



The Restaurant Industry: Savory, Smokey, or Sauced?

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Menu

First Course:

***Restaurant Industry Today: Choppy Waters
...Tomorrow...Still Dicey?***

Second Course:

***Cycles
Thesis***

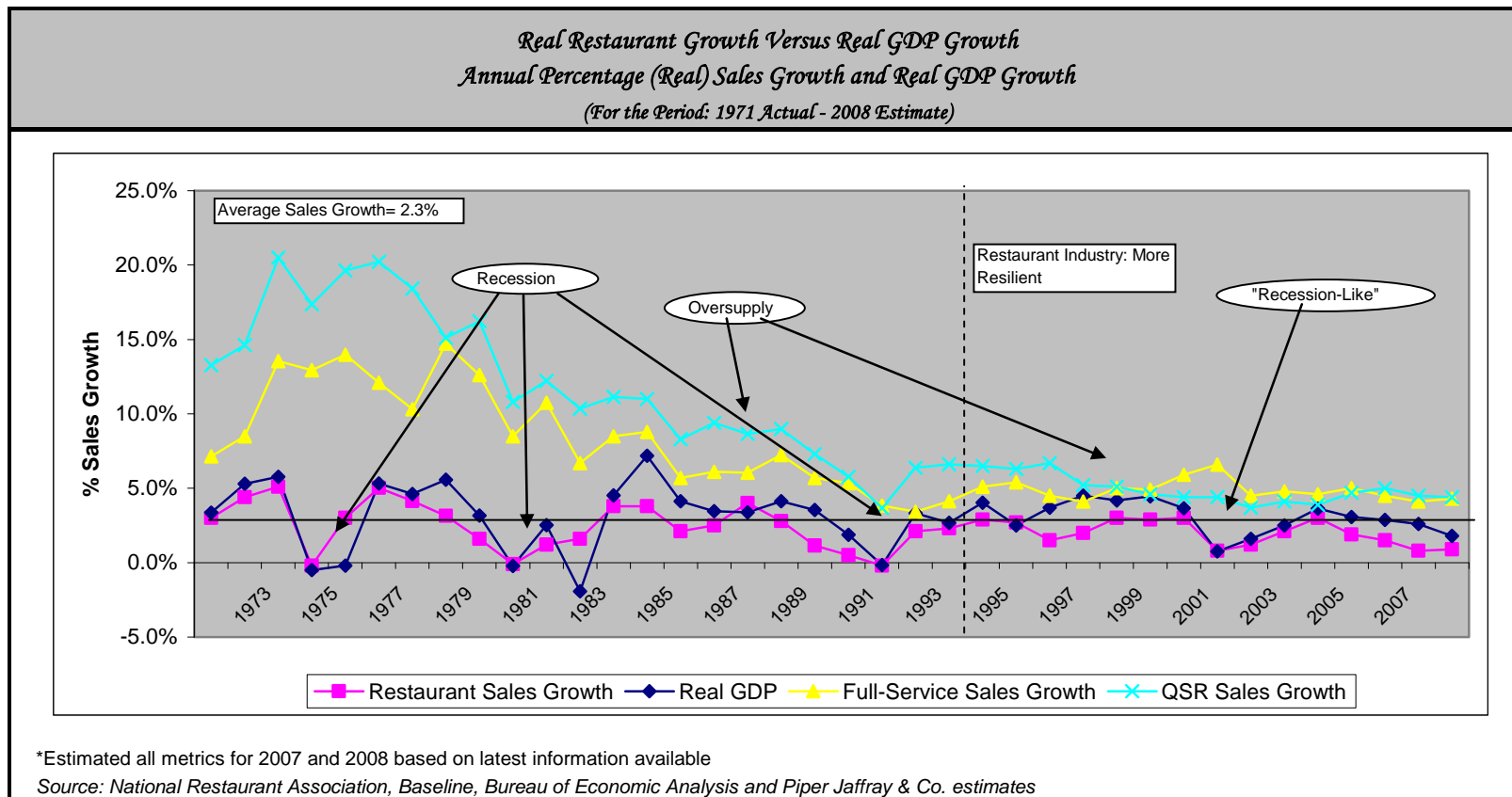
Third Course:

***The Stock Price:
Salty Risks, Sweet Successes***

Restaurant Industry Overview

- **Annual Projections:**

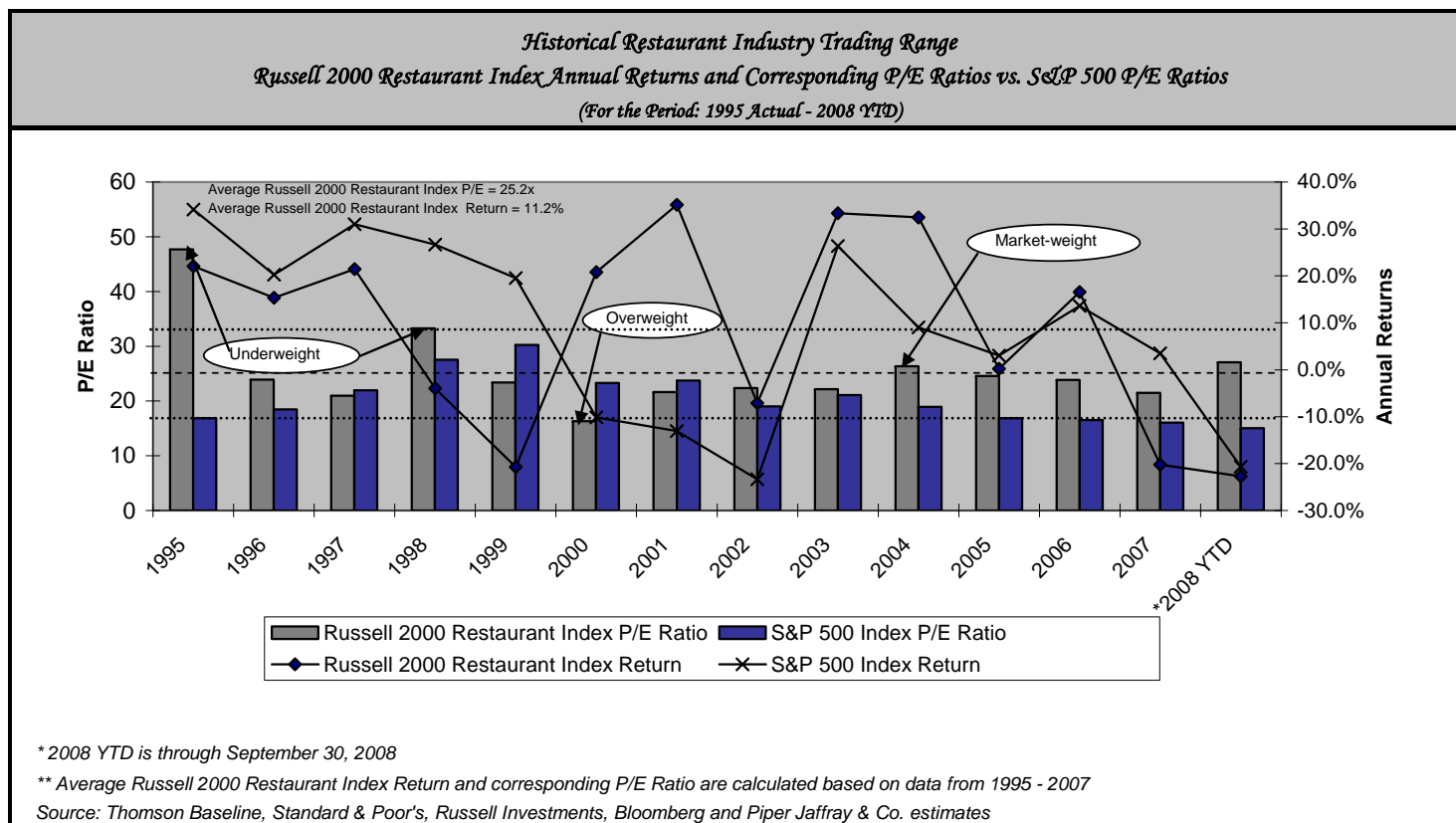
- Sales (2008) Expected to Reach \$558 billion (up 4.4% versus the prior year)
 - Full-Service sales of \$187 billion expected (up 4.3% versus the prior year)
 - Quick-Service sales of \$157 billion expected (up 4.4% versus the prior year)
- Real Positive Growth for the Past 17 Years
 - Negative only Three Times:
 - Credit Economic Recessionary Periods/Periods of Oversupply Show Mixed Results
 - Industry Proved Robust During the Most Recent Oversupply and “Recession-Like” Periods



