

# Market Brief

Tracking and interpreting restaurant trends

## THE ECONOMY

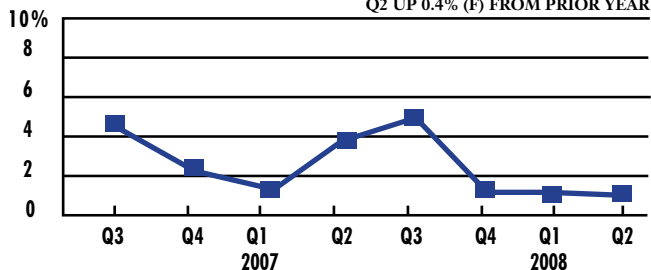
The economic picture is not exactly a cheery one, but the indicators don't presage disaster, either. Incomes are still rising, though unemployment has risen sharply as well. Economists continue to debate whether a recession has already started, is coming later or may be avoided. However, consumers are in a funk, with consumer confidence ratings far lower than the actual situation would indicate. Some economists argue that this is because prices are rising fastest for items that consumers purchase most often—food and gasoline—giving them frequent reminders of the pinch on their pocketbooks. Low consumer confidence is not a good sign for the foodservice industry, which is highly dependent on discretionary spending and consumer mood.

## INSIDE MARKETBRIEF

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### Gross Domestic Product Quarterly Rate of Increase

Q2 UP 0.4% (F) FROM PRIOR YEAR

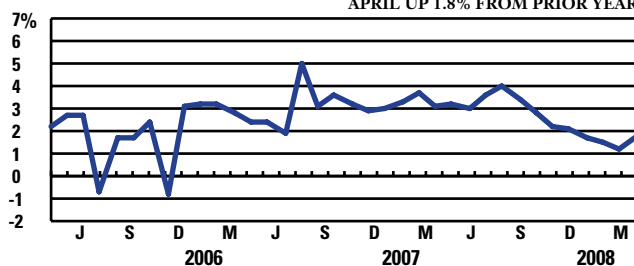


Source: Blue Chip Economic Indicators

U.S. gross domestic product (GDP) was forecast to grow only 0.4% in the second quarter compared to the second quarter of 2007, according to Blue Chip Economic Indicators. Blue Chip economists are forecasting third-quarter GDP growth will slow further. The low value of the U.S. dollar against other world currencies is strengthening export sales but also reducing domestic demand for imports and increasing domestic demand for U.S.-made goods.

### Real Disposable Personal Income Growth

APRIL UP 1.8% FROM PRIOR YEAR

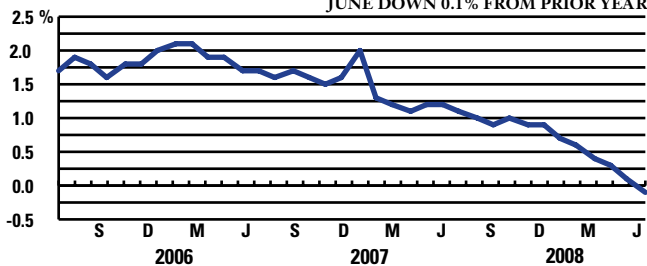


Source: U.S. Dept. of Commerce

Real disposable personal income (DPI) in the U.S. rose 1.8% in April over the same month a year ago, according to figures from the U.S. Bureau of Economic Analysis. This was the largest advance since November's 1.9% increase over the previous November. Compared to March, DPI was up 0.2% and personal consumption also increased 0.2%. Real DPI and real personal consumption decreased slightly (less than 0.1%) from the month before.

### Employment Growth: Total Non-Farm

JUNE DOWN 0.1% FROM PRIOR YEAR

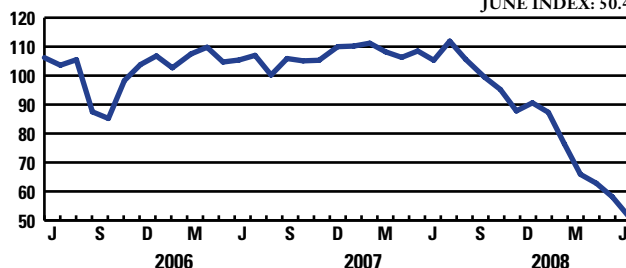


Source: U.S. Dept. of Labor

U.S. non-farm employment declined slightly in June by 0.1% over year-before figures. Non-farm payroll employment continued to trend down in June (-62,000), while the unemployment rate held at 5.5%. The number of unemployed persons was essentially unchanged in June from May, at 8.5 million. A year earlier, the number of unemployed persons was 7.0 million, and the jobless rate was 4.6%.

