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2017 Annual Spring Meeting

Why Are My Favorite Restaurants Closing? Review and Forecast of Restaurant Case Issues

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American Bankruptcy Institute 2017 Annual Spring Meeting Marriott Marquis, Washington, D.C.

WHY ARE MY FAVORITE RESTAURANTS CLOSING? REVIEW AND FORECAST OF RESTAURANT CASE ISSUES

April 21, 2017, 10:00 a.m.

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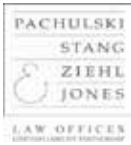


State of the Industry

The restaurant business is always precarious:

- Capital intensive
- Saturated industry
- Fickle consumers
- Expansion through incurring debt
- Leased real estate

(Source: J. Maze, Nation's Restaurant News, "Why so many restaurants are filing for bankruptcy" (September 28, 2016))



State of the Industry

From 2008 to 2016, restaurants lost roughly 14% of their foot traffic.

2016 “especially brutal” for the restaurant industry: the most major chain bankruptcies since the recession



(Source: DallasNews (The Dallas Morning News), “The taste of defeat: Why restaurant bankruptcies are on the rise” (January 27, 2017))

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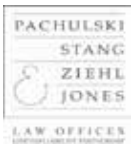
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State of the Industry

By mid-2016

In general, restaurant same-store sales declined for the first time in over 6 years. But, varying performance by segment:

- Fine dining (e.g., Ruth’s Chris): .1% YOY decline
- Casual dining (e.g., Applebee’s): 1.6% YOY decline
- Family dining (e.g., Chuck E. Cheese, Denny’s): .7% YOY growth
- Fast casual (e.g., Panera Bread): 2.2% YOY decline (mostly due to Chipotle’s troubles, others flat growth)
- Quick Service Restaurants (e.g., Burger King, Taco Bell): 1.7% YOY growth

(Source: Trinity Capital Investment Banking, Restaurant Industry Commentary & 2nd Quarter 2016 SSS)

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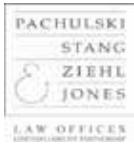
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Declining Sales

Sales at chain restaurants open at least 18 months dropped 2.4% in the quarter that ended in December 2016. Bleakest quarterly performance by the industry in over 5 years. December store sales drop of 4.3% was lowest monthly showing in over 3 years.

Fewer diners

Only 26% of restaurant operators reported an increase in customer traffic between November 2015 and November 2016.

Too many restaurants

Between 2006 and the industry's peak in 2014, the number of restaurants in the U.S. grew 7.3% to more than 638,000 – outpacing the 6.9% growth rate of the U.S. population over that period

(Sources: TDn2K, C. Jones, USA Today, "Many restaurant chains still struggling" (January 20, 2017); National Restaurant Association, Restaurant Performance Index, November 2016; J. Jorgan, L. Rizzo, Wall Street Journal, "Restaurant Chains Get Burned by Overexpansion, New Rivals" (October 16, 2016))

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Potential Factors Leading to Restaurant Financial Distress

- Changing diner demographics
 - Millennials dining out more frequently than baby boomers.
 - Changing preference for convenience, order customization, speedy service, quality ingredients and value, more favorable for fast casual format, rather than older casual dining segment.
- Declining sales
- Fixed or increasing rents
- Increasing labor costs: rising minimum wage requirements
- Debt loads due, in part, to overexpansion, stimulated by low interest rates
- Lower food prices, leading potential diners to eat at home
- Alternate dining options: meal-kit delivery services (e.g., Blue Apron), prepared foods from grocery stores

(Source: BDO, "The Counter: Restaurant Industry Scorecard", Q3 2016; J. Jorgan, L. Rizzo, Wall Street Journal, "Restaurant Chains Get Burned by Overexpansion, New Rivals" (October 16, 2016))

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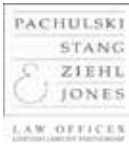
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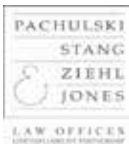
Casual Dining

- Casual Dining segment suffering the most: Bar-and-grill format the worst
- Older restaurants: need to remodel
- Stagnating format: need new menu items
- Need to drive revenues through increased traffic, not price increases (implemented post-recession)
- Most recent restaurant bankruptcies are casual dining concepts (followed by family dining chains).

(Source: Id.)

