

## **What Happens After What Comes Next? – Restaurant Research's Views on Where the Chain Restaurant Industry is Headed**

### **Restaurant Research, LLC**

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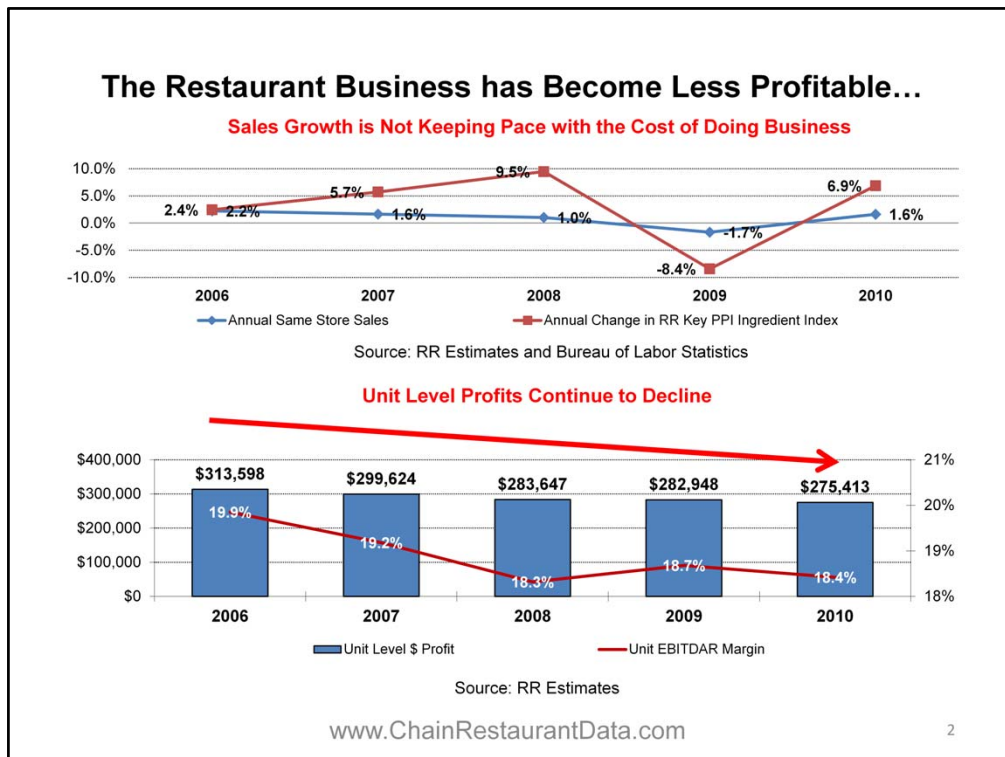
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- Restaurant Research is focused on providing unit level data that we get from a network of industry players and from public documents.
- Before we can talk about the future, we need to look at data which reveals where the chain restaurant industry has been.
- In the next few slides I will address how the environment has changed over the last 5 years for billion dollar+ restaurant chains with a focus on four key components: profits, development, reinvestment and access to capital.
- On the last slide, I will discuss how these trends are likely to impact the future of this business.
- One key point I would like everyone to keep in mind is that this is a very slow moving industry and developing trends take years to play out. This reflects that new entrants, technologies and products take a long time to implement across the country.



