April 2009

Market | Brief

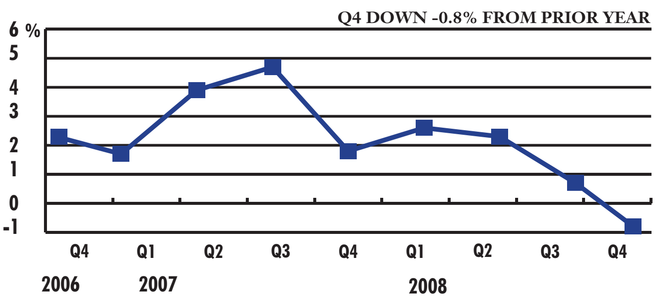
Tracking and interpreting restaurant trends

INSIDE MARKETBRIEF

THE ECONOMY

The recession of 2008-2009, unprecedented in post-World War II history, is a fast-developing story that looks different every week. While the key macro-economic indicators and restaurant industry statistics reported herein are universally negative, economic news in late March—including a stock market rally and surges in sales of existing homes and orders for durable goods—offers tantalizing hints of a turnaround beginning in the next few months. Nevertheless, the consensus of economists is that the recession will continue to ravage employment and company profits at least through the first half of 2009.

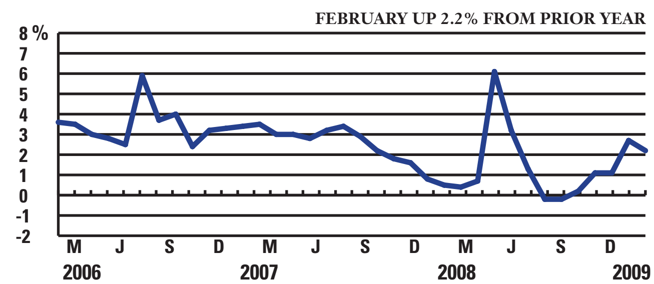
Gross Domestic Product Quarterly Rate of Increase



Source: Blue Chip Economic Indicators

U.S. real gross domestic product (GDP) contracted by -0.8% in the fourth quarter compared to the same quarter in 2007, according to Blue Chip economists' projections. At an annual rate, the economy declined by 6.2% during the fourth quarter. The Blue Chip consensus looks for real GDP to decline another 5.3% in the first quarter of 2009.

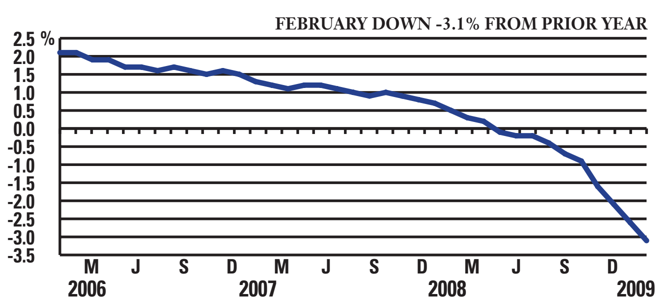
Real Disposable Personal Income Growth



Source: Bureau of Economic Analysis

U.S. consumers' disposable personal income (DPI) was up 2.2% in February over year-before levels but down 0.1% from month-before levels. In contrast, January's DPI was up 2.7% over the year before and up 1.6% over the month before. February's real DPI (adjusted to remove price changes) was down 0.4% from January.

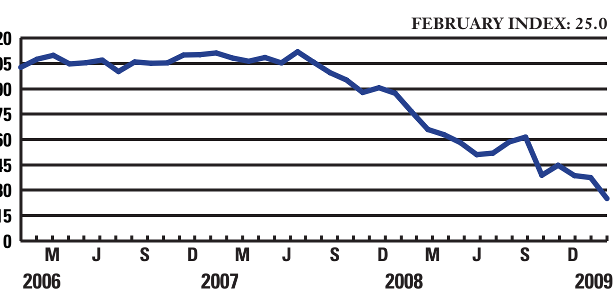
Employment Growth: Total Non-Farm



Source: U.S. Dept. of Labor

February's nonfarm payroll employment was down by 3.1% from year-before levels. The unemployment rate spiked to 8.1% from 7.6% in January. Over the past 12 months, the number of unemployed persons has increased by about five million, and the unemployment rate has risen by 3.3 percentage points.