Restaurant Industry Valuation

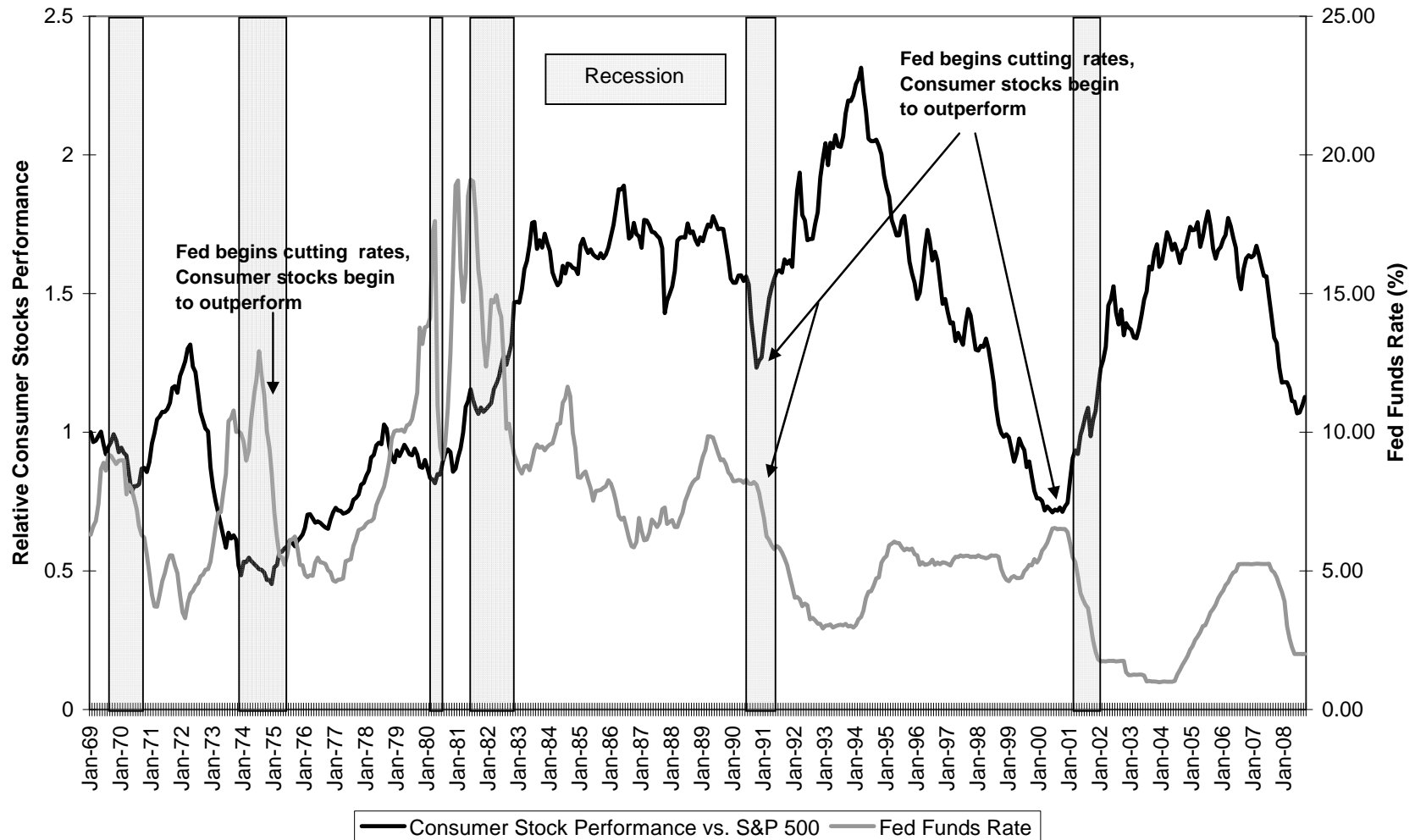
- **Restaurant Index Valuations**

- Average Russell 2000 Restaurant Index Return (13-Year Period):
 - Return: 11.2% versus 10.8% for S&P 500
 - Corresponding P/E Ratio: 25.2x versus S&P P/E of 20.8x
 - Russell 2000 Restaurant Index P/E Ratio: Historically 1.3x Greater than Corresponding S&P P/E Ratio
- Recessionary and Proceeding Three Year P/E Valuations (*PJC Restaurant Index):
 - 1991 (Recession)= 25x; 1990=14x, 1989=17x, 1988=16x
 - 2001 (Recession-Like)=22x; 2000=20x, 1999=21x, 1998=22x



