Trinity Capital

2nd Quarter 2011 Restaurant Industry Commentary

What's Inside This Commentary

Same-Store Sales Discussion and Analysis	1
Same-Store Sales Data	2
What to expect for 2012	4
Looking Down: Analyzing the Impact of Negative Trends in the Restaurant Industry	4

Same-Store Sales Discussion and Analysis

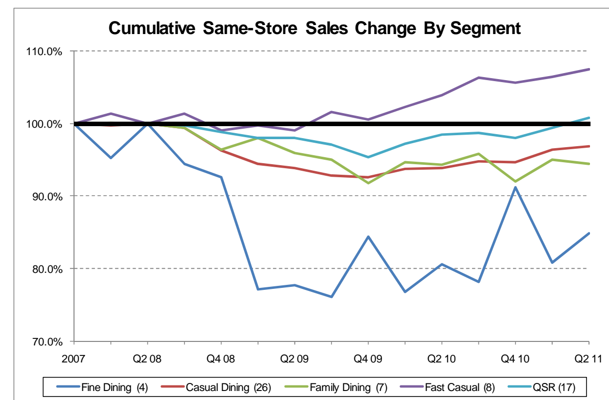
The second quarter of 2011 reported continued improvement in same-store sales, which is impressive and refreshing, as Q2 2011 is the first quarter that is comping over positive results from the prior year. However, the third quarter of 2011 may tell a different story as we focus on: (i) stubbornly high gasoline prices; (ii) volatile capital markets; (iii) persistent struggles with EU sovereigns and banks; and (iv) continued softness in the job market.

In fine dining, the companies we track were up from 2010 by an average of 5.3% for the second quarter of 2011. It is important to note that these positive percentage increases are much lower than the dramatic percentage declines the segment experienced during 2009 and the first quarter of 2010, and therefore fine dining sales continue to be well below pre-recession levels. Nonetheless, these gains represent real momentum as the segment is comping over positive results from the same quarter of the prior year.

In casual dining, the concepts that we follow were up by an average of 3.1% over last year. This is the fifth 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 0.2%, 0.4% and 0.5% for April, May and June, respectively. This is the first quarter reporting an increase in traffic in more than two years. The family dining concepts we track reported an average increase in same-store sales of 0.2% during the second quarter of 2011.

The fast casual segment reported positive same-store sales performance for an eighth consecutive quarter. The segment was positive by 3.5% for the second quarter of 2011. 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, 15 of the 18 concepts we track were positive during the second quarter of 2011 while the segment was up by an average of 2.4%. The Coffee/Snack segment had another strong quarter, up by an average of 4.5%. Starbucks led the way, up by 8.0%.



The rest of 2011 will be very telling for the restaurant industry as it comps over the positive results from the last two quarters of 2010 and any improvement in the economy is still stifled. It is important to note that the modest gains achieved over the last five quarters pale in comparison to the dramatic declines in 2009. At the current pace of same-store sales growth in the casual and fine dining segments it will still take several years for those segments to get back to pre-recession levels. Most importantly, aside from traffic, the biggest issue in the industry will be margin compression.

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

For more information, please contact:

Kevin Burke, Managing Director
310-231-3100
kburke@trinitycapitalllc.com
or
Visit us at:
www.trinitycapitalllc.com

