

OUTLOOK

Kick the Can Down the Road

Self-help authors from Benjamin Franklin to Stephen Covey have put their unique spin on achieving personal and business success. Unfortunately, the themes in many business motivation books are often repetitive from book to book and studying them can be drudgery. Some books take a complex route to solve the simplest of problems. Others restate the obvious.

I've noticed that CEOs and business process "wonks" are suckers for self-help business books. They gobble up the latest theories hoping to jump-start their businesses. The bestselling books often become "playbooks" for business transformation. If the CEO reads the book, then the vice presidents must read them, too. The employees are next and often endure frequent changes in business strategy brought on by the techniques and buzzwords espoused in the book. Once a CEO adopts one of these books as a "game-changer," it is only a matter of time before a new motivational framework is presented to the workforce to affect culture change.

Over the years, some of the more famous self-help books have become bibles of the corporate world. Ken Blanchard taught his disciples the basics of managing people with the *One Minute Manager*. It caught on quickly with corporations and the result was that weekly staff meetings became noticeably shorter. Jack Welch of GE popularized the "Six Sigma" strategy for improving product quality and customer satisfaction. Six Sigma became so important for big corporations that *Six Sigma for Dummies* was introduced for managers who couldn't grasp the complicated process outlined in the original book. In *Search of Excellence* author Tom Peters advocated aligning the corporation with the customer to achieve broader organizational goals. The age-old business adage of doing what's best for the customer was repackaged by Peters as "listening to the customer." He sold over six million copies.

In his bestseller *Good to Great*, Jim Collins researched 1,435 good companies and determined 11 of them were actually great companies. According to Collins, the great company CEOs set aside their big egos to focus on the higher calling of building a great company. Presumably, the other 1,424 CEOs remained egomaniacs and their companies suffered greatly.

The Art of War is still popular with many hard-charging CEOs. I once knew a CEO who loved *The Art of War* so much that he implored his vice presidents to act as though they were Israeli commandos and "take no prisoners." It didn't dawn on

him that the book was written by a Chinese general during the 6th century BC and not by an Israeli commando at Entebbe. I always wondered what he really wanted his employees to do. Surround the local Sysco house and demand more rebates?

There are so many self-help business books and popular business strategies out there right now that most people have a hard time keeping them straight. Just as soon as one self-help book becomes the rage and takes hold in a corporation, another one comes along to take its place.

Do any of these books really work? And, do they work during an economic and financial system meltdown when all rules get thrown out the door?

I've always been skeptical about the themes and even more skeptical about some of the authors. I am, however, willing to forgo my skepticism and offer a new self-help book to those operating in the restaurant business. If the past two years are any indication of the new business strategy I see being promulgated in restaurant America today, then my new self-help business book, *Kicking the Can Down the Road: Waiting For The Economy To Turn*, is sure to be a bestseller.

Many businesses have put all of their eggs into the "slash expenses" and "hope the economy improves" baskets. And it's not just restaurants. Kicking the can down the road is the theme of way too many U.S. businesses right now. It's also the theme of many banks and landlords, too. Businesses were so shell-shocked by the financial meltdown of 2008 and what they now perceive to be anti-business antics of Barack Obama and a Democratic Congress, that they can't think straight.

The main component of each and every business plan in 2009 contained these marching orders: Do what it takes to reduce costs in order to survive. Reduce headcount. Check. Cut portion size and find cheaper ingredients. Check. Increase labor productivity. Check. Cut back on capital improvements. Check. Put the squeeze on the landlords. Check. Work the banks for extended terms. Check. Hoard cash. Check.

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FINANCE SOURCES

Wells Fargo Closes on \$40 million in McDonald's Loans, \$350 Million in Other Restaurant Deals

Wells Fargo Restaurant Finance recently announced that it has closed on approximately \$40 million in loans for McDonald's franchisees since announcing the program in April. The program, which features customized financial products for McDonald's franchisees nationwide, covers fixed and floating rate loans.

Financing options are available for purposes such as restaurant acquisitions, rebuilds and relocations, equipment purchases and restaurant improvements, as well as a variety of wealth management and treasury management services.

"Looking out at our pipeline I suspect we will end the year with around \$45 million to \$50 million (in loans), and I think the pace will continue to be about \$4 million to \$7 million per month," said **Nick Cole**, executive vice president. Total commitments per operator are averaging about \$2 million to \$4 million.

While the bank may expand the small ticket lending to other concepts in the future, Cole said they are still some time away from that. The program is only six months old, however, and Wells is still in the learning phase.

Wells Fargo Restaurant Finance continues to make headway with their traditional lending programs, which are in the neighborhood of \$15 million to \$20 million per transaction.

"The reality is that the last 18 months has been the greatest time of growth in our (Wells Fargo restaurant) business since its inception more than a decade ago," said Cole.

"Our loan portfolio topped \$2.5 billion last month compared to just slightly over \$1.1 billion as of January 1, 2008. We have closed on close to \$350 million of new commitments for restaurant operators so far this year on top of more than \$650 million last year." It also has launched new initiatives for national franchise systems and added key staff to help jump start growth, he said.

"Our overall head count has increased by close to 20 percent over the last two years and our revenue has grown by close to 40 percent since 2006, when I joined the company," reported Cole. "We are very proud of the fact that we have grown from a small player to a leader in a very short time."

For more information on Wells Fargo Restaurant Finance, contact Nick Cole, executive vice president, at 760-918-2705, or by e-mail at james.n.cole@wellsfargo.com.

Retail Investment Group LLC Provides Sale/Leaseback Funding

Retail Investment Group LLC is a boutique brokerage shop that provides sale/leaseback funding to multi-unit restaurant operators. "Since we are a small company," said founder **Steven Davis**, "we provide personal service and walk our customers through the steps of a sale/leaseback transaction."

"If a franchisee has a certain amount of units, they can sell them one at a time," he said. "We're selling them to the retail market—1031 exchange buyers and traditional investors alike. No one is flipping the property these days. 1031 buyers are looking for safe investments." For franchisees, this means they can pick and choose the real estate they want to sell; there is no need to sell locations "as a package." "We sell individual properties at a retail value which commands a higher price and avoids a bulk discount."

