# UPDATE

*BELLWETHER FOOD GROUP, Inc.*

DATE: March 4, 2010

TO: Industry Friends and Colleagues

FROM: Bellwether Food Group

RE: Chain Restaurant Same Store Sales (SSS) 4th Quarter, Calendar Year 2009

<u>The 4th Quarter 2009 SSS reports</u>

The first thing you'll notice is that this quarter's update is about 10 days later than previous quarters, that reflects the fact that many chains, especially those with not so good news, are simply delaying reporting quarterly performance. For examples, chains-Dine Equity, Domino's, Morton's, Famous Dave's, and Wendy's/Arby's did not release 4th quarter calendar year sales performance until the first week of March.  Like many companies in other industries, there is reluctance to get out there right away with less encouraging news or an unpleasant story to tell.

The 4th quarter showed three trends, some brands doing remarkably well (like Panera, Starbucks and Steak N Shake) , some showing evidence that the worst is over (Ruby Tuesdays), and some still struggling in both Casual Dining (Red Robin, California Pizza Kitchen) , and QSR (Sonic, BK, and CKE) as well.  In the spirit of some positive signs are two notable points this quarter, the incredible performance reported by Panera, and Steak N Shake, up 7.4% and 14.3% respectively.

Panera performed amazingly well, with a 3.2% increase in traffic, a price increase of 2%, and an average check increase of 4.2%. This means, not only did they increase traffic, sustain a modest price increase, but they got consumers to spend more! How did they do that you might ask? It is not about the stars being aligned, it is about staying focused on the details.  They continue to focus on adding value, when they take a price increase, example their new plating for all their foods instituted last year.  The improvement in value appeal from their number 1 selling product U Pick 2 was an improvement that consumers could see and feel.  The focus on breakfast and adding new products was another and finally, their extension of merchandising tables in the lobby for grab and go products helped to build average check.  All details that consumers gave them credit for, with their continued loyalty.

At Steak N Shake it was traffic driven due to their repositioning work completed last year.  They did not have a strong value appeal and went with a Bar Bell pricing strategy adding real value at

$3.99, $4.99 and new larger, high quality burgers and sandwiches at $5.99. So lesson learned, stay true to what you are known for, great burgers and fries, develop a strong value message and pricing that appeals to the masses and deliver a great experience. Their average check is down, but traffic is driving all the improvement and then some.

Despite the challenging environment, some brands are growing restaurants this year. We look at three examples-Darden has published their plans to open 50-55 new restaurants, Panda will open 55-60 new restaurants, and Chipotle will open some 120-130 new restaurants this year.

In another interesting development, Burger King announced plans to work with Seattle's Best for their coffee program, which we assume will include at some point espresso based drinks, clearly a response to McDonald's investment in the espresso based drinks program, which is set to be in all US Stores by the end of calendar year 2010.

Since most espresso based drinks are consumed as separate beverage occasions, that is, not with a meal, it looks as though McDonald's is working on developing the beverage only occasions as well as grow the breakfast occasions, a profitable niche for many operators, especially convenience stores and Dunkin Donuts, not to mention those other guys-Starbucks. As we have talked about before, if this beverage only segment becomes a factor, then the QSR competitors will have to respond to stay relevant.

Most chain operators are working on at least three things. First, we are hearing a lot about a back to basics approach, (one large operator told us recently that 2010 was going to be *"the year of the guest-we are going to work smarter and refocus on keeping our guests happy so they come back more often, we lost some of that over the past couple of years"*).
The other two things, are new news, new menu items-reasons to communicate with their regular users, limited time offers- drives incremental traffic and frequency, it is a win. And finally, all are working to make the back of the house more efficient.

Very tough conditions in California—which represents now over 12% of the US economy, continues to get hit very hard, driven primarily by unemployment. Brands with a strong presence there, Jack in the Box, California Pizza Kitchen, Carl's Jr, El Polo Loco and others, are really feeling the sales pressure.

