

Restaurant refranchising: key takeaways and call transcript



Refranchising allows for more efficient resource allocation

Refranchising is an effective mechanism for efficiently allocating responsibilities to deliver better results. Refranchising allows companies to focus on product, pricing and promotion, leaving operational responsibilities in the hands of the franchisees that tend to be more entrepreneurial than corporate operators.

Managing Street expectations is critical

Guiding the Street to a narrow band of proceeds can be risky. There are many factors that a franchisor cannot control, such as the performance of the general economy, availability of financing, and the market's perception of fair value. DIN and EAT are two examples of companies that had to materially revise their original refranchising guidance, which has contributed to share price declines.

Goal is portfolio optimization, not proceeds maximization

Companies need to find a balance between maximizing sales proceeds and optimizing the store portfolio. The size of the franchisee, experience in its geography, operational capabilities, and financial resources are all important factors that can contribute to or detract from the long-term health of the system.

Inclusion of real estate increases likelihood of success

The inclusion of real estate makes a transaction more attractive for potential franchisees and lenders. Franchisees have historically paid 4x - 8.5x EBITDA for restaurants with real estate, and between 4x - 7x EBITDA (less normalized rent) for restaurants without underlying RE. The inclusion of RE lowers the risk to franchisee lenders, increasing the likelihood that transactions are completed. YUM's and SONC's refranchising efforts will likely include RE, while DIN's, which completed a sale-leaseback of all its real estate in 6/08, will not.

Capital reinvestment is relatively less affected

Franchisees looking to fund remodeling initiatives are less affected by credit market constraints. Capital reinvestment typically has more resilient ROIC, and is viewed as less risky than acquisitions. MCD, SONC, JBX, and CKR have remodeling programs underway. WEN is looking to start one.

Consider alternative financing sources given scarce credit

Money center banks have tightened lending standards, removing from consideration all but the best customers. Systems looking to refranchise in the current environment should look to non-traditional sources of funding including: unitranche financing, regional banks and S&L's, non-money center foreign banks, equity-laced financing, and joint ventures.

Well-capitalized category leaders to take share in '09

Given the deleveraging of the US economy, reduced consumer spending in 2009 will shrink the overall sales pie, resulting in SSS declines. Concepts that have been able to successfully take price will be best able to navigate continued traffic declines in '09. Well-capitalized category leaders will be able to weather a tough operating environment better than regional, under-capitalized competitors, using savvy marketing tactics and rich advertising budgets to take share.

Rachael Rothman, CFA +1 212 449 9393

Research Analyst
MLPF&S
rachael_rothman@ml.com

Michael Sang +1 212 449 7448

Research Analyst
MLPF&S
michael_sang@ml.com

Yinan Zhao +1 212 449 1335

Research Analyst
MLPF&S
yinan_zhao@ml.com

Chart 1: Current refranchising initiatives

Company	Units	Refranchising Target	Announced	Target Completion	Complete
CKR	241	75% Hardee's franchised	Apr, 2007	F2009	92%
DIN	475	95% APPB franchised	Nov, 2007	2010	23%
EAT	230	35% franchised	Apr, 2007	F08	92%
JBX	800	70% franchised	May, 2007	2014	14%
MCD ⁽¹⁾	2,300	Jan, 2006	2008	74%
MCD	1,000 - 1,500	84% inc. DLAs	Jan, 2008	2010	56% - 64%
SONC	230-280	12-14% franchised	Sept, 2008	F2013	4%
YUM - US	2,100	90% franchised	Dec, 2007	2010	26%
YUM - YRI	425	88% franchised	Oct, 2006	2009	70%

1) Units are targeted for conversion to direct licensing agreements (DLA's)

Source: Merrill Lynch, company documents

We are publishing the transcript from the conference call we hosted on October 14th, 2008, titled "Outlook for Restaurant Refranchising."

The call's featured speaker was Kevin Burke, Managing Director and Founder of Trinity Capital, LLC, a boutique investment bank specializing in the restaurant and food industries. The discussion focused on the state of restaurant refranchising in an environment where the tight credit markets, weak consumer demand, and margin headwinds have made it difficult for companies to sell assets.

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Refer to important disclosures on page 14.

Conference call transcript

Opening remarks

Rachael Rothman, Merrill Lynch: Hi, good morning everyone. I'm Rachael Rothman, Merrill Lynch's Equity Analyst covering Restaurants and Gaming. Thanks for joining us today on our conference call: the Outlook for Restaurant Refranchising.