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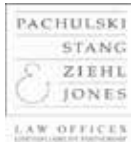


Restaurant Bankruptcies

Case	Court	Industry	Date	Results
HDOS Enterprises	Bankr C D Cal LA	Operates Hot Dog on a Stick restaurants	02/03/2014	Sale 8/14; liquidating plan confirmed 10/14
Buffet Partners, L.P.	Bankr N D Tex	Owens and operates buffet restaurant chain under the name Furr's Fresh Buffet	02/04/2014	Sale 4/15; case converted
Sbarro LLC	Bankr S D N Y	Global operator of Italian quick service and casual table dining restaurants	03/10/2014	Sale 5/14; plan confirmed 5/14
QCE Finance LLC	Bankr D Del	Operates Quizno's restaurant chain	03/14/2014	Plan confirmed 05/12/14. Final decree 12/15/15 Pre-pack
Fired Up, Inc.	Bankr W D Tex	Owens, operates and licenses Johnny Carino's Italian restaurants worldwide	03/27/2014	Plan confirmed 12/19/14; Case closed 03/31/16 Straightforward reorganization
S.B. Restaurant Co.	Bankr C D Cal SA	Operates Elephant Bar restaurants	06/16/2014	Sale 8/14; case dismissed
Verax Restaurant Group, Inc.	Bankr C D Cal LA	Operates a Denny's restaurant	08/26/2014	Order approving stipulation to dismiss case with one year refiling bar entered 07/09/15; Case dismissed 10/01/15
Sonoma Chicken Coop Skyport, Inc.	Bankr N D Cal	Restaurant	12/17/2014	Case dismissed 01/14/15 on motion of Debtor

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Restaurant Bankruptcies

Case	Court	Industry	Date	Results
J & B Partners Management LLC	Bankr S D N Y	Franchisees of Friendly's family-oriented restaurant chain.	01/06/2015	Plan confirmed 06/26/15. Final Decree entered 07/06/16
SW Liquidation, LLC, fka Saladworks, LLC	Bankr D Del	Fresh salad restaurant franchise	02/17/2015	Liquidation plan confirmed 10/29/15
Tutti Mangia Italian Grill, Inc.	Bankr C D Cal	Italian restaurant	02/19/2015	Plan confirmed 06/07/16; Final decree entered 08/16/16
Boston Restaurant Associates Inc.	Bankr D Del	Restaurant chain	05/20/2015	Plan confirmed 08/24/15 Final decree 10/29/15 Straightforward reorganization
Z'Tejas Scottsdale, LLC	Bankr D Ariz	Chain of casual dining restaurants.	07/22/2015	Converted to CH 7 on 03/02/16
Frontier Star, LLC	Bankr D Ariz	Equity owner and provider of management services, respectively, for Hardee's and Carl's Jr. restaurant franchises.	07/27/2015	CH 11 Trustee appointed. No sale or plan documents filed yet.
QSL of Medina, Inc.	Bankr N D Ohio	Owner of chain of automotive themed casual dining restaurants	11/16/2015	Sale 08/04/16; Plan confirmed 12/16/16
Restaurants Acquisition I, LLC	Bankr D Del	Operator of chain restaurants Black-eyed Pea and Dixie House primarily located in the Dallas-Fort Worth and Houston metropolitan areas	12/02/2015	Case converted to CH 7 09/30/16

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Restaurant Bankruptcies

Case	Court	Industry	Date	Results
Buffets, LLC (2016)	Bankr W D Tex	Owns and operates 150 buffet-style restaurants in more than 25 states.	03/07/2016	Highly contested sale hearing set for 04/04/17
East Coast Foods, Inc.	Bankr C D Cal LA	Owner of Roscoe's Chicken and Waffles restaurant chain.	03/25/2016	CH 11 Trustee appointed. No sale documents or plan filed yet.
Fired Up, Inc. (2016)	Bankr W D Tex	Hospitality company that owns and operates the Johnny Carino's Italian chain of restaurants	07/14/2016	Sale 10/07/16
Last Call Guarantor, LLC, for itself and on behalf of each of its series	Bankr D Del	Owns and operates sports bar and casual family-dining restaurants under Fox & Hound, Bailey's Sports Grille, and Champps	08/10/2016	Sale 09/20/16 – UTS has filed a MTD based upon lack of filing MORs and paying UST fees. Liquor license transfers still in process.
Sonoma Chicken Coop Skyport, Inc.	Bankr N D Cal	Restaurant	08/23/2016	Case dismissed 09/15/16 for failure to file Schedules & Statements
Cosi, Inc.	Bankr D Mass	Fast-casual restaurant chain	09/28/2016	Plan filed 02/07/17 – DS hearing set 03/21/17
Garden Fresh Restaurant Intermediate Holding, LLC	Bankr D Del	Fast casual restaurant chain	10/03/2016	Sale 01/09/17
Rita Restaurant Corp.	Bankr W D Tex	Casual Tex-Mex dining chain	10/04/2016	2 nd Amended Plan filed 03/08/17. Confirmation hearing set 04/12/17
DIP, Inc.	Bank D R I	Casual dining	10/31/2016	Case is pending. No sale documents or plan filed yet