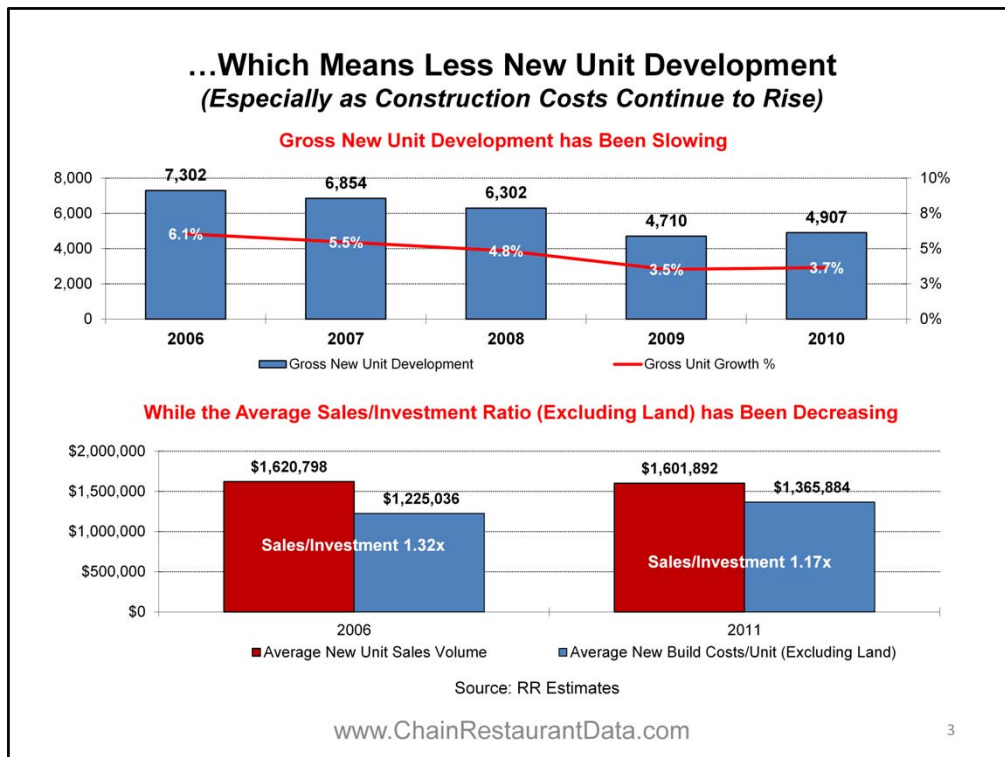
- It is common knowledge that the chain restaurant industry has become less profitable over the last ~5 years.

- As we can see from the top chart, while the top-line growth of these chains has been moderately positive over this period, sales have failed to keep pace with the rise in key ingredient costs used by industry players which reflects a loss of pricing power.

- In addition to rising food costs, mature chains have suffered further margin pressure by incorporating higher quality and healthier ingredients to better compete with new concepts.

- Also, increasing labor expense has been driven by higher minimum wages at the state and federal level and more expensive employee benefit plans needed to keep competitive.

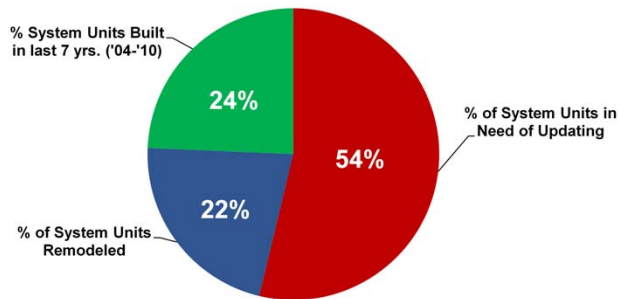
- We expect unit level EBITDAR profits will continue to be pressured going forward as chains continue to suffer from an inability to pass along commodity price increases to their cash strapped customers while a pro-labor political environment implies higher employee costs in the future.



- As we can see from the top chart, the industry's new unit development has been steadily slowing. We believe this reflects eroding sales to investment returns (please refer to bottom chart) as new store sales volumes struggle to keep pace with rising building costs which are pressured by the incorporation of higher-end finishes from mature chains trying to compete with newer and fresher concepts.
- When factoring in estimated land costs of \$450k for QSR and \$750k for sit-down, the current sales/investment ratio is well below 1.0x.
- I should note that the above trends could be partially offset by increased opportunities for operators to acquire existing stores from distressed or retiring operators at a fraction of new build costs (at least while economic pressures remain).