Consumer Confidence Index (Base 1985=100)



Source: The Conference Board

The Conference Board's Consumer Confidence Index, which had decreased only moderately in January, declined sharply in February. The index reached yet another low of 25.0, down from 37.4 in January on a scale on which 1985 economic conditions = 100. This is the lowest number ever seen for the index, which was established in 1967.

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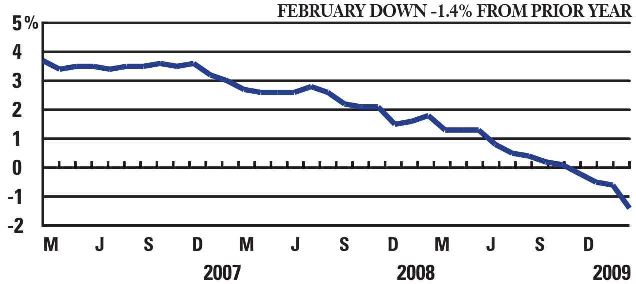
TECHNOMIC

12-Month Moving Average (Foodservice & Drinking Places Real Sales)



Source: U.S. Census Bureau

The moving average for sales of foodservice establishments (including restaurants, bars and taverns, and onsite foodservice) declined at a real-dollar rate of -1.4% in February, more than twice the rate of decline seen in January. The moving average first turned negative in November, and losses have accelerated each month since then.

Q4 KEY FINANCIAL METRICS – PUBLIC COMPANIES

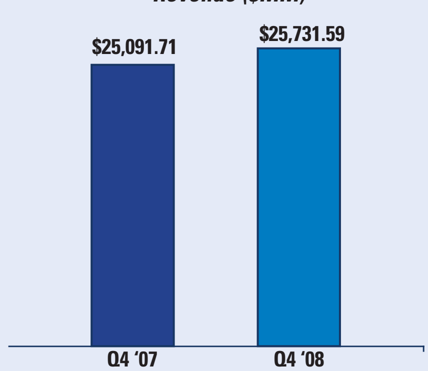
While public chains' revenues held fairly steady in the fourth quarter of 2008, the majority of full-service chains and a substantial minority of LSRs lost money. The chains' collective revenues were up a nominal 2.6% over year-before levels to $25.7 billion, but their collective net income was down by more than 69%. In fact, only 13 of 35 full-service restaurant companies reported any net income; 22 others suffered losses. The limited-service segment fared better, with 23 of 30 chains reporting bottom-line income and only seven showing losses. Overall, 36 companies made money and 29 lost money during the quarter.

▶ ***Bottom line:*** ***As difficult as it is to make money in the current economic climate, restaurant companies should be wary of focusing exclusively on cutting operating costs and running value promotions to drive traffic. Recessions damage weak competitors but reward the strong with a larger market share. Operations that devote resources to building their brand identity and attracting new customers should be in a strong position to profit when the economic turnaround comes.***

Public Company Fourth Quarter 2008 Industry Summary Results*

	QUARTERLY REVENUES ($ MM)			QUARTERLY NET INCOME ($ MM)			MARGINS %	
	2008	2007	% CHANGE	2008	2007	% CHANGE	2008	2007
GRAND TOTAL – 65 companies								
LSR total – 30 companies	17,314.70	16,843.31	2.8%	1,050.93	1,817,05	-42.2%	6.1%	10.8%
Excl. McDonald's	*11,749.70*	*11,089.71*	*6.0%*	*65.63*	*543.85*	*-87.9%*	*0.6%*	*4.9%*
FSR total – 35 companies	8,416.89	8,248.40	2.0%	-430.33	158.04	N/A	-5.1%	1.9%
GRAND TOTAL	**25,731.59**	**25,091.71**	**2.6%**	**620.60**	**1,975.09**	**-68.6%**	**2.4%**	**7.9%**
Excl. McDonald's	*20,166.59*	*19,338.11*	*4.3%*	*-364.70*	*701.89*	*N/A*	*-1.8%*	*3.6%*