### Consumer Confidence Index (Base 1985=100)

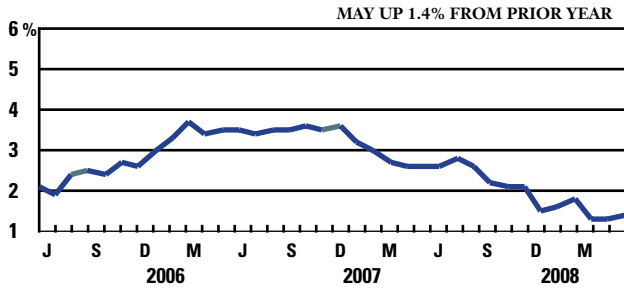
JUNE INDEX: 50.4



Source: The Conference Board

The Conference Board Consumer Confidence Index, which had dropped in May, plunged even further in June. The Index now stands at 50.4 (on a scale on which 1985 conditions = 100), down from 58.1 in May and the fifth lowest reading in the history of the index. The related Present Situation Index also declined further, and the Expectations Index dropped to an all-time low. Consumers' assessment of present-day conditions continues to grow more negative and suggests the economy remains stuck in low gear.

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



Source: U.S. Census Bureau

The moving average for real sales of foodservice establishments (including restaurants, bars and taverns, and onsite foodservice) rose 1.4% in May over prior-year figures, a slight improvement from the 1.3% year-over-year advances seen in March and April. Technomic data show that consumers are scaling back restaurant visits and spending at both full-service and limited-service restaurants, citing their shrinking discretionary income as well as higher gas prices.

SAME-STORE SALES Q1 2008

Olive Garden and Burger King bested all other chains in same-store sales advances for the first quarter. While these two chains proved that success could still be found both in limited service and full service, LSRs as a whole did better than FSRs—half of the LSR chains reporting boosted comparable-store sales at least nominally, versus only a third of the 27 full-service chains.

Olive Garden’s comps were up 5.7% at domestic stores, representing the 54<sup>th</sup> consecutive quarter of same-restaurant sales growth. Parent Darden International credited the Italian chain’s broad-based appeal, as well as advertising. Olive Garden’s success helped counteract declines at Darden’s Red Lobster chain, where same-store sales were down 2.0%; Bahama Breeze, which also saw a 2.0% decline; LongHorn Steakhouse, where same-store sales dipped 3.3%; and Capital Grille, where comps dropped 2.2%. All were on par or better than par for the troubled casual-dining sector, the company argued.