Same-Store Sales ("SSS") Data

	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11
Fine Dining:								
Fleming's	-18.0%	-5.7%	5.2%	9.0%	7.3%	18.4%	11.4%	9.9%
McCormick & Schmick's	-18.8%	-12.9%	-9.6%	-4.0%	-4.6%	-1.0%	-3.2%	-2.7%
Morton's Rest. Group	-16.8%	-5.3%	3.6%	7.1%	3.2%	5.3%	7.5%	8.2%
Ruth's Chris	-24.0%	-11.2%	-0.5%	2.9%	4.9%	9.2%	5.2%	5.8%
Mean	**-19.4%**	**-8.8%**	**-0.3%**	**3.8%**	**2.7%**	**8.0%**	**5.2%**	**5.3%**
Casual Dining:								
Applebee's	-6.5%	-4.5%	-2.7%	-1.6%	3.3%	2.9%	3.9%	3.1%
Benihana	-9.9%	-3.4%	1.4%	2.4%	4.7%	4.4%	5.6%	6.0%
BJ's Resturants	-1.6%	-0.2%	4.4%	5.3%	6.7%	5.9%	7.8%	6.9%
Bonefish	-5.8%	1.0%	3.6%	5.7%	7.8%	9.3%	9.6%	10.2%
Buffalo Wild Wings	1.5%	2.2%	0.5%	-0.5%	1.1%	-0.8%	2.4%	3.9%
Carrabba's Italian Grill	-7.5%	-3.6%	1.1%	3.5%	4.9%	5.4%	3.9%	4.8%
CEC Entertainment	-3.1%	-2.0%	0.7%	-2.2%	3.8%	3.9%	1.1%	-2.0%
Cheesecake Factory	-2.4%	-0.7%	2.7%	1.6%	2.9%	1.0%	2.1%	2.3%
Chili's Grill & Bar	-6.0%	-3.2%	-5.0%	-4.1%	-5.0%	-4.9%	-3.0%	2.1%
Dave & Buster's	-7.4%	-5.8%	-2.5%	-4.8%	-1.3%	1.2%	6.0%	-
Famous Dave's	-6.8%	-3.4%	-3.5%	0.6%	0.7%	-0.8%	-0.1%	-1.4%
Frisch's Golden Corral [1]	-2.4%	-3.6%	-6.4%	0.7%	4.4%	1.4%	2.0%	-
Granite City	-12.7%	-8.1%	2.1%	5.3%	4.0%	3.6%	3.8%	3.5%
LongHorn Steakhouse	-7.0%	-0.8%	1.9%	1.8%	6.8%	4.5%	6.1%	6.0%
Maggiano's	-6.6%	-1.6%	1.9%	1.3%	1.4%	4.7%	3.4%	5.7%
O'Charley's	-7.6%	-7.3%	-6.7%	-7.9%	-2.2%	-1.4%	0.4%	2.9%
Olive Garden	-2.9%	-1.4%	1.5%	-1.5%	2.0%	2.0%	0.0%	0.0%
Outback	-10.7%	-5.9%	-2.9%	3.6%	3.0%	2.5%	4.3%	1.8%
PF Chang's Bistro	-8.5%	-5.2%	-2.7%	0.1%	2.3%	1.3%	0.5%	-2.5%
Real Mex	-	-	4.3%	-2.2%	-2.4%	0.1%	-1.6%	-0.2%
Red Lobster	-7.9%	-8.4%	0.9%	-4.6%	-1.6%	-1.6%	0.1%	3.8%
Red Robin	-14.8%	-10.9%	-2.3%	-1.4%	1.7%	1.6%	2.1%	2.9%
Ruby Tuesday	-3.1%	-1.7%	-0.7%	0.3%	1.2%	4.2%	-1.2%	-0.1%
Stoney River	-17.1%	-10.3%	-8.3%	-0.7%	1.7%	3.7%	8.4%	6.3%
Taco Cabana	-4.3%	-4.5%	-2.0%	-0.1%	1.0%	2.3%	2.0%	4.5%
Texas Roadhouse	-4.4%	-2.3%	0.5%	1.5%	4.3%	3.1%	4.5%	4.3%
Mean	**-6.6%**	**-3.8%**	**-0.7%**	**0.1%**	**2.2%**	**2.3%**	**2.9%**	**3.1%**
Family Dining:								
Bob Evans	-2.8%	-4.2%	-4.1%	-3.5%	-0.9%	-0.5%	1.2%	-1.8%
Cracker Barrel	0.6%	-0.2%	0.6%	2.0%	2.4%	0.3%	-0.3%	-
Denny's	-7.2%	-7.0%	-6.2%	-5.9%	-1.1%	-1.4%	-1.7%	2.0%
Frisch's Big Boy	-0.1%	-0.4%	-3.4%	-2.7%	-0.8%	-1.1%	-0.6%	-
IHOP	-1.1%	-3.1%	-0.4%	-1.0%	0.1%	1.1%	-2.7%	-2.9%
Luby's	-13.3%	-12.5%	-4.8%	-0.5%	5.5%	2.7%	3.5%	-
Ninety Nine	-7.1%	-6.5%	-6.0%	-0.5%	1.2%	1.3%	3.1%	3.3%
Mean	**-4.4%**	**-4.8%**	**-3.5%**	**-1.7%**	**0.9%**	**0.3%**	**0.4%**	**0.2%**

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

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

SSS Data (Con't)

