Trinity Capital

# 4th Quarter 2012 Restaurant Industry Commentary

What's Inside This Commentary



## Same-Store Sales Discussion and Analysis

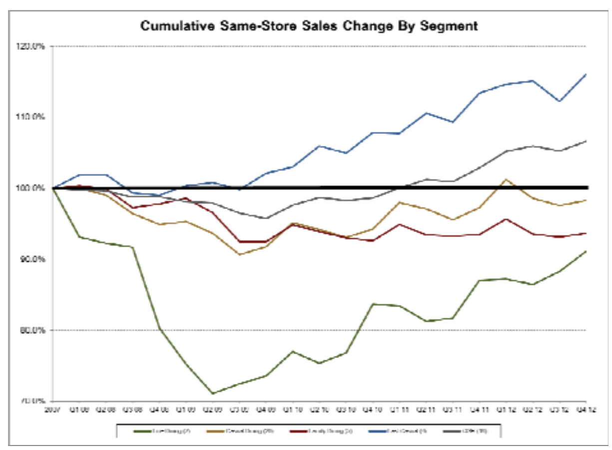
The restaurant industry reported its eleventh consecutive quarter of same store sales gains. The fourth quarter of 2012 remained positive in same-store sales growth, but to a lesser degree than in previous quarters. It is important to note that much of these gains are price, not traffic.

In *fine dining*, the companies we track were up from 2011 by an average of 4.7% for the fourth quarter of 2012. It is important to note that while fine dining sales continue to be below pre-recession levels they have climbed back to within 90% of YE 2007 sales.

In *casual dining*, the concepts we follow were up by an average of 1.0% for the fourth quarter of 2012. This is the eleventh consecutive quarter that the casual dining segment has posted positive quarterly same-store sales growth. However, five of the concepts had negative sales versus two in the third quarter. According to Knapp Track, casual dining guest counts were down by 3.3% in October, down by 1.1% in November and down by 3.4% in December. In fact, Knapp Track has reported negative guest counts in 14 of the last 17 months. Therefore, the SSS gains are purely a function of price. The family dining concepts we track reported an average increase in same-store sales of 0.1% during the fourth quarter of 2012, a slight improvement over the third quarter.

The *fast casual* segment reported positive same store sales performance for a fourteenth consecutive quarter. The segment was positive by 2.3%. This is the smallest same store sales growth since the fourth quarter of 2009, which is not surprising as this segment continues to comp over strong results.

In the *QSR* segment, the 19 concepts we track were positive during the fourth quarter of 2012 by an average of 3.6%. Pizza Hut and Wendy's slipped into negative territory at -1.0% and -0.5%, respectively. The Chicken segment had another strong showing in the fourth quarter, up by an average of 6.2% with Pollo Tropical leading the way, up 8.3% followed by Popeye's, up 6.4%. KFC had maintained its positive momentum as well, up 4.0% again.




We continue to closely watch the impact that reduced discretionary dollars from the 2% payroll tax increase has on restaurant sales and are concerned about further slowdown in traffic among all segments. As we mentioned last quarter, the QSR segment is resilient but not immune to lower consumer sentiment and spending. While fourth quarter same store sales in QSR were positive 3.6%, the pace of positive growth has slowed and operators should remain laser focused on cost controls and efforts to drive traffic.