Consumer Sector: Recession Performance

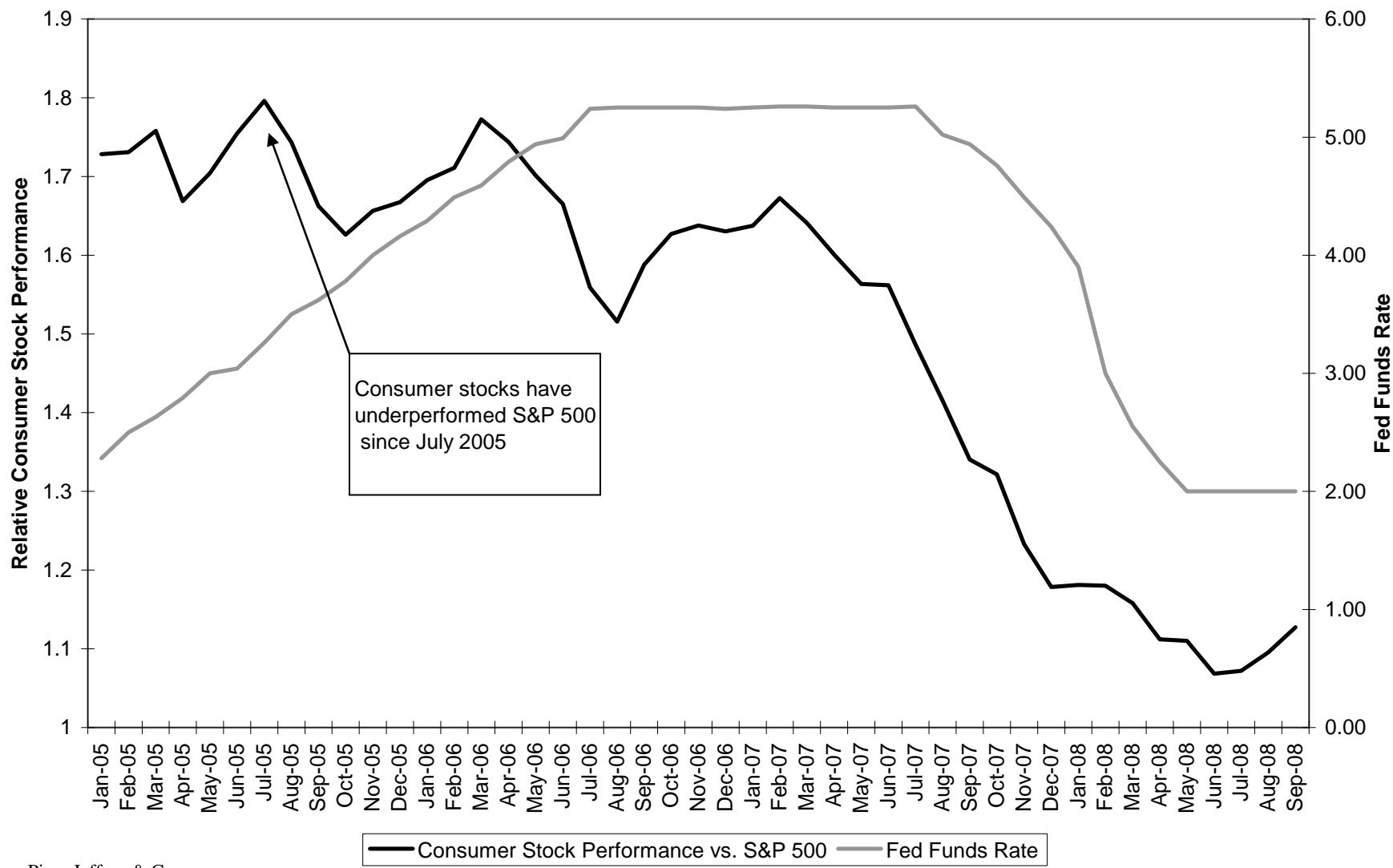
Relative Consumer Discretionary Stock Performance vs. Fed Funds Rate
(January 1969 - August 2008)



Source: Piper Jaffray & Co.

Consumer Sector: Current Performance

Relative Consumer Discretionary Stock Performance vs. Fed Funds Rate
(January 2005 - Present)



Source: Piper Jaffray & Co.

Consumer Sector: Current Performance

Market and Sector Performance

Index	Close 9/30/08	Total Return					
		September	Q1	Q2	Q3	YTD	2007
S&P 500	1,166.36	-8.9%	-9.4%	-2.7%	-8.4%	-19.3%	5.5%
Dow Jones Industrials	10,850.66	-5.8%	-7.0%	-6.9%	-3.7%	-16.6%	8.9%
NASDAQ Composite *	2,091.88	-11.6%	-14.1%	0.6%	-8.8%	-21.1%	9.8%
Russell 2000	679.58	-8.0%	-9.9%	0.6%	-1.1%	-10.4%	-1.6%
MSCI EAFE	1,553.15	-14.4%	-8.8%	-1.9%	-20.5%	-28.9%	11.6%
MSCI Emerging Markets	786.92	-17.5%	-10.9%	-0.8%	-26.9%	-35.4%	39.8%
S&P 500 Sector	Percent of S&P 500						
Consumer Discretionary	8.5%	-7.8%	-5.9%	-7.8%	-0.7%	-13.8%	-13.2%
Consumer Staples	13.2%	-1.3%	-2.2%	-5.3%	4.8%	-3.0%	14.2%
Energy	13.0%	-12.0%	-7.2%	17.3%	-24.6%	-18.0%	34.4%
Financials	15.7%	-4.9%	-14.0%	-18.3%	0.8%	-29.2%	-18.6%
Health Care	12.9%	-6.3%	-11.5%	-1.2%	0.5%	-12.2%	7.1%
Industrials	10.8%	-11.9%	-3.9%	-10.1%	-8.5%	-21.0%	12.0%
Information Technology	16.2%	-12.7%	-15.2%	2.5%	-11.9%	-23.4%	16.3%
Materials	3.3%	-14.5%	-3.0%	4.4%	-20.1%	-19.0%	22.5%
Telecommunication Services	3.0%	-12.6%	-13.7%	-4.1%	-14.8%	-29.5%	11.9%
Utilities	3.5%	-11.4%	-9.9%	8.0%	-18.0%	-20.3%	19.4%

* NASDAQ Composite performance calculated by percent change and does not include dividends.

Source: Piper Jaffray & Co.

