TRINITY CAPITAL
INVESTMENT BANKING

RESTAURANT INDUSTRY COMMENTARY

Inside This Issue

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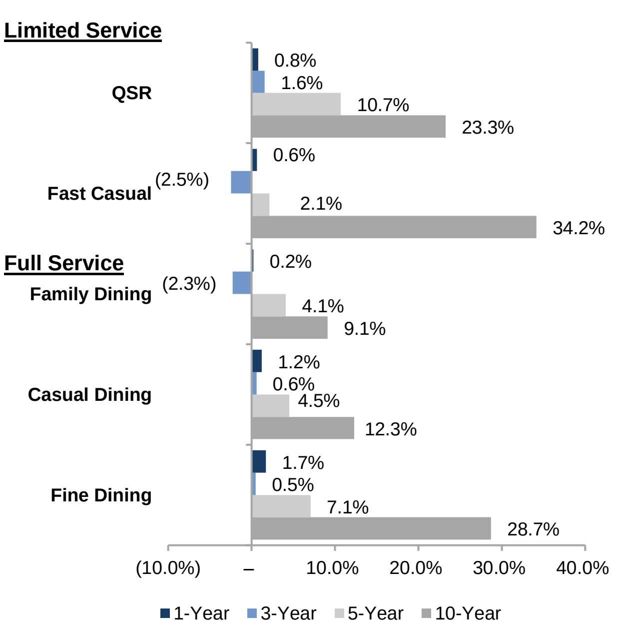
Same-Store Sales Discussion

Restaurant industry same-store sales ("SSS") increased for the sixth straight quarter in Q1 2019 following six consecutive quarters of SSS declines. Of the 59 companies we follow, 37, or 71%, generated SSS growth.

As shown in the figure below, long-term performance, measured over 3-, 5- and 10-year periods, has been most consistent in QSR. Fast casual provided the most growth over the past 10 years; however, the segment was *negative* over the past three years, as was the family dining segment. Fine dining led the industry with 1.7% growth in Q1 2019, extending its positive streak to three consecutive quarters.

Cumulative Q1 2019 SSS by Segment



Source: Company filings; Technomic, Inc.

QSR: The QSR segment extended its streak of positive year-over-year ("YOY") SSS growth to eight consecutive quarters with a 0.8% increase. Mexican concepts led the segment for the 12th straight quarter with 2.0% growth, largely due to another strong quarter from Taco Bell (+4.0%). Chicken concepts lagged the segment with a 0.1% decline, driven by a 2.6% decrease for Pollo Tropical, partially offset by 2.0% growth for KFC, its 12th consecutive quarter of growth. Domino's (+3.9%) delivered another strong quarter in Q1, but its growth is showing signs of slowing. The sandwich (+1.6%) and coffee/snack (+0.8%) segments posted modest growth led by industry leaders McDonald's (+4.5%) and Starbucks (+4.0%), respectively.

Fast Casual: Results for fast casual concepts were polarized in Q1, with strong performance for Chipotle (+9.9%), Shake Shack (+3.6%) and Noodles & Company (+3.0%), and substantial losses for Fuddruckers (-5.3%), Potbelly (-4.7%) and Pie Five (-4.4%). On average, sales were slightly positive (+0.6%) for the segment.

Family Dining: Family dining extended its positive streak of YOY growth posting a modest increase of 0.2% with strong results for Chuck E Cheese (+7.7%) offset by another weak quarter for Steak n Shake (-7.9%), which turned in the worst results in the segment for the 4th consecutive quarter and extended its losing streak to 10 quarters.

Casual Dining: The casual dining segment posted positive quarterly results for the sixth consecutive quarter with SSS growth of 1.2%. Texas Roadhouse (+5.2%) led the segment marking its 37th consecutive positive quarter. Other strong performers included BJ's (+2.0%), which also produced strong results in every quarter of 2018, and Olive Garden (+4.3%), which has consistently outperformed the segment, Texas Roadhouse excluded, over the past few years. On the other hand, Red Robin (-3.3%) lagged the segment, marking its 5th straight quarter of negative SSS.

Fine Dining: All fine dining concepts that report SSS served up positive results in Q1, as the segment led the restaurant industry with a 1.7% SSS increase. Capital Grille (+4.3%) and Ruth's Chris (+1.8%) led the pack, while Fleming's (+0.6%) and Del Frisco's Grille (+0.2%) delivered lower growth. Fine dining steak chains continued to be outperformed by casual steak chains in Q1 2019.

