Title: Welcome to The Restaurant Boiler Room Episode 10. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room:

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2. Brentwood Associates Acquires Orangetheory fitness locations
3. Bankruptcy filings for Gigi's Cupcakes and Mr. Gatti's Pizza
4. Question of the Week: What's your view on the KFC brand?

Tag Line: The Restaurant Boiler Room is a one-stop-shop for multi-million dollar merger and acquisition activity and financial complexities affecting 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 on an every-other-week basis. Feel free to find our content at Unbridled Capital's website at www.unbridledcapital.com

Now, let's enter the Boiler Room:

A. Burger King Looks to Keep Momentum Through Management Changes

    a. Background: Jose Cil was recently announced as the new CEO of Restaurant Brands International as Daniel Schwartz has transitioned to take the role of chairman and co-chairman of the company's board of directors. Restaurant Brands International (also known as RBI) owns Burger King, Popeye's and Tim Horton's. It is a restaurant franchisor consolidator that looks to continue to expand on its successes over the past 9 years, when its subsidiary 3G Capital bought Burger King for almost $1.6 billion. Thereafter, RBI bought Tim Horton's in 2014 for $11 billion and Popeye's for $1.8 billion in 2017 as well. I predict 2019 will see a continuation of M&A consolidation in the industry, so don't be surprised if RBI acquires another franchisor this year – maybe in the pizza space?

    b. Comments: For RBI, my eye is on Burger King, where it is hard to argue with BK's recent successes. Systemwide sales have increased to over $20 billion. Net restaurant growth accelerated to more than 1,000 per year. Corporate EBITDA has more than doubled since 2011. Burger King has enjoyed several years of same store sales growth, and their marketing plans seem edgier and more effective than in years past as they fight for competitive market-share against McDonald's in an environment of heavy discounting. Development, however, is a main cornerstone of RBI's strategy for growth. Q4 year-over-year growth of new units was 5.5% for the consolidated company, which almost quadrupled same-store sales growth during the same time period as Popeye's sales comps have started to drag.

    c. Effect on M&A: I am bullish on the Burger King brand, and Unbridled Capital has recently accepted several assignments to sell larger, platform BK businesses for franchisees. Sales growth has been strong in the brand, and BK has been improving its asset base. Marketing seems edgy and fun. And once you jettison McDonald's, which has a franchise model which doesn't really allow for a free market, then BK and Wendy's are some of the only national, Tier 1 burger chains that have the characteristics to attract major outside investment from the PE and family office communities. For this reason, I expect consolidation to continue and possibly accelerate within Burger King over the next several years.

d. Of concern, Burger King is battling for market-share in a very difficult burger environment where heavily discounted menu items are winning the day over new product innovation. I certainly hope this discounting trend changes across the industry. From what I have seen, franchisees have pre-G&A EBITDAR margins in the 18-20% range, on average, which is several points lower than some of the non-burger Tier 1 franchise concepts, likely in part because of discounting's effect on food cost. Also of concern are the aggressive remodeling and new unit development requirements imposed by RBI on franchisees. Overall, however, Burger King should certainly be a consideration for franchise groups looking to acquire significant scale.

B. Brentwood Associates Acquires Orangetheory fitness locations

a. *Background*: Brentwood Associates recently announced the acquisition of Afterburn Holdings, a leading Orangetheory Fitness franchisee that operates 12 studios and oversees an additional 8 studios in Houston, Texas. Brentwood is a leading middle-market private equity investment firm with a 30+ year history of investing in growth companies. Brentwood raised about $1.2bn for its 6th flagship fund in 2017.

b. Orangetheory is a fast-growing fitness franchise. Orangetheory franchisees have opened over 1,100 studios in 49 U.S. states and 22 countries and was ranked #60 in Inc. magazine's Fastest Growing Private Companies List. Orangetheory classes are a full-body workouts that utilize treadmills, rowers and weights to help members elevate their heart rate to the "Orange Zone" or between 84-91% of their estimated maximum heart rate. Per the company, just 12 minutes in the Orange Zone raises your heart rate and makes you burn more calories for up to 36 hours. Users wear heart-rate monitors, and real-time results are displayed on large screens in the studios. The intensity of the workout is based on individual heart rate zones, making sessions effective for all fitness levels.

c. Comments: I talked about Planet Fitness in Podcast Episode #9. Planet Fitness is exploding, and so is Orangetheory. The fitness area can be a great way to get into franchising that accentuates higher new-unit growth instead of growth just through acquisition, which is more common with the established franchise restaurant chains. With Orangetheory, franchisees are often smaller in scale – 1, 2- and 3-unit operators – and owners are normally involved heavily in the operation of each location. This makes consolidation much more difficult, which is why this Brentwood Associates acquisition caught my attention. Brentwood was a very successful Taco Bell franchisee for many years, when they owned KMAC, based in Arkansas and one of Taco Bell's largest franchise companies. Interestingly, several current and former Taco Bell PE investors are now either already invested in the franchise fitness space or are actively looking. Let's see if Brentwood can build a sizable platform investment in the Orangetheory brand.

d. *Effect on M&A*: I think you will continue to see huge growth and investment in the fitness space, and Orangetheory will eventually become a consolidation play for several adventurous investors, PE firms and family offices. When compared to restaurants, who doesn't like the low labor model? However, prospective investors will have to exercise much patience to see results (no pun intended). Fitness isn't without its risks. Customers are notoriously fickle in this segment. If you work out often, ask yourself two questions – 1. How many times have you changed your workout routine in the past 3-4 years, and 2. How many different gym memberships have you had during this time? Fitness folks like change (I do too), and there is always a new fitness fad to chase. Despite these challenges, keep a watchful eye as the fitness segment attracts increasing investment, potentially at the expense of fast-casual restaurants.

