UNBRIDLED CAPITAL
FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 8. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room:

1. Q4 Restaurant Sales Comp Update
2. Valuation update for 2019: EBITDA and Cap Rates
3. Restaurant Unit Count is Dropping
4. Question of the Week: What does Unbridled Capital do?

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. Q4 Restaurant Sales Comp Update

   a. Background: TDn2K just released its findings on December comp sales and traffic as follows: "December's same-store sales growth of 2.0% was the best monthly performance in over three years. Q4 same-store sales growth was 1.4%...the best in over 3 years. From an annual perspective, 2018 saw the industry return to a positive same-store sales growth of 0.7%, after 2 years of declining sales…However, the industry continues to suffer from declining guest counts. Same-store traffic growth was -0.9% in December. Q4 traffic growth was -1.6%. It continues to be through an acceleration in average spending per guest that the industry can produce positive sales growth amid the persistently falling guest counts. Average guest checks grew by 3.1% during the fourth quarter year over year."
   b. Comments: I am really pleased that we had a great December in comp sales as an industry. Traffic declines persist but are improving. The data suggests that you need to see 3-4% sales increases in order to get traffic growth as guest checks are rising to combat minimum wage increases. Weather was quite favorable in many places throughout the country, and this trend will hopefully continue in January and February as many Midwestern states were hit hard with winter weather in 2018.
   c. Effect on M&A: Generally, though, the storyline can't be seen in these overall numbers. Sales growth has been uneven throughout the country and in various brands. Some of my Taco Bell buddies are reporting 10-15% sales increases so far in January – that brand has incredible pricing power right now. I am hearing pockets of nice sales increases at Pizza Hut through its $5 line-up promotion. I've been told that Popeye's is struggling badly for sales right now, as is Hardee's. Papa John's is still trying to recover from its negative PR last year. Many other chains are seeing flattish sales comps, driven largely by discounting and lack of new product innovation.

B. Valuation Update for 2019: EBITDA and Cap Rates

a. *Background*: I just returned from a week's trip throughout the Southeast to see mid-sized franchisees, a few franchisors and some private equity groups. I saw a few Yum franchisees, met with Arby's Corporate, Hardee's Corporate, Roark Capital and several smaller, Atlanta-based PE firms. From these meetings, I think the general temperature was quite optimistic for 2019. Most of these groups were very positive on the growth in their companies. There was widespread and cautious optimism that 2019 could be a continuation of a strong current M&A environment and historically-high valuations in the sale of restaurant companies. Several groups talked about the difficulty of finding good employees, especially in Atlanta and Nashville, where growth has been so extraordinary that unemployment is close to 0%. Some franchisees talked about increasing consternation in the stock market, which saw a huge drop in December that sent a chilly warning to many of us. There was some mention of difficulty of same store sales comps in 2019 as we roll-over positive sales increases from last year's tax cuts in employee wages. There were some concerns about 3-4 more potential interest rate hikes in 2019, and their collective effect on borrowing costs, which reduces asset prices in the M&A process. Geopolitical uncertainty, US/China trade tensions and Republican/Democrat government shutdown fights were mentioned as concerning items to watch. However, overall, the message was very positive about growth and acquisitions.

b. *Effect on M&A*: I generally agree with these observations, concerns and reasons for optimism. In 2018, we saw a huge increase in valuations in several brands, including Pizza Hut and KFC. Others remained relatively flat in terms of valuation – but still at elevated levels. Only a few brands saw decreasing valuations. I expect 2019 valuations to be flattish, absent a macroeconomic event that shocks the industry. We might see slight EBITDA multiple declines if industry sales soften or if there are pronounced interest rate increases. Surprisingly, 10-year treasury has dipped back into the 2.7% range, 20-25 basis points lower than much Q2 and Q3 of 2018. So, cap rates have stayed very attractive and have improved a bit – which is quite a surprise as I thought cap rates would have worsened by now. So, for now, it looks like the M&A engine will stay primed for 2019, and it might even increase as sellers might act on what could be the final year at historically-high prices in this upcycle.