	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11
Fast Casual:								
Chipotle	2.7%	2.0%	1.3%	8.7%	11.4%	12.6%	12.4%	10.0%
Cosi	-10.7%	-11.9%	-3.4%	3.1%	5.2%	4.5%	1.7%	-0.2%
Einstein Noah Bagel	-3.1%	-1.4%	0.1%	-1.1%	0.7%	1.6%	-0.4%	0.2%
Panera Bread	2.8%	5.4%	9.5%	9.9%	6.9%	5.8%	3.3%	3.9%
Pei Wei	-0.7%	3.0%	2.2%	3.0%	0.8%	1.3%	-0.2%	-2.7%
Qdoba Mexican Grill	-3.1%	-1.7%	3.1%	4.6%	5.6%	6.4%	6.0%	5.1%
Steak n Shake	10.1%	14.4%	5.1%	7.5%	3.0%	2.1%	4.3%	4.9%
Tim Horton's (US)	4.3%	2.1%	3.0%	3.1%	3.3%	6.3%	4.9%	6.4%
Mean	**0.3%**	**1.5%**	**2.6%**	**4.9%**	**4.6%**	**5.1%**	**4.0%**	**3.5%**
QSR:								
Chicken:								
El Pollo Loco	-10.1%	-10.0%	-6.7%	-4.9%	-2.2%	-3.4%	-2.4%	-
KFC	-2.0%	-8.0%	-4.0%	-7.0%	-8.0%	1.0%	1.0%	-5.0%
Pollo Tropical	-0.1%	0.3%	3.7%	6.3%	8.8%	10.7%	13.5%	10.7%
Popeyes	-0.3%	-1.0%	-0.4%	0.4%	5.3%	6.2%	3.9%	0.5%
Mean	**-3.1%**	**-4.7%**	**-1.9%**	**-1.3%**	**1.0%**	**3.6%**	**4.0%**	**2.1%**
Coffee/Snack:								
Caribou Coffee	-0.5%	0.2%	5.2%	4.8%	4.4%	3.5%	4.3%	4.6%
Dunkin Donuts [2]	-	-	-0.6%	1.9%	2.7%	4.7%	2.8%	3.2%
Jamba Juice	-5.3%	-5.3%	-3.3%	-2.4%	-2.7%	0.2%	2.2%	4.3%
Krispy Kreme	5.1%	1.1%	3.4%	5.7%	5.0%	1.1%	7.0%	2.5%
Starbucks	-1.0%	4.0%	7.0%	9.0%	8.0%	8.0%	7.0%	8.0%
Mean	**-0.4%**	**0.0%**	**2.3%**	**3.8%**	**3.5%**	**3.5%**	**4.7%**	**4.5%**
Mexican:								
Taco Bell	-2.0%	-5.0%	-2.0%	1.0%	3.0%	4.0%	0.0%	-5.0%
Mean	**-2.0%**	**-5.0%**	**-2.0%**	**1.0%**	**3.0%**	**4.0%**	**0.0%**	**-5.0%**
Pizza:								
Domino's	0.0%	1.4%	14.3%	8.8%	11.7%	6.3%	-1.4%	4.8%
Papa John's	0.0%	-0.5%	-0.4%	0.4%	-0.6%	0.7%	6.1%	0.4%
Pizza Hut	-13.0%	-12.0%	5.0%	8.0%	8.0%	10.0%	-3.0%	-2.0%
Mean	**-4.3%**	**-3.7%**	**6.3%**	**5.7%**	**6.4%**	**5.7%**	**0.6%**	**1.1%**
Sandwich:								
Burger King	-4.6%	-3.3%	-6.1%	-1.5%	-4.2%	-5.8%	-6.0%	-5.3%
Carl's Jr.	-6.1%	-5.2%	-8.7%	-6.4%	-7.4%	-5.0%	-0.4%	1.1%
Hardee's	-2.7%	-1.8%	-2.5%	-1.8%	6.8%	8.3%	5.7%	6.9%
Jack in the Box	-6.0%	-11.1%	-8.6%	-9.4%	-4.0%	1.5%	0.8%	4.7%
McDonald's	2.5%	0.1%	1.5%	3.7%	5.3%	4.4%	2.9%	4.5%
Sonic Drive-In	-4.5%	-6.5%	-13.2%	-6.0%	-6.4%	-2.4%	1.2%	3.9%
Wendy's	-0.1%	-3.0%	0.8%	-1.7%	-1.7%	0.2%	0.0%	2.3%
Mean	**-3.1%**	**-4.4%**	**-5.3%**	**-3.3%**	**-1.7%**	**0.2%**	**0.6%**	**2.6%**
Mean Total QSR	**-2.7%**	**-3.5%**	**-0.8%**	**0.4%**	**1.6%**	**2.7%**	**2.3%**	**2.4%**

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

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

What to expect for 2012

The past two years in the restaurant industry have been marked by more change than perhaps the previous 20 years. Many restaurant operators complained to us about the halcyon days in the 90s and early 2000's when financing was easy, sales growth was a given and margins were larger. However, the economy has been consistently soft since the summer of 2008. Many state local and federal governments are experiencing unprecedented budget deficit challenges. Unemployment stubbornly remains at levels which undermine restaurant traffic and consumer sentiment today is at the lowest level in decades. Fortunately, traffic has firmed up for some concepts during the past several months.