Check out the new Chili's menu—they have really made some incredible progress. Having visited a number of their restaurants since December, they have done some great things with the menu-we were all very impressed. It is starting to feel like the Chili's we all used to know and love!

**<u>Unemployment—</u>**we talked at length about that recently, and most of the QSR operators we talk to have told us that issue is still the biggest concern, as their lower income customers tend to be the first group hurt when firms scale back on staff. One Senior Vice President commented, "*Our customer satisfaction and loyalty scores are strong, but our consumers are either reluctant to spend or don't have any money. Until the policy makers get this unemployment thing figured out, we are not expecting a big turnaround, so we are planning for slightly lower volumes".*

| Brand | Same Store Sales Versus Prior Year | Traffic Change | Pricing | Comments |
|---|---|---|---|---|
| Limited/Quick Service | | | | |
| Arby's | -11% | NA | NA | Company stores declined 12.6%, franchise stores -10.2%, tough environment, meaning about a 15% decline going back to 4th |
| Burger King | -3.3% | NA | NA | |
| Carl's Jr. (CKE) | -8.7% | NA | NA | |
| Chipotle | +2% | NA | NA | Will open 120-130 new restaurants in 2010 |
| Domino's | +1.4% | NA | NA | |
| Hardee's (CKE) | -2.5% | NA | NA | |
| Jack in the Box | -11% | NA | NA | Strong California presence, a driver of challenging sales trends |
| McDonald's | -0.7% | NA | NA | January update, no detail specific to US for 4th Qtr |
| Panera (company stores) | +7.4% | +3.2% | +2.0% | 4.2% increase in average check |
| Papa John's | -0.5% | NA | NA | |
| Popeye's | -1% | NA | NA | |
| Sonic | -6.5% | NA | NA | |
| Starbucks | +4% | NA | NA | Average check increase, indicating strong brand loyalty, and preference |
| Wendy's | March 4 | NA | NA | |
| Yum Brands | -8% | NA | NA | |
| KFC | -8% | NA | NA | |
| Pizza Hut | -12% | NA | NA | |
| Taco Bell | -5% | NA | NA | |
| Full Service | | | | |
| Applebee's | -4.5% | NA | NA | |
| BJ's | -.2% | NA | NA | |
| Bob Evans | -4.2% | NA | NA | Mimi's Café down 8.3% |
| Buffalo Wild Wings | +2.2% | NA | NA | |
| California Pizza Kitchen | -5.8% | NA | NA | |
| Cheesecake Factory | -0.7% | NA | NA | |
| Chili's | -3.2% | NA | NA | |
| Cracker Barrel | -0.2% | -2.3% | +2.4% | Ability to sustain pricing increases a good sign, with declining traffic, caused in part by unfavorable weather |
| Denny's | -3.7% | -6.7% | | 20% drop in traffic over the past 5 years |

| Brand | Same Store Sales Versus Prior Year | Traffic Change | Pricing | Comments |
|---|---|---|---|---|
| Famous Dave's | -3.4% AUV | NA | NA | Franchise stores -8.5% |
| IHOP | -3.1% | NA | NA | |
| Longhorn | +.5%-1.0% | NA | NA | Significant progress in remodeled stores |
| McCormick & Schmick's | -12.9% | -7.0% | | |
| Morton's | -11.6% | NA | NA | |
| Olive Garden | +1-1.5% | NA | NA | |
| PF Chang's | -5.2% | NA | NA | |
| Red Lobster | -1-1.5% | NA | NA | |
| Red Robin | -10.5% | NA | NA | Aggressive ad spend planned for 2010 |
| Ruby Tuesday's | -1.7% | +1.8% | | No restaurants closed this quarter, a positive |
| Ruth's Chris | -11.2% | | -8.9% | A 2.5% decline in average check, driven by pricing adjustments of -8.9% |
| Steak N Shake | +14.3% | +23% | | |
| Texas Roadhouse | -2.6% | NA | NA | |

The same store sales numbers give a good indication, but tell only part of the story. As a supplier, it is critical to look at the traffic and price increase/decrease numbers as well to get the whole story, as well as looking at the trends over the past 18-24 months.

