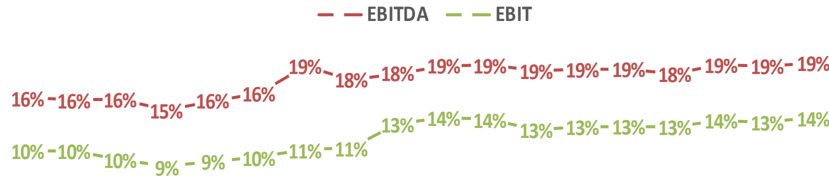
The Restaurant Group

London: RTN

The Restaurant Group (London: RTN)
Stock Price: 325p

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Ruby Tuesday	0.35	0.47	5.00	13.92	5.16
Bloomin Brands	0.76	1.13	7.27	12.43	12.43
Cheesecake Factory	1.19	1.56	9.10	13.26	11.87
Darden	1.20	1.73	10.80	18.81	14.95
Brinker	1.24	1.68	8.19	12.01	15.18
Minimum	0.35	0.47	5.00	12.01	5.16
Maximum	1.24	1.73	10.80	18.81	15.18
Median	1.19	1.56	8.19	13.26	12.43
Mean	0.95	1.31	8.07	14.09	11.92
STDEV	0.39	0.53	2.16	2.74	4.05
CV	41%	40%	27%	19%	34%
The Restaurant Group	0.82	1.03	4.21	5.96	6.29



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Min	Max	Median	Mean	Standard Deviation	Variation
Sales	186	205	218	228	216	227	200	264	314	367	417	436	466	487	533	580	635	685	186	685	340	370	165	45%
Gross Profit	29	32	32	32	33	37	36	47	60	73	81	79	86	89	97	110	119	132	29	132	66	67	34	51%
EBITDA	29	32	34	33	34	37	38	47	58	70	80	81	87	92	98	112	122	133	29	133	64	68	34	51%
EBIT	19	21	21	20	20	22	21	28	41	51	57	55	60	63	69	79	85	94	19	94	46	46	25	55%
Receivables						15	15	15	17	19	19	18	19	21	22	22	23	26	15	26	19	19	3	17%
Inventories						2	3	3	3	3	4	4	4	4	4	5	5	6	2	6	4	4	1	29%
PP&E						145	150	153	163	201	240	253	257	264	281	316	353	386	145	386	253	243	79	32%
Working Liabilities						50	54	65	73	80	85	82	81	85	91	99	108	119	50	119	82	82	20	24%
Net Tangible Assets						113	114	107	109	143	178	193	199	204	218	244	273	299	107	299	193	184	64	35%
MARGINS																								
Gross	15%	16%	15%	14%	15%	16%	18%	18%	19%	20%	19%	18%	19%	18%	18%	19%	19%	19%	14%	20%	18%	18%	2%	0.10
EBITDA	16%	16%	16%	15%	16%	16%	19%	18%	18%	19%	19%	19%	19%	19%	18%	19%	19%	19%	15%	19%	19%	18%	2%	0.09
EBIT	10%	10%	10%	9%	9%	10%	11%	11%	13%	14%	14%	13%	13%	13%	13%	14%	13%	14%	9%	14%	13%	12%	2%	0.15
TURNS																								
Sales/Receivables						15.43	13.16	17.06	18.53	19.73	21.64	23.79	25.10	23.39	23.69	25.87	27.99	26.55	13.16	27.99	23.39	21.69	4.57	21%
Sales/Inventories						95.28	78.20	98.43	109.13	115.66	114.40	108.19	120.15	128.95	121.03	116.38	119.68	115.01	78.20	128.95	115.01	110.81	13.39	12%
Sales/PPE						1.57	1.33	1.72	1.93	1.82	1.74	1.72	1.81	1.84	1.89	1.84	1.80	1.78	1.33	1.93	1.80	1.75	0.16	9%
Sales/NTA						2.02	1.75	2.48	2.87	2.56	2.34	2.26	2.35	2.38	2.44	2.37	2.33	2.29	1.75	2.87	2.35	2.34	0.26	11%
RETURNS																								
Gross Profit/NTA						32%	32%	44%	55%	51%	45%	41%	44%	44%	45%	45%	43%	44%	32%	55%	44%	43%	6%	0.14
EBITDA/NTA						33%	33%	44%	53%	49%	45%	42%	44%	45%	45%	46%	45%	45%	33%	53%	45%	44%	5%	0.12
EBIT/NTA						20%	18%	27%	38%	35%	32%	28%	30%	31%	32%	32%	31%	32%	18%	38%	31%	30%	5%	0.18
GROWTH																								
Sales		10%	6%	5%	-5%	5%	-12%	32%	19%	17%	14%	5%	7%	5%	9%	9%	10%	8%	-12%	32%	8%	8%	10%	1.14
Gross Profit		11%	-1%	2%	2%	11%	-1%	30%	26%	21%	11%	-2%	10%	3%	9%	13%	8%	12%	-2%	30%	10%	10%	9%	0.96
EBITDA		9%	7%	-3%	2%	10%	3%	23%	23%	22%	14%	1%	8%	5%	7%	14%	9%	10%	-3%	23%	9%	10%	8%	0.79
EBIT		11%	-4%	-4%	2%	9%	-5%	35%	46%	23%	12%	-3%	10%	5%	9%	15%	8%	11%	-5%	46%	9%	10%	14%	1.31
Receivables						19%	-10%	16%	4%	15%	-6%	-3%	6%	18%	-1%	0%	3%	24%	-10%	24%	4%	6%	11%	1.67
Inventories						11%	4%	6%	8%	12%	17%	5%	-12%	8%	24%	4%	9%	16%	-12%	24%	8%	9%	9%	0.99
PP&E						2%	6%	-2%	15%	31%	10%	2%	2%	4%	9%	15%	9%	10%	-2%	31%	9%	9%	9%	1.01
Working Liabilities						2%	16%	24%	5%	14%	-1%	-5%	2%	6%	8%	11%	8%	12%	-5%	24%	8%	8%	8%	0.98
Net Tangible Assets						4%	-1%	-13%	20%	40%	13%	4%	2%	4%	9%	15%	9%	10%	-13%	40%	9%	9%	12%	1.38

SINGULAR DILIGENCE

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The Restaurant Group (London: RTN) Runs Casual Dining Chains in the United Kingdom

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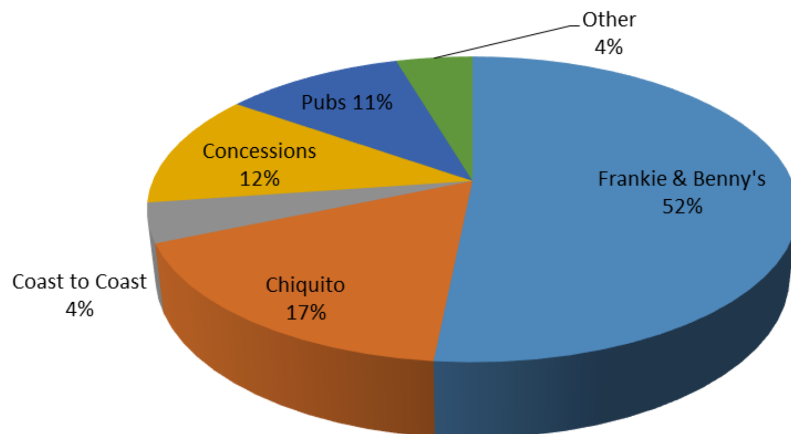
OVERVIEW

The Restaurant Group runs several restaurant chains in the United Kingdom. These are casual dining restaurants. The customer eats their food in the restaurant while a waiter provides table service. The company does not run any fast food chains. The majority (52%) of the company's sales come from its Frankie & Benny's chain. Frankie & Benny's is a U.K. created restaurant concept that is inspired by Italian-American restaurants. Despite being a U.K. company, most of the Restaurant Group's concepts are based on some variation of U.S. cuisine. Frankie & Benny's (52% of sales) has an Italian-American themed menu, Chiquito (17% of sales) has a Tex-Mex themed menu, and Coast to Coast (4% of sales) has a general American theme. So, 73% of sales come from three American inspired restaurant concepts. The other 27% of sales comes mostly from concessions (12%) and pubs (11%). In this issue, we will focus mostly on the three concepts that make up 73% of The Restaurant Group's sales. There are a few reasons for making this choice. One, the 27% of sales that come from other sources are difficult to discuss because the economics of concessions and pubs aren't especially similar. Two, the pubs and concessions are not grouped under a single brand name. For example, each of the pub locations The Restaurant Group owns maintains its own name. This means the future of The Restaurant Group is unlikely to be radically shaped by pubs or



The Restaurant Group's two largest chains (Frankie & Benny's and Chiquito) account for 69% of sales.

concessions. However, a concept for a chain – like Frankie & Benny's, Chiquito, or Coast to Coast – could spread across the U.K. to become a collection of a hundred or more locations using the same name. Finally, The Restaurant Group's strategy seems more focused on expanding its existing concepts rather than acquiring more pubs and concessions. However, we can't guarantee that will continue to be true. The organic growth of existing chains seems more repeatable than doing deals to buy pubs and get concessions. So, we will confine our speculation to the three American themed chains that The Restaurant Group already runs. Before we discuss those individual chains, let's take a look at the history of The Restaurant Group.

The Restaurant Group was founded in 1987 as City Centre Restaurant. The purpose of this entity was to manage the Garfunkel restaurant chain. Garfunkel's is a U.K. family restaurant roughly analogous to something like a Denny's in the United States. One difference between Garfunkel's and Denny's though is that Garfunkel's locations were focused on high traffic areas like airports, London tourist attractions, and movie theaters. In 1989, City Centre acquired the Mexican themed Chi-Chi's. It renamed the chain Chiquito. Now 27 years later, the company still owns this chain. About twenty years ago – in 1995 – City Centre opened the first Frankie & Benny's. This chain would go on to be the company's most successful. Today, Frankie & Benny's contributes a little over half of The Restaurant Group's sales. By the late

1990s, City Centre owned many different concepts. These included the family restaurant Garfunkel's, the Tex-Mex Chiquito, the Italian-American Frankie & Benny's, the rustic Italian themed Caffe Uno, the Pizza Hut competitor Deep Pan Pizza, the Asian themed Wok Wok, the upscale Italian themed Est Est Est, the Mexican cantina themed Nachos, and the 1940s American diner themed OK Diner. By the turn of the millennium, some of these concepts were underperforming. Deep Pan Pizza was a particular problem. And there was a trend of less traffic on the high streets – a U.K. term for town centers roughly synonymous with 'Main Street' in American English – where these chains had many of their locations. In October of 2000, the company's CEO resigned and was replaced by Andrew Guy. In March of 2001, Alan Jackson was made Executive Chairman. With these men in charge, The Restaurant Group would reshape itself over the next 5 years or so. Underperforming brands like Deep Pan Pizza, OK Diner, and Wok Wok were quickly sold. Management said it was focused on business segments with high returns on capital, good growth prospects, and some sort of barrier to entry. They found these in 'leisure park' locations. Leisure parks are to the U.K. what strip malls and 'power centers' with big box retailers in them are to the U.S. They are often anchored by a movie theater, bowling alley, or some other leisure attraction. Especially important is their ample parking and location away from the high streets. Land development is much more restrictive in the U.K. than in most parts of the U.S. Even in leisure park locations, U.K. restaurants have to pay their landlords a far higher share of their sales as rent than American restaurants do. It seems the demand for new casual dining options had outstripped the number of planning permission approvals to open new restaurants. This explains why The Restaurant Group's management saw a 'barrier to entry' in this business segment when it wouldn't appear that way to an American restaurant chain. The other area with a barrier to entry is concessions. These are located in airports. So, basically we are talking about chains in outdoor mall type locations and then concessions run in airports. Both have barriers insofar as there are a limited number of locations available to competitors. Also, landlords can actively avoid putting two similar concepts in head-to-head competition. In fact, it's in their interest to do so. Therefore, a landlord would prefer a mix of a fast food restaurant, a low end casual dining restaurant, and a high end casual dining restaurant over say two American themed restaurants with similar menus and prices. The restaurant operators would prefer to avoid such direct competition. And so would the landlords. The Restaurant Group kept its other well-performing businesses for a time. However, it mostly just milked them for cash. TRG sold its two Italian concepts – Est Est Est and Caffe Uno – in 2005. Garfunkel's shrunk from 33 locations in 2001 to just 13 locations in 2015. The sale of Caffe Uno in 2005 was pretty much the end of TRG's high street era. Even the company's pubs – which it acquired in two different deals made in 2005 and 2007 – are in drive to locations. TRG has since said its focus is limited to just 3 areas: 1) Leisure and retail parks 2) Concessions (so, airports), and 3) Rural and semi-rural pubs. From 2002 through 2015, TRG grew sales by 9% a year and EBITDA by 11% a year while paying out more than half its reported earnings in dividends.

What does TRG look like today? The 3 key chains you need to know about are Frankie & Benny's (261 locations), Chiquito (86), and Coat to Coast (21). Frankie & Benny's has a New York Little Italy theme. The dishes are basically New York-Northern New Jersey type Italian and just plain American food adjusted for a British palate. There are plenty of booths creating a casual family dinner type atmosphere. Chiquito is less focused on families. Coast to Coast is a general American themed restaurant that is similar to a TGI Friday's or TRG's own Frankie & Benny's. All three of these chains are located in leisure and retail parks which means there are often activities like movies or bowling in the same area. Each location has about 150 seats. The average check is about 15 to 17 GBP (about $20 to $22 U.S.) Tips are generally much lower in the U.K. than they are in the U.S. However, TRG's concepts are American themed and they seem to follow some American practices like free refills on non-alcoholic drinks (coffee, soda, etc.). This is not typical of restaurants in countries where there is minimal tipping. The lack of standardized tipping in the U.K. also complicates the minimum wage situation versus the U.S. In the U.S., waiters who work for tips can be paid very, very little in wages without violating any minimum wage laws. This is not true in the U.K. In addition, the U.K. has adopted an age based minimum wage law that makes it cheaper to employ younger workers and more expensive to employ older workers. In the U.K., you have to pay a 25-year-old waiter about twice what you'd pay a 16-year-old waiter. This isn't true in the U.S. because minimum wage laws don't discriminate on the basis of age and U.S. waiters work for tips that effectively count toward their minimum wage requirement. In the U.S., workers who generate the most tips take home the most money. This isn't necessarily true in the U.K. We'll discuss this issue more a bit later in the issue. But, Quan and I – and TRG's management – don't think recent changes to the minimum wage are a big issue because the minimum wage level affects TRG and its competitors equally and because the primary competition between restaurants is on customer traffic rather than price. So, changes in U.K. planning rules are more important than changes in the minimum wage.

TRG is a growth stock. It targets 850 to 900 locations within the next 8-10 years. That means the company would more than double its revenue by 2025 if everything went according to plan. That's a big 'if'. However, a 10-year plan with a sales growth trajectory of about 8% a year certainly qualifies the company as a growth stock. Nominal GDP in the U.K. is not going to grow anywhere near 8% a year through 2025. So, TRG hopes to grow faster than the economy it operates in.

The stock is very cheap. In relative terms, It's one of the cheapest stocks we've written about in Singular Diligence. Right now, TRG trades at about 6 times EBIT. Meanwhile, U.S. restaurant chains are trading at 12 to 15 times EBIT. Another way to look at TRG's price is relative to past acquisitions of U.K. restaurants. A lot of acquisitions of U.K. restaurant chains were done around 10 times EBITDA. TRG now trades at 4 times EBITDA. It's unusual for any restaurant that isn't seriously troubled to trade for just 4 times EBITDA. So, The Restaurant Group combines relatively good growth prospects with a relatively low price. It is cheaper than many peers while also having better growth prospects than those peers.

DURABILITY

TRG's Future Earning Power Depends on the Continued Popularity of the Italian American Themed Frankie & Benny's Chain

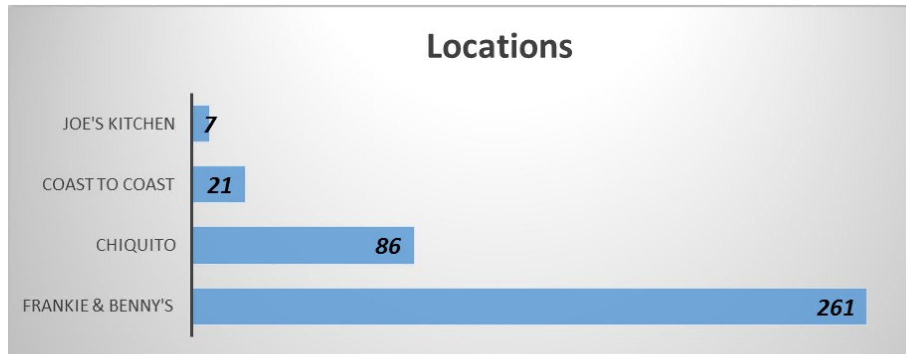
The durability of a restaurant stock depends on the popularity of its chains. The Restaurant Group has three concepts worth worrying about. The biggest is Frankie & Benny's. This chain accounts for a little more than half of The Restaurant Group's sales. The next biggest is Chiquito. That chain accounts for just 17% of sales. Coast to Coast accounts for 4% of sales. Coast to Coast might be worth worrying about in terms of potential future upside. It might have growth potential. But it isn't worth worrying about in terms of downside. After all, the worst Coast to Coast can do is cost The Restaurant Group 4% of its total sales. Meanwhile, a 10% drop in Frankie & Benny's profits as a chain would cost The Restaurant Group more than 5% of its profits per share. So, Frankie & Benny's is by far the most important chain when it comes to assessing the durability of The Restaurant Group's earnings. Chiquito is also important. No other part of the business is really big enough to worry about. So, we'll confine our discussion to the popularity of Frankie & Benny's and Chiquito.

Casual dining chains fall in and out of favor. Their sales can decline when they are in unpopular – which usually means outdated – locations. Or their sales can decline when they stick to an unpopular – which usually means outdated – theme. In other words, their physical positioning can become out of step with the times or their marketing positioning can become out of step with the times. The industry as a whole is perfectly durable. In fact, as economies become more developed they spend more and more of their income on restaurants. The U.S. is a higher per capita income country than the U.K. and not surprisingly the U.S. spends more per person at restaurants than the U.K. does. But the U.K. is a higher per capita income country than it was a quarter century ago and not surprisingly the U.K. spends more per person at restaurants than it did in 1990. You can see the pattern here. Some things like food consumed at home and clothing decline as a percent of total household spending as a country develops. Other things – like food eaten in a restaurant – increase as a percent of total household spending as a country develops. If a category increases as a proportion of total household spending, we should expect that category to grow – in the very long run – at a rate at least as great as the increase in output per person. So, if you expect the U.K. to grow real GDP per capita at say 1% a year in the decades to come – you would expect the overall restaurant industry to enjoy growth in real spending per capita that is no slower than 1% a year. Economies of scale at the individual restaurant location are not great enough beyond 100 to 150 seats or so to encourage the building of really big sites. People like variety. And they like a restaurant to be within driving distance of them. So, restaurants as businesses tend not to grow in size per location but only in terms of number of locations run under the same concept. The chain replicates. But each site stays the same size. From 2003 through 2016, TRG experienced same store sales growth of 2.4% a year. All other growth came from opening new locations. The restaurant business is durable and predictable for a chain that maintains its popularity. For example, in the 14 years from 2003 through 2016, The Restaurant Group only had same store sales declines in 2009, 2010, and 2016. The worst year was 2009. Even during that financial crisis, the decline was only 2% in 2009 and an additional 1.5% in 2010. So, over the entire course of the crisis, The Restaurant Group's same store sales declined less than 4%. Why is this?

One likely explanation is that restaurant compete for volume (seat occupancy) rather than price (average ticket). They change their menus, their advertising, their décor, they move locations, they invest in leasehold improvements, etc. instead of cutting prices. All these things are still competitive actions. They are acts born of rivalry. And they hurt the rivals. Moving to a better location means paying more in rent. Investing in upgrades to the physical layout of the restaurant ties up more capital and reduces the shareholder's return on assets. Advertising is an expense. And so on. Note however that what restaurants tend not to compete on is gross margin. Basically, casual dining restaurants apply a standard mark up over their food costs and sell the items on their menu for that price. So, if the direct costs – like ingredients – that go into a steak dinner cost $8 the restaurant might apply a mark-up of 3 to 4 times and list that item for $24 to $32 on its dinner menu. This would give the restaurant a gross margin of between 65% and 75%. In reality, the gross margin on menu items with high priced ingredients like steak is actually lower than the margin on menu items with low prices like pizza. A customer's willingness to pay $15 for a pizza can be greater than their willingness to pay $30 for a steak even though the $30 steak can be 'a better value' in the sense of the mark-up being lower. This might look like a trivial point to make. But, it's important when looking at why restaurants have different gross margins. In many cases, it's not that one restaurant is trying to undercut another on price. It's actually just that they have a

different menu mix. Finally, when a restaurant does compete on price it may actually be repositioning itself as a cheaper, lower quality alternative. If you see a $20 steak on one menu and a $30 steak on another menu – it's unlikely one restaurant is trading profit per customer for quantity of customers by doing this. It's more likely the restaurant selling the $20 steak is simply buying cheaper meat. Both chains have equal access to all kinds of meats at all kinds of prices. One chooses the lower quality ingredient and the lower price to segment the market and focus on customers who want a cheaper steak even if it's an inferior steak. Another chain does the opposite. In a sense, this really comes down to marketing position rather than direct price competition. Making the choice to sell a steak as cheaply as possible could damage a chain's durability. But probably not because it'll set off a price war. Instead, the chain is more likely to attract a certain kind of customer and lose another kind of customer. Societal shifts that affect a chain's customer base are the real threat to durability. So, when looking at a restaurant chain's durability ask two questions: 1) What is the physical position of the individual restaurants in the chain? 2) What is the societal position of the concept as a whole?

The physical position of TRG's individual restaurants is good. Frankie & Benny's is focused on retail parks. U.K. customer traffic is continually moving away from the high streets and toward the retail parks. Retail parks are also doing better at gaining customers in the evenings – which is what restaurants care most about. E-commerce obviously hurts retail parks. However, 80% of TRG's restaurants are in retail parks with at least one leisure activity such as a movie theater or bowling alley. As more shopping in the U.K. moves from the high streets and retail parks to the internet more locations in retail parks should be converted into eating and entertainment venues rather than shops.



Frankie & Benny's is 3 times the size of TRG's next largest chain

Restaurant chains fall in and out of favor with the public. This can be caused by societal shifts. It can also be caused by a restaurant's thematic positioning pendulum swinging too far in one direction. A restaurant may pander to its base and lose touch with the center in the same way a political party can. In the early 2000s, Chiquito was underperforming. Same store sales dropped 5.3% in 2003. TRG replaced Chiquito management. It changed the décor at one-third of the chains locations to downplay the "garish" Mexican theme. And it repositioned the chain away from customers looking to get drunk toward more families. In 2004, same store sales rose 5.8%.

This kind of thing happens all the time in the restaurant industry. It happens both in the U.K. and the U.S. Let's look at a stock Quan and I wanted to pick for Singular Diligence a couple years back. We desperately wanted to pick this stock. But, you never read an issue about it. Why? Because the stock plunge that had suddenly made it attractive enough to include in Singular Diligence was reversed too quickly. Between the time we started research on the stock and the time we were set to publish the issue – the share price had gone up, up, up. This happens all the time with restaurant stocks. They move violently along with even the slightest same store sales trend.

The stock Quan and I wanted to pick was Greggs. This is a fast food concept in the U.K. It is bigger outside the London area than inside it. And it is known for selling unhealthy food in high street locations. Same store sales dropped 2.7% in 2012 and 0.8% in 2013. That's not much of a drop. And, actually, customer footfall near Greggs locations probably dropped by at least that much. But the high street was seen as a bad place to be and unhealthy food was seen as a bad thing to be selling in a society that was more interested in less processed food than the previous generation of Brits had been. So, the stock dropped a lot more than the company's sales. Greggs responded by opening stores away from the high street. It started opening in retail parks, bus terminals, train stations. New locations would be 'food on the go' locations. These needed to be near where people worked, traveled, and sought out entertainment. Greggs also refitted its stores. It removed some features of its bakery legacy like bread slicers and bread ovens. It added seating. It put some "healthy sandwiches" on its menu. Same store sales rose 4.5% in 2014 and 4.7% in 2015. The stock went from a P/E range of 10-13 to a P/E range of 18-20. The share price went from under 500 pence to over 1,200 pence.

What does Greggs have to do with The Restaurant Group? This is what happens all the time with restaurant concepts and with restaurant stocks. In 4 out of 5 years, everything looks good with same store sales. In 1 out of 5 years, the concept loses some popularity. Every decade or two there is a string of a couple bad years in a row. Analysts and investors focus on this trend. Sales may drop a little. Earnings

may drop a decent amount. But you can be sure the stock will drop a tremendous amount. You can find restaurant stocks where a 3% to 5% decline in same store sales sets off a 30% to 50% – or more – decline not just in the stock price but actually in the P/E ratio. The Greggs example is just one such case. Same store sales dropped less than 5%. The P/E ratio contracted more than 50%.

Let's talk now about a more directly comparable stock: Brinker's. Brinker's is the owner of Chili's. Chili's is a very big chain – both owned and franchised – in the U.S. It's Tex-Mex. But it's Tex-Mex in a very general American sense. Chiquito and Chili's are probably pretty comparable. From 1994 through 1996, Chili's same store sales declined for 7 straight quarters. Chili's changed its menu and its advertising. And same store sales started growing again.

