Trinity Capital

1st Quarter 2012 Restaurant Industry Commentary

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Same-Store Sales Discussion and Analysis

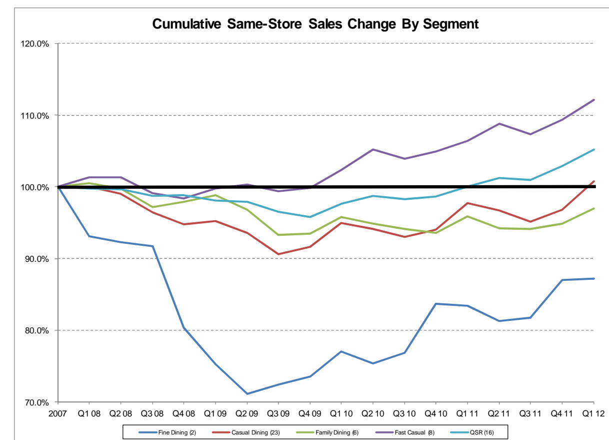
The first quarter of 2012 maintained the positive momentum in same-store sales, which is impressive as we continue to comp over positive results from the prior year. Bolstered by a mild winter, improving sales and traffic results, the restaurant industry reported its highest same store sales gains in more than three years

In fine dining, the companies we track were up from 2010 by an average of 4.6% for the first quarter of 2012. It is important to note that fine dining sales continue to be well below pre-recession levels as these positive percentage increases are much lower than the dramatic percentage declines the segment experienced during 2009 and the first quarter of 2010. Nonetheless, these gains represent real momentum as the segment continues to comp over positive results from the prior year.

In casual dining, the concepts we follow were up by an average of 3.1% for the first quarter of 2012. This is the eighth consecutive quarter that the casual dining segment has posted positive quarterly same-store sales growth. According to Knapp Track, casual dining guest counts were up by 1.2% in January, down by 0.1% in February and down by 3.4% in March, which indicates that price increases drove the same-store-sales results as opposed to traffic. The family dining concepts we track reported an average increase in same-store sales of 1.2% during the first quarter of 2012.

The fast casual segment reported positive same-store sales performance for an eleventh consecutive quarter. The segment was positive by 5.4% for the first quarter of 2012. The positive comps in the fast casual segment are more impressive than the other segments because they continue to comp over positive results and show no sign of slowing down.

In the QSR segment, all 19 concepts we track were positive during the first quarter of 2012 while the segment was up by an average of 5.1%. The Chicken segment had a very strong quarter, up by an average of 6.5%. Pollo Tropical led the way, up by 9.4%.



According to the National Restaurant Association, a majority of restaurant operators expect their sales to be higher in the coming months. However, we are concerned about the slowdown in traffic in the casual dining segment. According to Knapp Track, casual dining guest counts were down in April and May, which means traffic has been down for four consecutive months. Casual and fine dining chains are usually the first to feel the effects of an economic slowdown as consumers start to tighten their budgetary belts and start trading down.

Therefore, we recommend that all restaurant operators remain focused on keeping costs down and conserving cash in case the slowdown in traffic continues and same-store sales start to level off or even decline.

Contributing Editor Joshua L. Brannan is a Vice President for Trinity Capital.

