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FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 6. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room, I will roll-out and explain my Top 20 Macroeconomic M&A considerations for franchising in 2019. This topic is an all-time favorite as rated by listeners, readers and viewers on our website.

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:

At the end of each year around Christmas time, I come out with a list of top trends to watch in the franchise M&A industry for the following year. On the Unbridled Capital website, you can see the videos entitled 'Macroeconomic Update' for any given year. This year, I am limiting the list to the Top 20. They are in no particular order. I hope you enjoy. Here we go:

1. *Economy*: The economy is strong right now. How long will it continue? Many industry experts are now talking about the inversion of the yield curve as a reason to fear an earnings or economic recession soon. An inverted yield curve is often considered a sign of future economic recession as investors bet returns over the short term will exceed those over several years. Morgan Stanley now sees a 50 percent chance of an earnings recession in 2019. An economic slowdown would affect franchise M&A in several ways – lower consumer spending, tougher borrowing environment and less enthusiasm from investors for riskier and higher-priced investments. Since the restaurant industry has had so many recent private-equity and family office entrants, a slowdown would have a negative impact on M&A, valuations, refinancing and development.
2. *Low Unemployment:* Low unemployment is a blessing and curse. It is a big blessing in that it typically results in higher consumer spending, and more consumer spending usually results in higher revenues in restaurants. However, it also comes with the curse of difficulty in finding workers, and most friends of mine are bemoaning the growing labor challenges in their restaurants and markets. We reached a 49-year low of 3.7% for unemployment in November 2018. I was at a KFC restaurant in Louisville last week, and it only had 3 workers at lunch. I am a loyalist, but even I wasn't patient enough to stand in a 30-minute line. The Dunkin' dining room near my house is closed at least 25% of the mornings because they don't have enough workers. Lack of help is costing the industry several percentage points of growth, I am sure. It is a difficult problem to solve with low unemployment and rising wages.
3. *Housing Slowdown*: Will a potential housing slowdown leak over into commercial real estate? Recent data has been bumpy. Sales of previously owned houses in the US rose 1.4% to a seasonally adjusted annual rate of 5.22 million in October 2018, following a 3.4% drop in September. Anecdotally, I noticed a visible pricing slowdown recently when I sold a house on the Gulf Coast – vacation areas are oftentimes the first ones to feel the pinch. Affordability is an issue, and financing has gotten tighter as

interest rates have risen this year. Will we continue to see a slowdown here, and will it cross-pollinate into commercial real estate, where high prices and affordability are also issues at play? Operators might be wise to stall on new unit development and wait to see if they can get more competitive pricing if they are in a cash-rich position. I wouldn't be surprised to see strip center and pad sites take a dip in the back-half of 2019.