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

## Same-Store Sales ("SSS") Data

| | Q1 11 | Q2 11 | Q3 11 | Q4 11 | Q1 12 | Q2 12 | Q3 12 | Q4 12 |
|---|---|---|---|---|---|---|---|---|
| **Fine Dining:** | | | | | | | | |
| Fleming's | 11.4% | 9.9% | 10.1% | 0.3% | 5.4% | 6.8% | 10.1% | 4.0% |
| Ruth's Chris | 5.2% | 5.8% | 2.6% | 7.7% | 3.7% | 6.0% | 5.9% | 5.4% |
| **Mean** | **8.3%** | **7.9%** | **6.4%** | **4.0%** | **4.6%** | **6.4%** | **8.0%** | **4.7%** |
| **Casual Dining:** | | | | | | | | |
| Applebee's | 3.9% | 3.1% | -0.3% | 1.0% | 1.2% | 0.4% | 2.0% | 0.9% |
| Benihana | 5.6% | 6.0% | 6.4% | 7.0% | 4.8% | 4.5% | - | - |
| BJ's Resturants | 7.8% | 6.9% | 6.5% | 5.1% | 3.3% | 4.4% | 2.3% | 3.0% |
| Bonefish | 9.6% | 10.2% | 7.4% | 5.9% | 6.2% | 2.1% | 3.5% | 1.0% |
| Buffalo Wild Wings | 2.4% | 3.9% | 4.8% | 7.1% | 8.1% | 5.4% | 6.0% | 6.7% |
| Carrabba's Italian Grill | 3.9% | 4.8% | 6.3% | 3.5% | 4.3% | 1.5% | 6.3% | -0.4% |
| CEC Entertainment | 1.1% | -2.0% | -6.3% | -3.6% | -4.2% | -2.4% | -2.3% | -2.2% |
| Cheesecake Factory | 2.1% | 2.3% | 0.8% | 2.7% | 2.6% | 2.1% | 2.9% | 1.3% |
| Chili's Grill & Bar | -3.0% | 2.1% | 1.7% | 1.4% | 4.6% | 2.2% | 2.8% | 1.0% |
| Dave & Buster's | 5.3% | 1.9% | 2.7% | -0.9% | -0.3% | 5.4% | 5.4% | - |
| Famous Dave's | 3.0% | -1.2% | -0.1% | 3.6% | -1.6% | -0.6% | 0.2% | -6.0% |
| Frisch's Golden Corral [1] | -0.9% | -3.6% | -4.9% | 7.8% | 12.4% | 0.0% | 0.0% | 0.0% |
| Granite City | 3.8% | 3.5% | 3.0% | 4.0% | 1.9% | 1.5% | 2.5% | 2.6% |
| LongHorn Steakhouse | 6.1% | 6.0% | 4.8% | 6.7% | 3.8% | 3.0% | 2.2% | -0.8% |
| Maggiano's | 3.4% | 5.7% | 3.5% | 2.8% | 3.9% | 1.9% | 0.9% | 0.6% |
| Olive Garden | 0.0% | 0.0% | -2.9% | -2.5% | 2.0% | -1.8% | 0.3% | -3.2% |
| Outback | 4.3% | 1.8% | 6.0% | 3.6% | 5.3% | 2.3% | 4.5% | 5.3% |
| Red Lobster | 0.1% | 3.8% | 10.7% | 6.8% | 6.0% | -3.9% | -2.6% | -2.7% |
| Red Robin | 2.1% | 2.9% | 2.1% | 4.5% | 1.0% | 1.2% | 0.6% | 1.4% |
| Ruby Tuesday | -1.2% | -0.1% | -4.1% | -4.2% | -5.0% | -4.6% | 1.9% | 0.3% |
| Taco Cabana | 2.0% | 4.5% | 5.3% | 2.7% | 6.1% | 4.5% | 1.8% | 6.8% |
| Texas Roadhouse | 4.5% | 4.3% | 3.9% | 5.6% | 6.2% | 4.6% | 3.9% | 4.5% |
| **Mean** | **3.0%** | **3.0%** | **2.6%** | **3.2%** | **3.3%** | **1.5%** | **2.1%** | **1.0%** |
| **Family Dining:** | | | | | | | | |
| Bob Evans | 1.2% | -1.8% | -1.5% | 1.6% | -0.6% | 1.0% | 1.0% | 1.6% |
| Denny's | -1.7% | 2.0% | 0.9% | 1.6% | 2.4% | 0.8% | 0.4% | 1.7% |
| Frisch's Big Boy | 0.2% | 0.5% | 0.0% | 0.4% | 1.7% | -1.7% | -0.2% | 0.0% |
| IHOP | -2.7% | -2.9% | -1.5% | -1.0% | -0.5% | -1.4% | -2.0% | -2.6% |
| Luby's | 3.5% | -0.6% | 3.5% | 2.2% | 1.1% | 2.2% | 0.2% | 0.0% |
| **Mean** | **0.1%** | **-0.6%** | **0.3%** | **1.0%** | **0.8%** | **0.2%** | **-0.1%** | **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)**

