Trinity Capital

3rd Quarter 2011 Restaurant Industry Commentary

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Same-Store Sales Discussion and Analysis

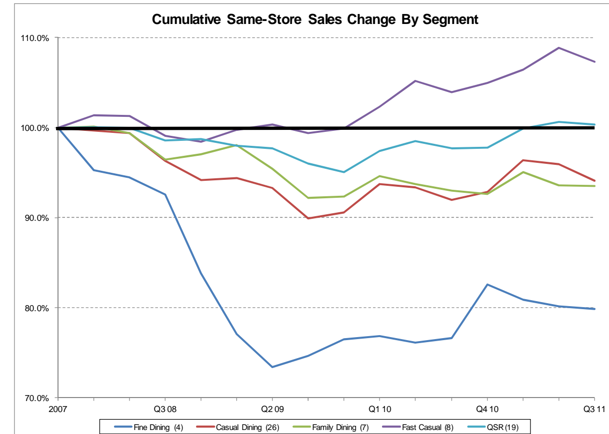
The third quarter of 2011 maintained the positive momentum in same-store sales, which is impressive as we continue to comp over positive results from the prior year. However, consumers are still in a tough state. A soft labor market has not improved. Consumers' costs have increased. Their homes' values are down, and persistent struggles in Europe have created volatile capital markets.

In fine dining, the companies we track were up from 2010 by an average of 4.2% for the third quarter of 2011. 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.

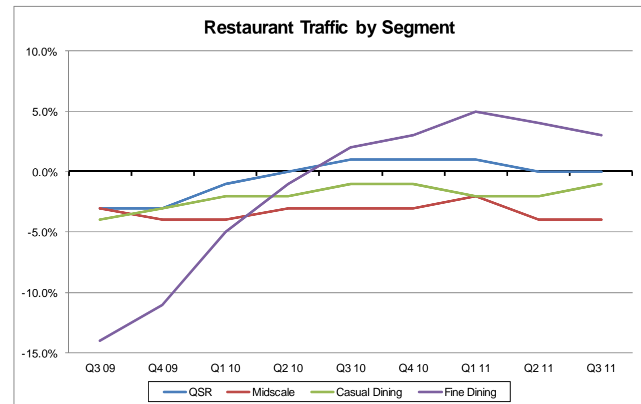
In casual dining, the concepts we follow were up by an average of 2.3% for the third quarter of 2011. This is the sixth consecutive quarter that the casual dining segment has posted positive quarterly same-store sales growth. According to Knapp Track, casual dining guest counts were up by 0.5% in July, down by 1.0% in August and down by 0.2% in September. The family dining concepts we track reported an average increase in same-store sales of 0.6% during the third quarter of 2011.

The fast casual segment reported positive same-store sales performance for a ninth consecutive quarter. The segment was positive by 3.2% for the third 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, 14 of the 19 concepts we track were positive during the third quarter of 2011 while the segment was up by an average of 2.7%. The Coffee/Snack segment had another strong quarter, up by an average of 5.5%. Starbucks led the way, up by 10.0%.



It is important to note that the majority of sales gains have come from price increases opposed to an increase in traffic. Rising commodity costs have forced most restaurant operators to raise their prices in an effort to maintain margins. Therefore, a significant portion of the positive news regarding top line growth is a result of commodity cost pressure and is not necessarily driving an improved bottom line.



Source: The NPD Group

Until the labor market and consumer sentiment improve we will continue to see soft traffic numbers, and the restaurant industry will continue to tread water.

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Same-Store Sales ("SSS") Data