Davis opened his own shop in 1999 after a long tenure with Marcus & Millichap. He enjoys the flexibility he can provide to his clients, including commissions. Without the large overhead, he says, "our fees are very competitive."

Retail Investment Group has worked with many Denny's franchisees, and has sold more than 30 of their sites in the past few years. The company has also worked with concepts such as Church's Chicken, KFC, Taco Bell, Burger King and Taco Bueno, to name a few. They sell about 12 to 24 properties per year, depending on the market, Davis said.

He likes working with franchisees, "because they have their blood, sweat and tears in their business. They are entrepreneurs like us. They will grab a broom if they need to, no matter how many locations they have." The company can evaluate a property within 24 to 48 hours and have it on the market three to five days later. The entire sale is usually a 90-day process, although understandably, the market has been a little harder these last few months, he said.

The point of differentiation really comes down to reputation and the ability to deliver, said Davis. "Our reputation is the only thing we have. I get dozens of references for recent transactions, and that's about keeping both sides of the transaction satisfied. That's success." For more information about Retail Investment Group, LLC, contact Steven Davis, managing member, (480) 429-4580, or by e-mail at steven@retail1031.com.

FRANCHISE FINANCE & DEVELOPMENT CONFERENCE

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www.restfinance.com.

GE Capital Funds Mellow Mushroom, Five Guys and a Wendy's Franchisee

GE Capital, Franchise Finance recently closed a \$25 million credit facility for Mellow Mushroom franchisor, **Home-Grown Industries of Georgia Inc.** (HGI). The financing consisted of a five-year senior term loan of \$21 million and a \$4 million revolving credit facility. Proceeds were used to complete a partner buyout, refinance the company's existing senior debt, and provide additional funds for new unit growth. Funding was provided through GE Capital, Franchise Finance's bank affiliate, GE Capital Financial, Inc.

Headquartered in Atlanta, HGI is the franchisor of more than 100 Mellow Mushroom restaurants. In addition to Mellow Mushroom's franchised units, HGI owns and operates three Mellow Mushroom units in Austin, Texas, Panama City Beach, Fla., and Tuscaloosa, Ala.

GE also closed on a \$9.35 million deal with **Legacy Restaurants Group LLC**, owners of multiple Wendy's franchise units in Kansas and Missouri. The loan helps Legacy acquire five new units from another franchisee located in Joplin, Mo. and refinance existing debt.

Legacy now owns and operates 17 Wendy's franchise units in the Topeka, Kan. and Kansas City, Mo. areas. This was the first GE Capital deal with Legacy.

The finance company recently closed on a \$30 million loan to **Five Guys Holdings Inc.**, franchisor of Five Guys Burgers and Fries, doubling the size of the credit facility. The new facility is made up of a \$5.25 million revolving line of credit and a \$24.75 million term loan. Funding was provided through GE Capital, Franchise Finance's bank affiliate, GE Capital Financial Inc.

Five Guys is a rapidly growing fast casual restaurant chain that started in 1986 in Arlington, Virginia. With approximately 500 units in 36 states throughout the U.S., the chain sells mainly hamburgers, hot dogs and french fries.

For more information on GE Capital, Franchise Finance, call 866-GET-GEFF (438-4333).

Kalinowski Joins Janney Montgomery Scott as Restaurant Equity Analyst

Mark Kalinoski, the former restaurant analyst at Citicorp/Smith Barney and Buckingham Research from 1996 to 2007 has been named Director-Equity Research of Restaurants for **Janney Montgomery Scott**, a New York investment firm. As the firm's sell-side analyst, Kalinowski will cover both limited-service restaurants and full-service restaurants.

For information, contact Mark Kalinowski at 212-940-6997 or by e-mail at mkalinowski@jmsonline.com

FCA Advises Taco Bell Transaction and Others

Franchise Capital Advisors recently closed a transaction for Karecor Inc., a Taco Bell franchisee located in Phoenix, Ariz. Karecor, owned by David Divine, received approximately \$750,000 in equipment and real estate financing for a new store that will be developed on a Home Depot pad. The financing was provided by a regional bank with more than \$1.0 billion in assets. Karecor currently has 11 locations.

FCA also worked on the following engagements:

- Lease advisory work for Charleston's Restaurant Group, and owner Hal Smith.
- Advisory for Basic Food Group, which is owned by Bill Ferguson. FCA located \$4 million construction and sale/leaseback financing for a Famous Dave's in Ft. Collins, Colorado. This is the fifth restaurant for Basic Food Group, with the company starting construction on a sixth location in Aurora, Colorado.
- For a private investment fund, FCA was engaged to sell or find a joint venture partner for two Applebee's restaurants in southern California. The two locations have historical combined revenues of \$4.5 million and are fully equipped.

Franchise Capital Advisors is a boutique investment banking firm that provides financial advisory services in the areas of mergers and acquisitions, sale/leasebacks, debt and equity placement, divestiture, recapitalization, debt restructuring and more. After forming an alliance with a national bank, the firm has added equipment funding to their slate of products. For more information on Franchise Capital Advisors, contact **Ryan Kress**, managing director, at 480-355-4380, or by e-mail at REK@FranchiseCapitalAdvisors.com; or **Steve Schwanz** at 480-355-4399 or by e-mail at SYS@FranchiseCapitalAdvisors.com.

Teleconference to Provide Leasing Strategies to Quickly Affect the Bottom Line

Hilco Real Estate and the Restaurant Finance Monitor will present a live teleconference on "Real Estate Lease Strategies for Profit-Driven Operators," to be held on **February 3, 2010**.

As 2010 opens and sales begin to pick up, how will the current leasing landscape have changed? How can operators benefit from those changes? What's possible, and how do you get it done? Is the short-term answer best for the long run? How do you know the difference? And finally, what does this all mean to your bottom line?

Don't miss Hilco Real Estate and Restaurant Finance Monitor's teleconference, which will discuss with the experts how operators can take advantage of new lease strategies. And, participants will also hear about real-life case studies where new lease strategies have changed the face of the operator's balance sheet.