I'm pleased to have with us today Mr. Kevin Burke, founder and managing partner of Trinity Capital, a boutique investment bank specializing in the restaurant and food industries. Since its founding in 2000, Trinity Capital has completed over \$10 billion in mergers and acquisitions, financial restructuring, and financing transactions. Clients have included corporations such as Burger King and Yum Brands, as well as private equity firms such as the Carlyle Group, Bain Capital, Thomas H. Lee Company, TPG, and Goldman Sachs Capital.

Prior to founding Trinity Capital, Mr. Burke was executive vice-president of Franchise Mortgage Acceptance Company (Nasdaq: FMAX). Mr. Burke began his career as an investment banker with Dillon Reed and Company and later joined L.F. Rothschild and Company. Thereafter he became a director and regional manager for the Prudential Securities Investment Banking Group.

The format of today's call will be approximately 15 minutes of directed questioning followed by Q&A from our listeners. And with that, let's get started.

Refranchising trends in last 10 years

Rachael Rothman, Merrill Lynch: Kevin, can you give our conversation today some context by discussing some of the history behind refranchising efforts over the last 10 years?

Kevin Burke, Trinity Capital: Yes, Rachael. Good morning everyone. The big waves of refranchising originally came from divestitures in the 70's and 80's for concepts that were trying to grow, and they first started seeding large franchise groups and/or one by ones with territory growth. The significant ones were when Tricon and Burger King spun off large packages of restaurants in the late 1990's. In Tricon's case, they had a good deal of debt when they spun out of Pepsi, and started to sell some of the premiere brands – Taco Bell, KFC, and Pizza Hut – to pay down debt. In Burger King's case, a lot of the refranchising was to return money to Grand Metropolitan after they acquired Burger King from Pillsbury. Both of those were fairly successful programs. I think the key that made them successful was that there was plenty of capital available at the time.

The next wave was somewhat spurred by shareholder activism wherein a lot of investment managers wanted to perhaps burn the Rembrandts, sell off all the real estate, pay some taxes, and perhaps return a dividend. Depending upon who you are and what your balance sheet looks like, some of that may be okay, some of it may be destructive to the balance sheet, and some may sow some seeds of financial ratio problems with lenders. Obviously capital is a key engine for growth here, so you've got to be able to consistently borrow from banks and/or bondholders, who look for some modicum of hard assets such as real estate and operating restaurants. If you don't have as many tangible assets, then you'll have trouble funding the company down the road.

The first refranchising wave originated in the 70's and 80's as concepts seeking growth seeded large franchise groups to expand geographically.

The second refranchising wave was spurred by activist shareholders seeking return of capital via the monetization of real estate.

The current wave of refranchising was ignited by shareholder activism as well as efforts to delever the balance sheet.

The valuation premium that investors assign to franchise royalty streams is a primary motivation behind refranchising.

Refranchising allows companies to focus on product, pricing and promotion, leaving operational responsibilities in the hands of the franchisees that tend to be more entrepreneurial.

Companies need to retain sufficient real estate and hard assets to ensure their ability to raise debt capital.

In the current environment, I think we have a continuation of some of the education from shareholder activism, and from some buying down of leverage, which we talked about a little bit with Tricon (now Yum Brands).

Benefits to refranchising from the company perspective

Rachael Rothman, Merrill Lynch: Can you walk us through some of what you see as the key benefits to refranchising from the company, or franchisor, perspective?

Kevin Burke, Trinity Capital: First, if you look at the larger and more successful systems like Yum or McDonald's, they really have valuations that run in three silos: real estate fundamentals, restaurant operating fundamentals, and royalties. Royalties have traditionally been valued at a higher premium by the market. There's always been somewhat of a temptation toward the introspection of how to shift resources from real estate and operating businesses to royalties, which has driven a lot of this. There are distinct P/E's associated with each of those three income streams.

Second, I think that some of these franchisors have correctly identified that if they can put more energy into product, pricing, and promotion, and less human and financial resources into operating businesses, they're going to be able to intensify their focus and deliver better results. They focus on their skill set and try to leave the operational activities to franchisees, who tend to be entrepreneurial and perhaps in some cases a little more invigorated running individual or multi-unit businesses than some of the corporate franchise restaurant operating divisions.

Common refranchising goals from the company perspective

Rachael Rothman, Merrill Lynch: In your experience what are some of the common goals that franchisors have when starting a refranchising program?

Kevin Burke, Trinity Capital: I think one of the things that they want to do is to optimize their presence in individual cities or DMA's, which are the areas in which a television signal reaches a population center. If they had a small presence in a market, they would want to get out. If they dominated a market, I think they would want to look at whether it is a good use of company resources or if the market would perform better in the hands of an entrepreneur.

