industry is most sensitive, suggest that the economy and QSR performance will remain weak through the balance of 2009 and through 2010. Here's why:

Consumer Spending

IT IS NOT COINCIDENTAL that consumer spending is the number-one barometer restaurant operators look to for a pulse of the economy. The growth or contraction of our economy is measured in terms of the size of the national economy, known as the Gross Domestic Product (GDP). Consumer spending comprised less than 60 percent of GDP for the four decades following the Second World War, whereas today it stands at approximately 70 percent. The increase was primarily driven by the proliferation of consumer debt as Americans took equity from their homes that inflated in value over a relatively short period of time, or tapped credit cards to the tune of several trillion dollars. But spending of this magnitude is not sustainable.

Consumer spending is a function of several influential components, the largest of which is employment. With federal unemployment expected to thrust through 10 percent in 2009, the elimination of jobs in and of itself may continue to mount pressure on people spending money that is not there to spend. Every 100,000 payroll jobs lost eliminates \$3 billion in disposable income. To date through this recession, more than 7.2 million jobs have been lost.

The profligate spending leading up to the credit crisis was fueled by plentiful consumer credit. U.S. household debt as a percentage of annual disposable personal income was at its highest rate of 127 percent at the end of 2007, compared with 77 percent in 1990, and remains close to its highs. In 1981, U.S. private debt was 123 percent of GDP; by the third quarter of 2008, it was 290 percent. This unprecedented amount of consumer debt has led to all-time-high credit card delinquencies. Over the past year alone, delinquency rates

on single-family residential mortgages have also more than doubled. High delinquency rates, in the face of increasing unemployment, means that credit cards do not get repaid, which eliminates capacity to spend and makes credit less available to consumers. Without available credit extended, consumers will likely pull back their spending and begin to save or retire debt. It is a vicious cycle.

Consumer spending also has been negatively impacted as people's net wealth significantly deteriorated. Approximately $30 trillion of market value from stocks, bonds and real estate was lost worldwide in 2008; about half of it in the United States alone. Because of dramatic drops in median home prices and harsh declining values of their investment portfolios, Americans no longer have the capacity or willingness to spend. In fact, the personal savings rate has recently increased from an all-time 40-year low, meaning, consumer spending may be catching up to the massive declines in real wealth. The bottom line is that the continuing economic uncertainty and household hardships may have resulted in significant changes in consumers' spending behavior. Consumers tend to respond with long and variable lags to changes in wealth and income. Until we start to see more convincing signs of stability in employment, home values, savings rates, and bank credit, meaningful economic recovery may elude us.

Fast food, usually up in a recession, has fallen approximately 2 percent from this time last year, and has been negative seven of the last nine months. While we remain surprised that many QSR brands are holding up as well as reported, we believe operators and brands continue to be exposed to significant risks. We fear that the magnitude of these risks and how they may directly impact franchised restaurant businesses may be underestimated. Interestingly enough, with the backdrop of the credit crisis, certain factors may have actually been benefiting QSR restaurant operators through 2009. However, we believe that these benefiting factors present certain risks to restaurant operators going forward.

Rising Energy Costs

From the beginnings of the credit crisis in late 2007, the price of oil nearly tripled from $50/barrel to $140, pushing gasoline prices to an all-time high in July 2008. This rapid rise greatly diminished the number of cars on the road, reducing traffic and consumers' opportunity for dining away from home. Virtually every public restaurant company's Q's and K's in 2007 and 2008 cited gasoline price increases as *the leading* reason for missing earnings. Gasoline prices have since come way down, with crude oil and unleaded gas decreasing 48 percent and 42.1 percent on a year-over-year basis as of June 2009 to $69.68 per barrel and $1.91 per gallon, respectively. However, experts believe that increasing global economic activity (primarily in Asia), expectations of an economic recovery and a future rebound in oil demand, continued production restraint by members of OPEC, and unrest in Iran and Nigeria may

continue to put upward price pressure on oil through 2010. The recent reprieve from higher energy costs may have actually helped QSRs, but anticipated increases may again reduce the number of cars on the road and hence restaurant traffic count.

