TRINITY CAPITAL
INVESTMENT BANKING

Restaurant Industry Commentary
&
1st Quarter 2014 SSS

What's Inside This Commentary — Published: August 2014

Same-Store Sales Discussion and Analysis

During the first quarter of 2014 ("Q1 2014"), the restaurant industry maintained positive momentum in same-store sales, which is impressive as it continued to comp over positive results from the previous two years. In fact, the industry reported its sixteenth consecutive quarter of same-store sales gains. Most of the country experienced one of the harshest winters in the last 30 years, which makes the same-store sales gains even more remarkable.

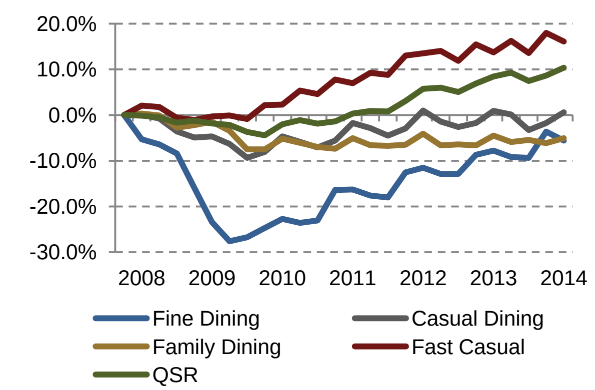
In the fine dining segment, the companies we track were up from 2013 by an average of 2.4% for Q1 2014. It is important to note that despite 17 consecutive positive quarters, fine dining sales remain more than 5.5% below pre-recession levels (see Cumulative Same-Store Sales graph). Nonetheless, these gains represent real momentum given the positive results over the last four years.

In the casual dining segment, the concepts we follow were down an average of 0.3% for Q1 2014. This is the third out of the last five quarters that the casual dining segment has posted negative same-store sales results. According to Knapp-Track, casual dining guest counts were down 4.2% in January, 4.0% in February and 3.9% in March. In fact, Knapp-Track has reported negative guest counts in 26 out of the last 32 months. The negative traffic counts in the first quarter were partially attributable to the harsh weather that affected a large portion of the country, but they are also an indication that consumers are not willing to accept the higher prices that many of the casual dining companies have used to buoy their same-store sales. The family dining concepts we track reported an average decrease in same-store sales of 0.6% during Q1 2014.

The fast casual segment continued its positive momentum with another positive quarter as the segment was up 2.1% for Q1 2014. The fast casual segment continues to produce positive same-store sales results despite comping over nearly four years of strong growth. Chipotle had a very impressive quarter as it was up by 13.4%.

In the Quick-Service Restaurant ("QSR") segment, 14 of the 18 concepts we track showed positive same-store sales during Q1 2014, and the segment was up an average of 1.8%. The pizza segment had a strong showing in the first quarter, up an average of 3.2%; Papa John's led the way, up 9.6%, followed by Domino's at 4.9%.

Cumulative Same-Store Sales Change by Segment



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

The year began on an undesirable note for the restaurant industry as a large part of the country was plagued by severe winter storms during Q1 2014. As a result, Technomic is projecting an estimated 3.0% growth in same-store sales for the restaurant industry over the remainder of 2014, a downward revision from its initial annual forecast of 3.5%. Growth of 3.0% is good news for restaurant operators if there is a genuine turnaround in customer traffic counts. Unfortunately, we are concerned that a large portion of the sales growth is going to be attributable to price increases and not to additional customer traffic. Thus, price increase will not only be critical to sales growth, but it will also be vital in order to offset rising commodity and labor costs. Therefore, our advice to restaurant operators is to remain very conscientious of their operations and every aspect of their profit and loss statements, because any increase in sales will likely be offset by rising costs.