For more information, watch your e-mail and upcoming issues of the Restaurant Finance Monitor.

With Financing Tough to Come by, Sellers are Turning into Bankers

With bank loans still frustratingly difficult to get, many business buyers have turned to an unlikely source for funding: sellers.

The sellers have little choice. Risk-averse banks are either not lending or they're not lending the full price. So sellers can either finance a big chunk of the deal themselves or not sell at all—or get a lower price.

"It's more common in the transactions being done," said Randy Evans, attorney with Krass Monroe in Minneapolis. "The problem is, not a lot of transactions are getting done."

Michael Ingram, vice president at National Franchise Sales, said that just a few years ago only a small number of deals included any seller financing, and the amount financed was typically low. Now roughly half the deals include some kind of seller financing. "We're absolutely seeing more," Ingram told the Restaurant Finance Monitor. "The bottom line is that (finding) adequate financing is so tough that seller financing is about the only way to get something done."

Ingram added that the SBA wants seller financing to be part of transactions—then noted that so few SBA deals are being made now in the restaurant industry that the requirement is largely moot. And, interestingly, more transactions are being funded with cash and no financing, he said.

The increase in seller lending is being felt broadly in the acquisitions market. Fewer deals are getting done, and those that do more frequently include some form of seller financing.

Earnouts, a type of seller financing in which the buyer agrees to pay an additional amount—10 to 20 percent—if the business meets certain earnings or revenue goals, have become more common. So have equity rollovers in which the seller retains ownership in the business or gets ownership of the buyer. A seller note, a straightforward loan to the buyer, is by far the most common type of seller financing in the restaurant and franchise spaces.

Seller financing adds a layer of complexity to a business sale, requiring a further set of negotiations and considerations on both sides of the deal. It also requires additional talks with the senior lender, which must approve the financing.

Earnouts are particularly complex, to the point where attorneys and many buyers shy away from them. "Our philosophy is to avoid earnouts whenever possible," said Steve Soderling, managing director at Tonka Bay Equity Partners. He was speaking at a mergers and acquisitions conference in Minneapolis in October. "They can create conflict between the long-term and short-term goals of the company."

Earnouts usually come up when a buyer and a seller can't agree on the price. There are numerous considerations. Should the earnout be based on revenue, EBITDA or net income? Who

will run the business during the earnout period? How long should the earnout period be—most recommend shorter periods to limit disputes.

Disputes can occur "when the seller thinks he should be paid and the buyer thinks he should not," said Keith Radtke, an attorney with Faegre & Benson, speaking at the M&A conference. Brian Holcomb, managing director of the investment banking firm Greene Holcomb & Fisher is "not a big fan of earnouts," but added that they "can be a big win" for the seller if the company performs well.

Seller paper is far more straightforward, but that doesn't mean that such deals don't have their complexities. Seller notes typically represent 20 to 30 percent of the purchase price and carry interest rates from 6 to 8 percent, Soderling said. But there are signs that the deals are stretching out for longer periods.

Historically, Ingram said, the deals he's seen have included a balloon payment at two years. These days, the seller is lucky to get a balloon at three—they're more likely to be amortized over a full 10 years because of buyers' concern about the economy. "They know it's rough," Ingram said. "They don't want to put themselves in a corner with any kind of balloon payment."

Sellers have to negotiate the deal with the senior lender, if there is one. Evans said banks typically allow buyers to make scheduled payments on the seller note, so long as there is no default on the senior note. And bankers will often allow sellers to have a second lien to provide them with some collateral protection.

Still, the seller note raises questions about the cash flow of the business being purchased, particularly in a recession. Buyers and sellers have to be sure that the business can support the extra level of debt.

While the deal is "moderately risky" for the seller, experts say they usually work out in the end, and the seller gets the benefit of the interest earned on the debt. Even so, it's not a route many sellers want to go, so the businesses being sold that way are frequently showing either less-than-stellar performance or the seller simply wants to get out of the business now.

In cases where the business is strong and the seller doesn't have to sell the business, many simply pull back and hope that the environment will improve in a year or two. "I definitely think there's some of that going on," Evans said. "We've seen transactions where you go in and explore the market, and at the end of the day the client says, 'Let's hang onto it and let the market come back.'"

Still, he said, "If you want to exit right now, (seller financing) is the way you do it."

—Jonathan Maze

Zwain Joins Board of Fatz Café

Long-time industry veteran and marketer **Larry Zwain** has joined the Board of Directors of **Fatz Café**, a regional chain of 47 casual dining restaurants located in five states in the Southeast.

Zwain's background includes tenure as President/CEO Boston Market, which was converted from "take-out" only, to fast casual leader of the home meal replacement category; and president/COO of PepsiCo Restaurants International (KFC/Pizza Hut/Taco Bell outside of the U.S.). Prior to that he was senior vice president of marketing in the U.S. for McDonald's Corporation.

Zwain is currently a partner in the boutique financial advisory firm **National Retail Concept Partners**, which provides advisory, from operations to financial, to multi-unit restaurant companies. He became interested in a board seat when **Milestone Partners**, a private equity firm, approached him about being on the Fatz board. There may be more than Zwain's love of their signature Calabash Chicken that spurred him to support the regional chain.

"They have a loyalty to their people and service to their guests that is outstanding," he said. He likes Fatz's Operating Partners Program, where above average store managers invest in their store, and there is no cap on the bonus the manager can receive based on yearly performance. "They have skin in the game and a pride of ownership," said Zwain.

Zwain sees himself bringing to the table his vast marketing background and new points of view. He also likes working with the people at Milestone Partners, whose focus is on smaller companies developing strong leadership and high growth potential. "They are very disciplined with investment criteria that makes sense," he said. "We have similar philosophies."

You can reach Larry Zwain, managing partner of National Retail Concept Partners, at 303-949-1783, or by e-mail at lzwain@nrpartners.com.

Sales Down? Blame the Microwave

Restaurateurs suffering from empty tables and declining sales have a new scapegoat: the microwave.

For years, according to the market research firm NPD Group, roughly 20 percent of meals were nuked in the microwave. But that changed last year, when microwave use increased 10 percent. Not coincidentally, that's also the first year of the Great Recession, and the outset of a brutal sales period for the nation's restaurants.