| | Q1 11 | Q2 11 | Q3 11 | Q4 11 | Q1 12 | Q2 12 | Q3 12 | Q4 12 |
|---|---|---|---|---|---|---|---|---|
| **Fast Casual:** | | | | | | | | |
| Chipotle | 12.4% | 10.0% | 11.3% | 11.1% | 12.7% | 10.2% | 4.8% | 3.8% |
| Cosi | 1.7% | -0.2% | -3.0% | 2.6% | 7.5% | -0.5% | -0.7% | -0.3% |
| Einstein Noah Bagel | -0.4% | 0.2% | 0.7% | 1.2% | 1.1% | 1.3% | 0.2% | 1.4% |
| Panera Bread | 3.3% | 3.9% | 4.4% | 4.4% | 6.3% | 5.9% | 5.8% | 4.9% |
| Qdoba Mexican Grill | 6.0% | 5.1% | 4.3% | 3.8% | 3.0% | 2.1% | 3.3% | 1.0% |
| Steak n Shake | 4.3% | 4.9% | 5.3% | 5.5% | 5.5% | 4.8% | 2.9% | - |
| Tim Horton's (US) | 4.9% | 6.4% | 6.3% | 7.2% | 8.5% | 4.9% | 2.3% | 3.2% |
| **Mean** | **4.6%** | **4.3%** | **4.2%** | **5.1%** | **6.4%** | **4.1%** | **2.7%** | **2.3%** |
| **QSR:** | | | | | | | | |
| **Chicken:** | | | | | | | | |
| KFC | 1.0% | -5.0% | -3.0% | -1.0% | 2.0% | 1.0% | 4.0% | 4.0% |
| Pollo Tropical | 13.5% | 10.7% | 7.9% | 7.8% | 9.4% | 7.8% | 7.0% | 8.3% |
| Popeyes | 3.9% | 0.5% | 1.7% | 5.9% | 8.1% | 8.4% | 6.8% | 6.4% |
| **Mean** | **6.1%** | **2.1%** | **2.2%** | **4.2%** | **6.5%** | **5.7%** | **5.9%** | **6.2%** |
| **Coffee/Snack:** | | | | | | | | |
| Caribou Coffee | 4.3% | 4.6% | 4.1% | 5.6% | 2.5% | 2.8% | 3.5% | - |
| Dunkin Donuts [2] | 2.8% | 3.2% | 6.0% | 7.4% | 7.2% | 4.0% | 4.0% | 3.2% |
| Jamba Juice | 2.2% | 4.3% | 3.3% | 7.7% | 12.7% | 5.7% | 2.5% | 0.6% |
| Krispy Kreme | 7.0% | 2.5% | 4.0% | 8.3% | 2.1% | 5.4% | 6.8% | 7.5% |
| Starbucks | 7.0% | 8.0% | 10.0% | 9.0% | 8.0% | 7.0% | 7.0% | 7.0% |
| **Mean** | **4.7%** | **4.5%** | **5.5%** | **7.6%** | **6.5%** | **5.0%** | **4.8%** | **4.6%** |
| **Mexican:** | | | | | | | | |
| Taco Bell | 0.0% | -5.0% | -2.0% | -2.0% | 6.0% | 13.0% | 7.0% | 5.0% |
| **Mean** | **0.0%** | **-5.0%** | **-2.0%** | **-2.0%** | **6.0%** | **13.0%** | **7.0%** | **5.0%** |
| **Pizza:** | | | | | | | | |
| Domino's | -1.4% | 4.8% | 3.0% | 6.8% | 2.0% | 1.7% | 3.3% | 4.7% |
| Papa John's | 6.1% | 0.4% | 5.3% | 1.7% | 1.1% | 5.7% | 2.5% | 5.2% |
| Pizza Hut | -3.0% | -2.0% | -3.0% | 6.0% | 5.0% | 4.0% | 6.0% | -1.0% |
| **Mean** | **0.6%** | **1.1%** | **1.8%** | **4.8%** | **2.7%** | **3.8%** | **3.9%** | **3.0%** |
| **Sandwich:** | | | | | | | | |
| Burger King | -6.0% | -5.3% | -0.3% | -2.0% | 4.2% | 4.4% | 1.6% | 3.7% |
| Carl's Jr. | -0.4% | 2.1% | 2.0% | 2.0% | 1.7% | 2.6% | 5.5% | 2.6% |
| Hardee's | 5.7% | 9.6% | 2.5% | 1.8% | 6.1% | 2.6% | 3.6% | 2.3% |
| Jack in the Box | 0.8% | 4.7% | 5.8% | 5.3% | 5.6% | 3.4% | 3.1% | 1.9% |
| McDonald's | 2.9% | 4.5% | 4.4% | 7.1% | 8.9% | 3.6% | 1.2% | 0.3% |
| Sonic Drive-In | 1.2% | 3.9% | -0.5% | 0.1% | 3.5% | 2.8% | 2.3% | 3.0% |
| Wendy's | 0.0% | 2.3% | 0.9% | 4.4% | 0.7% | 3.2% | 2.8% | -0.5% |
| **Mean** | **0.6%** | **3.1%** | **2.1%** | **2.7%** | **4.4%** | **3.2%** | **2.9%** | **1.9%** |
| **Mean Total QSR** | **2.5%** | **2.6%** | **2.7%** | **4.3%** | **5.1%** | **4.7%** | **4.2%** | **3.6%** |