	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11
Fine Dining:								
Fleming's	-5.7%	5.2%	9.0%	7.3%	18.4%	11.4%	9.9%	10.1%
McCormick & Schmick's	-12.9%	-9.6%	-4.0%	-4.6%	-1.0%	-3.2%	-2.7%	-1.0%
Morton's Rest. Group	-5.3%	3.6%	7.1%	3.2%	5.3%	7.5%	8.2%	5.1%
Ruth's Chris	-11.2%	-0.5%	2.9%	4.9%	9.2%	5.2%	5.8%	2.6%
Mean	**-8.8%**	**-0.3%**	**3.8%**	**2.7%**	**8.0%**	**5.2%**	**5.3%**	**4.2%**
Casual Dining:								
Applebee's	-4.5%	-2.7%	-1.6%	3.3%	2.9%	3.9%	3.1%	-0.3%
Benihana	-3.4%	1.4%	2.4%	4.7%	4.4%	5.6%	6.0%	6.4%
BJ's Resturants	-0.2%	4.4%	5.3%	6.7%	5.9%	7.8%	6.9%	6.5%
Bonefish	1.0%	3.6%	5.7%	7.8%	9.3%	9.6%	10.2%	7.4%
Buffalo Wild Wings	2.2%	0.5%	-0.5%	1.1%	-0.8%	2.4%	3.9%	4.8%
Carrabba's Italian Grill	-3.6%	1.1%	3.5%	4.9%	5.4%	3.9%	4.8%	6.3%
CEC Entertainment	-2.0%	0.7%	-2.2%	3.8%	3.9%	1.1%	-2.0%	-6.3%
Cheesecake Factory	-0.7%	2.7%	1.6%	2.9%	1.0%	2.1%	2.3%	0.8%
Chili's Grill & Bar	-3.2%	-5.0%	-4.1%	-5.0%	-4.9%	-3.0%	2.1%	1.7%
Dave & Buster's	-5.8%	-2.5%	-4.8%	-1.3%	1.2%	5.3%	1.9%	2.7%
Famous Dave's	-3.4%	-3.5%	0.6%	2.4%	3.3%	3.0%	-1.2%	-1.0%
Frisch's Golden Corral [1]	-3.6%	-6.4%	0.7%	4.4%	1.4%	-0.9%	-3.6%	-4.9%
Granite City	-8.1%	2.1%	5.3%	4.0%	3.6%	3.8%	3.5%	3.0%
LongHorn Steakhouse	-0.8%	1.9%	1.8%	6.8%	4.5%	6.1%	6.0%	4.8%
Maggiano's	-1.6%	1.9%	1.3%	1.4%	4.7%	3.4%	5.7%	3.5%
O'Charley's	-7.3%	-6.7%	-7.9%	-2.2%	-1.4%	0.4%	2.9%	-0.9%
Olive Garden	-1.4%	1.5%	-1.5%	2.0%	2.0%	0.0%	0.0%	-2.9%
Outback	-5.9%	-2.9%	3.6%	3.0%	2.5%	4.3%	1.8%	6.0%
PF Chang's Bistro	-5.2%	-2.7%	0.1%	2.3%	1.3%	0.5%	-2.5%	-3.7%
Real Mex	-	4.3%	-2.2%	-2.4%	0.1%	-1.6%	-0.2%	-
Red Lobster	-8.4%	0.9%	-4.6%	-1.6%	-1.6%	0.1%	3.8%	10.7%
Red Robin	-10.9%	-2.3%	-1.4%	1.7%	1.6%	2.1%	2.9%	2.1%
Ruby Tuesday	-1.7%	-0.7%	0.3%	1.2%	4.2%	-1.2%	-0.1%	-4.1%
Stoney River	-10.3%	-8.3%	-0.7%	1.7%	3.7%	8.4%	6.3%	6.8%
Taco Cabana	-4.5%	-2.0%	-0.1%	1.0%	2.3%	2.0%	4.5%	5.3%
Texas Roadhouse	-2.3%	0.5%	1.5%	4.3%	3.1%	4.5%	4.3%	3.9%
Mean	**-3.8%**	**-0.7%**	**0.1%**	**2.3%**	**2.4%**	**2.8%**	**2.8%**	**2.3%**
Family Dining:								
Bob Evans	-4.2%	-4.1%	-3.5%	-0.9%	-0.5%	1.2%	-1.8%	-1.5%
Cracker Barrel	-0.2%	0.6%	2.0%	2.4%	0.3%	-0.3%	-1.4%	-1.6%
Denny's	-7.0%	-6.2%	-5.9%	-1.1%	-1.4%	-1.7%	2.0%	0.9%
Frisch's Big Boy	-0.4%	-3.4%	-2.7%	-0.8%	-1.1%	0.2%	0.5%	0.0%
IHOP	-3.1%	-0.4%	-1.0%	0.1%	1.1%	-2.7%	-2.9%	-1.5%
Luby's	-12.5%	-4.8%	-0.5%	5.5%	2.7%	3.5%	-0.6%	3.5%
Ninety Nine	-6.5%	-6.0%	-0.5%	1.2%	1.3%	3.1%	3.3%	4.1%
Mean	**-4.8%**	**-3.5%**	**-1.7%**	**0.9%**	**0.3%**	**0.5%**	**-0.1%**	**0.6%**