The good news is that while people are eating at home more often, they're still in a hurry. In theory, at least, those rushed eaters should return to restaurants once their personal finances improve. Unless, that is, they grow accustomed to eating food that tastes like plastic and both burns your mouth and gives it frostbite at the same time.

Fraser Starts Distressed Company Advisory Firm

Former Buffets Inc. executive **Damon Fraser** has started his own consulting company, **FP Financial Advisors, LLC**, that specializes in helping distressed and underperforming companies.

Fraser can work with the management of the company to help develop a strategic plan that addresses challenges and deals with the company's strengths. Fraser can help with debt restructuring, lease negotiations, identifying and disposing of non-core business assets, staffing of critical senior management positions, communications and bankruptcy planning and administration.

Fraser is working with some distressed clients on mergers and acquisitions. "We help with the transition and counsel on how to buy or sell through that," he said. Fraser said he could also work as an outsourced business development arm for a smaller restaurant company. "If you're ready to open one or two units, you can't hire a vice president of real estate development," he said.

Fraser, who has a law degree, spent 12 years with Buffets Inc. in various capacities, most recently as vice president of restructuring. He had previously been the vice president of business development. For more information, contact Damon Fraser, principal at FP Financial, 612 877-2813 or Dfraser@fpadvisorsllc.com.

CIT: We're Still Lending

Bob Bielinski had a simple job: Introduce Paul Kasriel, the economist, at the 2009 Restaurant Finance & Development Conference.

Yet Bielinski is a managing director for the restaurant industry practice at CIT. And the conference came just days after his company had filed a prepackaged bankruptcy—fifth largest bankruptcy in U.S. history—and following a year in which it had fallen from its perch as the SBA's top industrial lender, a perch it had been on from 2000 to 2008. Bielinski clearly knew that the audience, much of it restaurant borrowers who had once looked to CIT as an option for loans, was eager for news.

And so he provided it. "No. 1, none of our operating subsidiaries are part of the filing," Bielinski said. "The filing was limited to the holding company. No. 2, we have the necessary funding to continue to operate to meet the needs of our clients. And we anticipate a quick confirmation of our (bankruptcy plan) December 8. This whole process should be done by the end of the year."

The company's booth at the conference was a popular destination for many attendees—and had actively been looking to make deals at the event. The company's bankruptcy plan, meanwhile, is on the fast track. If approved next month, and if federal regulators allow the company to collect deposits, CIT could emerge from bankruptcy by the end of the year.

FINANCE NEWS

Survey: Struggles Abound, but Independents are Faring Worse

It's a given that the recession has been tough on the overall restaurant industry, but it's increasingly clear that the companies taking the brunt of the hit are independent owners. Some have filed for bankruptcy and closing at a higher rate than chains, and new startups unable to get financing have not filled the void.

So it wasn't surprising earlier this month when franchises outperformed independents in the 2009 Restaurant Industry Benchmarking Survey from the Monitor and accounting firm SS&G. The survey was discussed at the Monitor's Restaurant Finance & Development Conference earlier this month. "We've been saying for years that franchises are less risky than independents, yet for the past four years of the survey, independents have outperformed franchises," said Brad Saltz, director of Restaurant Services for SS&G. "Not this year."

Unleveraged return on investment for franchises increased from 11.6 percent in 2007 to 12.9 percent last year. Independents' ROI fell from 14.8 percent to 11.1 percent. EBITDAR for franchisees fell slightly, from 15.5 percent in 2007 to 15.3 percent last year. Earnings for independents, however, fell from 14.9 percent to 12.8 percent.

Regardless, problems among restaurants are increasingly pervasive. Most years, it's a given that a high percentage of companies with 75 percent or more debt will be unable to service that debt, and last year was no exception—39.1 percent of companies with 75 percent or more leverage were unable to pay that debt. "Highly leveraged companies are more likely to run into trouble," Saltz said.

Yet a growing percentage of companies with less than 75 percent leverage find themselves in that boat now. According to the survey, 13.6 percent of companies with less than 75 percent leverage were unable to service that debt, up 75 percent from a year earlier, when it was 8.5 percent, and more than double 2006 when 5.9 percent of such companies couldn't pay off loans.

Margins fell 1.3 percent last year, overall, and 2.2 percent the last two years, according to the survey. And the broader industry saw lower overall returns in 2008, impacting all sectors and sub-sectors. Pizza restaurants continued to have the highest unleveraged ROI, at 15.1 percent, though that was down from 15.9 percent the previous year. Upscale casual restaurants saw their returns drop 27 percent, from 13.5 percent to 9.8 percent. Quick-serves remained at the bottom in terms of returns, at 9.5 percent, down from 9.9 percent a year earlier.

One of the main issues is costs. Few companies keep prime costs—labor and cost of sales—below 60 percent, and many that do are large companies with over \$1 billion in revenue, which on average kept costs at 59.4 percent. Average prime costs were 62.5 percent, and each sector surveyed averaged over 60 percent. Upscale casual had the worst cost performance, at 66.6 percent on average.

Another problem is the increasingly saturated restaurant market. The sales-to-investment ratio across all segments has been declining over the years, suggesting that the industry is overbuilt. Before 2005 it was 1.3 and each year since it has fallen. By last year it was at 1.0. "The long-term erosion of returns has been brought on by the inefficient use of capital," Saltz said. Returns on newer stores are in decline, even though margins for older and newer stores are similar, because those newer stores cost more to build.

Indeed, several speakers at another conference session noted that restaurateurs have many opportunities now to boost their profits through acquisitions and conversions. John Brodersen has built a large multi-unit Popeyes company largely by taking over failed restaurants in inner-city neighborhoods in Milwaukee, Chicago and Detroit. "I buy a lot of other people's garbage and turn it around," he said, and added that, "a lot of these opportunities are coming up in all brands."