Contributing Editor Aaron Edwards is a Vice President at Trinity Capital.

Same-Store Sales Data

	FY 2016			FY 2017				FY 2018				FY 2019
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
QSR												
Chicken												
Bojangles[1]	0.2%	0.8%	2.4%	(1.7%)	(1.4%)	(2.2%)	(3.1%)	(0.6%)	(0.2%)	0.4%	N/A	N/A
KFC	2.0%	6.0%	4.0%	2.0%	2.0%	1.0%	1.0%	0.0%	1.0%	1.0%	1.0%	2.0%
Pollo Tropical	(1.4%)	(1.0%)	(4.0%)	(6.7%)	(7.7%)	(10.9%)	(0.1%)	2.8%	3.4%	6.5%	(1.9%)	(2.6%)
Popeye's	0.0%	1.5%	3.0%	(0.4%)	(3.3%)	(2.6%)	(2.5%)	2.3%	1.8%	(0.2%)	(0.1%)	0.4%
Mean	**0.2%**	**1.8%**	**1.4%**	**(1.7%)**	**(2.6%)**	**(3.7%)**	**(1.2%)**	**1.1%**	**1.5%**	**1.9%**	**(0.3%)**	**(0.1%)**
Coffee/Snack												
Baskin Robbins	0.6%	(0.9%)	0.9%	(2.4%)	(0.9%)	0.4%	5.1%	(1.0%)	(4.0%)	1.8%	(3.7%)	(2.8%)
Dunkin Donuts	0.5%	2.0%	1.9%	0.0%	0.8%	0.6%	0.8%	(0.5%)	1.4%	1.3%	0.0%	2.4%
Jamba Juice[2]	4.2%	(1.1%)	(2.2%)	(5.8%)	0.0%	N/A	2.9%	2.3%	2.4%	N/A	N/A	N/A
Starbucks	4.0%	4.0%	3.0%	3.0%	5.0%	2.0%	2.0%	2.0%	1.0%	4.0%	4.0%	4.0%
Tim Horton's	5.9%	4.5%	3.6%	(0.1%)	(0.8%)	0.3%	0.1%	0.1%	0.0%	0.6%	1.9%	(0.6%)
Mean	**3.0%**	**1.7%**	**1.4%**	**(1.1%)**	**0.8%**	**0.8%**	**2.2%**	**0.6%**	**0.2%**	**1.9%**	**0.6%**	**0.8%**
Mexican												
Del Taco	3.3%	6.7%	5.5%	4.2%	7.1%	4.1%	2.4%	3.7%	3.3%	1.4%	1.9%	(0.1%)
Taco Bell	(1.0%)	3.0%	3.0%	8.0%	4.0%	3.0%	2.0%	1.0%	1.9%	5.0%	6.0%	4.0%
Mean	**1.2%**	**4.9%**	**4.3%**	**6.1%**	**5.6%**	**3.6%**	**2.2%**	**2.4%**	**2.6%**	**2.8%**	**2.8%**	**2.0%**
Pizza												
Domino's	9.7%	13.0%	12.2%	10.2%	9.5%	8.4%	4.2%	8.3%	6.9%	6.3%	5.6%	3.9%
Papa John's	4.8%	5.5%	3.8%	2.0%	1.4%	1.0%	(3.9%)	(5.3%)	(6.1%)	(9.8%)	(8.1%)	(6.9%)
Papa Murphy's	(4.0%)	(5.8%)	(7.8%)	(5.0%)	(4.3%)	(4.1%)	(2.6%)	(3.9%)	(2.4%)	(2.1%)	(1.3%)	N/A