Same-Store Sales ("SSS") Data

	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12
Fine Dining:								
Fleming's	9.0%	7.3%	18.4%	11.4%	9.9%	10.1%	0.3%	5.4%
Ruth's Chris	2.9%	4.9%	9.2%	5.2%	5.8%	2.6%	7.7%	3.7%
Mean	**6.0%**	**6.1%**	**13.8%**	**8.3%**	**7.9%**	**6.4%**	**4.0%**	**4.6%**
Casual Dining:								
Applebee's	-1.6%	3.3%	2.9%	3.9%	3.1%	-0.3%	1.0%	1.2%
Benihana	2.4%	4.7%	4.4%	5.6%	6.0%	6.4%	7.0%	4.8%
BJ's Resturants	5.3%	6.7%	5.9%	7.8%	6.9%	6.5%	5.1%	3.3%
Bonefish	5.7%	7.8%	9.3%	9.6%	10.2%	7.4%	5.9%	6.2%
Buffalo Wild Wings	-0.5%	1.1%	-0.8%	2.4%	3.9%	4.8%	7.1%	8.1%
Carrabba's Italian Grill	3.5%	4.9%	5.4%	3.9%	4.8%	6.3%	3.5%	4.3%
CEC Entertainment	-2.2%	3.8%	3.9%	1.1%	-2.0%	-6.3%	-3.6%	-4.2%
Cheesecake Factory	1.6%	2.9%	1.0%	2.1%	2.3%	0.8%	2.7%	2.6%
Chili's Grill & Bar	-4.1%	-5.0%	-4.9%	-3.0%	2.1%	1.7%	1.4%	4.6%
Dave & Buster's	-4.8%	-1.3%	1.2%	5.3%	1.9%	2.7%	-0.9%	-0.3%
Famous Dave's	0.6%	2.4%	3.3%	3.0%	-1.2%	-0.1%	3.6%	-1.6%
Frisch's Golden Corral [1]	0.7%	4.4%	1.4%	-0.9%	-3.6%	-4.9%	7.8%	12.4%
Granite City	5.3%	4.0%	3.6%	3.8%	3.5%	3.0%	4.0%	1.9%
LongHorn Steakhouse	1.8%	6.8%	4.5%	6.1%	6.0%	4.8%	6.7%	3.8%
Maggiano's	1.3%	1.4%	4.7%	3.4%	5.7%	3.5%	2.8%	3.9%
Olive Garden	-1.5%	2.0%	2.0%	0.0%	0.0%	-2.9%	-2.5%	2.0%
Outback	3.6%	3.0%	2.5%	4.3%	1.8%	6.0%	3.6%	5.3%
PF Chang's Bistro	0.1%	2.3%	1.3%	0.5%	-2.5%	-3.7%	-2.4%	-0.6%
Red Lobster	-4.6%	-1.6%	-1.6%	0.1%	3.8%	10.7%	6.8%	6.0%
Red Robin	-1.4%	1.7%	1.6%	2.1%	2.9%	2.1%	4.5%	1.0%
Ruby Tuesday	0.3%	1.2%	4.2%	-1.2%	-0.1%	-4.1%	-4.2%	-5.0%
Taco Cabana	-0.1%	1.0%	2.3%	2.0%	4.5%	5.3%	2.7%	6.1%
Texas Roadhouse	1.5%	4.3%	3.1%	4.5%	4.3%	3.9%	5.6%	6.2%
Mean	**0.6%**	**2.7%**	**2.7%**	**2.9%**	**2.8%**	**2.3%**	**3.0%**	**3.1%**
Family Dining:								
Bob Evans	-3.5%	-0.9%	-0.5%	1.2%	-1.8%	-1.5%	1.6%	-0.6%
Cracker Barrel	2.0%	2.4%	0.3%	-0.3%	-1.4%	-1.6%	3.5%	3.1%
Denny's	-5.9%	-1.1%	-1.4%	-1.7%	2.0%	0.9%	1.6%	2.4%
Frisch's Big Boy	-2.7%	-0.8%	-1.1%	0.2%	0.5%	0.0%	0.4%	1.7%
IHOP	-1.0%	0.1%	1.1%	-2.7%	-2.9%	-1.5%	-1.0%	-0.5%
Luby's	-0.5%	5.5%	2.7%	3.5%	-0.6%	3.5%	2.2%	1.1%
Mean	**-1.9%**	**0.9%**	**0.2%**	**0.0%**	**-0.7%**	**0.0%**	**1.4%**	**1.2%**

[1] Frisch's is a Golden Corral franchisee that operates 35 restaurants

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

SSS Data (Cont'd)