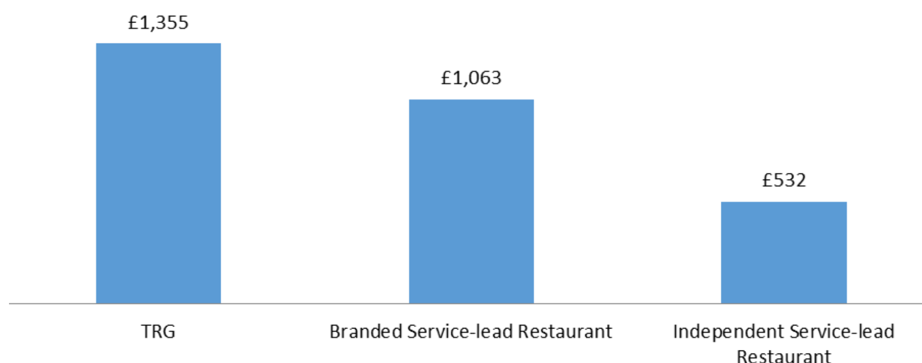
TGI Friday's is another good example. This concept actually started as a singles bar as much as a restaurant. But the concept went national. And the customers who had used TGI Friday's as a singles bar in the 1980s now had families. They went to the same place they had once gone on dates with their children in tow. TGI Friday's evolved with its customer base. As baby boomers aged, TGI Friday's changed. It encouraged more of a family atmosphere. It added more upscale items. There was more steak. Some of it was branded Jack Daniel's Grill. It started serving food on sizzling platters. Basically, it started featuring the food more and more. Once the concept had saturated drive through locations in the U.S. it started adding Chili's in places like airports, mall food courts, and stadiums. These are the kinds of places TRG has concessions. This all sounds very mundane and obvious as I condense 30 years of history into a paragraph about TGI Friday's development. It sounds especially obvious now and especially to Americans who aged in step with this chain. But, TGI Friday's has become something really quite different than what it started out as. So has Greggs. TGI Friday's was a singles bar that became a family restaurant. Greggs was a high street bakery that became a 'food on the go' sandwich shop. The company makes as much on sandwiches now as it does on "savories". These are the kinds of transitions restaurant chains make. They evolve to fill a niche. As society generally and their customer base specifically changes – they make slight, incremental changes along with it. Management uses the individual sites as test labs. They don't decide to refurbish all the restaurants at once. Instead they refurbish a third of them and wait a year. If same store sales go well in the refurbished sites they apply the change to the whole chain. Through all of this they keep the physical locations they control. The locations and the concept are key. A chain has to make sure it stays in popular locations and it has to make sure it manages the popularity of its concept well. But the thing about a chain like Frankie & Benny's is that it's essentially a U.K. version of Chili's or TGI Friday's. The Frankie & Benny's of 2026 won't look exactly like the Frankie & Benny's of today. But it will be hard to point to an exact moment in time where there was a huge transition and a break in the chain's history. More important than that, the chain will still be in many of the same locations it is in today. This might be hard for U.S. investors to realize, but Frankie & Benny's is actually – adjusted for the U.K.'s much smaller population than the U.S. – already of the same relative size as U.S. chains like Chili's and TGI Friday's. It's easier to find a Frankie & Benny's near you in the U.K. than it is to find either a Chili's or a TGI Friday's in the U.S. So, Frankie & Benny's is not a new chain. It is already pretty saturated. But, it can evolve to stay relevant in the U.K. the way Chili's and TGI Friday's did in the U.S. As far as Chiquito – that chain should benefit from being owned by the same company that owns Frankie & Benny's. Frankie & Benny's has similar food as Coast to Coast. It has different food than Chiquito. So, it makes sense for TRG to try to get two locations in a retail park whenever possible and put one Chiquito in there with either one Frankie & Benny's or one Coast to Coast. All metaphors are lies to the extent the comparisons are imperfect. But, the best we can do is say that Frankie & Benny's really isn't that different from a U.K. version of TGI Friday's and Chiquito really isn't that different from a U.K. version of Chili's. Each chain will have years with especially good same store sales trends and especially bad same store sales trends. But, both should be capable of rehabilitating their image when they inevitably falter – the same way countless U.S. casual dining chains have over the past several decades.

MOAT

The Economics of the Average Chain Restaurant Location are Better than the Economics of the Average Independent Restaurant – and Frankie & Benny's is Better than the Average Chain Restaurant

No single restaurant has much market share either in the United Kingdom or in any other country. For example, TRG owns Frankie & Benny's which is one of the biggest casual dining restaurant chains in the U.K. And yet when we segment the U.K. restaurant industry into even as narrow a sliver as casual dining restaurants with an average spend of between 10 GBP and 20 GBP per person we still find that TRG has less than 15% of that very narrowly defined market. And, of course, people in the U.K. don't limit their eating choices to just casual dining restaurants in that price range. They have a variety of choices in fast food: McDonald's, Burger King, KFC, Subway, Greggs, Costa Coffee, Starbucks, etc. The average ticket at these chains is about one-third the price of a meal at a TRG type location. Are they substitutes? Not really. It would be extraordinarily rare for anyone to ever find themselves choosing between going to Greggs or going to Frankie & Benny's. But, let's move one step closer to TRG's market segment. Now let's look at 'fast casual' restaurants in the U.K. These are places like Nando's, Pizza Hut, Wagamama,

Gourmet Burger Chicken, and Five Guys. They're fast. And they're like fast food in a lot of ways. But, they aren't that cheap. The average ticket at a "fast casual" chain is about 9 GBP. That's twelve dollars U.S. There are places in the U.S. where you can get a twelve-dollar meal at a fast casual restaurant. Especially for lunch. Because those are lunch focused fast casual chains I just mentioned. Some of these chains do get pretty close to competing with casual dining. The food quality of Five Guys is equal to the food quality of some casual dining. Pizza Hut has – at least at times in its history – been a lot closer to a low-end casual dining restaurant than it has been to true fast food. What we've outlined here is pretty much how the restaurant market segments look in both the U.K. and the U.S. But now we're going to talk about a segment of the market that exists only in the U.K. Let's talk about pubs. The average spend at a pub in the U.K. is very, very low. It's about 5 GBP to 10 GBP. Think roughly $7 to $13 in the U.S. So, a ten-dollar meal give or take a few dollars. Pubs started out focused on selling beer. In the U.K., people did not keep beer in their household at the same levels as Americans did. Beer drinkers in a household went much more frequently to their local pub. This frequency is important to a pub's business model because it makes it very different from the casual dining restaurant. Beer sales declined over time. And pubs focused more and more on food. However, a pub is kind of in the same situation as something like a Starbucks when it comes to food. Starbucks is a coffee shop. It gets lots of very frequent visitors. People will go to a Starbucks every day on their commute to work. Starbucks would like to sell these people food. Let's say Starbucks has a great idea for a breakfast sandwich. They can make it tasty and healthy and just all around wonderful. But it will cost $8. Is that a problem? A lot of diners in the U.S. charge $8 or even $10 for a breakfast entrée that includes meat and eggs and so on. Plus, you have to tip at those sit down restaurant. And tips are big in the



TRG's sales per location are 27% higher than the average chain restaurant and 155% higher than the average independent restaurant.

U.S. So, even a $6.95 breakfast sandwich turns into at least an $8 item when you include the tip. Competitively it would seem that if a place like Starbucks which has the convenient location and the coffee a commuter wants could make a better breakfast sandwich than a diner and sell that sandwich for less than a diner – they'll have a hit menu item on their hands. Won't they? Actually, they won't. The problem is frequency. Food – in the restaurant sense – is not a commodity product that is sold based on price and quality without regard to where and when and how often it is consumed. In the U.S., the same person might go to Starbucks as much as 5 times a week and a diner as little as one time a week. So, an $8 breakfast sandwich at Starbucks is more like a $40 a week or $173 a month indulgence. A bagel and cream cheese bought at a bakery costs a lot less. I'm sure you understand this intuitively when I just mention the names of restaurants. If you're an American and I say Dunkin Donuts, Starbucks, Burger King, Denny's, and Outback you understand that Starbucks competes head on with donut and bagel places, competes in some ways with Burger King, almost not at all with Denny's, and definitely not at all with Outback. This isn't really about the food though. There is nothing magical that puts coffee in competition with bagels and donuts. What's happening is that a $4 drive through breakfast sandwich at a McDonalds or a Burger King is competition for a place like Starbucks while an $8 breakfast sandwich at a sit down diner is not competition. It's not about the food. It's about the visit. Starbucks's best customers are the chains best customers because they visit it very, very frequently. To visit a place very frequently you need each visit to be consistent, quick, and cheap. You might be the kind of person who would be willing to pay more for the best type of food. But doing so might make you less likely to visit as frequently. And if your visits to Starbucks shrank from 5 times a week to three times to two times – suddenly Starbucks would be in direct competition with a diner for your business. You've become a once a week visitor who is willing to stay longer, pay more, etc. for the best quality stuff. But this has shifted you into a different kind of selection process. So, competition for a customer in the restaurant business is really about how the customer is using your restaurant. It's about the visit.

That's part of the reason why restaurants can evolve. They can move up and down in price. They can develop faster service or slow their service down. A restaurant is mostly just fixed in terms of its name and its locations. It takes a very long time to reposition a restaurant concept in your mind. And it takes a very long time to reposition the locations surrounding you – the customer – in terms of how close they are to you, how near they are to your work or the train station you visit or the movie theater you go to or whatever. Those are the more permanent features of a

restaurant chain. They are the concept and the locations. This is where we find a moat. Most of the other stuff is just efficiency. It takes a long time for one chain to be in all the same locations as another chain. It takes a long time for one chain to develop the kind of name and image that another chain has. It doesn't take much time at all to put the same menu item in its stores as you have in yours. Restaurants can add quinoa and ghost pepper and sriracha and black angus beef and anything else they want to their menus almost overnight. These things are easy to copy. What's hard to copy – and what depends a lot on the history of how your chain developed – is where a chain's locations are and what image pops into the public's mind when it hears the name of that restaurant. Locations and brand take time to develop.

Pubs started out as places to drink. They depend on a local customer base of frequent visitors. They are tied to one name and one location. It isn't easy for them to shift to a higher average ticket because this will reduce the frequency of visitors to their "local". Once that happens, the place is no longer your local pub. It's just a casual dining restaurant you go to every so often. It's just something in direct competition with places like Frankie & Benny's, Chiquito, and Coast to Coast. So, obviously pubs can keep their locations and re-position themselves over time into casual dining spots. Given enough time, any restaurant can attempt to do this. It risks losing its customer base. But as we saw with TGI Friday's and Chiquito it is possible to shift from a less family oriented place to a more family oriented place. This happens through evolution born out of experimentation. Management sees what works on a small scale and then doubles down on that approach across the whole chain. If some locations are working better than others they target locations with similar demographics to open new locations in.

TRG discovered that leisure park retail locations work best. Leisure parks and retail parks are basically the U.K. equivalent of strip malls. They are planned shopping and entertainment enclaves away from the high streets. The restaurants in these locations are usually chains. Many are fast food and fast casual locations. You are more likely to find a Starbucks or a Subway or a Pizza Hut there than you are to find a pub type restaurant. Retail parks normally have 2 or 3 casual dining restaurants. Big retail parks can have 5 to 6 casual dining restaurants. And TRG has between 1 and 3 restaurants in the same park.

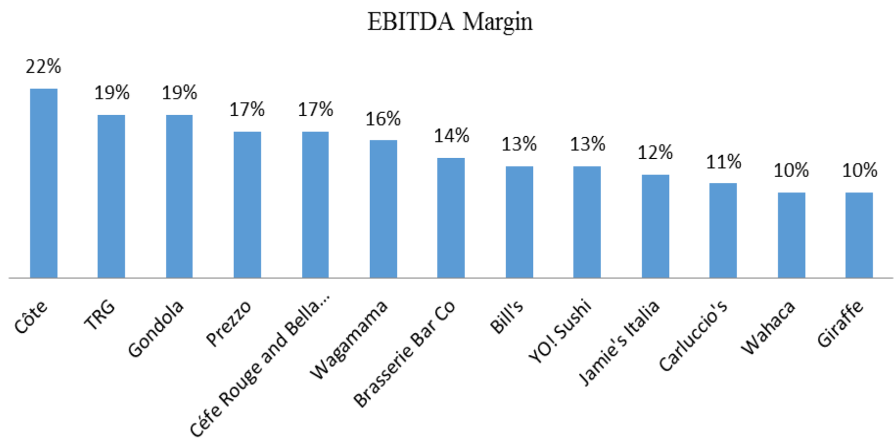
TRG doesn't really have advantages over other casual dining chains. But the damage one chain can do to another is small. Landlords limit the number of casual dining restaurants they put in the same location. And U.K. planning rules limit the number of new retail parks – often to protect the high streets from competition. The trend in the U.K. is for chains located in retail parks to benefit at the expense of independent restaurants located on the high street. From 2012 through 2015, sales at independent restaurants declined at a rate of 1.6% a year. Meanwhile, sales at branded restaurants rose at a rate of 6.1% a year. A lot of this is due to openings and closings. Same store sales gains even at successful chains are small. TRG has a long history of 2% to 2.5% a year same store sales gains. That means inflation adjusted sales at each location barely increase. But the number of new locations provides a lot of growth.

TRG's locations are well positioned physically. Are TRG's concepts well positioned psychologically? It's hard to say. The evidence points to yes. But we aren't in the U.K. So, it's hard for Quan and I to talk much about something as subjective as that. On top of that problem, there just aren't many publicly traded restaurants in the U.K. So, we can't do the kind of peer comparisons it is very easy to do in the U.S. TRG's sales per location seems very high. We don't have median data for sales per location. That would be more useful than the arithmetic mean. But, all we have is the mean. So, we'll do our best with that flawed figure. The average independent restaurant location in the U.K. generates 530,000 GBP in annual sales. The average branded restaurant does 1.06 million GBP. So, branded restaurants tend to do twice as much business per location as independent restaurants. They are obviously a lot more efficient on a per outlet basis. Wagamama, Carluccio's, and Cote all do more sales per location than TRG. They do 1.5 million to 1.6 million GBP. Wagamama is fast casual. Customers share tables with strangers. So that's really like a fast food concept. Carluccio's and Cote are on the high streets. Nando's also does more in sales than TRG. But it's fast casual too. So, I'd say the best comparison in terms of per location performance is that Carluccio's and Cote outsell Frankie & Benny's. However, Frankie & Benny's has 261 locations and a minimal presence in London. Carluccio's has 98 locations and more than 30 of those locations are in London. Cote has 73 locations and is a midmarket French bistro focused on high streets. Many of the most popular chains in the U.K. are Italian themed. In fact, TRG actually owns both of the two biggest casual dining chains in the U.K. that aren't Italian themed. Frankie & Benny's is Italian-American (but very American) and Chiquito is Tex-Mex. So, within the market segment TRG focuses on – it seems to do well. Margin protection is very high in this business. So, new concepts don't hurt competing restaurants much in terms of their profit levels relative to sales. The greatest risk to TRG's moat is self-inflicted mismanagement of its brands or loose planning in the U.K. If the rate of new casual dining location openings in retail parks gets too high, TRG will suffer. However, it is fairly easy for restaurants to exit the market. When a chain has a lot of underperforming locations, it closes them down. When a landlord has more restaurants that customer traffic to support these restaurants – they start filling their space with entertainment or shopping venues instead.

QUALITY

U.K. Casual Dining Restaurant Chains Tend to Have an EBITDA Margin Between 10% and 20% of Sales

TRG earns a high return on capital. This is partly due to TRG being an above average U.K. restaurant chain. But it's also partly due to the entire U.K. restaurant industry having an especially high return on capital. The high returns on capital are due to high margins. U.K. restaurant chains have high EBITDA margins and even high EBITDAR (Earnings Before Interest Taxes Depreciation and RENT) compared to U.S. restaurant chains. One possible explanation for this is that the potential demand for U.K. casual dining restaurants is higher than the amount of locations that get planning permission each year to add a restaurant. One way to think about restaurant margins is to talk about "prime cost". Prime cost is labor cost plus food cost. In theory, both of these are variable costs. However, food cost is more variable than labor cost. If you have less customers, it's easy to buy less ingredients. However, if you have less customers, it is not as easy to give your staff fewer hours or to fire them. But the quit rate in the restaurant industry is very high. It's not unusual for 50% to 100% of a restaurant's staff to quit in a year. So, a restaurant that stopped hiring for a month could actually reduce labor by 5% to 10%. I bring this up because it means labor is potentially more short-run variable than you might think. Very few firms in other industries can reduce their labor costs as quickly as restaurants can. Now, let's compare "prime cost" at TRG and the U.S. restaurant chains Quan collected data on. We don't have good data on other publicly traded casual dining restaurants in the U.K. – because there just aren't many publicly traded restaurants in the U.K. right now. There are many, many publicly traded casually dining restaurants in the U.S. So, we are using mostly U.S. restaurants for our peer comparisons.



TRG's 19% EBITDA margin is near the very top end of the range for U.K. casual dining restaurants.

For U.S. restaurants, "prime cost" – which you'll remember is food cost plus labor cost – is often 57% to 60% of sales. At TRG, prime cost has been about 54% of sales in almost every year for which we have data. Other expenses are about 33% of sales. This is true for both TRG and U.S. chains. The big differences for TRG and its U.S. peers are that TRG has lower food and labor costs as a percent of sales and TRG has higher rent as a percent of sales. This seems to always be the case in the U.K. versus the U.S. Landlords can simply charge higher rents for casual dining restaurants. That makes sense because planning permission is often more restrictive in the U.K. than zoning laws are in the U.S. and then the U.K. also has higher population density than the U.S.

The key to a successful restaurant on a per outlet basis in both the U.S. and the U.K. is simply generating enough sales relative to fixed costs. As an illustration, TRG averages 1.35 million GBP per location. This is 2.5 times more than the average independent restaurant in the U.K. Assume – probably pretty conservatively since we know a TRG location often has fewer than 150 seats – that since TRG is doing 2.5 times more sales than an independent location it is doing 1.5 times more sales per square foot. If fixed costs are 30% of sales – then having a 50% higher level of sales per square foot will result in a 15% lower level of fixed costs to sales. And remember that rent is an especially high expense in the U.K. It's also fixed. On top of this, U.K. restaurants seem to have lower asset turnover than U.S. restaurants. This may be due to investing more in improving the physical location than occupy. For example, TRG spends 1 million GBP outfitting a typical location. The most likely explanation for U.K. restaurants being more asset intensive than U.S. restaurants is higher construction costs. There's no evidence U.K. restaurants focus more on the physical plant of their restaurants compared to U.S. peers. But higher costs for doing the same work as in the U.S. would lead to a great initial investment in the location. High fixed costs can make it harder for small and independent restaurants to survive. And higher initial start-up costs for a location can raise the barrier of entry in the U.K. relative to the U.S. This could explain why there aren't enough U.K. restaurant locations to push EBITDA levels down to what we see in the U.S. It could be that competition for limited locations is a bigger deal in the U.K. Landlords may do better there. And chains with good leases may do better. In the U.K., EBITDA margins for restaurants range from about 10% to 20%. In the U.S., they range from more like 10% to 14%. For example, TRG has a 19% EBITDA margin while Brinker (Chili's) has a 13% margin, Cheesecake Factory has a 13% margin, Darden (Olive Garden) has a 12% margin, Ruby Tuesday has a 12% margin, and Bloomin Brands (Outback) has a 10% margin. Those are all successful U.S.

restaurant chains. How can TRG have so much higher margins?

We're not a hundred percent sure. We're very, very sure of the difference in rent. For example, the U.K. restaurant chains of TRG, Gondola, Prezzo, and Wagamama have rent expense in the 8% to 11% of sales range. Meanwhile, all the U.S. restaurants I mentioned before from Cheesecake Factory, to Chili's, to Olive Garden, and Outback have rent expense ranging from just 3% to 5% of sales. As a rule, U.K. restaurant chains have a rent expense level roughly double what you'd see at a comparable chain in the U.S. This has to do with planning permissions. It's easier for U.S. restaurants to locate in places people can drive to and park at along a major road without any big attractions in the same area. American subscribers to this newsletter will know where Olive Gardens tend to be located and Olive Garden spends just 3% of its sales on its rent. TRG spends 11% of its sales on its rent. In other words, a Frankie & Benny's may be paying as much as 4 times more on the space it occupies than an Olive Garden. But that's unavoidable as long as the U.K. doesn't develop more land for casual dining restaurants the way the U.S. has been doing for many, many decades.

For a statistical discussion of how similar or dissimilar the U.S. and U.K. restaurant industries are you can read the "Quality" notes section further on in this PDF. My own opinion is that the U.S. and U.K. restaurant industries are very similar with the big exception being that the U.S. has developed far more of its land for the use of casual dining restaurant chains than the U.K. has. The U.K. restaurant industry is only less competitive – and more profitable – than the U.S. restaurant industry insofar as it has less access to land than it would want. Basically, the rate of growth in U.K. casual dining locations hasn't been as fast as it otherwise could be. But it's not like the U.S. restaurant industry has a low return on capital. U.S. restaurant chains can make 25% to 35% pre-tax on their net tangible assets. Even after-tax, these guys are all making 15% or more on their investment in new locations. So, the more perfect competition in the U.S. hasn't driven down returns on capital for casual dining chains to a normal level. If it had, you'd expect returns on equity near 10% instead of 20% for a successful chain. In both countries, the restaurant industry is really very win or lose by concept. Most new restaurant concepts fail and fail quickly. An independent restaurant is probably going to close its doors within three years of opening them. The owners will lose everything they put into that location. The return on equity is negative. A few concepts will become successful. As they spread from having 1 location to 10 locations to 100 locations and beyond, each new location the company adds will have a return on equity of 20% or more after taxes. In a sense, the high return on equity of successful concepts can simply be explained by the fact that the vast majority of attempted new entrants have a concept that fails. Excess profits in the restaurant industry are really only earned by opening more locations under a proven concept. Think of it this way. Within 3 years: an unsuccessful restaurant will probably close. And yet within 3 years: a successful restaurant will probably have earned enough money to open a second location. This is because the failure rate for new restaurants is 60% in the first 3 years after opening. And it's because the payback period for a successful restaurant is often no more than 3 years. You can see how quickly a successful chain can take over spots vacated by new restaurants that come and go. There's no trend towards successful U.S. chains having their margins competed away over time. We have data on chains that were successful in 1993 and are still successful today. They've kept their margins virtually identical over those 23 years. The reason for this is probably that the economics of a concept can be best understood at the unit level. Once you know what a single successful Olive Garden looks like it isn't hard to imagine that 1,000 Olive Gardens will have similar economics to 100 Olive Gardens – the company will just be ten times bigger in every respect. A chain's return on capital can certainly deteriorate. But it's likely to be from self-inflicted wounds. Ruby Tuesday's problems aren't really that competitors slowly came in and chipped away at the company's profits through underpricing them or something. Ruby Tuesday has simply done a bad job of keeping the concept as popular as it once was. The same thing can happen at Frankie & Benny's or Chiquito. In fact, it did happen at Chiquito once before. But, absent a change in the popularity of the concepts themselves, TRG's margins and returns on capital should be the same in the future as they have been in the past.

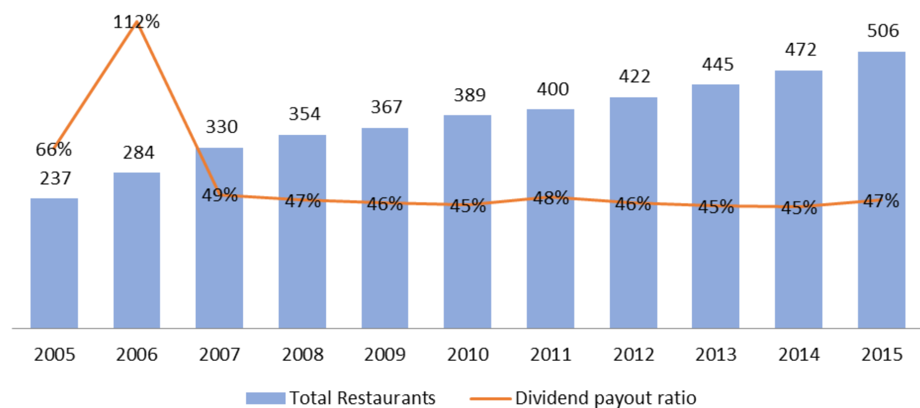
CAPITAL ALLOCATION

TRG Uses its Free Cash Flow to Add More Locations to Its Existing Chains and to Pay Dividends

TRG is a growth stock. But it also has a relatively high dividend payout ratio. From 2005 through 2015, TRG more than doubled its locations (from 237 to 506) while paying out 50% of its earnings in dividends. From 2007 through 2015, the dividend payout ratio was very stable at almost exactly 45% of earnings. So, TRG has a more consistent dividend payout ratio than most stocks we pick for Singular Diligence. Such a stable dividend payout ratio is unusual among American public companies. This stable dividend payout ratio might make you think management is less focused on the share price than the CEO of a U.S. company would be. That's probably not true. Half of the long-term incentive awards that TRG pays to its management are based simply on share price performance. Compensation comes in three parts. One part is the base salary. Another part is an annual bonus of up to 150% of the base salary. This is based simply on the company's profit level. And then there is the long-term incentive. This can be twice the base salary. It vests over a 3-year period. And the vesting depends on the total stock return versus an industry subsector of the FTSE (a U.K. stock index). So, management is rewarded for a good stock

performance relative to the industry benchmark. The only other factor in the long-term incentive plan is EPS growth. This raises some questions. There is a bit of a mismatch between what TRG management talks about and seems to actually focus on versus what they are rewarded for. Management has a financial incentive to increases EPS growth as much as possible – since that determines 50% of the incentive compensation – and to try to "talk up the stock" to get the highest P/E ratio. Dividends can improve the total return in the stock. But, half of TRG's incentive plan is determined by EPS growth without regard to dividends. So, management's financial incentive is clearly to try to generate the greatest possible growth in earnings per share and get analysts and investors to think of TRG as a growth stock. That's what the incentives say.

But what does management say? Management is focused on return on invested capital. This may be a consequence of the company's turnaround in the early 2000s. At the time of that turnaround, the new management team talked about focusing the business on barriers to entry, high returns on capital, and good growth prospects. In other words, they would sell off those chains that lacked barriers to entry, didn't generate high enough returns on capital, or didn't have any good ways to grow for the long-term. They would focus on keeping those chains that seemed to have barriers to entry, that were already generating high returns on capital, and which could have their success repeated at more and more locations opened each year. This focused the company on selling off its underperforming chains, milking the chains that had little growth prospects but were otherwise performing okay, and expanding the best chains in the best locations. The locations TRG focused on were concessions at places like airports and putting concepts like Frankie & Benny's and Chiquito in retail parks and especially leisure parks. This is a good strategy. And the execution of



Over the last decade, TRG grew its locations by 8% a year while paying more than 50% of its earnings out in dividends.

that strategy is what drove TRG's results over the last 10 plus years.

However, this is not really what management is incentivized to do. Looking narrowly at purely pecuniary incentives – management is incentivized to focus on EPS growth and P/E multiple expansion. There may be some incentive to pay dividends when nothing else can be done. But, that's about it. There really isn't much financial incentive to focus on returns on capital. For example, management would be better rewarded if they took on as much debt as possible to open as many stores as possible and buy back as much stock as possible in order to speed up the EPS growth rate.

That's not how management has behaved. And it's not how management talks to investors. They actually don't focus on EPS growth alone. Instead they talk about cash flow and return on investment. The company's presentation to investors shows a calculation of site and company EBIT/(Net Assets plus Debt). That's a return on investment calculation. But notice how it is earnings before interest and taxes on one side and debt on the other. That's not actually how management is incentivized. Management is not incentivized based on cash flow. Nor is management incentivized based on either the return on capital at the site level or the company level. The unleveraged return on net tangible assets is a great way to incentivize management to align executives with shareholders. Quan and I would love for TRG to use a mix of EPS growth and return on retained earnings. In other words, we'd love for management to be compensated in direct proportion to the profitability of the growth the company achieves. Don't just reward management for growth. And don't just reward management for paying out earnings as dividends. Instead, reward management for how much the company grows its earnings relative to how much of those earnings it retains. This may in fact be how TRG's management thinks. It is certainly how they talk to investors. But it is not how management is compensated. Management is compensated as if TRG was just focused on being a growth stock.

So how will TRG allocate capital in the future? You can probably assume TRG will pay out half of earnings in dividends. A successful restaurant has a quick payback period. So, restaurant chains don't need to borrow to grow. The best use of the earnings TRG chooses to retain is probably to open more Coast to Coast locations. Coast to Coast is an American themed chain. The first Coast to Coast restaurant was opened in Brighton in 2011. The company quickly opened 4 more Coast to Coasts in 2012, 5 in 2013, 3 in 2014, and then 8 in 2015. This chain has about 20 restaurants now. In theory, the U.K. could easily support 100 Coast to Coast locations. TRG likes

to open Coast to Coast in places where it already has a Frankie & Benny's or a Chiquito. There are places where you can actually find one of all three chains. TRG also has another concept called Joe's Kitchen. There were only 4 of these restaurants as of last year. There are probably more by the time you're reading this. Again, if the chain is successful, the U.K. could one day support 100 Joe's Kitchen locations. So, ignoring the prospect for more Frankie & Benny's and Chiquito, TRG has the potential for between 80 and 180 more restaurants under the Coast to Coast and Joe's Kitchen names depending on whether Joe's Kitchen is successful or not. This means TRG could double in size within a decade.

