National Restaurant Search

EXECUTIVE RECRUITERS

Serving the hospitality industry Since 1981

AUGUST 2011 NEWSLETTER

National Restaurant Search LLC

National Restaurant Search has remained the food industry's most respected executive search firm for nearly three decades. We seek to be the best. Therefore we are committed to recruiting the best candidates for our clients needs. We strive for excellence in everything we do and our clients needs always come first. Over the years we have built relationships, credibility and reputation by establishing an exceptional level of trust with both our clients and candidates. With offices in Chicago, Atlanta, and Minneapolis, and opening in Dallas in 2011, we offer a full range of search and consulting services to national and international corporations, early stage entrepreneurial companies, private equity and venture capital firms.

Our profession is an art, not a science. The quality of creative thinking the recruiter brings to his art, the judgment he uses in assessing prospects against client requirements, and the skill to close in a manner beneficial to the client and candidate come only from experience. There is simply no substitute for experience. Our search consultants all have executive level management experience within the hospitality industry, which makes us uniquely positioned to bring our clients valuable organizational perspective, while helping them to capitalize on the brightest talent and best performing candidates in the marketplace.

National Restaurant Search continually monitors the hospitality industry and keeps abreast of economic trends that affect our clients. We are also acutely aware that the shortage of talent, already evident before the recession, is reasserting itself strongly. Companies have begun to think strategically again, and in looking for growth are seeking out those managers and executives who can offer both operational strength but also practical leadership in taking organizations and teams forward. We see this as a challenging but exciting time to be partnering with clients to help them build and strengthen their management teams as they seek new growth in a much changed world.

I would welcome the opportunity to discuss how National Restaurant Search can be of service to you and your organization.

Sincerely,

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Articles

1: Restaurant Finance Monitor Article on National Restaurant Search

2: *Pondering the Poach* by Deborah L. Cohen

Restaurant Industry Stock Review
July 2011

by Zacks Equity Research

The restaurant industry is finally showing improvements and seems poised for long-term growth. Riding on the back of a slowly reviving U.S. economy and the consequent rise in comparable-store sales, restaurant operators have managed to post improved results in recent months. We expect restaurant companies to continue delivering better numbers in the upcoming quarter over the year-earlier period.

In second quarter 2011, most big names in the industry outperformed the Zacks Consensus estimates. More good news came from the NPD foodservice market research report, which stated that annual visits to restaurants are expected to increase by 8% over the next ten years.

A recent survey by the National Restaurant Association revealed that the Restaurant Performance Index (RPI), measuring the health and outlook on the U.S. restaurant industry, was 99.9 in May, down 1.0% from April. The slowdown in May was temporary.

For the first time in six months, the RPI stood below 100 in the month. The RPI run-rate in the last six months connotes improvements in same-store sales and customer traffic.

The Current Situation Index, which measures comparable-store sales, traffic counts, labor costs and capital expenditures in the restaurant industry was 99.2 in May, down 1.1% from April. The Expectations Index, which measures restaurant operators' six-month outlook on the above indicators, stood at 100.6, down from 101.5 in the prior month. Restaurant operators' capital spending plans are also on the rise, reaffirming their optimistic outlook on the industry.

Going Forward

Looking ahead, we see solid top-line trends. We believe well-positioned companies will drive above-average traffic trends and enjoy pricing power, leading to same-store sales increases in 2011. The economy is continuing to improve, albeit at a modestly lower rate, but a sluggish labor market, over-supply of restaurants in the industry, higher gasoline prices and food cost inflation may weigh on industry profitability.

Restaurants have been trying to win back cash-conscious guests by revamping promotions, offering discounts and focusing on value-for-meal menus. However, the tendency to offer discounts has been moderating. We remain cautiously optimistic over the near-to-medium term, with consumers continuing to look for value, distinct dining experiences, as well as convenience and enhanced menu deals in a gradually improving economic backdrop.

Drivers of the Restaurant Industry

The U.S. restaurant industry consists of Quick Service Restaurants (QSR), Midscale Restaurants, Casual Dining, Non-Commercial and Fine Dining/Upscale restaurants.

In the midst of what is considered to be a moderate recovery, there are three potential drivers of net income growth for the restaurant industry: unit expansion, same-store sales, cost-containment efforts and marketing tools.

