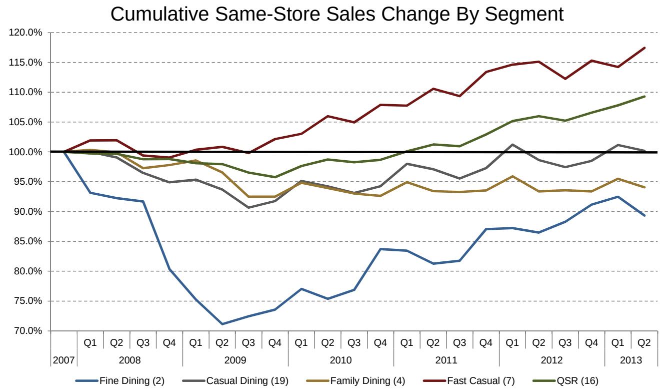
TRINITY CAPITAL
INVESTMENT BANKING

2nd Quarter 2013 Restaurant Industry Commentary

What's Inside This Commentary	



Same-Store Sales Discussion and Analysis

The second quarter of 2013 maintained the positive momentum in same-store sales, which is impressive as we continue to comp over positive results from the prior two years. The restaurant industry reported its thirteenth consecutive quarter of same store sales gains. It should be noted however, that traffic has slowed or declined within many prominent chains so the gains can be attributed to price increases opposed to increased customer visits.

In fine dining, the companies we track were up from 2012 by an average of 3.3% for the second quarter of 2013. It is important to note that fine dining sales still 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 early 2010. Nonetheless, these gains represent real momentum given the last two years' positive results.

In casual dining, the concepts we follow were up by an average of 1.6% for the second quarter of 2013. This is the twelfth out of the last thirteen quarters that the casual dining segment has posted positive quarterly same-store sales growth. However, according to Knapp Track, casual dining guest counts were down by 0.5% in April, down by 0.8% in May and up by 3.1% in June. In fact Knapp Track has reported negative guest counts in 19 of the last 23 months. We expect to start seeing more positive guest count numbers in the coming months as the segment comps over two plus years of negative numbers. The family dining concepts we track reported an average increase in same-store sales of 0.7% during the second quarter of 2013.

The fast casual segment rebounded with another positive quarter after reporting negative same-store sales performance for the first quarter of 2013 since the second quarter of 2009. The segment was up by 2.0% for the second quarter of 2013. The fast casual segment continues to produce positive same-store sales results despite comping over nearly four years of strong growth.

In the QSR segment, 14 of the 16 concepts we track were positive during the second quarter of 2013 while the segment was up by an average of 3.1%. The Coffee/Snack segment had another strong showing in the second quarter, up by an average of 6.2% with Krispy Kreme continuing to lead the way, up 10.0% followed by Starbucks, up 9.0%.

There is some good news related to food costs. The rise in food costs seems to have eased as the nation emerged out of severe drought in the Midwest last year. As suggested by the U.S. Department of Agriculture (USDA) report, price inflation for all food is expected at 1.5-2.5% in 2013 down from estimates of 2.5-3.5%. Commodities like fish and seafood, dairy products, fats and oils, sugar sweets, non-alcoholic beverages, cereals and bakery products and other foods will likely witness a decline in prices. Although USDA expects poultry costs to increase in 2013, feed prices will likely cool off with a favorable weather in the new harvest season, leading to lower poultry prices in 2014. Therefore there may be some bottom line improvement in the coming months for restaurant operators which will be welcome relief as traffic continues to be stagnant.

