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FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 7. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room:

A. Sales and traffic outlook for restaurants
B. Restaurant financing update from the RFDC Conference
C. Franchisor takeovers and rumors continue their feverish pace
D. Question of the Week: What would you say to convince a franchisor to refranchise their restaurants?

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. Sales and traffic outlook for restaurants

By many indications, it has been a good start to the holiday season across the country, with noticeable increases in consumer spending, especially on-line. Unemployment is remarkably low as well. Let's hope the holiday season will lead to stronger December sales and traffic in restaurants.

However, it has been a mixed bag in terms of restaurant sales performance this year. TDn2K reports that comp sales in restaurants were up for the 6th consecutive month in November at 1%. The West Coast and Southeast areas were the strongest, and New England was the weakest performing area geographically.

Increasing sales is good news, but for 2018, it has come from pricing and new unit development. Traffic has been down for virtually the entire year and was down almost (2%) in November.

Major franchise brands have mostly produced strong same store sales comps. For example, for Q3, here is a rank-and-stack list of high-to-low comp sales for select brands: Applebee's, Domino's, Wingstop, Taco Bell, Outback, Chipotle, Sonic, McDonald's, Chili's, Del Taco, Dunkin', IHOP, Denny's, KFC, Pizza Hut, Jack-in-the-Box, Bojangles, Popeye's, Wendy's, Burger King, Red Robin and Papa John's.

For this group, there was a heavy concentration in the 0-2% comp sales range. The total range was +7.7% to (9.8%), but removing Papa John's and Red Robin, no group was worse than (1.0%).

Here are some comments:

1. Throughout much of the Midwest particularly, there was very cold weather in early 2018. I'd expect to see some favorability as comp sales should be stronger this winter in many places.
2. Pricing increases will continue, especially on the West Coast and in the Northeast. Franchisees will be combating annual minimum wage increases, many of which take place at the start of the New Year.

Because pricing will necessarily increase to combat rising minimum wage, don't be overly excited if we see 2% sales growth in January, February or March. However, all positive sales trends are a good thing.

3. It is interesting to note that to-go sales have been accelerating rapidly, approaching 9% on a year-over-year basis in 2018. These strong increases are likely hiding the fact that there just aren't as many customers sitting in restaurants these days.
4. Competition is fierce from delivery, grocery and convenience stores.
5. New unit development has been steady and increasing. This has resulted in higher overall industry sales but is challenging comp sales significantly in lesser brands, independent restaurants and mom-and-pops. Remember that eating-out is a very mature industry. Most sales growth comes at the expense of other restaurants. We are sharing slices of the same pie, and the pie isn't getting bigger.

B. Restaurant financing update from the RFDC Conference

The Restaurant Monitor came out with an article summarizing some lender comments from the RFDC Conference in mid-November. I thought some of these points were good ones – here is a summary:

1. Rising interest rates are on the minds of restaurant operators but even though they're about a full point higher than they were a year ago, they're still not their biggest cost concern.
2. The middle of the P&L is stressed with rising wages, healthcare costs and commodity price increases that trump higher interest rates.
3. In general, the demand for capital is decreasing.
4. Term loan B-rated or the high-yield market was $3.3 billion as of November 2018, down from $3.7 billion the year before. This might decline further as interest rates continue to increase.
5. There is an increased chance of recession, and this is concerning to lenders, who typically make a 5-7-year term loans and must consider the risk of recession in their pricing.
6. One lender commented that the operating environment is much tougher today than it has been.
7. There was another comment that few operators are seeing margin expansion in their P&Ls. Specifically, there has been margin contraction of 100 to 200 basis points on average this year.
8. There have been some positive signs recently in casual dining, but QSR is the most resilient segment.

To me, it sounds like lenders are becoming a bit more cautious in today's operating environment. Certainly, the refinancing market has dried-up this year as higher interest rates have dissuaded franchisees from changing their capital structure unless M&A necessitates it.

C. Franchisor takeovers and rumors continue their feverish pace

It has been a crazy year of M&A activity at the franchisor level across many brands in the restaurant sector.

Here are just a few examples: Jack-in-the-Box sold Qdoba to Apollo Global Management. Inspire Brands just acquired Sonic Drive-in after buying Buffalo Wild Wings earlier this year. Bojangles announced a take-private transaction with Durational Capital Management and The Jordan Company. Taco Bueno was just acquired in bankruptcy by Sun Holdings. There have been rumors that Papa John's has been looking for a buyer as it is struggling to overcome negative sales comps.

Additionally, private investor groups are growing like weeds. Roark Capital is massive, 3G Capital owns several Tier 1 restaurant brands and JAB Holdings owns Panera and a plethora of breakfast and coffee brands. For the week of December 17th, we can now add Jollibee Foods to the list as well.

Philippine-based Jollibee Foods Corp just announced the completion of its takeover of Smashburger after its initial investment into the brand in 2015. This isn't a surprise to me, but what I found interesting was a comment about Jolibee's plans from executive Jose Minana - "Our vision is to be one of the top five restaurant companies in the world" and "We are looking at more acquisitions here in the United states."

Also on December 17th, Jack-in-the-Box announced that it is exploring strategic and financing alternatives. This is indicative language that means they are considering a possible sale of the company. Jack indicated that it has already held discussions with potential buyers. Remember that Jack is primarily a West Coast brand, where minimum wage increases have created a difficult environment for all franchise operators.

In any given year, M&A activity starts to ramp up in Q1. There have been many announcements recently and expect more announcements in 2019 – both on the franchisor and franchisee side.

D. Question of the Week: What would you say to convince a franchisor to refranchise their restaurants?

This is a great question as refranchising has been a huge trend for many brands over the past several years. Here are some thoughts on how I'd respond:

1. Corporate Refranchising has been a critical component of driving higher valuations and share price.
2. Many large and mid-sized brands have completed major refranchising efforts in the past 2-3 years.
3. The asset-lite model results in higher margins, lower G&A and lower capital expenditures.
4. Selling stores to franchisees also greatly reduces the risk of earnings misses for public companies as well as a significant reduction in operational risk.
5. The recent franchisee M&A boom has produced a heavy supply of buyers who are well-capitalized franchisees and investors.
6. Buyers are increasingly paying record prices for refranchised markets as demand has greatly outstripped supply.
7. The capitalization and operational expertise of today's franchisees are stronger than a few years ago.
8. Many buyers of fast-casual franchises are large, QSR operators who understand development, operations, financing and management.
9. Development agreements can be combined with refranchising to aid new unit growth.
10. For the franchisor, substantial new unit growth drives higher revenue growth and share price.
11. Selling larger groups of stores is the right idea to attract the best franchise partners who have the vision and capitalization to grow.
12. Selling smaller groups of stores will result in undercapitalized franchisees who won't be able to grow, remodel or weather an economic downturn.
13. Record valuations will not be here forever – increasing interest rates, tepid traffic, competition and risk of recession – all are reasons to act now.
14. The risk of waiting 12-24 months to refranchise could be 10-25% in lower prices due to these factors.
15. For these reasons, the time to act is now when considering a system-wide refranchising effort.
16. Strategy and pacing/sequencing are very important. Do not haphazardly plan to sell a market or two. A larger plan is needed with experts who can maximize value and find the best franchise partners for your future.

<u>Closing:</u> Thanks so much for entering the Boiler Room today. You can find our podcasts on iTunes, Google Play, TuneIn, Stitcher and Spotify. If you like these podcasts, please listen, rate and review! I also encourage you to

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