Other things to consider are: 1) concentrating the system in the hands of partners, so that they can delegate the QSC elements (quality, service, and cleanliness), which are some of the operational rigors, to an entrepreneur; 2) refocusing their efforts on product pricing, promotion, and brand development, which they're very good at; and 3) establishing a business model free from the operational vagaries of labor, utilities and energy, and commodity prices that can cause interruptions during a supply shock, which will produce more stable results and a friendlier atmosphere for applying a dividend discount model. I think that with many of the large franchisors being public, the exposure on the operating side is probably worth a careful look. That's been a question that some of these larger companies have had to focus on: what is the right quotient to have in the restaurant operating area?

Another goal is to optimize real estate holdings. If you want to take money off the table, just make sure that you're leaving yourself with enough hard assets in the eyes of the credit world. I think the real estate has become a little bit of a dilemma in recent years, because it's gotten to be so expensive. Certainly in its balance sheet context, real estate is recorded at historical acquisition costs; however, in terms of realization, those numbers have been quite different. There's been a lot of

agitation, as we alluded to earlier, by shareholder activists to sell those assets off. I think that some of the franchisors have thought about whether they can cash in on some of this real estate and whether it makes sense, because you do have to have enough real estate on the balance sheet to be taken seriously when you're in the bond market or when you're dealing with banks.

Some other goals are: 1) to use the proceeds to pay down debt; 2) to show increased liquidity on balance sheets for security analysts; 3) to buy back stock; or 4) to fund other activities that they've determined to be more accretive than sitting on real estate in what's now perhaps a declining real estate valuation environment. Good restaurant performance can be 2-3%, perhaps 4% SSS for an intermediate time frame, 3-5 year horizon, and obviously the equity markets sort of yawn at those kind of gains. The income from disposal of these assets would be much higher than income from 2%-4% SSS growth; however, we do feel it is important for the franchisor to operate a reasonable % of stores.

Critical issues to consider when refranchising

Rachael Rothman, Merrill Lynch: As teams think about undertaking a refranchising effort, can you highlight for us some of the key critical issues?

Trying to guide the Street to a narrow band of proceeds can be risky. There are many factors that a franchisor cannot control, such as the performance of the general economy, availability of financing, and the market's perception of fair valuation.

Kevin Burke, Trinity Capital: Sure. One of the biggest ones is really managing Street expectations. The lessons learned out of the marketplace are not to try to predict too much what the results will be, because there are so many factors that the franchisor cannot control: 1) the performance environment in general, 2) the economy, 3) the amount of financing and liquidity available, and 4) what analysts will do in building a model and assuming before the fact, 5) what asset divestitures will produce, 6) what kind of proceeds will be generated from real estate sales and operating business sales. I think that as we've all come to see in the last 24 months, it can be very difficult to predict valuations. Even if you have the results that you perhaps anticipate, it can be very difficult to predict how the market will receive them and what it will do to your share price and so forth. So I think that managing the Street expectations is probably the most critical aspect.

Companies need to find a balance between maximizing sales proceeds, and optimizing the store portfolio.

Another issue that you have to contend with is to balance the proceeds you're getting with bringing in an experienced, well-capitalized partner who is setup for success. One of the things that some of the larger systems like Taco Bell, Burger King, and McDonald's have discovered is that you really have a partnership between the franchisor and the franchisee, and it's very important to recognize that. You want to set somebody up for success, so the notion of having an auction and selling to the highest bidder and driving prices above what the market might commonly determine value to be is not always the best thing to do. I think getting a better operator at a market price is probably better, so that's a challenge in trying to balance proceeds versus the health of the system and the capabilities of the franchisee or partner.

Maintaining an adequate number of company-operated stores is important to 1) test new concepts, 2) share in the pain of the system, and 3) maintain credibility with franchisees.

Another critical issue is to make sure that franchisors are retaining an adequate number of stores and presence in the market, so that they can: 1) test and train, 2) have skin in the game in purchasing, 3) can feel the pain of the system when things aren't going right, and have credibility in dealing with franchisees. Having the creditability to interact with franchisees in a way that says we're all store operators and we're looking for the common good is important, because there is always tension between getting paid on sales through royalties and getting paid on bottom line. Things like discounts, two for one's, and pricing issues can sometimes put a franchisor and franchisee at odds, so I think having a good quotient of stores is very important.

The size of the franchisee, experience in its geography, operational capabilities, and financial resources, and are all important factors that can contribute to, or detract from, the long-term health of the system.

Another critical issue is to make sure that you've got the right number and size of franchisees. How many of the franchisees do we have in the system that would make good candidates to bring in as larger partners? It's certainly more profitable to run 300 franchisees than to run 1,000. It's an important goal to optimize that number, because a larger franchisee will be more sophisticated and better funded. That's typically going to be associated with better results, and that's something to keep your eye on: what is the size of these franchisees and how many of them are in our system.