Play-By-Play: The \$\$\$ Purse \$\$\$ Strings

• Current Restaurant Industry Profile:

- Same-Store Sales: - Little-to-No Traffic, Price Driving Comps
- Supply/Demand: + Decreases in Supply Ease Lack of Demand
- Margins: - Depressed
- Sentiment: - Negative Market/Consumer Sentiment
- Economy: - Anemic Growth, Consumer "Pocketbook" Pressures Persist



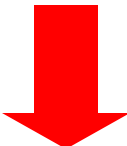
Russell 2K						Russell 2000					
Russell 2K Restaurant:	R2K Rest. P/E:	Russell 2000:	P/E:	SEL 500:	SEL 500 P/E:	Russell 2K Restaurant:	R2K Rest. P/E:	Russell 2000:	P/E:	SEL 500:	SEL 500 P/E:
-6.0%	25.5x	-10.2%	50.9x	-9.9%	20.0x	-14.7%	18.3x	0.2%	74.4x	-3.2%	21.2x
1Q08 1H08: Are Stocks "Cheap" Enough??? Economic Issues Persist Anemic Same-Store Sales Growth: Impacted by NYE/Easter Shifts Commodity/Labor Inflation Continues 2H08 Rebound???: SSS: Must be Driven by Traffic Requires Benign Cost Inflation						2Q08 Sector Rotation Back into The "Group!?!?" Replacement Value: Are Stocks "Cheap" Enough??? Economic Issues Persist: Gas Prices on the Rise (Again) Same-Store Sales: Stabilize Commodity Inflation Continues But...: Stimulus: Fed Rate Cut Cycle/Tax Rebates Finding Guidance/Estimates Overall Achievable					
Russell 2K						Russell 2000					
Russell 2K Restaurant:	R2K Rest. P/E:	Russell 2000:	P/E:	SEL 500:	SEL 500 P/E:	Russell 2K Restaurant:	R2K Rest. P/E:	Russell 2000:	P/E:	SEL 500:	SEL 500 P/E:
3Q08 Sluggish Expectations vs. Prior-Year Sluggish Sales Restaurant-Level Costs Increasing (COGS, Labor) Can FY09 Group EPS Increase? - Lackluster SSS - Difficulty in Locking Food Contracts: Fuel Surcharges (Who is at Peak Margins, Where is There Opportunity + Capacity Rationalization + Moderate Growth = Fundamental Shift: Cash Flow Generation ("one-off" items: Houston Hurricanes)						4Q08 Lending Environment!!! FY09 Guidance: ??? SSS: unfavorable COGS: unfavorable labor: unfavorable ("one-off" items: lapping Southern CA fires)					



Source: Bloomberg, Thomson Baseline and Piper Jaffray & Co.



Industry Thesis

 *Same-Store Sales*


+

Commodities & Labor 

= *Cost Management & Balance Sheets*

Snapshot: Same-Store Sales

- **Knapp Track Data:**
 - Top-Line Softness: Continues to Permeate Restaurant Sector
 - Traffic: Remains Challenged
 - Easing Comparisons: Not a Catalyst for Trend Reversal

Knapp-Track Restaurant Data																			
Monthly Same-Store Sales: Casual-Dining																			
Casual-Dining		First Quarter			Second Quarter				Third Quarter			Fourth Quarter			Full				
Year	Metric	Jan	Feb	Mar	1Q	Apr	May	Jun	2Q	Jul	Aug	Sep	3Q	Oct	Nov	Dec	4Q	Year	
2008	SSS	-0.7%	-0.9%	-1.7%	-1.1%	-2.0%	0.6%	-1.9%	-1.2%	-3.9%	-3.6%			 SSS					
	Traffic	-3.0%	-3.2%	-4.5%	-3.6%	-4.8%	-2.7%	-4.3%	-4.0%	-6.2%	-6.0%								
	Price	2.3%	2.3%	2.8%	2.5%	2.8%	3.3%	2.4%	2.8%	2.3%	2.4%								
2007	SSS	-2.3%	-1.7%	-1.7%	-1.9%	-0.1%	-1.5%	0.8%	-0.2%	0.4%	1.7%	-1.1%	0.3%	-1.1%	-2.2%	-3.8%	-2.5%	-1.1%	
	Traffic	-4.8%	-4.1%	-3.2%	-4.0%	-2.0%	-3.1%	-1.9%	-2.3%	-2.7%	-1.5%	-3.6%	-2.6%	-3.3%	-4.0%	-5.3%	-4.3%	-3.3%	
	Price	2.5%	2.4%	1.5%	2.1%	1.9%	1.6%	2.7%	2.1%	3.1%	3.2%	2.5%	2.9%	2.2%	1.8%	1.5%	1.8%	2.2%	
2006	SSS	5.5%	-0.3%	2.3%	2.5%	-0.8%	-1.2%	-1.8%	-1.3%	-2.6%	-1.6%	0.8%	-1.1%	-1.1%	-1.6%	0.6%	-0.6%	-0.1%	
	Traffic	3.1%	-2.5%	-1.5%	-0.3%	-3.9%	-4.4%	-4.4%	-4.2%	-5.0%	-3.7%	-1.8%	-3.5%	-3.6%	-3.6%	-1.7%	-2.9%	-2.7%	
	Price	2.4%	2.2%	3.8%	2.8%	3.1%	3.2%	2.6%	2.9%	2.4%	2.1%	2.6%	2.4%	2.5%	2.0%	2.3%	2.3%	2.6%	
2005	SSS	2.2%	2.2%	3.2%	2.7%	3.6%	3.8%	2.8%	3.4%	1.8%	1.7%	1.6%	1.7%	0.9%	2.0%	2.4%	1.8%	2.4%	
	Traffic	1.0%	0.8%	0.9%	0.9%	1.6%	2.0%	0.6%	1.4%	-0.5%	-0.3%	-0.5%	-0.4%	-1.0%	-0.7%	-1.0%	-0.9%	0.2%	
	Price	1.2%	1.4%	2.3%	1.8%	2.0%	1.8%	2.2%	2.0%	2.3%	2.0%	2.1%	2.1%	1.9%	2.7%	3.4%	2.7%	2.2%	
2004	SSS	4.5%	5.7%	3.0%	4.3%	2.6%	0.6%	2.2%	1.7%	1.9%	-2.1%	1.4%	0.4%	0.0%	1.3%	3.3%	2.7%	2.3%	
	Traffic	3.0%	4.1%	2.5%	3.2%	1.7%	-0.7%	0.4%	0.5%	0.5%	-2.8%	-0.1%	-0.4%	0.0%	-0.2%	1.3%	0.8%	1.0%	
	Price	1.5%	1.6%	0.5%	1.1%	0.9%	1.3%	1.8%	1.2%	1.4%	0.7%	1.5%	0.8%	0.0%	1.5%	2.0%	1.9%	1.3%	
2003	SSS	1.0%	-0.3%	1.0%	0.6%	0.4%	1.6%	1.6%	1.2%	0.0%	3.8%	2.4%	2.0%	2.4%	1.5%	-0.1%	1.3%	1.3%	
	Traffic	-1.3%	-2.9%	-1.8%	-2.0%	2.4%	0.4%	-0.5%	-1.1%	-1.5%	1.0%	0.2%	-0.1%	0.6%	0.2%	-1.5%	-0.4%	-0.9%	
	Price	2.3%	2.6%	2.8%	2.6%	-2.0%	1.2%	2.1%	2.3%	1.5%	2.8%	2.2%	1.9%	1.8%	1.3%	1.4%	1.5%	2.1%	
2002	SSS	3.6%	2.3%	1.0%	2.2%	2.6%	3.3%	0.8%	2.2%	2.0%	0.9%	1.4%	1.5%	1.5%	4.5%	-1.3%	1.4%	1.8%	
	Traffic	2.1%	1.0%	-0.2%	0.9%	1.1%	1.2%	-0.2%	0.6%	-0.3%	-0.5%	0.2%	-0.2%	-0.3%	1.9%	-2.6%	-0.5%	0.2%	
	Price	1.5%	1.3%	1.2%	1.3%	1.5%	2.1%	1.0%	1.6%	2.3%	1.4%	1.2%	1.7%	1.8%	2.6%	1.3%	1.9%	1.6%	
2001	SSS	5.7%	2.6%	4.0%	4.1%	1.8%	1.5%	2.8%	2.1%	0.1%	2.4%	0.0%	0.8%	1.0%	2.0%	4.3%	2.5%	2.4%	
	Traffic	3.0%	-0.2%	1.1%	1.3%	-0.9%	-1.1%	-0.1%	-0.6%	-2.3%	0.0%	-1.9%	-1.4%	-1.1%	0.2%	2.6%	0.6%	0.0%	
	Price	2.7%	2.8%	2.9%	2.8%	2.7%	2.6%	2.9%	2.7%	2.4%	2.4%	1.9%	2.2%	2.1%	1.8%	1.7%	1.9%	2.4%	
2000	SSS	5.3%	6.3%	7.0%	6.2%	4.9%	5.3%	4.8%	5.0%	3.6%	4.8%	6.6%	5.0%	3.3%	3.1%	2.7%	3.0%	4.8%	
	Traffic	2.7%	2.8%	3.3%	2.9%	1.5%	2.5%	0.6%	1.5%	0.0%	1.3%	2.0%	1.1%	0.3%	-0.2%	-0.9%	-0.3%	1.3%	
	Price	2.6%	3.5%	3.7%	3.3%	3.4%	2.8%	4.2%	3.5%	3.6%	3.5%	4.6%	3.9%	3.0%	3.3%	3.6%	3.3%	3.5%	