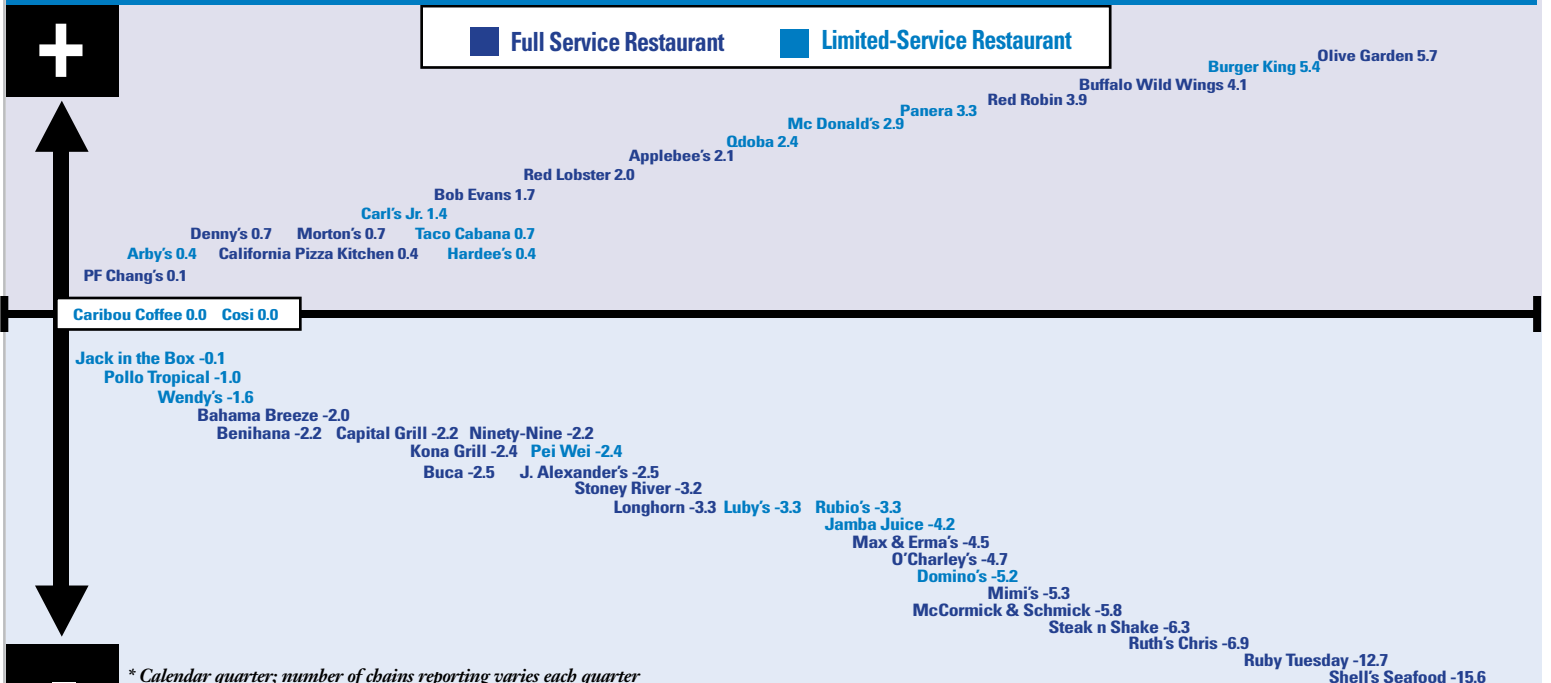
Burger King increased sales 5.4% in the U.S. and 5.8% systemwide against year-ago figures in the same stores. Net income rose 21% for the quarter from the year-ago quarter. The company attributed part of the increase to the new Whopper ad campaign in the U.S. Unlike McDonald’s, Burger King has succeeded by concentrating on its core fast-food burger customer rather than making efforts to upscale the menu.

The most dramatic drop in same-store sales came from full-service Shell’s Seafood, where comps plunged 15.6% from year-before figures. Ruby Tuesday also experienced a double-digit decline of 12.7%.

In limited service, the worst decline was at Domino’s, where comps were down 5.2% from the same quarter of 2007.

**Bottom line:** Troubles in the casual-dining sector are widespread, and now limited-service chains are also feeling the pinch from declines in consumers’ discretionary spending. As the winners prove, however, there are still ways to overcome negative economic factors and achieve strong growth. Both Olive Garden and Burger King do so by knowing their customers and finding a value proposition and strong brand identity with wide appeal.

Chains Reporting 1<sup>st</sup> Quarter 2008 Same-Store Sales (% up or down from 1<sup>st</sup> Quarter 2007)\*



\* Calendar quarter; number of chains reporting varies each quarter

Source: Public Company Reports

## Q1 KEY FINANCIAL METRICS – PUBLIC COMPANIES

**Net income of public restaurant chains was down sharply in the first quarter compared to year-before figures, leading to weaker margins.** Net income declined by a weighted 28.1% among 70 companies reporting their financials (excluding McDonald's). Even with McDonald's enormous size and strong global results, weighted net income figures for all 71 companies including McDonald's were down 5.5%. Bottom-line earnings were down 10.7% at LSRs (excluding McDonald's) and a dramatic 50.8% at FSRs, compared to the same quarter of 2007.

**FSR first quarter 2008 net income declines** were driven by Brinker, which recorded a \$93 million loss due to asset impairment related to Romano's Macaroni Grill; Cracker Barrel, which recorded an \$82 million loss due to the sale of Logan's Roadhouse (accounted for in the comparable year-ago period); Landry's, which recorded a \$20 million loss due to the sale of Joe's Crab Shack (also accounted for in the comparable year-ago period). All three companies posted approximately flat same-store sales in the first quarter.

**Lower income meant lower margins.** Margins for the 70 chains (excluding McDonald's) showed a weighted average of 3.7%, compared to 5.7% for the first quarter of 2007. With McDonald's, margins came to 6.7%, compared to 7.8% for the first quarter last year. Even without McDonald's, the LSRs collectively held the line on margins better than FSRs—4.7% in the first quarter of 2008 versus 5.6% in the first quarter of 2007 for the LSRs, and 2.6% versus 5.9% for the FSRs.

