Trinity Capital

3rd Quarter 2012 Restaurant Industry Commentary

What's Inside This Commentary

Same-Store Sales Discussion and Analysis

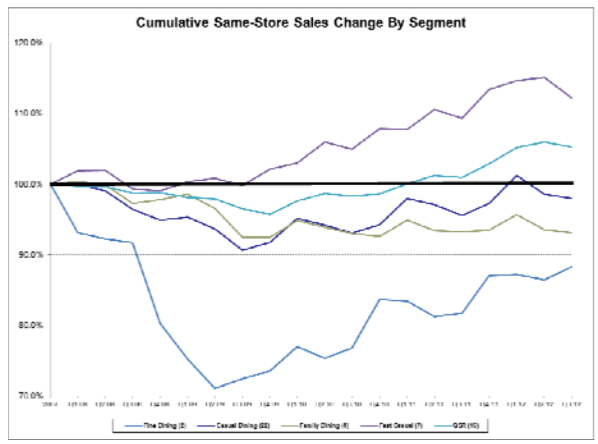
The third quarter of 2012 maintained the positive momentum in same-store sales, which is impressive as we continue to comp over positive results from the prior year. The restaurant industry reported its tenth consecutive quarter of same store sales gains. It should be noted however, that traffic has slowed or declined within many prominent chains.

In fine dining, the companies we track were up from 2011 by an average of 8.0% for the third quarter of 2012. 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 last year's positive results.

In casual dining, the concepts we follow were up by an average of 2.6% for the third quarter of 2012. This is the tenth consecutive quarter 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 1.3% in July, down by 1.2% in August and down by 2.3% in September. In fact Knapp Track has reported negative guest counts in 12 of the last 14 months. The family dining concepts we track reported an average decrease in same-store sales of -0.1% during the third quarter of 2012. We believe this is ominous.

The fast casual segment reported positive same-store sales performance for a thirteenth consecutive quarter. The segment was positive by 2.7% for the third 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 third quarter of 2012 while the segment was up by an average of 4.2%. The Chicken segment had a strong showing in the third quarter, up by an average of 5.9% with Pollo Tropical leading the way, up 7.0% followed closely by Popeye's, up 6.8%. KFC had its strongest showing since Q1 2008, up 4%.



With the end of the 2% payroll tax holiday, we will be closely watching to see the impact that reduced discretionary dollars has on restaurant sales while consumers readjust their spending habits. We are concerned about further slowdown in traffic in the casual dining segment since casual and fine dining chains are usually the first to feel the effects when consumers start to tighten their budgetary belts and start trading down. But the QSR segment will not be immune and operators should remain focused on cost controls and implement grass roots efforts to drive traffic through reimaging, intelligent pricing and promotion.

Contributing Editor Sharon E. Hatchell is a Senior Vice President for Trinity Capital.