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Restaurant Bankruptcies

Case	Court	Industry	Date	Results
WK Capital Enterprises, Inc.	Bankr D KS	Owner of 56 Pizza Hut restaurants in six states	01/23/2017	Sale Motion forthcoming. Letter of Intent submitted to purchase 52 out of 56 stores 03/08/17
Lone Star Steakhouse & Saloon of Springfield, Inc.	Bankr E D Tex	Restaurant chain	02/13/2017	341(a) set 03/17/17
TX. C. C., Inc. 2017	Bankr E D Tex	Owns and operates a chain of restaurants	02/13/2017	341(a) set 03/17/17

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Trade Creditor Concerns

Brad Boe

Performance Food Group; Denver

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TRADE CREDITOR PRE-PETITION CONCERNS

- Capital structure – debt maturity schedules, current portion of long term debt, interest expense, liquidity (there should typically be 40 days of liquidity in a restaurant operation yet Logan's had 5 days liquidity when they filed Chapter 11)
- Declining EBITDA
- Declining same store sales
- Resignation of CEO/CFO
- Can you raise prices without having a negative impact on sales
- If there is a history of discounting, what portion of the customer base will you lose if you eliminate discounting
- The price differential between grocery stores and restaurants is at an all-time high meaning people are eating at home more often than going out – supermarket deli's and meal kit sellers are thriving
- The homogenous nature of the casual dining sector – restaurants do not distinguish themselves from one another. If one chain closed today no one would notice
- Eliminating or drastically reducing cap ex spending
- Too many casual dining restaurants open – the industry needs a shakeout akin to the theatre chain filings in the early 2000's when thousands of screens were closed
- Slowdown of customer payments – giving up the discount
- Requests from restaurants for extended terms
- Creditors need to stay the course with terms unless it can be in the form of a contemporaneous exchange (Sears, Charlie Brown's) to eliminate preference exposure

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TRADE CREDITOR POST-PETITION CONCERNS

- Try to be appointed to the unsecured creditors committee
- Undergo a preference defense analysis
- Obtain critical vendor status
- Obtain PACA payments
- Analyze 503(b)(9) claims – enter into a trade creditor agreement for post-petition payment of pre-petition admin claims in the ordinary course in exchange for post-petition terms of sale
- Evaluate strategic alternatives – pursue a strategy that maximizes value for the unsecured creditors – this may mean a lower recovery while increasing liquidity for the debtor to give a longer runway to success
 - Assess whether the restructuring will create a viable business going forward or whether the process is being run solely for the benefit of the secured creditors
 - Determine whether a restructuring is preferable or whether a sale is in the best interests of creditors and will generate greater recoveries
- Review short term liquidity projections – do the short term cash flow projections allow for reasonableness of the size of the DIP and exit facilities
- Assess cost management and top line stabilization
- Assess the terms of the DIP – preserve and pursue the pre-petition unencumbered assets for the benefit of the GUC's
- Assess the go forward business plan – review debtor's projections and develop an independent point of view of the business plan and long term liquidity
- Investigate pre-petition liens – validate properly perfected liens
- Minimize dilution of recoveries – understand contract rejections and potential damage claims
- Assess possible causes of action – analyze pre-petition transactions, current and former management, insiders, and challenge blanket releases for negotiations to maximize unsecured creditor recoveries

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Certain Key Legal Issues Arising in Restaurant Chapter 11 Cases

John E. Mitchell

Akerman LLP; Dallas

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There are multiple legal issues that either are unique to restaurant Chapter 11 Cases, or otherwise can end up being seminal issues that drive the success or failure of the restructuring. The following are just a few of the issues that can arise in the Chapter 11 restructuring of a restaurant chain.