Pizza Hut	1.0%	(2.0%)	(4.0%)	(7.0%)	(3.0%)	0.0%	2.0%	4.0%	0.0%	1.0%	1.0%	0.0%
Pizza Inn	0.3%	0.2%	(1.2%)	0.1%	(9.5%)	1.4%	2.7%	2.3%	2.5%	2.3%	2.7%	3.3%
Mean	**2.4%**	**2.2%**	**0.6%**	**0.1%**	**(1.2%)**	**1.3%**	**0.5%**	**1.1%**	**0.2%**	**(0.5%)**	**(0.0%)**	**0.1%**
Sandwich												
Burger King	(0.8%)	(0.5%)	1.8%	(2.2%)	3.0%	4.0%	5.1%	4.2%	1.8%	(0.7%)	0.8%	0.4%
Jack in the Box	1.1%	2.0%	3.1%	(0.8%)	(0.2%)	(1.0%)	(0.2%)	(0.1%)	0.5%	0.5%	(0.1%)	0.2%
McDonald's	1.8%	1.3%	(1.3%)	1.7%	3.9%	4.1%	4.5%	2.9%	2.6%	2.4%	2.3%	4.5%
Sonic Drive-In[3]	2.0%	(2.0%)	(2.0%)	(7.4%)	(1.2%)	(3.3%)	(1.7%)	(2.9%)	(0.2%)	2.6%	N/A	N/A
Wendy's	0.4%	1.4%	0.8%	1.6%	3.2%	2.0%	1.3%	1.6%	1.9%	(0.2%)	0.2%	1.3%
Mean	**0.9%**	**0.4%**	**0.5%**	**(1.4%)**	**1.7%**	**1.2%**	**1.8%**	**1.1%**	**1.3%**	**0.9%**	**0.8%**	**1.6%**
Mean Total QSR	**1.6%**	**1.8%**	**1.3%**	**(0.3%)**	**0.4%**	**0.4%**	**1.0%**	**1.1%**	**0.9%**	**1.2%**	**0.7%**	**0.8%**
Fast Casual[1]												
Chipotle	(23.6%)	(21.9%)	(4.8%)	17.8%	8.1%	1.0%	0.9%	2.2%	3.3%	4.4%	6.1%	9.9%
El Pollo Loco	2.4%	1.6%	(1.3%)	(0.3%)	2.9%	1.7%	1.4%	(1.1%)	(0.9%)	2.6%	4.4%	2.4%
Fuddruckers	(1.0%)	(0.8%)	(1.6%)	(1.1%)	(0.9%)	(3.6%)	0.6%	0.6%	(5.8%)	(3.9%)	(11.2%)	(5.3%)
Noodles & Company	(1.0%)	(0.7%)	(1.3%)	(2.0%)	(3.4%)	(3.5%)	(0.9%)	(0.2%)	5.4%	5.5%	4.0%	3.0%
Pie Five	(12.0%)	(14.7%)	(17.4%)	(15.8%)	(16.2%)	(17.3%)	(13.7%)	(12.6%)	(6.4%)	(1.8%)	(3.6%)	(4.4%)
Potbelly	1.7%	0.6%	0.1%	(3.1%)	(4.9%)	(4.8%)	(2.4%)	(3.6%)	(0.2%)	(0.2%)	(1.7%)	(4.7%)
Shake Shack	4.5%	2.9%	1.6%	(2.5%)	(1.8%)	(1.6%)	0.8%	1.7%	1.1%	(0.7%)	2.3%	3.6%
Zoe's Kitchen[4]	4.0%	2.4%	0.7%	(3.3%)	(3.8%)	(0.5%)	0.3%	(1.5%)	(2.5%)	(7.6%)	N/A	N/A
Mean	**(3.1%)**	**(3.8%)**	**(3.0%)**	**(1.3%)**	**(2.5%)**	**(3.6%)**	**(1.6%)**	**(1.8%)**	**(0.8%)**	**(0.2%)**	**0.0%**	**0.6%**