Revenue ($MM)



Net Income ($MM)

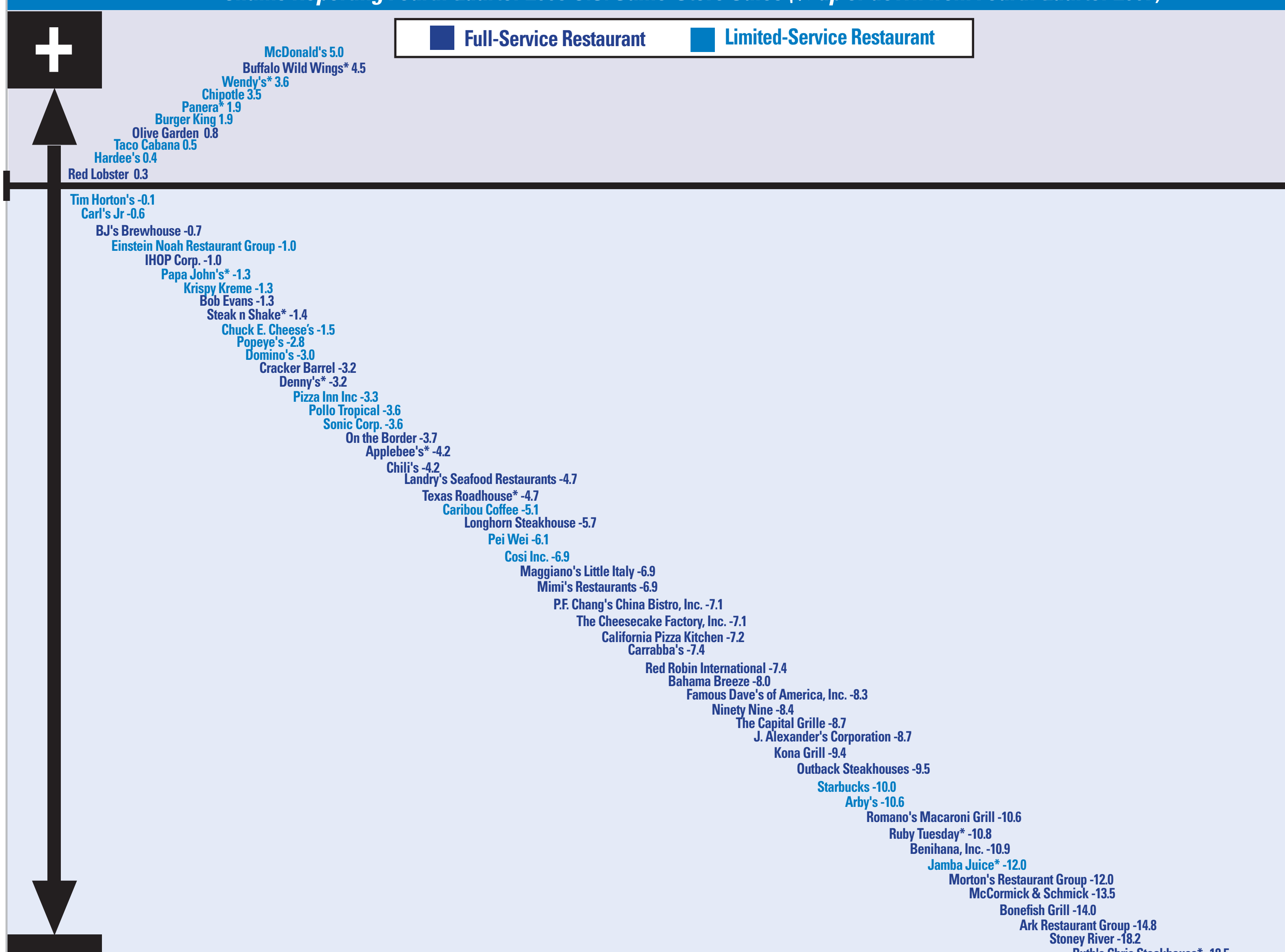
** Calendar quarter; number of chains reporting varies each quarter*
Source: Public Company Reports

