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FRANCHISE INVESTMENT BANKING

<u>Title</u>: Welcome to The Restaurant Boiler Room Episode 1. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

<u>Today, in the the Boiler Room</u>:

1. Amazon minimum wage hike to $15 nationwide could cripple restaurant valuations
2. Inspire Brands acquires Sonic: What this means to Sonic valuations
3. KFC Leadership change: Why it shouldn't impact the KFC domestic business
4. *Question of the Week*: What does the rising 10-yr mean to valuations?

<u>Tag Line</u>: The Restaurant Boiler Room is a one-stop-shop for multi-million dollar merger and acquisition activity and financial complexities pressuring the franchise restaurant industry. We talk money, deals, valuations and risk – delivered to the front door of franchisees, private equity firms, family offices, large investors and franchisors across the world on an every-other-week basis. Feel free to find all of our content at Unbridled Capital's website at www.unbridledcapital.com

<u>Now, let's enter the Boiler Room</u>:

A. Amazon minimum wage hike to $15 nationwide could cripple restaurant valuations
    a. *<u>Background</u>*: This Amazon announcement was on the heels of Sept 2018 unemployment numbers being released – showing a drop of (0.2%) to 3.7%, the lowest unemployment rate since 1969.
    b. *<u>Why it is important</u>*: Competition for labor is intense right now for franchisees looking to fill team member positions in their businesses. The most common complaint I hear from franchisees is the inability to find qualified workers. They also bemoan the intensifying competition from Walmart, Target, and now, Amazon. Pizza companies are concerned about Uber, Lyft and third-party delivery platforms competing for their deliver drivers and driving up their labor costs.
    c. *<u>How it will affect M&A</u>*: Let's take a quick restaurant P&L example. Say a restaurant is doing $1MM in sales with 30% labor, two-thirds of which is variable, and the average hourly wage goes from $10 to $15 per hour. Labor would increase by $100,000 in this example, assuming no pricing increases. If an average franchisee has a 4-5% profit margin, this labor increase would make the restaurant unprofitable. Since valuations are calculated as a multiple of EBITDA, unprofitable restaurants have no or negative value, and the multiplying effect means a massive change in value when profitability goes up or down.
    d. *<u>Personal experience</u>*: I have personally seen the ravaging effects of $15 minimum wage on restaurant companies operating on the West Coast. I would not be a surprised to see 10-20% of all restaurant franchises close on the West Coast in the next few years because of rising labor costs. Keep a watchful eye as the trend of rising wages continues to creep into the middle of the country.

B. Sonic gets acquired by Inspire Brands: What this means to Sonic valuations
    a. *Background*: Inspire Brand's acquires Sonic for $2.3BB. Inspire owns Arby's, BW-3, R Taco and now Sonic. Roarke Capital is the largest shareholder in Inspire Brands. Among other franchise companies, Roarke owns Hardee's/Carl's Jr, Jimmy John's, Culver's and Massage Envy. The announcement has indicated that the Sonic headquarters will stay in OKC.
    b. *Why it is important*: This is a continuing trend of consolidators: first it was Yum (of which I am an alumnus), who owns KFC, Taco Bell and Pizza Hut. Restaurant Brands International as become a recent entrant into multiple-franchisor ownership and owns Burger King, Popeye's and Tim Horton's. JAB Holding Company (a Luxembourg investment firms) owns Panera, Krispy Kreme, Einstein Bagels, Pret a Manger and others.
    c. *How it will affect M&A*: Roarke has historically invested in management, allowing its businesses to continue to run with little perceived interruptions. However, senior management changes at Sonic are likely here. Several franchisees have told me that it is time for a leadership change at the top at Sonic. Also, during post-acquisition integration, marketing and advertising can suffer temporarily while the new organization figures itself out. If this happens here, and sales drop, we could see lower valuations for franchisee businesses in Sonic in the near-term. Sonic has languished a bit this year and is regaining momentum, which is a very delicate thing and can come and go quickly in the incredibly-competitive burger segment.
    d. *Personal experience*: I have conflicting opinions here. If you believe many franchisees, this acquisition could result in a meaningfully positive change in direction for the brand. Experience tells me, however, that big ideas will stall at Sonic for a few quarters while the post-acquisition integration takes hold, using Jimmy John's as an example. So, don't be surprised if we see a short-term lull in Sonic M&A while franchisees wait on the sidelines to see what happens. Let's just hope that sales don't take a hit in the meantime.

C. KFC Leadership change: Why it shouldn't impact the KFC domestic business
    a. *Background*: Tony Lowings replaces Roger Eaton as CEO of KFC Global. This is an internal promotion – Tony worked recently in KFC South Pacific and was Managing Director of Asia Pacific.
    b. *Why it is important*: KFC domestic has had a great 4-year turnaround. Sales are up on a multi-year basis, assets are getting remodeled, store count has stabilized, new product offerings have been successful, and advertising has been a hit. Leadership changes are a time to pause and consider if this successful trend will change.
    c. *How it will affect M&A*: Given recent KFC US successes domestically, it would be surprise to me if this leadership change would result in anything meaningfully different here in the US. The KFC M&A market continues to be super-strong with business valuations eclipsing 6.5X of EBITDA for the best and largest KFC businesses. Some larger, legacy franchisees are now selling, which is a nice balance to a system that also has many smaller franchisees who have operated for 40+ years.
    d. *Personal Experience*: Kevin Hochman has a marketing background and has done a great job with the advertising campaign of the ever-changing Colonel Sanders. Positive results should continue with the brand, though there are some sales and traffic concerns for the entire industry as we move into 2019.

D. *Question of the Week*: What does the rising 10-yr mean to valuations?
    a. *Background*: The 10-year treasury started 2018 at around 2.41%. It has been steadily rising for much of the year, reaching a 7-year high of almost 3.25% on October 5th. Since then, it has backed off and is trending in the range of 3.15% as of October 18th.
    b. *Why it is important*: The 10-year is a good measure of interest rates and cap rates, both of which affect restaurant valuations. Cap rates and real estate valuations move in opposite directions on a direct and immediate basis. Interest rates have a moderate impact on restaurant valuations - higher borrowing costs ultimately lead to lower valuations.
    c. *How it will affect M&A*: To this point, most restaurant valuations are higher this year, largely ignoring any effects of the rising 10-yr. Real estate valuations are also largely unchanged, likely because of the high amount of cash in the marketplace. But the trend of sky-high valuations and rising interest rates can't continue forever. Expect both business and real estate valuations to get pressured in 2019 with continued momentum from the rising 10-yr.
    d. *Personal Experience*: We have been in a very low interest rate environment for a long time. The Fed has hiked interest rates three times this year already, and most economists predict this trend to continue. For now, sellers and buyers should take advantage of record valuations and still-cheap money. But watch for this trend to slowly change in the next 12-24 months.

Closing: Thanks so much for entering the Boiler Room today. You can find our podcasts on iTunes, Google Play, Stitcher and Spotify. If you like these podcasts, please listen, rate and review! I also encourage you to visit our website at www.unbridledcapital.com for the best franchise M&A and financial resources in the industry. Our website includes podcasts, videos, white papers and a list of our M&A transactions.