Many operators employ some "best practices" designed to improve efficiency. According to the survey, 59 percent of operators take inventories weekly and nearly two-thirds inventory key items like meat and beer on a daily basis. Most operators, 85 percent, know their ideal food cost and 34 percent said in the survey that their actual food cost was within 1 percent of the ideal—49 percent said it was within 1 to 2 percent of ideal. "You should know what your ideal food cost should be," Saltz said. "How do you know where you are if you don't know where you should be?"

Another strategy is to end payroll early in the workweek, like Monday, Tuesday or Wednesday, rather than Sunday. Ending payroll on a weekend makes restaurateurs less able to manage overtime. Only 41 percent of companies ended payroll Monday through Wednesday. Those companies "continue to show the lowest labor," Saltz said.

John Buchanan, president of Lettuce Consulting Group, said management should be involved in making changes to improve efficiency and reduce costs, especially given that they're the ones implementing any plans. They can also be easily trained. "I question any solution that relies on automation," he said. "What you're asking them to do is not that hard. It's not magic or mystery."

Charlie Morrison helped steer a turnaround of the Pizza Inn chain in part by focusing on operations. Once an 800-unit chain, the company declined to 310 units by this decade. The chain "was broken, operationally," said Morrison, the chain's CEO. The company focused on training, accountability, support systems, discipline and consistency. It also added reporting with a new POS system, providing managers with the ability to access key cost and labor information anywhere, even over a smartphone. "We had to restore the operations culture," he said, "and show that the business model is productive and will grow in the future."

— Jonathan Maze

Private Equity in Restaurants Tries to Regain Footing

The private equity markets, much like the broader economy, have fallen considerably from the precipitous highs they reached in 2006 and 2007. Or, to put it more succinctly, “We’re back to normal,” said San Francisco-based consultant Mark Saltzgaber. Nevertheless, the market could feel the impact of those years for some time, even if private equity funds ramp up activity again, as many expect.

Private equity investors have been increasingly important players in the restaurant market, according to Saltzgaber, who was speaking about the private equity market of the past decade at the 2009 Restaurant Finance & Development Conference this month. The number of private equity deals in the restaurant space has increased for much of the past decade.

That may suggest that private equity groups may be more willing in the coming years to buy into restaurants, despite concerns about the sector. “More players are looking at the category in spite of the fundamentals,” Andy Barish, an analyst with Cowen & Company, said at the conference.

A private equity investor is more likely to buy a restaurant company right now than is a strategic buyer such as another restaurant owner. “It’s a pretty good industry for financial acquisitions as opposed to strategic acquisitions,” said Steven Kron, an analyst with Goldman Sachs. “It’s not the best industry to find synergies.” That’s a stark change from the 1990s, when strategic buyers dominated the restaurant merger and acquisition space.

Overall, private equity deals exploded in the middle part of this decade, increasing from a volume of just \$15 billion in 2003 to \$330 billion in 2006, according to Saltzgaber. Private equity funds raised \$54.7 billion in 2003. By 2007 they had raised \$325.7 billion.

Free-flowing credit led to a similar explosion in the types of finance companies providing debt financing, according to Rod Guinn, strategic operating partner for FocalPoint Partners in Los Angeles. The result was higher multiples on acquisitions and lower prices for the debt, along with more flexible terms. According to Barish, multiples increased on average from 6.5x EBITDA in 2004 to 8.8x EBITDA in 2006. In 2005, Los Angeles-based Leonard Green & Partners purchased the 38-unit Claim Jumper chain for \$225 million—11.3 times EBITDA.

Many of these deals didn’t go as planned. The height of the market, from 2005 to 2007 when average multiples exceeded 8, was “the greatest period of failure among LBO deals,” Guinn said. The high-end seafood chain The Oceanaire didn’t fall within that period—it was sold in 2004 to Clarion Capital Partners for \$20 million. But it recently filed for bankruptcy, shuttered many of its locations, and at the conference its founder, Phil Roberts of Parasole Restaurant Holdings said the new owners focused too much on expansion at the expense of quality and “picked really crappy sites.” Roberts said that one

of the bad sites was across the street from a homeless shelter.

Not surprisingly, the private equity market has fallen off a cliff with the collapse in the credit markets. There are fewer lenders and securities options available, according to Guinn. The leveraged debt market has lost 40 to 50 percent of its underwriting capacity. Private equity deal volume fell from \$231 billion in 2007 to just \$6 billion so far this year, according to Saltzgaber.

Prices are higher, and multiples are lower. Church’s Chicken, which Arcapita sold to Friedman Fleischer & Lowe earlier this year, went for \$370 million, or 7.1 times earnings. That’s also the average sized multiple this year, according to Barish. “Private equity is sitting on the sidelines,” Guinn said. “Three quarters of the sources are out of the market. It’s harder to get a deal done.”

Still, many private equity buyers that made purchases in recent years could have an exit strategy on the horizon in the form of an improving market for equities. The IPO market is showing signs of rebounding from a brutal “nuclear winter” for IPOs—only eight U.S. companies went public in the first half of this year. A restaurant company hasn’t gone public since 2006, and there have been only five follow-on offerings in that time.

But the Dow is back in five figures territory and investors are clearly showing a willingness to put funds into the restaurant sector—which has outperformed the broader markets since spring. Now, there is some speculation that the improved equity market could encourage some privately held chains to seek a public offering. “Clearly, there’s been an increase in demand,” said Damon Chandik, managing director for investment banking at Piper Jaffray & Co. He said there is some demand among stock investors for a high-growth public restaurant company.

One high-growth company that some believe could be a candidate for the public market is Colorado-based Noodles & Company, which received an investment from the Och-Ziff Group in 2007. Keith Kinsey, who is Noodles’ chief operating officer and its chief financial officer (he joked at the conference that he frequently has arguments with himself), acknowledged at the conference that the public market is one of three options the company has as an exit strategy for its investors.

As for the private equity market, many believe it could be showing signs of coming back. According to the online private equity tracking firm PitchBook, volume has stabilized this year. “There is a massive amount of powder on the sidelines,” Saltzgaber said. An improved economy could lure more of that money onto the playing field. “Private equity funds get paid management fees to do one thing: put money to work,” he said. “There is pent-up demand on the private equity side.”