[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)

	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11
Fast Casual:								
Chipotle	2.0%	1.3%	8.7%	11.4%	12.6%	12.4%	10.0%	11.3%
Cosi	-11.9%	-3.4%	3.1%	5.2%	4.5%	1.7%	-0.2%	-3.0%
Einstein Noah Bagel	-1.4%	0.1%	-1.1%	0.7%	1.6%	-0.4%	0.2%	0.7%
Panera Bread	5.4%	9.5%	9.9%	6.9%	5.8%	3.3%	3.9%	4.4%
Pei Wei	3.0%	2.2%	3.0%	0.8%	1.3%	-0.2%	-2.7%	-3.6%
Qdoba Mexican Grill	-1.7%	3.1%	4.6%	5.6%	6.4%	6.0%	5.1%	4.3%
Steak n Shake	14.4%	5.1%	7.5%	3.0%	2.1%	4.3%	4.9%	5.5%
Tim Horton's (US)	2.1%	3.0%	3.1%	3.3%	6.3%	4.9%	6.4%	6.3%
Mean	**1.5%**	**2.6%**	**4.9%**	**4.6%**	**5.1%**	**4.0%**	**3.5%**	**3.2%**
QSR:								
Chicken:								
El Pollo Loco	-10.0%	-6.7%	-4.9%	-2.2%	-3.4%	-2.4%	-	-
KFC	-8.0%	-4.0%	-7.0%	-8.0%	1.0%	1.0%	-5.0%	-3.0%
Pollo Tropical	0.3%	3.7%	6.3%	8.8%	10.7%	13.5%	10.7%	7.9%
Popeyes	-1.0%	-0.4%	0.4%	5.3%	6.2%	3.9%	0.5%	1.7%
Mean	**-4.7%**	**-1.9%**	**-1.3%**	**1.0%**	**3.6%**	**4.0%**	**2.1%**	**2.2%**
Coffee/Snack:								
Caribou Coffee	0.2%	5.2%	4.8%	4.4%	3.5%	4.3%	4.6%	4.1%
Dunkin Donuts [2]	-	-0.6%	1.9%	2.7%	4.7%	2.8%	3.2%	6.0%
Jamba Juice	-5.3%	-3.3%	-2.4%	-2.7%	0.2%	2.2%	4.3%	3.3%
Krispy Kreme	1.1%	3.4%	5.7%	5.0%	1.1%	7.0%	2.5%	4.0%
Starbucks	4.0%	7.0%	9.0%	8.0%	8.0%	7.0%	8.0%	10.0%
Mean	**0.0%**	**2.3%**	**3.8%**	**3.5%**	**3.5%**	**4.7%**	**4.5%**	**5.5%**
Mexican:								
Taco Bell	-5.0%	-2.0%	1.0%	3.0%	4.0%	0.0%	-5.0%	-2.0%
Mean	**-5.0%**	**-2.0%**	**1.0%**	**3.0%**	**4.0%**	**0.0%**	**-5.0%**	**-2.0%**
Pizza:								
Domino's	1.4%	14.3%	8.8%	11.7%	6.3%	-1.4%	4.8%	3.0%
Papa John's	-0.5%	-0.4%	0.4%	-0.6%	0.7%	6.1%	0.4%	5.3%
Pizza Hut	-12.0%	5.0%	8.0%	8.0%	10.0%	-3.0%	-2.0%	-3.0%
Mean	**-3.7%**	**6.3%**	**5.7%**	**6.4%**	**5.7%**	**0.6%**	**1.1%**	**1.8%**
Sandwich:								
Burger King	-3.3%	-6.1%	-1.5%	-4.2%	-5.8%	-6.0%	-5.3%	-0.3%
Carl's Jr.	-8.7%	-6.1%	-7.4%	-5.0%	-0.4%	2.1%	2.0%	2.0%
Hardee's	-2.5%	-1.2%	6.8%	8.3%	5.7%	9.6%	2.5%	1.8%
Jack in the Box	-11.1%	-8.6%	-9.4%	-4.0%	1.5%	0.8%	4.7%	5.8%
McDonald's	0.1%	1.5%	3.7%	5.3%	4.4%	2.9%	4.5%	4.4%
Sonic Drive-In	-6.5%	-13.2%	-6.0%	-6.4%	-2.4%	1.2%	3.9%	-0.5%
Wendy's	-3.0%	0.8%	-1.7%	-1.7%	0.2%	0.0%	2.3%	0.9%
Mean	**-5.0%**	**-4.7%**	**-2.2%**	**-1.1%**	**0.5%**	**1.5%**	**2.1%**	**2.0%**
Mean Total QSR	**-3.7%**	**-0.6%**	**0.8%**	**1.8%**	**2.8%**	**2.6%**	**2.2%**	**2.7%**