Same-Store Sales ("SSS") Data

	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12
Fine Dining:								
Fleming's	18.4%	11.4%	9.9%	10.1%	0.3%	5.4%	6.8%	10.1%
Ruth's Chris	9.2%	5.2%	5.8%	2.6%	7.7%	3.7%	6.0%	5.9%
Mean	**13.8%**	**8.3%**	**7.9%**	**6.4%**	**4.0%**	**4.6%**	**6.4%**	**8.0%**
Casual Dining:								
Applebee's	2.9%	3.9%	3.1%	-0.3%	1.0%	1.2%	0.4%	2.0%
Benihana	4.4%	5.6%	6.0%	6.4%	7.0%	4.8%	4.5%	-
BJ's Resturants	5.9%	7.8%	6.9%	6.5%	5.1%	3.3%	4.4%	2.3%
Bonefish	9.3%	9.6%	10.2%	7.4%	5.9%	6.2%	2.1%	7.4%
Buffalo Wild Wings	-0.8%	2.4%	3.9%	4.8%	7.1%	8.1%	5.4%	6.0%
Carrabba's Italian Grill	5.4%	3.9%	4.8%	6.3%	3.5%	4.3%	1.5%	6.3%
CEC Entertainment	3.9%	1.1%	-2.0%	-6.3%	-3.6%	-4.2%	-2.4%	2.3%
Cheesecake Factory	1.0%	2.1%	2.3%	0.8%	2.7%	2.6%	2.1%	2.9%
Chili's Grill & Bar	-4.9%	-3.0%	2.1%	1.7%	1.4%	4.6%	2.2%	2.8%
Dave & Buster's	1.2%	5.3%	1.9%	2.7%	-0.9%	-0.3%	5.4%	5.4%
Famous Dave's	3.3%	3.0%	-1.2%	-0.1%	3.6%	-1.6%	-0.6%	0.2%
Frisch's Golden Corral [1]	1.4%	-0.9%	-3.6%	-4.9%	7.8%	12.4%	0.0%	0.0%
Granite City	3.6%	3.8%	3.5%	3.0%	4.0%	1.9%	1.5%	2.5%
LongHorn Steakhouse	4.5%	6.1%	6.0%	4.8%	6.7%	3.8%	3.0%	2.2%
Maggiano's	4.7%	3.4%	5.7%	3.5%	2.8%	3.9%	1.9%	0.9%
Olive Garden	2.0%	0.0%	0.0%	-2.9%	-2.5%	2.0%	-1.8%	0.3%
Outback	2.5%	4.3%	1.8%	6.0%	3.6%	5.3%	2.3%	4.5%
Red Lobster	-1.6%	0.1%	3.8%	10.7%	6.8%	6.0%	-3.9%	-2.6%
Red Robin	1.6%	2.1%	2.9%	2.1%	4.5%	1.0%	1.2%	0.6%
Ruby Tuesday	4.2%	-1.2%	-0.1%	-4.1%	-4.2%	-5.0%	-4.6%	1.9%
Taco Cabana	2.3%	2.0%	4.5%	5.3%	2.7%	6.1%	4.5%	1.8%
Texas Roadhouse	3.1%	4.5%	4.3%	3.9%	5.6%	6.2%	4.6%	3.9%
Mean	**2.7%**	**3.0%**	**3.0%**	**2.6%**	**3.2%**	**3.3%**	**1.5%**	**2.6%**
Family Dining:								
Bob Evans	-0.5%	1.2%	-1.8%	-1.5%	1.6%	-0.6%	1.0%	1.0%
Denny's	-1.4%	-1.7%	2.0%	0.9%	1.6%	2.4%	0.8%	0.4%
Frisch's Big Boy	-1.1%	0.2%	0.5%	0.0%	0.4%	1.7%	-1.7%	-0.2%
IHOP	1.1%	-2.7%	-2.9%	-1.5%	-1.0%	-0.5%	-1.4%	-2.0%
Luby's	2.7%	3.5%	-0.6%	3.5%	2.2%	1.1%	2.2%	0.2%
Mean	**0.2%**	**0.1%**	**-0.6%**	**0.3%**	**1.0%**	**0.8%**	**0.2%**	**-0.1%**

[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)