— Jonathan Maze

ANALYST REPORTS

PF Chang's China Bistro
PFCB-NASDAQ
(Neutral)
Recent price: \$31.10



Arizona-based **PF Chang's China Bistro** owns its namesake casual-dining chain, PF Chang's, and the fast-casual concept Pei Wei Asian Diner. P.F. Chang's has 180 units, Pei Wei 150. Both feature Chinese and Asian cuisine and are market share leaders in that category in the casual-dining and fast-casual sub-sectors, respectively.

New **Janney Capital Markets** analyst **Mark Kalinowski** initiated coverage of PF Chang's China Bistro with a neutral rating. The company's positives include above-average same-store sales trends at Pei Wei, which should return to positive comp sales in the fourth quarter, and its market-share leadership in Asian cuisine. Yet the company faces risks, notably Kalinowski's outlook calling for continued weak same-store sales at PF Chang's and its heavy presence in California, where the economy is struggling and where 18.8 percent of all bistros are located. EPS estimates for 2009, 2010 and 2011 are \$1.74, \$1.84 and \$2.12 respectively, falling in line with the consensus. "Our neutral rating on PFCB reflects a blend of positives and negatives that, in our view, do not meaningfully outweigh one another at the present time."

Jack in the Box Inc.
JACK-NASDAQ
(Outperform)
Recent price: \$18.50



California-based **Jack in the Box Inc.**, was founded in 1951. It operates three concepts: Jack in the Box, which has 1,393 company-owned stores and 749 franchised units; Qdoba, a fast-casual burrito chain which has 97 company-owned and 326 franchise units, and the 61-unit convenience store concept Quick Stuff.

Oppenheimer analyst **Matthew DiFrisco** is "incrementally more cautious" about Jack in the Box, given a significant slowdown implied in same-store sales guidance and an outlook for diminished margins. "However, the longer-term story of better returns and stronger CF (cash flow) generation continues to progress, supporting our Outperform" rating. He also notes that Jack beat FY09 guidance for most metrics other than same-store sales. Its results are not being hurt by its exposure in the brutal California market and its premium positioning. "While near-term results are suffering, we're encouraged that JACK is not aggressively entering the discount war, and is instead preserving its strong brand equity."

Panera Bread
PNRA-NASDAQ
(Outperform)
Recent price: \$63.64



Missouri-based **Panera Bread** owns and franchises a rapidly growing chain of more than 1,300 bakery-cafes. The company has become the leader in the emerging "quick-casual" segment of the restaurant industry, thanks to its specialty bread, sandwiches and more upscale setting compared to traditional fast food.

Panera Bread recently announced that its board has approved a share repurchase program of up to \$600 million, or 30 percent of the company's current market cap. Current COO Bill Moreton will be named the new CEO of the brand in May 2010, when Ron Shaich will assume the role as executive chairman. **Raymond James** analyst **Bryan Elliott** raised EPS estimates for 4Q09 and 2010 to reflect the impact of the share repurchase program, and reiterated his Outperform rating. The program will be funded with existing cash, operating free cash flow from the business and potentially a modest drawdown on the revolver. "We believe adding a modest amount of leverage makes sense" given the company's below-average risk profile resulting from its significant franchise operations, its significant EBITDA and cash flow power. In addition, "We are optimistic that the announced management transition will go smoothly given the company's deep bench strength and Shaich's continued involvement in the global strategy decisions."

Cheesecake Factory
CAKE-NASDAQ

(Buy)

Recent price: \$19.10



The Cheesecake Factory operates upscale, full-service casual dining restaurants, including 146 under The Cheesecake Factory brand name in 34 states and the District of Columbia, and 13 under the Grand Lux Café name in nine states. It also has one under the RockSugar Pan Asian Kitchen name in California. Founded in 1972, the company is based in Calabasas Hills, California.

Goldman Sachs analyst **Steven Kron** reiterated his Buy rating on CAKE and added it to the Americas Conviction Buy List. "CAKE is likely to be among the biggest beneficiaries of the improvement in higher-end spending we have seen across restaurants and retail in recent months." This supplements the Buy thesis, which calls for upward EPS revisions in 2010 on modestly improving sales, which should be flat year-over-year, and better-than-peer cost opportunities. Estimates of \$1.18 are Street high, 8 percent above consensus, and Kron's 12-month, \$23 price target offers 21 percent upside. Improving sales at some high-end retailers supports improving demand among premium brands, and CAKE's sales have tracked this group of retailers more recently, as opposed to its restaurant peers—given the cross-fertilization of guests at higher-end malls.

YUM! Brands

YUM-NYSE

(Buy)

Recent price: \$35.65



Kentucky-based **Yum! Brands** is the largest restaurant company in the world in terms of unit count. The company operates and franchises several brands, including KFC, Pizza Hut, Taco Bell, Long John Silver's and A&W All-American Food. It has over 34,000 restaurants worldwide, 76 percent of which are franchises.

Janney Capital Markets analyst **Mark Kalinowski** initiated coverage of **Yum! Brands** with a Buy rating, noting that the company "should trade at a P/E premium to its peers." Kalinowski estimates that the fair value for the shares is \$40, which was 21 percent above the November 2 closing price of \$33.12, and 13 percent above its share price on November 19. The company offers investors "meaningful growth opportunities outside the U.S., particularly in China. "We look for 40 percent or more of the company's operating profits to be generated in the fast-growing market by 2013." In addition, the company's corporate culture, with its emphasis on recognizing achievement, "appears underappreciated by the Street." He believes that culture helps explain Yum Brands' track record of at least 10 percent EPS growth in each of the last several years.

Wendy's/Arby's Group

WEN-NYSE

(Overweight-1)

Recent price: \$4.16



SERVING FRESH IDEAS DAILY.

Wendy's/Arby's Group operates and franchises Wendy's and Arby's restaurant systems in the U.S. and Canada. The Wendy's system comprises 6,623 restaurants, 1,399 of which are company-owned, while Arby's has 3,741 restaurants, 1,171 of which are owned by the company, which is headquartered in Atlanta.