Unit Expansion: Emerging from a lackluster economy, most of the companies have accelerated their pace of restaurant openings. With the expected recovery in consumer confidence, companies are turning back to unit expansion, though not aggressively.

BJ's Restaurants Inc. plans to open 12 to 13 restaurants in fiscal 2011 compared with 10 restaurants in fiscal 2010. In the long run, there still exists room to open at least 300 outlets. **Chipotle Mexican Grill Inc.** plans to open 135-145 new restaurants in 2011, maintaining a growth rate of 13%.

In fact, the companies are set to explore international markets. While Chipotle is primarily concentrating on European countries including U.K., Germany and France, **Buffalo Wild Wings Inc.** will expand its overseas footprint by opening more than 50 company-owned and franchised restaurants in Canada over the next 5 years. Another restaurant, **P.F. Chang's China Bistro Inc.** has also eyed the Canadian market.

Darden Restaurants Inc. announced a formal area development agreement with Americana Group to spread its operations in the Middle East. Several food chains including **Denny's Corp.**, Pollo Tropical of **Carrols Restaurant** and **Starbucks Corporation** intend to tap the fast-growing Indian market.

McDonald's Corp and **Yum! Brands Inc.** already have considerable coverage in India. Companies like Yum! Brands and McDonald's are aggressively expanding in China to capitalize on the fastpaced economic growth in Asia.

Same-Store Sales: The second driver consists of menu price increases and traffic counts. Restaurant operators reported positive same-store sales and customer traffic growth in recent months. Growth in menu price has accelerated, as per figures from the Bureau of Labor Statistics.

Cost-Containment Efforts: Some cost cuts have been achieved through integrated information systems, including point-of-sale, automated kitchen display, labor-scheduling and theoretical food cost systems.

Marketing Tools: Social media as a marketing tool has created ripples in the industry. As per National Restaurant Association, 8 out of 10 operators support the view that social media will become an important marketing tool in the future. Hence, they are likely to incorporate Facebook, online review sites, Twitter and blogs into their marketing mix over the next two years.

OPPORTUNITIES

With the economic outlook improving, the fortunes of a number of industry players have turned around. These companies promise long-term growth opportunities:

Buffalo Wild Wings offers investors one of the strongest growth stories in this space. Buffalo Wild Wings had also been able to consistently deliver positive comps during the height of market turmoil.

With consistent earnings and a healthy balance sheet, McDonald's provides relative safety and moderate growth opportunities in the current scenario, as well as exposure to faster-growing international markets. McDonald's U.S. comparable-store sales have been showing continued uptrend since the last few months on strong sales of beverage as well as core menu products.

Boasting a unique position in the hyper-competitive bar and grill segment, yet another stock, **BJ's Restaurants** offers investors a strong growth story with a viable business strategy and debt-free balance sheet. The company delivered impressive second quarter results in terms of earnings per share and same-store sales growth.

Improved Californian Market

The core California market, which was badly hit by the recession resulted in a high rate of unemployment and weak consumer confidence, has started to turn around. We see plenty of growth opportunities in the California and Texas markets. BJ's Restaurants and **Red Robin Gourmet Burgers Inc.** are expanding rapidly in California.

Job Growth in the Sector

The restaurant industry is the major contributor to job growth in the U.S. According to the National Restaurant Association, Texas and Florida will likely show the strongest job growth over the next 10 years.

Remodels and Menu Innovations Remain Key to Success

Additionally, restaurants are accessing different means to plug the problems of heightened competition in a somewhat over-supplied domestic market. Companies continue to reduce their energy consumption and are remodeling their restaurants to give an up-market feel. They are rolling out new, smaller prototypes to augment the perception of value and drive traffic thereby reducing construction and occupancy costs to enhance returns on capital.

While Darden has embarked on an extensive remodeling plan for its core brands like Olive Garden and Red Lobster to spur their same-store sales, Chipotle Mexican Grill is introducing typical Southeast Asian cuisine coupled with naturally raised food, for which it is well known.

The introduction of small plates or individual appetizers by several chains such as California Pizza Kitchen, BJ's Restaurants and Buffalo Wild Wings has already tasted success. Limited Time Offers are also on the rise following the success of Buffalo Wild Wings and Red Robin Gourmet Burgers.