**Continued expansion helped revenue advances.** Despite the worsened economic climate, revenues were up 9.1% without McDonald's (or 10.1% with McDonald's). Full-service restaurants boosted revenue totals by 12.5%, versus a non-McDonald's total of 7.5% for the LSRs.

► **Bottom line: Restaurant companies continue to see total revenues grow, but net revenues and margins are being eroded. As consumers cut back further on discretionary spending, chains know that they can no longer count on growth by building more units, and are cutting back on expansion plans. Now, with food and energy prices rising sharply, pressures on the bottom line will only become more severe.**

### Public Company 1<sup>st</sup> Quarter 2008 Industry Summary Results\*

	QUARTERLY REVENUES (\$ M)			QUARTERLY NET INCOME (\$ M)			MARGINS %	
	2008	2007	% CHANGE	2008	2007	% CHANGE	2008	2007
<b>GRAND TOTAL – 71 companies</b>								
LSR total – 33 companies	16,420.24	15,270.37	7.5%	1,448.93	1,325.20	9.3%	8.8%	8.7%
<i>Excl. McDonald's</i>	<i>10,805.44</i>	<i>9,977.67</i>	<i>8.3%</i>	<i>502.83</i>	<i>562.80</i>	<i>(10.7%)</i>	<i>4.7%</i>	<i>5.6%</i>
FSR total – 38 companies	8,320.35	7,397.85	12.5%	213.74	434.49	(50.8%)	2.6%	5.9%
<b>GRAND TOTAL</b>	<b>24,740.59</b>	<b>22,668.22</b>	<b>9.1%</b>	<b>1,662.67</b>	<b>1,759.69</b>	<b>(5.5%)</b>	<b>6.7%</b>	<b>7.8%</b>
<i>Excl. McDonald's</i>	<i>19,125.79</i>	<i>17,375.52</i>	<i>10.1%</i>	<i>716.57</i>	<i>997.29</i>	<i>(28.1%)</i>	<i>3.7%</i>	<i>5.7%</i>
<b>TOP 100 – 44 companies</b>								
LSR total – 20 companies	15,872.45	14,761.14	7.5%	1,457.69	1,356.19	7.5%	9.2%	9.2%
<i>Excl. McDonald's</i>	<i>10,257.65</i>	<i>9,468.44</i>	<i>8.3%</i>	<i>511.59</i>	<i>593.79</i>	<i>(13.8%)</i>	<i>5.0%</i>	<i>6.3%</i>
FSR total – 24 companies	7,841.38	6,967.27	12.5%	214.19	449.40	(52.3%)	2.7%	6.5%
<b>TOTAL TOP 100</b>	<b>23,713.83</b>	<b>21,728.41</b>	<b>9.1%</b>	<b>1,671.88</b>	<b>1,805.59</b>	<b>(7.4%)</b>	<b>7.1%</b>	<b>8.3%</b>
<i>Excl. McDonald's</i>	<i>18,099.03</i>	<i>16,435.71</i>	<i>10.1%</i>	<i>725.78</i>	<i>1,043.19</i>	<i>(30.4%)</i>	<i>4.0%</i>	<i>6.3%</i>
<b>NON-TOP 100 – 27 companies</b>								
LSR total – 13 companies	547.79	509.23	7.6%	(8.76)	(30.99)	N/A	(1.6%)	(6.1%)
FSR total – 14 companies	478.97	430.58	11.2%	(0.45)	(14.91)	N/A	(0.1%)	(3.5%)
<b>TOTAL NON-TOP 100</b>	<b>\$1,026.76</b>	<b>\$939.81</b>	<b>9.3%</b>	<b>(\$9.21)</b>	<b>(\$45.90)</b>	<b>N/A</b>	<b>(0.9%)</b>	<b>(4.9%)</b>

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

## WHEN YOU NEED TO RAISE PRICES: KNOWING WHAT THE MARKET WILL BEAR

At a time when multiple factors are squeezing margins in the industry, operators are increasingly uncertain about how increases in menu prices may impact their customers' visits and purchase patterns. The answers to this question vary from concept to concept, depending on the customer base, why they visit the concept and how they view its value equation.

