Trinity Capital

4th Quarter 2011 Restaurant Industry Commentary

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Same-Store Sales Discussion and Analysis

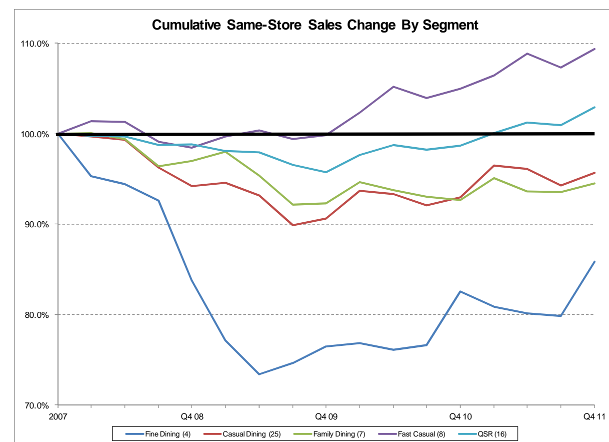
The fourth quarter of 2011 maintained the positive momentum in same-store sales, which is impressive as we continue to comp over positive results from the prior year. Buoyed by modest gains in national employment and a mild winter, a solid majority of restaurant operators reported positive same-store sales and traffic results

In fine dining, the companies we track were up from 2010 by an average of 4.0% for the fourth 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 3.0% for the fourth quarter of 2011. This is the seventh consecutive quarter that the casual dining segment has posted positive quarterly same-store sales growth. According to Knapp Track, casual dining guest counts were down by 0.8% in October, down by 1.6% in November and up by 0.4% in December. The family dining concepts we track reported an average increase in same-store sales of 2.0% during the fourth quarter of 2011.

The fast casual segment reported positive same-store sales performance for a tenth consecutive quarter. The segment was positive by 4.2% 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, 16 of the 19 concepts we track were positive during the fourth quarter of 2011 while the segment was up by an average of 4.3%. The Coffee/Snack segment had another strong quarter, up by an average of 7.6%. Starbucks led the way, up by 9.0%.



According to the National Restaurant Association, a majority of restaurant operators expect their sales to be higher in the coming months. Fifty-three percent of restaurant operators expect to have higher sales in six months (compared to the same period in the previous year), matching the proportion who reported similarly last month. In comparison, only nine percent of restaurant operators expect their sales volume in six months to be lower than it was during the same period in the previous year, up slightly from seven percent who reported similarly last month.

Restaurant operators are also generally optimistic about the direction of the overall economy. Thirty-five percent of restaurant operators said they expect economic conditions to improve in six months, down slightly from 37 percent last month. In comparison, 14 percent of operators said they expect economic conditions to worsen in the next six months, up slightly from 11 percent who reported similarly last month. (cont'd on page 4)