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

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

## Impact of Supermarket Trends on Restaurants

For many years, food consumed away from home represented a growing percentage of total consumption. Since 2008 and the commencement of the Great Recession, food consumed at home has increased. Economic realities have driven consumers to prepare more affordable meals in their homes. At the same time, supermarkets have become more formidable competitors to restaurants through their broader offering of convenient pre-prepared or easily prepared foods with fresh high-quality ingredients and restaurant standard taste. Restaurant operators should be cognizant of trends occurring in supermarkets, which are competing for the consumer food dollar. In that regard and based on numerous discussions with food and supermarket industry participants, Trinity sees the following major trends occurring in the grocery store which could impact restaurants:

*Frozen Food Improvements:* In prior times, the general perception of frozen foods was that they were of inferior quality and nutritional value. This has changed. Surprisingly, according to the FDA, there is actually no difference from a nutritional standpoint between fresh and frozen fruits and vegetables. Because frozen produce is harvested and promptly flash frozen, it is more nutrient dense than the fresh product which spends much of its time in distribution. Likewise, many frozen meals now consist of high quality ingredients with relatively low fat and sodium levels. These meals are portioned controlled and provide an attractive alternative to home-cooked alternatives and to restaurant served offerings as well. Consumers can stay at home without the need to make a meal from scratch but still have a nutritious, flavorful experience. Without the historical stigma, frozen meals are a greater threat to restaurant traffic than ever before.

*Store Brand Growth:* Like frozen foods, store brands (or private label) used to be considered of inferior quality versus national brand products. Many consumers are now more comfortable with the quality of store brands, and appreciate the lower prices. Having attended the Private Label Manufacturers Association conference in Chicago, we believe national brands will continue to lose share. Perhaps concerned about this trend, ConAgra recently bought Ralcorp, a store brand producer, for $6.8 billion. Lower store brand pricing combined with a resulting increase in national brand promotion activity could result in lower overall grocery prices, which would be a negative for restaurants.

*Mini-meals:* Bigger is not necessarily better. Food retailers are offering more pre-portioned snacking or mini-meal options as consumers increasingly prefer smaller bites and more frequent eating patterns. Nutritionists recommend such diet programs as healthier than infrequent large meals. Look for increased offerings in grocery stores of healthy, convenient smaller-sized food choices. Restaurant operators may wish to add menu items such as tapas and sharable entrees that address this desire for smaller portions and give consumers a choice.

*Increased Importance of Millennials:* Supermarkets and food companies realize that Millennials (born between 1982 and 2001) are a growing percentage of shoppers. This group tends to have passionate interests regarding food, its origin and how it is prepared. At the same time, they want affordable foods that are flavorful and ethnically diverse, and prefer natural, healthy options. Millennials are more interested in quality products at low prices and less concerned about brand loyalty. Grocery stores are increasing their offerings of food directed at Millennials, and we believe certain restaurants should as well.

*Smart Phone Apps:* With the proliferation of smart phone applications, consumers are increasingly making smarter shopping decisions at supermarkets, while saving money. Such apps include label translators, nutritional content guides, smart substitution tools and shopping list generators. Increasingly, smart phones will be tied into in-store discounts, specials and other deals. Ultimately, experts expect smart phones to enable the individual shopper to access specific promotions tailored to their preferences. Smart phone users are looking for more interactivity in their shopping experience, both at the grocery store and in the restaurant.

*Growing Influence of Retail Dieticians:* It is anticipated that supermarket-employed dieticians will increasingly attempt to influence and educate consumers on making better buying decisions. Consumers are being more selective about food choices and are more frequently reading labels to learn nutritional and caloric values. Supermarkets will often act as "gate keepers" demanding that label claims are substantiated and transparent. Grocery stores will offer more healthy options rich in nutrients, antioxidants and vitamins. Restaurant operators should strive to be more flexible in meeting various dietary requests.