Another critical issue is to make sure that you have a program and you're not just tossing a few stores out there. The things that you want to do are to make sure that you have good legal agreements, good financial backing, and an operator that's got good experience in the system, the geography, and the right leadership. It is critical, particularly if you're public, to make sure you are spending time on grooming a potential partner, if you will, insomuch as a 50 store operator is more of a partner than a one store operator. That is something that should not be overlooked.

The other thing too is to make sure that franchisees and franchisors come together understanding their partnership. The franchisee should be expected to operate more like an equity than a bondholder: renovate stores, build new stores, and continue some growth. Therein lies the growth that the equity markets require, adding not just SSS and profitability, but also units. As you become more of a franchisee driven concept, it becomes very important to manage that fulcrum between the franchisee and the franchisor to see that system units are growing. That's a very important co-efficient, four-wall economics being intact and in good shape. It is going to be a challenge for the larger concepts to make sure that they are using incentives and pressures to continue development.

Refranchising acquisition multiples in today's environment

Rachael Rothman, Merrill Lynch: Can you talk a little bit about what you are seeing in the way of acquisition multiples in this space? Most recently, given the credit conditions in today's market?

Kevin Burke, Trinity Capital: Well, trying to pick multiples right now is sort of like determining the average height of Wilt Chamberlain and a midget. The result you get is a meaningless number. I think right now we really have a sort of once-in-a-century constraint on leverage, and it's distorting a lot of the multiples. I don't really think that you can look into the market now and say well this trade happened recently, because some of those transactions are happening with some degree of coercion, distress, or a reason to close. There are a lot of circumstances that have been underlying some of these recent sales.

The inclusion of underlying real estate makes a transaction more attractive for potential franchisees and lenders.

Franchisees have historically paid 4x - 8.5x EBITDA for restaurants with real estate and between 4x - 7x EBITDA (less normalized rent) for restaurants without underlying real estate.

Historically, franchisees purchase stores with real estate between 4x and 8.5x cash flow. Without real estate, and putting on a normalized rent, you'd probably look at historically between 4x and 6.75x, maybe even 7x. There have always been some trades on either side of that, but basically that's the bandwidth. We've financed thousands and thousands of units in that range, and that's typically what you'd expect.

Recently, depending upon the age of the buildings that are being bought, the system performance, and the increasing scarcity of capital, I think those numbers are going to trade toward the lower end of the range. I would caution everyone not to look at what's going on this year and print the tape with that as here's the standard, here's the last trade, that's what I can expect. I do believe that however long this leverage malaise is going on, it will at some point reconcile and we'll have a better indication of how the market values these assets.

Keys to successfully refranchising units

Rachael Rothman, Merrill Lynch: Can you talk about what a few keys to a successful refranchising are from a bigger picture perspective?

Kevin Burke, Trinity Capital: I think that you really need to make sure that you're not trying to conduct a blind auction just driven by proceeds, because nobody wants Darth Vader in their system just because he paid the highest price. You want to make sure that you've got people that are capable and well-capitalized, that will be good partners, and will actually bring something to the table besides: "I'm a franchisee. Sell me the stores."

I think the other thing is that it's important for a system to talk to its constituents, including its creditors, shareholders, and franchisees. Really lend them a little bit of shared mind, so that they can see: 1) what the franchisor has in mind, 2) what they're trying to achieve, 3) what the genesis of the program is, and 4) how it is going to help better the system. I think that's important to get a message out.

It's also important not to set expectations, because the franchisors cannot be expected to have a crystal ball about what real estate or restaurant operating companies are worth, nor be put into a position of second guessing what initial estimates were. In terms of giving guidance on that, we think that it's not a good idea. You just set yourself up for trouble. I think the other thing is you don't want to sell restaurants when you have to. You want to sell restaurants when there's some optionality. Then you can be a little bit more discrete about who it is that you talk to, and whether you conduct a transaction or not. You can give the market a little sense of: "Look, if we have a transaction that makes sense on a strategic or financial or both basis, then we'll do it." If you don't, you're certainly not under any duress to get deals done, so that you can talk about them in an IR perspective if you will.

Things that can increase success nowadays would be some sort staple-on financing program. We don't think it's a good idea for public companies to start directly guaranteeing loans, and we've always been vocal opponents of that; however, there are some things that franchisors can do to create liquidity. In this environment especially, I think it's very important take some serious steps to get things like that done. I think it's safe to assume that these transactions have perhaps not ground to a halt, but been very, very, slow this year due to that. We would encourage franchisors to look into that.