Same-Store Sales ("SSS") Data

	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Fine Dining:								
Fleming's	5.2%	9.0%	7.3%	18.4%	11.4%	9.9%	10.1%	0.3%
McCormick & Schmick's	-9.6%	-4.0%	-4.6%	-1.0%	-3.2%	-2.7%	-1.0%	-
Morton's Rest. Group	3.6%	7.1%	3.2%	5.3%	7.5%	8.2%	5.1%	-
Ruth's Chris	-0.5%	2.9%	4.9%	9.2%	5.2%	5.8%	2.6%	7.7%
Mean	**-0.3%**	**3.8%**	**2.7%**	**8.0%**	**5.2%**	**5.3%**	**4.2%**	**4.0%**
Casual Dining:								
Applebee's	-2.7%	-1.6%	3.3%	2.9%	3.9%	3.1%	-0.3%	1.0%
Benihana	1.4%	2.4%	4.7%	4.4%	5.6%	6.0%	6.4%	7.0%
BJ's Resturants	4.4%	5.3%	6.7%	5.9%	7.8%	6.9%	6.5%	5.1%
Bonefish	3.6%	5.7%	7.8%	9.3%	9.6%	10.2%	7.4%	5.9%
Buffalo Wild Wings	0.5%	-0.5%	1.1%	-0.8%	2.4%	3.9%	4.8%	7.1%
Carrabba's Italian Grill	1.1%	3.5%	4.9%	5.4%	3.9%	4.8%	6.3%	3.5%
CEC Entertainment	0.7%	-2.2%	3.8%	3.9%	1.1%	-2.0%	-6.3%	-3.6%
Cheesecake Factory	2.7%	1.6%	2.9%	1.0%	2.1%	2.3%	0.8%	2.7%
Chili's Grill & Bar	-5.0%	-4.1%	-5.0%	-4.9%	-3.0%	2.1%	1.7%	1.4%
Dave & Buster's	-2.5%	-4.8%	-1.3%	1.2%	5.3%	1.9%	2.7%	-0.9%
Famous Dave's	-3.5%	0.6%	2.4%	3.3%	3.0%	-1.2%	-0.1%	3.6%
Frisch's Golden Corral [1]	-6.4%	0.7%	4.4%	1.4%	-0.9%	-3.6%	-4.9%	7.8%
Granite City	2.1%	5.3%	4.0%	3.6%	3.8%	3.5%	3.0%	4.0%
LongHorn Steakhouse	1.9%	1.8%	6.8%	4.5%	6.1%	6.0%	4.8%	6.7%
Maggiano's	1.9%	1.3%	1.4%	4.7%	3.4%	5.7%	3.5%	2.8%
O'Charley's	-6.7%	-7.9%	-2.2%	-1.4%	0.4%	2.9%	-0.9%	-1.5%
Olive Garden	1.5%	-1.5%	2.0%	2.0%	0.0%	0.0%	-2.9%	-2.5%
Outback	-2.9%	3.6%	3.0%	2.5%	4.3%	1.8%	6.0%	3.6%
PF Chang's Bistro	-2.7%	0.1%	2.3%	1.3%	0.5%	-2.5%	-3.7%	-2.4%
Red Lobster	0.9%	-4.6%	-1.6%	-1.6%	0.1%	3.8%	10.7%	6.8%
Red Robin	-2.3%	-1.4%	1.7%	1.6%	2.1%	2.9%	2.1%	4.5%
Ruby Tuesday	-0.7%	0.3%	1.2%	4.2%	-1.2%	-0.1%	-4.1%	-4.2%
Stoney River	-8.3%	-0.7%	1.7%	3.7%	8.4%	6.3%	6.8%	7.2%
Taco Cabana	-2.0%	-0.1%	1.0%	2.3%	2.0%	4.5%	5.3%	2.7%
Texas Roadhouse	0.5%	1.5%	4.3%	3.1%	4.5%	4.3%	3.9%	5.6%
Mean	**-0.9%**	**0.2%**	**2.5%**	**2.5%**	**3.0%**	**2.9%**	**2.4%**	**3.0%**
Family Dining:								
Bob Evans	-4.1%	-3.5%	-0.9%	-0.5%	1.2%	-1.8%	-1.5%	1.6%
Cracker Barrel	0.6%	2.0%	2.4%	0.3%	-0.3%	-1.4%	-1.6%	3.5%
Denny's	-6.2%	-5.9%	-1.1%	-1.4%	-1.7%	2.0%	0.9%	1.6%
Frisch's Big Boy	-3.4%	-2.7%	-0.8%	-1.1%	0.2%	0.5%	0.0%	0.4%
IHOP	-0.4%	-1.0%	0.1%	1.1%	-2.7%	-2.9%	-1.5%	-1.0%
Luby's	-4.8%	-0.5%	5.5%	2.7%	3.5%	-0.6%	3.5%	2.2%
Ninety Nine	-6.0%	-0.5%	1.2%	1.3%	3.1%	3.3%	4.1%	5.5%
Mean	**-3.5%**	**-1.7%**	**0.9%**	**0.3%**	**0.5%**	**-0.1%**	**0.6%**	**2.0%**

[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)

