



THE CYPRESS GROUP

"Results through Focused Expertise"

Investment Bankers
Exclusively Serving the
Restaurant Industry

Observations on the New Realities of the Restaurant Industry

SPECIAL POINTS OF INTEREST:

- **Restaurant Finance & Development Conference:**

Cypress is pleased to announce that Dean Zuccarello, & J.B. Hewetson of The Cypress Group, will be moderating a panel on Mergers & Acquisitions at this year's 2009 conference. The conference is being held November 9-11 at the Bellagio Hotel in Las Vegas

The Cypress Group provides a full range of Investment Banking and Strategic Advisory Services to the Restaurant Industry

Services Include:

- Mergers, Acquisitions & Divestitures
- Restructuring, Turnaround Situations & Bankruptcy
- Capital Formations: Debt & Equity
- Strategic Advisory Services
- Valuations & Fairness Opinion
- Litigation Support

Since 2008, the economy, consumers, and the restaurant industry have been in the vice grips of America's deepest and longest recession since the Great Depression. Finally, a light at the end of the tunnel is beginning to emerge with most economists now saying that we have reached or passed the bottom. While the going is certainly still rough, business conditions are beginning to improve, unemployment is stabilizing and consumers are dipping their toes back in the spending pool. Additionally, capital flow is increasing with equity investors coming off the sidelines and lenders beginning to seriously pursue new debt facilities for borrowers. With the economic recovery will come increases in consumer spending, restaurant traffic, transaction counts, and sales levels. However, we do not expect a rebound to pre-2008 levels. The restaurant industry, just like the broader economy, faces a new reality, and operators who approach it with a flexible, creative mindset realizing that it's no longer "business as usual" will prevail. Our key observations are as follows:

Industry Dynamics: Survival of the Fittest -

The economy is recovering, but the current shakeout is not over. Our industry will continue to see store closures, balance sheet restructurings, and bankruptcies in the near term. The winners and survivors will typically be larger, well established concepts with the brand strength, marketing, and advertising to drive traffic from a more cautious and fiscally conservative consumer. In addition, focused concepts that have a strong "local" presence with the ability to differentiate their brands from national competitors will also do well. Overall, industry unit growth will slow considerably and industry consolidation will continue. Operators should micro-manage existing operations and realize that a significant portion of near-term growth opportunities will come from acquisitions and/or conversions. For well capitalized, opportunistic acquirers, the market will be quite ripe. Brands that develop and execute an effective acquisition strategy will be in a position to take advantage of the current downturn and pursue a growth strategy with lower unit investment, more predictable cash flow, and compelling unit level economic returns with more upside when traffic rebounds.

Value Proposition, Differentiation, and Segment Migration -

The consumer's focus on value will remain and signifies a shift in consumer behavior that must be addressed. Concepts must effectively communicate their value proposition and become "top of mind" when consumers evaluate choices. While offering value in terms of price is very important and will be critical to concepts' success going forward, the most successful brands will develop a value strategy that encompasses facets other than just the lowest price. These successful concepts must also provide customers with exceptional value in service, menu quality, and experience to differentiate their brands from competitors. Segment migration will continue to evolve as consumers shift between and among fine dining, casual, quick casual, and QSR brands. For example, an upscale quick casual concept can benefit from migration from both casual dining and QSR if the concept can successfully satisfy new consumer value expectations in terms of price, service, and quality.

Debt Capital Markets -

As has occurred in prior recessions and recoveries, the debt capital markets will evolve to align with the new post-recession economy. In the next 18 months, we will see significant evolution in debt capital sources for our industry. The conventional industry financing sources have curtailed lending activity and some have even shut down operations. Some of these long term players will return, but new groups will also emerge to provide debt capital for a variety of uses across the industry. Be prepared and flexible in working with old sources of capital while embracing these new sources. Understand that all companies will be operating under new, stricter standards in loan underwriting and credit management for the foreseeable future. The timing on capital structure approvals and closings will be extended. From an underwriting perspective, lenders will place heightened emphasis on historical performance, especially sales and costs trends which will trump projections. Secondary sources of repayment will be reviewed and analyzed and required equity contributions will increase. Borrowers should expect higher interest rate spreads, increased fees, tighter covenants, and more frequent monitoring of financial statements and business performance.

Equity Capital Sources -

Equity capital will become a more critical and necessary component of restaurant company business plans than ever before. The ability of restaurant companies to expand solely by monetizing existing operations will be limited. Our industry will be well served to embrace outside equity and financial partners, particularly for expansion purposes. Franchisors must reconsider their view on external equity partners (e.g. private equity) in their franchise system and take creative approaches as some have already done in creating in-house funds to promote system growth. Franchisees will have limited and restricted ability to internally fund future capital requirements for growth and capital investment spending. Concepts that are flexible in welcoming new equity and junior capital will be able to achieve higher growth, new brand participants, and expansion.

Conclusion –

All participants across the industry have been in survival mode for the past 18 months, if not longer. Finally, the dust is beginning to settle. Unfortunately, some industry participants have not survived and others will continue to struggle as going concerns, but for those companies still in operation, all will have a new reality to face and embrace across the industry. Companies must be flexible in adapting to this new way of doing business and not forget what has allowed us to still be standing here today; running our businesses with a solid team system-wide and making ourselves the obvious choice for the customer. To sum it all up, the restaurant industry, just like the broader economy, is evolving, and those operators who are on the front end of the curve and opportunistic will come out the other side as industry and market leaders.

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