Despite numerous challenges facing the **Wendy's/Arby's Group**, **Barclay's Capital** analyst **Jeffrey Bernstein** remains bullish on the company's shares, noting that it has "growth potential well above peers" and its stock is trading at a discount compared with such peers. Bernstein sees "meaningful growth opportunities" in the next 12 to 16 months, even though the company is in the early stages of "a long and difficult journey to rebuild momentum in a very competitive QSR segment." He believes that management will be able to capture "much of the low-hanging fruit as it relates to both the Wendy's brand and the broader corporate cost structure." But the specifics around the Arby's brand turnaround are "much less apparent and we therefore remain cautious on assuming any meaningful improvement at that brand in the near-term." He expects Wendy's and corporate momentum will overshadow ongoing struggles at Arby's.

ACCOUNTING

Here Come the GAAP Changes

Recent updates in generally accepted accounting principles (GAAP) that are effective for the 2009 fiscal year could keep some company accountants busy this winter. According to Dustin Minton of SS & G, the new accounting standards will affect companies that have made acquisitions; use interest rate swaps to manage their interest rate risks or those that report minority interests in their financial statements. In addition, all companies will have to evaluate any uncertain tax positions and implement certain financial disclosures.

Here is a brief rundown of some of the guideline changes.

FASB codification

The Financial Accounting Standards Board, or FASB, got all of its paperwork into one file, so to speak, when it organized thousands of FASB accounting pronouncements into a single source. The process, known as Codification, grouped those statements into about 90 accounting topics and four levels.

In effect, the board took the thousands of documents that govern GAAP standards and turned them into one big, overarching guidebook. The Codification does not change GAAP, only the reference to FASB guidance.

Business combinations and non-controlling interests

Negative goodwill, or the gain a company realizes when it purchases another business for less than fair value, must now be treated as a gain from a bargain purchase. The gain will be recognized as a P&L item in the current period. In addition, certain transaction costs are no longer capitalized and require recognition as an expense in the current period. The changes, in FASB Codification Topic 805, Business Combinations, align the standards with International Financial Reporting Standards.

Non-controlling interests, formerly minority interests, should now be shown as a component of equity, rather than in the mezzanine section of the balance sheet. Profit or loss attributable to the non-controlling interest is now reported as a component of the controlling entity's P&L.

Derivatives and hedging

FASB Topic 815 expands disclosure requirements for the financial statements of companies that have a cash flow or fair value hedge.

The expanded disclosures include:

- Why the agreement was entered into;
- How the agreement is accounted for;
- How the agreement affects financial positions and results;
- A tabular disclosure of fair value and the gains or losses on these agreements.

Uncertain tax positions

FASB has made life a bit easier for accountants working for privately held companies, which no longer have to disclose unrecognized tax benefits that would affect the tax rate if they were recognized. But that doesn't mean they shouldn't evaluate whether the tax is a transaction with the entity or its owner or whether any uncertain tax positions exist. Companies must also analyze tax positions taken by each of their entities, including:

- The decision not to file a tax return;
- Any shift in income between jurisdictions;
- The decision to include reporting taxable income in a tax return;
- The decision to classify a transaction, entity or other position in a tax return as tax exempt;
- The entity's status, including its status as a pass-through entity or a tax-exempt non-profit.

The disclosures should contain the amount of penalties and interest incurred; significant changes in unrecognized tax benefits that will occur in the next 12 months and a description of the tax years that remain subject to examination by the major jurisdiction.

More to come

FASB is considering a right-of-use model that could completely change lease accounting for operating leases. The company would record a leased restaurant location that it has a "right to use" as an asset, while its obligation to pay the lease payments would be recorded as a liability. A re-measurement of the liability would be done at the end of each period. A draft of the proposal is expected early in 2010 but is not expected to be effective until 2011.

All the changes end a long quiet period in the GAAP world. FASB continues to work with the International Accounting Standards Board to converge the two sets of standards into one set of standards that companies can use worldwide. This is just a brief summary. We recommend a review of the complete guidance before implementing the changes.

*For more information, go to www.fasb.org. Or contact **Dustin J. Minton**, CPA, at **SS&G**, at dminton@ssandg.com, or 877-385-2388.*

MARKET WRAP

Landry's Restaurants, Inc.

LNJ • NYSE

Common Stock Offering

Date: November 17, 2009

Debt Issuance: \$406,500,000 principal amount of senior notes

Interest Rate: 11.625%

Net Proceeds: \$400,100,000

Initial Purchasers: Jefferies & Company, UBS Securities, Inc. and Deutsche Bank Securities, Inc. The notes will be offered and sold to the Initial Purchasers and resold only to qualified institutions.

Use of Proceeds: The company plans to use the gross proceeds from the offering and sale of the notes, together with borrowings under an amended and restated senior credit facility, to refinance debt, pay related transaction fees and expenses and for general corporate purposes or, if consummated for the proposed acquisition of the company by Tilman Fertitta, its CEO and largest shareholder.

INCOME STATEMENT

Nine months ended September 30, 2009

Restaurant Revenue	\$650,001,318
Gaming Revenue	\$164,902,868
Net Income	\$24,824,417
Net Income Per Share	\$1.19

BALANCE SHEET

As of September 30, 2009

Cash	\$44,997,852
Total Assets	\$1,567,134,210
Long Term Debt	\$906,077,836
Shareholders' Equity	\$331,129,724

SUMMARY:

Landry's Restaurants, Inc. operates restaurants primarily under the names Landry's Seafood House, Charley's Crab, The Chart House, Saltgrass Steak House and Rainforest Cafe. In addition, the company owns and licenses restaurants under the trade name Rainforest Cafe. The company also owns and operates the Golden Nugget Hotels and Casinos in downtown Las Vegas and Laughlin, Nevada and the Kemah Boardwalk in Kemah, Texas.

Max & Erma's Restaurants, Inc.

Chapter 11 Filing

Date Filed: October 23, 2009

Debtor: G & R Acquisition, Inc.

Largest Creditors: GE Capital/FFCA \$1,704,000; State of Ohio Department of Taxation \$1,100,00; Pennsylvania Bureau of Collections \$300,000; State of Michigan Revenue Department \$190,000.