Rising Food Costs

GIVEN THAT FOOD COSTS generally represent about a third of a restaurant's operating expenses, the increase in commodity prices to record highs in 2008 made a significant impact on the industry's profitability. Through 2008, the United States was wrestling with the worst food inflation in 18 years, with food prices rising more than 4 percent in 2008, compared with an average 2.5 percent annual rise for the last 15 years. Restaurant operators were subjected to sharply higher commodity costs for grains, meats and dairy, as the weak dollar has made them cheaper to foreign buyers, further lowering their supply to U.S. buyers. Commodity costs also were greatly impacted by increasing diesel fuel prices. In 2007, milk and other dairy products jumped 13 percent. And of course, whole bird spot prices increased nearly 13 percent in 2007 and another 8 percent in 2008.

Meanwhile, commodity prices for other restaurant ingredients have come off their all-time highs from 2008, which recently has been providing franchisees some reprieve. However, with overall broiler production in third-quarter 2009 expected to be 4.6 percent less than for the same period in 2008 and fourth quarter production to be slightly lower than for the same period in 2008, broiler prices are expected to gradually increase going forward. We anticipate other food costs may increase, as well, as input feed prices may increase, the U.S. dollar may continue to weaken, and inflation pressures from the Federal government's spending spree may take root. The recent reprieve from higher commodity costs may have actually helped QSR operators. But anticipated cost increases, which cannot be easily passed on to consumers, may present additional risks that can impact the cost of sales and hence cash flow.

Consumers Trading Down and Limited Time Offers

RECESSIONS HAVE BEEN kinder to the QSR industry than other retail trades, and this economic downturn is no surprise in that regard. To help prevent lower traffic count, brands have been vying for market share with the re-introduction of aggressive limited time offers (LTOs) across all sectors from QSRs to fine dining. However, the $1.00 fast food menu items or $5 lunch meals and 2-for-$20 deals in casual dining continue to add undue pressure on operators' food costs, thereby reducing cash flow. It seems that as brands compete for market share, they continue to up the ante by offering even more enticing margin-eating value deals. It is possible that aggressive LTOs from casual dining may now be taking some traffic count back from QSRs. Rising commodity costs in the face of brands' attempts to drive traffic at the expense of aggressive LTOs may exacerbate pressure on franchisees' food costs and profitability. Eventually, the downward pressure on operating margins may outweigh the benefit of attempting to drive traffic to the restaurants. For any one particular brand and its franchisees, LTOs are not sustainable in the long term because franchisees may not be able to absorb the increased food costs for long periods of time. In this incredibly competitive environment when aggressive and long-standing LTOs may no longer be sustained by a particular brand, traffic count and sales may wane as other competitors' value propositions become more attractive.

Artificially Low Interest Rates

AS OF THE BEGINNING of 2009, the fixed income market, in particular Treasury securities, has been driven up as the demand for safe, liquid assets has been so great that at times market participants have pushed the yield on some near-term Treasury securities to zero. The Federal Open Market Committee also has played a key role in keeping the effective fed funds target rate essentially at zero. This has resulted in extremely favorable interest rate conditions for restaurant operators because a significant portion of franchise debt is

variable rate indexed, for the time being, to the artificially low Prime Rate, a Treasury index or the London Inter-Bank Offer Rate (LIBOR). However, interest rates most likely cannot stay at these levels, particularly in the light of the government's enormous ongoing structural budget deficit.

Sustaining the Economy

THE FEDERAL GOVERNMENT'S ATTEMPTS to sustain a $14-trillion economy cannot continue without implications on inflation and the dollar. To finance the enormous 2009 budget deficit and the expensive Obama stimulus, bailout and social programs, the Federal government is planning a 15-fold increase in the U.S. monetary supply and the enormous issuance and sale of approximately $3.5 trillion of U.S. Treasury notes in the 2009 fiscal year. Such actions typically would result in a staggering devaluation effect on the dollar, which might in turn present inflationary pressures that may cause interest rates and commodity prices to increase.

Therefore, the recent reprieve restaurant operators may have benefited from such as: artificially low interest rates; gasoline and food prices coming off all-time highs; aggressive LTOs driving traffic to stores; and consumers trading down likely will wane. In fact, these factors may become looming liabilities to restaurant operators.