TRG rarely uses much debt. It had 88 million GBP of debt in 2008. That was its peak level. Net debt to EBITDA was about one to one. TRG should definitely avoid debt. Fixed expenses are high for any restaurant. But they are much higher in the U.K. than in the U.S. TRG's rent is about 11% of sales. This rent is in the form of long-term leases. Those leases are not easy to get out of. Right now, EBITDAR/(Rent + Interest Expense) is 2.7. This is essentially a cash flow measure of fixed charge coverage. Most of TRG's peers use much more debt. But, in many cases, this can be traced back to their ownership by a private equity firm. That's actually a big reason why we are mentioning U.S. peers for TRG more often than U.K. peers. In the U.S., there are a lot of restaurant chains in public hands. In the U.K., these chains are more likely to be controlled by a private equity firm. Their stock just isn't traded. So, we don't have the data we'd like to have.

Finally, it's worth mentioning TRG has paid a special dividend twice in the last 10 years. If we include these special dividends, we get a slightly higher average dividend payout ratio in the post turnaround era. Let's look at 2002 through 2015. From 2002 through 2015: TRG grew sales by 9% a year, profits by 11% a year, and paid out 56% of its earnings in dividends.

VALUE

TRG Trades at a Discount Both to the Multiples at Which U.K. Restaurants Were Acquired in the Past and to the Multiples at Which U.S. Restaurants Trade Right Now

The Restaurant Group is trading at a very low price in absolute terms. It is trading at an even lower price in relative terms. Both in the U.K. and in the U.S., restaurant stocks tend to trade at high prices. In the past, U.K. casual dining chains that went private did so at a price of around 10 times EBITDA. Right now in the United States, publicly traded restaurants tend to be priced in the 12 to 14 times EBIT range. What does TRG's EV/EBIT look like? Let's start by adjusting EBIT for pre-opening expenses. Once you do that, you get current EBIT of 94 million GBP. This is what TRG would earn in pre-tax profits if it stopped opening restaurants. We could look at TRG's EBIT a different way though. This is the way Quan and I prefer to look at most stocks – and certainly how we like to look at restaurant stocks. Since 2005, TRG has been limited to chains located away from the high street. So, we can look at the last 10 years of the company's history as being similar to what the company is like now. If we assume those 10 years are "normal" for the company, we can simply average the margin level over those 10 years. We get 13%. TRG has tended to earn 13 pence pre-tax for every one pound of sales it makes. Sales are much more stable than EBIT at a restaurant. So, we should – as long-term investors – price restaurant stocks using their current level of sales rather than their current level of EBIT. If we do this at TRG we get 89 million GBP as our "normal" EBIT figure. This works out to an EV/Normal EBIT of 6.3. Remember, TRG is a U.K. stock. A U.S. restaurant chain would pay a minimum tax rate of 35%. So, a U.S. stock with an EV/Normal EBIT of 6.3 would be equivalent to an unleveraged P/E of 9.7. A U.K. restaurant company only pays a 20% tax rate. So, at that same EV/EBIT of 6.3 – a U.K. restaurant stock would have a normalized P/E of 7.9. Basically, we are saying that TRG is trading at a P/E of 8 if you replace the "E" with our estimate of normal earnings and if you include debt in the "P" part of the equation. U.S. peers tend to trade at 12 to 14 times EBIT. Should we take the tax difference into account? A dollar earned in the U.K. is 23% more valuable (0.80 / 0.65 = 123%) than a dollar earned in the U.S., because a company keeps more of its money after tax in the U.K. If you give U.K. companies full credit for this lower tax rate, you would believe that U.K. stocks should be priced 23% higher than U.S. stocks in terms of EV/EBIT. If you don't give U.K. companies any credit for their country's lower tax rate, you would believe U.K. and U.S. stocks should be priced equally in terms of EV/EBIT. Under no circumstances, would you believes the U.K. stocks should be priced at a discount to their U.S. peers. So, let's go with that. TRG is in a country with a lower tax rate than the U.S. So, TRG certainly should not trade at a lower price to PRE-tax profits than its U.S. peers. The lower bound of what TRG should trade for then is the price to pre-tax profits that the U.S. restaurant stocks most like TRG trade for. What are these stocks?

Let's start with Darden. Darden's most important assets are Olive Garden and Longhorn Steakhouse. The stock trades for 11 times EBITDA and 19 times EBIT. However, Darden's margin is abnormally low right now. The current margin is 6%. The historical median margin is 8%. So, we'd estimate that Darden is trading for an EV/EBIT of about 15 if we use a typical year. If we use a peak margin year, the stock trades for just 12 times EBIT. Darden's management is focused on improving the company's margin. So, maybe investors are giving the company the benefit of the doubt when it comes to these plans. Maybe they think the company's margin in the future will normally be as high as it was in only the best years. That's possible. Right now, Quan and I would say Darden is trading at 15 times normal pre-tax profits and perhaps 12 times the most optimistic assessment of what a leaner Darden would

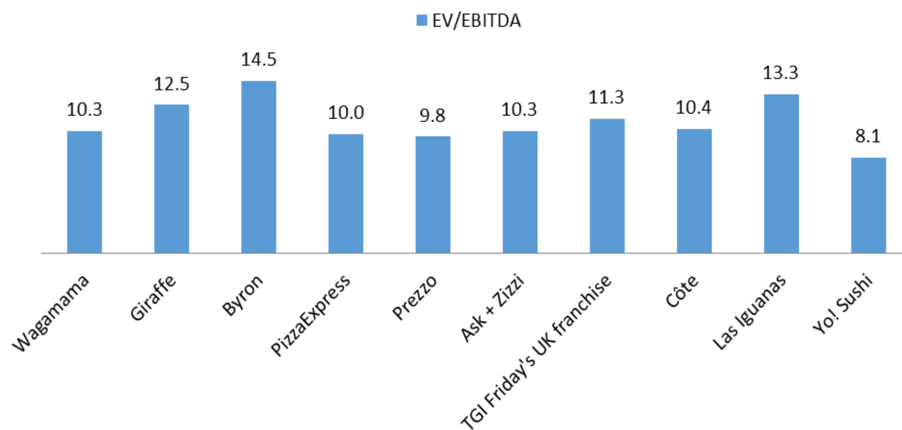
earn in a normal year. So, Starboard – the fund that controls Darden – might say the stock only trades at 12 times pre-tax profit. But, Quan and I would say it trades at 15 times pre-tax profits. So, Darden is a peer of TRG. And Darden's priced at an EV/EBIT of 15.

Brinker's owns Chili's and Maggiano's. The stock trades at 8 times EBITDA and 12 times EBIT. However, if we use the historical median EBIT margin and apply it to today's sales we get an EV/Normalized EBIT of 15. Brinker's has an especially high margin right now. Darden has an especially low margin. In reality, they are both trading at an EV/Normal EBIT of about 15.

Cheesecake Factory is trading at 9 times EBITDA and 13 times EBIT. Using the historical median margin and applying it to today's sales we get an EV/Normal EBIT of just 12 times. So, our EV/EBIT range is: Cheesecake (12), Darden and Brinker's (15).

Bloomin Brands owns Outback Steakhouse, Bonefish Grill, Carrabba's, and Fleming's. The company's margin is right in line with its past history. So, the EV/EBIT of 12 is normal. That gives us two pairs of differently priced peers. Cheesecake and Bloomin on the low end with 12. And Darden and Brinker's on the high end with 15.

Finally, we have Ruby Tuesday's. This stock is hard to price. It might be very cheap. But it is troubled. Whether that trouble is short-term or long-term is the question. Ruby Tuesday's same store sales have declined in 8 of the last 9 years. That's very unusual for a long established chain. The company's pre-tax margin is 2.5% as I write this. The historical median level is 6.7%. If the company could ever string together a chain of same store sale increases as long as the same store sales decreases it has experienced, this stock would turn around in a big way. The stock's EV/EBIT is 14 right now. But, normalized EV/EBIT is 5. Ruby Tuesday's may not be a good peer for TRG. However, it is the U.S. restaurant stock that TRG is priced most like. In fact, Ruby Tuesday would pay a 35% tax rate in the U.S. while TRG pays a 20% tax rate in the U.K. So, the two stocks are actually priced the same based on normal after-tax profit. No one would argue that Ruby Tuesday is a higher quality business with a better future than TRG. But they are priced the same.



Past acquisitions of U.K. casual dining chains tended to be done at prices between 8 and 14 times EBITDA with a price near 10 times EBITDA being the most common.

There are other stocks we could use as peers. Bravo Brio is priced at 9 times normal EBIT. Again, it has been experiencing same store sales declines. So, Bravo is priced above TRG but is an inferior peer in terms of same store sales trend. Chuy's is a very expensive stock that is fast growing. It is priced at 15 times EBITDA and 20 times normal EBIT. Chuy's could easily be a superior growth stock versus TRG. So, we will exclude it as a peer.

That leaves us with 6 possible peers for TRG. Here they are along with their EV/EBIT ratio. Ruby Tuesday (5), Bravo Brio (9), Cheesecake Factory and Bloomin Brands (12), and finally Darden and Brinker's (15). TRG doesn't have the troubled recent history of either Bravo Brio or Ruby Tuesday. The best peers for TRG in my view are Cheesecake, Bloomin, Darden, and Brinker's. All of these stocks trade in the 12 to 15 times pre-tax profit range and have to pay higher taxes than TRG does because they are in the United States.

For this reason, I think it's appropriate to value TRG at not less than 12 times EBIT. The stock now trades at a little over 6 times normal EBIT. So, TRG is worth double what the market has priced it at.

Now, you might be wondering if it's fair to price TRG like a U.S. restaurant chain since it's a U.K. chain. In some ways, it's not. But all of those ways favor TRG over the U.S. peers. Let's look at the 5-year growth rate of TRG's U.S. peers. Cheesecake has 5-year sales growth of 5%, Bloomin has 4%, Brinker has 1%. Darden hasn't grown recently. All of these stocks have grown slower than TRG. Meanwhile, TRG's return on capital (calculated as EBIT/Net Tangible Assets) is higher than these peers. Here are the stocks in descending ROC order: TRG (31%), Cheesecake (26%), Chuy's (24%), Brinker's (23%), Darden (23%), Bloomin (22%). If we consider TRG's U.S. peer group to consist of 4 stocks – Cheesecake, Bloomin, Darden, and Brinker's – we can say that TRG has the lowest EV/EBIT, the lowest tax rate, the highest return on capital, and the highest growth rate of that group. U.K. stocks may be underpriced versus U.S. stocks right now because of the recent referendum which will eventually lead to the U.K. exiting the European Union. Let's assume this will cause a recession in the U.K. and yet no recession in the U.S. But, if you are a long-

term investor who intends to hold whichever restaurant stock you buy in 2016 through the year 2021, does this matter? The answer is no. TRG is cheaper than these U.S. peers now – when you are considering buying the stock. And TRG is likely to be earning as high a return on capital or higher, growing as fast or faster, and being taxed at the same rate or less than all 4 of these peers in the year 2021. If you can buy TRG for a lower EV/EBIT than you can buy U.S. restaurant stocks for today, the question you need to ask is what TRG's ROC, sales growth, and tax rate will look like in 2021. Is there any reason to believe TRG will go from being better than these 4 peers today in these areas to being worse than them? In the short-term – maybe. TRG may perform worse over the next 1 to 3 years. U.K. households may do worse than U.S. households over the next year or three. There's no reason for them to continue to do worse over the next 5 years. So, a long-term investor should prefer TRG over all other restaurant stocks. A conservative relative valuation for TRG is 12 times EBIT. This is the price the perhaps slightly inferior U.S. restaurant chains that are most like TRG trade at today.

GROWTH

TRG's Future Growth Will Come from Fully Saturating the U.K. Market with its Existing Chains

We know that the fastest growing parts of the U.K. restaurant industry are fast casual restaurants and casual dining. TRG runs casual dining restaurants. So it is in one of the best positioned parts of the U.K. restaurant industry. We also know that traffic to retail parks and leisure parks is growing at the expense of traffic to the high streets. TRG's locations are in retail parks and leisure parks rather than on the high street. So, TRG is well positioned for growth in that way as well. Finally, we used peers from the U.S. when comparing TRG to other restaurants. The U.S. food away from home market is more mature than the U.K. market. So, there may be a longer runway for growth in the U.K. than in the U.S. However, this point is the most debatable. Households spend a greater fraction of their income at restaurants as they have more income. In other words, spending at restaurants grows faster than household income. So, it may not be the case that there is a point of maturity that we should look at as an end point. Instead, we should just imagine that whichever countries grow household income the fastest are likely to have the fastest growing restaurant industries. One big difference between the U.K. and the U.S. is that the U.K. has pubs and the U.S. doesn't. The market share of independent restaurants in the U.K. declined from 80% of the industry in 2012 to just 76% today. This sounds like a small shift relative to branded chains. But, it leads to a huge difference in annual growth trends. Over the last 3 years, independent restaurants have shrunk 1.6% a year while branded restaurants have grown 6% a year. TRG runs branded restaurants. So, while the U.K. restaurant industry may not be growing very quickly as a whole – the only part that TRG competes in (branded chains) is growing more than 5% a year. That's quite fast considering how slow U.K. nominal GDP growth was over the last few years.

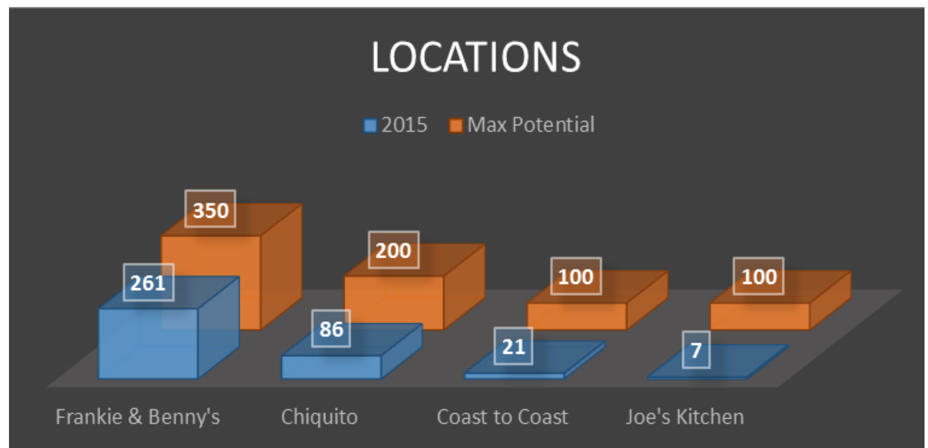
Of course, TRG's existing concepts will eventually reach a point of saturation in the U.K. Some of these chains are already quite big. Here is the existing restaurant count and the potential number of locations TRG management says that chain can one day support: Frankie & Benny's 261 (350), Chiquito 86 (200), Coast to Coast 21 (100). TRG also believes they can add some concessions, pubs, and "other" restaurants. This would include things like Joe's Kitchen. That might be true. But let's ignore all that. Let's just use the 3 chains of Frankie & Benny's, Chiquito, and Coast to Coast. And let's trust TRG's potential targets. We have no idea if these potential targets are realistic or not. But they're the best estimates we have. So, let's see how many total new locations TRG thinks it can add to each chain. Frankie & Benny's has 261 locations now and TRG thinks it can reach 350 or more. That's a potential 89 more locations. Chiquito has 86 locations now and TRG thinks that chain can reach 200 or more sites. That's 114 more potential locations. Coast to Coast has 21 locations now. TRG thinks Coast to Coast can reach 100 or more locations. That's a potential 79 more locations. So, TRG thinks it may eventually be able to add 114 more Chiquito locations, 89 more Frankie & Benny's, and 79 more Coast to Coasts. That's a total of 282 more locations TRG thinks it can add. Those 3 chains now have 368 locations combined. So, that's an addition of about 75%. TRG's same store sales have tended to grow about 2% a year over the last 10 to 15 years. Let's assume TRG can grow its number of locations by 75% over the next decade and grow same store sales at all its locations by 2% a year for the next decade. What would that look like in terms of sales and profit growth for the company?

Remember, we're assuming this growth takes a full decade. So, this is sales growth from 2016 to 2026 we're thinking about. That works out to 8% annual sales growth. Growing these 3 chains from 368 locations now to 650 locations by 2026 would mean 5.8% compound annual growth in the number of locations. So, if same store sales were roughly flat, these chains would grow about 6% a year. Of course, flat same store sales would cause bad location economics and poor profit growth or even declining profits. What I want to show here is that perhaps TRG can grow at about 8% a year for the next 10 years. And, if it does so, TRG will be able to get most of that growth simply from adding more locations to existing chains.

Are these targets that TRG has for the eventual size of each chain realistic? Let's compare the U.K. to the U.S. We can divide the U.S. population by the U.K. population to get a multiplier. This multiplier can then be applied to the number of locations TRG projects for each chain to get us a "U.S. equivalent" size. For example, Frankie & Benny's already has 261 sites in the U.K. That's equivalent to a 1,305 site chain in the U.S. This is because the U.S. population is 5 times the size of

the U.K. population. A 350 site goal is very ambitious. That would be equivalent to a 1,750 site chain in the U.S. Is there such a chain? Yes. There's one. It's called Applebee's. And it has 1,878 sites in the U.S. There are very, very few casual dining chains in the U.S. with more than 1,000 locations. This tells us there should be very, very few casual dining chains in the U.K. with more than 200 locations. In the U.S.: Applebee's has 1,878 sites, IHOP has 1,441 sites (though it's mostly a breakfast place), Chili's has 1,252 sites, Olive Garden has only 840 sites. So, even the ubiquitous Olive Garden falls short of the 1,000 site mark in the U.S. That means we shouldn't assume the U.K. can support more than 3 or so chains with more than 200 locations. Frankie & Benny's is the biggest casual dining chain in the U.S. If it reaches 350 locations in the U.K., that would be like reaching 1,750 sites in the U.S. Applebee's is the largest casual dining chain in the U.S. It has 1,878 sites right now. So, yes, 350 sites sounds like the maximum number of locations we could expect Frankie & Benny's to ever have. TRG says Chiquito has the potential to reach 200 locations. That's equivalent to 1,000 locations in the U.S. Chili's has 1,252 sites in the U.S. Chili's and Chiquito are pretty comparable. So, again, TRG's estimate of the future potential of that chain is just within the realm of reasonability. Finally, TRG has estimated Coast to Coast's future potential is 100 sites. That's equivalent to 500 sites in the U.S. Olive Garden has 840 sites, Outback has 753, Ruby Tuesday has 687 sites, and so on. As you can see, chains of 500 locations aren't unthinkable in the U.S. And chains of 100 locations aren't unthinkable in the U.K. It's possible Coast to Coast could one day support 100 locations. Any other chains that turn out to be successful – like let's say Joe's Kitchen – could also be assumed to have a ceiling at 100 locations.

The type of culinary theming of U.K. restaurants isn't exactly the same as in the U.S. Italian themes – especially pizza – are big in the U.K. We looked at



Going by TRG's own estimates: Frankie & Benny's is now at 75% of total saturation, Chiquito is at 43%, Coast to Coast is at 21%, and Joe's Kitchen is at maybe 7%.

the 40 largest casual dining chains in the U.K. These account for a huge number of all branded restaurants. So, we'll use them as a biased by illustrative sample to stand in for the branded casual dining market as a whole. The top 40 have 4,970 locations. Pubs account for 1,902 (38%) of the top 40 chain locations. Italian themed restaurants – excluding pizza – account for 1,088 locations (22%). So, pubs and Italian restaurants account for 2,990 locations. American themed restaurants – excluding pizza – account for 334 outlets. There are only two American themed restaurants in the top 40: Frankie & Benny's (261 locations) and TGI Friday's (73). Pizza Hut has about as many locations as Frankie & Benny's. Pizza Hut is positioned more as a casual dining restaurant in the U.K. I excluded it because a pizza focused restaurant doesn't seem to count as American themed. The food being served is really American style pizza. But, I don't think people eating out in the U.K. think of pizza as especially American. Other top 40 chains include Japanese, French, and Mexican themed restaurants. Taken together, these 3 themes are bigger than the American theme. Taken separately, each is about half the size of the total number of American themed locations. Right now, TRG has the biggest American themed restaurant in Frankie & Benny's and the biggest Mexican themed restaurant in Chiquito. Coast to Coast is American themed. But it is much smaller than TGI Friday's. There is plenty of room for more American themed restaurants. Mexican themed restaurants may also do fine.

Since 2005, TRG grew its store count by 7.9% annually. TRG opened 44 restaurants last year. They plan to open 40 restaurants this year. If they continued at this pace, the annual growth in locations would be 7% a year over the next 5 years. More conservatively, we could imagine a number as low as 5% a year over the next 10 years to fill out all the existing chains to the sizes TRG has talked about being their full potential. So, growth in the number of locations of 5% to 7% is possible at the big chains. Concessions, pubs, and other may not grow at all. This can drag down the overall company's growth rate. Location growth of at least 5% a year seems reasonable in most years. At least for the next 5-10 years. Let's take the shortest of those time periods and the lowest growth rate. Let's assume 5% annual growth in the number of total locations at TRG from 2016 through 2021. That would leave the company 28% bigger in location terms than it is now. That's perfectly reasonable.

Same store sales are harder to predict. Historically, TRG often achieved 3% annual same store sales growth. The number of new restaurant openings can drag down same store sales growth. New location openings for the industry as a whole slowed from 2.8% in 2014 to 1.5% in 2105. This sounds like a slow growth rate. However,

what seems to be happening is that pubs are shrinking while restaurants are growing. In fact, there have been years where the number of food led restaurants – so not pubs, which focus on drink – grew by almost 7%. That's probably too rapid a rate of growth to allow for much if any same store sales growth. However, if this figure slowed to say 4% to 5% a year, you could easily see same store sales growth.

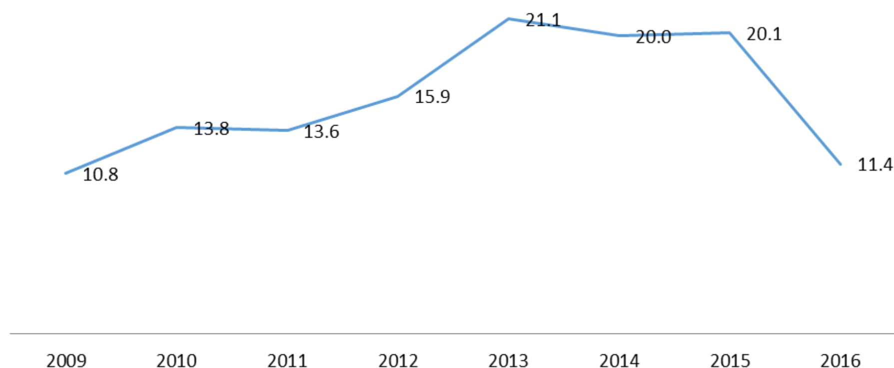
Obviously, TRG's same store sales can decline as Bravo Brio's sales have recently and as Ruby Tuesday's sales have for almost a decade now. This can happen because of a change in the popularity of Frankie & Benny's primarily and secondarily a decline in Chiquito's popularity. TRG is sensitive to the popularity of Frankie & Benny's. That chain now provides half of all sales. A reasonable expectation for TRG's same store sales – if the company is able to maintain the popularity of those chains – is maybe 1% to 2% annual same store sales growth. So, over the next 5-10 years, you might see location growth of 5% to 7% a year and same store sales growth of 1% to 2% a year. This could lead to sales growth of about 6% to 9% a year. I think it's reasonable to expect TRG will grow companywide sales by about 6% a year over the next 5 years. This would make the company about one-third bigger in 2016 than it is today. The stock's return would be a combination of the earnings per share growth rate (for which companywide sales growth is a good proxy), the dividend yield, and the earnings multiple's expansion or contraction. TRG's earnings multiple (EV/EBIT = 6.4) is so low right now, that it's actually this "value" part of the investment case that could provide the most return. Assume the EV/EBIT multiple expands from 6.4 to 12 over the next 10 years. That's a long time to converge with its U.S. peers. Even over such a long period of multiple expansion, this factor would contribute 6.5% a year to the stock's annual return. That's potentially as high or higher than the contribution from actual earnings growth. In fact, if the multiple expansion from an EV/EBIT of about 6 to an EV/EBIT of about 12 happened in as little as 5 years – the contribution to your return in holding the stock would be about 13% a year from the multiple expansion. So, is TRG a growth stock or a value stock? Quan and I think TRG can grow faster than U.K. GDP. That makes it a growth stock. But we also think the stock is cheap enough that the contribution from "value" to your return in the stock even if you hold TRG shares for 5 years or more could actually be greater than the contribution from "growth". This is especially true if you consider the dividend yield to be another form of "value" investing. So, we think TRG is a solid moderate growth company. But TRG stock may be a bit more of a value stock than a growth stock right now.