C. Restaurant Unit Count is Dropping

a. *Background*: The Restaurant Finance Monitor just came out with an interesting article entitled 'Still Too Many Restaurants." They report a drop of 1% in the number of restaurants from 2017 to 2018, resulting in 4,330 fewer restaurants than a year ago. Fast casual expansion declined from 8-9% to 2% in the past year. QSR unit growth remained relatively flat, and full-service chains grew by 2%, they report. For full-service, this growth is likely the result of a depressed base.

b. *Comments*: Full-service restaurants and independents have taken a big hit in recent years. Look around at the restaurants that have closed in your area, for example. In Louisville, I have seen a mass exodus of Applebee's, Hometown Buffett and Ruby Tuesday's, among others. There are hardly any independents anymore, unless you go to the eclectic area of town. Fast casual has had a big slowdown as well – the high cost of labor and real estate has necessitated big sales volumes for success. Some fast-casual brands are doing great, but many have placed a halt on their expansion plans as new units are underperforming financially. QSR might look like clipping a bond coupon – boring, slow but steady. Same store sales growth has decent, and new unit growth has largely been flat – a trade-off of unit growth and decline between various brands. For example, I'm told of an explosion of QSR and fast casual chicken competition popping up in the Texas/Oklahoma areas particularly, where some small towns are seeing three new competitors open in the same year.

c. *Effect on M&A*: I have said this quite a bit over the years, but operators need to push their franchisors to close unprofitable units. The amount of time spent on unprofitable restaurants can dwarf the time investment in the successful ones that are making all the money. Sometimes it is okay to admit defeat and cut loses – separating the wheat from the chaff. At Unbridled, we rarely see a 10-store portfolio that doesn't have at least one badly negative EBITDA location that needs closing. As a specific example, we are looking at a smaller business now, that if one location closed, the overall valuation would increase by almost 25%. For operators, keep in mind that if your location is EBITDAR negative, then it isn't even covering rent. There is no financial reason to keep a store like this open – you make money by locking the doors. You make even more money by sub-letting and subsidizing rent. And you make a ton of money if an EBITDAR negative location isn't included in a sale of a larger package of locations in the M&A process.

D. Question of the Week: What does Unbridled Capital Do?

a. Unbridled Capital is a franchise investment banking company based in Louisville, KY. I own and manage Unbridled and have been involved in the franchise industry since the early 2000's, starting as a KFC Corporate employee working in finance and operations. Our core business is sell-side M&A: helping franchisees and franchisors in the sale and disposition of their locations. We also do buy-side M&A: helping large franchisees acquire more locations or get into another brand for growth. We help with financing as well, whether it is placing debt for a new entity that is acquiring a platform of franchises or recapitalizing an existing business through an acquisition or for purposes of borrowing money more efficiently.

b. Our clients choose us because of the depth of our relationships with franchisees, private equity companies and family offices – leading to the highest prices in a sale of their companies. We also offer an intense focus and expertise in getting deals completed efficiently and on the best possible terms with the least risk. Our clients appreciate our four cornerstone principles: innovation, comprehensiveness, relatability and passion for success.

c. Unbridled has historically had a huge penetration in the Yum system – a system in which I famously tell people that I know almost every Taco Bell, KFC and Pizza Hut franchisee. Over the past 12-18 months, we have had 15 or so Taco Bell assignments, 10-12 KFC assignments and 10-12 Pizza Hut assignments, representing hundreds of restaurants and approaching $1 billion in collective valuations. For example, we will probably sell 600-800 Pizza Huts over a three-year period. In 2018, Unbridled also sold Corporate markets for Papa Murphy's International and Papa John's. This is an area of growth for our firm for 2019 and beyond.

d. Our average deal size is probably 20-40 units, though we regularly work on larger transactions as well. In the Yum system, I have many long-term friends who are smaller franchisees, so particularly in KFC and Taco Bell, Unbridled will readily help smaller franchisees in the sale of their businesses.

e. Unbridled is rapidly growing into other brands. We have had recent or current assignments in Five Guys, Burger King, Applebee's, Arby's, Planet Fitness and several smaller franchisors.

f. Finally, we have a 6-person team: me, Derek Ball, Tony Petrunin, Charles Scholtz, Rene Newsome and Tom Pope. Everyone on our team has an advanced degree of some kind. Derek is an attorney, which helps greatly with deal execution work. Tony is a former Pizza Hut Corporate employee with international franchising and investment banking experience. Charles has a JD/MBA and knows contracts and valuations. Rene is a CPA and worked for many years for Steak N Shake. Tom Pope is a former E&Y partner and Tax professor at the University of Kentucky.

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.