Risks Facing Restaurant Operators

ONE OF THE BIGGEST threats we believe franchisees now face is rising interest rates. Consider the impact on unit-level profitability from an anticipated increase in interest rates. A reversion from the current 30-day LIBOR rate of .23 percent (LIBOR was 2.46 percent one year ago) to its historical 20-year mean of approximately 4.45 percent is, at best, troublesome. Assume that your restaurant with $19,000 weekly sales in 2007 comps down 2 percent for two consecutive years, now generates 5 percent earnings before interest, taxes, depreciation and amortization (EBITDA) margin (after overhead allocation) and has annual occupancy expense of $85,000. Today, that same restaurant with weekly sales of $18,000 that is encumbered by a 15-year, $500,000 variable rate mortgage indexed to the 30-day LIBOR, plus a 2.25 percent margin (for an effective interest rate of 2.48 percent) would result in a Fixed Charge Coverage Ratio of 1.06x (lender covenants generally require an FCCR maintained above a 1.25x). An increase in LIBOR to its historic 20-year average would increase the effective interest rate to 6.7 percent. The restaurant in this scenario with the higher interest expense no longer covers its debt service (before capex) with an FCCR of .96x. Consider that 30-day LIBOR was at 5.01 percent in only December 2007. With the same 2.25 percent margin, the effective cost of funds increases 422 basis points to 6.7 percent. This restaurant's debt service has now increased by $13,000 per year. Now, subtract from the EBITDA margin the impact from an increase in gas prices (lower traffic) or enduring LTOs (increasing food prices) and you may be confronted with a serious cash flow shortfall.

Operators facing these additional challenges without any significant offset in performance may end up in technical default with their lenders, or worse, monetary default. Lending institutions are aggressively enforcing loan provisions to charge the default rate of interest, re-price loans or unfavorably modifying loan terms. Ultimately, if a resolution with your lender is not achieved, one of the paths lenders may take is to invoke acceleration clauses mandating immediate payment of the entire loan balance, plus pay any onerous prepayment penalties, loan modification fees and legal fees. This can certainly leave operators in an unnerving situation, particularly given the current limiting options in accessing financing.

Many franchisees may soon be required to refinance their maturing loan obligations. Franchisees that entered into relationships with any one of leading franchise finance lenders in the late 1990's were provided either fixed rate loans with 10- or 15-year maturities, or variable rate loans in the early 2000's with 7- to 10-year maturities. Many of these loans have much longer amortizations (anywhere from 10 to 25 years), presenting borrowers with significant balloon or refinance risk. Since the majority of the monthly loan payment for a typical 25-year amortizing mortgage is applied to pay interest for approximately the first 15 years, only 25 percent of the principal amount is paid down after 10 years. That means if your loan matures in 10 years, you may need to refinance 75 percent of the original loan amount. In the wake of the credit crisis, lenders have become less unresponsive employing much more stringent credit standards. Where lenders were once providing 3.5x to 5x leverage five to seven years ago, they now are hard pressed to lend up to 3x times cash flow.

Going back to the example provided above, your restaurant with $940,000 in current annual sales and a 5 percent EBITDA margin would qualify for a loan today in the approximate amount of $140,000 (5 percent of $940,000 at 3x leverage). After 10 years of making monthly payments on your $500,000 loan, you may still owe $391,000. That may leave you in the precarious position of having to infuse new equity of approximately $250,000 to complete the refinancing. The opportunity for operators to successfully refinance their debt obligations may be extraordinarily compromised unless they are able to contribute a significant amount of additional equity to their businesses.

Franchisees who may need to access their equity to contribute toward refinance shortfalls, or to meet working capital needs, may also need that same capital to complete their capital expenditures. The continuing and meaningful obligations franchisees face in keeping up with current imaging requirements is demanding. These obligations must be financed either from cash flow, owners' equity or by a third party. However, funding for capex in the current economic environment has proved to be among the more serious risks franchisees face. Equity, investments and savings may have been materially reduced and tapping debt capital from franchise lenders is difficult.

As operators potentially face the confluence of one or more of these risks coming to fruition, access to capital will be of paramount importance. However, the recent credit crisis has effectively changed the landscape of franchise lenders for a long time to come. The mass exodus of franchise lenders has removed a tremendous amount of lending capacity from the market. Furthermore, some franchise lenders are so immersed in managing their loan portfolios, contending with increasing defaults, high brand concentration exposures and bringing solutions to de-leverage, that getting their attention to refinance or modify loan obligations can be a challenge. We anticipate there will be an unprecedented need for debt financing by franchisees as they look to the debt markets to survive and meet their working capital needs, capex, new equipment requirements, finance growth opportunities and refinance maturing debt obligations. In an environment where the number of available financing alternatives has been reduced sharply and the demand for new financing may be so great, this disparity may perhaps become the greatest risk that franchisees will face.