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

Same-Store Sales ("SSS") Data

	FY 2011				FY 2012				FY 2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Fine Dining										
Fleming's	11.4%	9.9%	10.1%	0.3%	5.4%	6.8%	10.1%	4.0%	5.4%	2.0%
Ruth's Chris	5.2%	5.8%	2.6%	7.7%	3.7%	6.0%	5.9%	5.4%	6.6%	4.6%
Mean	8.3%	7.9%	6.4%	4.0%	4.6%	6.4%	8.0%	4.7%	6.0%	3.3%
Casual Dining										
Applebee's	3.9%	3.1%	-0.3%	1.0%	1.2%	0.4%	2.0%	0.9%	-1.3%	1.3%
Benihana	5.6%	6.0%	6.4%	7.0%	4.8%	4.5%	-	-	-	-
BJ's Restaurants	7.8%	6.9%	6.5%	5.1%	3.3%	4.4%	2.3%	3.0%	-0.4%	0.0%
Bonefish	9.6%	10.2%	7.4%	5.9%	6.2%	2.1%	3.5%	1.0%	0.5%	0.2%
Buffalo Wild Wings	2.4%	3.9%	4.8%	7.1%	8.1%	5.4%	6.0%	6.7%	1.9%	4.0%
Carrabba's Italian Grill	3.9%	4.8%	6.3%	3.5%	4.3%	1.5%	1.0%	-0.4%	-1.7%	0.3%
CEC Entertainment	1.1%	-2.0%	-6.3%	-3.6%	-4.2%	-2.4%	-2.3%	-2.9%	1.6%	2.9%
Cheesecake Factory	2.1%	2.3%	0.8%	2.7%	2.6%	2.1%	2.9%	1.3%	1.6%	0.9%
Chili's Grill & Bar	-3.0%	2.1%	1.7%	1.4%	4.6%	2.2%	2.8%	1.0%	-1.1%	-0.6%
Dave & Buster's	5.3%	1.9%	2.7%	-0.9%	-0.3%	5.4%	5.4%	3.7%	1.8%	-0.9%
Famous Dave's	3.0%	-1.2%	-0.1%	3.6%	-1.6%	-0.6%	0.2%	-6.0%	-1.8%	3.8%
Frisch's Golden Corral	-0.9%	-3.6%	-4.9%	7.8%	12.4%	-	-	-	-	-
Granite City	3.8%	3.5%	3.0%	4.0%	1.9%	1.5%	2.5%	4.5%	2.7%	2.5%
LongHorn Steakhouse	6.1%	6.0%	4.8%	6.7%	3.8%	3.0%	2.2%	-0.8%	-1.6%	3.5%
Maggiano's	3.4%	5.7%	3.5%	2.8%	3.9%	1.9%	0.9%	0.6%	0.4%	0.2%
Olive Garden	0.0%	0.0%	-2.9%	-2.5%	2.0%	-1.8%	0.3%	-3.2%	-4.1%	1.1%
Outback	4.3%	1.8%	6.0%	3.6%	5.3%	2.3%	4.5%	5.3%	2.5%	2.8%
Red Lobster	0.1%	3.8%	10.7%	6.8%	6.0%	-3.9%	-2.6%	-2.7%	-6.6%	3.2%
Red Robin	2.1%	2.9%	2.1%	4.5%	1.0%	1.2%	0.6%	1.4%	1.4%	3.6%
Ruby Tuesday	-1.2%	-0.1%	-4.1%	-4.2%	-5.0%	-4.6%	1.9%	0.3%	-2.8%	-3.1%
Taco Cabana	2.0%	4.5%	5.3%	2.7%	6.1%	4.5%	1.8%	6.8%	2.0%	1.1%
Texas Roadhouse	4.5%	4.3%	3.9%	5.6%	6.2%	4.6%	3.9%	4.5%	3.7%	4.7%
Mean	3.0%	3.0%	2.6%	3.2%	3.3%	1.6%	2.0%	1.3%	-0.1%	1.6%
Family Dining										
Bob Evans	1.2%	-1.8%	-1.5%	1.6%	-0.6%	1.0%	1.0%	1.6%	0.0%	-0.6%
Denny's	-1.7%	2.0%	0.9%	1.6%	2.4%	0.8%	0.4%	1.7%	-0.7%	0.6%
Frisch's Big Boy	0.2%	0.5%	0.0%	0.4%	1.7%	-1.7%	-0.2%	-1.7%	-0.9%	1.0%
IHOP	-2.7%	-2.9%	-1.5%	-1.0%	-0.5%	-1.4%	-2.0%	-2.6%	-0.5%	1.9%
Luby's	3.5%	-0.6%	3.5%	2.2%	2.2%	1.1%	2.4%	0.2%	-0.1%	-
Mean	0.1%	-0.6%	0.3%	1.0%	1.0%	0.0%	0.3%	-0.2%	-0.4%	0.7%