SAME-STORE SALES Q4 2008

Virtually all public restaurant chains tallied real-dollar declines in same-store sales in the fourth quarter of 2008. Of 76 chains reporting fourth-quarter comps, 61 showed nominal declines and only 15 recorded nominal increases—mostly very small gains. But food-away-from-home prices rose 4.4% in 2008, so only two chains could boast any real advance: in limited service, McDonald's, whose domestic same-store sales comparisons were up 5.0%, and in full service, Buffalo Wild Wings, which reported same-store sales up 4.5% (but only in company-owned units—comps rose by just 2.5% at franchised units). The public chains' weighted average for fourth-quarter comps was a 2.2% decline, but it would have been even worse—a 3.3% drop—without the outsize effect of McDonald's. **McDonald's pulled up the LSR average.** Including McDonald's, the sector showed a combined nominal sales increase of 0.8%; without McDonald's, it showed a 1.8% decline. Also doing well was burger rival Wendy's—comps at North American company-operated units increased 3.6% and North American franchise same-store sales were up 3.8%. In the LSR Mexican sector, Chipotle reported comps up 3.5% over the year before. In total, 10 LSR chains showed nominal increases while 18 reported declines. **Most full-service chains showed sales declines, some of them steep.** Only five chains reported nominally positive numbers, while 43 registered declines—including 11 that showed double-digit drops. The weighted average same-store sales decline in FSR was 5.3%.

▶ ***Bottom line:* *While the economic climate is worse in full service, business is down almost everywhere. The few chains still growing same-store sales are clearly offering something their competitors aren't: a very, very clear value proposition in terms of price, menu quality, service and concept differentiation.***

Chains Reporting Fourth Quarter 2008 U.S. Same-Store Sales (% up or down from Fourth Quarter 2007)*



** Calendar quarter; number of chains reporting varies each quarter*
*** Corporate units only*
Source: Public Company Reports

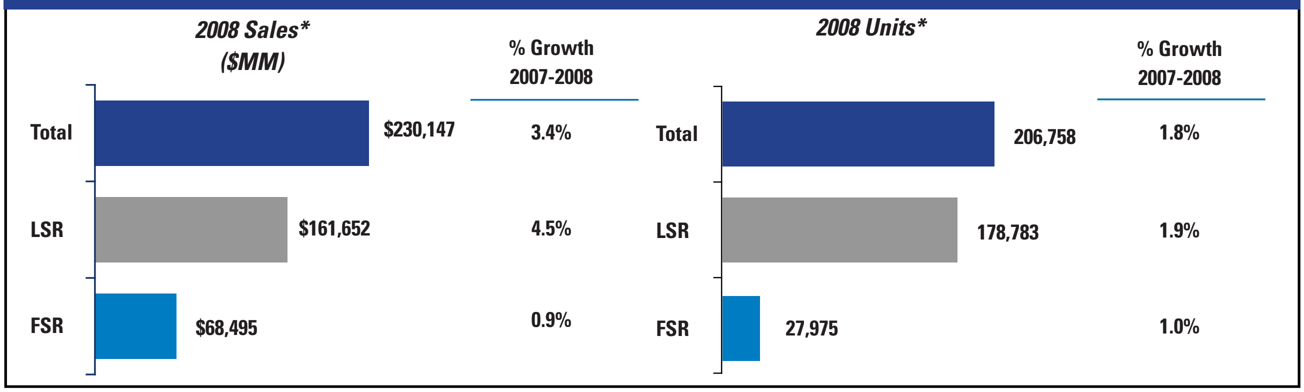
LESSONS FROM THE TOP 500 CHAINS

Technomic has completed data gathering and analysis for our annual *Top 500 Chain Restaurant Report.* Since the 1970s, Technomic has been tracking annual performance of the restaurant industry as a whole and the 500 largest chain brands specifically. The new sales and unit numbers for 2008 show an industry in transition, battered by the recession that began in December 2007.