	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12
Fast Casual:								
Chipotle	8.7%	11.4%	12.6%	12.4%	10.0%	11.3%	11.1%	12.7%
Cosi	3.1%	5.2%	4.5%	1.7%	-0.2%	-3.0%	2.6%	7.5%
Einstein Noah Bagel	-1.1%	0.7%	1.6%	-0.4%	0.2%	0.7%	1.2%	1.1%
Panera Bread	9.9%	6.9%	5.8%	3.3%	3.9%	4.4%	4.4%	6.3%
Pei Wei	3.0%	0.8%	1.3%	-0.2%	-2.7%	-3.6%	-1.9%	-1.7%
Qdoba Mexican Grill	4.6%	5.6%	6.4%	6.0%	5.1%	4.3%	3.8%	3.0%
Steak n Shake	7.5%	3.0%	2.1%	4.3%	4.9%	5.3%	5.5%	5.5%
Tim Horton's (US)	3.1%	3.3%	6.3%	4.9%	6.4%	6.3%	7.2%	8.5%
Mean	**4.9%**	**4.6%**	**5.1%**	**4.0%**	**3.5%**	**3.2%**	**4.2%**	**5.4%**
QSR:								
Chicken:								
KFC	-7.0%	-8.0%	1.0%	1.0%	-5.0%	-3.0%	-1.0%	2.0%
Pollo Tropical	6.3%	8.8%	10.7%	13.5%	10.7%	7.9%	7.8%	9.4%
Popeyes	0.4%	5.3%	6.2%	3.9%	0.5%	1.7%	5.9%	8.1%
Mean	**-0.1%**	**2.0%**	**6.0%**	**6.1%**	**2.1%**	**2.2%**	**4.2%**	**6.5%**
Coffee/Snack:								
Caribou Coffee	4.8%	4.4%	3.5%	4.3%	4.6%	4.1%	5.6%	2.5%
Dunkin Donuts [2]	1.9%	2.7%	4.7%	2.8%	3.2%	6.0%	7.4%	7.2%
Jamba Juice	-2.4%	-2.7%	0.2%	2.2%	4.3%	3.3%	7.7%	12.7%
Krispy Kreme	5.7%	5.0%	1.1%	7.0%	2.5%	4.0%	8.3%	2.1%
Starbucks	9.0%	8.0%	8.0%	7.0%	8.0%	10.0%	9.0%	8.0%
Mean	**3.8%**	**3.5%**	**3.5%**	**4.7%**	**4.5%**	**5.5%**	**7.6%**	**6.5%**
Mexican:								
Taco Bell	1.0%	3.0%	4.0%	0.0%	-5.0%	-2.0%	-2.0%	6.0%
Mean	**1.0%**	**3.0%**	**4.0%**	**0.0%**	**-5.0%**	**-2.0%**	**-2.0%**	**6.0%**
Pizza:								
Domino's	8.8%	11.7%	6.3%	-1.4%	4.8%	3.0%	6.8%	2.0%
Papa John's	0.4%	-0.6%	0.7%	6.1%	0.4%	5.3%	1.7%	1.1%
Pizza Hut	8.0%	8.0%	10.0%	-3.0%	-2.0%	-3.0%	6.0%	5.0%
Mean	**5.7%**	**6.4%**	**5.7%**	**0.6%**	**1.1%**	**1.8%**	**4.8%**	**2.7%**
Sandwich:								
Burger King	-1.5%	-4.2%	-5.8%	-6.0%	-5.3%	-0.3%	-2.0%	4.2%
Carl's Jr.	-6.1%	-7.4%	-5.0%	-0.4%	2.1%	2.0%	2.0%	1.7%
Hardee's	-1.2%	6.8%	8.3%	5.7%	9.6%	2.5%	1.8%	6.1%
Jack in the Box	-9.4%	-4.0%	1.5%	0.8%	4.7%	5.8%	5.3%	5.6%
McDonald's	3.7%	5.3%	4.4%	2.9%	4.5%	4.4%	7.1%	8.9%
Sonic Drive-In	-6.0%	-6.4%	-2.4%	1.2%	3.9%	-0.5%	0.1%	3.5%
Wendy's	-1.7%	-1.7%	0.2%	0.0%	2.3%	0.9%	4.4%	0.7%
Mean	**-3.2%**	**-1.7%**	**0.2%**	**0.6%**	**3.1%**	**2.1%**	**2.7%**	**4.4%**
Mean Total QSR	**0.8%**	**1.8%**	**3.0%**	**2.5%**	**2.6%**	**2.7%**	**4.3%**	**5.1%**

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

[2] Dunkin Donuts did not report quarterly same store sales prior to Q1 2010.