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

SSS Data (Cont'd)

	FY 2011				FY 2012				FY 2013	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Fast Casual										
Chipotle	12.4%	10.0%	11.3%	11.1%	12.7%	10.2%	4.8%	3.8%	1.0%	5.5%
Cosi	1.7%	-0.2%	-3.0%	2.6%	7.5%	-0.5%	-0.7%	-3.9%	-4.5%	-2.7%
Einstein Noah Bagel	-0.4%	0.2%	0.7%	1.2%	1.1%	1.3%	0.2%	1.4%	-0.6%	0.7%
Panera Bread	3.3%	3.9%	4.4%	4.4%	6.3%	5.9%	5.8%	4.9%	3.3%	3.7%
Qdoba Mexican Grill	6.0%	5.1%	4.3%	3.8%	3.0%	2.1%	3.3%	1.0%	-1.5%	1.3%
Steak n Shake	4.3%	4.9%	5.3%	5.5%	5.5%	4.8%	2.9%	1.3%	0.3%	4.2%
Tim Horton's (US)	4.9%	6.4%	6.3%	7.2%	8.5%	4.9%	2.3%	3.2%	-0.5%	1.4%
Mean	4.6%	4.3%	4.2%	5.1%	6.4%	4.1%	2.7%	1.7%	-0.4%	2.0%
QSR										
Chicken										
KFC	1.0%	-5.0%	-3.0%	-1.0%	2.0%	1.0%	4.0%	4.0%	4.5%	3.0%
Pollo Tropical	13.5%	10.7%	7.9%	7.8%	9.4%	7.8%	7.0%	8.3%	3.8%	6.4%
Popeye's	3.9%	0.5%	1.7%	5.9%	8.1%	8.4%	6.8%	6.4%	0.5%	4.3%
Mean	6.1%	2.1%	2.2%	4.2%	6.5%	5.7%	5.9%	6.2%	2.9%	4.6%
Coffee/Snack										
Caribou Coffee	4.3%	4.6%	4.1%	5.6%	2.5%	2.8%	3.5%	-	-	-
Dunkin Donuts	2.8%	3.2%	6.0%	7.4%	7.2%	4.0%	4.0%	3.2%	1.7%	4.0%
Jamba Juice	2.2%	4.3%	3.3%	7.7%	12.7%	5.7%	2.5%	0.6%	1.3%	1.7%
Krispy Kreme	7.0%	2.5%	4.0%	8.3%	2.1%	5.4%	6.8%	7.5%	11.4%	10.0%
Starbucks	7.0%	8.0%	10.0%	9.0%	8.0%	7.0%	7.0%	7.0%	7.0%	9.0%
Mean	4.7%	4.5%	5.5%	7.6%	6.5%	5.0%	4.8%	4.6%	5.4%	6.2%
Mexican										
Taco Bell	0.0%	-5.0%	-2.0%	-2.0%	6.0%	13.0%	7.0%	5.0%	6.0%	2.0%
Mean	0.0%	-5.0%	-2.0%	-2.0%	6.0%	13.0%	7.0%	5.0%	6.0%	2.0%
Pizza										
Domino's	-1.4%	4.8%	3.0%	6.8%	2.0%	1.7%	3.3%	4.7%	6.2%	6.7%
Papa John's	6.1%	0.4%	5.3%	1.7%	1.1%	5.7%	2.5%	5.2%	1.6%	3.4%
Pizza Hut	-3.0%	-2.0%	-3.0%	6.0%	5.0%	4.0%	6.0%	-1.0%	-1.0%	-2.0%
Mean	0.6%	1.1%	1.8%	4.8%	2.7%	3.8%	3.9%	3.0%	2.3%	2.7%
Sandwich										
Burger King	-6.0%	-5.3%	-0.3%	-2.0%	4.2%	4.4%	1.6%	3.7%	-3.0%	-0.5%
Carl's Jr.	-0.4%	2.1%	2.0%	2.0%	1.7%	2.6%	5.5%	2.6%	2.9%	-
Hardee's	5.7%	9.6%	2.5%	1.8%	6.1%	2.6%	3.6%	2.3%	1.1%	-
Jack in the Box	0.8%	4.7%	5.8%	5.3%	5.6%	3.4%	3.1%	1.9%	0.1%	0.1%
McDonald's	2.9%	4.5%	4.4%	7.1%	8.9%	3.6%	1.2%	0.3%	-1.2%	1.0%
Sonic Drive-In	1.2%	3.9%	-0.5%	0.1%	3.5%	2.8%	2.3%	3.0%	1.3%	0.1%
Wendy's	0.0%	2.3%	0.9%	4.4%	0.7%	3.2%	2.8%	-0.5%	0.7%	0.3%
Mean	0.6%	3.1%	2.1%	2.7%	4.4%	3.2%	2.9%	1.9%	0.3%	0.2%
Mean Total QSR	2.5%	2.6%	2.7%	4.3%	5.1%	4.7%	4.2%	3.6%	2.5%	3.1%