**Resultantly, Remodeling Older Systems Is Critical**  
*But Declining Profitability Makes It Hard for Industry Players to Keep Up*

Many Units are Outdated or Have Inconsistent Formats



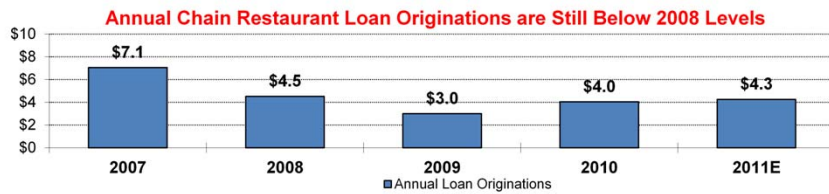
Source: RR Estimates

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- We believe less new store development pressures operators to do a better job of updating their existing facility base. Resultantly, there is a lot of important remodeling work to be done since we estimate that less than half of chain restaurant industry stores reflect their concept's current image. This is problematic as the disparity between new buildings and older formats creates image inconsistencies for brands in this position.
- Reimaging older stores typically requires a significant investment that can range from \$200k to \$500k to more than \$1 million for a scrape and rebuild.
- But, declining profitability makes it hard for industry players to keep up and we think this has important implication for the future that we will discuss shortly.

## More External Capital Will be Needed, but is Hard to Come by



### Underwriting Guidelines are More Stringent

	2006	2011
<b>Minimum Equity Requirements</b>		
Minimum Equity % - Acquisitions	22.3%	26.6%
Minimum Equity % - New Construction	17.5%	27.6%
<b>Leverage Ratios</b>		
Debt/EBITDA	5.50	3.82
Minimum FCCR	1.20	1.24
Debt+leases/EBITDAR	6.00	5.49
Loan to Value	82%	72.9%

Source: RR Jan. 2011 Lender Survey

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- All this is to say that more external capital will be needed to reimage and maintain the industry's aging facility base. However, we believe capital will continue to be hard to come by because of declining industry profitability aggravated by national franchise lenders that have scaled back originations or closed shop. As you can see from the top chart, we estimate that 2011 originations are 40% below 2007's level.
- Although lending terms have eased slightly since the 2008 credit crunch as we can see from the bottom table, equity requirements and leverage ratios remain stringent – especially for smaller operators and those in weaker concepts.
- This is partially offset by low interest rates which are not expected to increase any time soon and by the entrance of some new lenders.
- Net/net, we expect capital for industry players will continue to be hard to come by.

**RR Anticipates Future Success Will Require/Favor Concepts  
& Operators Capable of Generating a Higher ROI**

*Key Objectives Include:*

- Menu optimization
- Lower operating costs
- Smaller/more efficient new build footprints
- More cost effective remodel initiatives
- Franchisees obtaining larger scale

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• Taking all this together, it is our opinion that tomorrow's operators must learn how to compete in a business environment that has grown more difficult over the last 5-10 years.

• We believe concepts and operators capable of generating sufficiently high returns will be required to focus on the following key objectives:

• **First, menu optimization:**

• Concepts must be able to adapt more quickly to rapidly changing consumer preferences, disposable income levels and constantly fluctuating commodity prices.

• This requires greater operational flexibility at the system and unit levels. Also operators must have the financial wherewithal to purchase new back-of-the-house equipment to facilitate menu changes.

• In any case, quick changes to the menu may represent the best way for operators to maintain their food margins in the future.

## **Second, lower operating costs:**

- We believe continued improvements in software and technology are necessary to automate order taking, payment processing and menu presentation.
- More sophisticated cost control and supply chain inventory management systems will further minimize product waste and help off-set food price increases and quality improvement initiatives.
- Finally, the implementation of more energy efficient equipment and better energy purchasing procedures can save utility costs.

## **•Third, more efficient new builds and remodels:**

- Operators must determine how to lower occupancy costs so that more capital is available to improve food quality and service.
- We believe this requires placing less emphasis on expensive décor and large footprints which can help reduce excess costs for both new builds and remodels.
- Operators could also look to non-traditional development and recycled retail sites as ways to get into facilities for less.

## **•Fourth, franchisees obtaining larger scale:**

- We believe the highly competitive and capital intensive nature of the restaurant business will continue to strongly favor larger operators who will enjoy economies of scale and better access capital.

## **•Concluding Remarks:**

- Thanks for your time. Please feel free to contact me in the future with any questions you may have.