MISJUDGMENT

We Are Assuming TRG Can Grow About 6% While Paying a 4% Dividend Yield – The P/E Ratio on the Stock Shows the Market Does Not Believe TRG Will Continue to Grow

There are several ways we might misjudge The Restaurant Group as a stock. The most likely way is for us to be wrong about same store sales. Restaurant chains often go through periods of consecutive gains in same store sales one quarter after another. And then they often go through other periods during which they have consecutive declines in same store sales in quarter after quarter. If TRG posts same store sales declines for a year or two years in a row – the stock may react very negatively. This would be justified if you – the investor – knew that the same store sales trend of TRG would follow the sort of almost decade long declines that have plagued Ruby Tuesday. The problem is that you can't know that ahead of time. Even very good restaurant concepts can have a year or two of declining same store sales. It doesn't even have to be caused by anything specific to the company. For example, the U.K. recently held a referendum on whether or not to leave the European Union. The majority of votes cast in that referendum were for "leave". That means the U.K. is likely to leave the European Union sometime in the next two years or so. Untangling itself from the European Union, could do damage to the U.K.'s short-term economic growth. In other ways, it could obviously benefit parts of the economy. For example, if the Pound is cheaper versus the Euro, the U.S. dollar, etc. this can help U.K. exporters and U.K. tourism. Since the referendum, the Pound has dropped quite a lot. That could be temporary. And other ill effects of leaving the E.U. could make it more likely the U.K. will enter a recession. Same store sales depend in part on nominal GDP growth. The rate of inflation matters. And the real rate of GDP growth matters. On top of this, people spend more at restaurants – or rather, they visit them more frequently – when they are feeling optimistic about their income situation. And they visit less when they are feeling poorer. So, the U.K. leaving the E.U. could hurt U.K. stocks like TRG. It could make it more likely TRG will post negative same store sales for a couple years in a row. And it could make it more likely TRG shares will react violently to such a same store sales decline. Also keep in mind that TRG earns its income in Pounds. If you are a U.K. investor, this presents no problem. Your savings are in Pounds right now. But, if you are a U.S. investor, a Canadian investor, etc. you are taking savings in a currency that is not the same as what TRG earns its money in. And then you are trading that currency for Pounds to buy TRG shares. Is this a good deal right now? It's certainly a better deal than it was before the referendum. We have only two pieces of advice on currency exchange rates for long-term investors. One is that there's nothing wrong with having say 50% of your portfolio in stocks denominated in currencies other than your home country's currency. So, if you are an American, and you have more than 50% of your money in the U.S. – go right ahead and buy TRG stock without worrying at all about the currency. Don't try to hedge any positions you have in other countries. Our second piece of advice is that – other

things equal – you want to avoid swapping into a currency that is trading above purchasing power parity with your own. This issue will quickly be out of date in terms of exchange rates. So, you'll need to check currency exchange rates yourself if you're worried about that. You can look at The Economist's "Big Mac Index" for a very rough gauge of where currencies are versus where they should be. You can also simply go on Google and search for currencies and their premium or discount to purchasing power parity (PPP) with the U.S. Dollar. As I write this, the Great British Pound is not especially overvalued versus the U.S. Dollar. So – for Americans at least – there is absolutely nothing to worry about in terms of the currency TRG trades in. This is advice for long-term investors. The Pound could do anything next month or next year. When we recommend a stock in Singular Diligence we expect you to buy that stock today and then hold that stock for a full five years. If you aren't willing to hold a stock for five years – currency fluctuations could be more of a problem. Purchasing power parity is a very good yardstick for the long-run. It's not going to help you figure out where the Pound will be versus the Dollar in a year or two though. Both Quan and I have no problems putting our own money into stocks denominated in Pounds at today's exchange rates. It's not something we think you should worry about either. But, your brokerage account will of course show the combination of TRG's gains and losses in Pounds while you hold it and the added fluctuations of translating those Pounds back into your home currency. I don't think we're likely to have "misjudged" the long-term future of the Pound. But, I do think we have no idea what short-term to medium-term movements in currencies will be. So, this isn't so much a misjudgment risk as a pure uncertainty risk. You could easily be hurt more than we expect by the Pound's performance. But you could just as easily benefit from the Pound's performance. We've assumed complete neutrality as far as currencies go. When we discuss the total return potential of TRG, we're just talking in Pounds. Basically, we're talking as if you were a U.K. based investor buying this stock. Of course, Quan and I aren't U.K. based. I invest in U.S. dollars. And TRG is – among the stocks we've picked for Singular Diligence so far in 2016 – the stock I'm most interested in investing my own money in right now.



Over the last year, TRG's P/E ratio dropped more than 40% (from 20 to 11) while same store sales dropped less than 3%.

There are a few other risks of misjudgment. Most are pretty small. The U.K. changed its minimum wage laws. See the "Misjudgment" section of the notes at the back of this PDF for details. Basically, the lowest wage an employer is allowed to pay has increased for workers 21 years and older. It hasn't changed for teens. The U.K. government plans to increase the minimum wage by about 25% within the next 5 years. Undercutting each other on price isn't really a feature of competition in the restaurant industry. And the industry is completely localized. Minimum wage laws have the most potential to harm a firm if it's something like a price focused exporter. In such a case, they'd now be competing against other firms that can still access cheap labor they no longer can. Restaurants aren't doing anything like that. The minimum wage law will raise the cost of labor for all of them. For restaurants, labor and food costs are considered variable and are together taken as the "prime cost". You can then mark-up your menu prices by some percentage over prime cost. So, an increase in the minimum wage is basically the same thing as an increase in food costs. In either case, there can be a short-term negative impact as restaurants are slower to change their menu prices than their costs change. But, the long-run impact is simply fewer people eating out because it's more expensive. TRG can see the same volume declines in traffic that all restaurants would see if they raise their menu prices. Higher minimum wages also incentivize a company to find ways to eliminate labor. And, in the case of the U.K. where older workers have higher minimum wages, it also encourages hiring younger workers in place of older workers. So, hiring more people in their teens. And avoiding hiring people in their early twenties who have no prior experience. It's a short-term negative. Looking out 5 years, I don't think we'll remember this minimum wage thing being an issue at all. The same is true of "Brexit". I expect you'll see headlines about Brexit's negative impact on the U.K. economy generally and consumer confidence specifically throughout 2016, 2017, and 2018. But by 2020 and 2021, I imagine we won't hear a thing about Brexit anymore. I consider a long-term investment to be 5 years or more. This is a newsletter for long-term investors. So, I expect you won't be selling TRG before 2021. In other words, I expect talk of both the minimum wage hike and Brexit to have petered out by the time you sell TRG.

The reason the stock is down so much recently is probably the same store sales declines. For example, TRG's same store sales have decline 2.7% so far in 2016. This is a concern. In fact, it's a big concern. But, TRG is now trading at about half the price of a typical restaurant stock. A so far brief record of moderate declines in same store sales does not warrant pricing a stock at 50% off what a normal restaurant chain goes for. TRG also has better growth prospects than the U.S. peers we discussed in the "value" section. So, you have to believe same store sales declines will be sustained to justify this price.

How do we know TRG won't keep posting same store sales declines forever? We don't. Ruby Tuesday pretty much has. We might misjudge TRG's prospects here. We might be ignoring a warning sign that the Frankie & Benny's concept is now in permanent decline. But, the other risk of misjudgment is being biased by recent information. Greggs is a good example. Greggs posted same store sales performance that was weak in 2009-2013. It was up 0.8% in 2009, up 0.2% in 2010, up 1.4% in 2011, then down 2.7% in 2012, and down another 0.8% in 2013. The stock got down to a P/E around 12. And that P/E ratio was on the company's lowest operating margin number in 25 years. So, the P/S ratio – which is probably a better indicator for a restaurant – was even cheaper. The media, analysts, etc. were pretty negative on Greggs during the same store sales declines in 2012 and 2013. In 2014, Greggs grew same store sales by 4.5%. In 2015, Greggs grew same store sales by another 4.7%. Margin expanded. The P/E went from about 12 to about 20. The stock more than doubled. And people pretty much forgot the risk that the concept might be obsolete which worried them so much in 2012 and 2013. I can't say whether that fear was absurd or reasonable. But, I can say the market took the risk perhaps too seriously while the most recent same store sales figures were negative and took the risk perhaps not seriously enough when the most recent same store sales figures were positive. In other words, the market focused on just the most recent same store sales number. It didn't look at the last quarter century or so of really pretty predictable results at Greggs. TRG's recent same store sales numbers are bad. But, you're only buying TRG stock today. You're not going to sell it for at least 5 years. That means you don't want to focus on what TRG's same store sales will be in 2016. You want to focus on want TRG's same store sales will be in 2021. The most recent numbers won't help you make that estimate. The long-term trend over the last 15 years or so is probably a better guide. Quan and I would guess that TRG's same store sales are more likely to be up between 1% and 2% when you sell the stock in 2021 than they are to be down 1% to 2% as they are right now. This is the biggest risk of misjudging TRG stock. The market might be right in putting so much weight on the most recent results. But, Quan and I think the market tends to focus way too much on the very recent past.

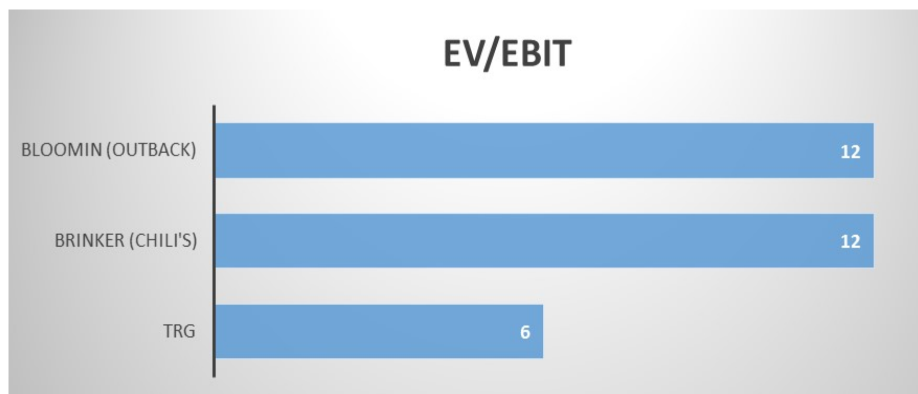
FUTURE

TRG is So Cheap Compared to Peers the Stock Can Provide a Solid 5-Year Return Even if Same Store Sales Are Close to Flat From Now Through 2021

We're now going to look out five years at what a possible 2021 could look like for TRG. We're doing this because we – as long-term investors – always want to focus on what a business will look like when we sell it rather than what a business looks like when we buy it. Some bad things could happen to TRG between now and 2021. One, the company's same store sales could continue to decline. As I mentioned earlier, same store sales declined 2.7% in the early part of this year. So, TRG has declining same store sales right now. If that continued for several years, it would leave TRG in a bad place for 2021. Two, the country TRG is in – the U.K. – could have a recession. It could last for a few years. That might put TRG in a slightly worse place than we'd imagine for 2021. However, this macroeconomic factor actually can't be very big when looking out to 2021. Recessions are neither very deep in percentage terms nor very long lasting when compared to company and even industry specific factors. So, if you're concerned about both TRG's same store sales and "Brexit" – the popularity of TRG's concept and the impact that has on same store sales should be your much bigger concern. Obviously, if you are a momentum type investor, a trader, or someone with an investment time horizon of less than 3 years – these factors could and probably should put you off TRG stock. The company is experiencing same store sales declines right now. And the U.K. is about to leave the E.U. These trends are bad for TRG. And they would be bad for an investor who held the stock in 2016, 2017, and 2018. I don't think they are a big issue for an investor planning to hold the stock through 2021. I certainly don't think "Brexit" is anything to worry about if you're a long-term investor. Finally, there is the industry problem that could crop up. Casual dining chains in the U.K. could open too many new locations. So, let's organize the three risks for the next 5 years into the company risk, the industry risk, and the country risk. The company risk is that the Frankie & Benny's and Chiquito chains will decline in popularity and TRG will continue to post negative same store sales. The industry risk is that TRG's competitors will open too many new restaurants especially in retail parks and leisure parks. And the country risk is that the U.K.'s "Brexit" will cause a recession that lasts multiple years. Same store sales declines will lead to even bigger percentage declines in earnings. So, a 5% drop in same store sales leads to a much, much larger drop in earnings. This is because a large portion – as much as 40% to 50% – of a restaurant company's expenses are relatively fixed. The truly variable part of a restaurant's costs are just the "prime cost" of food plus labor. Everything else will still be an expense even on lower sales. Continuously declining same store sales are a huge problem for restaurant companies. But many restaurant chains

experience a couple quarters or even a couple years of same store sales declines and then turn them around. This may happen once or twice a decade even to a good chain. We know TRG's own Chiquito had a brief bad period in the early 2000s. And, of course, TRG had negative same store sales during the financial crisis – as did almost all restaurant chains. It's likely TRG would have negative same store sales during a U.K. recession. But will TRG still be posting same store sales declines in 2021? And will the U.K. still be in a recession in 2021? I think the answer to both these questions is likely to be no. TRG is no more likely to have negative same store sales in 2021 than any other restaurant stock you can buy today. And the U.K. is no more likely to be in a recession in 2021 than the U.S. is. It's a fair point to say that the U.K. may be more likely to be in a recession than the U.S. in 2016, 2017, or 2018. But it doesn't make any sense to say the U.K. is more likely to be in a recession in 2021. So, if you're willing to commit to a 5-year holding period – as Quan and I expect all readers of Singular Diligence to be – than Brexit is simply something you have to endure holding the stock through rather than something you have to worry will be depressing the stock's price at the very moment you hope to sell. Let's leapfrog over the next few years. What might 2021 look like?

We don't know how many restaurants competitors will open. If the U.K. enters a recession, they'll plan to open fewer locations. And if all casual dining chains – not just Frankie & Benny's – are showing weaker same store sales, they'll plan to open fewer locations. Restaurant openings are likely to be trend chasers. As long as the same store sales trends of the most recently opened locations looks good, chains will keep pushing into more and more places. They'll stop when oversaturation is hurting same store sales. And they'll stop when they are in the middle of a recession. Otherwise, they'll be relentless in opening new locations because the return on capital



TRG trades at a 50% discount to publicly traded U.S. peers like the owner of Outback Steakhouse (Bloomin) and Chili's (Brinker).

for an additional location in a successful chain is very high.

How many locations will TRG open? The company could open up to 150 stores over the next 5 years. It's reasonable to assume that – if same store sales eventually turn back to positive – TRG could have as many as 650 stores in 2021. And it could have plans on the table to open another 40 to 50 stores annually in 2021 and beyond. So, when you are planning to sell TRG in 2021, the stock could have a total of 650 stores and be opening new stores at a rate of 40 to 50 a year. That would mean the unit growth rate in terms of locations would be running at about 6% a year. At that rate of 40 or more store openings a year – TRG would be able to pay a dividend equal to half of earnings. It might actually be able to pay a bit more than that. But, we'll assume half. Assume an inflation level type rate of same store sales growth. Even if you expect really low inflation in the U.K. in 2021 – and I'm not sure we'll still be in quite as low an inflation world 5 years from now as we are today – you'd still want to assume same store sales growth of between 0% and 2% a year. So, in 2021, you'd own a stock growing its EPS by about 6% to 8% a year and paying out half of that EPS in dividends. This rosy scenario could get you a return in the stock over the next 5 years of up to 18% a year if the earnings multiple on the stock rises to the same EV/EBIT ratio that U.S. restaurant chains have right now.

What about a gloomy scenario? Quan sketched out an arbitrary one of those. This is meant to show how bad things would have to be before TRG would start underperforming as a long-term investment. This is not our actual prediction of how we expect the company to look in 2021. Let's assume TRG has 0% same store sales growth between now and 2021. But let's also assume that TRG and its competitors continue to open new locations at an aggressive rate. This causes TRG's margin to decline. It goes from the roughly 13% EBIT margin it has had recently to just a 10% EBIT margin. That's the level TRG had in 1998-2005 during its turnaround. The stock would still be able to pay a dividend yield of around 4% on today's price. And the expansion in the earnings multiple from today's low level to what we think would be a fair level (a P/E of 15) for a decent restaurant chain would add close to 6% a year to your total return. In fact, we'd expect your total return in the stock to be 9% to 10% a year even without any net cumulative same store sales growth between 2016 and 2021 if TRG could manage to keep its margin at 10%. In other words, if TRG's profits per store decline by 20% to 25% between 2016 and 2021, we still think you could make almost 10% a year buying the stock and holding it through 2021. Obviously, this return would be a pure "value" stock return. You'd get a dividend yield of about 4% a year. And you'd get earnings multiple expansion from today's P/E of about 8 to a future P/E of about 15. There's a simpler way of looking at this. Right now, TRG is a value stock. It has a dividend

yield of about 5.4%. Let's call that 5%. And it has an EV/EBITDA of about 5. Historically, acquisitions of U.K. restaurant chains have been done at around 10 times EBITDA. Assume you buy TRG stock today and hold it for 5 years. Then assume the company goes private or is otherwise acquired at 10 times EBITDA. If the stock had stagnant EBITDA between now and 2021, you'd still earn close to 20% a year over your 5 years holding the stock. That's because the dividend yield is 5% and because a multiple expansion from 5 to 10 completed in 5 years requires a compound capital gain of 15% per year. Should you expect a 20% annual return in TRG? Absolutely not. For one, TRG won't pay as high a dividend in the future as it did in the past if the company's earnings decline. It's only safe to assume the same payout ratio. Not the same dividend level. Secondly, those restaurant chain acquisitions done at 10 times EBITDA were during a period of very low interest rates and very high stock prices. Stocks could be cheaper in the future. And restaurant chain acquisitions in the U.K. could tend to be done at a much lower multiple. Let's assume TRG can't pay a dividend yield of 5% a year. Instead, it cuts the payout by about 20%. So, you get a dividend yield of just 4% on your purchase price. And let's further assume that restaurant acquisitions in the U.K. are done at 7 times EBITDA instead of 10 times EBITDA. TRG now trades at 5 times EBITDA. So, it would need to increase in price by 7% a year between now and 2021 to trade at 7 times EBITDA even if it has a stagnant EBITDA level. That 7% annual price appreciation plus the 4% dividend yield would give you an 11% annual return over a 5 year holding period. I think that's a good "base case" for buying TRG stock. It now pays a dividend yield of more than 5%. You anticipate getting a dividend yield between 2017 and 2021 of about 4% on your purchase price. It now trades at 5 times EBITDA. You expect the stock to trade at 7 times EBITDA when you sell it. You're willing to hold the stock for 5 years. That gets you to a scenario where you can make 10% a year even if the company doesn't increase its earnings. That's the definition of a value stock. You can hold it for 5 years. It doesn't have to grow. And you can still make 10% a year. That's value investing. I personally think TRG has more growth potential than most value stocks. I can see the company expanding Frankie & Benny's, Chiquito, and maybe Coast to Coast to a lot more locations over the next 10 years. I don't know if that progress will stall because of problems with the chains or problems with the U.K. economy. But, I think you can buy TRG as a value stock and expect a 10% a year annual return while knowing it might turn out to be a growth stock that delivers a return more like 15% to 20% a year. In either case, you need to go in to the stock planning to hold it through 2021. Restaurant stocks have extreme price swings depending on their very recent same store sales trends. A stock with a negative 2% same store sales trend can have a P/E under 10 while the same stock in a year with positive 2% same store sales can have a P/E over 20. This is obvious advice. But, don't sell the stock when it has a P/E of 10 and same store sales are down 2%. Sell the stock when it has a P/E of 20 and same store sales are up 2%. Of course, this means you need to have faith in a year when same store sales are down that they will one day be up again. That faith is critical to any restaurant stock investment. If you don't think you can hold a restaurant stock while same store sales are down and getting worse – you can't buy a restaurant stock in the first place. If you can handle seeing bad same store sales trends and you have the patience to hold a stock for 5 years, Quan and I think TRG is your best investment choice for 2016 so far.

The Restaurant Group (London: RTN)
Appraisal: 698p

Price-to-Appraisal: 47%

Owner Earnings	(in millions)
Pre-tax Owner Earnings	
Revenue	£685.0
* Normal EBIT margin	13%
= Pre-tax Owner Earnings	£89

Business Value

TRG's business value is £1,424 million.

- Pre-tax owner earnings are £89 million
- Fair multiple = 16x pre-tax owner earnings
- £89 million * 16 = £1,424 million

Fair Multiple

TRG's business is worth 16x pre-tax owner earnings

- Growing restaurant chains usually trade at more than 20 P/E
- U.K. corporate tax rate is 20%
- 20x after-tax owner earnings equals to 16x pre-tax owner earnings

Share Value

TRG's stock is worth 698 pence a share.

- Business value is £1,424 million
- Net debt is £32 million
- Equity value is £1,392 million
- £1,424 million - £32 million = £1,392 million
- Equity Value = 698 pence/share
    - 199.4 million outstanding shares
    - £1,392 million / 199.4 million = 698 pence

Price/Appraisal

Restaurant is trading at 39% of its value.

- Business Value = £1,424 million
- Enterprise Value = £560 million
- £560 million / £1,424 million = 39%

	EV/Sales	EV/Gross	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Ruby Tuesday	0.35	0.47	5.00	13.92	5.16
Bloomin Brands	0.76	1.13	7.27	12.43	12.43
Cheesecake Factory	1.19	1.56	9.10	13.26	11.87
Darden	1.20	1.73	10.80	18.81	14.95
Brinker	1.24	1.68	8.19	12.01	15.18
Minimum	0.35	0.47	5.00	12.01	5.16
Maximum	1.24	1.73	10.80	18.81	15.18
Median	1.19	1.56	8.19	13.26	12.43
Mean	0.95	1.31	8.07	14.09	11.92
STDEV	0.39	0.53	2.16	2.74	4.05
CV	41%	40%	27%	19%	34%
TRG (Market Price)	0.82	1.03	4.21	5.96	6.29
TRG (Appraisal Value)	2.08	2.62	10.69	15.14	16.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

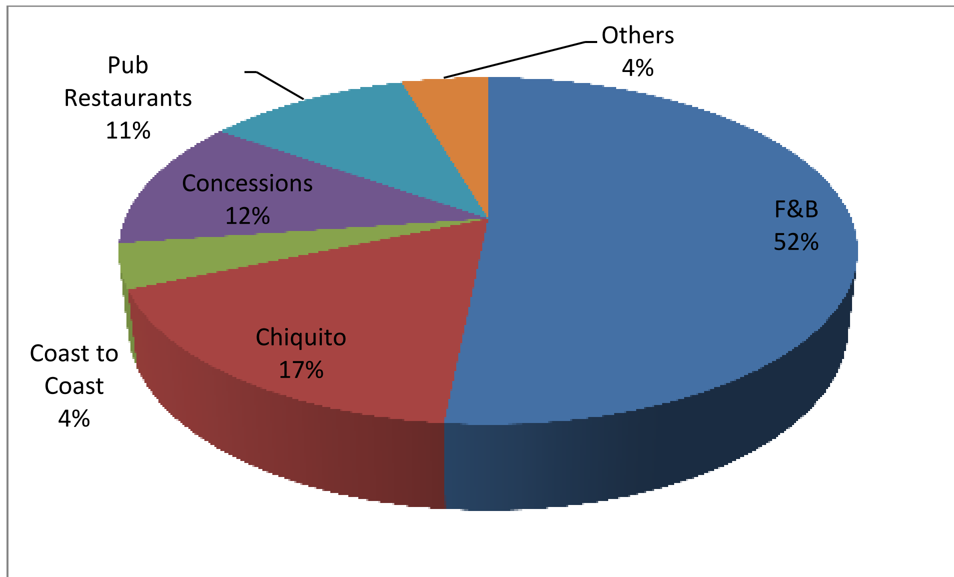
NOTES

The Restaurant Group

London: RTN

Overview

The Restaurant Group: a Giant Casual Dining Group with a Focus on Niche Locations



85% of TRG's restaurants are in leisure and retail parks or concession areas

- TRG was originally founded in 1987
  - As City Centre Restaurant plc.
  - With the objective of owning and managing the Garfunkel's restaurant chain
    - Garfunkel's is a casual family restaurant
      - Similar to Denny's
    - Garfunkel's operated in[1]
      - Airports
      - Prime tourist locations in London
        - Feeding off tourists and cinema-goers
- Over the year, City Centre acquired and developed new brands
  - Acquired the Mexican chain Chi chi's
    - In 1989
    - Renamed the chain as Chiquito
  - City Centre's greatest development was Frankie & Benny's
    - Opened the first restaurant in 1995
    - Frankie & Benny's is an nostalgic American dinner chain
      - Themed to reflect the 1950s Italian-American backstory
- City Centre had a structure that promote development of new brands[2]

- Citi Centre gave generous autonomy to its divisional leaders
  - Quickly scrapped unsuccessfully test launches
  - Rolled out those that earn good ROI just as quickly
- Maintained minimal corporate management staff
  - Financial staff
    - 40 accountants, payroll clerks and purchasing managers
  - A human-resources director
    - Set policy
    - But doesn't handle hiring or recruiting
  - A corporate chef
    - Barbara Eggar
      - A American-born graduate of The Culinary Institute of America
    - Gets involved in the development of new concepts
    - But leaves day-to-day menu management to the executive chef at each of the chains
- Central office was almost like a bank or an investor
  - Finance is the only area where brands have no latitude
- The company appointed a "champion" to spearhead the development of a prototype
  - For the so-called embryo concept (2)
  - The concept champion shares office space with one of other brands
    - Until the concept proves viable
      - => has 2 or 3 units open
    - => the champion finds and staffs his own office

- By late 1990s, City Centre owned a bunch of brands[3]
  - Garfunkel's
  - Chiquito
  - Frankie & Benny
  - Caffé Uno
    - Casual Italian eateries
    - Rustic "Tuscany farmhouse" décor
    - A menu boasting made-from-scratch dishes
  - Deep Pan Pizza
    - A sit-down pizza restaurant
    - Compete head-to-head against Pizza Hut
  - Wok Wok

        - Offers a menu of house-made noodles
            - And other made from-scratch Asian dishes
    - Est Est Est
        - A high-end Italian chain
        - With a light, exposed-steel décor
        - Operating in affluent communities in northern England
    - Nachos Mexican Bar & Restaurant
        - Old-fashioned neighborhood cantinas
        - Selling burritos, enchiladas and other basic Mexican fare
    - O K Diner
        - 1940s-style American diners
        - Offering burgers, hot dogs and other typical diner fare
- Then came problems
    - Its biggest brand Deep Pan Pizza underperformed
    - Other high street brands struggled
    - Analysts criticized City Centre for
        - Having too many brands
        - Operating in too many markets
    - James Naylor resigned as CEO
        - In 03 October 2000
        - Andrew Guy was promoted to CEO
- In March 2001, Alan Jackson was appointed as Executive Chairman
    - Andrew Page joined two months later
        - As Finance director
- The new management refocused the business
    - Sold underperforming brands
        - Deep Pan Pizza
        - O K Diners
        - Wok Wok
    - Focus on business segments with 3 key characteristics[4]
        - High return on capital
        - Good growth prospects
        - Barrier to entry
    - They found two best performing segments that meet these criteria
        - Leisure Parks
            - Restaurants operate in out-of-town leisure parks
                - Frankie & Benny's

            - Chiquito
        - Concessions
            - Operates at U.K. airports
    - They kept well-performing High Street brands
        - Garfunkel's
        - Caffé Uno
        - Est Est Est
        - These are cash cow
        - But they let the business shrink overtime
            - Sold Est Est Est
                - In March 2005
            - Sold Caffé Uno
                - In November 2005
            - The number of Garfunkel's declined
                - 2001: 33 locations
                - 2006: 29 locations
                - 2011: 23 locations
                - 2015: 13 locations
- The company was renamed as The Restaurant Group
    - In 2004
- The sale of Caffé Uno basically signal the end of TRG's High Street presence
    - In 2005
- TRG also made two small acquisitions to enter the pub business
    - Blubeckers[5]
        - In June 2005
        - Paid £27 million
        - A chain of 12 family-oriented pub-restaurants
            - Operates in semi-rural locations
        - These pub-restaurants are a drive-to destination
            - Within easy reach of large urban populations
        - TRG planned to expand by taking leases on existing pubs
            - From large pubcos such as
                - Punch
                - Enterprise
    - Brunning & Price[6]
        - In October 2007
        - Paid £32 million

            - 12 quality pubs
                - Most sites are in rural or semi-rural locations
                - 5 are freeholds
            - B&P's sales: £18 million
                - Pre-tax profit: £1.2 million
            - B&P pubs have a more relaxed feel compared with Blubeckers
            - B&P's pubs aren't branded
                - But share a similar type of fit out and operating style
                - High quality food
                    - Won the Good Pub Guide's Food Pub of the Year for the 3rd time
                        - In 2007
                - Attract a regular and loyal customer base
- TRG focused its growth on
    - Leisure and retail parks
    - Concessions
    - Rural and semi-rural pub-restaurants
- TRG's strategy paid off
    - TRG benefit from controlled supply in its locations
        - Construction and extension of leisure and retail parks are difficult
            - Due to restrictive planning law
    - This allowed TRG make high ROIC
        - EBIDA margin: 19%
        - EBIT/NTA: 31%
    - Since 2002
        - Sales CAGR: 9.28%
            - 2002: £216 million
            - 2015: £685 million
        - EBITDA CAGR: 11%
            - 2002: £34 million
            - 2015: £133 million
        - While TRG return more than 50% of earnings in dividends
- Today, TRG has
    - 506 restaurants
        - Frankie & Benny's: 261 (F&B)
        - Chiquito: 86
        - Coast to Coast: 21

        - Garfunkel's: 13
        - Joe Kitchen: 3
        - Pub restaurants: 54
        - Concessions + fillings: 68
    - F&B offers traditional home-style dishes from Little Italy[7]
        - Combined with popular American dishes
        - Provides value for money
        - Cozy booth
        - Casual family meal
            - Or a catch up with friends
        - Restaurant walls are filled with family snapshots
            - And memorabilia showing life on the lowest side of the Big Apple
                - Helping you into a "New York state-of-mind"
    - Chiquito[8]
        - Fun, amazing atmosphere
        - Fantastic food
        - Décor draws inspiration from Mexican architecture and Latin style
        - The menu offers traditional Mexican
        - Open 7 days for
            - Lunch
            - Lazy afternoons
            - Lively evenings
        - Attract a broad mix of
            - Young adults
            - Couples
            - Teenagers
            - Families
            - Large parties
    - Coast to coast
        - Coast to Coast takes its inspiration from the Lincoln High way[9]
            - Spans the U.S. from New York to San Francisco
            - Great range of authentic food and drinks
                - Best of classic American food
                    - Aberdeen Angus beef burger
                    - Deep dish style Chicago pizzas
                    - Distinctive steaks
                    - Etc.

