Title: Welcome to The Restaurant Boiler Room Episode 13. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room:

1. Buffalo Wild Wings tries to regain momentum
2. High amount of restaurant lenders with fewer deals in the marketplace
3. February sales and traffic update for restaurants
4. Quick comments on Moe's Southwest Grill
5. Update from the Taco Bell Franchise Forum in Palm Springs

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. Buffalo Wing Wings tries to regain momentum

   a. Background: Peter Romeo had a recent article talking about a 2.2% Q4 2018 sales increase for Buffalo Wild Wings franchisee Diversified Restaurant Holdings, who owns 64 units. Though one franchisee hardly represents the entire brand, the idea here is that a possible turnaround could be taking hold. As you may know, BW-3 was acquired in February 2018 by Inspire Brands, one of the largest restaurant aggregators, who is also owned by Roark Capital. BW-3 had red-hot comp sales growth of about 5% for the 4-year period from 2012 through 2015. However, same store sales turned negative for 2016 through 2018.

   b. Comments: Many of the casual dining chains have started to see a nice rebound in sales and profits in the past few periods, and this might be spilling over into BW-3 too. Casual dining has fought back with better value, higher off-premise sales and drink specials.

      However, I have concerns about BW-3. First, I think their food is average at best. There are too many competitors that have equally good wings and much better overall bar food. Also, the prices are way too high – much higher than most competitors. Food quality is an issue too. Additionally, it really isn't a competitive advantage anymore to have a bunch of TVs showing sporting events. Heck, I can watch sporting events now at many McDonald's. Finally, in my humble opinion, BW-3 has really missed the mark with the millennial craft-beer and local beer phenomenon. Not only do I think BW-3 is losing business to other casual dining franchises, but independents are taking business from them too.

It is interesting that Inspire has evidently not completed the final draft of their turnaround plan for Buffalo Wild Wings. Overall, there appears to me to be many ways to improve this brand quickly and profitably. Sorry management, but this is an easy turnaround in my opinion, especially with the high amount of brand equity it has. People still want to eat wings, drink beer and watch sports, and BW-3 has been around awhile and has good assets in good locations. I want the brand to succeed, and I am one of its customers who came a bunch in 2012-2015 and now rarely comes at all anymore. For this reason, I think any reasonable turnaround plan can be very successful. There is a ton of low-hanging fruit here, remembering that the availability of wings and volatility in wing prices is a concern for the brand.

c. Effect on M&A: BW-3 largely scrapped a refranchising plan several years ago. Over the past few years, many large PE and family-office friends and clients of ours have gone from uber-interested in the brand to somewhat lukewarm. In 2015-2016, overall interest in the brand appeared to me to almost equal Taco Bell or Dunkin' but with significantly less supply of franchises for sale. Now, however, I think the supply and demand curves for BW-3 are basically balanced. If they re-institute refranchising, it will be met with competition from other casual dining brands also selling restaurants across the country in likely the same markets.

B. High amount of restaurant lenders with fewer deals in the marketplace

a. Background: Restaurant Research recently put out some news about the franchise lending space. From a high-level, they report that originations have been trending down by almost double figures in the past few years. I can concur that many lenders are singing the blues for several reasons – 1. Huge reduction in refinancings, 2. Sharp wind-down in corporate refranchising, 3. Increase in competition from regional, super-regional and small national lenders who are new entrants into the franchise lending business or who are building a dedicated franchise platform and 4. A general feeling that M&A might be slowing down, especially when removing the halo effect from several large and recent transactions.

b. Comments: Increased lender competition and massive industry-wide consolidation have been the biggest factors here, in my opinion. Many franchise systems – most notably Taco Bell, Wendy's, Pizza Hut and Burger King – have experienced huge consolidation in recent years. While future consolidation will continue, likely half of more of the older, smaller franchisees have now sold their companies, in most cases to large, institutionally-backed franchise consolidators. There just isn't as much supply as several years ago. And if you go to any of these brand-specific franchise conventions, it is easy to see it. Perhaps the most vivid example is at KFC, where the convention no longer looks like franchisees who resemble the farmers in the famous American Gothic painting, but instead are younger, walk faster and wear knock-off Gucci shoes (they wear the real ones at Taco Bell).

On the lender competition side, I now go to these conventions and feel more like a franchisee than an investment banker. Lenders are more eager than ever to talk with Unbridled. Sure, we are likely doing more franchise investment banking business than everyone else, but I sense that lenders are not meeting their quotas and are desperately looking for places to lend money. I would be almost sure that the number of lenders in the franchise space has almost doubled in the past 4-5 years.

c. Effects on M&A: What does this mean? Competition for loans will continue to intensify and is already showing itself in previously-overlooked brands. If you own a brand with decent sales and traffic comps, expect massive interest. Also, these lenders salivate for larger transactions, not smaller ones. The lending market for $5MM or less loans, for example, is virtually non-existent anymore on a national scale. Finally, I think you will see a dismantling of this growth in lending platforms soon. Why? Market changes are expected as the environment gets tougher, and there are too many smart and experienced lenders who now are making less money than they did in previous years. Expect an exodus of these lenders if originations continue to decline. They'll get replaced with reps with little experience or average skills because they won't be paid as much – watch out for that too.