	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12
Fast Casual:								
Chipotle	12.6%	12.4%	10.0%	11.3%	11.1%	12.7%	10.2%	4.8%
Cosi	4.5%	1.7%	-0.2%	-3.0%	2.6%	7.5%	-0.5%	-0.7%
Einstein Noah Bagel	1.6%	-0.4%	0.2%	0.7%	1.2%	1.1%	1.3%	0.2%
Panera Bread	5.8%	3.3%	3.9%	4.4%	4.4%	6.3%	5.9%	5.8%
Qdoba Mexican Grill	6.4%	6.0%	5.1%	4.3%	3.8%	3.0%	2.1%	3.3%
Steak n Shake	2.1%	4.3%	4.9%	5.3%	5.5%	5.5%	4.8%	2.9%
Tim Horton's (US)	6.3%	4.9%	6.4%	6.3%	7.2%	8.5%	4.9%	2.3%
Mean	**5.6%**	**4.6%**	**4.3%**	**4.2%**	**5.1%**	**6.4%**	**4.1%**	**2.7%**
QSR:								
Chicken:								
KFC	1.0%	1.0%	-5.0%	-3.0%	-1.0%	2.0%	1.0%	4.0%
Pollo Tropical	10.7%	13.5%	10.7%	7.9%	7.8%	9.4%	7.8%	7.0%
Popeyes	6.2%	3.9%	0.5%	1.7%	5.9%	8.1%	8.4%	6.8%
Mean	**6.0%**	**6.1%**	**2.1%**	**2.2%**	**4.2%**	**6.5%**	**5.7%**	**5.9%**
Coffee/Snack:								
Caribou Coffee	3.5%	4.3%	4.6%	4.1%	5.6%	2.5%	2.8%	3.5%
Dunkin Donuts [2]	4.7%	2.8%	3.2%	6.0%	7.4%	7.2%	4.0%	4.0%
Jamba Juice	0.2%	2.2%	4.3%	3.3%	7.7%	12.7%	5.7%	2.5%
Krispy Kreme	1.1%	7.0%	2.5%	4.0%	8.3%	2.1%	5.4%	6.8%
Starbucks	8.0%	7.0%	8.0%	10.0%	9.0%	8.0%	7.0%	7.0%
Mean	**3.5%**	**4.7%**	**4.5%**	**5.5%**	**7.6%**	**6.5%**	**5.0%**	**4.8%**
Mexican:								
Taco Bell	4.0%	0.0%	-5.0%	-2.0%	-2.0%	6.0%	13.0%	7.0%
Mean	**4.0%**	**0.0%**	**-5.0%**	**-2.0%**	**-2.0%**	**6.0%**	**13.0%**	**7.0%**
Pizza:								
Domino's	6.3%	-1.4%	4.8%	3.0%	6.8%	2.0%	1.7%	3.3%
Papa John's	0.7%	6.1%	0.4%	5.3%	1.7%	1.1%	5.7%	2.5%
Pizza Hut	10.0%	-3.0%	-2.0%	-3.0%	6.0%	5.0%	4.0%	6.0%
Mean	**5.7%**	**0.6%**	**1.1%**	**1.8%**	**4.8%**	**2.7%**	**3.8%**	**3.9%**
Sandwich:								
Burger King	-5.8%	-6.0%	-5.3%	-0.3%	-2.0%	4.2%	4.4%	1.6%
Carl's Jr.	-5.0%	-0.4%	2.1%	2.0%	2.0%	1.7%	2.6%	5.5%
Hardee's	8.3%	5.7%	9.6%	2.5%	1.8%	6.1%	2.6%	3.6%
Jack in the Box	1.5%	0.8%	4.7%	5.8%	5.3%	5.6%	3.4%	3.1%
McDonald's	4.4%	2.9%	4.5%	4.4%	7.1%	8.9%	3.6%	1.2%
Sonic Drive-In	-2.4%	1.2%	3.9%	-0.5%	0.1%	3.5%	2.8%	2.3%
Wendy's	0.2%	0.0%	2.3%	0.9%	4.4%	0.7%	3.2%	2.8%
Mean	**0.2%**	**0.6%**	**3.1%**	**2.1%**	**2.7%**	**4.4%**	**3.2%**	**2.9%**
Mean Total QSR	**3.0%**	**2.5%**	**2.6%**	**2.7%**	**4.3%**	**5.1%**	**4.7%**	**4.2%**

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

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

What happened with the Fiscal Cliff?

The Fiscal Cliff came and went just like December 21st and we didn't have a financial Armageddon as many *doomsday preppers* would have expected. One of the reasons many financial pundits have been incorrect in their prognostications about the demise of the economy is the strong hand that the Federal Reserve has been playing since the onset of the financial crisis of 2008. The Fed has bought stock in leading corporations such as AIG and General Motors, bailed out Fannie Mae and Freddie Mac, loaned money to foreign central banks, bought mortgage-backed securities in the open market and finally has become the majority purchaser of United States treasury securities issued each month to roll over our debt and fund our persistent deficit. This is an enormous task and while the Fed should get good grades in the stability they have brought to the U.S. and world economy, the stability comes at a tremendous cost: *We have sold out the next couple generations of Americans and maybe worse.*

So what is the Fiscal Cliff? Initially, the Fiscal Cliff was brought on by the crisis in which the United States credit rating was ultimately downgraded by Standard & Poor's last year. The Simpson Bowles commission was created by the Obama administration and tasked with coming up with a deficit reduction package which would have some balance between tax rate increases and spending cuts. Under this program there was supposed to be a 4 to 1 ratio of spending cuts to projected revenue from tax rate increases. If no agreement was reached by December 31, then sequestration would take place and produce automatic spending cuts and tax increases of approximately $400 billion per year including allowing the expiration of the Bush era tax cuts. This was to keep in line with the $4 trillion (over ten years) in deficit reduction contemplated by the Simpson Bowles Commission.

At the end of the year, Washington could not agree to anything substantive with respect to spending cuts. So instead, they agreed upon a framework whereby the Bush era tax cuts would expire for those earning more than $400,000 per year ($450,000 for married filers) and other taxes would be increased as well. In addition, the agreement provides that Congress propose spending cuts by the end of February which will address the balance of the targeted deficit reduction of approximately $400 billion per year.