(1) Bojangles was taken private by Durational Capital Management and Jordan Co. in Q4 2018

(2) Jamba Juice was taken private by Focus Brands, a portfolio company of Roark Capital, in Q3 2018

(3) Sonic Drive-In was taken private by Inspire Brands, a portfolio company of Roark Capital, in Q4 2018

(4) Zoe's Kitchen was taken private by Cava Group in Q4 2018

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

Same-Store Sales Data (Cont.)

	FY 2016			FY 2017				FY 2018				FY 2019
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Family Dining												
Chuck E Cheese	2.6%	3.7%	(1.6%)	(2.8%)	(3.8%)	(6.9%)	(6.0%)	(5.1%)	1.0%	2.2%	3.3%	7.7%
Cracker Barrel	3.2%	1.3%	0.6%	(0.4%)	(0.8%)	0.2%	1.1%	1.5%	(2.6%)	1.4%	3.8%	1.3%
Denny's	(0.5%)	1.0%	0.5%	(1.1%)	2.6%	0.6%	2.2%	1.5%	(0.7%)	1.0%	1.4%	1.3%
IHOP	0.2%	(0.1%)	(2.1%)	(1.7%)	(2.6%)	(3.2%)	(0.4%)	1.0%	0.7%	1.2%	3.0%	1.2%
Luby's	(0.2%)	0.0%	(2.2%)	(4.4%)	(2.5%)	(4.5%)	1.5%	1.5%	2.4%	3.9%	(3.0%)	(2.2%)
Steak n Shake	(0.7%)	0.2%	(0.4%)	(3.3%)	(3.1%)	(2.2%)	(1.8%)	(1.7%)	(3.4%)	(6.9%)	(5.1%)	(7.9%)
Mean	**0.8%**	**1.0%**	**(0.9%)**	**(2.3%)**	**(1.7%)**	**(2.7%)**	**(0.6%)**	**(0.2%)**	**(0.4%)**	**0.5%**	**0.6%**	**0.2%**
Casual Dining												
Applebee's	(4.2%)	(5.2%)	(7.2%)	(7.9%)	(6.2%)	(7.7%)	1.3%	3.3%	5.7%	7.7%	3.5%	1.8%
Bahama Breeze	4.7%	3.9%	2.6%	0.5%	1.4%	1.2%	2.5%	0.2%	0.6%	1.1%	(1.1%)	(3.7%)
BJ's Restaurants	(0.2%)	(3.4%)	(2.2%)	(1.3%)	(1.4%)	(1.7%)	1.6%	4.2%	5.6%	6.9%	4.5%	2.0%
Bonefish	0.9%	1.7%	(1.9%)	(0.8%)	(2.6%)	(4.3%)	0.6%	0.9%	1.5%	1.8%	(1.1%)	1.9%
Carrabba's Italian Grill	(4.8%)	(2.1%)	(2.3%)	(3.8%)	0.4%	(2.8%)	1.3%	0.9%	(0.6%)	(0.6%)	0.8%	0.3%
Cheesecake Factory	0.3%	1.7%	1.1%	0.3%	(0.5%)	(2.3%)	(0.9%)	2.1%	1.4%	1.5%	1.9%	1.3%
Chili's Grill & Bar	(1.8%)	(1.3%)	(3.2%)	(1.7%)	(1.7%)	(3.0%)	(1.6%)	(1.1%)	0.4%	1.9%	3.0%	2.7%
Chuy's	1.0%	0.3%	(1.1%)	(0.7%)	(1.0%)	(2.1%)	1.3%	(1.5%)	1.0%	0.5%	0.9%	3.2%
Dave & Buster's	1.0%	5.9%	3.2%	2.2%	1.1%	(1.3%)	(5.9%)	(4.9%)	(2.4%)	(1.3%)	2.9%	(0.3%)
Famous Dave's	(4.3%)	(3.8%)	(4.7%)	(4.8%)	(3.2%)	(1.5%)	1.8%	(0.9%)	(1.6%)	(1.4%)	(1.5%)	(0.7%)
Joe's Crab Shack	(6.8%)	(6.5%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Kona Grill	2.5%	0.7%	(4.1%)	(4.3%)	(5.3%)	(7.2%)	(6.5%)	(8.3%)	(12.1%)	(14.1%)	N/A	N/A
LongHorn Steakhouse	2.2%	0.6%	0.1%	0.2%	3.5%	2.6%	3.8%	2.0%	2.4%	3.1%	2.9%	3.8%
Maggiano's	(1.7%)	(0.6%)	(0.8%)	1.6%	0.5%	(2.6%)	1.8%	0.5%	0.3%	0.0%	1.8%	0.4%
Olive Garden	2.4%	2.0%	2.6%	1.4%	4.4%	1.9%	3.0%	2.2%	2.4%	5.3%	3.5%	4.3%
Outback	(2.5%)	(0.7%)	(4.8%)	1.4%	0.3%	0.6%	4.7%	4.3%	4.0%	4.6%	2.9%	3.5%
Red Robin	(3.2%)	(3.3%)	(4.4%)	(1.5%)	0.5%	(0.1%)	2.7%	(0.9%)	(2.6%)	(3.4%)	(4.5%)	(3.3%)
Taco Cabana	(3.8%)	(4.1%)	(3.5%)	(4.5%)	(4.7%)	(12.6%)	(7.4%)	0.9%	3.1%	12.2%	5.1%	(0.5%)
Texas Roadhouse	4.2%	3.4%	1.4%	3.2%	4.0%	4.5%	5.8%	4.9%	5.7%	5.5%	5.6%	5.2%
Mean	**(0.7%)**	**(0.6%)**	**(1.5%)**	**(1.1%)**	**(0.6%)**	**(2.0%)**	**0.5%**	**0.5%**	**0.8%**	**1.6%**	**1.7%**	**1.2%**
Fine Dining												
Fleming's	(0.8%)	(1.9%)	0.2%	(2.9%)	(1.3%)	(1.0%)	3.1%	2.9%	0.3%	0.5%	(0.4%)	0.6%
Ruth's Chris	1.5%	2.1%	0.0%	0.7%	2.9%	(1.6%)	1.5%	1.1%	1.3%	3.7%	(0.1%)	1.8%
Capital Grille	3.7%	(1.2%)	1.2%	0.9%	0.5%	2.0%	3.8%	2.8%	2.6%	3.9%	3.7%	4.3%
Del Frisco's Grille	(2.0%)	(1.4%)	2.7%	(0.9%)	(3.2%)	(5.4%)	0.9%	(1.4%)	0.7%	(0.4%)	(0.8%)	0.2%
Sullivan's[(1)]	(2.9%)	(3.2%)	0.9%	1.1%	(5.2%)	7.7%	(10.8%)	(10.3%)	(6.0%)	N/A	N/A	N/A
Mean	**(0.1%)**	**(1.1%)**	**1.0%**	**(0.2%)**	**(1.3%)**	**0.3%**	**(0.3%)**	**(1.0%)**	**(0.2%)**	**1.9%**	**0.6%**	**1.7%**