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

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

All is quiet on the Western Front

The inability of the European nations to sustain their generous levels of social spending was borne out by the bond market. Germany, ostensibly the nation with the best credit quality in the European Union ("EU") experienced failed treasury auctions in three of the past six auctions as investors felt that the yield and risk weighted returns of German sovereign debt were unattractive. The other nations in the EU need no discussion. Fortunately, the eurozone issues distracted much world attention and financial press away from the challenges we are still experiencing here in the U.S. Moreover, investors have been looking at U.S. denominated assets as a flight to quality alternative to Europe. While this is fortunate, we believe this is creating somewhat of an eye in the storm. However, the U.S. consumer, ever ebullient and ready to spend, came out and gave the economy a strong start to the holiday shopping season. This has provided some restaurant concepts a much needed boost.

Will the European financial crisis impact U.S. restaurant traffic in 2012?

We believe that there is no easy solution to the European economic crisis. European leaders have two choices: runaway inflation (which hurts voters especially the poor) or starkly austere budget cuts (which hurts voters especially the poor). In either case, there will be a meaningful spike in unemployment. This will put pressure on trade with the U.S. on two fronts. The first will be a significantly less demand for U.S. products which will slow down our export sales to Europe. Secondly, there will be a softer euro which will make EU merchandise more competitive in U.S. markets, putting further pressure on U.S. companies. In both cases there will be a negative impact on U.S. employment at a time when we desperately need to create jobs. This is not good news for the restaurant business in 2012.

How will the U.S. economy perform in 2012 and beyond?

The good news for the U.S. economy is that it is backed by tremendous natural resources, unique infrastructure, plentiful energy sources (if they're used properly) and superior demographics. Every year a couple million young Americans hit the job market which is an advantage we have over Europe, China and Japan. While Canada, Brazil and Australia also have abundant natural resources, the United States alone has positive demographics, a stable political system, unrivaled national defense and a currency in the U.S. dollar that is used as the reserve currency for almost every nation around the world. So whatever happens, the U.S. will remain not just a survivor, but on top of the pack. This is very good for restaurants in the long-term.

In the short run the United States has to focus on an increasingly ineffective Congress which has been unable to rein in runaway spending. Even in the middle of this crisis, we are spending $1.60 for every dollar we receive in tax receipts. The longer we let this imbalance persist, the more damage we do to our global strategic stance. More importantly, it is impossible to revive the economy without addressing structural budget imbalances. Other chores such as fixing regional bank balance sheets and commercial and residential real estate are also subject to a stable financial environment in Washington.

To Promote or not to Promote

We have been troubled by an increasing trend of federal agencies, and even the administration itself, promoting economic statistics that tell half the story or, worse yet, are even potentially misleading. For example, for all the hoopla about November's reduction in the unemployment rolls, the number was 80% due to job-search attrition and the remaining 20% was in the confines of a statistical error. While it is important for leadership to point out all the positive developments in our economy, we must be careful not to mislead the consumer onto thin ice. As another example, there were 400 commercial banks on the FDIC's Cease-and-Desist list in 2009. Today there are 852. This is not an example of improvement, yet the FDIC's largest field office in Orange County, California is being closed down as we speak. We strongly believe that the American people are big enough to accept the truth and encourage the Department of Labor, Bureau of Labor Statistics, Commerce Department and the administration to give an unvarnished version of our economy's economic progress.