When working on volume and profitability projections, it is imperative to look at the trends over the past 2- 3years, not just the last year. With traffic down overall, the unit economics change, as does the playing field for manufacturers.  Specifically, many brands, in Casual Dining especially, are simply going to have lower average unit volumes for the foreseeable future.

For example, Ruth's Chris is down about 30% over the past 24 months, and while sales have stabilized, Ruby Tuesdays' average unit volumes are projected to be about 20-25% less than their historical highs.

**Organizational dynamics-the emotional tone**

Everyone in every organization is asking harder questions and demanding more from everyone they work with. Many are under more pressure than ever before-as a result the emotional tone, the environment matter even more. This applies in every organization.

We have two examples from opposite ends of the spectrum. The emotional tone and leadership style of any organization certainly impacts performance be it positive or negative, and the fact that Burger King is in litigation with a group of franchisees, is at best a terrible distraction for all concerned.

On the other end of the spectrum, Chipotle's senior executives don't just "visit" their restaurants, they actually get behind the counter and work in their restaurants, something

Steve Ells is very proud of and that resonates well throughout their entire system and organizational culture.

Admittedly, it is no secret that Burger King and its franchise community have had challenges for some time, current management at Burger King inherited the culture, and that those tensions are not easily soothed over time. It is also well known, that Steve Ells and the management team have created an incredible culture. They recognize and embrace that a philosophy and business practices to recruit and develop happy, motivated employees is a major part of the business model, they believe it to be a big driver of customer satisfaction and their overall success.

At the same time, it is interesting to see how each of these organizations is responding to a new, challenging set of business conditions. The cultural dynamic at one organization is to engage in litigation, the behavior at the other firm is to spend more time actually working in the restaurants with their team members.

**Implications for Manufacturers**
**Placing the right bets, having fewer, better sales people-a follow up**
Last quarter we got quite a bit of feedback around the chain operator comments regarding the need for enhanced talent and overall business literacy, with the national accounts sales talent. There was great interest in that subject. A few have even shared with us that they are “ramping up the skill sets” of their chain teams-the focus being on competency versus only “having a lot of relationships”.

We will share some of the insights we have obtained over the past 6-9 months from the some 100 or “C” level executives in the chain restaurant about their perspective of the role and importance of sales talent in being successful with their organizations.

In describing the best sales people they work with, the ones they make time for and respect, five themes came through:

- They listen
- They know my business and my operations
- They have relationships throughout the organization
- They follow up and do exactly what they say they will do
- They do the first three before they try to sell anything

Noticeably absent from this list are best product, best price or large market share.

**The Targeting & Prioritization Protocol**

One of the ways smart manufacturers works through where and determine how much to invest in today's climate is to set priorities as an organization, by utilizing these six elements of definition and analysis:

- **Strategic Fit:** Are the strategies, targets and goals of the chain aligned with your strategies and goals?
- **Size of the Prize:** How big is the opportunity on a quantitative or relative measure? Does it justify the investment?
- **Accessibility:** How much access do you have to those who make and influence the decisions? How much do you know about how the chain makes decisions?
- **Transactional / Relational:** How does the account typically behave when selecting products in your categories? Is the account primarily focused on cost — hence transactional? Or, are they more interested in a long-term relationship, and can they see the benefits of working with a "co-investor" in their business?
- **Innovation Score:** How important is innovation to the chain? Are they known for entering new categories and driving culinary innovation, or not?
- **Financial Health:** this assessment, with clear guidelines and protocol is one that must be a part of this process. Consider these questions: Is the chain growing? Are they able to take price increases? Do they have cash (public companies)? Are the franchisees in trouble? Are they able to get financing to expand? Are they in bankruptcy?

If you have any additional questions, comments or some additional insights, please feel free to call any of us.

Regards

Jon Jameson, North Carolina, 843-422-4285
Mac Brand, Chicago, 773-348-8420
Rob Hardy, Boston, 617-281-5175