The inclusion of RE lowers the risk to lenders, increasing the likelihood that transactions are completed.

PE firms are sensible partners for franchisors, as they can help sponsor less well-funded franchisees, enabling them to be more active in acquiring and renovating stores.

Companies should look outside their own system for potential partners when refranchising.

Another thing that companies can do to increase the likelihood of success in a franchising program is to include real estate in the package. It gives lenders a hard asset to lean on, and it certainly increases the chance that you're going to have any lenders to talk with in the first place. Certainly 7, 20, 30 stores in a package with no real estate puts enormous burden on the financial institution to have to underwrite, because essentially it's a venture in a small business format.

The other thing I think is that there are some private equity firms that we believe make sense for franchisors to transact with, whereby the private equity firm can sponsor a franchisee. They can provide more capital than a normal franchisee. They can be a little more active in building new stores, renovating stores, looking to acquire stores, and perhaps driving a little bit of consolidation in systems that probably have that as a back burner goal.

Private equity can play a role, particularly those private equity sources that are not your standard Kirkland Ellis, 10 year deal, 10 year standard documents, where you have private equity firms that tend to be very trigger happy to get out of a deal once they've made a couple of dollars, because obviously coming in and out is a disturbance to the system. For those firms that are on a different format it obviously makes sense to explore that aspect.

Another issue is that it really makes sense to look outside your system when selling stores. It's easy to find somebody that you know is a proven operator in your system. It's also good to probably bring in some fresh blood and not wind up with thoroughbred disease by having the same old people that have been taught the same things. It's sort of like having an organization hire everybody out of the same school even if it's the right school. Over time that's perhaps not attractive.

I think the last thing is hiring advisors to identify buyers, arrange financing, make sure that things close, and get real time feedback without any bias to both executives running these programs as well as investor relations departments. I think it's really important to make sure that you're not just having an informal look see, but actually putting a program out there and driving some directives into it. It helps to have a little bit of third party plausible deniability in determining how the auction or the sale is conducted and having a little introspection about who it is that you want to partner with, without the political baggage of doing it internally and with a preponderance of your own franchisees.

Rachael Rothman, Merrill Lynch: Thank you so much Kevin, and a special thanks to your team for getting up so early and preparing all this information. It's really great.

Question and answer

Question 1: Can you go over what a few suggestions maybe for franchisees looking to find financing in this market environment?

Kevin Burke, Trinity Capital: Sure. That's obviously been a hot topic. The harder the Fed tries to generate liquidity, it seems like the more the banks are freezing up, and the reason is simple: banks don't want to be out in a five or ten year commitment, have a run on the bank, and not have the liquidity to fund it. Obviously the run on the bank mentality that hit a lot of hedge funds and certainly some of the prominent banks has made people very nervous, so in spite of all this liquidity that's been injected into the market, bank executives are telling loan committees to be very, very, cautious. That has taken all but the best customers out of the market from a borrowing perspective.

Non-traditional sources of funding include: 1) uni-tranche financing, 2) regional banks and S&L's, 3) non-money center foreign banks, 4) equity-laced transactions, and 5) joint ventures.

That issue, a lack of capital, has really driven the proposition that we had in the early '90s, when we went through sort of the same thing. What happens is that you create new vehicles. Certainly, we and Franchise Mortgage Acceptance Company, were instrumental in developing alternatives such as CMO look-alike financing that became somewhat akin to a commercial mortgage backed security or an asset backed security. That became a funding vehicle. I think now the things to look for will be non-traditional sources of financing, because there's just not going to be a lot of money center lending, which the industry has relied heavily on since about 2000. There are five ideas that we have right now to navigate through this artificially induced scarcity of capital.

One of the things we would suggest is unitranche financing, which you would get from some of the private or public mezzanine lenders, whereby they will lend the entire leverage package in a subordinated two-tranche package. Certainly that kind of financing is available in the market, albeit a little bit more expensive than banks.

There's also regional banks and S&L's. Throughout the country, there are a number of regional banks and saving and loans that will provide financing for small packages. You just have to find them. It's not easy, and they're not going to be doing \$50 million loans. They can be found for smaller packages, however, and they do still have liquidity. Some of them have been very unfazed as they may have not participated in the leveraged buyout loan, subprime mortgage crisis and have balance sheets that are intact.

Another source is some of the foreign banks that are not money center banks that do U.S. lending, whether they are Canadian banks, banks on the Continent, or banks in Asia. Some of them do have regional lending offices in the United States, and make modest size loans. That's certainly an avenue for attack, and certainly we have relationships with some of those institutions and have been looking to them recently in this scarcity of capital environment.