I. Landlord / Tenant & Real Estate Issues in Chapter 11.

1. Timing of the Chapter 11 Filing.
 - a. Store closures, termination of leases & lockout issues.
 - Timing of the filing is often critical.
 - b. Payment of Partial Rent / Delaying First Month's Rent.
 - i. Post-petition Rent:
 - Bankruptcy Code § 365(d)(3) requires a debtor to "timely perform all obligations of the debtor...until such lease is assumed or rejected"
 - Bankruptcy Code § 503(b)(1) "actual and necessary costs and expenses of preserving the estate."
 - Stub Rent? Billing Date Approach v. Proration Approach; varies by circuit.
 - Billing date: 3rd, 6th, 7th, 8th, S.D. Tex., D. Del.
 - Proration: 2d, 4th, 9th, 10th
 - ii. File in first 5 – 10 days of month?

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- c. Prepetition Notice of Default with Cure Deadline – Is there an Automatic Termination?
 - i. If a lease has been terminated prepetition, it cannot be assumed by the debtor.
 - o Bankruptcy Code § 365(c)(3): "The trustee may not assume or assign any executory contract or unexpired lease of the debtor...if such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief."
 - ii. Automatic Termination Post-petition?
 - o Bankruptcy Code § 362(b)(10): "[The automatic stay does not apply to] any act by a lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under the title to obtain possession of such property.
 - o *See In re C.W. Mining Co.*, 641 F.3d 1235 (10th Cir. 2011). A nonresidential lease can, under certain circumstances, automatically terminate post-petition despite the automatic stay. In such cases, the lease ceases to property of the estate. Like with any other contract, however, the **termination must occur automatically**, without further action by the landlord.
 - o Bankruptcy Code § 108(b) provides for a 60 day extension, in certain circumstances.

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2. Assumption / Rejection of Leases.

- a. Master Lease Issues.
 - i. Leases for multiple locations structured as unitary, master leases.
 - ii. Bankruptcy Code § 365(b) authorizes assumption of an executory contract or unexpired lease. The general rule is that a debtor must assume or reject a contract in its entirety. *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996).
 - iii. Exception: Severable leases and contracts. "Where a contract, though contained in a single document, is divisible into several different agreements, some of the divisible agreements may be assumed or rejected under § 365 without assuming or rejecting the entire contract." *Id.* at 389. This can include master agreements. *Stewart Title*, 83 F.3d at 739.
 - iv. A severable or divisible contract is one that "includes two or more promises each of which can be enforced separately, so that failure to perform one of the promises does not necessarily put the promisor in breach of the entire contract." BLACK'S LAW DICTIONARY 324 (7th ed. 1999). Courts which have analyzed the issue of severability look to the state law governing the agreement in order to determine whether an agreement is divisible for § 365 assumption and rejection purposes. *See In re Convenience USA*, 2002 WL 230772, at *2(Bankr. M.D.N.C. 2002); *Stewart Title*, 83 F.3d at 739; *In re Plum Run Serv. Corp.*, 159 B.R. 496, 498–99 (S.D. Ohio 1993).

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- v. *Stewart Title*, decided under Texas law, determined that a contract is divisible, or severable, when one party's performance consists of more than one "distinct and separate item[] and the price paid by the other party is apportioned to each item." No one test or rule of law can be used to ascertain whether a contract is divisible or indivisible. Determination of the issue depends primarily on the intention of the parties, the subject matter of the agreement, and the conduct of the parties. *Stewart Title*, 83 F.3d at 739 (citations omitted).

b. Cure Issues.

- i. Bankruptcy Code § 365(b)(1)(A) provides that a contract cannot be assumed unless all defaults have been cured (or will be cured).
- ii. What about unliquidated, unmatured obligations? Known to landlord?

ORDERED that upon entry of this Order approving the assumption of the Real Property Lease and payment of the Cure Amount, the Landlord is forever barred, estopped, and permanently enjoined from asserting against the Debtors any monetary defaults, non-monetary defaults, or claims that are (i) determined as of [DATE] (ii) known to the Landlord, and (iii) if asserted, would give rise to a default under the Real Property Lease existing as of [DATE]. The prior sentence shall not apply to the following, which the Debtors shall remain liable for: (i) amounts owed under the Real Property Lease that are unbilled or not yet due as of [DATE], such as common area maintenance, insurance, taxes, and similar charges; (ii) any regular or periodic adjustment or reconciliation of charges under the Real Property Lease which are not due or have not been determined as of [DATE]; (iii) any percentage rent that may come due under the Real Property Lease; or (iv) other obligations, including indemnification obligations, if any, unknown to the Landlord under the Real Property Lease as of [DATE].