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

Same-Store Sales ("SSS") Data

	FY 2011			FY 2012				FY 2013				FY 2014
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Fine Dining												
Fleming's	9.9%	10.1%	0.3%	5.4%	6.8%	10.1%	4.0%	5.4%	2.0%	4.2%	4.9%	1.7%
Ruth's Chris	5.8%	2.6%	7.7%	3.7%	6.0%	5.9%	5.4%	6.6%	4.6%	4.2%	5.5%	2.6%
Capital Grille	7.9%	7.0%	5.7%	5.7%	2.8%	4.0%	2.3%	3.0%	4.5%	3.2%	6.7%	0.1%
Del Frisco's	N/A	N/A	N/A	7.9%	7.3%	5.3%	5.9%	1.9%	5.9%	4.4%	5.2%	5.1%
Mean	**7.9%**	**6.6%**	**4.6%**	**5.7%**	**5.7%**	**6.3%**	**4.4%**	**4.2%**	**4.3%**	**4.0%**	**5.6%**	**2.4%**
Casual Dining												
Applebee's	3.1%	-0.3%	1.0%	1.2%	0.4%	2.0%	0.9%	-1.3%	1.3%	-0.4%	-0.3%	-0.5%
BJ's Restaurants	6.9%	6.5%	5.1%	3.3%	4.4%	2.3%	3.0%	-0.4%	0.0%	-2.2%	-2.7%	-2.9%
Bonefish	10.2%	7.4%	5.9%	6.2%	2.1%	3.5%	1.0%	0.5%	0.2%	-2.7%	0.9%	-1.5%
Buffalo Wild Wings	3.9%	4.8%	7.1%	8.1%	5.4%	6.0%	6.7%	1.9%	4.0%	4.3%	4.0%	5.7%
Carrabba's Italian Grill	4.8%	6.3%	3.5%	4.3%	1.5%	1.0%	-0.4%	-1.7%	0.3%	0.0%	0.9%	-1.8%
CEC Entertainment	-2.0%	-6.3%	-3.6%	-4.2%	-2.4%	-2.3%	-2.9%	1.6%	2.9%	-2.1%	-1.3%	1.6%
Cheesecake Factory	2.3%	0.8%	2.7%	2.6%	2.1%	2.9%	1.3%	1.6%	0.9%	1.0%	1.1%	1.2%
Chili's Grill & Bar	2.1%	1.7%	1.4%	4.6%	2.2%	2.8%	1.0%	-1.1%	-0.6%	-1.9%	0.2%	0.5%
Dave & Buster's	1.9%	2.7%	-0.9%	-0.3%	5.4%	5.4%	3.7%	1.8%	-0.9%	-0.9%	2.4%	0.7%
Famous Dave's	-1.2%	-0.1%	3.6%	-1.6%	-0.6%	0.2%	-6.0%	-1.8%	3.8%	-2.3%	-1.1%	-3.3%
Granite City	3.5%	3.0%	4.0%	1.9%	1.5%	2.5%	4.5%	2.7%	2.5%	0.4%	0.6%	N/A
LongHorn Steakhouse	6.0%	4.8%	6.7%	3.8%	3.0%	2.2%	-0.8%	-1.6%	3.5%	3.2%	2.9%	0.3%
Maggiano's	5.7%	3.5%	2.8%	3.9%	1.9%	0.9%	0.6%	0.4%	0.2%	0.6%	0.9%	0.2%
Olive Garden	0.0%	-2.9%	-2.5%	2.0%	-1.8%	0.3%	-3.2%	-4.1%	1.1%	-4.0%	-0.6%	-5.4%
Outback	1.8%	6.0%	3.6%	5.3%	2.3%	4.5%	5.3%	2.5%	2.8%	-0.3%	1.1%	0.8%
Red Lobster	3.8%	10.7%	6.8%	6.0%	-3.9%	-2.6%	-2.7%	-6.6%	3.2%	-5.2%	-4.5%	-8.8%
Red Robin	2.9%	2.1%	4.5%	1.0%	1.2%	0.6%	1.4%	1.4%	3.6%	5.4%	3.7%	5.8%
Ruby Tuesday	-0.1%	-4.1%	-4.2%	-5.0%	-4.6%	1.9%	0.3%	-2.8%	-3.1%	-11.4%	-7.8%	-1.9%
Taco Cabana	4.5%	5.3%	2.7%	6.1%	4.5%	1.8%	6.8%	2.0%	1.1%	1.8%	-2.9%	0.8%
Texas Roadhouse	4.3%	3.9%	5.6%	6.2%	4.6%	3.9%	4.5%	3.7%	4.7%	2.9%	2.5%	3.0%
Mean	**3.2%**	**2.8%**	**2.8%**	**2.8%**	**1.5%**	**2.0%**	**1.3%**	**-0.1%**	**1.6%**	**-0.7%**	**0.0%**	**-0.3%**
Family Dining												
Bob Evans	-1.8%	-1.5%	1.6%	-0.6%	1.0%	1.0%	1.6%	0.0%	-0.6%	-1.9%	-1.8%	-4.1%
Denny's	2.0%	0.9%	1.6%	2.4%	0.8%	0.4%	1.7%	-0.7%	0.6%	1.2%	0.9%	0.5%
Frisch's Big Boy	0.5%	0.0%	0.4%	1.7%	-1.7%	-0.2%	-1.7%	-0.9%	1.0%	-0.1%	0.0%	-3.6%
IHOP	-2.9%	-1.5%	-1.0%	-0.5%	-1.4%	-2.0%	-2.6%	-0.5%	1.9%	3.6%	2.4%	2.4%
Luby's	-0.6%	3.5%	2.2%	2.2%	1.1%	2.4%	0.2%	-0.1%	1.0%	2.4%	1.2%	2.0%
Mean	**-0.6%**	**0.3%**	**1.0%**	**1.0%**	**0.0%**	**0.3%**	**-0.2%**	**-0.4%**	**0.8%**	**1.0%**	**0.5%**	**-0.6%**