Another thing to think about is some sort of equity-laced transaction, where you ask an investor – a mezzanine lender, a private equity firm, a private investor, a pension, or a casualty and life company – for a senior loan, and then award them some modicum of equity in the transaction. With a proven concept and a proven operator, that is often an inducement that will result in a transaction.

Finally, the last thing I would recommend is to look for joint ventures or other kinds of franchisor support, where a lender will feel that they have most favored nation status with that franchisor. They're going to be somewhat protected through the advent of a joint venture or some other mechanism or support device from the franchisor.

Question 2: Why are some companies seemingly easily able to rebrand assets such as JBX, CKR, while others such as YUM and DIN struggle to meet their targets?

Kevin Burke, Trinity Capital: That's a great question. First of all, I think that some of the smaller systems have identified operators that are very well capitalized and do not mind coming to a transaction with 30%-40% capital. These same operators also seem to be very entrepreneurial, have the right DNA to run a business, and have good lending relationships lined up before they go into a transaction.

Regional lenders are wary of lending to larger systems during bad times, since they tend to have significant, existing balance sheet exposure to these companies.

The current environment of weak casual dining fundamentals and tight credit has hampered DIN's refranchising efforts on both ends: DIN has had trouble selling assets at the desired price and DIN's franchisee partners have had trouble acquiring financing.

Another thing too is some of the more niche brands have a lot of clout in their marketplace and are a little bit of a lower perceived risk than some of the major systems would be on a national basis by regional lenders. I think that a challenge for the larger systems is that in good times the capital is very, very, available; however, in bad times, people tend to look at their exposure to a large system and say "Gee I've already got \$850 million on my balance sheet toward this organization." They tend to clam up a little bit. It's counter intuitive, but it does seem to work that way. Certainly this is an environment where concentration risks, be it geographic or to an obligor or to a system, is driving these banks away.

Question 3, part 1: Do you have any knowledge of DineEquity's situation in their refranchising of the Applebee's restaurants? Given that they are somewhat leveraged in terms of their total balance sheet and have to make some commitments with respect to sales, could you comment on how negotiations are going under these circumstances, especially given that DineEquity is in a position where they need to sell units? Do you have any comment on how that process is going?

Kevin Burke, Trinity Capital: Sure. Well, we do know how that process is going. The good news is that DineEquity is the largest sit-down restaurant concept in the world, and they have a lot of weight to throw around and great human resources to put on this issue. I think the challenge they have is they sort of threw a party or had a wedding on a rainy day. This is clearly not a great environment to be trying to sell real estate or restaurants, because it's a buyers market not a sellers market. Obviously, at the time a lot of this was negotiated and planned, they didn't count on, nor did anybody, the environment we are in now, so that's been a challenge for them.

I think one of the crucibles in that whole issue is the price, and it's really the philosophy we introduced earlier: the highest price is not the best. Get the best operator and everything else will take care of itself. If you get a high price and bad operator, you're just sort of swapping the timeframes of your problems. If you get a lower price with a great operator, you're investing in the future. I think that dynamic is probably one of the key issues in the program they're running. They have very, very capable people running this program. We know them. They know the issues, and I think that like many people, they're struggling with the lack of any financing out there and some of the issues we talked about: how much real estate you have, what markets you are in, what same stores sales performance is. All of those issues are central to somebody providing liquidity in the transaction, and we think that it's very, very difficult to line up all the stars, particularly given that you probably need to do a sale and at a certain price. I think those are all the issues that they are grappling with right now.

Question 3, part 2: Obviously there's been some reset in terms of how these assets are being valued. What is the market right now for your average Applebee's unit, and are the buyers that you are aware of in the market able to get the appropriate financing right now?

Kevin Burke, Trinity Capital: Well, many of them are not able to get financing. It depends on who you are. Obviously if a boutique size private equity firm were to back somebody, the financing would be there. As I said, the crucible becomes price. In my opinion, the right thing to do is to take some paper back. If you want to do a transaction and you need to do a transaction, then you have to say well what can we do to make it happen? My thought is if the market were 5x cash flow excluding real estate, then probably the science needs to be: "All right, then let's do 4x in cash and a turn of seller paper." Those are the kind of things that will be needed, not just for DineEquity but for anybody that's trying to sell casual and family dining restaurants in an atmosphere where people are very nervous about the consumer.

Given the deleveraging of the US economy, the casual dining pie will shrink and SSS is likely to contract in 2009; however, well-managed concepts will be able to take share.