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c. Timing of Assumption / Rejection

- i. Bankruptcy Code § 365(d)(4). Nonresidential real property leases are deemed rejected if not assumed within 120 days of the petition date. A bankruptcy court can grant a one-time 90 day extension. Thereafter, a landlord must give written consent for any further extensions.
 - Automatic and deemed rejected. No order. Clear title issues for landlords in certain jurisdictions, i.e. California?
 - Order must be entered by bankruptcy court prior to running of deadline.

d. Performance Pending Assumption / Rejection

- i. Billing Date Approach v. Proration Approach
- ii. Prepetition Taxes Arising Post Petition
 - What are the terms of the lease?

II. Franchisor / Franchisee.

- a. Issues to Consider when the Franchisor is the Debtor.
 - i. Rejection of franchisee agreements.
 - ii. Impact on franchisee's ability to use intellectual property.
 - iii. Enforceability of non-compete agreements.
- b. Issues to Consider when the Franchisee is the Debtor.
 - i. Franchisor controls Chapter 11 often with greater rights than senior secured lender.
 - ii. Assignability of franchise agreements to third parties over franchisor objection.
 - iii. Pre-bankruptcy sales of franchise. Fraudulent transfer and preference risk? Who owns the customer lists? What value for release of a non-compete?

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III. Cash Collateral. Does the Court need to engage in an analysis of how much time it takes to prepare food?

- a. Bankruptcy Code § 363(c)(2) provides that a debtor-in-possession may not use, sell or lease cash collateral unless each entity with an interest in the cash collateral consents or the court authorizes the use of cash collateral.
- b. Bankruptcy Code § 363(a) defines cash collateral as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property . . . whether existing before or after the commencement of a case under this title.
- c. Bankruptcy Code § 552(a) limits a secured creditor's interest in post-petition property of the estate. "Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

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- d. Bankruptcy Code § (b)(1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
- e. *In re Cafeteria Operators, L.P.*, 299 B.R. 400 (N.D. Tex. 2003). Not all cash proceeds generated post-petition are cash collateral of prepetition lender's collateral. "Restaurant revenues are primarily the fruit of Debtors' labor; however, they do contain some component of proceeds of inventory. Thus, the cash generated from the sale of the inventory is Bank Group's cash collateral. In the alternative, pursuant to § 552(b), the equities of the case warrant limiting the Bank Group's interest in Debtors' post-petition cash to the value of the Debtors' inventory subject to Bank Group's lien that is converted to cash upon its sale."

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IV. Fair Labor Standards Act (FLSA), 29 U.S.C. § 201 et. seq.

- a. The [Fair Labor Standards Act \(FLSA\)](#), also known as the federal Wage and Hour Law, regulates minimum wage, overtime, equal pay, recordkeeping, and child labor for employees of enterprises engaged in interstate or foreign commerce, and employees of state and local governments.
- b. Increasingly in Chapter 11's, attorneys are seeking to bring "collective actions" under 29 U.S.C. § 216(b) to recover minimum and overtime wages on behalf of wage earners.
- c. In the restaurant industry, many employees have what are called "dual jobs." When an employee is employed by one employer in both a tipped and a non-tipped occupation, such as an employee employed both as a maintenance person (i.e. cleaning the bathrooms) and a waitperson (earning tips), a tipped employee cannot spend more than 20 percent in the workweek in non-tipped duties, otherwise, minimum wage must be paid.
- d. Collective actions outside the Chapter 11 process can be expensive, but attorneys pursuing collective actions against Chapter 11 debtors can use the various noticing requirements and opportunities in Chapter 11 to notice past employees and solicit consents to proceed in the collective actions (i.e. notices included with a plan and disclosure statement). Claims may include prepetition unsecured, priority, and current post petition administrative wages.

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V. Structured Dismissals.

- a. *Czyzewski v. Jevic Holding Corp.*, - S.Ct. -, 2017 WL 1066259, at slip op. *2 (U.S. Mar. 22, 2017). The bankruptcy cannot order a distribution scheme in connection with the dismissal of a Chapter 11 case, without the consent of the affected parties, that deviates from the basic priority rules that apply under the primary mechanisms the Bankruptcy Code established for final distributions of estate value in business bankruptcies.
- b. Structured Dismissals are Increasingly Popular.
 - i. Issues post dismissal
 - BNC Notices
 - Automatic Stay Lifts / Litigation commences
 - Confusion among creditors / No finality
 - Not all creditors are paid / Who bears the responsibility?