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

SSS Data (Cont'd)

	FY 2011			FY 2012				FY 2013				FY 2014
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Fast Casual												
Chipotle	10.0%	11.3%	11.1%	12.7%	10.2%	4.8%	3.8%	1.0%	5.5%	6.2%	9.3%	13.4%
Cosi	-0.2%	-3.0%	2.6%	7.5%	-0.5%	-0.7%	-3.9%	-4.5%	-2.7%	-3.6%	-4.6%	-9.5%
Einstein Noah Bagel	0.2%	0.7%	1.2%	1.1%	1.3%	0.2%	1.4%	-0.6%	0.7%	-1.4%	0.1%	1.6%
Noodles & Company	2.0%	5.2%	5.4%	6.8%	6.8%	3.4%	4.2%	2.2%	4.7%	2.1%	3.9%	-1.6%
Panera Bread	3.9%	4.4%	4.4%	6.3%	5.9%	5.8%	4.9%	3.3%	3.7%	1.3%	1.1%	0.1%
Qdoba Mexican Grill	5.1%	4.3%	3.8%	3.0%	2.1%	3.3%	1.0%	-1.5%	1.3%	2.0%	2.3%	7.0%
Steak n Shake	4.9%	5.3%	5.5%	5.5%	4.8%	2.9%	3.8%	1.3%	0.3%	4.2%	3.0%	3.7%
Mean	**3.7%**	**4.0%**	**4.9%**	**6.1%**	**4.4%**	**2.8%**	**2.2%**	**0.2%**	**1.9%**	**1.5%**	**2.2%**	**2.1%**
QSR												
Chicken												
KFC	-5.0%	-3.0%	-1.0%	2.0%	1.0%	4.0%	4.0%	4.5%	3.0%	-4.0%	-5.0%	-3.0%
Pollo Tropical	10.7%	7.9%	7.8%	9.4%	7.8%	7.0%	8.3%	3.8%	6.4%	6.5%	7.0%	6.3%
Popeye's	0.5%	1.7%	5.9%	8.1%	8.4%	6.8%	6.4%	0.5%	4.3%	5.1%	0.3%	4.3%
Mean	**2.1%**	**2.2%**	**4.2%**	**6.5%**	**5.7%**	**5.9%**	**6.2%**	**2.9%**	**4.6%**	**2.5%**	**0.8%**	**2.5%**
Coffee/Snack												
Baskin Robbins	-2.8%	1.7%	5.8%	9.4%	4.6%	1.1%	1.5%	-4.4%	1.6%	4.2%	2.2%	0.5%
Dunkin Donuts	3.2%	6.0%	7.4%	7.2%	4.0%	4.0%	3.2%	1.7%	4.0%	4.2%	3.5%	1.2%
Jamba Juice	4.3%	3.3%	7.7%	12.7%	5.7%	2.5%	0.6%	1.3%	1.7%	-3.4%	0.3%	0.6%
Krispy Kreme	2.5%	4.0%	8.3%	2.1%	5.4%	6.8%	7.5%	11.4%	10.0%	3.7%	1.6%	3.3%
Starbucks	8.0%	10.0%	9.0%	8.0%	7.0%	7.0%	7.0%	7.0%	9.0%	8.0%	5.0%	6.0%
Tim Horton's	6.4%	6.3%	7.2%	8.5%	4.9%	2.3%	3.2%	-0.5%	1.4%	3.0%	3.1%	1.9%
Mean	**3.0%**	**5.0%**	**7.6%**	**7.9%**	**5.3%**	**4.3%**	**4.0%**	**3.4%**	**5.3%**	**3.3%**	**2.5%**	**2.3%**
Mexican												
Taco Bell	-5.0%	-2.0%	-2.0%	6.0%	13.0%	7.0%	5.0%	6.0%	2.0%	2.0%	1.0%	-1.0%
Mean	**-5.0%**	**-2.0%**	**-2.0%**	**6.0%**	**13.0%**	**7.0%**	**5.0%**	**6.0%**	**2.0%**	**2.0%**	**1.0%**	**-1.0%**
Pizza												
Domino's	4.8%	3.0%	6.8%	2.0%	1.7%	3.3%	4.7%	6.2%	6.7%	5.4%	3.7%	4.9%
Papa John's	0.4%	5.3%	1.7%	1.1%	5.7%	2.5%	5.2%	1.6%	3.4%	1.8%	6.6%	9.6%