Remember we have a \$50 trillion world economy, \$14 trillion of it in the U.S. and \$36 trillion in the rest of the world. When you look at our frequency and our consumption, we're really an \$11 trillion economy masquerading in a \$14 trillion number through the use of credit cards, leverage, loans, government borrowing, and so forth. There are a lot of people that are concerned that if leverage is not there, then we're going to have SSS contraction, which is the environment we're in in the casual dining space now.

I think that there will be winners and losers in that pie. That pie is very likely to be smaller next year. Well-managed concepts, DineEquity is one of them, can negotiate these hard times by stealing share from others. We've seen some failures in that space, and the companies that will come out on top are going to be very aggressive and proactive about taking share, making that a primary objective, having a plan for 2009, and then leaving these transactions to the forces of the market. As I said, this would be either seller paper or dynamics other than your traditional walk into a money center bank and borrow 80 percent and put 20 percent down, because we believe that's not working right now.

Question 3, part 3: You mentioned winners and losers. Maybe this sort of follows that earlier question, but who are the winners and losers right now?

Kevin Burke, Trinity Capital: Well, I think without throwing darts at people, you can look at the SSS performance this year of the large concepts. I think that McDonald's is doing well, Burger King is doing well, Taco Bell is doing well, Pizza Hut is doing okay. There are some concepts that have used their incremental advertising budgets and thrown some weight around. I think that what you'll see next year is the better capitalized systems will be able to elbow some of the regionals out of the way, but nobody is immune to a down turn.

We've even seen Darden, which used to specialize in consistency of quarterly SSS results, slip a little bit this year. The reality is the pie is getting smaller, and so the well-managed, well-capitalized, well-led companies are going to have tactics, some predatory marketing and so forth, to aggressively take share from struggling concepts.

Companies that have been able to successfully take price will be better able to navigate continued traffic declines in '09.

One thing to note is that SSS is not the whole story. We had a big commodity bump this year as we all know, and everybody raised prices. If you strip all the price out, traffic is down much, much, more so than what a cursory glance at SSS would suggest. The folks that have been able to hang on to SSS performance by virtue of lower traffic but more price are examples of those that can negotiate the difficult environment that we'll have next year, when you're going to have a different set of issues but the same pressure of generally declining traffic in the industry. It's going to create some winners and losers.

Casual dining concepts with scale - a sizeable geographic store footprint and a large ad budget - should outperform smaller regionally-focused concepts.

What are some specific ones? I think clearly in the space you're talking about, in casual dining, the concepts that have identified a niche, have a good geographic store footprint, and have good ad budgets will be making progress next year. Those that have been regional, less successful, and are not doing well right now will continue to hemorrhage performance, but will be more defensive and not looking at how to perform well next year since it will be much harder next year to perform.

Question 4, part 1: Can you comment on the sheer amount of restaurant supply available for sale in a historical context, and what implications that has? Just the absolute number of restaurants available to be refranchised. Seems like everyone is trying to move units right now.

Kevin Burke, Trinity Capital: Well, I wouldn't say everyone is trying to move units right now. There have been some announced programs, but some of the larger systems don't necessarily need to sell restaurants. Some of them are even buying. Burger King has bought high quality units out of its system very recently. I wouldn't say there's a general trend of everyone getting rid of restaurants. I do think that some companies think that shedding some assets can, perhaps distract is not the right word, but at least give investors something to think about on a call other than a tough operating environment and negative SSS. Coming up with a cash flow trophy of an extraordinary gain on the sale of assets may be in the back of some companies' minds.

I think that the dynamics that have driven a lot of this restaurant growth are meals away from home. That is a trend that we think will be relatively stable next year. Perhaps not growing as it has historically, but the frequency of dining out that's going to change is going to have a lot to do with your economic strata, gasoline prices, and then how much of your income is discretionary vs. non-discretionary. Obviously, if you're in an office park and you don't pack a lunch, you're going somewhere. We would say that is sort of a non-discretionary expenditure even though you can bring a bag lunch. A discretionary expenditure is if you go to Ruth's Chris twice month, then you're going to knock that down to once a month or even once every other month if you've got budget troubles.

There are a lot of majors that don't need to sell that may be selling some restaurants right now, and if they don't get the results they want, then they're just not going to do it.

I do think that frequency is going to be under assault, and I think that some of these franchisors will look to sell stores if they have reasonable transactions on the table. The number of units out there is really diffused a little bit because there are five different disciplines. There's fast food, fast casual, family dining, casual dining, and fine dining. Those are really independent markets. Some of them will be big value plays as they get beat up. Others will perform better and perhaps have a better chance of selling restaurants. I think that the bottom line on the number of restaurants for sale out there is this: there are a lot of majors that don't need to sell that may be selling some restaurants right now, and if they don't get the results they want, then they're just not going to do it. I think this is true for some of the larger announced programs such as McDonalds, Yum, CKE, and DineEquity, because they have some optionality. Perhaps less with DineEquity, but the sheer number of restaurants is probably not so much a pricing issue as the supply of liquidity if that was your underlying question.