Succession Planning for Restaurant Management Companies

Many privately held restaurant management companies do not have formal succession plans. They are generally family-owned, and there are some questions about which family member would be next on deck if the CEO were to sell, retire or experience a health issue. Moreover, many of these companies simply do not have a succession plan because the only person that can really implement one is the boss himself, and if he is not ready to deal with this issue, it simply doesn't happen. Consequently, there are meaningful leadership gaps in many restaurant companies, even those that have quietly grown to $100 million + in annual sales. This lack of planning can become a significant issue for lenders, creditors, shareholders and employees.

The obvious question answered by a succession plan is who will run the business when the CEO steps down. However, well prepared succession plans actually take into consideration many other factors such as the musical chairs among senior leadership when a new CEO is anointed. A good succession plan will avoid indulging in the Peter Principle or ignoring key opportunities to promote talented executives within the company. In fact, succession plans are often used as a form of retention for key employees particularly when there is a clear-cut path for promotion for highly-motivated, talented junior executives. For instance, the CEO is not the only position which needs to be addressed by a succession plan. A good human resources department will develop an organizational chart which identifies the key leadership positions which must be addressed in a comprehensive succession plan.

Lenders and investor groups frequently require key man life insurance for the top couple of executives, particularly if they are unusually talented individuals. Key man life insurance addresses the tremendous loss in value an organization would experience with the loss of its CEO, chief operating officer or other valuable individuals, such as, a key salesman. The sudden death or incapacity of one of these key officers would result in an insurance payout to the company as a beneficiary to partially offset the value deterioration which transpires upon losing the superstar leader.

A tragic example of this is when the In-N-Out Burger's troika of key leadership died in a corporate jet crash in 1993. This represented a significant challenge to the organization in the months following this tragedy and led to many industry participants prohibiting concentrated executive team travel risk. It also highlighted the value of key man insurance.

Family owned businesses periodically update their succession plans to take in consideration the potential for talented and proven family members' progression into the leadership structure. This is a way to address management and sibling rivalries and to establish a clear hierarchy as the organization matures and managers and family members either grow with the company or fall behind. Sometimes the second generation in a family is more interested in driving a sports car and living on the beach than putting long hours in at the office. Succession plans can be useful in addressing this kind of challenge with a clearly identified path to leadership as well as an incentive for aspiring younger family members.

It is always important to seek objective counsel in creating a succession plan. This prudence can help ensure that a business is properly staffed with leadership that will provide good stewardship of assets for years to come. In addition, it is important to note that properly discharging your duty as a fiduciary includes naming successors that will not represent material deterioration in management skills of the organization. We frequently find some restaurant management companies that operate P&Ls that are 300 or even 500 basis points better than the system-wide averages. This is frequently due to the incremental management strength of the organization, and this must be protected by a well-conceived succession plan for the greater good of the shareholders and creditors.

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Capital Markets' Thirst for Growth Offers Opportunity to Franchised Restaurant Owners

2012's slow transaction pace for financings and M&A activity has impacted capital markets to the benefit of large, successful restaurant owners. The contrasting dynamic between a desire for growth among investors and a lack of "quality transactions" during the first half of the year is generating heightened competition by restaurant-hungry capital sources. This renewed capital flow to restaurant companies, in combination with some regulatory issues and macro economic developments, has lead to several trends of which restaurant owners should be aware.

Today's middle market restaurant acquisitions are largely taking place at the hands of strategic buyers. Across all industries, strategic capital has regained a firm position within the capital markets related to acquisition, joint venture and partnership market development. This trend comes as corporate balance sheets are flush with cash. In fact, there is now more than $1.2 trillion in cash in the S&P 500, excluding the financial sector[1]. This represents an all time record high, both in absolute dollars and as a percentage of assets. The economic paralysis among US consumers has resulted in a surge of strategic buyers who must replace organic with acquired growth.