To give operators some hard data for that evaluation, Technomic conducted a June 2008 survey on consumer price sensitivity. The research showed that consumers have a clear idea of how much they're willing to spend for a restaurant meal, which differs by daypart and type of restaurant. Some highlights:

- **Breakfast:** Most consumers think breakfast should be under \$5 at a fast-food restaurant, but could reasonably be \$5-\$8 at a fast-casual or full-service restaurant.
- **Lunch:** The majority thought \$5-\$8 was an appropriate lunch price range at a QSR (either a traditional fast-food eatery or a fast-casual alternative). For a family-dining place, the most frequently suggested range was \$8-\$12. But for casual dining, almost equal numbers selected the \$8-\$12 range and the \$12-\$15 range as reasonable.
- **Dinner:** For this daypart, consumers' price expectations differ widely. That is, no suggested range for any type of restaurant was cited by more than half of respondents. But the most frequently cited ranges were \$5-\$8 for a fast-food restaurant, \$8-\$11 in a fast-casual or family-style place, and \$12-\$15 for casual dining.

### PRICES THAT CUSTOMERS WILL ACCEPT

Technomic's research found that consumers have an idea in their mind of what they think the price of a meal or a menu item should be. But they also have a sense of what they'd be willing to pay. The research shows that most consumers are willing to pay 13% to 20% more than what they consider the ideal price. At a full-service restaurant, they're a little more resistant—that is, they're willing to pay about 12% to 16% more.

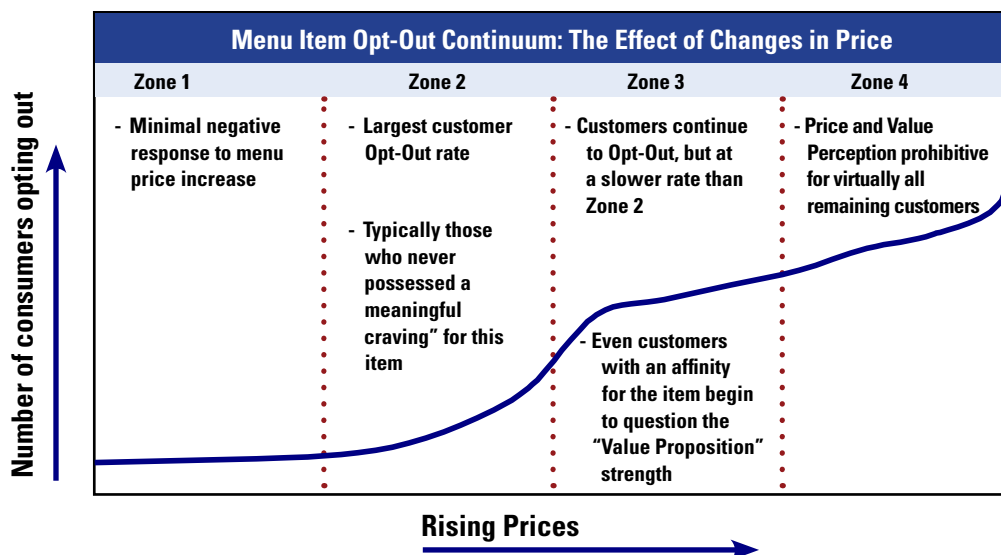
These levels of price resistance may vary based on concept positioning and on every consumer's unique mindset, motivations and "push buttons." While price increases will always result in a certain level of customer trade-out, the rate will vary based not only on the size of the increase but also on the particular consumer.

Additionally, people are willing to be more flexible about the price of some items than they are about others. They'll accept bigger price hikes for items with ingredients or preparation techniques they can't duplicate at home, particularly center-of-the-plate items. Customers will resist price increases on items that are easier to eliminate from a meal, such as appetizers and desserts. They are also more price-sensitive on breakfast and lunch fare.

### THE BREAKING POINT ON PRICE

When does an item's price become too much for the customer to bear? There's no simple yes-or-no answer. A small price increase will have little negative impact on traffic and orders, but a very large one can place the menu item or restaurant out of reach for most consumers. In between these extremes are price ranges that have different effects on different types of customers. This is shown in graphic form on the following page. This generic model is valid for any type of restaurant and any check average.

If we think of the smallest price increases as level 1 and the largest ones as level 4, the middle ranges are level 2 and level 3. Level 2 is a moderate price increase and is associated with the largest customer opt-out rate. Level 3 is a substantial price hike, which will make even more customers opt out. However, the patrons who opt out at level 2 and those who opt out at level 3 are two different types of customers. Those who stop buying an item after a moderate price increase typically can take it or leave it; they never had a real craving for the item. Level 3 opt-outs, who turn away from the item only after a fairly hefty price hike, are core customers who truly enjoy that menu item; it takes a lot for them to question the value proposition, but eventually they will.