Question 4, part 2: Right. It just seems like from memory that the laundry list of franchisors who have announced refranchising programs seems longer than is normal, but it doesn't sound like you're worried about the overhang of supply.

Kevin Burke, Trinity Capital: No, not at all. In our opinion it's a very, very, small issue. I think the issue is financing, and, remember, everybody is getting better at this business. They're getting better at marketing, pricing, product promotion, and product development. I think that if you really ask yourself what's the biggest thing that's going to happen next year, you're going to see a tale of two cities, borrowing from Dickens. You're going to see those that are well capitalized that have good marketing departments and rich ad budgets, go out and clobber people. You're going to see a big delta between a well-capitalized, well-managed leader in its category and some of the regional, under-capitalized, thinly traded, barely public companies, who are going to be much more focused on putting out fires than trying to figure out how to get into the passing lane.

Question 4, part 3: Do you think the regional banks or other lenders are drawing a distinction between growth capital used to buy restaurants as opposed to remodeling capital?

Companies looking to fund remodeling initiatives are relatively less affected by credit market constraints. Capital reinvestment typically has resilient ROIC, and is less risky from a lender's perspective than acquisitions.

Kevin Burke, Trinity Capital: When you're underwriting in a loan committee the first thing you want to do is look at the quality of the system. Then you look at the financial wherewithal of your borrower. Then you look at his DNA and how long he's been in the system. Is this somebody we want to underwrite? I think that's really what they look at. If the proceeds are used for remodeling restaurants, I think it's a safer loan, because that activity for the major concepts almost always leads to increased traffic.

Acquisitions are a little more risky of a venture. I mean the money center banks got hung with \$229 billion of leveraged buyout loans last year, showing that acquisitions do have risks. Many of those acquisitions are not performing well, so I do think that there's gravitation towards remodeling and rehabilitation, particularly when it's a programmatic thing like when Burger King says, "Hey, this is what we're doing to all of our store fronts," or when Yum says, "Look, here's our new package for Bold Choice Taco Bell." Those things I think are safer bets, because you've got proven operators that already own the asset, are familiar with them, and probably wouldn't risk trying to renovate a property that's not going to have some resiliency, making it an accretive transaction taking on the debt.

Question 5: Can you talk a little bit about how a company goes about finding the right buyer for a package of refranchised stores?

Kevin Burke, Trinity Capital: Sure, that's a good question. I think as I alluded to earlier, it's very important to look outside your system. Historically, people have just gone to their leading franchisees and given them a very fair price, with the real estate sometimes thrown in. That has been the play that people have run the most.

We think that the better DNA you've got in your system, the better you're going to perform. Trying to go outside the known universe can really lead to good results, particularly if you're looking into other systems that are perhaps downstream from you in terms of their market prominence. Try to pick out some of the winners, some of the A students, out of concepts that are perhaps not as promising as the one at hand. Getting these entrepreneurs to come is important. I think if you put an entrepreneur in a collection of stores that was previously run by a corporate lifer, sometimes that leads to very, very, good results.

The other thing is the right guy's got to have some capital. You really want somebody financially married to something, not just upside, you want him to have downside, so you just want to be able to make sure that you have a partner that's going to feel some real pain that's significant to his net worth. Getting people to put money in is always a good practice, and franchising is no different.

The third thing is being able to qualify peoples' experiences. The fact that somebody says they ran something, and they did, is by no means a coefficient of success. You've got to look at where it was, when they got to it, and then what they did. What their skill was in navigating that system? How they handled their particular geography? Obviously, labor costs are different in Alabama than they are in New York? What is it that they brought to the table in their leadership skills in finance and accounting, operations, HR, legal, training, advertising, POP, local advertising? What are the things that they did that really moved the chains down the field and would really interest a system in inviting them in as a potential franchisee? I think the more time that is spent on the pedigree of the operator at hand, the better the results will be. If you really look at the way the market values these things, whether you sell something for 5x or 5.5x is a sheer rounding error over the course of a 20 or 40 year franchise continuity, where you're collecting the 3.5% to 5.5% royalties for an extended period of time.

Rachael Rothman, Merrill Lynch: Excellent. If anybody would like to reach out to Kevin or his team directly, they are some of the top experts in field, and can be reached either through me, or directly at 310-231-3100, or www.trinitycapitallc.com.

Again, a special thanks to Kevin and his team for all of their efforts and thanks to all of you for joining and listening in today.

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