This macro trend is amplified within the restaurant space. With margin compression and reimage pressures expected to continue, restaurant companies not only find earnings growth through acquisition, but also safety in size. Beyond simply generating investor returns, size is proving a valuable tool for enhanced ability to roll over geographic or short term economic pot-holes. It also provides operators with more ease in living up to remodel requirements and funding new development. As we have seen, size among restaurant operators is a coveted and necessary attribute. Smaller operators therefore are generally looking to expand or to get out, and larger operators continue to seek growth more aggressively with increased access to capital.

Not only are restaurateurs in successful concepts sitting on more cash, but lenders and investors are seemingly begging them to use their money. Why is that? So far, 2012 has demonstrated a surprising void in large scale M&A and financing transactions across most U.S. industries. This has come as a surprise to many capital sources of debt and equity that began the year with projections of outsized capital deployment. Like most professionals in the financial sector, they believed business owners would harvest equity value as it has become propped up by favorable tax and lending environments. Therefore, traditional and non-traditional financing sources aligned resources . . . resources that are not being snatched-up as anticipated.

Traditional Financing Sources: Today, traditional senior debt providers are eager to lend to large, strong operators in good brands. For those borrowers who have access to this capital, we strongly believe the time to take advantage is now. We are seeing larger transactions in strong credits with access to L+275 – L+475 (depending on how aggressive leverage becomes) with the ability to straight line amortize over up to 12 years in non-real estate transactions. In addition, for acquisition financing, lenders are more flexible on the amortization schedules in early years to allow for lumps in integration. These terms are historically attractive and readily available to good borrowers. Senior lenders have become so aggressive, in fact, that the resulting borrowing levels have allowed many acquiring companies within the restaurant industry to effect transactions without the use of mezzanine capital or equity partners. We do not believe this will last.

Global economic exposure to our domestic capital markets will eventually lead to a significant tightening of availability and higher interest rates. We do not believe today's ease of availability and attractive pricing related to traditional lenders can continue. In addition, Basel III will soon restrict even the smaller regional banks. Therefore, non-traditional and mezzanine sources of capital will increasingly grow in importance to fill out the capital structures of transactions in our industry. Fortunately, investors seeking returns are generating ample capital pools from which these types of funds can draw.

[1] Factset Research, 2012

Non-Traditional Financing Sources: Capital flows to private equity and specialty finance providers have swollen as a result of the limited return potential of public debt and equity markets. In fact, amongst all the private equity capital available to US corporations, just that which is targeted at middle market opportunities is currently estimated at $425 billion. We believe this glut of investment capital will pressure funds to expand the parameters of their focus to a greater range of opportunities and increase the frequency with which non-traditional sources of capital will be used by restaurant owners.

Already, this has caused a certain froth of competition among capital providers which has inured to the benefit of many restaurant owners. Aggressive lending coupled with hungry private equity and strategic buyers has resurrected premium market multiples for high-quality, performing assets, especially for assets demonstrating proclivity for growth. It has also compelled a blurring of the delineation between strategic and financial buyers; many large strategic buyers are now backed by financial investors and behaving as such. We are seeing these types of acquirers increasingly taking an important role within the restaurant industry as deals get bigger and bigger.

While the first half of 2012 has surprised the capital markets with the lack of transactions – today's pipeline of middle market transactions, particularly restaurants, continues to build. As more and more capital availability is thrown at the industry, many restaurant operators have chosen to take advantage either by selling their business or getting access to the favorable leverage markets to re-cap, dividend or, perhaps more commonly, to acquire. As additional restaurant owners begin to take advantage of capital availability, we see the markets becoming somewhat crowded, but capable of handling the pipeline. Further, as consensus builds around a probable extension to tax policy, a spill over of today's pipeline into 2013 is potentially more likely and less problematic for sellers.

It's a counterintuitive capital environment within the restaurant focused capital providers. Our nation continues to face tremendous economic uncertainly, yet capital availability to large operators has not been this robust in several years. Sellers, buyers and traditional borrowers can all participate in these trends to their advantage if they do it thoughtfully and quickly. Please contact us if we can help.

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