2012 Restaurant Space: Themes Expected, YUM US business spinoff?
by: John A. Gordon, Principal

After working detailed analytical projects, attending several major blockbuster restaurant investment conferences, monitoring almost every investor and earnings call, reading tons of analyst research, my own travels throughout the US to restaurants talking to managers, employees, customers and others, here are some 2012 and beyond themes that may play out:

US restaurant inventory won't decline, delaying supply rationalization. Almost one million US food and beverage venues mean you can get something to eat almost anywhere. This industry is driven by growth, and in the US that is difficult. For every closed restaurant, landlords are quick to sign up another restaurant quickly to get rental income moving. We don't feel flat inventory expectations to be a positive driver of same store sales as some analysts have hoped.

Rising commodity costs, especially for the beef centric concept menus, will be a real problem. So far we are hearing commodity baskets will be up 3 to 5%. That exceeds the amount of average check or product mix shifts likely to be able to cover costs. So more cost containment or unit growth/customer capture are the ways to organic growth. Share repurchases in our opinion isn't organic growth, and we hope financial reporting will improve to call that out.

Restaurants are leaving money on the table, via both revenue and expense control opportunities. There are both revenue opportunities such as, lack of suggestive upselling in QSRs and expense items (for example, casual dining operations way over schedule at 500p and under schedule at 900p; and especially in summer, overly cooled restaurants burn utility costs.

There's a real dichotomy between US domestic and international QSR franchising: older QSR franchisors such as YUM, Burger King, Arby's and Dominos (DPZ) have had slow to negative US franchisee growth, as a result of negative same store sales, difficult access to credit and dated sites, but have better (BKC) or booming international trends. The companies will always follow perceived returns but I wonder if has to be one or the other. With credit conditions difficult, perhaps a new franchising model is needed: a dose of aggressive franchisor fee and royalty incentives and partially guaranteed loan packages to buy down interest rates for franchisees.

And, I'll say it: ***maybe now it does make more sense for YUM to split off its US business and move headquarters to China.*** Is it not only an investor/China story but better operational focus?

Strong getting stronger: McDonald's (MCD) is an amazing institution that deserves its own restaurant sub-segment all to itself. I think the national scope potential nosebleed valuation operators—Chipotle (CMG), BJ's (BJRI) and Panera (PNRA) have the location runway to develop more and either don't franchise (CMG, BJRI) or limit their franchising (PNRA) to maximize upside. In addition, national scope niche chains like Cheesecake Factory (CAKE) with only 140 units that truly stand out –can grow nicely.

Private Equity's intended thesis of improved business operations and better managerial synergies, especially with highly levered acquisitions of struggling, older larger brands hasn't been proven yet. Many of the 2005-

2008 class large acquisitions have failed via Chapter -11s (Real Mex, Friendly's, Perkins, and more may follow in 2012) but we see some younger, start-up PE backed firms lined up for IPO, with potential. Perhaps then, smaller really is better?

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