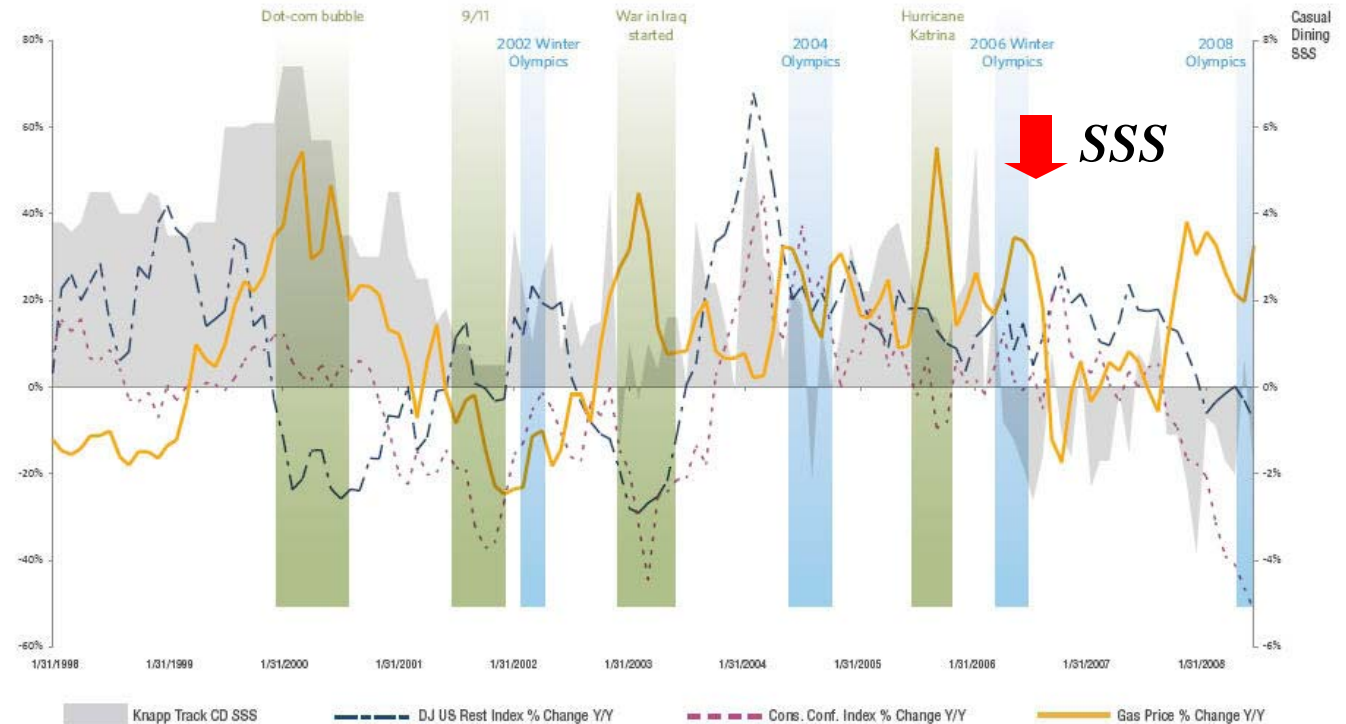
Source: Knapp-Track

Snapshot: Same-Store Sales

- **Current External Factors:**

- Olympics
- Gas
- Consumer Confidence
- Hurricanes
- Elections

Impact of Economic Conditions on Restaurant Comparable Sales



Observations:

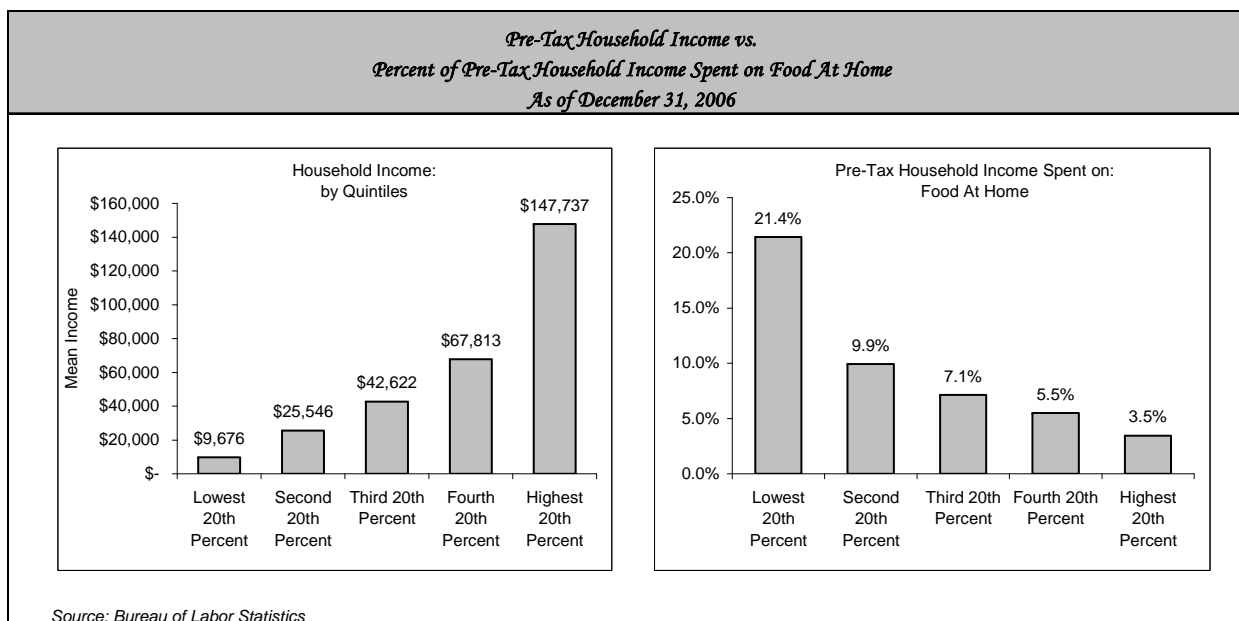
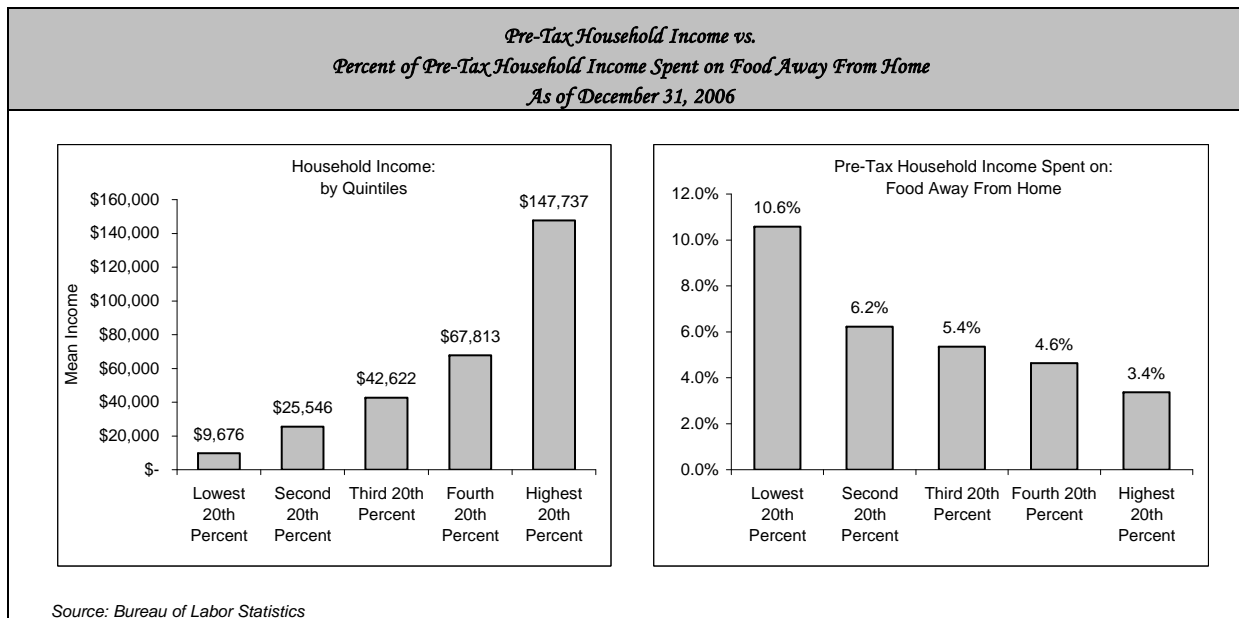
- ✓ Historically, restaurant comparable sales have dropped during Olympic events. This leads us to believe that this year's Olympics will have the same negative effect on comparable sales in July and August.
- ✓ This is the first time three major events take place simultaneously: high gas prices, very low consumer confidence and the Olympics. This combination is not favorable for restaurant comparable sales.
- ✓ Lower gas prices, improved consumer confidence and the end of the Olympics should give a boost to restaurant comparable sales.

Source: ICR, Inc.

Snapshot: Commodities

- **Hitting Home!**
 - At Home. Away-From-Home Inflation

Commodities



Snapshot: Commodities

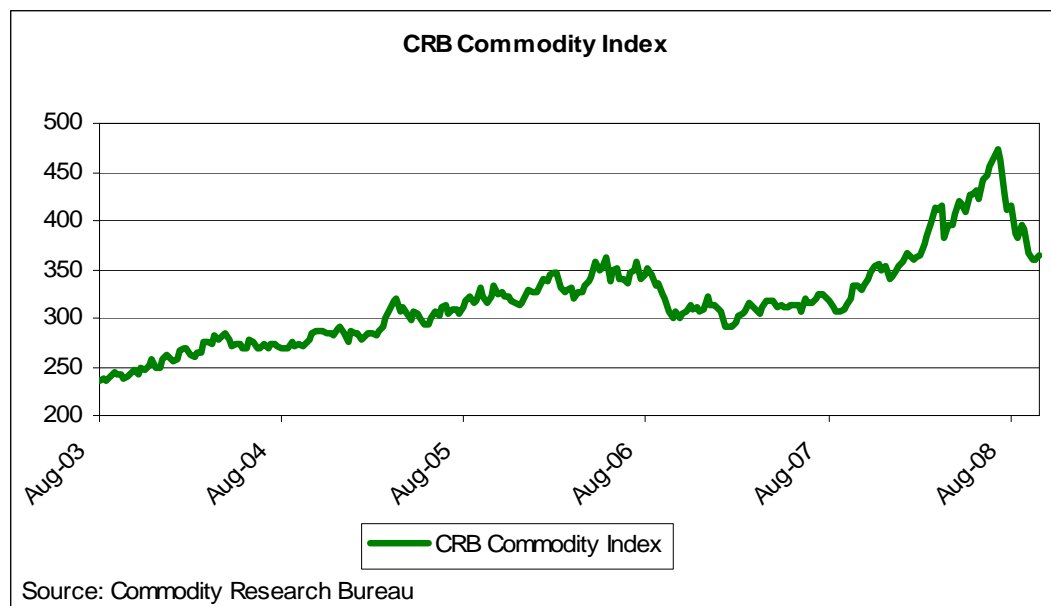
- **Commodities**

- Grains: corn up; rice up; wheat at inflection point, neutralizing on a y-o-y basis
- Proteins: beef up; chicken broilers up; pork down; turkey up
- Dairy: milk up, cheese volatile and mixed
- Coffee: up, but moderating
- Produce: lettuce down, tomatoes up, oranges down