4. *Rising Minimum Wage:* Rising minimum wage is affecting restaurant P&Ls significantly, and unless you own a best-in-class brand that can offset it with higher prices, there is a big risk in EBITDA slippage in 2019 depending on where you operate. With the recent ballet measure minimum wage increases in Arkansas and Missouri, there are now only 21 states that are on the federal minimum wage of $7.25 per hour, 10 of which are in the Southern US. Missouri will raise to $8.60, effective January 1, 2019; $9.45, effective January 1, 2020; $10.30, effective January 1, 2021; $11.15, effective January 1, 2022; $12.00, effective January 1, 2023 and an annual indexing beginning January 1, 2024. For Arkansas, they were already at $8.50 and will go to $9.25, effective January 1, 2019; $10.00, effective January 1, 2020; and $11.00, effective January 1, 2021. I was at a recent franchisor office, and their President told me that rising minimum wage on the West Coast was the single biggest threat to their overall business.
5. *Changes in Interest Rates*: Interest rates have increased several times this year. With recent and wild stock market swings, in addition to talks of a trade war with China, some are calling for rate neutrality after a year in which the fed funds rate increased from 1.25% to 2.25%. Certainly, President Trump has been vocal on his views that recent interest rate increases should stop. Whether or not we are nearing neutrality or 0.50 – 1.00% away, the talk of neutrality is a short-term welcome sign for M&A activity, which thrives on the continued low interest rate environment to borrow more money at better terms.
6. *EBITDA Multiples Drop Slowly*: This year, as a general statement, Unbridled Capital has seen EBITDA multiples flatten for the best brands, increase for the next level of large national brands and decrease for lower-tier brands, sub-sandwich brands, casual dining brands, fast casual brands and some pizza brands. The most surprising to me has been the rapid increase in EBITDA multiples paid for brands like KFC, Arby's and Pizza Hut through recent M&A transactions. For 2019, I expect the industry to undergo a slow drop in EBITDA multiples due to a slowing economy, lower restaurant traffic and higher interest rates. As an aside, I have been repeating this same warning for the past few years, and I have been wrong each time. I've been amazed at the length of the expansive environment of EBITDA multiples in franchising. I can't see it continuing much longer, but it may have a soft landing.
7. *Real Estate Cap Rates* – Cap rates have been edging up this year. The 10-year is a good measure of cap rates, which move in opposite directions on a semi-delayed basis. Real estate valuations are largely unchanged currently, likely because of the high amount of cash in the marketplace. But the trend can't continue forever. Real estate valuations will get pressured with any continued momentum from the rising 10-yr, which started 2018 at around 2.41% and is now hovering at 2.86% after reaching a 7-year high of almost 3.25% on October 5th. For now, sellers and buyers should take advantage of record valuations and still-cheap money for real estate financing. But watch for this trend to slowly change in the next 12-24 months.
8. *Best Brands Will Get Better*: In a survival-of-the-fittest industry that grabs and claws for 1% sales growth, there is a sustainable competitive advantage in the brands who can combine the following attributes: most loyal customer following, most innovative products, highest unit count, biggest unit growth rate, most years of consecutive positive sales comps and brands with a dominate position among their competitors in a narrow segment of the market, such as burgers, pizza, tacos, and chicken. Names such as McDonald's, Starbucks, Chick-fil-a, Taco Bell, Domino's, Panera and Dunkin' are examples of the best at what they do. Other great brands with a national footprint include Wendy's,

Popeye's, Buffalo Wild Wings, KFC, Burger King and Arby's. Expect many of these brands to utilize their successful platforms to grow and take market share from others when the economy slows.

9. *Will Somebody Focus on Product Innovation, Please?* I saw one recent industry report indicating that restaurant brands are spending up to 10X more on value offerings and advertising than on product innovation. I think brands are doing themselves a big disservice by not increasing product innovation. It should be a hint to free-thinking contrarians – when everyone else is doing it, do something different. Product innovation works, and when done well, it positions a brand for 3-5 years of positive sales momentum. Just look at Taco Bell. And ask Pizza Hut what happened when they tried to unwind the $10 any-topping pizza promotion. It was utterly painful and destructive.
10. *Traffic Stagnation* – Traffic growth has been very elusive in 2018. Black Box intelligence just reported November 2018 restaurant comp sales were up 1% (6th month in a row) while traffic was down almost (2%). While comps will be easier in 2019, the trend is a bit worrisome. To-go and off-premise sales are hiding slight sales declines as people just aren't eating as much inside restaurants. Competition from delivery, grocery, convenience stores and new unit development are fierce. Expect this trend to continue. If you operate a brand with strong traffic growth, then you have a valuable commodity.
11. *Expansion of Automation* – This is no longer a bold prediction. However, the expansion of automation is still one of the biggest stories in the industry going forward. Kiosks are just the start. Rising minimum wage will necessitate robots as burger flippers and pizza makers – and soon. For giggles, go online and look around. Within 5 years, California might not actually employ people at restaurants.
12. *Rising Dissatisfaction of Third-Party Delivery* – Grub hub, Uber Eats, DoorDash and others are creating a new marketplace for getting food into the hands of customers who don't come into the restaurants. However, they are doing so at a price. Most franchisee friends of mine say they are losing money on third party delivery. Most franchisor buddies of mine are very concerned that they are not able to capture data on their customers. Both groups are concerned about product quality. I believe we will start to see brands take delivery in-house at an accelerating pace. The customer data is just too valuable – it is worth more to franchisors – way more – than the third-party delivery relationship.
13. *Rise of the Angry Franchisee* – We have seen significant fighting from the franchise bases of McDonald's and Jack-in-the-Box recently. Franchisees want better marketing, more representation, relief on remodeling obligations and other concessions. Franchisors, for the most part, are losing touch with their franchise base as they have refranchised so many restaurants and no longer operate. For example, it is difficult for a millennial-aged brand president with no company stores to truly understand a sixty-year old franchisee who operates 40 units. The rise of the angry franchisee almost looks like a unionization of sorts in some brands. Expect the trend to continue in 2019 as newcomers look to early-mover franchisee action groups to fight their franchisors for change.
14. *Fast-Casual Continues to Struggle*: Many fast-casual franchisees own larger investments in legacy QSR concepts. As such, the struggle in most fast-casual brands has largely gone unnoticed by most since many franchisees have deeper pockets. However, the fast-casual model has not proven to work very well in some cases. Real estate is too expensive, build-to-suit menu products are too expensive to staff, and food costs are high. Just count the sea of workers at a Blaze Pizza location at lunchtime. As minimum wage increases hit the red states, it is possible that hundreds of fast casual restaurants could eventually close.
15. *Take Notice of Generation Z* – who is Generation Z? According to NPD Group, they 2 – 20-year olds, represent 21% of restaurant dollars spent, 24% of restaurant visits and are 23% of the US population. They will start to become important with franchisees soon. I happen to know this group well – I have kids in high school and middle school. My question is this – is your brand attracting these youngsters?