## HOW CUSTOMERS OPT OUT

What will these customers do when they walk away from the item at the new price? They might continue to visit your concept but choose different menu items that have a lower price or a higher perceived value. They might turn to takeout, reducing their check average by eliminating server tips as well as beverages, sides and desserts that could be sourced elsewhere. Or they might trade out of your restaurant altogether—migrating to a similar competitor, trading down to a less expensive type of restaurant, trading out to retail foodservice, or preparing their own meals more often.

## WHAT DINERS LOOK FOR

Technomic asked consumers what specific factors would influence their decision to spend more at restaurants, by menu item and by daypart.

Consumers would spend more for premium ingredients and big portions. Recent MarketBrief research on consumer reaction to price increases, published in last month's issue, showed that just over half of consumers would prefer to receive less food at the old price rather than pay more for the same portion. Yet when asked "What would make you pay *more* for a specific type of item?" consumers cited larger portions and premium ingredients:

- **Sandwich:** premium meats, a larger portion, freshly baked bread, premium cheese
- **Salad:** more protein, a larger portion, a side of bread, premium cheese or vegetables
- **Pizza:** premium cheese, a larger portion, more protein

Consumers would pay more for a meal if they liked the restaurant's atmosphere, cleanliness and friendly staff. The most cited factors included:

- **Atmosphere:** 43% said great "atmosphere and ambiance" would make them likely to spend more at dinner, and a third cited atmosphere in relation to their purchasing decisions for the breakfast and lunch dayparts.
- **Cleanliness:** Between 40% and 45% of consumers (depending on daypart) ranked "an exceptional level of cleanliness" as a factor that would soften their objections to higher prices.
- **Friendly staff:** Cited by 40% in connection with dinner and by about a third in connection with breakfast and lunch.
- **Fresh bread:** The aroma and taste of "bread baked fresh daily in the restaurant" appealed to 43% in connection with breakfast and 40% in relation to lunch.
- **Premium meats:** The use of high-end meats would influence 40% to spend more for dinner items and 33% to spend more at lunch.

► **Bottom line:** *Most consumers don't hold operators responsible for reasonable menu price increases, but they have a keen sense of the concept's value equation. It's essential to understand how your consumers view your menu and how they will tolerate price increases, and then act accordingly.*

## BUSINESS-BUILDING IMPLICATIONS

- Your goal is to raise menu prices yet minimize the number of consumers opting out of the particular menu item or the entire concept. Before doing that, ask: Why are people visiting our restaurant? Knowing the answer will enable you to present a value equation that keeps customers operating within their comfort zone as they make purchase decisions. Compatibility with the consumer's lifestyle, a craveable menu, service, hospitality and the restaurant's atmosphere all have an impact on consumers' price sensitivity.
- To understand your own price-value equation, you should also know your competitors and their prices. Before making menu decisions, check the menus of similar restaurants in the area (as well as a few that are slightly more upscale or downscale). To quantify your restaurant's value equation, rank price ranges of 10 relatively similar concepts for different mealparts. Yours should be within the range even after price increases are taken.
- Customers are most willing to pay more for "craveable" items that have no substitutes and that they can't duplicate on their own. The menu should be designed and priced with this in mind. Though center-of-plate items rate high in craveability, the right appetizers and desserts can also be must-have-at-any-price items.
- Consider multi-tier pricing to give customers a range of options from inexpensive to premium. McDonald's, for instance, promotes Dollar Menu items and premium salads and sandwiches along with a menu of core items at middling price ranges.
- Perception of premium ingredients is key, but it must be created before the customer tastes the item. Consider enticing menu descriptions, quality photography and the use of familiar consumer-branded products to position an item as premium.
- Consider adding bread baked on-premise to enhance "fresh" positioning.
- Non-food components of the value equation, from ambiance to exceptional cleanliness to friendly service, play a big part in how consumers value your restaurant and its menu and consequently on how much they're willing to pay.

For questions or clarification on Technomic's recent Menu Price Elasticity Study, feel free to contact Darren Tristano, Executive Vice President, Technomic, Inc., at 312-506-3850 or [dtristano@technomic.com](mailto:dtristano@technomic.com).

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