Secured Creditors: National City Bank, Huntington National Bank, and Park National Bank are owed approximately \$16.1 million according to the filing. The debtor was under a Forbearance Agreement and a judgment was obtained by the banks prior to the filing.

SUMMARY:

Max & Erma's was a public company up until July, 2008 when it was acquired by G&R Acquisition, Inc. an entity formed by Gary Reinert, Sr. of Pittsburgh, Pennsylvania. Under the terms of the agreement, G&R acquired all of the outstanding shares of the Company for \$4.00 per share in cash. The deal totaled \$10 million in cash and the assumption of about \$18 million in long-term debt. When Reinert bought the company in 2008, he acknowledged that Max & Erma's was a turnaround project.

At the time of the April, 2008 merger, Max & Erma's owned and operated 79 casual dining restaurants in Ohio, Indiana, Michigan, Pennsylvania, Kentucky, Illinois, North Carolina, Georgia and Virginia. The company also franchised 27 restaurants in Ohio, Missouri, Pennsylvania, Michigan, Virginia, South Carolina, West Virginia and Indiana.

Damon's Grill, also owned by G & R, filed for bankruptcy at the same time as Max & Erma's.

Spicy Pickle Franchising, Inc.

OTCBB • SPKL

\$2.2 Million Private Placement

Date Announced: September 30, 2009

Shares Sold: The company sold 22 units for cash in a total amount of \$2,200,000.

Transaction: Each unit consisted of 769,231 shares of common stock and a warrant to purchase an additional 384,615 shares of common stock at \$.19 per share. The warrants expire September 22, 2014. The company issued a total of 16,923,082 shares of common Stock and warrants to purchase 8,461,530 shares. Of the securities purchased, 13,846,158 shares and 6,923,070 warrants were purchased by members of the company's board of directors.

INCOME STATEMENT

Nine months ended September 30, 2009

Revenues	\$3,181,641
Net Loss	(\$1,363,138)
Net Loss Per Share	(\$.03)

BALANCE SHEET

As of September 30, 2009

Cash	\$1,228,844
Total Assets	\$2,909,646
Long Term Debt	\$488,000
Shareholders' Equity	\$3,679,478

SUMMARY:

Founded in 1999, Spicy Pickle Franchising, Inc. is headquartered in Denver, Colorado and currently has 30 company-owned and seven franchised Spicy Pickle locations in eleven states. Spicy Pickle is a sandwich concept that also serves hot pressed panini and sub sandwiches and salads. Spicy Pickle utilizes fresh focaccia and ciabatta breads baked fresh daily from scratch, high quality meats and cheeses with no preservatives, additives or MSG.

The Company has signed agreements with franchisees to open 60 additional restaurants under the Spicy Pickle Brand.

OUTLOOK

Continued from page one

Restaurant operators have done an admirable job of reducing costs (thanks to a big drop in commodity prices) and have made their restaurants more efficient. At the beginning of the year, many Wall Street restaurant analysts predicted that a large number of restaurants, especially in casual and fine dining, would close because of declining sales. It didn't happen in any great numbers. Restaurants have been resilient.

Cost cutting has been so successful for many chains, some are even showing margin improvement. Wendy's has improved its operating margins by over four points, despite negative sales trends. But the cost-cutting game may be over. Food commodity prices are due to rise in 2010, according to David Maloni, who publishes a weekly commodity report for the American Restaurant Association.

Restaurant closings are still a possibility. At last week's Restaurant Finance & Development Conference at the Bellagio in Las Vegas, Goldman Sachs analyst Steven Kron suggested that as many as 10,250 casual dining restaurants and 7,500 bar and grill-themed restaurants needed to close in order for those restaurants to be in equilibrium with current demand and population growth. That suggests additional discounting and cost cutting is in store.

Companies must eventually come to grips with the pros and cons of their business model. They need to build demand for their products by other methods than just discounting. Is the restaurant relevant to the consumer? If an operator can't stir demand, they are simply kicking the can down the road, as the title of my book suggests, hoping to stay in business until the economy gets better. It won't work.

Some bold business transformation strategies were on display last week at our Restaurant Finance & Development Conference. Here are some of the more powerful ones I heard in the halls:

"I sure hope it gets better next year."

"Once the consumer starts spending again, we'll all be in good shape."

"We've stripped so much cost out of our model, that if we start to see some sales traction, we'll be fine."

"Down three-to-four percent is the new normal."

Wait a minute. What if things don't get better next year and the consumer doesn't start spending again? What if the consumer is mad at all the cost cutting and portion size reductions and quits going to restaurants? What if the unemployment rate goes higher as most economists now predict? If down three-to-four percent is the new normal, then all restaurants will be closing within three to five years and the Restaurant Finance Monitor will one day be studied by graduate students in Ancient History or the Classics. An inevitability of sales decline has crept into the business lexicon of too many businesses.

"The companies that are sitting around just hoping things will get better next year will die," says Malcolm Knapp, an industry consultant, senior management confidante and keeper of the Knapp-Track survey of casual dining sales results.

Knapp doesn't mince words about the crisis he sees in the current business strategies of many chains. He believes that operators who will be successful post-recession are using the down economy to reposition their offerings to consumers and taking advantage of lower costs for remodeling, repositioning and research and development.

Knapp points to the work Darden Restaurants did with Olive Garden during the recession of the late 1980s as a sign that companies can succeed during a downturn. "Darden was having trouble with Olive Garden, but retooled the concept and came out of the recession much stronger," said Knapp.

It's not just restaurants that are kicking the can down the road. Banks and landlords are also getting into the act, too. Greg Soule, a Minneapolis real estate attorney said he sees tighter credit criteria for new real estate deals but says that banks and landlords have been forced to extend and reprice many existing deals for their shakier clients in the hope the economy turns around and the client's business improves. "No one wants the keys back," said Soule. The new buzzword for this act of forbearance according to Soule is "extend and pretend."

Maybe Kicking The Can Down The Road will never be a bestseller like Welch's or Covey's book. There are too many companies already practicing this business method for it to be sexy. It's too easy to implement. Therein lies the problem.

—John Hamburger

RESTAURANT FINANCE MONITOR

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