VI. WARN Act Issues.

- a. Worker Adjustment and Retraining Notification Act, 29 U.S.C. § 2101, et seq. The WARN Act requires certain businesses and employers to give at least 60 days' advance written notice of a plant closing or mass layoff.
- b. Failure to do so prior to the Chapter 11 filing could result in significant administrative claims being incurred by the estate.

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Distressed Restaurant Operational Challenges

Jonathan M. Tibus

Alvarez & Marsal, Atlanta

Craig Boucher

Mackinac Partners, Washington, D.C.

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This should be easy...

- **Macro trends have been great the last few years:**
 - Unemployment trending down for 5+ years
 - Steady economic growth
 - Low gas prices & interest rates = more consumer discretionary spending
 - Low interest rates & commodities = lower costs
 - Valuations on the rise

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But bad news abounds

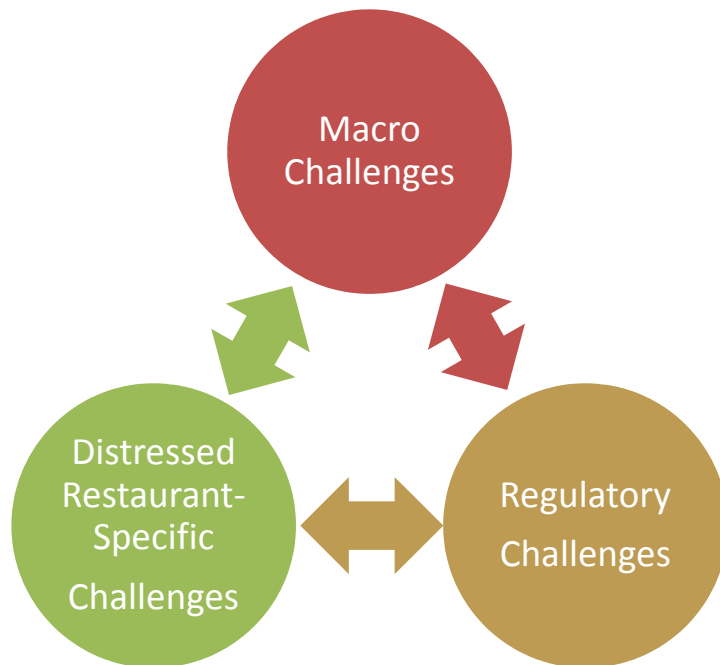
- In addition to all of the Ch. 11's -

SSS Down	<ul style="list-style-type: none"> • Down 2.4% in 2016, worst year since the recession* • Traffic trends worse than SSS at most, implying "death spiral"
Chronic heavy discounting	<ul style="list-style-type: none"> • Gross-to-net sales erosion • Endless appetizers, "2-can-dine", kids eat free
Activist Investors re-energized	<ul style="list-style-type: none"> • Took a breather in 2016, but back in the mix • Darden, Bob Evans, Buffalo Wild Wings, Fiesta, Bravo Brio, Chipotle
CEO Turnover & Vacancies	<ul style="list-style-type: none"> • Popeye's, Quiznos, DineEquity (Applebee's & IHOP), Ruby Tuesday's, Papa Murphey's, Fiesta Restaurant Group, Noodles & Co.
Daily news of store closures	<ul style="list-style-type: none"> • Famous Dave's, Noodles, Logan's, Ruby Tuesdays, outback, Cosi, Garden Fresh, Buffets

* TDn2K "BlackBox"