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

Capital Improvements and Reimaging to Remain Competitive: Franchisor versus Franchisee Perspectives

The Great Recession of 2008 unmasked an age-old problem at many of the nation's largest and most mature restaurant brands, which is the need to continuously reinvest in the image and operations of restaurants in order to remain competitive. Numerous new concepts have been developed over the last several years and regardless of whether they are better or worse than their existing competitors, their facilities are newer and more appealing to customers. While the need for reinvestment is generally accepted by both the franchisors and franchisees within these mature brands, reaching a consensus on a plan that will balance the priorities and responsibilities of the respective groups remains a challenge. As in any critical franchisee-franchisor debate, there are frequently two sides of the story with respect to marketing, operational and financial disciplines.

During the 1990s, thousands of corporate locations were sold to franchisees by the nation's leading restaurant concepts. This trend continued into the next decade and resulted in a paradigm shift in the "collective brand balance sheet". By and large, franchisees became highly levered in order to fund the acquisitions of these corporate restaurants and subsequently faced high debt service obligations. That was exacerbated by the fact that franchisees do not have the same scale and resources as the franchisor. As a result, the collective curb appeal began to tire at a significant portion of the restaurants in these mature brands.

A steady drumbeat of new concept emergence has raised the bar for customer standards of restaurant marketing, including national and local media, upgraded curb appeal, better menu boards and interior remodeling. While a new concept might not be any better than the more established brands, they do have new stores with a fresh look and customers have taken notice. Moreover, many of the mature brands have failed to keep pace over the last 10 years with operational improvements in technology and kitchen equipment, including POS and accounting software, drive-through systems, management software, new cooking equipment, warming bins and novel devices like the Coca-Cola freestyle machine.

The lesson appears to be quite clear to everyone; reinvesting in restaurant image and operations can help drive sales, facilitate new product development and create efficiencies that enhance cash flow. These positive outcomes would be welcomed by both the franchisors and franchisees, so what is the problem? In short, there are conflicting perspectives and priorities between the two groups.

Franchisors live off of the top line by charging franchisees royalties as a percent of sales. Improving curb appeal is always a recipe to generate incremental sales and is a default position for franchisor executives, who are accountable for royalties. For example, if a franchisor mandated all franchisees to build new state-of-the-art restaurants and offer steeply discounted menu options, sales and royalty revenue would soar.

On the other hand, franchisees live off of the bottom line and the free cash flow that they take home. The above example would be devastating to franchisees as they would be responsible for providing the reinvestment capital and would realize very little profit even with a large boost in sales. If a franchisee does not realize an appropriate return on investment, they will not be able to attract funding for any additional investments. Currently, there are many franchisees in mature brands that are generating a slim profit and are already highly levered, so they have little, if any, capacity to invest more capital.

The relationship between franchisors and franchisees is united when both parties get what they want, sales AND profit, but the relationship can become quite polarizing and destructive to everyone involved when there is an imbalance in those objectives. Sophisticated concepts recognize this and are very responsive to the governing issues. Solving these issues involves a balancing act between the operational, marketing and financial disciplines of a given concept. Franchise systems that are working well generally have an unspoken division of responsibility in that the franchisor manages products, promotion and pricing and the franchisee focuses on quality, service and cleanliness. Responsibility for reimaging or new building falls somewhere in between, thereby, requiring collaboration. While this is somewhat of an oversimplification, it is nonetheless a psychological default position for many industry participants.