        - A great bar serving specialty cocktails
        - Wide range of beers, spirits and traditional milkshakes
        - Music is an eclectic mix of
            - Motown
            - American rock
        - Customers are guarantee to lift their spirits
      - Coast to Coast has similar menu to F&B or TGI Friday's[10]
    - Pubs[11]
      - An ideal place for people who like to get together
        - Eat
        - Drink
        - Talk
        - In a relaxed friendly atmosphere
      - Each pub has its own style and personality
      - Mostly in beautiful rural or semi-rural locations
        - Has local feel
        - Set in intriguing buildings with fascinating histories
            - Preserve the character of the buildings
    - Frankie & Benny's, Chiquito, and Coast to Coast are usually found in leisure retail parks
      - Leisure and retail parks usually feature
        - Cinemas
        - Family lifestyle offers
            - Bowling
      - Many times they're in the same leisure/retail parks
      - Restaurants are about 3,000-4,000 square feet in size
        - 140-150 seats
      - Average check:
        - Frankie & Benny's: £15-17
        - Chiquito: £15.5
        - Coast to Coast: £16.75
- TRG target 850-950 locations
    - In the next 8-10 years
    - At this rate, TRG can easily double its revenue

[1] "If you thought The Restaurant Group, owner of the Garfunkel's chain, was a high street operator, then think again.

Okay, so the 237-strong company still operates 30 Garfunkel's outlets. But the evergreen brand - founded in the 1979 - remains a predominantly central London affair, feeding off tourists and cinema-goers in the city's West End. "It's very much a cash cow," explains TRG property director Kieran Pitcher, who joined the group late last year from the Laurel Pub Co. "There would be no sense in exiting that because it's a profitable business."

Despite that, TRG's focus has been slowly shifting away from the high street for the past four years. The shift was underlined in March 2005 when the 17-strong Est Est Est chain was sold to bar group Living Ventures for £16.401. But it was the sale in November of the 53-strong Caffé Uno brand to Paramount Restaurants, owner of Chez Gérard, for £33m, that effectively signalled the end of TRG's high street representation, and in particular a move away from the crowded high street pizza and pasta market." – *Beyond the High Street*, David Shrimpton, The Estates Gazette, 18 March 2006

[2] "City Centre's success in developing new concepts has been a direct result of its decentralized management style, according to Guy. **The company awards generous autonomy to its divisional leaders, quickly scraps unsuccessful test launches and just as quickly rolls out those that earn a good return on investment**.
…
One of the cornerstones of the company's growth strategy is to channel new brands continually into the market in a never-ending gamble to win consumers' favor.

"We truly believe failure is the price of success," Guy said. He cited as an example the company's recent effort to launch an Indian-menu restaurant, which was shuttered after only eight weeks when it did not meet sales projections.

"**I really believe a well-intentioned failure is better than not taking a risk**," he said.

City Centre maintains a minimal corporate management staff, pushing responsibility for development, operations and marketing onto each of its divisions.

"**The one thing that is central is finance**," Guy said. **"Each of the divisions has a lot of accountability - we have very tight financial controls. That is the only area where they have no latitude. Other than that they have a lot of leeway as to how they run their concepts**."

Guy described the central office as being "almost like a bank or an investor" in each of the brands.

In addition to the centralized financial staff, which includes about 40 accountants, payroll clerks and purchasing managers, City Centre has a human-resources director, who sets policy but does not handle hiring or recruiting, and a corporate chef, who gets involved in the development of new concepts but leaves day-to-day menu management to the executive chef at each of the chains.

The corporate chef, Barbara Eggar, is an American-born graduate of The Culinary Institute of America. Her background in Southern California style cuisine brings an emphasis on the use of fresh ingredients and made-from scratch menu items to the company, Guy said.

As an idea evolves for a new restaurant brand, the company appoints a "champion" to spearhead the development of a prototype for the so-called embryo concept. The concept champion shares office space with one of the company's other brands until the brand proves viable and has two to three units open, at which point the director finds and staffs his or her own office.

The brand leaders are reassigned to other posts if their concepts do not prove viable, according to Guy." – *City Centre Restaurants Thrive on Decentralized Management Structure*, Nation's Restaurants News, 23 March 1998

[3] "Included among the strongest brands in City Centre's portfolio are the following:

* Garfunkel's, a 40-unit chain -- including 12 airport locations -- which Guy described as being "similar to a Denny's" with an all-day breakfast menu and an all-you-can-eat salad bar.

* Chiquito Restaurant & Bar, a 22-unit chain of Tex-Mex eateries specializing in oversized margaritas.

* Caffe Uno, a 50-unit chain of casual Italian eateries with a rustic "Tuscany farmhouse" decor and a menu boasting made-from-scratch dishes.

* Frankie & Benny's, a fast-growing, midpriced Italian chain featuring a "1950s Little Italy" ambience and a fun menu that plays off its fictional namesake characters.

* Est Est Est, a high-end Italian chain with a light, exposed-steel decor operating in affluent communities in northern England.

* Nachos Mexican Bar & Restaurant, a six-unit chain of old-fashioned neighborhood cantinas selling burritos, enchiladas and other basic Mexican fare and generating about 40 percent of its sales from the bar.

* Deep Pan Pizza Co., a 90unit chain of sit-down pizza restaurants that pits its panpizza offerings head-to-head against Pizza Hut.

* OK Diner, a 20-unit chain of 1940s-style American diners offering burgers, hot dogs and other typical diner fare.

Included in the company's "embryonic" category are three experimental concepts, including FoodWorld, Fraternity House and Cafe Metro, a gourmet-coffee concept." – *City Centre Restaurants Thrive on Decentralized Management Structure*, Nation's Restaurants News, 23 March 1998

[4] "We have also focused considerable effort on the future shape of the Group and have **developed a strategy for growth which will focus on those business segments which display the following three key characteristics**:

• High returns on capital
• Good growth prospects
• Barriers to entry

Our two best performing business segments Leisure Parks and Concessions display all of these three key characteristics and are segments where we have been able to leverage our core competencies. **We intend to focus our development efforts in these areas and gradually to reduce the Company's dependency on High Street restaurants**. Consequently we have also decided to disclose our results under the following three principal categories: Leisure Parks; Concessions; and High Street Restaurants." – City Centre 2001 Annual Report

[5] "TRG bought the 12-strong Blubeckers chain from CI Traders of the Channel Islands for £27m last June. **The acquisition forms another aspect of TRG's flight from the high street, this time into family-oriented pub-restaurants in semi-rural locations. "They're very much a drive-to destination, within easy reach of large urban populations," says Pitcher. TRG is looking to expand by taking leases on existing pubs from large pubcos such as Punch and Enterprise**. However, it is not looking to expand sister brand Edwinns, a more upmarket food offering that trades from five sites." – *Beyond the High Street*, David Shrimpton, The Estates Gazette, 18 March 2006

[6] "Following the acquisition of Brunning & Price ('B&P'), we added a further 14 new pub restaurants to our portfolio. We are delighted with the performance of the B&P pub restaurants since the acquisition and we intend to grow the business. **The B&P pub restaurants have a more relaxed feel compared with Blubeckers. Although B&P's pubs are not branded they all share a similar type of fit out and operating style. The quality of food is high B&P won the Good Pub Guide's Food Pub of the Year Award for the third time in 2007 and they attract a regular and loyal customer base**. We are delighted to have retained all of the operational management team at Brunning & Price**. It is an experienced, talented and successful team and we look forward to working with the team to further develop and grow our Pub Restaurant business.**

During 2008 we are expecting to open a total of 5-10 new pub restaurants and, Longer-term, the Pub Restaurant business has the potential to become a significant part of the Group." – TRG 2007 Annual Report

[7] "**Frankie & Benny's brings together the best of classic American and Italian style and cuisine, offering traditional home-style dishes from Little Italy combined with popular American dishes** that always provide great value for money.

The kitchen buzzes with bustling activity as the chefs prepare dishes from our broad menu – pizza, pastas, burgers, grills and other favourites while, in typical stateside fashion, service at Frankie & Benny's is second to none!

Settle into a cosy booth to enjoy delicious, perfectly cooked and filling food while enjoying a casual family meal or a catch up with friends and observe the clatter and chatter of the open kitchen and the familiar classic 50's and 60's soundtrack playing in the background. The restaurant walls are filled with family snapshots and memorabilia showing life on the lower east side of the Big Apple, helping you into a "New York state-of-mind".

Frankie & Benny's provides a fun and friendly atmosphere for all to enjoy delivering fantastic value, great food and brilliant service.

First opened in 1995 in Leicester, **Frankie & Benny's has become one of the best known casual dining brands in the United Kingdom, and trades successfully in leisure and retail locations, stand-alone sites and at five airports**. The estate comprises almost 200 restaurants spread across the country from Aberdeen to St Austell." – TRG 2009 Annual Report

[8] "**Mexican for fun, for fantastic food, for an amazing atmosphere – for a good time, guaranteed**.

Chiquito offers great value, authentic Mexican food in a fun and lively venue, with **fantastic Latin American music**. What more do you need for a great night out? The décor draws inspiration from **Mexican architecture and Latin style. Some sites have a rustic and relaxed feel while others demonstrate the buzz and graphic energy of contemporary Mexico City.**

The menu offers traditional Mexican, including nachos, burritos, enchiladas and our signature sizzling fajitas, as well as favourites from "North of the Border" – burgers, salads and steaks from the grill. We specialise in Mexican beer and fantastic cocktails to ensure every meal is a fiesta.

Chiquito is open seven days a week for lunch, lazy afternoons and lively evenings, so whether you're out shopping, meeting friends after work or planning a party it's the only place to be!

Trading in the UK for over 20 years, Chiquito continues to attract a broad mix of young adults, couples, teenagers, families and large parties. More than 60 leisure, retail and stand-alone sites cover the United Kingdom with more development planned for the years ahead." – TRG 2009 Annual Report

[9] "**Coast to Coast takes its inspiration from the Lincoln Highway, which spans the United States of America from New York to San Francisco**. This is reflected in our great range of authentic food and drinks, all served with superb hospitality and service. **We offer the best of classic American food** – Aberdeen Angus beef burgers, deep dish style Chicago pizzas, distinctive steaks, amazing seafood dishes, wraps and South-West American specials. **Coast to Coast is more than just a restaurant, with a great bar serving speciality cocktails and a wide range of beers, spirits and traditional milkshakes. The music is an eclectic mix of Motown and American Rock, songs you may not have heard in a little while, but are absolutely guaranteed to lift your spirits and make you smile**. We currently have five restaurants open and see significant opportunities to grow Coast to Coast into a great brand." – TRG 2012 Annual Report

[10] One customer reviewed in Tripadvisor: "A large group of us pounced on Coast to Coast one night, some of us had already dined there before and reported back good things, for me it was my first time there and probably not my last.

First things first, Coast is an alternative to Frankie & Benny's and TGI, they practically serve the same menu - pizzas, steaks, ribs, if you've been to any if the American themed/styled franchises then you will probably know what to expect menu-wise. However, it is a pretty good alternative.

Drinks are eye wateringly expensive, but then they always are in these types of restaurants, and **food is of a similar price and quality to its competitors**. Between us we had various starters covering much of what was available - prawns, mushrooms, platters, chowder, wings, all of it very good and what you expect.

The mains were similarly good, and between us we had steaks, burgers, wraps, pizza, again no nonsense food and nothing to complain about. **There just isn't anything to distinguish it from the other restaurants mentioned.**

I have to mention that **our main waiter was tremendous, always within earshot and bringing our drinks mere seconds after we ordered them throughout the meal**.

Very good venue, just don't expect anything wildly different to the other two restaurants."

[11] "Really great pubs are timeless, familiar and very British. **Everybody knows what their perfect pub looks like. For us it's an ideal place for people who like to get together, eat, drink and talk in a relaxed friendly atmosphere.**

Each of our pubs has its own style and personality, and you'll always find a warm welcome, ageless interiors, fine British pub food, a large variety of great real ales and fine wine and great coffee.

Mostly set in beautiful rural or semi-rural locations, each pub has a 'local' feel and many are set in intriguing buildings with fascinating histories. We don't want all our pubs to look and feel the same **– instead we preserve the character of the building, which after all was what attracted us to the pub in the first place**.

We open all day, and you can pop in for a fresh coffee, a pint of real ale, glass of wine or some honest home cooking at any time. The range of beers available changes frequently and seasonal and local specials mean the menu also offers new choices alongside trusted favourites each time you visit.

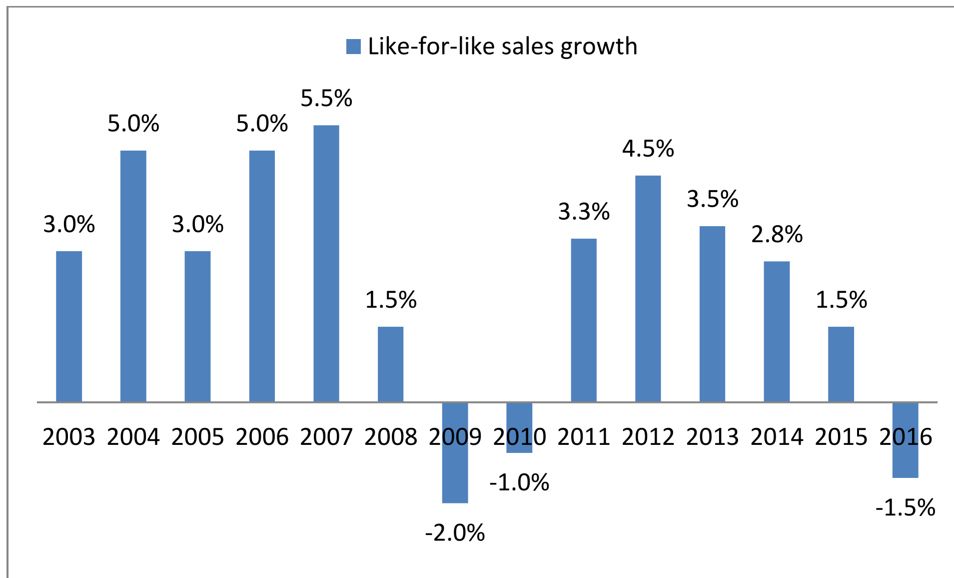
There's friendly, engaging service from the moment you arrive, ensuring that all your needs are taken care of. We hire people who genuinely like people and enjoy "being there" for our customers, and have the flair to operate their own business within our Group.

We believe that really great pubs will never go out of fashion, and that opportunities to expand in the sector are available for experienced operators with the right offer for customers. In 2007 The Restaurant Group bought Brunning & Price, an award winning pub business. By blending the expertise that Brunning & Price

brings with our own resources, ideas and experience, we will develop our pubs business and aim to open three or four new sites a year going forward." – TRG 2009 Annual Report

Durability

Restaurant Chains Can Adapt to Stay Relevant



TRG's like-for-like growth averaged 2.4% over the last 14 years

- **Biggest Negative**: Chains can go out of favor
- 2 factors can hurt a restaurants
  - Outdated location
  - Outdated concept
- TRG focuses on locations with favorable secular trend
  - TRG focuses mostly on retail and leisure parks
  - Retail parks have evolved
    - Historically, retail parks were large out-of-town locations[1]
      - Contained big box retailers
        - Furniture stores
        - Home improvement stores
        - Garden centers
        - Supermarkets
      - Leasing these spaces is significantly less expensive than in
        - Shopping center, or
          - (Shopping center is like in-door mall)
        - High street
      - Retail parks weren't aesthetically pleasing
      - But was a convenient location

        - Large amount of parking
- Retail parks started attracting high street retailers and leisure operators[2]
    - For cheaper rent
    - Increased floor space
        - Marks and Spencer and Next could display their entire offering
            - Food
            - Clothes
            - Furniture
            - Home ware
        - The Arcadia Group could house all their brands under one roof
            - Topshop
            - Dorothy Perkins
            - Topman
            - Burton
- Retail parks transformed into a softer environment, filled with[3]
    - Home wares
    - Fashion retailers
    - Improved leisure provision
        - Common fixtures
            - Restaurants
            - Cinemas
            - Gyms
- => Customers can now browse and eat
    - Leisure and restaurants help[4]
        - Increase dwell time
        - Extend trading hours
        - Increase traffic
    - => Benefit other retailers
        - Making retail parks even more attractive to retailers
    - Example:
    - Consumers spend about 48% more on retail goods
        - If they use the catering facilities in out-of-town parks
    - At Glasgow Fort scheme
        - After the expansion of the leisure
            - Footfall grew 8%

            - Retail sales grew 6%
            - Leisure spend grew 35%
            - Average customer spend on leisure is £22 per person
    - Out-of-town locations for leisure work for the same reasons as for retailing[5]
        - Accessible locations
        - Free parking
        - Managed environments
    - Retail parks make out-of-home dining and socializing[6]
        - Easy
        - Attractive
        - Affordable
    - This is especially true for TRG's target customers[7]
        - Families or
        - Couples
    - The strength of retail parks made TRG resilient during the Great Recession
        - Same store sales declined only
            - 2% in 2009
            - 1% in 2010
        - TRG was the only listed restaurant group to increase earnings in 2009[8]
    - Recent data reflect the trend[9]
        - Retail footfall in the U.K. was down by 1.1%
            - In February 2016
        - High street footfall declined by 2.9%
        - Shopping centers declined 0.6%
        - Retail parks: increase 2.5%
            - As a result of additional attractions
                - Restaurants
                - Entertainment
        - Customer footfall in the evening increased 0.2%
    - E-commerce may hurt retail-only retail parks[10]
        - Only 20% of TRG's restaurants are in retail-only retail parks
            - These parks may add leisure operators overtime
- Restaurant chains are durable
    - Chains have shown the ability to adapt
        - Can change menu or in-store atmosphere to stay relevant

            - Rolling out winning formula to existing restaurants is easier and faster than opening new restaurants with that formula
                - Existing restaurants already have visibility
                    - Just need to get the new message out
                        - While not alienating current customers
    - Example:
    - Chiquito
        - Underperforming in early 2000s
            - Chiquito's like-for-like sales declined 5.3% in 2003
        - TRG changed Chiquito management
            - Revamps its menu
            - Refresh the store format
                - Refurbished 1/3 of the "garish" Mexican-themed sites
                - Move away from a "let's-go-out-and-get-pissed-on-slammers" clientele
                    - Towards the family market
        - => Chiquito's like-for-like sales grew 5.8% in 2004
    - Greggs
        - Over 90% of Greggs stores were on high streets
        - Greggs also faced competition from supermarket in traditional bakery
        - Like-for-like sales declined
            - 2012: -2.7%
            - 2013: -0.8%
        - Greggs even has the stigma of selling unhealthy foods
        - Greggs transformed into a food-on-the-go chain
            - Started opening stores away from high street
                - Retail parks
                - Bus terminal
                - Train stations
                - Industrial estates
                - Where people are at
                    - Work
                    - Travel
                    - Leisure
            - Greggs refitted its stores
                - Removed things like bread slicer or bread ovens
                - Add seating to the stores

            - Revamped its menu
                - Added “healthy sandwich” range
                - Relies less on traditional bakery products
                    - Sandwich: 1/3 of revenue
                    - Savory: 1/3 of revenue
                    - Drinks: 1/6 of revenue
        - Result:
            - Same store sales grew again
                - 2014: 4.5%
                - 2015: 4.7%
            - Share price more than doubled to 1,000-1,200 pence per share
                - From less than 500 pence per share in 2012-2014
            - P/E increased
                - From 10-13
                - To 18-20
    - Brinker
        - Brinkers faced challenges in 1990s[11]
            - Chili’s comparable sales fell for 7 quarters
                - (570 restaurants)
                - From October 1994 to June 1996
            - The menu had grown tired
            - Chili’s overhauled its menu and its advertising
            - And sales grew again
    - TGI Friday[12]
        - In 1990s, TGI was able to keep pace with the aging baby boomer crowd
            - These customers once frequented its singles-oriented bars
                - They then brought their kids in for food
                    - Described as “familiar with a twist”
                    - In a more family-oriented atmosphere
            - TGI upscaled its core concept
                - More upscale choices are being added
                    - Friday’s Jack Daniel’s Grill
                        - Combines steak, chicken or salmon with a bourbon sauce
                    - Chophouse Classics:
                        - Same protein portions served with an onion-based sauce

- On sizzling platters
- Began setting up shop in nontraditional locations
  - Airports
  - Food courts
  - Stadiums

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[1] "Historically, **Retail Parks were large out of town locations that contained big box retailers – furniture stores, home improvement stores, garden centres, supermarkets** – ideal due to the size of the stores on offer and the fact that leasing these spaces is significantly less expensive than it would be in a Shopping Centre.

They were never the most aesthetically pleasing of places – but they didn't need to be. They served a purpose, and **their purpose was a convenient location to house large stores, which catered to the side of retail that didn't work as well in other locations.** The out of town aspect meant there was a large amount of parking which was suitable for the products on sale and customers could go and get what they needed relatively hassle-free." – Retail Park Evolution, http://www.foundationrecruitment.co.uk/news/retail-park-evolution/

[2] "With the rise of the Internet it was increasingly less necessary for people to travel to get the sort of products on offer at Retail Parks – customers could compare prices online and they could get large items delivered. **Unlike Shopping Centres, Retail Parks were not designed for people to 'browse' – they were designed for people to stop off in the car, get what they needed and leave. If they wanted a day out shopping they would visit a Shopping Centre where there would be a large retail mix and a leisure offering.** Retail Parks still held a purpose, however they were losing their USP and with that the grasp of their customer base as more options became available to them.

So they started to evolve – **high street retailers and leisure companies saw the appeal of expanding their portfolios into Retail Parks, enticed by the cheaper rent and the increased floor space.**

Retailers like Marks and Spencer and Next could display their entire offering; food, clothes, furniture, home ware. **The Arcadia group could house all their brands under one roof** – OUTFIT is a fixture at a large number of Retail Parks and carries Topshop, Dorothy Perkins, Topman, Burton. All of which had huge benefits to the brands, but also the consumer.

Other fixtures now prevalent are cinemas, gyms and restaurants – with well-known brands such as Frankie and Bennies and Nandos being regularly available at a number of schemes. A huge improvement on what Retail Parks were previously – **customers could still visit and purchase things they couldn't get else where, but, like at a Shopping Centre, they could also browse, eat and had now had reason to 'dwell'**." – Retail Park Evolution, http://www.foundationrecruitment.co.uk/news/retail-park-evolution/

[3] "**Retail park sales growth has eclipsed in-town performance and has encouraged more leisure operators to expand their out-of-town locations**.

Few shoppers now find themselves at a retail park with little more than a burger van, although **it wasn't so long ago that a hot cup of tea and a chip butty passed for the food and beverage provision at many out-of-town sites.**

The transformation from locations selling bulky goods to a softer environment filled with homewares and fashion retailers has helped the leisure provision improve at most retail parks. Restaurants, cinemas and even gyms are now common fixtures." – *Out-of-town Locations Top the Charts for Retailers*, Retail Week, 22 February 2013

[4] "Retail just can't get enough of leisure. For landlords it's the sector's vitality during the downturn and the raft of expansionist operators that are springing up; **for retailers, leisure potentially extends trading hours, increases footfall and improves dwell times. Not every retailer is sold, but most are**.

It's a trend firmly established in out-of-town parks and the increasingly complementary nature of retail and leisure was underlined in the latest analysis by data intelligence specialist CACI. **Based on 170,000 exit interviews with shoppers in more than 100 retail centres across the UK as part of its annual Shopper Dimensions report, CACI's research showed that consumers who use the catering facilities spend approximately 48% more on retail goods than those who do not**.

The findings also indicated a positive shift upwards – **the average spend on catering increased 9% between 2012 and 2013. Plus, the growth in restaurant spend outpaced the outlay in cafes and fast-food restaurants**.

…

The findings support research carried out by British Land at its recently leisure-extended Glasgow Fort scheme. "**Since the expansion of the leisure, footfall is up 8%, retail sales are up 6% and leisure spend is up 35%. Average customer spend on leisure is £22 per person,**" says John Maddison, head of retail warehouse asset

management at British Land. “If any retailers were not convinced by the benefits of leisure, these figures make a very compelling argument.”” – _The Increasingly Complementary Nature of Retail and Leisure_, Mark Faithfull, Retail Week, 30 April 2014

[5] “Not surprisingly then, out-of-town parks are adding leisure facilities at full throttle – expanding their food and beverage offers, putting in drive-thru coffee shops and extending into new areas including gyms, cinemas and family lifestyle offers such as bowling.

Out-of-town locations for leisure work for largely the same reasons as retailing – consumers want accessible locations, free parking and managed environments, while landlords want relatively cheap development and the potential to produce rental uplift across a park, plus long leases.” – _The Increasingly Complementary Nature of Retail and Leisure_, Mark Faithfull, Retail Week, 30 April 2014

[6] “Diana Wehrle, marketing and insights director at Springboard, said the disproportionately large fall in high street shopping traffic was down to “the tough retail trading environment”, which has led to shops competing on price to capture customers’ disposable income.

She said the simultaneous increase seen in retail parks, which tend to feature larger, warehouse-style outlets, reflected demand for furniture and household goods.

She also identified a shift towards shopping in the evening, with customer footfall in February showing a 0.2% increase in the evening, compared with a 3.9% fall during daytime hours.