The statistics that make up today's restaurant industry provide important insights into winners and losers among concepts and segments. Despite today's altered economic climate, the numbers still provide an indicator of trends, particularly when 2008 financials are checked against more recent data.

The nation's Top 500 chains increased their sales by 3.4% in 2008, while growing their unit counts 1.8%. That means average unit volumes were up 1.6%. But within the Top 500 cohort, limited-service restaurants did far better than FSRs. Limited-service players collectively were up 4.5% in total sales, with a 1.9% increase in units. Full-service chains collectively tallied only 0.9% nominal growth and increased unit count by 1.0%—meaning that their average unit volumes were down.

Top 500 Full Service vs. Limited Service Performance Comparison



** U.S. only*

However, it should be noted that the consumer price index for all items rose at an annual rate of 3.8% in 2008, and the inflation rate for food away from home was 4.4%—so even limited-service restaurants saw a real-money decline.

LSR: BENEFITING FROM VALUE FOCUS AND TRADE-DOWNS

The recession took a toll on all restaurant sectors in 2008, but quick-service and fast-casual operations also derived a benefit from consumers trading down from full service (and faced new challenges to meet higher quality demands for food and service). However, as the recession has continued, LSRs are also beginning to see downturns in sales and traffic. By March 2009, public LSR chains on average were reporting flat sales.

Limited-Service Top 500 Menu Categories
U.S. Sales and Unit Growth in 2008

	Sales Growth*	Unit Growth*
Bakery Cafe	12.5%	7.4%
Other Sandwich	9.1	1.9
Coffee & Other Beverage	6.9	4.4
Mexican	4.9	1.5
Hamburger	4.3	1.0
Donut	4.1	10.5
Chicken	4.1	1.7
Pizza	2.1	1.6
Frozen Desserts	-0.8	-1.5
Family Steak	-3.7	-2.2
Cafeteria/Buffet	-5.2	-4.8

** U.S. only*

Above-average growth was seen during 2008 in the LSR bakery/café, sandwich, beverage and Mexican menu clusters, all of which beat the overall LSR sales increase of 4.5%. These same four menu clusters have been on a growth path for several years. In 2007, the beverage cluster grew sales 20.1%; the bakery/café sector grew 13.3%; the sandwich cluster expanded by 6.2%; and the Mexican cluster was up 6.1%. Here's how the leading clusters fared in 2008:

- **The bakery/café cluster** demonstrated the continued appeal of the fast-casual sub-sector, offering higher-quality food and ambiance than those of traditional quick-service restaurants at a higher price point. It may have benefited the most of all LSR segments from customers trading down from full-service restaurants. Segment leader Panera Bread increased revenues by 22%, net income by 17% and same-store sales by 3.4%.

- **The "other sandwich" cluster** (differentiated from the hamburger segment) offered much of the same "fresh" appeal as the bakery/café cluster, plus strong value positioning. Segment leader Subway increased sales by expanding its popular $5 foot-long sandwich menu; the chain continued to grow briskly in 2008, surpassing the 30,000-store mark two years ahead of schedule. Its biggest competitor, Arby's, admitted that Subway's $5 sandwiches have hurt its sales; Arby's is now testing a value menu including new roast-beef and roast-chicken sandwiches. Third-place sandwich chain Quiznos Sub also rolled back prices and unveiled a new menu design to strengthen its value appeal. But as discounting grows in importance, this sector may struggle to maintain profits along with sales.