In trying to balance the allocation of resources between the three disciplines of marketing, operations and finance it is imperative to have a good yardstick for each of these vital functions. Financial results are perhaps the easiest metric to understand, provided there is uniformity and consistency of data collection and accurate reporting. The golden rule with capital is that there needs to be market-based returns on equity and debt capital in order to sustain the business and attract additional capital when required. Operational results involve both a subjective and an empirical dimension that need to be combined in order to produce a coefficient of operational strength that correctly summarizes a franchisee's operational impact within their system. Good operations feed both the financial and marketing disciplines! Finally, marketing composes the most challenging of these three disciplines because consumer psychology is so difficult to understand. The tremendous change in traditional media and the advent of social media have further complicated this function. Clearly, brands need to have good curb appeal, good products, good messaging and consistency in these respective categories in order to retain existing customers and attract new ones. Each of these three disciplines compete for resources and must be harmonized by both franchisor and franchisee leadership in a way that creates victories for their brand. This can only happen with "uber"-cooperation and fact-based discussions between franchisor and franchisees. Winning systems will find a way to make this happen!

The hard part is trying to determine when to financially reap and when to sow for a franchise system that has franchisees of different sizes, skill sets, ages, and geographies. Franchisees need to realize profits and this requires the reimaging investment to produce meaningful economic profits, not just sales. In order for franchisees to realize profits there has to be intelligent reimaging design that is both affordable and drives traffic. Franchisors that will concentrate solely on sales will not be successful in this new environment; they must generate profits for franchisees to continue to maintain growth and profitability.

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The Impracticality of $15/Hour Fast Food Crew Labor Pay

Recently, the Service Employees International Union ("SEIU") funded protests in as many as 60 cities outside nearly 1,000 leading quick-service restaurants ("QSR") petitioning for union representation and a wage of $15.00 per hour for crew workers. Several poorly researched articles appeared in newspapers around the country decrying the social injustice of the current minimum wage of $7.25 per hour at QSR establishments. If this wage increase were granted, it would lead to the closure of tens of thousands of restaurants and the loss of hundreds of thousands of jobs. This is a clear case of the age-old admonition, *be careful what you wish for.*

Fast food restaurants provide reasonably good products and extremely quick service times in prime retail locations. Although the products are generally not among the healthiest restaurant fares, the average price per person is typically about five dollars and the service time is approximately three minutes. There are plenty of departures from these numbers, but they suffice as a proxy for the industry. The three most important costs in this industry are food, labor and occupancy. Those three cost categories, more than anything, can financially make or break a QSR location.

The average annual revenue for a top 50 QSR concept is around $1 million for freestanding locations. Approximately 700 crew hours per week are required in order to generate this revenue. These establishments typically spend approximately 30% to 32% of their total revenue on labor and this generates pretax cash flow (EBITDA) of approximately 9% or $90,000. The $90,000 must be used to pay for, among other items, principal and interest on outstanding debt; federal, state and local taxes; store remodeling and maintenance. The after tax profit for most of these establishments is approximately 2.5% or $25,000 per store. Given that the vast majority of fast food establishments are owned by family business operators with five or less locations and taking into consideration the significant financial risk, effort and time required from these operators, there is already little, if any, room for additional cost.

Increasing the minimum wage from $7.25 per hour to $15.00 would add approximately $300,000 per year in crew wage expenses to the prototypical QSR establishment highlighted above. Obviously, with only $25,000 of profit on a $1.5 million asset, the industry does not have the capacity to absorb a 100% crew-level wage increase. As a nationally recognized expert in QSR P&L analysis, I can assure you that this unprecedented increase in employment cost would lead to the immediate closure of thousands of restaurants nationwide. The first table below represents a system average P&L statement for one of the leading concepts in the QSR segment.