C. Bankruptcy filings for Gigi's Cupcakes and Mr. Gatti's Pizza

a. *Background*: Danny Klein at QSR Magazine reported that both Gigi's Cupcakes and Mr. Gatti's pizza filed for bankruptcy in recent weeks. Gina Butler started Gigi's Cupcakes in 2008. The day before she opened her 1st store, she was cleaning houses to pay the plumbing bill. After a contractor tacked on a surprise $15,000 dry wall charge, Butler famously kicked off the business with just $33 to her name. Gigi's was sold to FundCorp in 2016, and at the time had about 100 franchised units nationwide and relocated from Nashville to Texas with the deal. The article points out that 18 franchise owners of Gigi's are suing the various corporate entities for misrepresentation.

b. Mr. Gatti's is a pizza and entertainment restaurant company that was acquired by Sovrano in 2015 from Blue Sage Capital. It has three company-run units and 73 franchised locations while opening its first new restaurant in seven years in 2018.

c. *Comments*: This is a continuation of the winners and losers in today's franchising environment for restaurants. There are just too many pressures in the market-place for struggling brands. New unit development, competition of labor, capital-intensive remodeling projects, rising minimum wage, discounting and rising commodity costs are just several challenges that can collectively demolish a brand that can't grow its revenues in a meaningful way. In the case of Gigi's, I believe expansion happened too quickly. How many times have we seen ice cream franchises fail over the years? Gigi's looked similar to me in this way – these types of franchises do not offer 'center-of-the-plate' products, so two things quickly happen: 1. Customers come in droves at first but don't return often enough to sustain a profitable business and/or 2. Center-of-the-plate food businesses like restaurants and grocery stores can quickly add a line extension to their product menus to compete quickly and easily with treats and desserts – likely at a much lower cost, even if product quality is generally lower.

d. For pizza, you probably know that Unbridled Capital has enormous, industry-leading expertise in the pizza segment. We will likely sell 600-800 Pizza Huts over a 3-4-year period. We have been a Corporate refranchising agent for Papa John's and Papa Murphy's. We have sold Little Caesar's restaurants as well. Why do I mention all of this? From all of this business, I can tell you that the pizza segment is uber-competitive. Everyone is fighting for 1-2% annual sales growth, but there is too much of a crowd, especially with Domino's taking so much market share from everyone recently. Legacy franchise pizza concepts can be in trouble if their appeal to customers starts to shrink.

e. *Effect on M&A*: I have said it many times but continue to expect a bi-furcation of value between the have and have-not brands. The valuation gap will likely widen in 2019, and if we see a recession in 2020, it should widen further and faster. If investors decide to acquire languishing brands, do so with this knowledge and adjust pricing expectations accordingly.

D. Question of the Week: What's your view on the KFC brand?

   a. I love the KFC brand, having worked at the Corporate headquarters almost 20 years ago. KFC competes in the chicken segment, which has had an enormous influx of competitors in the past 5-10 years. As KFC unit count has dropped by almost 25% in the past decade, the health of the franchise system has actually improved in a big way. AUVs are up, the brand has experienced four plus years of same store sales growth, capital has re-entered the system, the American Showman remodels are driving younger customers back to the restaurants, the marketing program has been fun and new product innovation has been high. For example, KFC is about to release a Cheetos Chicken sandwich, taken out of the Taco Bell product innovation playbook, which should drive incremental sales and trial. For these reasons, M&A consolidation in KFC is picking-in, and many smaller franchisees are selling. KBP Foods has grown to almost 700 restaurants, and several other larger franchisees have emerged in the past several years. However, the brand still has a bunch of 2-3-unit franchisees, making the barrier somewhat difficult to entry for new consolidators. For mid-sized and larger KFC franchisees, their business valuations have exploded recently for this very reason – there are limited opportunities to buy sizeable KFC franchise businesses while the demand has increased due to positive financial performance and momentum. I think KFC is positioned for continued growth. Yum is a great company with a patient and disciplined business model.

   b. I will be attending the KFC Convention in Orlando from Feb 6-9, 2019. Please stay tuned to future podcast episodes, and I will discuss the new products, ideas and plans coming out of the Convention. Also make sure to check-out Unbridled Capital's YouTube Channel to get real-time videos from the Convention floor, or you can follow us on Twitter, Linked-in or Facebook for updates as well.

Closing: Thanks so much for entering the Boiler Room today. You can find our podcasts on iTunes, Google Play, Stitcher, TuneIn 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.