2013 Restaurant Themes, Issues, and Opportunities
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The restaurant space will be interesting in 2013. Sales issues, cost issues, expansion issues, franchisee issues. There are still too many restaurants in the US and x-US markets sales increases have slowed. The two industry leaders, McDonald's (MCD) and Darden (DRI), are both somewhat in the penalty box and under pressure. Here are our thoughts on 2013 issues and opportunities.

Comps Cliff Coming: In looking at 2013, it is likely restaurants will get off to a bad start. In Q4 and Q1 2013, the restaurant space will fall off a cliff of sorts: the comps bulge generated last winter. Driven then both by warmer weather, price increases, a bit lower sales of discounted items and the peak of the 2010-2011 restaurant recovery, the January-March 2012 number will be hard to beat.

The following chains will likely have the hardest sales comp comparisons in Q1. Every single chain had lower comps most recently reported than the Q1 peak, versus the most recent quarter or monthly update:

Company/symbol	FY 2012, Latest Trend	2012 Q1 Jan-March Comp
McDonalds (MCD)	+2.4%	+7.3%
Starbucks (SBUX)	+7.0%	+9.0%
YUM (1)	-6.0%	+14.0%
Jack in Box (JACK)	+3.1%	+5.6%
Chipotle, (CMG)	+4.8%	+12.7%
Texas Roadhouse (TXRH)	+3.6%	+5.8%
Blooming' Brands (BLMN)	+3.6%	+5.3%
Buffalo Wild Wings (BWLD)	+6.0%	+9.1%
Panera (PNRA)	+5.8%	+7.7%

(1) China Division only

More sales news. Traffic throughout the sector has eroded since fall 2012. In the QSR space generally, traffic now is very marginally positive and average check 2-3% favorable, but in the overall casual dining space, traffic is negative and totally offsets about a 2.5% check increase. A few positive standouts exist, however: Texas Roadhouse (TXRH), Panera (PNRA), Starbucks (SBUX), and Popeye's (AFCE).

One question is why was investor disclose so poor at YUM? The China same store sales trend is so stunningly negative—large sequential decreases from +19% in FY-11 to -6% just noted this week for Q4 2012, perhaps the largest decline anywhere over such a short time.

Extreme discounting is the newest news but is really an old story. The current price spectrum of restaurant TV ads runs from $.99 grillers at Taco Bell to $11.99 thirty piece shrimp at Red Lobster. This does not portend positive for the average check. The comps cliff has affected marketing strategies everywhere via low price marketing.

Earnings standouts: Texas Roadhouse (TXRH), Panera (PNRA), Starbucks (SBUX) and Popeye's (AFCE) were Q3 (and Q2) positive standouts: positive sales and traffic, sales beat and earnings beat $.01 or more over estimate. Does prior performance guarantee future results?

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Dividends are the goal. Dividends will be important in a low growth, low return world. The US restaurant market is way overdeveloped and worldwide development takes time and proper store level economics. We'll be glad to see companies like Dunkin Brands (DNKN,1.80% yield), Burger King (BKW,.90% yield), and Bloomin' Brands (BLMN, zero yield) finally work their way out of private equity positions so that more substantial dividends can be paid. THI, another pure play 100% "capital light" franchisor, is also low at 1.70%. That there are two coffee sector players in this group is interesting. Lower coffee commodity costs advantage will accrue to the franchisees not the corporate entities.

Some IPO's and M&A will happen. We still wonder when Noodles will be ready for their IPO. Fast casual is "hot". Another fast casual brand, Pei Wei could be a candidate once its lower newer unit open sales problem is fixed. Jamba (JMBA) seems to be of value for those strategic buyers who need an established beverage platform. It was clear from the 2012 SBUX and DRI transactions that the path to a rich M&A valuation is to develop a unique but mainstream product that well-heeled restaurant majors can buy for entry at rich multiples. There will continued private equity churn, they always have fresh powder to deploy. The wave of 2006-2008 PE acquisitions will soon come due to sell.

Several Turnarounds should be watched. Interesting that the two worldwide restaurant leaders, MCD and DRI are both challenged. No surprise that MCD went into a new product new news tempo decline as it changed CEOs in 2012. New products news yields sales.
It will be fascinating to watch Darden (DRI) work out of its current tight cash position caused by lagging big brands and resulting profit shortfall, big remodeling capital expenditure (CAPEX) requirements and now debt service for its 2012 acquisitions. Of necessity, they will look for another acquisition in 2014, once its free cash flow position improves. We wonder if BKW has the worldwide AUV sales base potential anywhere except Latin America for franchisees to expand profitably.

Restaurants must more creatively test revenue and expense solutions: Restaurants can offset negative cost pressure and difficult comps pressure by looking at revenue increases beyond price increases and cost reductions beyond food portion cuts and labor hour savings. Unique store level pricing tiers and dual wage tiers to offset Obamacare are but two examples. The industry needs to test aggressively new ideas. I have published more details on my website, www.pacificmanagementconsultinggroup.com.

Defrancising v. Refranchising company strategy divergence will continue. Those who can operate restaurants well will continue to do so, those who can not, will refranchise. Panera (PNRA), Texas Roadhouse (TXRH) and Qdoba (JACK) are building new units /converting franchisees to company operation.

Franchisors still need to improve investor reporting and franchisee disclosure if they hope the franchising "capital light" business model will be sustained. How can DineEquity (DIN), now 100% franchised, be properly analyzed if there is no franchisee profitability reporting?

Is there room for optimism? Yes. Commodity cost forecasts have come in at the low end of forecasts. Some restaurants, such as Sonic (SONC) have finally sorted out their marketing focus.

Investor Recommendations. Look for a rough first half. Be ready for and go light or short the nine companies

noted above that will have a negative same store sales cliff In Q1. Restaurant space investor attractiveness will be better second half 2013. Look for potential dividend upside effects at BKW, BLMN, and DNKN late in 2013. DRI likely must cut its dividend so react light/short accordingly.

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