C. February sales and traffic update for restaurants

  a. Background: TDn2K reports the following for Feb 2019 – 'Chilly Sales and Traffic Growth, Understaffed Restaurants Plagued by February.' Comp sales and traffic were (0.61%) and a shocking (3.67%) in February, respectively.

  b. Comments: These results are concerning for sure, especially the eye-popping drop in traffic. February's same-store traffic drop was the worst result for the industry since September of 2017. The traffic decline was so severe that not even a 3.1% year-over-year increase in average guest check was able to deliver positive sales comps. Ouch.

     Part of this surprise was due to really bad weather in the Midwest and East Coast in February. Many of you remember the huge winter storms and cold temperatures. Part of this is also a roll-over of the positive impact of tax cuts on last year's paychecks for American workers. But most of this drop in traffic, in my opinion, is of larger concern across the restaurant industry.

  c. Effect on M&A: I wouldn't be surprised to see these sales and traffic trends continue. There are too many restaurants. Unless you operate an awesome brand with a great consumer experience and strong loyalty, you don't have much pricing power right now. Customers have many options, and while there is certainly too much discounting in the industry, it is a necessary reality that operators have to keep pricing low to attract customers. Labor shortages are a big concern. Just an opinion, but we might be seeing the start of a longer-term trend of moderate pain that will result in store closures and future financial uncertainty for franchisees.

D. Quick Comments on Moe's Southwest Grill

  a. Background: Congrats to Moe's Southwest Grill for being named the 2019 Franchise Times ZOR Award winner in the category of 'South of the Border.' This article caught my attention because we seem to talk about QSR all the time on The Restaurant Boiler Room, and I thought it would be nice to give a shout-out to fast-casual brands - I have often been negative on them in the past on this podcast.

  b. Comments: At over 700 units and growing, Moe's is an interesting brand and part of Roark Capital's empire of franchisor brands. Unlike most QSR brands, Moe's still is a place where a smaller franchisee (or larger one) could invest and operate. Moe's has an AUV of slightly over $1MM, is growing its off-premise sales and has a reasonable build-cost. For consolidators, it could be an interesting brand to enter for several reasons – 1. Lack of competition, 2. Ability to consolidate smaller franchisees at lower multiples, 3. High concentration in the Southeast and East Coast, where labor costs and concerns are lower and 4. Offers an investment into the Mexican

QSR space that is very elusive. Taco Bell is almost impenetrable, Chipotle is all Corporate-owned, Taco Johns is small, Del Taco is mostly West Coast, etc…

E. Update from the Taco Bell Franchise Forum in Palm Springs

   a. Background: I just returned from Taco Bell's Franchise Forum. As an aside, the Forum was actually in Indian Wells and only 2 miles from the recent BNP Paribas Open tennis tournament. If you are a fan of tennis, this tennis facility at Indian Wells is incredible – I have never seen so many beautiful palm trees, flowers and pristine tennis court – all with a stunning back-drop of desert mountains, some of which are snow-capped. Quite breathtaking.

   b. Comments: There were a few new faces this year – due to two large M&A transactions recently that brought new family offices into Taco Bell in the South and East Coast. Franchisees were generally in a great mood – by informal poll of just a few franchisees, I'd say that many are up almost double digits in sales this year with most also experiencing traffic increases. Taco Bell has been able to push higher prices successfully – while most other brands simply can't do it because of competition, less loyal customer base or lack of new product innovation.

      There appear to be several exciting new breakfast items in the planning phase for Taco Bell as they evidently look to ramp-up that slow-building sales-layer. In my opinion, Taco Bell can make breakfast a much bigger thing than what they are doing currently. Finally, there were more lenders in attendance than I have ever seen previously, some of whom admitted to me that there is no way their bank will actually ever be able to compete with the crazy LIBOR + 175 – 200 rates offered by the most competitive banks in attendance.

   c. Effects on M&A: As listeners know, Unbridled does a ton of Taco Bell M&A work. Like KFC, however, the number of small franchisees at Taco Bell is noticeably dropping in favor of well-capitalized consolidators who hire smart people but know nothing about restaurants. For now, expect the 8X EBITDA multiples to continue for Taco Bell acquisitions, with buyers eager to acquire and even more eager to develop new units to buy-down their multiples and increase their equity and profitability.

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.