Franchise-Driven Business Model

Most of the companies are transforming to more a franchise-centric model to reduce the volatility in earnings and increase cash flow generation. However, **Panera Bread Co.** is slightly more inclined toward company-owned unit openings, which speaks to the company's fundamental strength and makes us optimistic on the stock.

Breakfast Menus a Key Driver

Breakfast has accounted for nearly 60% of the U.S. restaurant industry and remains a key driver of traffic growth in recent years. Over the past five years, morning meal traffic has increased at an average rate of 2% per year, while lunch visits were flat, and supper traffic declined 2% per year on average.

We can thereby conclude that growth potential remains mainly in the QSR markets. Leveraging the trend, **The Wendy's Company** has expedited its breakfast menu in different markets. The company targets to have about 1,000 restaurants serving its new breakfast by the end of this year.

According to an analysis by NPD, which has a ten-year projection of foodservice trends based on aging, population growth and trend momentum, servings of breakfast sandwiches are projected to outpace the industry's growth forecast. Annual servings per capita of breakfast sandwiches at foodservice are expected to jump from 11 in 2004 to 14 in 2019.

Currently, there are a number of stocks in the restaurant industry universe with a Zacks #2 Rank (short-term Buy rating). These include BJ's Restaurants, Buffalo Wild Wings, Chipotle, Darden and McDonald's.

WEAKNESSES

Higher Food and Gasoline Prices

Food costs account for about one-third of restaurant sales. Wholesale food prices have been on the rise this year. Prices of corn, wheat, coffee and other commodities have also trended up, mainly due to a decline in the U.S. and Russian production prospects, compelling many restaurants to raise prices on some of their products.

The companies are expecting industry-wide increases in commodity and energy costs for fiscal 2012 as well. Dairy and beef prices witnessed a steep rise on a year-over-year basis.

With more expensive food and a spike in gasoline prices, people will have less disposable income and will prefer to dine at home. In our opinion, most of the restaurants will try to safeguard their margins by passing the cost increases to consumers. While big and established chains like McDonald's, Yum! and Starbucks will survive the price increases due to their broad customer base and larger economies of scale, smaller chains will feel the heat of rising commodity costs.

Steep Competition and Promotional Offers

Competition among casual dining restaurants is expected to remain fierce with respect to price, service, location and concept in order to drive traffic. The environment is still value-sensitive. High discount rates applied to menu prices in order to battle difficult economic conditions are resulting in price wars among competitor companies.

Hence, the failure of any promotional offer will put pressure on the company's same-restaurant sales growth. Dishes featured in the Olive Garden promotion from February to May failed to be accretive to Darden's growth, for instance.

Shutdown of Regional Restaurant Chains

A large number of independent U.S. restaurant units fell victims to the downturn, while chain restaurants did relatively better. Large national chains, which attract mainly higher-income visitors, are performing better than regional restaurants as upscale-customers are recovering faster than the lower-income group.

Lag in Traffic Growth Barring Fast Casual Restaurants

According to a recent NPD foodservice market research report, visits to the leading fast casual restaurant chains grew 17% over the last three years while the rest of the industry experienced its steepest traffic declines. However, fast casual unit availability increased 12% since 2007.

Visits to the leading fast casual restaurant chains like Chipotle and Panera were up 6% for the year ending December 2010 versus a year ago. This compares with a 1% decline in total industry visits for the same time period.

Given the lack of overall earnings catalysts, it is difficult to be enthusiastic about a number of restaurant stocks. There are still quite a few names that lack the earnings catalysts of their better positioned peers. These include **Brinker International Inc.**, Yum!, **The Cheesecake Factory Inc.**, **Einstein Noah Restaurant Group Inc.** and **Domino's Pizza Inc.**, all of which retain the Zacks #3 Rank (short-term Hold). **Jamba Inc.** and **Denny's** retain the Zacks #4 Rank (short-term Sell).

CONCLUSION

The restaurant industry is not immune to uncertainties in the macro economy. Companies appear to be in a good position to take advantage of an improved economy as evident from their capital budgets. Easy comparisons from the prior year will likely place this year's performance in a favorable light.

On the consumer front, while they were previously struggling to survive in a recessionary environment, they are now grappling with steeply rising commodity costs, a still-high unemployment rate and dreary wage gains. These factors are expected to continue weighing on their spending behavior. In our opinion, a set of focused efforts will help restaurant companies operate with a cautiously optimistic outlook in 2011.

FULL ANALYST REPORTS

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