	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Fast Casual:								
Chipotle	1.3%	8.7%	11.4%	12.6%	12.4%	10.0%	11.3%	11.1%
Cosi	-3.4%	3.1%	5.2%	4.5%	1.7%	-0.2%	-3.0%	2.6%
Einstein Noah Bagel	0.1%	-1.1%	0.7%	1.6%	-0.4%	0.2%	0.7%	1.2%
Panera Bread	9.5%	9.9%	6.9%	5.8%	3.3%	3.9%	4.4%	4.4%
Pei Wei	2.2%	3.0%	0.8%	1.3%	-0.2%	-2.7%	-3.6%	-1.9%
Qdoba Mexican Grill	3.1%	4.6%	5.6%	6.4%	6.0%	5.1%	4.3%	3.8%
Steak n Shake	5.1%	7.5%	3.0%	2.1%	4.3%	4.9%	5.3%	5.5%
Tim Horton's (US)	3.0%	3.1%	3.3%	6.3%	4.9%	6.4%	6.3%	7.2%
Mean	**2.6%**	**4.9%**	**4.6%**	**5.1%**	**4.0%**	**3.5%**	**3.2%**	**4.2%**
QSR:								
Chicken:								
KFC	-4.0%	-7.0%	-8.0%	1.0%	1.0%	-5.0%	-3.0%	-1.0%
Pollo Tropical	3.7%	6.3%	8.8%	10.7%	13.5%	10.7%	7.9%	7.8%
Popeyes	-0.4%	0.4%	5.3%	6.2%	3.9%	0.5%	1.7%	5.9%
Mean	**-0.2%**	**-0.1%**	**2.0%**	**6.0%**	**6.1%**	**2.1%**	**2.2%**	**4.2%**
Coffee/Snack:								
Caribou Coffee	5.2%	4.8%	4.4%	3.5%	4.3%	4.6%	4.1%	5.6%
Dunkin Donuts [2]	-0.6%	1.9%	2.7%	4.7%	2.8%	3.2%	6.0%	7.4%
Jamba Juice	-3.3%	-2.4%	-2.7%	0.2%	2.2%	4.3%	3.3%	7.7%
Krispy Kreme	3.4%	5.7%	5.0%	1.1%	7.0%	2.5%	4.0%	8.3%
Starbucks	7.0%	9.0%	8.0%	8.0%	7.0%	8.0%	10.0%	9.0%
Mean	**2.3%**	**3.8%**	**3.5%**	**3.5%**	**4.7%**	**4.5%**	**5.5%**	**7.6%**
Mexican:								
Taco Bell	-2.0%	1.0%	3.0%	4.0%	0.0%	-5.0%	-2.0%	-2.0%
Mean	**-2.0%**	**1.0%**	**3.0%**	**4.0%**	**0.0%**	**-5.0%**	**-2.0%**	**-2.0%**
Pizza:								
Domino's	14.3%	8.8%	11.7%	6.3%	-1.4%	4.8%	3.0%	6.8%
Papa John's	-0.4%	0.4%	-0.6%	0.7%	6.1%	0.4%	5.3%	1.7%
Pizza Hut	5.0%	8.0%	8.0%	10.0%	-3.0%	-2.0%	-3.0%	6.0%
Mean	**6.3%**	**5.7%**	**6.4%**	**5.7%**	**0.6%**	**1.1%**	**1.8%**	**4.8%**
Sandwich:								
Burger King	-6.1%	-1.5%	-4.2%	-5.8%	-6.0%	-5.3%	-0.3%	-2.0%
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	-8.6%	-9.4%	-4.0%	1.5%	0.8%	4.7%	5.8%	5.3%
McDonald's	1.5%	3.7%	5.3%	4.4%	2.9%	4.5%	4.4%	7.1%
Sonic Drive-In	-13.2%	-6.0%	-6.4%	-2.4%	1.2%	3.9%	-0.5%	0.1%
Wendy's	0.8%	-1.7%	-1.7%	0.2%	0.0%	2.3%	0.9%	4.4%
Mean	**-5.3%**	**-3.2%**	**-1.7%**	**0.2%**	**0.6%**	**3.1%**	**2.1%**	**2.7%**
Mean Total QSR	**-0.5%**	**0.8%**	**1.8%**	**3.0%**	**2.5%**	**2.6%**	**2.7%**	**4.3%**

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

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

(cont'd from page 1)

In addition, restaurant operators reported higher expectations for staffing levels in the months ahead. Twenty-four percent of restaurant operators plan to increase staffing levels in six months (compared to the same period in the previous year), while just seven percent said they expect to reduce staffing levels in six months.

Along with a positive outlook for sales and staffing levels, restaurant operators also continue to plan for capital spending in the months ahead. Forty-nine percent of restaurant operators plan to make a capital expenditure for equipment, expansion or remodeling in the next six months, essentially unchanged from the proportion reporting similarly last month.

All of these data points seem to indicate that the restaurant industry may be on its way to a sustainable recovery.

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

Implications of Healthcare Reform

The Congress has approved and President Obama will soon sign into law a comprehensive health-care bill which significantly increases taxes and fees on both individuals and the healthcare industry as a whole. The purpose of this bill is to provide universal healthcare to US citizens that are not otherwise covered by Medicare or Medicaid. Of particular importance to this bill is providing coverage for the approximately 40 million uninsured individuals, including those who are high risk and therefore cannot afford insurance coverage premiums. While we will not debate the politics, merits or idealism behind the goal of the legislation, we strongly believe there are unforeseen costs associated with implementing this program which are not funded in the existing legislation. If we are right, this will be particularly painful for the economy and the restaurant industry in particular.