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Primary Challenges



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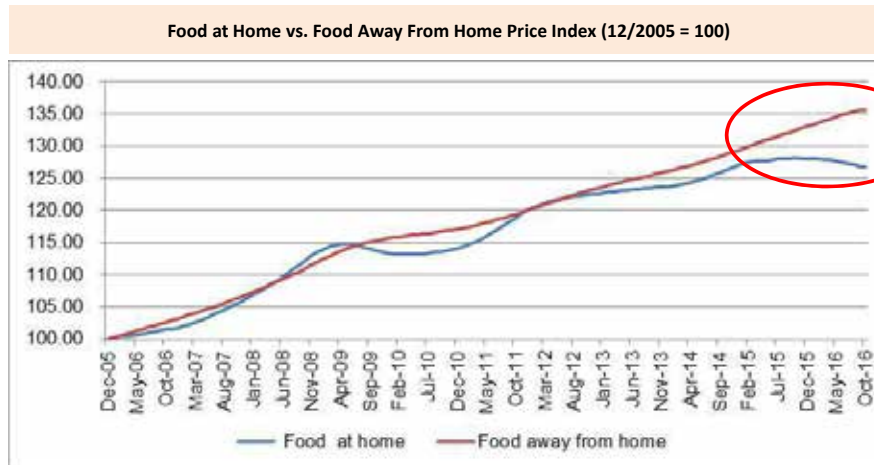
Macro Challenges

- **Overcapacity:**
 - Low interest rates = too much real estate = too many real estate deals
 - 2,500 retail stores closed in 2016; 300-400 malls expected to go out of business
 - Heavy Tenant Improvement investment is a operations time bomb
 - Consolidation trends in distributors higher case fees and push towards private-label and house-brand product
 - Sysco & US Foods. Back on?
 - Regional consolidation
 - Consolidation trends in food producers leading to higher prices (currently obscured by low commodity prices)
 - Heinz/Kraft/Mondelez,
 - Anheiser Busch/SAB Miller
 - Four companies control almost all pork, cattle, chicken, and milk production

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Macro Challenges

- **Commodity prices influencing behavior:**
 - Spread between Food-at-Home and Food-away-from-home is wider than it's been in years, and growing ←
 - Negative impact on restaurant traffic, even as it improves gross margins



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Regulatory Challenges

- Affordable Care Act (in flux)
- FLAA minimum wage: Standard Salary Level = \$48k (on hold)
- Menu labelling Requirements (delayed several times)
- PCI Compliance (ongoing)
- Chip-and-PIN/Cybersecurity costs/data breach risks and costs (ever evolving)
- State and Local regulations re: scheduling, time off, personal leave (ever evolving)
- Federal and local minimum wage increases
- NLRB ruling that franchisors are “joint employers” (being challenged)

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Distressed Restaurant Specific Challenges

- **Assets have been bled to death or near-death**
 - Tired décor, aging and mis-matched small wares, patched up kitchen equipment
 - Ongoing cash triage between stores, spend limited to health and safety issues
- **Managing for Optionality**
 - Need to preserve all forms of *potential* value (e.g. keep a store open b/c it may have real estate value, even if it's an underperformer)
 - Inefficient SG&A, and difficulty making strategic changes
- **Planning and Implementation Cycles Becomes Broken**
 - Inability to commit to next years' purchases, product introductions, promotional calendars, IT investments, even menu cycles
- **Morale, accountability, turnover, "Quitting on the job"**
 - Lack of stability and strategy leads to low moral and turnover
 - Difficult to find quality replacements - do without, or turn to consultants and temps
 - Difficult to push improvements through – resistance, limited training, indifference

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Management Responses to Challenges

- **Near term price/cost fixes**
 - Raise prices
 - Trim portions / "Value engineer" the menu (sometimes aka lower quality)
 - Tighten productivity controls
 - Careful not to sabotage sales (staff for the sales you *should* have)
- **Cut SG&A and Marketing – and hope you don't get it wrong!**
- **Close underperforming stores**
 - Almost never the case somehow that poor stores have leases near termination
 - Landlords receptive to negotiations to avoid dark stores – in the right locations
- **The "Easy Button"...**
 - Common response to try a "big idea" – no tipping, outlandish promotion, huge IT investment w/ questionable payoff, strategic pivot
 - Doomed to fail w/o buy-in, including investments in store condition, training, and marketing support

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Conclusions

- **What's Ahead**

- More soft traffic – no external catalyst for that to change
- Hope for marginal brands on regulatory and compliance costs, but probably not enough to overcome other macro factors
- Ongoing shakeout in Casual Dining – too many stores, too many brands that have under-invested for years.
 - Death spiral already initiated in many places, consolidations will continue
- Fast-Casual is next (Pie Five, Noodles)
 - Crowded field, after years of investors chasing the trend
 - Concepts will get squeezed as QSR moves up and Casual Dining moves down
- “Restaurants have historically led the market lower during the three-to-six-month periods prior to the start of the prior three U.S. recessions.” So....

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