Retail parks were able to poach customers from the high street, she said, by “providing the right environments and price points to make out-of-home dining and socialising easy, attractive and affordable”.” – UK High Street Struggles in February as Shoppers Head for Retail Parks, Rob Davies, The Guardian, 14 March 2016

[7] “"The high street became just too competitive as a trading environment," says Pitcher. "We had reached saturation point in most provincial locations." An added problem, says Ben Page, head of property acquisitions for TRG, was that **many high streets had been gaining a reputation as late-night binge drinking locations. "It was not a particularly attractive place to be. It wasn't appealing to our core customer base, which is the family market. They prefer a secure environment, out of the town centre, where there's easy access and it's easy to park."**

And where its customers are heading, TRG is following. It is now focusing on two areas: out-of-town leisure and retail parks, and concession-based outlets in airports and shopping centres. "They are delivering higher levels of growth and they have higher barriers to entry," explains Pitcher." – *Beyond the High Street*, David Shrimpton, The Estates Gazette, 18 March, 2006

[8] "**TRG was the only listed restaurant group to increase earnings in 2009. Yet this does not appear to be reflected in its rating. The shares are trading on about 11.4 times 2010 pre-tax profit of 49.6m, compared with Clapham House's 16.9 times or Carluccio's' 16.5 times. One reason could be that in terms of brand TRG appears less racy than its high street rivals**. But investors ignore TRG at their peril. The current year has started well and with the group likely to pay off all its debt in three years or expand, it is well positioned to create further value." – *Blockbuster Films Help TRG Defy Recession*, Kwan Yuk Pan, Financial Times, 03 March 2010

[9] "**Shoppers are deserting the high street in favour of purpose-built retail parks, according to figures that underline tough conditions for retailers**.

Total retail footfall in the UK was down by 1.1% in February, according to figures from the data analysts Springboard and the British Retail Consortium.

The bulk of the decline was down to a fall-off in visits to the high street, which were 2.9% lower than the same month in 2015.

Shopping centres also welcomed fewer visitors, down 0.6%, but retail parks reported an increase of 2.5%, partly as a result of additional attractions such as restaurants and entertainment." – UK High Street Struggles in February as Shoppers Head for Retail Parks, Rob Davies, The Guardian, 14 March 2016

[10] "Many of its restaurants are located in shopping parks. **Mr Breithaupt acknowledged that about 20pc of its sites are essentially "retail-only" and so have been hit by falling footfall at shops.**

"**One of the things that's probably driving that is internet shopping and home deliveries getting better and faster," he said. "We'll look very carefully about opening on retail-only sites**."

Recent consumer industry data have suggested the looming vote on Britain's membership of the European Union is affecting consumer confidence, the Restaurant Group boss added.

The recent fall in like-for-like revenues was also partly due to the company's expansion plan, he argued, which has resulted in new sites cannibalising customers from the more established locations." – Frankie & Benny's Seen as Bid Target after It Warns of Tough Trading, Ben Martin, Daily Telegraph, 10 March 2016

[11] "**For its part, Brinker has struggled to revive several concepts that had gone stale. Comparable-store sales at Chili's, with 570 restaurants, fell for seven quarters, starting in October 1994 until June 1996, and the menu had grown tired**. The chain, the Brinker flagship, accounts for about 70% of Brinker's annual sales of $1.34 billion in the most recent fiscal year, ended July 31.

"As Chili's goes, it leads the company, up or down," Mr. McDougall says.

…
Four months later, Mr. McDougall dumped three flailing concepts -- Grady's American Grill, Spageddies Italian Kitchen and Kona Ranch Steak House. Brinker Chief Financial Officer Russell Owens describes the process as "painful," but said he believes it made employees realize that **the company won't let a strong chain, such as Chili's, carry underperforming ones**. "It sends a message that there's accountability for each brand," he says.

Mr. McDougall calls those deals "a real defining moment in the history of this company." He adds, "We traded three concepts, average players, for Michael Jordan, Scottie Pippen."

In addition, Mr. McDougall, 55 years old**, finalized a new management plan a year ago to put each of the company's nine restaurant chains under a separate team, each with its own chefs and marketers**. Some longtime executives left in the shuffle -- for a variety of reasons. **Today, Brinker operates more like a holding company with a few central functions such as finance and legal**. The different "concept teams" are even grouped together at Brinker headquarters in offices decorated like their specific restaurants.

Under the new structure, Chili's has overhauled its menu and its advertising and has reported positive sales growth for 13 months running. The chain also is testing a takeout window; one Dallas store added the equivalent of a week's sales from takeout business, says Doug Brooks, president of Chili's Grill & Bar, who adds that the chain "needed to be brought up to the '90s."" – Brinker Readies New Path for Its Casual-Dining Empire, Emily Nelson, the Wall Street Journal, 05 March 1998

[12] "At T.G.I. Friday's, which helped pioneer the segment with menu innovations such as potato skins and fried mozzarella, change has been ongoing and insightful**. It has kept pace with the aging baby boomer crowd that once frequented its singles-oriented bars and is now bringing the kids in for food described as "familiar with a twist" in a more family-oriented atmosphere**.

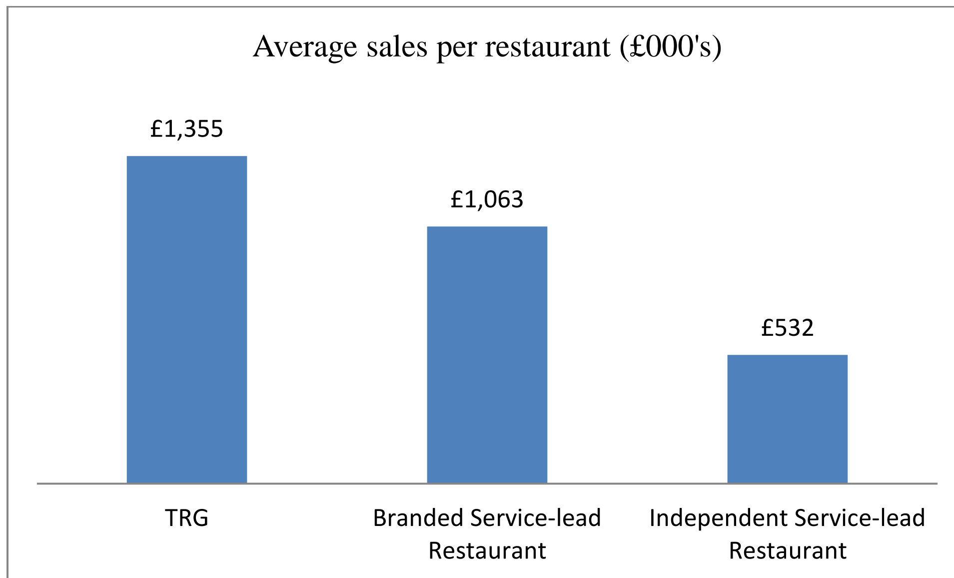
…

Friday's has upscaled its core concept, adding items that raised sales in 1998. Like many others in casual dining and quickservice segments alike, **it has also begun setting up shop in nontraditional locations such as airports, food courts and stadiums. International growth is also a key strategic initiative.**

On the menu, more upscale choices are being added. Recent hits include Friday's Jack Daniel's Grill, which combines steak, chicken or salmon with a bourbon sauce, and Chophouse Classics, the same protein portions served with an onion-based sauce on sizzling platters. Priced from $11 to $15, the new items are popular and are helping to increase check averages." – Coming of Age: Operators Upgrade, Reinvent Casual Dining, Dana Tanyeri, Bill Communications, June 1999

Moat

The Restaurant Group Focuses on Locations with High Barrier to Entry



TRG's sales per restaurant is 2.5 times higher than those of independent restaurants

- **Biggest Negative**:
  - The industry has low barrier to entry
  - Leisure and retail park owners can have power over tenants
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Is the threat of new entrants high or low?
      - **(=)** Barrier to entry is low
        - But the impact on successful chains isn't very high
    - Is the bargaining power of buyers high or low?
      - (**=**) Customers have a lot of choice
    - Is the threat of substitutes high or low?
      - **(-)** people spend more on eating out as they have more disposable income
    - Is the bargaining power of suppliers high or low?
      - **(-)** Inputs are commodity
        - Employees are paid low wages

- But the government set minimum wages
- Is the rivalry within the industry high or low?
  - **(+)** Very intense
- **For the company**
  - Is the threat of new entrant different for this company specifically?
    - **(-)** Lower than the industry
  - Is the bargaining power of buyers different for this company specifically?
    - **(-)** Customer don't as many choice at leisure and retail parks
  - Is the threat of substitutes different for this company specifically?
    - **(-)** As low as the industry
  - Is the bargaining power of suppliers different for this company specifically?
    - **(-)** As low as the industry
  - Is the rivalry within the industry different for this company specifically?
    - **(=)** There's less direct competition in leisure and retail parks

- **Competitive landscape**
  - The U.K.'s Office of National Statistics (ONS) estimate the total consumer spend on catering services: **£87.6 billion**
  - Industry consultants say this number massively overstates the market
    - Horizons said that ONS's figure includes
      - All drink served in pubs
        - Whether or not it was consumed with food
      - Overnight hotel accommodation
        - If you have spent £20 on a night in a pub
        - then slept it off in a hotel charging £80 for the overnight stay
        - ONS says that you have spent £100 on eating out
  - Horizons estimates the U.K. out-of-home food service market at **£46.6 billion**
    - In 2014
    - Managed pubs accounted for **30.3%** of restaurant meals
      - In 2013
  - NPD estimates U.K.'s out-of-home food service market: **£52.2 billion**
    - In 2015
    - Including
      - Restaurants
      - QSR

- Food served in pubs, hotel, and other venues

- Allegra has a different estimate
    - (TRG uses Allegra data)
    - Total market: **£57.61 billion**
        - Service-lead restaurant: £20.91 billion
        - Fast food and take away: £12.78 billion
        - Pubs: £23.92 billion
- Mintel has a far different estimate:
    - 2015: **£31.05 billion**
        - Fast food: £9.7 billion
            - (excluding coffee shops)
    - 2014: **£30.47 billion**
        - Fast food: £9.4 billion
    - Mintel says the market include
        - Takeaway and fast food,
        - Full-service restaurant
        - Pubs/clubs/taverns/bars etc.
    - Mintel's estimate might be close to Allegra if the £30 billion number doesn't include pubs
- NPD estimate the casual dining market at **£4.7 billion**
    - (Restaurants with average spend per head between £10-20)
    - => TRG has **14%** market share of this <u>narrowly</u> defined segment
        - Restaurants with average spend per head between £10-20
- The market include
    - Fast food, sandwich bars, and coffee shop:
        - Average spend per head: **£3-5**
        - Fast food chains include
            - McDonald's
            - Burger King
            - KFC
        - Sandwich bars include
            - Subway
            - Greggs
        - Coffee shop include
            - Costa Coffee
            - Starbucks
            - Etc.

- Fast casual:
    - Average spend per head: **£9**
    - Fast casual players include
        - Nando's
        - Pizza Hut
        - Wagamama
        - Gourmet Burger Chicken
        - Five Guys
- Pub-restaurants
    - Average spend per head: £5-10
    - These are neighborhood pubs that started sell more food
        - As beer sales declined
    - Customers visit local pubs frequently
        - => so local pubs must keep spend per head low
            - They can't transform into a upmarket restaurant
                - Without alienating existing customers
    - 9 of the top 15 biggest chains are pub restaurants
        - Hungry Horse
        - Sizzling Pub
        - Harvester
        - Toby Carvery
        - Fayre & Square
        - Brewer Fayer
        - Beefeater
        - Ember Inns
        - Flaming Grills
    - Family-oriented pub restaurant like Harvester is opening in retail parks
- Full-service casual dining
    - Average spend per head: £10-20
    - Biggest chains are mostly Italian chains
        - Focus on pizza and pasta
        - Example:
            - Pizza Express
            - Prezzo
            - Zizzi
            - Ask

- Carlucio's
- Bella Italia

- Fine dining
  - Mainly independent restaurants
- Many casual dining competitors focus on high streets
  - And London
- TRG focuses on leisure and retail parks
  - And has little presence in London
- At leisure retail parks
  - Restaurants are mostly chains
    - Mostly fast food and fast casual restaurants
    - Familiar names
      - Coffee shops
        - Starbucks
        - Costa Coffee
        - Café Nero
      - Sandwich bars
        - Greggs
        - Subway
      - Fast food
        - McDonald's
        - Burger King
        - KFC
      - Pub-restaurants
        - (occasionally)
        - Harvester
        - Hungry Horse
      - Fast casuals
        - Nando's
        - Pizza Hut
        - Five Guys
        - Wagamama
        - Ed's Easy Dinner
      - Casual dining
        - Frankie & Benny's (F&B)
        - Chiquito
        - Coast to Coast

- Prezzo
                - Pizza Express
                - Zizzi
                - YO! Sushi
                - Chimichanga
                - TGI Friday
        - A retail parks normally have about 2-3 casual dining restaurants
            - Big retail parks can have 5-6 casual dining retaurants
            - TRG can have 1-3 restaurants in the same parks
- **Customer retention**
    - No specific data for TRG
    - Casual dining doesn't enjoy high frequency purchase
        - Like coffee shops
    - People have a lot of choices
    - Normally, people have a preferred restaurants for a certain type of food
        - Or a certain type of occasions
    - Once people like a restaurant, they may repeat visit
        - If it's in a 5- to 10-minute drive
- **Customer acquisition: better than average**
    - TRG's restaurants benefit from being in places with limited supply
        - Retail parks construction and extension are carefully planned
        - Retail parks usually have only 1-3 casual dining restaurants
            - (In addition to quick service and fast casual restaurants)
            - Very big retail parks may have 5-6 casual dining restaurants
        - That helps TRG get people try it first
            - Then retain the customers if it's good
    - Chains in general enjoy advantage in customer acquisitions
        - They have greater awareness than independent restaurants
        - They have greater experience and scale in marketing
        - F&B has a data base of 1.4 million opted in users
        - Frankie & Benny's apps had over **500,000** downloads
        - F&B's Facebook page has
            - **410,798** people likes
            - **2,275,549** people visited
            - For comparisons
                - Harvester: 280,047 people like
                    - Harvester is a pub-restaurants that attract families

            - Harvester is owned by Mitchells & Butlers
            - Harvester's average spend per head is £7-10
        - Pizza Express: 264,056 people like
        - Prezzo: 162,463 people like
        - Zizzi: 67,948 people like
        - Chiquito: 53,282 people like
- Chains have been gaining market share
    - According to Allegra, service-led restaurant market: £20.38 billion
        - (in 2015)
        - Independent restaurants: £15.49 billion
            - 3-year CAGR: -1.6%
            - **76%** market share
                - Declined from **80%** in 2012
        - Branded restaurants: £4.89 billion
            - 3-year CAGR: 6.1%
            - **24%** market share
                - Increased from **20%** in 2012
- There's evidence that TRG has higher than average sales per outlet
    - According to Allegra – The UK Restaurant Market 2015 report
        - Sales per outlet of service-lead restaurants: **£0.9 million**
            - Independent restaurants: **£0.53 million**
                - £15.49 billion revenue
                - 29,100 outlets
            - Branded restaurants: **£1.06 million**
                - £4.89 billion revenue
                - 4,600 outlets
    - Estimated sales per outlet of major chains:
        - Wagamama: **£1.6 million**
            - Wagamama is a noodle bar
                - With canteen-style
                - Customers share table with strangers
            - It's more of a fast casual
        - Carluccio's: **£1.5** million
            - Carluccio's operates on high streets
            - 1/3 of Carluccio's locations are in London
        - Côte: **£1.5** million
            - Operates on high streets

            - Nando's: **£1.44 million**
                - Fast casual
            - TRG: **£1.35** million
            - YO! Sushi: £1 million
            - Strada: £1 million
            - Pizza Express, Ask, Zizzi: £0.85-0.9 million
            - Prezzo: £0.85-0.9 million
            - Café Rouge: £0.85 million
            - Bella Italian: £0.8 million
            - Giraffe: £0.8 million
    - Frankie & Benny's is a big brand
        - It has **261** locations in the U.K.
            - Equivalent to having **1,305** restaurants in the U.S.
            - Pizza Express is the only casual dining chains with more sites
                - Pizza Express has **443** locations in the U.K.
                    - Average **£15** spend per head
                - Nando's has **365** locations
                    - But it's a fast casual chain
                    - Average **£5-10** spend per head
                - Pizza Hut has **270** locations
                    - But it's a fast casual chain
                    - Average **£10-11** spend per head
                    - (repositioned itself away from fast food)
            - Next big casual dining chains are mostly pasta/pizza chains
                - Prezzo: **234** locations
                    - Average **£14-15** spend per head
                - Zizzi: **141** locations
                    - Average **£18** spend per head
                - Ask: **111** locations
                    - Average **£14** spend per head
                    - PizzaExpress, Ask and Zizzi were owned by Gondola Holdings
                        - Ask and Zizzi are now owned by Bridgepoint
                - Carluccio's: **98** locations
                    - Average **£16** spend per head
                    - 1/3 of the sites are in London
                - Bella Italia: **97** locations

        - Average **£10-12** spend per head
    - Other than Italian chains, next big chains are
        - Wagamama: **119** locations
            - A Japanese noodle chain
                - With canteen-style layout
            - Average **£8-10** spend per head
                - Wagamama is more like a fast casual chain
        - Café Rouge: **90** locations
            - A French-themed chain
            - Predominantly a high street brand
            - Average **£10** spend per head
        - **Chiquito**: **86** locations
            - Mexican food
            - Average **£15.5** spend per head
        - YO! Sushi: **75** locations
            - A conveyor belt sushi chain
            - Average spend per head: **£15**
        - TGI Friday's: **73** locations
            - Average spend per head: **£15-17**
        - Côte: **73** locations
            - A mid-market French bistro
            - Focus on high streets and town centers
            - Average spend per head: **£17-20**
        - Bill's: **72** locations
            - Bill's is an English brand
                - It was originally a green grocer
            - Average spend per head: **£15-17**
        - Other chains have less than 100 sites
  - => excluding Italian chains, TRG owns 2 largest casual dining chains
    - Frankie & Benny's
    - Chiquito

- **Margin protection: Good**
  - Margin in this business depends on volume
    - Restaurants don't compete on price
      - They target certain market segment
        - Have a certain mark-up over food and labor cost
    - Volume helps leverage fixed costs

- Volume explains the high rate of failures in this business
  - According to Cornell University and the National Restaurant Association
    - **60%** of restaurants fail within the first 3 years
    - **75%** of restaurants fail within the first 5 years
- Oversupply can leads to lower margin
- TRG's locations provides some volume protection
  - Supply is controlled[1]
  - Planning laws in the U.K. are restrictive
  - All development must get "planning permission"
    - Approved by local planning authority
  - Commercial properties have different use classes
    - **Class A1**: shop
      - For the retail of goods other than hot foods
      - As a post office
      - For the sale of tickets by a travel agency
      - For the sale of sandwich or other cold food
        - For consumption off the premises
      - For hairdressing
      - Etc.
    - **Class A2**: Financial and professional services
      - Financial services
      - Professional services
        - (other than health and medical services)
      - Any other services which is appropriate to provide in a shopping area
        - Including use as a betting office
    - **Class A3**: Food and drink
      - For sale of food or drink for consumption on the premises
        - Or of hot food for consumption off the premises
  - **Change of uses** requires planning permission
  - The decision on any planning application is based on local planning policies
    - Some key focuses of local planning policies:
      - (**Source**: National Planning Policy Framework)
      - Building a strong, competitive economy
      - Ensuring the viability of town centers

        - Supporting a prosperous rural economy
        - Promoting sustainable transport
        - Conserving and enhancing the natural environment
        - Conserving and enhancing the historic environment
- The number of new leisure and retail parks is small
    - There are 1,550 leisure and retail parks/schemes in the U.K.
        - (Source: TRG 2015 Final Result presentation)
    - Only 79 new schemes in pipeline
        - From 2016 to 2021
        - **5%** increase over 5 years
- About ¾ changes on an existing retail park need planning permission
    - (Source: one CBRE out-of-town retail expert said)
    - By local committee
        - They care about
            - The impact on town center
            - The impact on local economy
                - Job creation
                - GDP growth
            - The impact on local population
                - Traffic
                - Safety
                - Etc.
    - The process is usually slow and bureaucratic
- It takes a lot of time and effort to get permissions
    - Some projects never get passed
    - Example:
    - **Inverness Estate**
        - Inverness applied for 6 new restaurants
            - 3 drive-through takeaways
            - 2 restaurants
            - 1 pub
        - The scheme was rejected
            - In 2011
        - Reasons
            - It would take people away from city center
            - It breaches the Inverness Local Plan

        - Earmarked for business use
      - Restaurant chains should instead be directed towards vacant premises in the city center
  - Inverness submitted a new proposal
    - 4 restaurants, including
      - Frankie & Benny's
      - Chiquito
      - A drive-through McDonald's
  - The new proposal was rejected
    - In 2013
    - 18 months after the first proposal was rejected
  - Reasons
    - Potential impact of the new restaurants on business in Inverness city center
    - The land is zoned for offices
      - Rather than food outlets
  - The park submitted another application
    - For a £13million expansion
      - Add 3 new big name restaurants
        - Frankie & Benny's
        - TGI Friday
        - Nando's
        - => add 180 jobs
      - Revamp its shop fronts
      - Redesign its car park
  - The project was opposed by key city center players
    - Inverness Bid
      - That would be against the council and Scottish Government's commitment to supporting city centers
      - These are destination restaurants
        - People choose to go there
        - Rather than simply catering for people already at the retail park
    - Eastgate Shopping Center
      - The restaurants would draw footfall out-of-town

            - Planning officer John Kelly supported the plan
                - There would be no significant impact on the viability of the city center
                - The park began operating 20 years ago
                    - Beginning to show its age
                    - Lack basic user amenities
                        - Public toilets
                    - There's limited restaurant provision to serve the retail park
        - **Teesside Park**
            - The old Springs Health Club was closed in the park
                - In 2007
            - Park owner applied for a £7.5 million development
                - Replace the gym with 3 separate buildings
                    - A Nando's restaurant
                    - A Harvester family pub
                    - A 66-bed Travelodge hotel
            - The Stockton council blocked the plan
                - In 2013
                - It would hurt the town center business
            - The site was later used to build a furniture store
                - Baker and Stonehouse
                    - One of Teesside's flagship home-grown businesses
    - Retail parks can get extension overtime
        - But park owners are rational
            - (usual funds)
        - They plan the number of food units based on traffic[2]
            - They can estimate food demand from shoppers
            - 70-75% of the demand is for low-spend catering
            - The rest is for higher-spend casual dining
                - This explains why there are only a few casual dining restaurants in each retail park
        - Landlords pay attention to tenant mix
            - Unlikely to have two restaurants with the same concept[3]
- Landlords may have power over restaurateurs
    - They may demand higher rent if supply is limited

            - It's more competitive in leisure parks now than before[4]
                - Always 8-10 operators vying for a site
        - But restaurateurs usually enter 20- to 25- year lease contracts
            - With rent increase in line with RPI/CPI
        - By the end of the lease term, retail parks may have done some extensions
            - Adding some catering units
            - => Average sales per restaurant remain stable
                - So does margin
        - Otherwise, average sales per restaurants increase a lot
            - Landlords may demand higher rents
            - And restaurateurs won't benefit from margin expansion
    - TRG has become more significant to landlords
        - Winning restaurant formats help[5]
            - Increase footfall
            - increase dwell time
            - Extend trading hours
        - TRG's restaurants can be destination-type restaurants
            - A lot of people use TRG restaurants as a pure destination[6]
        - TRG opened more restaurants in the same leisure/retail parks
            - Most Chiquitos and Coast to Coast co-locate with F&B
                - Example:
                - F&B and Chiquito co-locate at
                    - Brougton Shopping Park
                    - Kingswood Parks
                    - Cambridge Leisure
                    - Kingston Retail Park
                    - Glasgow Fort
                    - Etc.
                - F&B, Chiquito, and Coast to Coast co-locate at
                    - Middlebrook Retail Park
                    - Valley Centertainment Leisure Park
- Moat evaluation
    - Barrier to entry:
        - Low for restaurants in general
            - But failure rate is very high
                - 60% within 3 years

        - 75% within 5 years
    - Supply is controlled in TRG's locations
  - Impact of new entrant
    - A new restaurant in a retail parks is likely to have a different concept
    - But a good entrant can hurt traffic to existing restaurants
    - TRG's strategy to co-locate several casual dining concepts may help mitigate this risk
      - Negligible level of cannibalization[7]
  - Rivalry among existing firms
    - Very tough
    - A lot of price point
    - A lot of concepts
    - A lot of innovation
- Conclusion
  - TRG doesn't have a wide moat
  - But it can have a more stable business than most restaurant chains
    - F&B is a big/strong brand
      - Chiquito and Coast to Coast are the biggest in its concept
        - Can follow F&B's growth
        - By co-locating with F&B
    - TRG operates in a controlled-supply environment
      - Faces familiar competitors
        - Fast foods
        - Fast casuals
      - This is the most important factor in TRG's moat

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[1] "Mr Page is heading into semi-retirement after the group behind chains such as Frankie & Benny's and Garfunkel's broke through the pound(s)1bn market capitalisation last year.

Shares in Restaurant Group hit the 500p mark last year, which achieved Mr Page's personal target. "I said to my wife: 'When we get to a fiver, I will feel that we have done a good job.'" Shares have since rallied to 620p.

The performance of the group was aided by its decisions to leave the high street and not overload itself with debt - as many leisure groups did - in the noughties.

The Restaurant Group moved its estate to retail and leisure parks, as well as transport hubs, rather than the high street. Mr Page said that the decision to move off the high street was "blindingly obvious" in retrospect.

"**The logic behind it was clear: there was bags of growth in eating out, but my concern was that everyone would see that and throw capital at it," said Mr Page. "We wanted to capture the demand, but mitigate the supply side: we looked for areas with barriers to entry."**" – *Page to Leave Restaurant Group on a High*, Duncan Robinson, Financial Times, 21 January 2014

[2] "Stephen Logue, founder and non-executive chairman of Logue & Bailey Consultants, gives his views on the sustainability of F&B at Westfield London: **Westfield hopes to attract 25 million visitors each year and, on that basis, the shopper-generated demand for catering should be around £30m**.

Conventionally, 70-75% of this demand is for low-spend catering, with an average per-person spend of £4. This leaves roughly £8m for the higher spend on casual dining - equivalent to eight restaurants.

Westfield has a plethora of table service restaurants that outstrip shopper demand, so it will need a high level of nocturnal, non-shopping related demand. As the immediate local market is not particularly affluent diners will need to be persuaded to travel from Chiswick, Holland Park, the rest of west London and beyond. In addition, the absence of alcohol-led operations will deter the 18- to 24-year-old evening visitors.

Equally, **there are not many affordable outlets, such as McDonald's, Burger King and KFC, to meet the demand of the core shopper, representing about £20m of spend**. If families can't find affordable food and drink, repeat visits will drop off.

Nando's has a day-long queue, which has been attributed to the local demographic. I would add that Nando's comes close to meeting demand for a fast, no-frills, manageable eating experience.

Overall, Westfield has been magnificently executed, but it faces a serious challenge. The catering has an inadequate sustenance supply, an oversupply of shopper-related leisure dining and a serious glut in destination dining unless the nocturnal scene can be animated to a level beyond that ever achieved elsewhere." – *A Food Court of Fine Dining*, Rosalind Mullen, Caterer & Hotelkeeper, 11 December 2008

[3] "During 2005, the concessions division opened five new airport units, including three at Luton. **But although the growth of regional airports is offering the possibility of putting in quick-service, grab-and-go offerings, the opportunities at airports are limited. This has led TRG to broaden its focus once again, turning its attention increasingly to shopping centres**, in which it opened three units last year.

