Private Equity and Restaurants, 2011 Update
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Executive Summary

We've updated our 2010 PE and Restaurants paper to identify what's going on in the US restaurant space by private equity (PE) firms. The result: a lot of activity and investments, some high profile failures but just a few apparent successes to date.

PE's often target distressed investments, and this shows up in the results. Failure is not unexpected. Every PE firm is different and has different strategies.

The PE effect on different stakeholders is important to consider. The stakeholders have some common interests, some contradictory: (1) the PE sponsor investor (2) the company operator itself (3) franchisees (4) other stakeholders (employees, creditors, consumers).

Franchisor franchisee reporting is very poor and makes the effect on franchisees difficult to read. Data in general for this topic is very limited.

There have been some apparent"successes", but with the surge of 2011 PE Chapter 11 filings (AKA failure for investors, employees and creditors), "failure" right now outnumber the successes. Most of the class of 2005 acquisitions has failed.

All the recent 2010-2011 acquisitions and many of the 2005-2009 acquisitions are unreadable, still in the works.

PE and Restaurants: the model and background

The "PE model" was that best practices and synergistic management practices could be introduced, and that companies could build/grow without supercharged Wall Street/investment community pressure. That premise is still to be determined.

The restaurant space had two big waves of PE acquisitions in 2005-2006 and 2010-2011. Since 2005, we've seen almost $21 billion in transactions, and we count seventy plus major chain restaurant brands PE owned. This count exceeds the 53 publicly held/traded US chain restaurants as of October, 2011.

Transaction Summary:

Company Status	Number of Transactions in Universe
Completed IPO	2
Positive Trend	3
Resale to other PEs	2
Pre-IPO designated	3
To be determined	36
Distressed/covenant breech/loss	3
Chapter 11 filing	9
Total	56

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Defining Success:

Since most privately held company earnings data is not made public, one must gather data wherever possible: debt disclosure, press reports, surveys, bankruptcy filings, resale transactions and the like. Generally, though, growth in chain system sales and number of units can be a proxy for success, as can resale to other PE firms. Chapter 11/7 filings and distressed, near default conditions are badges of failure.

For chain restaurants that franchise, little franchisee specific data is available. This is one of the great financial reporting weaknesses in the restaurant space. Franchisees power the capital and unit development of most franchisors, and represent the effective source of the bulk of the brand valuation.

2010-2011 Transactions: Not enough time yet:

There have been 20 major restaurant PE transactions in 2010 and through 2011. Two large 2010 acquisitions, Burger King (BKC) and CKR Restaurants (CKR) are still doing quarterly reporting but have shown little trend movement since their acquisitions. Roark Capital acquired Arby's in 2011, and now owns 11 restaurant brands. Only estimated sales data and unit count data is available, so economics is not discernible yet. Many transactions have just occurred and no trend is possible.

Proxies for Success:

National/international brands seem to have done better. Dominos (DPZ) went public in 2006, levered up and levered down, and transitioned through the pizza recession of 2008-2010. DPZ is growing internationally but their US franchisees are struggling or in no growth mode. Dunkin Brands (DNKN) had a successful 2011 IPO and is about to begin issuing quarterly guidance. US Dunkin Donuts franchisee store counts are up.

Bojangles, Logan's, Papa Murphy's and Church's have been resold to other PE firms, with positive press reports of system sales and EBITDA growth. Logan's, Dave and Buster's and Chuy's are in pre-IPO mode.

While still listed as to be determined, Yard House, Noodles and Corner Bakery are building AUV and unit counts, which have to be good signs.

Proxies for Failure: Bankruptcy and Distress:

Of the 55 PE transactions since January 1, 2005, nine concepts have filed Chapter 11 and two have announced technical default, one has had a sure loss. By transaction timing, many of the 2005 transactions have failed.

• **Chapter 11s:** Charlie Brown's, Unos, Barnhill Buffet, Perkins/Marie Calendars', Claim Jumper, Real Mex, Sbarro's, Friendly's and Bugaboo Creek. Average EV/EBITDA multiple of 7.4 X at acquisition. Five were 2005, two were 2006, and two were 2007 era transactions.

• **Announced Covenant Breech:** Quizno's, El Pollo Loco. Average EV/EBITDA multiple was 10.8X at acquisition.

• Three PE investments sold via management buy out (MBO), that we estimate had to be at a large loss for the PE sponsor: Pacific Equity, Sizzler (9.3X) and Pat N Oscars, and Cheeseburger in Paradise (Outback/Bain parent). Pat N Oscar's, part of the Sizzler acquisition, was sold by MBO and filed for Chapter 7- liquidation in 2011.

High acquisition price multiple alone does not explain the Chapter 11s or announced default group. Of this group, only Quiznos was a national scope, most were older, regional chains. The average time cycle to Chapter 11 was about 5 years from acquisition. We'd speculate that lack of menu renewal, lack of effective marketing budget size, lack of capital spending and older site locations were factors.

The To be Determined Group:

There are some very large chains in the TBD group. Outback Steakhouse Group is the largest group of brands that struggled through the recession and have lost AUV and a modest number of US units.

Burger King (BKC) had a successful 2006 IPO but then ran into global headwinds especially in the US, which resulted in its forced 2010 sale to 3G Capital. Burger King US franchisees have suffered sales/profit declines and are best described in rebuilding mode. And Arby's has just been acquired and bears watching, as do the three Golden Gate capital brands: Macaroni Grill, On the Border and California Pizza Kitchen.

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