We believe the economy will continue to challenge consumers in 2012 for a number of reasons. Europe is a mess because its banking system is loaded with bad loans and the ratio of workers to pensioners is unsustainable and if unchecked will lead to insolvency. The United States Federal Reserve Board cannot fix Europe. More importantly, we have not been able to fix our own problems here in the United States especially with continued challenges in housing prices, commercial real estate, regional banks and unemployment. Our government's answer to all of these problems is the same: spend more money we don't have. The recent plan to submit a jobs bill pushing us further into the red ink of unsustainable debt may lead to unsettling consequences in the credit markets. This, of course, could impact consumer sentiment which may, in turn, hurt restaurant traffic. It seems there are no easy answers to our nation's financial mess.

One thing restaurant operators can do to weather the storm is to become as efficient as possible in key areas where restaurant operators have traditionally been able to exercise dominion: food cost, labor, G&A (overhead) and occupancy. Over the years, we have helped hundreds of restaurant operators reduce these costs even in times of unprecedented difficulty. This can be done and generally produces a surprising amount of incremental savings. Another area which clearly impacts the bottom line is quality, service and cleanliness ("QSC"). Customers are attracted to friendliness, timeliness and cleanliness. Making inroads to the customers of your key competitors depends largely on executing within the four walls of the restaurant. The other aspect that will lead to a brand's success includes products, pricing, promotion and curb appeal. Concepts that continue to make progress in retaining existing customers and winning new ones will be the ones that survive and eventually flourish.

Another key aspect that restaurant operators must pay close attention to is that of their capital structure. Many restaurant operators have variable-rate debt, loans or mortgages whose interest rate varies each month with respect to an index (which is normally LIBOR -the London Inter-Bank Offer Rate). We believe that there is a possibility the disturbance in the credit markets could push interest rates higher thus affecting LIBOR-based restaurant operator debt. One possible solution to this is to examine the possibility of obtaining interest rate swaps or caps to freeze your interest rate expense in the face of uncertainty. Any restaurant operator with significant portions of variable-rate debt should explore this opportunity. There are trade-offs in this endeavor, but nonetheless it is important to explore this as a risk mitigation tool.

Finally, we believe that the segments that offer lower cost alternatives should be the beneficiary of significant trading down in 2012 because of pressure on family budgets. This should inure to the benefit of QSR, fast casual and family dining concepts. Brands should exploit this opportunity to embrace trading down through local media initiatives, as well as, previously mentioned intensification of QSC. Remember, it's value, not price, that generates traffic under so-called value initiatives. Value means good experience as much as it means quantity and QSC. In the end, scrutiny of your P&L's and excellent execution are the best buffer for any potential softness in the economy. Don't assume any line item on your P&L is immune from being a contribution to preserving or increasing margins.

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

Looking Down: Analyzing the Impact of Negative Trends in the Restaurant Industry

(originally authored for the August 2011 issue of *Franchise Times*)

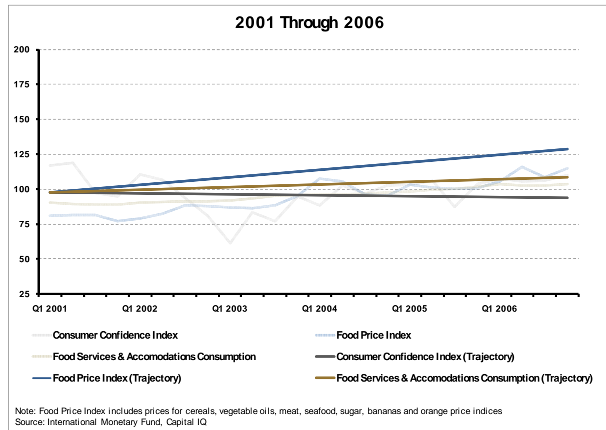
Most restaurants today are suffering a margin squeeze due to higher costs and decreased consumer spending. Understanding how increasing cost pressures impact the operating leverage in the industry unveils a changing risk reward paradigm that business owners and investors should understand.