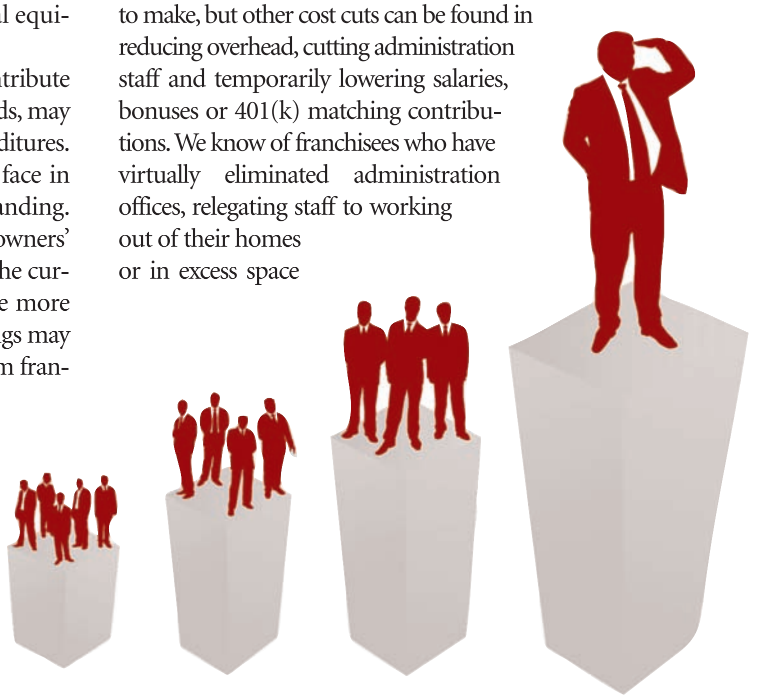
What Steps Should Franchisees Take?

We believe it is critical at this juncture for franchisees to analyze their debt obligations and capital structure, and to evaluate their potential risk exposure. The results of this analysis, at the very least, will be an eye-opener. We also take note that, given the state of the economy and our perspective on what may transpire, now is the time to acquire a complete understanding of your on- and off-balance sheet obligations and working capital requirements.

Equally important is going through your profit and loss statements in detail to look for additional ways to cut costs that you have not yet implemented. This would extend beyond the obvious adjustments to labor, food and controllable expenses. Perhaps less obvious places to look for savings includes bidding out insurance or other contracts to significantly lower costs.

An area that you may be reluctant in exploring because of the implied consequences is approaching suppliers for concessions. Landlords are being approached in droves by their tenants for rent adjustments. To the extent franchisees are paying over-market rent or facing occupancy costs that render a store unprofitable, negotiating a current market rent is generally more favorable to the landlord than having to vacate the space.

It is a more extreme and difficult decision to make, but other cost cuts can be found in reducing overhead, cutting administration staff and temporarily lowering salaries, bonuses or 401(k) matching contributions. We know of franchisees who have virtually eliminated administration offices, relegating staff to working out of their homes or in excess space



within restaurants. These operators are able to reduce total overhead costs to less than 4 percent of revenue. It may be an unconventional approach, but unconventional times call for unconventional means.

Franchisees exposed to variable rate debt have options to mitigate this exposure. Depending on the size of debt obligations, entering into interest rate swap agreements (converting variable rate debt to fixed rate debt) has been an effective way to hedge against rising interest rates. This, of course, is predicated on a substantial and credit worthy performing loan. Alternatively, preparing your company for a refinance or convert to a fixed rate also may be a viable solution. In this effort, it is critical that franchisees demonstrate effort and actions preserving profitable operating margins. Also critical is assembling projections and budgets that are realistic and credible for lenders to support. Having all of your financials and documentation in order will increase your chances of a successful financing. This is equally important in obtaining financing for any purpose.