- **In General**

- Continued to Ease; Downward from Peak Levels Reached in Early July
 - However, Majority of Key Inputs Remain at Elevated Price Levels Compared to Last Year
- FY08: Expect Restaurant-Level Margin Pressure for Remainder of Year
 - Result of a Continued Commodity Inflation Combined with Lackluster Same-Store Sales Results
- FY09: At Least 4%-5% Food Inflation, Advance Hitting Center-of-the-Plate Items

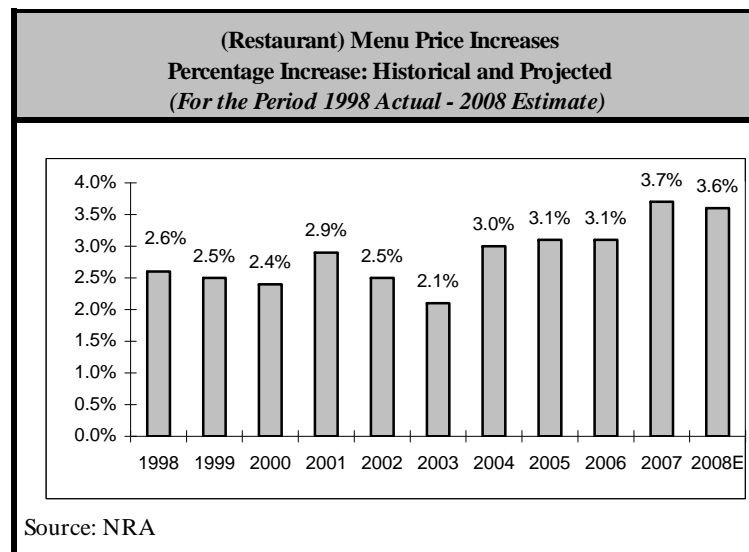
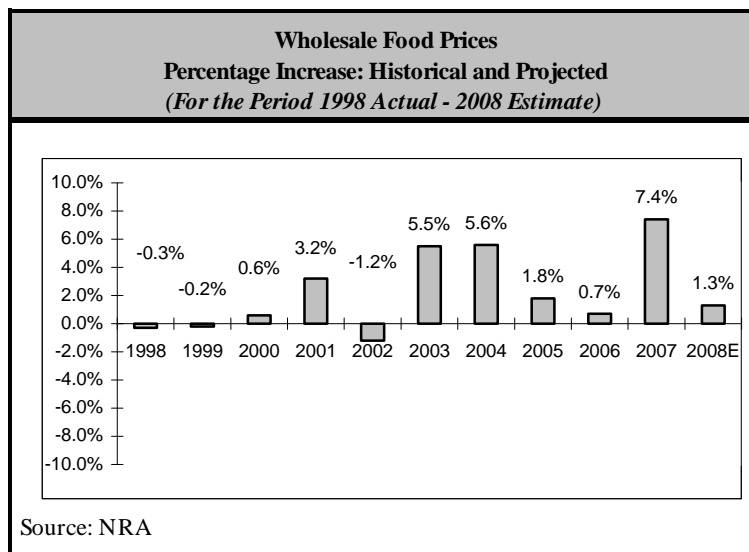
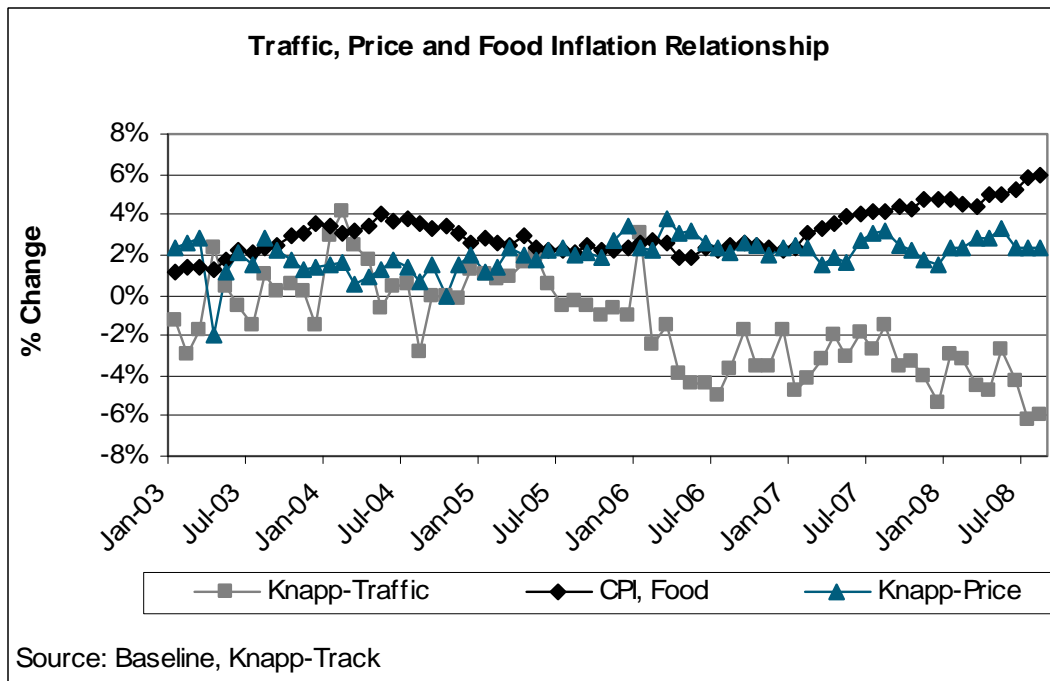
Commodities