Note: Kona Grill had not reported SSS figures as of the publication date

(1) Sullivan's was taken private by Romano's Macaroni Grill in Q3 2018

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

Franchisor vs. Franchisee: How Much Development is Enough?

There has been a recent trend of franchisors increasing development demands on the franchise community, particularly when restaurants change hands or other franchisor consents are granted to a franchisee. In brands that are performing exceptionally well, this issue is much easier to digest by the franchise community than the in cases where performance has been mediocre or even intermittent.

Clearly, if a concept does not develop and grow, it is possible to lose momentum and the growth in advertising funds necessary to remain competitive, so some level of development needs to occur. While a publicly traded franchisor is heavily incentivized to grow unit count, it is also important to recognize that in development, 100% of the cost obligation normally falls on the franchisee. In the average restaurant concept, the franchisee can expect perhaps 10% EBITDA as a percentage of sales, while the franchisor enjoys royalties of perhaps 5% of sales. This represents a two-to-one ratio of current returns despite one party bearing 100% of the cost obligation[1].

As the restaurant industry matures, white space is found less frequently in the dynamic markets dominated by the leading franchisees. Consequently, development opportunities for many of the leading franchisees consist of infilling their markets which may lead to some degree of cannibalization. When restaurant densities hit a certain breakpoint, profitability changes dramatically, and flow-through can diminish by 25% or so. Unfortunately, it is often the case that the future costs of overdevelopment are not properly analyzed in determining where and when to develop.

Let's suppose that in exchange for being able to purchase 30 stores in a neighboring DMA, the franchisor has requested that the franchisee develop several restaurants. The franchisee is so eager to own the 30 stores that he agrees to the development agreement without much diligence into how the new stores would impact his current market. The morning after closing, the franchisee reacquaints himself with the notion that there is limited, if any, existing white space in his marketplace. The franchisee finds himself forced to develop two stores near a current location, leading to the cannibalization of sales and consequential margin degradation illustrated in Scenario A (above right). Not only will the franchisee experience lower per unit cash flow in the near-term, but his capex obligations triple. Scenario B illustrates an ideal case, where store location selection is backed by empirical data and ample white space, allowing for little-to-no cannibalization of existing stores in the market.

Illustrative Development Returns Comparison

Scenario A: Poor Site Selection / Limited White Space

	Pre-Development	Post-Development
Units	1	3
Sales	**$1,500**	**$3,300**
EBITDA	225	330
EBITDA %	*15.0%*	*10.0%*
Est. Development Costs		3,000
Cash-on-Cash Return		*11.0%*

Scenario B: Proper Site Selection / Ample White Space

	Pre-Development	Post-Development
Units	1	3
Sales	**$1,500**	**$4,500**
EBITDA	225	675
EBITDA %	*15.0%*	*15.0%*
Est. Development Costs		3,000
Cash-on-Cash Return		*22.5%*

In Scenario A above, the EBITDA margin is 50% lower with three stores. If the franchisee borrowed to fund development, such poor performance could cause them to bump up against covenants in their loan documents. In addition, the franchisee must struggle with finding three times as many managers, shift leaders and crewmembers in what has proven to be a tight labor market – the franchisee has three times as many management headaches for only 50% more cash flow, and this is probably a trade-off that might not be made without some assurances of further growth down the road.