Pizza Hut	-2.0%	-3.0%	6.0%	5.0%	4.0%	6.0%	-1.0%	-1.0%	-2.0%	-1.0%	-4.0%	-5.0%
Mean	**1.1%**	**1.8%**	**4.8%**	**2.7%**	**3.8%**	**3.9%**	**3.0%**	**2.3%**	**2.7%**	**2.1%**	**2.1%**	**3.2%**
Sandwich												
Burger King	-5.3%	-0.3%	-2.0%	4.2%	4.4%	1.6%	3.7%	-3.0%	-0.5%	-0.3%	0.2%	0.1%
Jack in the Box	4.7%	5.8%	5.3%	5.6%	3.4%	3.1%	1.9%	0.1%	0.1%	-1.4%	1.9%	0.7%
McDonald's	4.5%	4.4%	7.1%	8.9%	3.6%	1.2%	0.3%	-1.2%	1.0%	0.7%	-1.4%	-1.7%
Sonic Drive-In	3.9%	-0.5%	0.1%	3.5%	2.8%	2.3%	3.0%	1.3%	0.1%	5.9%	2.2%	1.4%
Wendy's	2.3%	0.9%	4.4%	0.7%	3.2%	2.8%	-0.5%	0.7%	0.3%	3.1%	2.9%	0.7%
Mean	**2.0%**	**2.1%**	**3.0%**	**4.6%**	**3.5%**	**2.2%**	**1.7%**	**-0.4%**	**0.2%**	**1.6%**	**1.2%**	**0.2%**
Mean Total QSR	**2.0%**	**2.7%**	**4.5%**	**5.4%**	**5.1%**	**4.2%**	**3.7%**	**2.6%**	**3.1%**	**2.3%**	**1.6%**	**1.8%**

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

Designer Pizza Takes Fast Casual By Storm

A wave of fast casual pizza concepts has swept the nation as over 30 concepts have originated and begun building restaurants in the majority of large DMAs. Driven by consumer demand, we estimate there will be over 500 of these establishments in operation by the end of 2014, which represents over 20% unit growth in this sub-category over 2013. The leaders in this category, including Blaze Pizza, Pieology and PizzaRev, are developing stores at a rapid pace and are fine-tuning their concepts to appeal to their target demographics, specifically the more demanding Millennial and Generation X customers. Traditional concepts, such as Pizza Hut, Domino's and Papa John's, have taken notice, but have yet to react as, for the time being, they have concluded that fast casual pizza concepts cater to a different customer base. At present, fast casual concepts do not compete with home delivery and are not likely to be served at events that commonly feature pizza, such as sporting events and home sports viewing, due to the highly personalized nature of the product. Nonetheless, Pizza Hut is currently testing new concept stores that embody the high degree of customization and other characteristics of this new fast casual pizza segment.