We strongly believe that next year, restaurant concepts that properly understand the potential difficulties of economic headwinds will prepare for the challenges posed by potentially tighter consumer spending. If the consumer goes from three occasions to two, winning restaurant concepts understand that they have to be 33% better in order to run-in-place. We are very impressed with some of the leading concepts' adjustments to this more challenging economic environment. For instance, when economists pointed out that the fourth quarter of 2011 would be challenging, McDonald's responded with LTOs of McRib and Monopoly back-to-back - two surefire modules that almost always produce positive same-store sales for the chain. Similarly, for 2012, Taco Bell is launching the Dorito Loco Taco, improving its salsa and beans and launching a product line with celebrity chef Lorena Garcia. These are stark examples of leading concepts adjusting for a difficult environment which we believe will enable them to pull away from the pack. This is a trend we believe needs to be replicated across the industry as continued economic difficulty among consumers will demand innovation, quality improvements and an overall more compelling consumer proposition.

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

Recapturing Business Value & Protecting Family Wealth

Hands Tied & Fingers Crossed

Today, most long time restaurant owners do not have anywhere near the net worth or perceived family wealth that they enjoyed 5 or even 10 years ago . . . not by a long shot. Sales in many concepts are down 5%-20% and that impact on "EBITDA" has been devastating. Since the trailing EBITDA drives value, owners (even those with the luxury to pay themselves the same as they did before the wheels came off the economy) understand that they're not as wealthy as they once were. Waiting, therefore, for an economic recovery before succession planning "seems like" the only smart option.

Consequently, today there are only two categories of non-distressed restaurant owners: the acquirers and "the prayerful." Acquirers are buying assets in order to reach scale they feel necessary to survive in the uncertain future. The "prayerful" are essentially waiting for an economic recovery that will get them back to the EBITDA levels they once enjoyed.

But the wait and see owners haven't necessarily been sitting idle. Many have spent the last three years doing everything in their power to inject efficiencies into their business. In fact, some have been successful in rationalizing labor, occupancy and/or debt service. They have successfully stabilized or even grown EBITDA, and the value of their companies have subsequently increased from the recent lows.

However, they're still not where they were. Having exhausted all feasible options for preserving or rebuilding value, these action oriented owners now find themselves in the uncomfortable position of waiting for global and domestic policy to dictate how much wealth they will be able to pass along to their children.

Owners with near term succession goals, therefore, may face the question of selling/diversifying or hoping (hands tied and fingers crossed) for global politics to align for an economic recovery. But why would a business owner sell today at a lower valuation than they would have gotten 5 years ago, and possibly lower than they might earn 5 years from now?

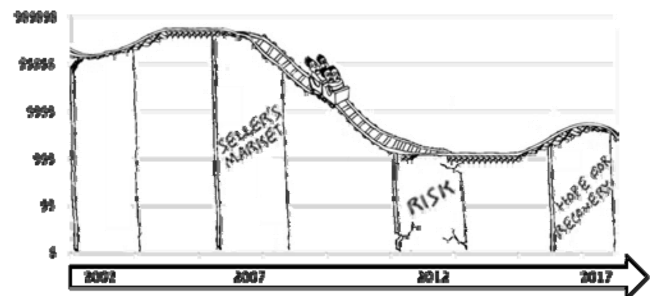
There are actually several good reasons: 1) value, even at a depressed level, is still available to sellers - the buyer market today is still in session and equipped to take on the significant near term industry risk 2) where business valuation is no longer in the control of owners, asset diversification offers a smarter way to ride an anemic economic recovery and 3) we may never see a better tax environment in which to sell.

<u>Today's Buyers:</u> Trinity is approached every day by large sophisticated buyers who need to acquire restaurant assets. These companies are either betting on a better recovery or they are buying assets to achieve scale as a protective mechanism against continuing industry difficulties. But in most cases, they are executing a well thought out, detailed strategy targeted at addressing the next five years' risk.