Development is a necessity – public restaurant companies cannot survive on same-store sales alone. It is imperative that franchisees and franchisors look beyond the obvious when entering into development agreements and conduct the necessary market research to ensure success by making strategically sound decisions. We believe that the lack of white space for some of the nation's leading brands will eventually lead to strong examination of other avenues of sales. This would include NTL's, delivery and carryout, multiple store layouts and joint locations (not cobranding but sharing real estate). In any case, we are not out of whitespace yet but eventually this will force development to occur in different modes.

Contributing Editor Kevin Burke is a Managing Director at Trinity Capital.

[1] Ignores equity, financing capital and gains on disposition.

Impact of Institutional Investors on Franchised Restaurants

The first private equity investment I can remember in a restaurant franchisee was an investment by a New York fund into a Taco Bell operator in 1997. Following that successful investment, investors became increasingly attracted to the steady cash flow and predictability of franchisees in leading concepts, and institutional investors – such as private equity, pension funds and family offices – began to slowly test the waters of franchised restaurant investments. As of 2019, institutional investors have invested in as many as 60 of the Franchise Times Top 200 companies. In reviewing this history, the question becomes, *have institutional investors had a positive or negative impact on the restaurant industry?*

Institutional investors have, by and large, professionalized operations, developed more efficient capital structures and invested in existing assets and growth of new units. These investors strengthen operator accountability by requiring business plans and budgets, with periodic review of performance compared against said plans and budgets. In addition, they bring increased analytics to review and improve operations and investment activities, and they install boards of directors for further oversight. This has inculcated the franchised restaurant industry with a high level of sophistication resulting in significant efficiency gains in the systems in which institutional investment has occurred. In many of the leading restaurant systems, if you compare the institutionally backed franchisees with the other franchisees, you will notice a material difference in the performance of these two groups: *the sponsor-backed franchisees are meaningfully outperforming the independent group.*

Institutionally backed franchisees invest significantly more into assets through maintenance, remodeling and new unit development than independent franchisees. Institutional capital generally migrates to concepts with proven, consistent sales and traffic growth and profitable four-wall economics, which are conducive to accretive remodeling and development returns. Institutional investors realize that remodeling and development may be sources of attractive returns on capital. We recently completed an analysis of two of the leading franchise concepts in the US – one of the concepts has been receptive to institutional investment within the franchise system, while the other has basically forbidden institutionally-backed franchisees. The remodeling and development dollars invested in each of these brands was a 4-to-1 ratio, meaning the brand that permitted institutional investment had four times as much remodeling and development activity. Institutional investors bring deep pockets and are prepared to invest if the brand offers reasonable returns on investments, which ultimately benefits the franchisor through higher royalties.

When we first brought institutional investors to the restaurant industry, many franchisors were hesitant, citing that they didn't want well-lawyered, well-moneyed – and potentially troublesome – smart guys from New York making trouble in their brand. I will say decisively that institutional investors are clearly well-lawyered and well-moneyed; however, our experience has been that once they've made an investment in a brand, they realize that creating trouble is the quickest way to undermine their investment and potential liquidity event down the road. In fact, many institutional investors have stifled their operators and set the expectation that they want no political feedback – negative or positive – being dished out to the franchisor. For better or worse, it will be very difficult to find a franchisee operator of an institutionally backed franchise company agitating the franchisor. This may have been the initial expectation by franchisor executives, but it has not materialized in the industry after over 20 years.

In conclusion, I would say that institutional investment in the franchised restaurant industry has been a success for both franchisees and franchisors. That is not to say there haven't been some miscues here and there, but in general, institutions have brought capital, expertise, accountability, transparency and a surprisingly low modicum of politics. If you were to remove this impact on the industry over the past 20 years, we would be operating in a remarkably different environment today...

Contributing Editor Kevin Burke is a Managing Director at Trinity Capital.

For more information, please contact:
Kevin Burke, Managing Director, at:
310-231-3100
kburke@tcib.com
or
Visit us at:
www.tcib.com