There are several elements of the legislation that would support our concerns. The first is the problematic timing of cash flows. According to the bill, industry fees and taxes are charged over a ten-year period to pay for benefits applied over a six-year period. This allows the bill to remain revenue neutral on its face, but the problems with this kind of legislative wizardry are obvious and significant. Not only must we pre-pay for 4 years to cover a black hole of expenses related to the bill, but the numbers keep getting bigger. Initially, it was determined that this program would cost approximately $900 million over the course of its first 10 years. Recently however, the Congressional Budget Office revised its cost estimate and is now projecting $1.7 trillion over the same ten-year span. The fundamental questions are how will the incremental cost be paid given our intractable budget deficits and waning number of eager US Treasury bond buyers, and what unforeseen taxes will we face to make up the difference?

Another significant issue concerning this legislation is the review by the Supreme Court of the constitutionality of individual mandates as well as mandates imposed on the state. Last week the Supreme Court reviewed the legislation and will render its decision in June. Essentially, this legislation focuses its taxes on high income individuals, high-cost employer health plans and industry fees for healthcare companies. For example, under present law individuals are required to pay 7.65% of their base wage to Social Security up to a cap of $106,800. Beyond that, there is an unlimited tax of 1.45% for Medicare hospital insurance ("MHI"). Under this legislation, the 1.45% MHI tax will increase by 2.35% above $200,000 and self-employed individuals are not permitted to deduct any portion of the additional tax. Employers are liable for collecting this tax and subject to penalties if they fail to do so.

The legislation also stipulates a new 3.8% tax on unearned income such as interest, dividends, capital gains, annuities, royalties, rents and any other income which is not derived through a salary or trade. The threshold of this tax is $200,000 for singles and $250,000 for joint filers. Thus if the Bush tax cuts are left to expire, then capital gains and qualified dividends will be taxed at 23.8% and nonqualified dividends would be taxed at 43.4%. In addition, health insurance providers, pharmaceutical manufacturers and medical device companies will also be taxed in accordance with their industry market share.

There are three ways that these developments impact the restaurant industry. The first is that there will be a $900 per person fee on all qualified employees which are not covered by employer health care insurance. The second issue is that the

pass through entity taxes will be applied to entrepreneurs who own restaurant companies and this clearly will reduce take-home wages. The final issue is that we strongly believe that the proposed tax revenues in this legislation will not come close to offsetting the cost of universal healthcare insurance for all Americans covered under the Act. Consequently, we believe additional taxes and revenue measures will be necessary almost immediately to properly fund this program. As a result, the economy will be funding astronomical deficits, healthcare reform and the shortfalls inherent to what we believe is a significant imbalance in this legislation's revenue and cost assumptions.

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

You Should Consider a Liquidity Event Now

We believe, business owners and investors should carefully consider a meaningful "liquidity event" in 2012. A confluence of factors has created an advantageous time to pursue a sale of all or a portion of company stock or assets, or, for certain owners, a dividend re-cap. These factors include a high likelihood of rising capital gains and dividend tax rates, a much improved company sale valuation environment and the prospects for future economic and market challenges. Together, they have combined to form a compelling argument for business owners to actively evaluate transaction alternatives in the immediate term.

Rising Capital Gains and Dividend Tax Rates

Unless Washington extends the current rate, the federal tax on capital gains will increase from 15% to 20% on January 1, 2013. In addition, as part of the Obama healthcare legislation, 3.8% will be added to capital gains, so that for most sale transactions in 2013, the new rate will be 23.8%. While the law and higher capital gains rates could be repealed as occurred in 2010, most analysts believe this is not likely given the continuing $1 trillion plus federal deficits, the political attractiveness of taxing the wealthy and the general perception of an improving economic outlook.

For many long-time business owners, a sale of stock or assets will trigger a substantial tax gain. Paying a 15% tax this year versus 23.8% in the future would result in significantly higher net proceeds and long-term wealth. Due to the greater starting principal and the impact of compounding investment returns, Bernstein Global Wealth Management has estimated that a seller at a 15% tax rate will have nearly 43% greater wealth in 30 years than a seller at 23.8%, all else equal.