Capex obligations will not go away. We therefore recommend that franchisees budget and divert a portion of free cash flow to a capital expenditure reserve fund. Having a dedicated and committed source of funds to meet these obligations can then be referenced to by franchisees in developing a mutually agreed upon plan with their franchisor of a timeline to complete re-imaging requirements. In the event you are able to build a reserve account that exceeds your capex obligations, the next goal would be to continue to build the reserve account and use these funds to approach lenders for pre-payment of high interest rate debt, if applicable. Lenders that are taking steps to shrink their balance sheets may be approachable to buy back debt at a modest discount, reducing liabilities on your balance sheet.

Franchisees who already have explored and executed these avenues still may not be accumulating excess cash flow. Rather, some may find themselves anxiously waiting to receive their syrup rebate money, deferring critical maintenance and repairs, or ignoring capex altogether. Hopefully, franchisees are not in a situation having to schedule payments just right to not miss paying payroll taxes, sales taxes, property taxes, royalties, NCAC or lender or lease equipment payments. If any one of these, or a combination of these, ingredients has been used in your recipe for navigating the current economy, then it may be time to explore more extreme alternatives.

To meet significant working capital shortfalls or capex requirements, franchisees may need to selectively explore the sale and leaseback of real estate that is either unencumbered or relatively unlevered. Despite the contraction of real estate financing by commercial banks, cash buyers are still active and looking for quality investments. Admittedly, capitalization rates have come off their record lows for single-tenant triple net properties. However, some favorable still exist. Franchisees not interested in permanently divesting valuable assets, despite a serious need to generate cash, may be successful in negotiating buyback provisions, particularly if the real estate can be sold to their franchisor or a private individual, as opposed to institutional real estate buyers. In these instances, franchisees may be able to retain ownership in the long run.

It is important to note that prior to moving forward with any sale leaseback, a pro-forma analysis should be undertaken to ensure that the decision is sound. For instance, after the payment of the 15 percent capital gains tax and 25 percent depreciation recapture tax, state income and transfer taxes, repayment of the loan, any associated prepayment penalties and other transaction costs, the net proceeds may not provide you with enough working capital to make the transaction worthwhile. Other analysis that is helpful in determining whether or not sale leaseback transactions make sense is reviewing the after tax impact on exchanging debt service for rent expense. (Only interest expense is tax deductable whereas 100 percent of the rent expense reduces net income, hence tax liability.) Also review your loan covenants and balance sheet ratios pre versus post transaction to see if loan covenants or prudent credit ratios are tripped. Last but not least, consider that real estate assets in the current and future lending environment offer the most valuable collateral lenders require for them to issue financing with the maximum advance rates at the lowest cost of funds.

If all of these strategies have not, or cannot be executed, a business restructuring may be the next step to explore. We have restructured more than 400 different franchisees' businesses. The one common denominator among all of these engagements was that many times the franchisee waited too long to anticipate, develop and implement a game plan to contend with the economic factors and financial risks discussed above.

Implementing a plan is very resource intensive and negotiating with landlords, lenders, other creditors and their respective legal counsel is extremely time consuming. It is common that franchisees facing a restructuring already are so inundated trying to meet the daily operating requirements, that the thought of negotiating with the countless counterparties becomes overwhelming and is put off for another day. But if you find yourself in this predicament, don't wait to act.

Being proactive and communicating candidly with your franchisor and lenders regarding your current situation is the best strategy for a successful outcome. However, before stepping into this unfamiliar bubble-gum, it is prudent to consult with a trusted advisor that is proficient in working with franchisees, their franchisor, their lenders and landlords. The insertion of an impartial, emotionally unattached advisor that obtains a comprehensive understanding of your current financial situation, looming off-balance sheet obligations, loan obligations, lenders' rights and the strengths and weaknesses of your business, will provide a much higher likelihood that a successful plan can be implemented should you need to pursue this alternative.

In executing any of the strategies described above, the ingredients for the best original recipe are to focus on operations and not spend time playing accounts payable shell games. Whichever direction the economy heads from here, the right original recipe for success is to fully assess your situation, understand the risks, execute one or more of the strategies discussed herein, or ask for outside help before it is too late. That is what the Colonel would do.

Trinity Capital LLC is a FINRA ("NASD") registered investment bank boutique providing financial restructuring, restaurant consulting, mergers & acquisitions, debt, equity and real estate capital raising for middle-market companies. For more information, contact David Stiles, senior vice president, at (310) 268-8330, or by e-mail at dstiles@trinitycapitalllc.com.