Leading QSR Concept Average P&L

Sales	$ 1,200,000	100.0%
Cost of Goods Sold	384,000	32.0%
Gross Profit	$ 816,000	68.0%
Labor Expense	$ 396,000	33.0%
Other Operating Expenses	150,000	12.5%
Store-Level EBITDAR	$ 270,000	22.5%
Rent	$ 102,000	8.5%
G&A	60,000	5.0%
EBITDA	$ 108,000	9.0%

Wage Effect Analysis

	Wage ($)								
	$ 7.25	$ 8.25	$ 9.25	$ 10.25	$ 11.25	$ 12.25	$ 13.25	$ 14.25	$ 15.25
EBITDA ($)	$ 108,000	$ 72,120	$ 36,240	$ 360	$ (35,520)	$ (71,400)	$ (107,280)	$ (143,160)	$ (179,040)

	Wage ($)								
	$ 7.25	$ 8.25	$ 9.25	$ 10.25	$ 11.25	$ 12.25	$ 13.25	$ 14.25	$ 15.25
EBITDA (%)	9.0%	6.0%	3.0%	0.0%	-3.0%	-5.9%	-8.9%	-11.9%	-14.9%

	Wage ($)								
	$ 7.25	$ 8.25	$ 9.25	$ 10.25	$ 11.25	$ 12.25	$ 13.25	$ 14.25	$ 15.25
Labor (%)	33.0%	36.0%	39.0%	42.0%	45.0%	48.0%	50.9%	53.9%	56.9%

The second table clearly illustrates how, assuming all else is constant, this segment leading concept with above average profit margins would become unprofitable, even with substantially lower wages than the proposed $15.00 per hour.

Minimum wage jobs are entry level positions and are not for heads of households; they are for students, part-time workers and frequently for those in between employment, looking for a wage but not a career. The industry average length of employment of a QSR crew level employee is only 120 days. Thousands of college educations have been financially supplemented by part-time and summer QSR employment. In addition, hundreds of thousands of career minded workers got their first employment experience in a QSR establishment. Many executives in the fast food industry actually began working in restaurants and most of these chains provide advancement for ambitious, responsible and talented employees. Denuding the students and other entry-level workers of the training and experience of QSR entry-level crew employment would hurt the economy by lowering employment, shrinking the QSR industry and eliminating supplemental tuition and spending money for countless students nationwide.

At a time when the economy is not producing abundant meaningful job opportunities for high school and college graduates, it would be devastating to eliminate a significant portion of the employment base of the restaurant industry, which is the second largest employment pool in the nation after government.

Mark Wilson, a former deputy assistant secretary of the US Department of Labor, published a study last year determining that 49% of all minimum wage earners were 24 years of age or younger. This number is even higher in the QSR industry. The same study proved the popular notion that "minimum wage workers being poor adults (ages 25 and older) working full-time as head of household" is largely false. Instead, just 4.7% of minimum wage workers actually fit in this category according to US Department of Labor data. While no industry with insufficient wages can thrive over time in a democracy, it is recklessly destructive to undermine the leading source of student employment in order to add non market driven compensation to entry-level jobs.

Entry-level workers cannot expect a wage that will support a household. With any modicum of intelligence, aptitude and work ethic an employee can rise in the QSR ranks very quickly. For example, the median raise for full-time minimum wage workers in the second year is $0.90 per hour, which is a 12.4% increase. Those in the top 25% of the same data set earn a second year raise of $2.45 per hour, which is a 33.8% increase. This underscores the fact that the labor market pays for talent, punctuality, aptitude and work ethic.

Finally, a significant (from ≈ $7.50 to $15) increase in minimum wage would be one of the most inflationary events in the past 30 years. Modest menu price increases could potentially relieve a portion of this burden to capital providers, but an increase in crew-level wages of this magnitude would inevitably lead to meaningfully higher assistant, night and general manager salaries as well. Adequate compensation incentives are vital to most businesses that want to retain and reward deserving employees. This applies to minimum wage unskilled workers. Government or union mandated wages will prove as destructive to the QSR industry as they were to the US steel, automobile, television, and camera manufacturers of the 1970s.

In the end, a glacial minimum wage increase is not the best solution to providing social justice to entry-level employees in the QSR industry. We must recognize the cause-and-effect repercussions this would inevitably create in the overall industry; higher minimum wages would increase QSR restaurant expenses, drive already thin profit margins into negative territory and leave small business owners and operators with one of two choices: lay off employees or close the restaurant altogether. The resulting loss in employment opportunities and income would be materially counterproductive to an economic recovery that continues to face many challenges.

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