The attractions are similar to those offered by the out-of-town leisure and retail parks - a secure, safe environment appealing to the family market and with higher barriers to entry. **Unlike the free-for-all of the high street, where TRG could have opened a Chiquito only for another Mexican eatery to spring up next door, shopping centre landlords are more likely to have an eye for tenant mix and be unwilling to flood the scheme with restaurants**." – *Beyond the High Street*, David Shrimpton, The Estate Gazette, 18 March 2006

[4] "**As you know, we're not into the high street: there are no barriers to entry there, so you can really struggle, with people stealing your trade. We look at places like leisure parks, though even there the scene has changed. When we first started going into them, not so many other operatives there. Now, there's always a good 8-10 vying for a site.**" - Danny Breithaupt said in an interview with the Eat Out Magazine, 10 January 2015

[5] "TRG's profits rose 15 percent to pounds sterling 30 million in the first half on revenues up 11 percent at pounds sterling 280 million as the group saw an increase in customer numbers and a rise in spending per head.

Page said: "Consumers are becoming more selective but also there are signs of greater confidence and they still want affordable treats." He added that the group's pipeline of new restaurants was the best it has ever been, **with the big out-of-town shopping centres keen to attract winning restaurant formats that increase footfall and make shoppers stay longer**." – *Frankie & Benny's Owner TRG Toasts a Tasty Time for Sales*, Evening Standard, 30 August 013

[6] "The Restaurant Group, which owns the Frankie & Benny's and Chiquito chains, said it was likely to beat market expectations for 2010 in spite of "unusually harsh weather" in November and December.

The group revealed a 1 per cent fall in like-for-like sales for the year compared with a 0.25 per cent increase before the weather-related disruptions.

"People were fearful of going out in the evenings, and evening trade is important to us, especially at that time of year," said Andrew Page, chief executive. "But these things happen."

…

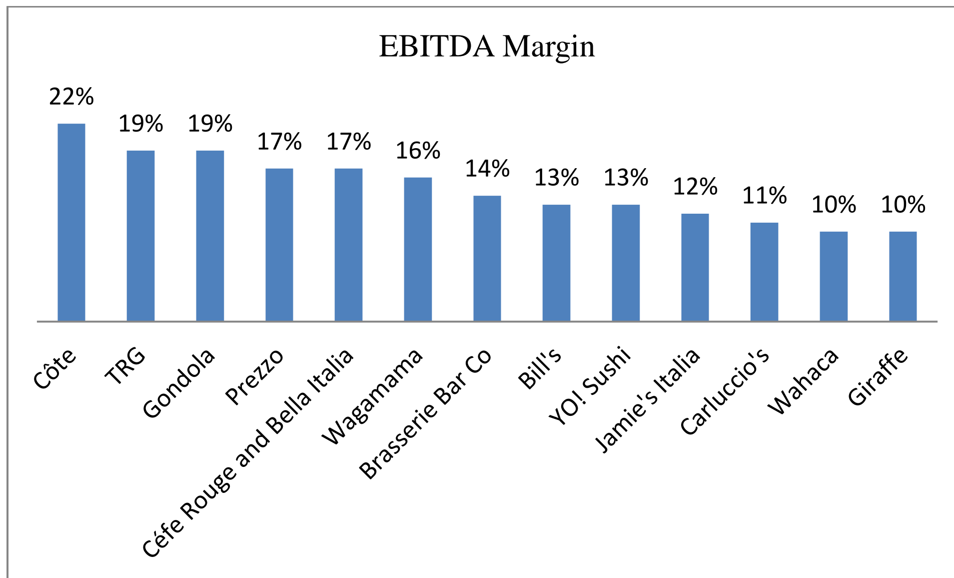
Analysts at Liberum Capital said that **even the steep fall in like-for-like sales in November and December - an estimated 7 to 8 per cent decline - beat the performance of Cineworld, which also operates in leisure parks and shopping centres**. Cineworld experienced a 13 per cent decline in box office earnings during a similar period.

"Whilst films are important to our business, they are not the be-all and end-all," said Mr Page. "A lot of people use the restaurants as a pure destination."" – *Restaurant Group Weathers Severe Trading Conditions*, Rose Jacobs, Financial Times, 12 January 2011

[7] "Following its launch at the end of 2011 in Brighton, Coast to Coast is now a well-established and successful part of the Group's portfolio of brands. **Most of our Coast to Coast restaurants are co-located with Frankie & Benny's and in a number of cases both Frankie & Benny's and Chiquito. It has a distinct market position and as a result we see negligible levels of cannibalisation in such co-located situations**. Our location strategy for Coast to Coast tends to be on leisure and retail schemes in larger markets. We are also confident that the brand can work well in some UK city centre locations, following the successful Birmingham Broad Street opening at the end of 2013." – TRG 2014 Annual Report

Quality

Are U.K. Restaurants Over-Earnings?



U.K. casual dining chains earn about 10-20% EBITDA margin

- **Biggest Negative**:
  - U.K. restaurants might be over-earning
  - U.K. restaurants seem to have lower asset turnover than U.S. peers
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Can the industry charge a high price?
      - (+) The industry can have high mark-up on food and labor cost
    - Does the industry have low costs?
      - (=) food costs are commodity
        - Minimum wages are set by the government
    - Does the industry have low need for assets?
      - (+) the industry has high need for assets
        - Asset turnover is about 2x
          - (for leasehold restaurants)
  - **For the company**
    - Can the company charge a higher or lower price than the industry?

            - **(=)** same as the industry
        - Does the company have higher or lower cost than the industry?
            - **(-)** TRG has higher sales per store than the industry
        - Does the company have more or less need for NTA than the industry?
            - **(-)** TRG seems to have higher asset turnover than the industry
- Restaurants don't compete on price
    - Restaurateurs use a method called "pricing by gross profit"
        - They estimate
            - Cost to search each person entering the restaurant
            - Fixed cost
            - A range of potential volume
        - => Decide a mark-up to gain a reasonable profit margin
        - They usually watch prime cost
            - Prime cost = (labor + food cost)/sales
            - These are controllable cost
                - Although labor costs are less variable than food cost
            - According to the U.K. Restaurant Benchmarks by Baker Tilly
                - Food cost: 28-32% of sales
                    - This number can varies
                    - Pasta or pizza has low input cost
                        - => low food cost/sales
                    - Steak has high input cost
                        - => high food cost/sales
                - Labor cost: 30-35% of total sales
        - Fixed cost is significant
            - Occupancy
                - Rent
                    - Restaurants usually enter 15- or 20-year lease
                    - Long lease help depreciate high fit-out cost slowly
                        - TRG's CapEx per new site is about £1 million
                - Common area maintenance costs
                - Property insurance and taxes
                - Etc.
            - Operating cost
                - Supplies
                - Utilities
                - Repair and maintenance

        - Credit card fees
        - Marketing
        - Training
        - Recruiting
        - Etc.
      - G&A
      - Depreciation
    - In TRG's case
      - Prime cost is about **54%** of sales
        - In almost every year
      - Other expenses: **33%** of sales
        - Including:
          - Rent: **11%** of sales
          - D&A: **6%** of sales
          - G&A: **6%** of sales
          - Operating cost: **10%** of sales
      - If we consider prime cost variable (it's not)
        - Fixed cost is about **33%** of sales
    - A typical U.S. restaurants
      - (based on data of many U.S. casual dining chains we collected)
      - Prime cost: 57-60%
      - Operating cost: 15-16%
      - Occupancy: 6%
      - G&A: 5-6%
      - D&A: 4-5%
      - EBITDA margin: 12-14%
      - EBIT margin: 8-10%
  - It's very hard to underprice successful chains
    - Successful chains have huge volume
    - According to Allegra – The UK Restaurant Market 2015 report
      - Sales per outlet of service-lead restaurants: **£0.9 million**
        - Independent restaurants: **£0.53 million**
          - £15.49 billion revenue
          - 29,100 outlets
        - Branded restaurants: **£1.06 million**
          - £4.89 billion revenue
          - 4,600 outlets

        - TRG averages **£1.35 million** revenue per outlet
            - => **2.5 times** more in independent sales per outlet
            - TRG restaurants are unlikely to be **2 times** bigger in size
                - Sales per square foot might be **50%** higher or more
        - If fixed cost is **30%** of sales
            - 50% higher volume result in **15%** lower fixed cost/sales
        - Underpricing successful chains require getting higher volume than them
            - A daunting task
                - Each of their site has built up awareness for many years
                - They have higher than average volume
    - => new restaurants don't compete on price
        - They compete on volume, by
            - Being unique
                - Being unique means having a unique selling point
                - Good food or great service isn't unique
            - Having good marketing
                - Get people try out
                - Get people increase visit frequency
            - Providing good food and service
                - Help retain customers
- U.K. restaurants have higher EBITDA than U.S. restaurants
    - EBITDA margin of U.K. chains varies greatly:
        - Côte: 22%
        - **TRG: 19%**
        - Gondola: 19%
            - Owned Pizza Express, Ask, Zizzi, and Byron
        - Prezzo: 17%
        - Casual Dining Group: 17%
            - Owns Café Rouge and Bella Italia
        - Wagamama: 16%
        - Brasserie Bar Co: 14%
            - High-end restaurants with £30 average spend per head
        - Bill's: 13%
        - YO! Sushi: 13%
        - Jamie's Italia: 12%
        - Carluccio's: 11%
        - Wahaca: 10%

        - Giraffe: 10%
  - EBITDA margin of U.S. casual dining chains clusters around 10-14%
    - Chuy's Holdings: 14%
    - Brinker: 13%
    - Cheesecake: 13%
    - Darden: 12%
    - Ruby Tuesday: 12%
    - Brio Bravo: 11%
    - Bloomin: 10%
  - Differences
    - U.K. restaurants have significant higher rent
      - U.K. casual dining chains pay about 10% of sales for rent:
        - TRG: 11%
        - Gondola: 10%
        - Prezzo: 9%
        - Wagamama: 8%
          - Wagamama is like a fast casual chain
          - Customers share table with strangers
      - U.S. peers pay about 4% of sales for rent:
        - Cheesecake: 6%
        - Chuy's Holdings: 5%
        - Brio Bravo: 4%
        - Brinker: 4%
        - Bloomin: 4%
        - Ruby Tuesday: 4%
        - Darden: 3%
      - Reasons:
        - U.K. casual dining chains are predominantly on
          - High streets
          - Shopping centers
          - Leisure and retail parks
          - Rent are most expensive in shopping centers
            - Least expensive on out-of-town retail parks
        - U.S. casual dining restaurants aren't usually in high profile locations
    - U.K. restaurants <u>may</u> have higher mark-up on food
      - We don't have a lot of data to prove this point

- We have <u>only</u> food cost/sales data of TRG
    - It's about **23%** of sales
- U.S. peers spend about **26-32%** of sales in food costs
    - Cheesecake: 26%
    - Ruby Tuesday: 27%
    - Brinker: 28%
    - Darden: 31%
        - (Activists want to reduce Darden's food costs)
    - Bloomin: 32%
        - Bloomin has expensive ingredients (steak)
- But U.K. restaurant benchmarks seem similar
    - (According to Baker Tilly)
    - Food cost: **28-32%** of sales
- Staff costs/sales are remarkably similar
    - Bloomin: 28%
        - Steakhouse has high food cost and low labor cost
    - Cheesecake: 31%
    - Brinker: 32%
    - Darden: 32%
    - Ruby: 33%
    - Gondola: 32%
    - Prezzo: 32%
    - **TRG: 32%**
- It's possible that U.K. restaurants have slightly higher mark-up over food cost
    - Because of
        - Higher labor cost
            - U.K. has higher minimum wages:
                - 18-20 years old: £5.30 ($8.48)
                - 21-24 years old: £6.70 ($10.72)
                - 25 and over: £7.20 ($11.52)
            - Tips don't count toward minimum wages
        - Higher rent expense

▪ U.K. restaurants have lower asset turns
- Sales/Average NTA:
    - U.K. chains:
        - TRG: 2.35x

                - Gondola: 2.20x
                - Prezzo: 1.61x
            - U.S. chains:
                - Bloomin: 3.92x
                - Bravo Brio: 2.93x
                - Brinker: 2.75x
                - Cheesecake: 2.73x
                - Darden: 2.67x
                - Chuy's Holdings: 2.53x
                - Ruby Tuesday: 1.53x
        - No good reason
            - Wild guess: U.K. restaurants spend more on fit-out?
        - Estimated sales per square foot
            - **TRG: £340 ($540)**
            - Cheesecake: $1,050
            - Brinker: $650
            - Olive Garden: $570
            - Bloomin: $500-550
            - Chuy's Holding: $537
            - Bravo Brio: $500
- **Will EBITDA margin of U.K. restaurants decline?**
    - 3 lines of thought
    - **#1:** U.K. restaurants aren't really more profitable
        - They have lower asset turns => need higher margin
            - If U.S. restaurants has 25% higher asset turnover
                - And U.S. restaurants make 12% EBITDA margin
                - => U.K. restaurants need 15% EBITDA margin
                    - To achieve similar EBITDA/NTA
        - Site economics varies greatly
        - Giraffe or Wahaca makes only 10% EBITDA margin
            - At 1.6x asset turn like Prezzo
                - => They can make only 16% EBITDA/NTA
                - Lower than U.S. peers' EBITDA/NTA
                    - Bloomin: 38%
                    - Brinker: 36%
                    - Cheesecake: 36%
                    - Chuy's Holdings: 36%

- Darden: 33%
- Bravo Brio: 27%
- According to Baker Tilly's U.K. restaurant benchmarks
  - Under £200 sales per square foot: likely make operating loss
  - At £200 to £300 sales per square foot: 0-5% EBIT margin
  - At £300 to £400 sales per square foot: 5-10% EBIT margin
- TRG's high margin might be due to company-specific quality
  - Not due to U.K. industry's overearning
- **#2:** U.K. restaurants might be naturally more profitable than U.S. peers
  - U.K. restaurants have higher fixed cost
    - High minimum wages
    - High rent expense
  - => higher risk
  - => need higher reward to justify the risk
    - According to Mitchells & Butlers[1]
      - The rule of thumb in the industry
        - Freehold assets: require mid to high teens ROIC
        - Leasehold assets: require 25% ROIC
    - An industry consultant explain that restaurant has high risk/high reward[2]
      - Failure rate is high
        - 60% of new restaurants fail in 3 years
        - 75% fail in 5 years
      - Successful restaurants can have 3-year payback period
- **#3:** U.K. restaurants are over-earning
  - U.K. restaurants may really have higher ROIC than U.S. peers now
  - Chains will keep opening due to high ROIC
    - More outlets will reduce average volume
      - Leading to lower ROIC
  - Problem with this argument:
    - Restaurant isn't a new industry
    - TRG has been enjoying high margin, high ROIC since 2002
    - One may say that the U.K. market is not mature yet
      - And profitability may decline as the market saturates
    - But that didn't happen to U.S. chains
      - Darden, Brinker, and Cheesecake don't have lower margin than they did in 1993

                - EBITDA margin was basically flat
                    - Just went up and down through cycles
- Conclusion: there's possibility that U.K. restaurants are over-earnings
    - This is the biggest risk to an investment in TRG
    - In this case, TRG may have some protection
        - Thanks to its locations
            - Supply is controlled
        - In worst case, TRG's EBITDA margin may decline to 15%
            - (if asset turns don't improve)
            - EBIT margin: 10%
            - It will still make an above average return
- 8 dimensions of quality
    - Relative size
        - Customers are individual
        - Suppliers can be big
            - But they sell commodity
        - TRG is the biggest casual dining group in the U.K.
    - Focus
        - TRG have several brands
            - F&B
            - Chiquito
            - Coast to Coast
        - TRG focuses on several segment
            - Leisure and retail park
            - Concessions
            - Rural and semi-rural pub
                - Pubs aren't branded
    - Customer engagement
        - F&B has a data base of 1.4 million opted in users
    - Cross-selling
        - F&B, Chiquito, and Coast to Coast can open in the same places
            - Help segment the market
    - Retention
        - No information
    - Words of mouth
        - No information
    - Reinvestment rate

- TRG doesn't spend much on advertising
- Spent over £600 million in CapEx since 2002

- Stock's popularity
  - Market cap: £780 million
  - Float: 198 million shares
  - Share turnover: 126%
    - (= 3-month average daily volume * 252/Float)
  - Daily trading value: almost £4 million
  - TRG name is difficult to look for in
    - Google Finance
    - Stockopedia

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[1] "Well, we have internal hurdle rates, which are important for discipline but, of course, it's not the actual hurdle rate that matters, it's what -- it's not the hurdle rate, it's what you actually achieve that matters.

I think **there is a general rule of thumb in the industry that, on a freehold asset, you'd want to be producing income in mid to high teens, and Tim did say, if you look at our freehold investments, we're satisfied with what we've got but we'd like them to do better. And certainly, we'd expect a higher return, as everybody would, from leasehold sites. And a benchmark of most people producing 25% returns and north is the market target**, so, clearly, we want to be in that same kind of space.

If you get returns at those kind of levels, in and around those kind of levels, then we would be producing significant shareholder value." – Alistair Darby, Mitchells & Butlers' former CEO, 2012 Final Result Presentation, 27 November 2012

[2] "The cold fact of the matter is that opening up a restaurant may be one of the worst investments you could make with your money. That's a horrible, sobering statement coming from someone like me who's in the business of helping restaurants succeed, but it's the truth. Most restaurant fail. Oh, the failure rate isn't the "90%" you may have heard from friends and family, but **according to Cornell University, and the National Restaurant Association, 60% of restaurants fail within the first three years of operation. After five years, the number might be as high as 75%.**

Uggghh!

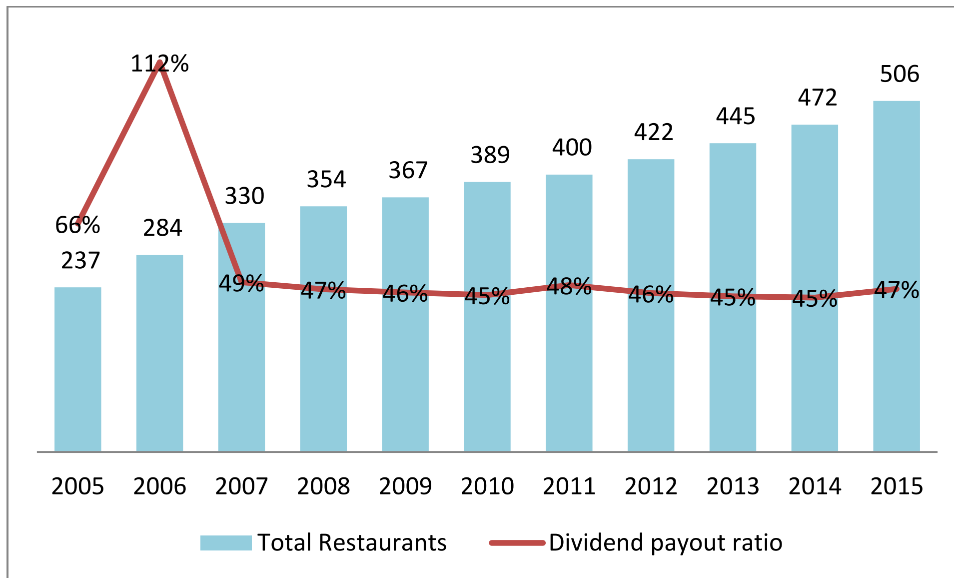
Why the hell would anyone want to get into this business with a failure rate like

that? Risk and reward my friend, risk and reward.

As with other high risk investments, opening the right kind of restaurant in the right kind of market can pay off very well financially. Some of the better chains can see average net profits approaching, and even exceeding 30% of sales. That's a great return! While the risk of opening a restaurant is huge, the reward can also be huge. **If you happen upon the right concept, and manage it well, you could see your investment paid off in 3 years or less, and have lots of residual cash flow to boot.**" – The Biggest Mistakes Restaurants Make, and Why They Have a High Failure Rate, Brandon O'Dell, http://www.evancarmichael.com/

Capital Allocation

The Restaurant Group Just Open New Restaurants and Pay Dividends



Since 2005, TRG more than doubled the number of restaurants while paying about 50% of earnings

- **Biggest Negative**:
  - 50% of Long-term incentive awards are based on share performance
- Share dilution is negligible
- Compensation includes
  - Base salary
  - Annual bonus
    - Mainly based on pre-tax profit during the year
    - Annual bonus is up to 150% of basic salary
  - Long-term Incentive Plan (LTIP)
    - Up to 200% of base salary
    - Vest over 3 years depends on
      - 3-year TSR vs. the FTSE 350 Travel and Leisure sector
        - (excluding airline)
        - Weight: 50%
        - 30% of this element of the award vests for a median ranking
        - Increasing to full vesting for an upper quartile ranking

        - Question: Does this make management focus on share price???
      - EPS growth
        - Weight: 50%
        - 30% of this element of award vests for annual growth equal to RPI + 4%
        - Increasing to full vesting for growth equal to or in excess of RPI + 10%
    - LTIP award are granted in the form of nil cost options
      - Equivalent to restricted stock unit?
- TRG management is focused on ROIC
  - Although: ROIC isn't an element in TRG's incentive plan
  - They're clear about 3 key characteristics it seek:
    - Distinct barrier to entry
    - High return on capital
    - Good growth prospects
  - In TRG's presentation, they show calculation of site and company ROI
    - = EBIT/(Net asset + debt)
  - TRG's touchstones are[1]
    - Cash flow, and
    - Return on investment
  - Most sites are leasehold
    - But TRG may buy freehold when potential return is satisfactory
  - In 2008-2009, the credit crunch cause many developments delayed[2]
    - TRG didn't replace postponed projects with less attractive projects
- They focus on organic growth[3]
  - Opened stores in areas with barriers to entry[4]
    - On-edge or out-of-town leisure and retail parks
    - Rural & semi-rural pubs
    - Concessions
      - Mainly airports
  - Developed new formats
    - Coast to Coast was successful launched in 2011
      - In Brighton
      - In 2001
    - Coast to Coast takes its inspiration from the Lincoln High way[5]
      - Spans the U.S. from New York to San Francisco

            - Great range of authentic food and drinks
                - Best of classic American food
                    - Aberdeen Angus beef burger
                    - Deep dish style Chicago pizzas
                    - Distinctive steaks
                    - Etc.
            - A great bar serving specialty cocktails
            - Wide range of beers, spirits and traditional milkshakes
            - Music is an eclectic mix of
                - Motown
                - American rock
            - Customers are guarantee to lift their spirits
        - The first Coast to Coast restaurant was a great success
            - => TRG opened more stores
                - 4 in 2012
                - 5 in 2013
                - 3 in 2014
                - 8 in 2015
            - Currently has 21 Coast to Coast stores
            - Potential: over 100 stores
        - TRG opens Coast to Coast store in the same place with
            - Frankie & Benny's, or
            - Chiquito, or
            - Both
        - TRG recently has a new brand[6]
            - Joe's Kitchen
                - Currently has 4 sites
            - TRG plans to open 100 Joe's Kitchen
                - In 10 years
- TRG uses little debt
    - Debt level peaked at £88 million
        - In 2008
        - Reasons:
            - TRG paid £35 million special dividend
                - In 2006
            - Acquired Brunning & Price
                - In 2007

- £33 million
  - Net Debt/EBITDA was about 1x
- Net debt has declined to £32 million today
  - 0.24x EBITDA
- TRG has significant fixed charge
  - Rent is about 11% of sales
  - EBITDAR/(Rent + Interest Expense): 2.7
- Peers tend to use more debt
  - Most casual dining chains are owned by PE firms
  - Tragus
    - Tragus owns
      - Café Rouge
      - Bella Italia
      - Strada
    - Blackstone paid £267 million for Tragus
      - In December 2006
      - At the peak of the buyout boom
      - Used £167 million debt
    - In 2013
      - Tragus's pretax losses doubled to £36 million
      - The bulk of this loss stemmed from interest on its net debt
        - £324.6 million on June 02, 2013
    - Apollo acquired Tragus's debt
      - In the secondary market
    - Tragus agreed a restructuring deal
      - In 2014
      - Slashing its debt burden from £354 to £91 million
      - Undergo a company voluntary arrangement
        - Cut its rent bill to make the company profitable again
        - Landlords at 51 of its 290 sites will be asked to agree to rent reductions
          - 40% in 19 cases
          - 50% in the remaining cases
        - Hopes to exist 30 to 40 of these leases over the next few years
        - Landlords would be left with less than a penny if it went bankrupt

            - Apollo has agreed a debt-for-equity swap to reduce Tragus's debt burden
            - Tragus's debt burden hindered it during the downturn[7]
                - Mid-market restaurants prospered
                - But large interest payments meant it couldn't invest in its estate
                    - Posted £36 million pre-tax loss last year
            - Sold Strada
                - For £37 million
                    - Had previously acquired Strada for £140 million
                        - In 2007
                - Strada suffered worse trading than Bella Italia and Café
                    - Tragus couldn't invest in Strada
        - Gondola
            - Gondola owns
                - Pizza Express
                - Ask
                - Zizzi
                - Byron
            - Cinven bought Gondola for £900 million
                - In 2007
            - Cinven used about £600 million debt
                - Net Debt/EBITDA was 5.8x in 2007
                - Besides, rent expense is about 9-10% of sales
            - Gondola eventually sold all of its brands
                - Sold Byron for £100 million
                    - In 2013
                    - To Hutton Collins Partners
                        - Hutton Collins also owns Wagamama
                - Sold Pizza Express for £900 million
                    - In 2014
                    - To Hony Capital
                        - A Chinese private equity firm
                - Sold Ask and Zizzi for £250 million
                    - To Bridgepoint
                        - Bridgepoint also owns Pret a Manger
        - Mitchells & Butlers

- Mitchells & Butlers' Net Debt/EBITDA: 4.3x
- But Mitchells & Butlers owns most of its pubs
  - Like most pubcos
- EBITDAR/(Rent + Interest): 2.73x

- TRG returns moss excess cash to shareholders
  - TRG maintains about 50% dividend payout ratio[8]
  - TRG also pay special dividend 2 times over the last 10 years
    - In 2006: 16 pence per share
      - In addition to 6-pence-per-share regular dividend
    - In 2014: 3.45 pence per share
      - In additional to 14.85-pence-per-share regular dividend
  - TRG created great value for shareholder
    - From 2002 to 2015
      - Total income: £483 million
      - Total dividend: £269 million
        - Averaging 56% payout rate
      - Sales CAGR: 9.28%
        - 2002: £216 million
        - 2015: £685 million
      - EBITDA CAGR: 11%
        - 2002: £34 million
        - 2015: £133 million
    - => implies about 20% after-tax return on equity

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[1] "Our core objective continues to be growth in shareholder value and our strategy to achieve this is to build a business capable of delivering long-term, sustainable and growing cash flows. **Our touchstones are cash flow and return on investment. Our business model enables our shareholders to enjoy the benefits of high returns on capital, growth in profits and cash flow and sizeable income distributions from our progressive dividend policy.** The Group has a consistent record of converting profits into cash at a very healthy rate, and delivering increasing cash flows each year, and in 2013 this was again the case." – TRG 2013 Annual Report

[2] "**Our philosophy regarding capital expenditure remains consistent that is, we focus on cash generation and return on invested capital at rates ahead of TRG's weighted average cost of capital.** We will continue to apply the same high level of analytical rigour, commercial analysis, experience and risk adjustment to each capital project that we undertake. This approach has served TRG well over the last seven

years and we do not intend to deviate from it. **This means that projects that have been postponed or delayed by the developers will not be substituted with unduly risky and/or less attractive projects. Rather, we will retain our cash until such time as either the original projects reappear or other equally attractive opportunities become available.** In the meantime, our surplus cashflow will be applied towards reducing debt." – TRG's 2008 Final Result statement

[3] "**Our core objective is to grow shareholder value by building a business capable of delivering long-term sustainable and growing cash flows.** We do this by providing great food, drink and service in well-appointed restaurants and pubs. Within the eating out market we focus on sectors where there are barriers to entry, good growth prospects and strong returns. **Our growth model is primarily based on organic roll out of new sites. While most such sites are leasehold, we also acquire freehold premises where these give a satisfactory level of return. Although not a core part of our development plans, we remain open to evaluating acquisitions of existing businesses where there is a clear strategic rationale and where this would enhance shareholder value.**

Our business model is to grow through a combination of like-for-like sales growth and new site development. **The profits from this growth are converted into cash at a healthy rate, which we use to maintain our existing estate in good order, pay dividends and invest in more new sites generating high levels of return.** This has proven to be a very successful and value-accretive business model which has enabled the Group to grow in a predominately organic way funded principally by internally generated cash flows. **This model delivers high returns, growth and income for shareholders in the form of dividends.**

Key to achieving all of this is that we continue to provide great service and food in our restaurants, and evolve our brands and offerings in line with changing consumer trends." – TRG 2014 Annual Report

[4] "The Restaurant Group's key objective is to grow shareholder value and the strategy deployed to achieve this is to build a business capable of generating long-term, sustainable and growing cash flows. In pursuit of this we have built a scalable business model which is focused on the growing casual eating out market. **We have targeted areas of this market which offer distinct barriers to entry, where we can be confident of delivering good growth in profits and cash flows and where there is potential for high returns on investment. This has led the Group to focus on edge and out of town leisure and retail developments, rural and semi-rural pubs and our Concessions business which operates principally on airports.** The Group operates in the expanding casual dining market, and our offerings continue to provide

good value for money in comfortable surroundings with excellent service from our dedicated teams.