Food costs vary from year to year, but the trajectory is clear. Costs are higher today than they were 5 years ago, and in 5 years costs will likely be higher than today. [1] Comparing this trend to the away-from-home food consumption index and the consumer confidence index offers insight into the future. In the context of rising food costs and decreasing customer spending, operators can predict continued margin deterioration. If these trends persist into the future, maniacal oversight and refinement of the P&L will not be enough. Innovation, customer service and consumer perception of value-add

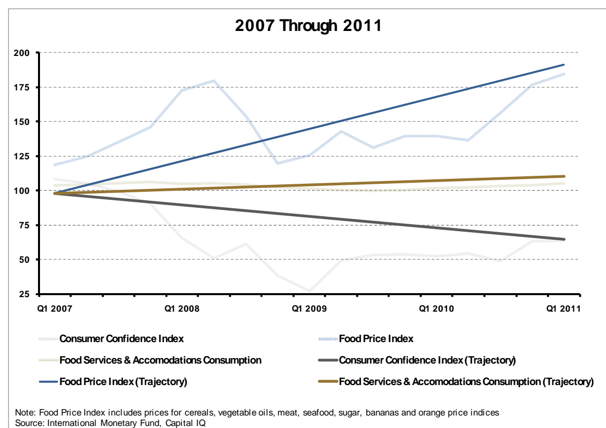
[1] See June, 2011 USDA report, "Why Have Food Commodity Prices Risen Again?", predicting short term commodity pricing relief from today's highs, but a 10 year forecast of continued historically high pricing.

products is the only formula that will allow long term success in the restaurant industry.

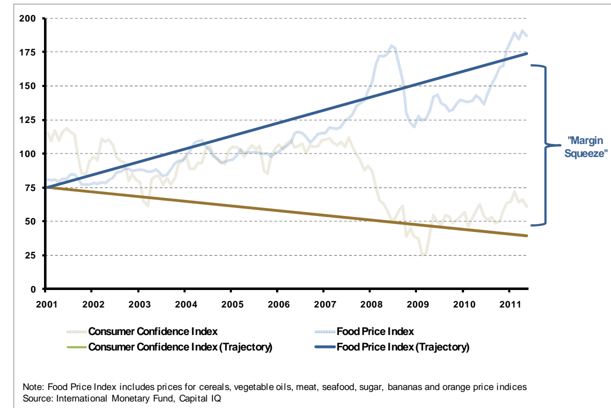
From 2001 to 2006, or as we like to say, "the good old days", consumer confidence remained rather flat but robust, with manageable upward pressure on costs. Restaurant strategy for maintaining or growing margins in these days largely relied on driving more traffic with products and services for which customers would tolerate *marginal* price increases.



In the last 5 years however, we've experienced a dramatic divergence in food costs and confidence. Consumption [2] *(the middle line) is a reflection of restaurateurs' ability to pass along rising costs to customers.* In this graph, the downward pressure on confidence prohibits away-from-home food and beverage spending from keeping pace with food costs at retail. (Important to note, this divergence from the tighter band of the previous 5 years began a solid year before the 2008 economic collapse).



This widening gap between food costs and confidence drives the margin squeeze facing restaurateurs. As a result of the last several years of cost escalations, restaurant profitability has become so fragile that small changes to the cost structure can have devastating effects on the cash flow and value of the business. The trend lines are clear, and restaurants operators must consider these changes as they grow, borrow or sell assets in future years. Analyzing direct operating leverage provides a platform to understand the requirements of future profitability.



Direct Operating Leverage, or Business "Flow-Through"

Direct operating leverage, or business "flow-through," is the degree that businesses leverage rent, debt service, G&A, fixed labor, utilities, insurance and other fixed costs amidst changes in sales and variable costs; a simple measure is comparable period change in cash flow or EBITDA as a percentage of the change in same period Sales. If sales increased from $1,000,000 in 2009 to $1,010,000 2010, resulting in increasing EBITDA from $100,000 to $103,000, the 2009/10 flow-through is measured comparing the relationship between a $10,000 change in sales and a $3,000 change in EBITDA for a flow-through of 30%.