Snapshot: Commodities

- *Marketing Executives Can Be the Answer*
- *...Price Is Not!*

Commodities ↑

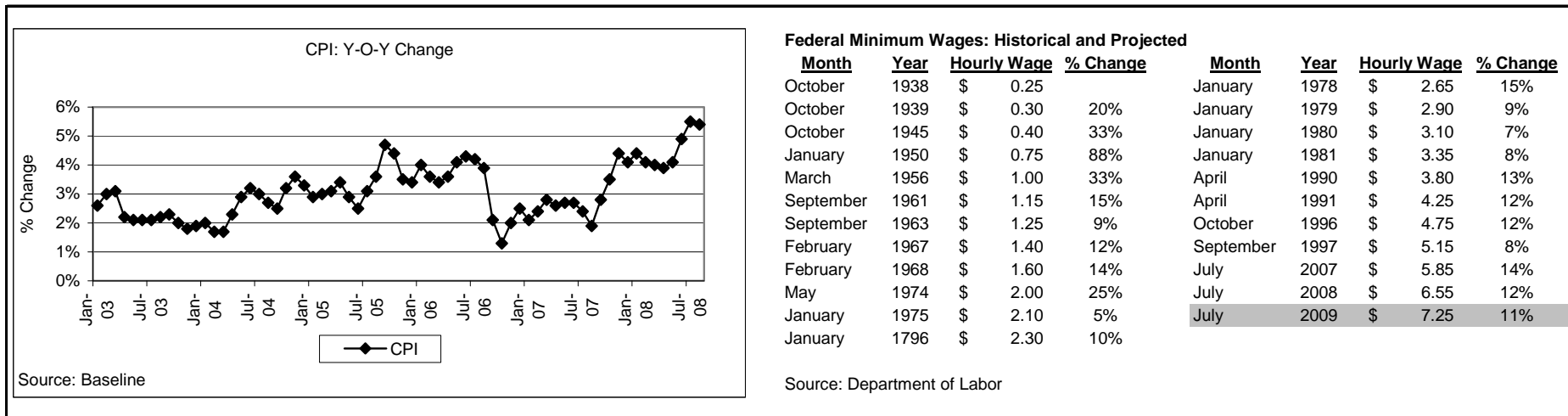


Snapshot: Labor

- **“Laboring” Over Labor :**

- Focus: Minimum-Wage Paying Operators
- Heightened Concern: Automatic Standard of Living Adjustments
 - Arizona, Colorado, Florida, Missouri, Montana, Oregon, Vermont and Washington
- CPI Increasing at Rates Greater than the Planned Federal Minimum Wage Increases
 - Final of Three Planned \$0.70 per hour Increments (an 11% July 2009 Federal Increase)
- Two-Thirds of All States Expected to Face Federal Minimum Wage Mandates Increases in July
 - Resulting in a Range of 1%-11% Wage Increases

Labor ↑





Mysticism of Marketing

- ***Marketing ROI: Got Returns?***
 - ***Maintenance:***
 - Traditional Campaigns
 - ***Growth:***
 - Penetrate New Frontiers
 - Allocate Budget (%) / Measure Success (SSS, margins)
 - ***Other:***
 - Value
 - LTO's

Restaurant Industry Risks

- **Business Strategy Implementation:** The company may or may not be able to successfully implement its business strategy, for which the ability to do so may be dependent upon the capability to market products, enter into distribution agreements, increase brand recognition, identify/secure new locations, and manage growth and related costs in addition to other unforeseen issues.
- **Expansion:** To successfully expand business, new stores need to open on time and in a profitable manner. Delays or failures in opening new stores may harm the company's ability to meet growth objectives and, in turn, may affect operating results. The company cannot guarantee they will be able to reach all expansion goals. In addition, many factors affect success of new restaurants, which may also not achieve operating results similar to those of restaurants in existence.
- **Site Selection:** The number and quality of sites may be limited, and the company may face competition from other companies for desired locations, causing an increase in costs.
- **Market Approval:** The success of new locations will be affected by competition, consumer tastes, and spending habits within new markets as well as the company's ability to create brand recognition. Changes in consumer preferences could harm future profitability and may be based upon health concerns, economic conditions, disposable consumer income, and consumer confidence.
- **Brand Reputation/Recognition:** As competitors enter the market, brand recognition becomes crucial to maintaining loyalty. Continued and improved brand recognition may depend upon product offerings and new store development. If brand building efforts are not successful, the company may not be able to recover expenses, increase future revenues, and may affect implementation of the business strategy. The value of the brand may also suffer if consumers use products inconsistent with company standards.
- **Cannibalization:** The opening of new locations in established markets may cause reduced sales or traffic in existing locations. New locations added to established markets may not reach the same level of sales and operating performance as previously established.
- **Access to Human Capital:** The success of the company is influenced, in part, by its ability to attract, motivate, and retain an adequate amount of employees. Delays in hiring or increases in employee turnover may cause a negative impact on the business, financial condition, operating results, or cash flows of the company. An increase in competition for employees could result in higher wages for employees and, thus, higher labor costs.
- **Seasonality:** Quarterly operating results may vary due to fluctuations in same-store sales, changes in food costs, timing of restaurant openings, pre-opening expenses and operating expenses, availability and cost of labor including management, changes in the competitive dynamic, disruption in supply flow, general economic conditions and consumer spending, and fluctuations in stock compensation.
- **Commodity (Price and Availability) Fluctuations:** Commodity prices may fluctuate depending on weather conditions, economic and political conditions, foreign currency fluctuations, export quotas.
- **Competition:** A high level of competition exists within the restaurant industry including concept, food quality, service, price, and location. If the company is not able to effectively differentiate itself, then the competitive position may be weakened. New market entrants or existing competitors may have greater financial, marketing, and operating resources than the company, which may also cause its competitive position to be weakened.
- **Legal Claims or Proceedings:** The company might become involved in legal proceedings in the ordinary course of business. In researching claims against the company or defending allegations, the company may incur legal fees, settlement fees, damages, or remediation expenses that may harm the business, reducing sales or negatively affecting the profitability of the company.
- **Public (or Medical) Concerns or Opinions:** An unfavorable report on the health effects of ingredients contained in products, or the products themselves, may reduce demand, which could harm business and reduce sales and profits.
- **Publicity:** The company may be subject to complaints or litigation from customers, for any number of reasons. Negative publicity due to allegations may negatively affect the company, regardless of whether the allegations are true or whether the company is held liable.
- **Federal, State, and Local Regulations:** The industry must comply with regulations relating to the sale of food and liquor if appropriate, as well as labor laws. The inability to obtain or maintain licenses or to comply with federal, state, and local government regulations could negatively affect the operating results of the company.

Analyst Certification—Nicole Miller Regan

The views expressed in this report accurately reflect my personal views about the subject company and the subject security. In addition, no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.

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The Restaurant Industry: Savory, Smokey, or Sauced?

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