- **The beverage cluster** grew more slowly than in previous years, with signs that the category may have limited room for further expansion in an economy in which consumers forego "treats." Coffee segment leader Starbucks reported net income down 53% in the fiscal year that ended September 28; U.S. same-store sales were down 5%. In its first quarter of 2009, net income dropped 69% from the same quarter last year, and U.S. same-store sales were down 10%. The smoothie cluster also ran into trouble, with leader Jamba Juice recording revenues for the fiscal year up 8.1%, same-store sales down 8.1%, and a net loss of $149 million on revenues of $343 million.

- **The Mexican cluste**r combines QSR giant Taco Bell with a number of successful fast-casual chains, led by Chipotle. Taco Bell focuses on value positioning for a primarily youthful clientele; it had its ups and downs in 2008, but retained its position as the sixth largest U.S. chain. Chipotle, meanwhile, continues to parlay its "fresh" and "made for you" positioning into strong growth; it reported revenue up 22.7%, net income up 10.8% and same-store sales up 56.8% in 2008.

FSR: PERILS OF NOT CHANGING WITH THE TIMES

The declines in full service are much steeper than those in LSRs. Casual-dining chains face complex challenges beyond the current economic climate, which has cut into consumers' discretionary spending. They've become victims of their own success—a mature category with too many units and nothing to make one chain stand out from another. Many chains have overbuilt, with expansion rates averaging 5% over the past four years even as sales growth slowed, so restaurant supply now exceeds demand. **On top of that, many casual-dining chains lack differentiation.** At dinner time, the most important daypart for casual-dining chains, 85% of consumers surveyed by Technomic in 2008 said that they are eating at home more often—cooking or sourcing prepared meal solutions from food retailers. Other options were also popular; over a third of respondents were using independent and fast-food restaurants in place of casual-dining chains.

Chains in four of seven menu clusters reported at least some nominal sales growth in 2008.

Full-Service Top 500 Menu Categories U.S. Sales and Unit Growth in 2008		
	Sales Growth*	Unit Growth*
Asian	9.3%	12.3%
Italian	3.4	2.1
Varied Menu	1.5	1.7
Family Style	0.5	-0.2
Seafood	-0.4	2.9
Steak	-0.7	2.3
Mexican	-1.8	-2.0

** U.S. only*

- **The Asian cluster** was the single high-growth cluster, but its showing of 9.3% sales growth required 12.3% growth in unit count, a pattern of declining average unit volumes that does not bode well. Segment leader P.F. Chang's reported same-store sales down 7.1% in the most recent quarter. In 2007, the cluster grew sales by 13.7% and units by 13.2%.

- **Italian concepts** did well, at least compared to other full-service sectors, with sales up 3.4% (compared to a 4.8% increase in 2007). What's more, they accomplished this with 2.1% unit growth, meaning that unit volumes rose. The sector is dominated by Olive Garden, which traded on its reputation of outstanding hospitality, freshness and value to boost same-store sales every quarter all the way through 2008. Although parent Darden Restaurants reported a drop of 1.4% at Olive Garden in the most recent quarter, interrupting a 14-year streak of positive same-store sales growth, the concept remains well positioned for the future.

▶ ***Bottom line:* *As difficult as it is to make money in the current economic climate, restaurant companies should beware of focusing exclusively on cutting operating costs and running value promotions to drive traffic. Recessions damage weak competitors but reward the strong with a larger market share. Operations that devote resources to building their brand identity and attracting new customers should be in a strong position to profit when the economic turnaround comes.***

BUSINESS BUILDING IMPLICATIONS

- **The 2008 financial results and early 2009 indicators make it very clear that value will remain the customer's absolute prime consideration** in restaurant spending—at least until the economy improves, and possibly much longer. That does not mean that low prices alone are enough to draw traffic. Instead, 2008's winning chains all offered clear concept differentiation and a good understanding of their core customers. All were outstanding among their competitive set in food freshness, menu innovation, ambiance, hospitality and convenience.

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