My kids love Chick-fil-A, Taco Bell, Starbucks, Raisin' Canes, Zaxby's and Dunkin'. They like the Colonel Sanders commercials but still can't remember a time they've eaten there. They almost never eat inside a restaurant. My daughter orders food on her phone almost exclusively. This age group is even more digitally-savvy than the dreaded millennials, and they are very ethnically diverse. It will be fun to watch them assimilate into the American consumer engine as they age but also a forewarning to brands that don't have Generation Z customers now.

16. *Franchisors Relent on Development and Store Closures* – I have been talking about this for a few years now, but franchisors will eventually be forced to relent on excessive development obligations, like we are noticing in Burger King, Popeye's, Taco Bell and others. Franchisors will also have to relent on store closures, most notably Pizza Hut. Separating the wheat from the chaff isn't always a bad thing when trying to revitalize a brand. Same store sales growth plus new unit development growth is badly outpacing consumer spending growth. This imbalance cannot continue for long – brands will be faced with development slowdowns and store closures soon.
17. *Rise Again, Special Asset Group*: Practically no one knows what a Special Asset Group is in 2018, not even lenders within their own banks, but they'll slowly start to learn in 2019. These are departments within banks that specialize in workouts of non-paying or slow-paying franchisees. Franchisor bankruptcies may also continue to happen, like Taco Bueno's Chapter 11 filing and acquisition by Sun Holdings. From an M&A perspective, these deals often trade at much lower valuations but come with a mess of administration and pressure. They aren't for everyone, but we will start to see more of them in 2019, especially on the franchisee side.
18. *Slow Death of Restaurant Real Estate*: This is a crazy, futuristic prediction, but I am continuing to hear a faint buzz of younger family-office groups questioning restaurant real estate altogether in favor of roaming, mobilized kitchens or on-demand, centralized food prep and delivery. Search the internet for Pizza Hut and Toyota, who are developing a self-driving pizza-making and delivery truck. Or also look at a roaming gas station model that delivers gasoline to your front door on demand. Or maybe even a drone delivering tacos to your home. Sound outlandish? It might be here sooner than you think.
19. *Refranchising Wave Nears Completion* – most Tier 1 franchisors have either completed their transition to an asset-lite model (less than 3% Corporate-owned) or are almost there. Refranchising is now hitting Tier 2 brands, which are smaller in unit count and regional in size. Tier 3 brands will likely following suit with increasing frequency in 2019, signaling what could be the slowdown of the massive refranchising wave that has dominated the industry over the past several years.
20. *Financial Investors Want Out as Remodels Come Due* – Brands like Hardee's, for example, don't have a current remodeling plan. Watch for what happens when they announce it. And for other brands that are heavily penetrated with financial investors already, expect them to sell before major capex programs are enforced. Financial investors hate to remodel restaurants unless they get a big sales lift, which is normally quite elusive.

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