It is true that many of these buyers are exploiting an opportunity to buy at perceived value pricing today, but that is almost always driven by a plan in place to grow acquired assets and better leverage them within their own organization. (In fact, buyers without a clearly defined approach are rare to find . . . mostly because those kinds of gamblers have already lost in this market.) In addition, these buyers are generally well enough capitalized to stomach a potential two to three years of financial uncertainty. They have a plan, they have capital and they have an appetite to take risk.

<u>Diversification; They Can Do it Better</u>: The economic recovery that everyone hopes to enjoy will take at least five years, and it all depends on factors largely outside the control of a restaurant owner. Let's face it, owners have done everything in their power to survive the last few years . . . but they're running out of tricks.

Entrepreneurs risk the bulk of their capital in their businesses for a powerful reason . . . control. Many of our restaurant clients enjoy the control of driving their net worth with their own hard work and brain power; they understand their business and have difficulty finding better investment options outside their own sphere of influence. But the reality today is that most owners no longer control the value of their companies; they're waiting helplessly for the return of the consumer, and in that scenario, recapturing past financial greatness will require a lot of global political victories and frankly . . . luck.



Owners have endured a roller coaster for the last several years - - a free-fall of restaurant economics and value. Everyone hopes to make it through 2012 and into the anticipated recovery, but that recovery is dependant on that pillar of risk holding up, which would require improving unemployment, housing, healthcare and the cost of commodities. That recovery is also dependant, like it or not, on the European leaders fixing their economy – our banks are exposed, and therefore so are we - - it's just a fact.

Having done everything in their power already - restaurant owners now find themselves waiting with their

fingers crossed for the crumbling pillar to hold; they can't influence an economic recovery, but they're anxiously waiting with all their chips in one asset . . . their business. Why would anyone do that? The value of their business is no longer controlled by their efforts; in fact, choosing not to sell and to let it ride is in reality a bet or a prayer that Washington and global politicians can fix this mess. If net worth is now measured in chips on the table and you're going to bet . . . bet smart.

Asset managers implement risk mitigation for their clients and live and die by one word: diversification. Clients are more and more advised to extract the equity that remains before having to test the strength of the crumbling risk pillar we face in 2012/13. They are told to use that money to diversify by investing in, for instance, large, multi-national, publicly traded companies that offer ready liquidity.

There are plenty of solid public companies who, just like a restaurant owner will benefit greatly from an economic recovery. However, unlike most private restaurant companies, they don't face the very real threat of insolvency in the face of an economy that could get much worse before it gets better. If there is nothing more to be done to enhance the value of assets but hold on until Washington makes everything better . . . taking money off the table and spreading it around is the smart thing to do.

By the way, diversification doesn't mean giving up your restaurant business entirely. For instance, consider selling a partial stake to someone with a more sophisticated infrastructure than you can afford, and more importantly, someone with a plan to enhance value through a tougher economic environment. Keep equity in the business and let that more sophisticated operator run with it . . . this is known in the business as knowing your limitations. In this environment, it's not a sign of weakness, it's a recognition of reality . . . the restaurant industry will have to learn to operate on thinner margins – in that scenario scale and infrastructure will win the day; if you don't have both consider partnering with someone that does, and do it soon before you lose tax favor.

Favorable Tax Environment: Sellers in 2012 will most likely be the final beneficiaries of Custar's last stand on favorable capital gains. After the ball drops on December 31, 2012, the federal long-term capital gains rate will literally explode 68% from 15% to 25% (21.2% plus 3.8% Medicare tax from Obama's health plan). So if you've owned a private company for at least a year and you don't sell it before January 1, 2013, the gain will be worth 13.3% less after-tax. Two comments: 1) the amount of sales growth and EBITDA expansion that would be required to make up for a tax increase of that size should make those with their fingers crossed think twice about waiting the requisite time, and 2) consider the perils of being in the same boat with a bunch of other sellers who wait until the 3rd quarter of 2012 before they decide they want to sell . . . if you're going to sell, sell early 2012.

Many readers may be able to hold on and regain the performance level and enterprise value they have enjoyed in the past. That however will require strategy and stomach to get through the next several years. In all cases, understanding the near term economic risks and putting those uncertainties into the context of your family's future financial security is a good use of time. We all hope for it, but an economic recovery is not a certainty. If it's the case that a recovery of value is entirely dependant on a rising economic tide out of your control, consider a diversified approach to ride the rising tide that mitigates risk as much as possible.

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