The genius behind the designer pizza concept is that the food is simple, authentic and quick to prepare in an assembly line format. In addition, the customer is in control because they can customize the type and quantity of items they want on their pizza as they proceed down the line during the ordering process. This is very popular with Millennials and Generation X consumers, who are accustomed to instant gratification and the process control they experience with their smartphones. Most of these concepts are using high quality ingredients and significantly less pizza dough, which means fewer calories and carbohydrates and curries favor among the more health-conscious Millennials. Following the “Chipotle model” of order customization, this new category has been wildly successful, and many people are foregoing traditional pizza in favor of the fast casual designer pizza option.

Fast casual designer pizzas start with a modest sized ball of dough, which when put into a press, produces a very thin crust, similar to a pizza appetizer at a fine dining Italian restaurant. Ingredients of the customer’s choice are then added, including a variety of cheeses, such as goat, gorgonzola and feta, which expands far beyond the shredded mozzarella offered at traditional QSR pizza restaurants. After the ordering process is complete, the pizza’s thin crust allows for cook times as little as two minutes. The end product is affordable, quick to prepare and contains substantially fewer calories and carbohydrates than traditional pizza, making it well aligned with the segment’s target demographic. Furthermore, some of the concepts serve alcohol, which drives traffic, enhances average tickets and boosts margins.

The fast casual format features expedited service, attractive restaurants, higher quality ingredients, no gratuity and a generally healthier fare than QSR and continues to attract customers from both above and below its average ticket. Higher spending customers do not consider moving from casual dining to fast casual “trading down,” and so in a belt-tightening family no one is unhappy to make the move. When comparing QSR and casual dining to fast casual, Millennials perceive fast casual as healthier, better quality and a cool experience they are willing to share with friends on social media.

This trend has capitalized on America’s love for pizza with a healthier, higher quality product that provides instant gratification for the consumer. Low barriers to entry should lead to intense competition in the segment over the next few years as entrants race to become one of the few concepts worthy of expanding to a national platform. The rapid rise of fast casual pizza concepts is in some ways analogous to the explosion of growth in the “better burger” segment that has taken place over the last decade. Operators in the designer pizza segment should be very careful not to repeat the miscues of the “better burger” segment on their way to long-term success. Notwithstanding, the fast casual pizza segment has made substantial inroads with key demographics and that should enable the segment to become a permanent fixture of the fast casual category.

Contributing Editor Kevin Burke is a Managing Director for Trinity Capital.

Restaurant M&A: Significant Activity Pick-up in the First Half of 2014

With substantial equity and debt capital available for transactions, restaurant merger and acquisition activity picked up noticeably during the first six months of 2014 versus the same period in 2013. According to Capital IQ, 91 restaurant M&A deals closed in the first half of 2014 versus 76 in 2013 (and 74 in 2012). The disclosed dollar volume grew over 200%, primarily due to a couple of large transactions. In addition, there have been a number of prominent announcements regarding new deals that should close later this year.

Some of the more noteworthy transactions include:

<u>Closed</u>

- Sale of CEC Entertainment (Chuck E. Cheese) to Apollo for $1.3 billion
- Sale of PJ United (large Papa John franchisee) by The Halifax Group to TPG Growth
- Sale of a majority stake in Flynn Restaurant Group (large Applebee's and Taco Bell franchisee) by Goldman Sachs/Weston Presidio to Ontario Teachers' Pension Plan
- Sale of Checkers Drive-In by Wellspring Capital to Sentinel Capital
- Sale of On the Border by Golden Gate Capital to Argonne Capital/Fortress
- Sale of Morgan's Foods (large Yum! Brands franchisee) to Apex Restaurant Group
- Sale of Smoothie Factory and Redbrick Pizza to Brix Holdings
- Sale of Patina Restaurant Group to Delaware North
- Sale of Fox & Hound to Cerberus
- Sale of Quiznos to creditors

<u>Announced</u>

- Sale of Red Lobster by Darden to Golden Gate Capital for $2.1 billion
- Sale of TGI Friday's by Carlson to Sentinel Capital and TriArtisan Capital for $800-$900 million (est.)
- Rumor that Ruby Tuesday hired Goldman Sachs to explore strategic alternatives
- Sale of 56 Wendy's restaurants by Carlisle Corp. to NPC International
- Investment into The Portillo Restaurant Group (Portillo's Hot Dogs) by Berkshire Partners at a $1 billion (est.) valuation
- Del Taco owners Goldman Sachs Mezzanine Partners, Charles Bank Capital Partners and Leonard Green and Partners exploring a sale

Several factors have contributed to the increased deal activity, including:

Shareholder activism: Publicly traded restaurant chains have often been targeted by activist hedge funds. In many cases, shareholders have pushed for a sell-off of brands and/or real estate to create greater focus and value. In this year's most prominent example, Darden Restaurants announced the sale of Red Lobster, an underperforming concept, to Golden Gate following significant pressure from shareholders including Barrington Capital and Starboard Value.