Certain owners believe they will be better off waiting on a sale because their higher forecasted earnings will result in an increased valuation that would offset any capital gains tax rate increase. Assuming constant valuation multiples and market conditions and a company with very low basis (the purchase price is practically all gain), EBITDA would need to increase by over 11% to achieve the same net proceeds. For some businesses, this may be an appropriate trade off given the high probability of substantially higher future earnings. There is substantial inherent risk in this strategy, however, that changes will occur in the transaction environment, with interest rates and/or regarding economic conditions as noted below.

Similarly, the federal tax rate on dividends is set to rise from 15% to the marginal ordinary income rate or as much as 43.4%. For certain companies such as C-corporations, a dividend recapitalization, wherein new debt proceeds are distributed to shareholders, makes much more sense to pursue in 2012 before the tax rate rises.

Improved Company Sale Environment

Market conditions for company sales have improved substantially in 2012 for several reasons. Firstly, there is an unprecedented amount of acquisition equity capital on the sidelines available for deals. It is estimated that private equity funds have over $500 billion and corporations over $2 trillion in liquidity. With relatively few quality companies "on the market", these large war chests are bidding up valuations.

Secondly, interest rates are extremely low and acquisition debt capital has become more readily available through the high yield markets and commercial banks. As lenders are providing greater amounts of low cost leverage through higher multiples of cash flow and/or advance rates on collateral, buyers are able to pay higher prices.

Third, the economy has demonstrated some stability with improved metrics in many areas including

unemployment, manufacturing and, even, housing. This has a positive effect on both consumer and business confidence, providing buyers more confidence to "pull the trigger" on acquisitions.

Overall, these and other factors have led to an uptick in valuation multiples being paid in M&A transactions. For healthy companies in particular, some market participants are observing that the bidding wars for such businesses today are reminiscent of the 2005-2007 time period.

Potential Challenges Ahead

While the economy and capital markets are demonstrating strong trends for sellers, much risk of a stumble or shock to the system exists. Certainly, any major European debt or structural meltdown could set back the stock markets as well as investor and lender confidence. Oil prices have been rising dramatically, and $5.00 a gallon gas would paralyze the consumer who represents two-thirds of the U.S. economy. An Israeli attack on Iran would shoot oil prices even higher. Also, the U.S. economy is fragile, in that most of the corporate profit gains have come from pushing the labor cost line to the lowest percentage of sales in recent memory. This brings into question whether corporations have any more ammunition for profit improvement, especially when the top line sales are held down by, not coincidentally, the low wage and interest rate environment. All of these points will be front and center in the 2012 Presidential and Congressional elections, which themselves inject tremendous uncertainty for the future direction of taxes, the economy and the capital markets. Lastly, with federal, state and local deficits running wild, government spending and employment will continue to drop, slowing economic demand for goods and services. In sum, there are real economic and political risks that could readily dampen the M&A market in 2013.

Urgency Required

We recommend to business owners considering a sale transaction that they formulate an accelerated plan in order to "get in front" of the busy anticipated M&A calendar later this year. We expect many owners to pursue liquidity events for tax purposes by December 31st. Also, many private equity firms are looking to sell portfolio companies this year before carried interest (their promoted share of profits) is converted from capital gains treatment to ordinary income. As a result of the heavy forward calendar, the third and especially the fourth quarters are likely to be "clogged up", and the availability of financing sources, legal professionals and other sale transaction resources will be very limited. Also, we believe buyers will have substantial negotiating leverage in the fourth quarter as they will know the economic benefit to sellers of closing in 2012 without the time left for sellers to "switch horses." "Re-trades" will be common.

Conclusion

Whether you are a business owner, investor or stockholder, if you are contemplating a meaningful sale or cash distribution during the next several years, we believe you should consider acting with urgency. There are numerous alternatives available from a 100% sale to minority equity sale to a dividend re-cap. Whatever makes sense for you, it is prudent to orchestrate a liquidity event in order to diversify your wealth in what is likely to be the lowest tax rate environment of our lifetime and in a very favorable deal market. Any transaction process can take four to six months if not longer to complete; therefore, to beat the year-end rush, we encourage you to act promptly. Trinity Capital is well versed in all types of sale and dividend transactions discussed in this article and we would be pleased to share our perspectives on your situation.

Contributing Editor Bob Woolway is a Managing Director for Trinity Capital.

For more information, please contact:

Kevin Burke, Managing Director
310-231-3100
kburke@trinitycapitalllc.com