*Conclusion:* We believe restaurant companies should be mindful of all major competitors for the consumer food dollar. By monitoring trends occurring in supermarkets, restaurant operators may wish to adjust their strategy as it relates to such issues as menu items, portion sizes, target marketing and the use of technology in customer interfaces.

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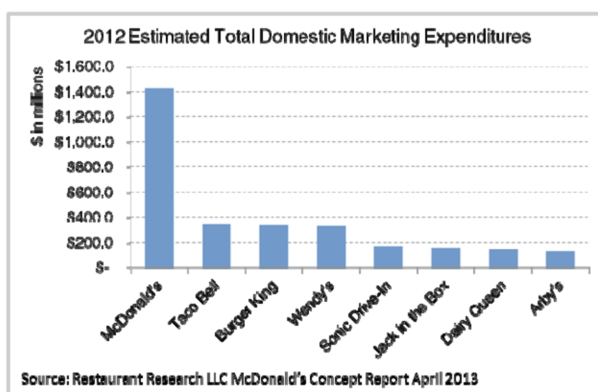
## Restaurant Local Area Advertising Expenditures and Social Media

Social media and changing dynamics in cable and televised media have completely changed the landscape of local area restaurant advertising. In fact, there have been more changes in local area advertising spending in the past two years than in the past 20 years. For example, social media is much less efficient at the local level than a nationally coordinated campaign, and therefore many franchisors have successfully asked for and received local area contributions from franchisees to fund national/centralized efforts. This consolidation into one effort frequently leads to tremendous cost reduction in aggregate agency fees, often as much as 80% or 90% of prior year spend. In addition, these dollars are channeled through the hands of organizations which deploy resources more effectively in order to generate more impressions per unit of spending, increased bilateral information flow and effective messaging.

KFC and Taco Bell have successfully channeled local area spending into national/centralized stewardship, effectively reducing the number of agencies and attendant fees while greatly improving their media efficacy. Local area advertising spending suffers inherent conflicts as the cost of GRP's ("gross rating points") can vary dramatically from market to market, thereby favoring larger markets when ad funds are allocated by equivalent media time buys. When more of these funds are skewed towards the larger markets to compensate for their higher televised media costs, it can lead to franchisee conflicts. This development has been traditionally viewed by franchisees as an unfair treatment of small market franchisees. Effectively "nationalizing" this spending addresses some of the inherent inequities built into the old world fixed contribution gross rating point advertising system. Another important issue is that the quality of the agency and results are generally much better when selected by franchisor advertising executives/professionals as opposed to franchisees (although there have been some infrequent yet significant exceptions to this!) Some brands have been able to exploit the presence of two different agencies, one for cable and televised media and the second for social media. As long as there is consistency in messaging, this can provide some advantages in engaging expertise from the nation's best providers in each discipline.



Source: Restaurant Research LLC McDonald's Concept Report April 2013

Notably, McDonald's strategy differs somewhat from the prevailing QSR trend of consolidating local and national ad spends in order to improve quality, pricing, targeting and uniformity of messaging. Many of the McDonald's local or franchisee directed media efforts have substantial budgets and professional agencies. In larger local markets, McDonald's franchisees have very sophisticated programs which target all the usual suspects e.g. soccer moms, tweens, HFFUs, African-Americans, acculturated Hispanics, un-acculturated Hispanics, etc. with very effective product; price point and branding messages. As an older and well organized concept, this is not unusual, and this is exacerbated by the fact that the 4% (of sales) McDonald's advertising budget is divided 60% local and 40% national. McDonald's periodically adds to the national spend and also contributes in markets where they have substantial corporate stores. Perhaps more importantly, their overall budget of nearly a billion and a half dollars represents such hegemony to their average competitor that it creates ample leeway in funding effective professional national and local campaigns in social or televised media.

Finally, social media will transform much of how restaurant operators promote their concepts to most consumers now and dramatically in the future. Several restaurant concepts have already successfully integrated social media into their organizations realizing not just advertising and promotional success, but also realizing benefits in real-time consumer feedback on products; pricing and service! The enormous potential reach of social media is a real threat to televised media for certain demographics. This is particularly true as programming has mushroomed in the cable and televised media world during the past 10 years making customers harder and more expensive to find. Ultimately, it will be much more effective to reach local customers in a nationally directed campaign which continuously examines where to allocate local area media spending.

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