Strategic repositioning: In part due to the constrained economic recovery and the negative impact on casual dining, some owners have decided to sell assets to re-focus on other business priorities. In announcing its sale of TGI Friday's, Carlson stated "this transaction frees up resources that the company can deploy to focus on and accelerate the growth of its hotel and travel business."

Aging owners: Many restaurant owners started their chains a few decades ago. This graying boomer generation is now looking for liquidity to fund retirement and for estate planning purposes. Especially in cases where no children are involved in management and no other successor is in place, a company sale into the current favorable environment is compelling. We have seen a number of franchise owners, in particular, pursue this path.

Excess capital and higher valuations: Trinity Capital is contacted on a daily basis by private equity and other capital sources seeking new investment opportunities. There has been a paucity of attractive acquisition targets given the enormous current private equity "dry powder" and pressure to invest. Buttressed by substantial available debt (see below) and rising restaurant stock prices, buyers have pushed up valuation multiples to levels approaching the pre-Recession environment. Sellers of concepts, franchisors and franchisees have benefited.

Low-cost debt: The ease and low cost of borrowing is contributing to the more active restaurant M&A calendar. In addition to lower interest rates, covenants are looser and principal amortization is less demanding. Private equity buyers such as Apollo, TPG Growth, Argonne and others have taken advantage. With cheaper debt available, buyers can be aggressive in committing to transactions at attractive valuations for sellers.

Improving consumer sentiment: After a soft retail/consumer first quarter due largely to unusually harsh weather, restaurants have seen some positive momentum especially in the fast casual, QSR and fine dining segments. Optimism about continued improvements has spilled over to the casual dining area as shown by deals for On the Border, TGI Friday's and Red Lobster.

Re-franchising/franchise repurchases: Certain franchisors have proactively changed their mix of owned versus franchised locations by either selling off owned stores (re-franchising) or buying out existing franchisees. Wendy's has aggressively sold off a large number of corporate units. Noodles, Red Robin and others have re-purchased units from franchisees.

Financial restructurings: While general economic conditions are apparently improving, certain restaurant segments remain tough, in particular casual dining. Some over-leveraged chains that have suffered guest count declines have turned to a sale through a restructuring. Cerberus acquired Fox & Hound, in which it held a significant debt position, through a bankruptcy process. Furr's Fresh Buffet was sold in a bankruptcy court transaction to Food Management Partners which also owns Don Pablo's and 35 franchised Buffalo Wild Wings units. Finally, the major creditors of Quiznos took a controlling interest through a bankruptcy.

Consolidation: Although the restaurant industry has seen several larger companies sell off brands in recent years, consolidation continues. Certain franchisors are seeking add-ons of other franchised concepts to leverage an existing administrative infrastructure as shown by Brix Holdings' (Red Mango franchisor) acquisition of Red Brick Pizza and Smoothie Factory. Many larger franchisees have been buying chains within their existing system or in another non-competing brand, again to leverage their infrastructure. Flynn Restaurant Group has purchased many units in the Taco Bell system to go along with its leading Applebee's position, and NPC International, the largest Pizza Hut franchisee, has purchased a number of Wendy's restaurants.

In summary, 2014 has seen a busier M&A calendar for restaurant transactions due to a variety of factors including greater availability of capital and higher valuations. This activity has occurred despite uneven performance among chains, especially with casual dining, which has seen continued traffic count declines. We anticipate continued M&A closings and sale agreements throughout the year if interest rates remain low and no serious consumer shocks occur. In fact, we are surprised even more owners have not decided to sell given the extremely favorable market conditions. We believe this is partly due to uncertainty about the country's economic recovery and the general cautiousness among operators. We encourage restaurant owners to consider their strategic options while this environment is still available.

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