So we have to wait and see if Congress and the President will, after having failed last summer and again in December, agree to a reasonable spending cut package which will satisfy the Treasury and financial markets, our trading partners and most importantly our citizen taxpayers.

We believe that the agreement at the end of February will consist of yet more delays with respect to the tough decisions of spending cuts *(February will become some later month in the year)* and a promise of tax reform which basically translates to eliminating all deductions, including state income tax and mortgage credit for anybody earning more than the average *voter*! We believe the tax reform will be deferred until it becomes a campaign issue for the 2014 midterm congressional elections. We also further believe that regardless of what the Republican Caucus does in February, they will be poorly portrayed by the media throughout these affairs giving the President and the Democratic Caucus the upper hand in implementing tax reform and spending policy.

Our current budget deficit is approximately $1.1 trillion and the agreement as it stands produces approximately $80 billion a year in relief. This will leave us with a budget deficit of $1.02 trillion (hardly an improvement in the intergenerational transfer of debt from today's citizens to future generations). More alarmingly, U.S. demographics will present us with 30% more seniors 10 years from now and Social Security cash flows will reverse from inflows to outflows. In addition, the same group of seniors will become big users of Obamacare or other federally funded medical coverage programs such as Medicaid or Medicare. This spells trouble for the business as usual of never ending deficits and we believe the financial markets will put their foot down at some point in time. *We just don't know when!*

All this activity will likely put some pressure on interest rates including restaurant loans and mortgages. It is also likely that the tax packages may modestly dampen the economy in 2013, as well. Finally, if a tax reform package substantially reduces primary home mortgage and state income tax deductions, we believe there will be incrementally more of a drag on the economy in 2013, and beyond. Stay tuned until the last minute in February because we do not believe the politicians in Washington will get anything done before the last possible moment.

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

The Importance of the QSR Drive-thru Window

The QSR drive-thru window has emerged as an integral pillar of sales from its inception in the mid-1960s as an alternative to drive-ins. Many leading QSR concepts now realize between 70% and 80% of their sales from their drive-thru windows. As the importance of these sales was realized by management at the leading concepts, significant changes began to emerge which have shaped the way drive-thru windows are used in the industry today.

Several major developments have played an instrumental role in elevating drive-thru window sales to the lofty percentage that they occupy now in the industry. The first development was adding technology to vastly improve the communications and speed of service enjoyed by drive-thru customers. Developing headsets for crewmembers vastly increased customer responsiveness by getting information to the kitchen as quickly and accurately as possible. Another break-through in communications was the advent of high fidelity two-way radio systems to enable customers and crewmembers to communicate simultaneously and more clearly without signal breakup. This vastly increased order accuracy and helped speed of service as well. Finally, adding a second window enabled crewmembers to divide the payment and product functions along two different windows in order to vastly increase speed of service. This was a key development and the reduction of service time at drive-thru windows was demonstrable.

Another break-through which plays a significant role in providing the efficiency we see nowadays is the significant development which has taken place in exterior menu boards. Menu boards were originally poorly placed, insufficiently lighted and often featured information which was not supported by the realities of the kitchen. Over the years menu boards have developed improved lighting, flexible pricing and even now have become completely interactive with the advent of light emission diode technology television screen menus. Some concepts have begun to use menu boards to promote LTOs and certain bundling options on screens located in advance of the final order screen.

One of the often misunderstood developments which has been foundational to today's speed of service, quality and accuracy of drive-thru service has been the orientation of kitchens to incorporate the drive-thru. In former days, drive-thru windows were added to stores that were originally laid out without a stack and drive-thru. These kitchens did not aptly accommodate the drive-thru window activity and the location of food delivery, payment functions and other functions was an afterthought which led to inefficiency with employee movements and unnecessary product travel within the kitchen. When kitchen design improved to accommodate the sales prominence of drive-thrus, drive-thru window service improved dramatically which reduced the customer wait time and made it even more attractive to customers.

Today you can drive your car up in a stack of a major concept, enjoy a video presentation concerning LTOs, pull up to the menu board and see real-time confirmation of your order… drive a little further and pay for your order... all in about 2-3 minutes if all goes well. This is a big improvement since the QSR founding days in San Bernardino!

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