Simple Flow Through Calculation

	2009	2010	*Delta*
Revenues	1,000,000	1,010,000	***10,000***
EBITDA	100,000	103,000	***3,000***
Flow Through			***30.0%***

For years, the industry has been in a growth mode, which has meant that the most efficient operators have been measured on their ability to increase that flow-through percentage. Today, however, many of those same operators, without the ability to attract incremental traffic or price up, are working to minimize the flow-through effects of negative comp store sales. This effect is intensified when the P&L is burdened with the increasing food and variable costs we realistically face in the future.

[2] Consumption is represented by the Food Services & Accommodations Consumption Index

Understanding Your Business's Flow-Through in the Changing Environment

The following scenarios offer a glimpse into the frail nature of restaurant cash flow when faced with rising cost structures. Let's assume a typical QSR business will suffer a 2% margin loss related to variable costs over some period of time. These comparisons demonstrate the impact on a business in both positive and negative sales scenarios, assuming the entire 2% is isolated to a spike in COGS.

Increasing Sales: Flow Through Comparison			
	Base Case	Stable Costs	+2% Costs
Sales	**1,000,000**	**1,100,000**	**1,100,000**
COGS	320,000	352,000	374,000
Fixed Labor	150,000	150,000	150,000
Variable Labor	150,000	165,000	165,000
Occupancy	85,000	85,000	85,000
Royalties/Advertising	90,000	99,000	99,000
Other Operating	50,000	50,000	50,000
Operating Profit	**155,000**	**199,000**	**177,000**
G&A	50,000	50,000	50,000
EBITDA	**105,000**	**149,000**	**127,000**
Debt Service	40,000	40,000	40,000
Free Cash Flow	65,000	109,000	87,000
EBITDA Flow Through		***44%***	***22%***

Increasing Sales - Growth Flow-Through: Note that in a 10% growth scenario, a slight increase in the cost of sales nearly cut in half the percentage flow-through to the bottom line. With higher costs, fewer dollars flow into EBITDA. While the impact is dramatic, there's nothing shocking there. However, this exercise gets interesting when applying the same cost increase to a contraction period.

Declining Sales: Flow Through Comparison			
	Base Case	Stable Costs	+2% Costs
Sales	**1,000,000**	**900,000**	**900,000**
COGS	320,000	288,000	306,000
Fixed Labor	150,000	150,000	150,000
Variable Labor	150,000	135,000	135,000
Occupancy	85,000	85,000	85,000
Royalties/Advertising	90,000	81,000	81,000
Other Operating	50,000	50,000	50,000
Operating Profit	**155,000**	**111,000**	**93,000**
G&A	50,000	50,000	50,000
EBITDA	**105,000**	**61,000**	**43,000**
Debt Service	40,000	40,000	40,000
Free Cash Flow	65,000	21,000	3,000
EBITDA Flow Through		***44%***	***62%***

Declining Sales - Negative Flow-Through: In this comparison, as long as variable costs are maintained, the same 44% of the change in sales will be the impact to EBITDA. However, the impact of increasing COGS in a year of sales contraction is violent. When cost increase and revenue declines simultaneously, operating leverage unwinds and things get bad fast – very fast.

That 2% gross margin deterioration, combined with a 10% decrease in sales, caused the business to lose approximately 60% of the EBITDA that it previously produced . . .

Comparing the impact to the bottom line of the example above, a gross margin deterioration of just 2% slows cash flow recovery from sales growth from 44% to the bottom line to 22%. Now apply that analysis to the contraction scenario, and the destructive impact of sales declines go from 42% to 62% against the pool of cash flow that you would use for example, to service debt or remodel.

From a leverage perspective (let's assume there's $400,000 of debt), this business just went from under 4x leveraged, to nearly 10x . . . or as the bankruptcy judges say, from healthy to insolvent. Obviously sales decreases of 10% and cost increases of 2% don't happen overnight, but they can happen quickly, and operators need to prepare for the impact.

Many believe that the macro global demographic trends allow no future reprieve to the cost trends we are suffering today. The only solution, therefore, is adaptation. The restaurant industry will have to lean to innovation: innovation at the product and service offering level and innovation at the expense rationalization level.

Operators in brands with conventional or commoditized burgers, steaks, pizza or sandwiches must become maniacal cost cutters. They must reset the expectations of their partners and employees: district/regional managers can no longer expect to have offices (they have to work from their car now), and landlords can no longer expect long term tenants with the ability to pay rents at the levels they have grown accustom. Cost cutting, however, can only go so far before the customer experience is destroyed. Therefore, up and coming restaurants must define themselves with products and services innovative enough to allow price to compensate for increasing costs.

Contributing Editor Chad J Spaulding is a Managing Director for Trinity Capital.