The Group's strategy is to deliver further organic growth through the roll out of our brands. We have a solid pipeline of sites for development, coupled with a strong focus on continuing to deliver like-for-like sales growth from our existing restaurants. Our Concessions business operates in a dynamic and complex market where our management teams have market-leading expertise and a track record of innovation and improving sales performance. The Group continues to look for opportunities to expand this area of the business." – TRG 2014 Annual Report

[5] "**Coast to Coast takes its inspiration from the Lincoln Highway, which spans the United States of America from New York to San Francisco**. This is reflected in our great range of authentic food and drinks, all served with superb hospitality and service. **We offer the best of classic American food** – Aberdeen Angus beef burgers, deep dish style Chicago pizzas, distinctive steaks, amazing seafood dishes, wraps and South-West American specials. **Coast to Coast is more than just a restaurant, with a great bar serving speciality cocktails and a wide range of beers, spirits and traditional milkshakes. The music is an eclectic mix of Motown and American Rock, songs you may not have heard in a little while, but are absolutely guaranteed to lift your spirits and make you smile**. We currently have five restaurants open and see significant opportunities to grow Coast to Coast into a great brand." – TRG 2012 Annual Report

[6] "The Restaurant Group is planning a major expansion of its new casual dining chain Joe's Kitchen.

The company, which owns other brands including Frankie & Benny's, Garfunkel's and Mexican concept Chiquito, **plans to open 100 Joe's Kitchen outlets over the next five to 10 years across the UK.**

It has appointed Savills to advise on the expansion and is seeking sites of between 3,000 sq ft and 4,000 sq ft.

It will focus on sites in prime high street locations, as well as shopping centres and major mixed-use schemes.

Cities including London, Edinburgh, Manchester and Birmingham top the shopping list which also includes second-tier regional cities and affluent market towns.

The all-day casual dining concept first opened in Borough, SE1, in 2005, and it has since opened three more restaurants in Derby, Manchester Airport and

Bromley." – _Expansion goes on the menu at Joe's Kitchen_, Rolt Ember, Estates Gazette, 12 September 2015

[7] "Apollo, which owns the group alongside Oak Hill Capital Partners, Deutsche Bank and York Capital Management, has agreed a debt-for-equity swap to reduce Tragus's debt burden.

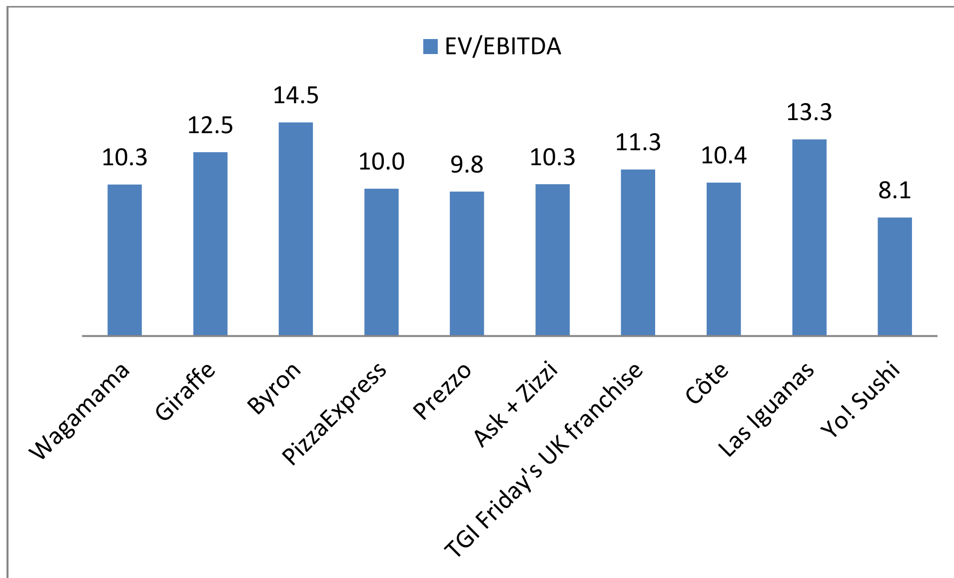
Tragus's large debt pile hindered the group during the downturn. Although mid-market restaurants prospered in this period, Tragus's large interest payments meant that the group could not invest in its estate. Last year, it posted a £36m pre-tax loss.

The decision to sell Strada caps a difficult period for the 56-strong chain of Italian restaurants, which has suffered worse trading than the group's Bella Italia and Café Rouge brands. "**If we were to carry on just parking and not investing in Strada, it would not be good for the brand," said Mr Richards. "The business is still profitable. It has some fabulous sites."**" – _Café Rouge Owner Tragus to Sell Struggling UK Strada Brand_, Duncan Robinson, Financial Times, 04 June 2014

[8] "As a result of the strong financial performance in the year, the Board is recommending a final dividend of 9.3p per share to give a total for the year of 15.4p, an increase of 10% on the prior year. **This dividend is covered almost two times by earnings per share, in line with our stated dividend policy**." – TRG 2014 Annual Report

Value

TRG Is Trading at a Big Discount to Other Casual Dining Chains



U.K. casual dining chains are usually acquired at 10x EBITDA

- **Biggest Negative**:
    - Share price is sensitive to like-for-like sales growth
- Key inputs
    - Share price: 265 pence per share
    - Number of outstanding shares: 199.4 million
    - Market cap: £528 million
    - EV: £560 million
    - Current EBIT: £94 million
        - Excluding pre-opening expenses
    - Normal EBIT: £89 million
        - Using 13% long-term median EBIT margin
            - Since 2005, when TRG sold other high street brands
    - EV/Current EBIT: 5.96
    - EV/Normal EBIT: 6.29
    - Tax rate: **20%**
- U.S. peers trade at about 12-14 EV/EBIT
    - Darden
        - Main assets include
            - Olive Garden

            - Average check: $16.5
        - LongHorn Steakhouse
            - Average check: $18.75
    - Darden is trading at
        - $62.07 per share
        - EV: $8,090 million
        - 10.80 EV/EBITDA
        - 18.81 EV/EBIT
    - Darden's margin is currently lower than normal
        - Current margin: 6%
        - Historical median margin: 8%
            - Implies 14.95 EV/EBIT
        - Margin in good year: 10%
            - Implies **12** EV/EBIT
    - Starboard's plan is to improve Darden's margin
- Brinker
    - Brinker owns
        - Chili's Grill & Bar
            - Average check: $14.52
        - Maggiano's Little Italy
            - Average check: $27
    - Brinker is trading at
        - $47.15 per share
        - EV: $3,736 million
        - 8.19 EV/EBITDA
        - **12.01** EV/EBIT
        - If we use historical median EBIT margin
            - 15.18x EV/EBIT
- Cheesecake
    - Average check: $20.8
    - Cheesecake is trading at
        - $49.19 per share
        - EV: $2,494 million
        - 9.10 EV/EBITDA
        - **13.26** EV/EBIT
        - If we use historical median EBIT margin

            - **11.87x**
- Bloomin
    - Bloomin owns
        - Outback Steakhouse
            - Average check: $22
        - Carrabba's Italian Grill
            - Average check: $21
        - Bonafish
            - Average check: $25
        - Fleming's Prime Steakhouse & Wine Bar
            - Average check: $72
    - Bloomin is trading at
        - $17.29 per share
        - EV: $3,330 million
        - 7.27 EV/EBITDA
        - **12.43** EV/EBIT
        - If we use historical median EBIT margin
            - **12.43x**
- Ruby Tuesday
    - Average check: $14
    - Ruby is trading at
        - $3.54 per share
        - EV: $390 million
        - 5.00 EV/EBITDA
        - **13.92** EV/EBIT
        - Ruby's current margin is low
            - Ruby has been in trouble
            - Comparable store sales decline in 8 of the last 9 year
            - The last time comparable store sales grew was in 2011
                - 0.9%
            - Comparable store sales <u>decline</u> in the last 3 years:
                - 2013: 1%
                - 2014: 5.3%
                - 2015: 0.5%
    - Ruby's current EBIT margin: 2.5%
    - Historical median EBIT margin: 6.7%
        - Implies **5.16** EV/EBIT

- Bravo Brio
  - Bravo Brio owns 2 Italian restaurant chains
    - Bravo
      - 51 restaurants
      - Average check: $21.8
        - Lunch: $16.79
        - Dinner: $25
    - Brio Tuscan Grille
      - Average check: $26.17
        - Lunch: $20.05
        - Dinner: $30.48
      - 65 restaurants
  - Bravo Brio is trading at
    - $8.18 per share
    - EV: $231 million
    - 5.93 EV/EBITDA
    - **14.45** EV/EBIT
  - Bravo Brio has been in trouble
    - Comparable store sales declined in the last 3 years
      - 2013: -2.8%
      - 2014: -5.0%
      - 2015: - 2.8%
    - EBIT margin declined:
      - 2015: 3.9%
      - Peak: 8.5%
        - In 2010
      - Median 5.8%
    - Assuming median margin, Bravo Brio is trading at **9.40** EV/EBIT
- Chuy's Holdings
  - Chuy's is a fast-growing, full-service restaurant concept
    - Offering authentic and freshly-prepared Mexican and Tex Mex inspired food
  - Average check: $14.23
  - Chuy's is trading at
    - $33.46 per share
    - EV: $586 million
    - 14.64 EV/EBITDA

                - **20.92** EV/EBIT
            - Chuy's has grown very fast
                - Number of restaurants
                    - 2007: 8
                    - 2010: 23
                    - 2013: 48
                    - 2014: 59
                    - 2015: 69
            - 5-year sales CAGR: 25%
- U.S. peers are less attractive than TRG
    - Only Chuy's has higher growth than TRG
    - Other peers have lower growth
        - Darden, Ruby Tuesday, and Bravo Brio are struggling
            - Ruby has lower sales than 5 years ago
            - Bravo Brio's 5-year sales CAGR was only **4.3%**
                - 2010: $343 million
                - 2015: $424 million
        - Cheesecake's growth has slowed down
            - Grew over 20% annually before 2006
            - 5-year sales CAGR was only **4.8%**
                - 2010: $1,659 million
                - 2015: $2,101 million
        - Bloomin's 5-year sales CAGR was **3.8%**
            - 2010: $3,628 million
            - 2015: $4,378 million
        - Brinker's 5-year sales CAGR was **1%**
            - 2010: $2,858 million
            - 2015: $3,002 million
    - U.S. peers have lower ROIC
        - EBIT/NTA
            - TRG: 31%
            - Cheesecake: 26%
            - Chuy's: 24%
            - Brinker: 23%
            - Darden: 23%
            - Bloomin: 22%

        - Brio Bravo: 19%
- U.K. casual dining chains are often acquired at about 10x EBITDA
    - Recent deals include
        - Gourmet Burger Chicken
            - In September 2010
            - Price: £30 million
            - EBITDA: £1.5 million
            - EV/EBITDA: **20**
        - Wagamama
            - In March 2011
            - Price: £215 million
            - EBITDA: £20.9 million
                - Wagamama's EBITDA margin in 2011 was 19%
                - It's normal EBITDA margin is 16%
                - => £17.4 million normal EBITDA at the time of the deal
            - EV/EBITDA: **10.3**
                - **12.4x** normal EBITDA
        - Giraffe
            - In March 2013
            - Price: £49 million
            - EBITDA: £3.9 million
            - EV/EBITDA: **12.5**
        - Byron
            - In October 2013
            - Price: £100 million
            - EBITDA: £6.9 million
            - EV/EBITDA: 14.5
        - Pizza Express:
            - In July 2014
            - Price: £900 million
            - EBITDA: £90 million
            - EV/EBITDA: 10
                - Pizza Express is considered mature in the U.K.
                - Has 443 sites
                - Acquirer was Hony Capital
                    - A Chinese private equity firm

            - Honey might want to grow Pizza Express in China
- Prezzo
    - In November 2014
    - Price: £304 million
    - Forward EBITDA: £31 million
    - EV/EBITDA: **9.8**
    - Analysts urged Prezzo to reject the bid[1]
        - Price was low
            - Doesn't reflect Prezzo's prospect
    - Prezzo at that time had
        - 200 Prezzo restaurants
        - 37 Chimichanga restaurants
- Ask and Zizzi
    - In December 2014
    - Gondola sold to Bridgepoint
    - Price: £250 million
    - EBITDA: £24.3 million
    - EV/EBITDA: **10.3**
- TGI Friday's UK franchise
    - In December 2014
    - Price: £225 million
    - EBITDA: £19.9 million
    - EV/EBITDA: **11.3**
- Côte
    - In July 2015
    - Price: £250 million
    - EBITDA: £24 million
    - EV/EBITDA: **10.4**
- Las Iguanas
    - In July 2015
    - Price: £85 million
    - EBITDA: £6.4 million
    - EV/EBITDA: **13.3**
- YO! Sushi
    - In November 2015
    - Price: £81 million

        - EBITDA: £10 million
        - EV/EBITDA: **8.1**
        - YO! Sushi was rumored to be sold for £100-130 million in early 2015
            - Implies 10-13 EV/EBITDA
            - It was eventually sold for 8.1 times EBITDA
                - In November 2015
                - This might reflect the change in market valuation of restaurants
- TRG is currently trading at only 6.1x EBITDA
    - At 10x EBITDA, it's worth £1,330 million
        - £1,298 million equity value
        - Or 651 pence per share
- Historically, TRG's share price was sensitive to like-for-like sales growth
    - On January 04, 2008, share price declined by 31%
        - From 176 pence per share
        - To 120 pence per share
    - On January 14, 2016, share price declined by 14%
        - From 638 pence per share
        - To 550 pence per share
        - Reasons: like-for-like sales growth trended lower
            - Grew just 1.5% in December 2015
    - On March 09, 2016, share price declined by 17%
        - From 540.5 pence per share
        - To 446 pence per share
        - Reason: like-for-like sales declined 1.5% for the first 10 weeks of 2016
    - TRG was expensive in 2013-2015
        - P/E was between 19 and 25
        - Analysts were optimistic
        - Just in December 2015, UBS set TRG's price target at **860** pence per share[2]
            - Expected over 1,000 possible additional locations
                - Vs. management's target of 250 additional sites
            - The least optimistic analyst set target at 635 pence per share
            - TRG was trading at **676.5** pence per share that day
                - Declined to less than **390** pence per share today
                - Within 3 months

- TRG wasn't expensive in the 2009-2013 period
    - P/E was between 9 and 13
    - "TRG appears less racy than its high street rivals"[3]
- TRG was rumored as bid target[4]
- Quan's take: TRG share price can go up very quickly

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[1] "Peel Hunt analyst Nick Batram **said there was "no doubt" TPG was buying Prezzo at "a very attractive price" that was "not so good for independent shareholders**".

The analyst urged them to reject the bid: "History has shown that independent shareholders that have been able to hold unquoted equity have done well rejecting unattractive bids in the past - Fitness First is a good example. Therefore, for those that can, we would reject the bid."

Douglas Jack, analyst at Numis, said he expected many of the independent investors "to conclude that this cash offer does not fully reflect the value and future prospects of the business".

However, sources close to the situation said the offer valued the business in line with recent leisure deals, for example the sale of restaurant rival Pizza Express to Hony in July was done at roughly ten times its earnings and offered the Chinese bidder huge Asian expansion opportunities." – *Prezzo Gobled up by TPG*, Ashley Armstrong, 06 November 2014, Telegraph

[2] "Last month, the company said it had opened 25 new restaurants at that stage in 2015, and expected to open between 43 and 45 in the year as a whole, up from 40 in 2014. It expects to open as many again in 2016.

UBS thinks the opening plan could continue for the next five years.

"Management has a track record of delivering strong returns through value-creating new site additions**. Our detailed analysis of the existing restaurant locations of its key brands F&B, Chiquito and Coast to Coast versus town population density suggests over 1,000 possible additional locations (280% site uplift), versus the circa 250 sites that management targets (c70% site uplift)**," writes Analyst Heidi Richardson.

"While our base case is more conservatively set, the analysis supports our view that TRG could accelerate its restaurant roll-out rate, adding 45-50 sites per annum through

the forecast period, and highlights the scale of the group's potential medium-term upside," she adds.

If the company does manage to meet the UBS forecast for new openings, then this would drive double-digit revenue growth for 18 years assuming 2.5% like-for-like sales growth, Richardson says.

"We believe that a combination of management initiatives to continue driving volume, and a more favourable pricing environment, will see sustainable like-for-like sales growth going forward, following the average 2.6% like-for-like growth posted in 2011-14. **We also see limited risk from wider market supply growth given that total restaurant numbers in the UK are declining, while TRG's predominantly out-of-town locations provide a controlled supply environment**," she writes.

UBS is forecasting that the company will report 10.5% compound annual revenue growth between 2015 and 2019, and 12.0% compound earnings growth over the same period.

It is starting coverage of the stock with a Buy rating and a 860 pence target price.

Restaurant Group shares are up 3.2% at 676.50 pence on Friday, meaning they are up 2.5% for the year-to-date.

The wider analyst community is overwhelmingly positive about the stock. **Four have it at Strong Buy, six at Buy, three at Hold and just one at Sell, according to data compiled by Thomson Reuters**.

Nomura is the bank with a Reduce rating on the stock. It downgraded it in November from Neutral, **warning that the impending introduction of the National Living Wage would hit Restaurant Group's margins**. It thinks the market is under-appreciating the impact the higher wage bill will have on the company.

It thinks the UK restaurant industry will try and pass higher wage costs on to customers, but thinks this would put pressure on like-for-like sales growth.

Nomura cut its price target on Restaurant Group to 635 pence when it downgraded the stock last month." – *Restaurant Group growth set to continue as it plans more openings*, 18 December 2015 News Markets

[3] "**TRG was the only listed restaurant group to increase earnings in 2009. Yet this does not appear to be reflected in its rating. The shares are trading on about 11.4**

times 2010 pre-tax profit of 49.6m, compared with Clapham House's 16.9 times or Carluccio's' 16.5 times. One reason could be that in terms of brand TRG appears less racy than its high street rivals. But investors ignore TRG at their peril. The current year has started well and with the group likely to pay off all its debt in three years or expand, it is well positioned to create further value." – *Blockbuster Films Help TRG Defy Recession*, Pan Kwan Yuk, Financial Times, 03 March 2010

[4] "Sales from sites open for more than a year slumped by 1.5pc in the first 10 weeks of 2016, said the company, which also owns the Chiquito, Coast to Coast and Garfunkel's brands, in its annual results. The recent weak trading rattled investors, who sent **Restaurant Group's stock to its lowest in three years, and prompted analysts at brokers Peel Hunt and Cenkos to warn the business is now a potential target for buy-out firms**.

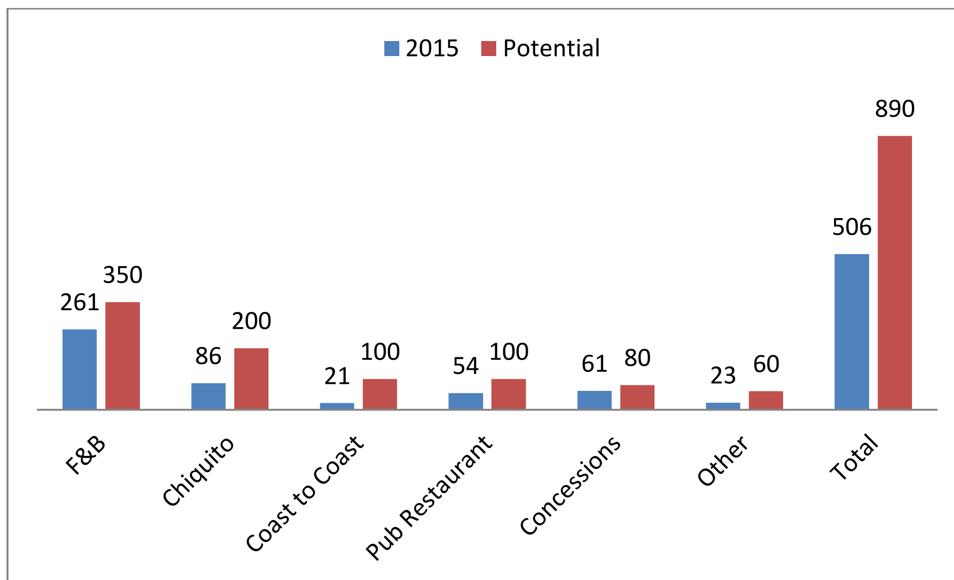
Private equity houses own many of the branded casual dining chains that have grown explosively in recent years, including Nando's and Las Iguanas, and which are increasingly vying with Restaurant Group for customers. Buy-out firms find restaurant chains attractive because they can be expanded quickly and are highly cash-generative.

"**We wonder how long before private equity predators look to capitalise on the group's strong trading positions**," Simon French, of Cenkos, said following Restaurant Group's share price plunge. Nick Batram, analyst at Peel Hunt, added: "**We believe private equity may start running the slide rule over the business**."

However, **despite the mounting speculation, Danny Breithaupt, chief executive of Restaurant Group, said the company, which reported an 11.2pc rise in pre-tax profits to PS86.8m, had not received any approaches from interested bidders**. Full-year revenues rose 7.9pc to PS685.4m." – *Frankie & Benny's Seen as Bid Target After It Warns of Tough Trading*, Ben Martin, Telegraph, 10 March 2016

Growth

TRG Can Keep Opening 40-50 Restaurants a Year



TRG has potential to open up to about 900 restaurants

- **Biggest Negative**:
  - Like-for-like sales growth is hard to predict
- The casual dining market is less mature than in the U.K. than in the U.S.
  - According to Mintel, the U.S. restaurant market: $482 billion
    - In 2014
    - Including
      - Limited-service restaurant: **41.9%**
        - (fast food, fast casual)
        - **$202 billion**
      - Full-service restaurant: **49.6%**
        - **$239 billion**
        - Mintel estimate the casual dining market at **$124 billion**
          - Including restaurants with average check
            - Between $8 and $20 per entrée
            - $20 per person
          - Example: Red Lobster, Chili's, Applebee's
        - => casual dining is about **25.7%** of the market
          - Fine/upscale dining is about **23.9%** of the market
      - Other limited service: **8.5%**

            - (snack and beverage bars, cafeterias/grills/grill buffets)
            - **$41 billion**
- The U.K.'s Office of National Statistics (ONS) estimate the total consumer spend on catering services: **£87.6 billion**
- Industry consultants say this number massively overstates the market
    - Horizons said that ONS's figure includes
        - All drink served in pubs
            - Whether or not it was consumed with food
        - Overnight hotel accommodation
            - If you have spent £20 on a night in a pub
            - then slept it off in a hotel charging £80 for the overnight stay
            - ONS says that you have spent £100 on eating out
- Horizons estimates the U.K. out-of-home food service market at **£46.6 billion**
    - In 2014
    - Managed pubs accounted for **30.3%** of restaurant meals
        - In 2013
- NPD estimates U.K.'s out-of-home food service market: **£52.2 billion**
    - In 2015
    - Including
        - Restaurants
        - QSR
        - Food served in pubs, hotel, and other venues
- Allegra has a different estimate
    - (TRG uses Allegra data)
    - Total market: **£57.61 billion**
        - Service-lead restaurant: £20.91 billion
        - Fast food and take away: £12.78 billion
        - Pubs: £23.92 billion
- Mintel has a far different estimate:
    - 2015: **£31.05 billion**
        - Fast food: £9.7 billion
            - (excluding coffee shops)
    - 2014: **£30.47 billion**
        - Fast food: £9.4 billion
    - Mintel says the market include
        - Takeaway and fast food,

        - Full-service restaurant
        - Pubs/clubs/taverns/bars etc.
    - Mintel's estimate might be close to Allegra if the £30 billion number doesn't include pubs
- NPD estimate the casual dining market at **£4.7 billion**
    - (Restaurants with average spend per head between £10-20)
- These data show the restaurant market is underpenetrated in the U.K.
    - According to Mintel
        - U.S. restaurant market: $482 billion
        - U.K. restaurant market: £30.47 billion (about $48 billion)
        - => U.S. restaurant market is **10x** bigger
            - But the U.S. population is only 5x
    - According to Allegra, Horizons, and NPD
        - U.K. out-of-home food service: about £50 billion ($80 billion)
        - U.S. out-of-home food service is about $500 billion
            - (if including Bars and Taverns)
            - Source: National Restaurant Association
        - => U.S. out-of-home food service is **6.25x** bigger
    - According to Allegra, service-led restaurant market is just £20.91 billion
        - Or about $33 billion
        - => **7.25 times** less than U.S. full-service restaurant market
            - $239 billion
    - According to NPD, U.K. casual dining market is **£4.7 billion**
        - Or about $7.5 billion
            - **16x** less than the U.S. casual dining market
    - The U.K. eat-out market seems dominated by
        - Fast food and takeaway: **31%** (according to Mintel)
            - Average spend per head: £3-5
        - Pubs: **30%** (according to Horizons)
            - Average spend per head: £5-10
        - According to Allegra
            - Fast food, takeaway, and pubs: **64%** of market
        - These data indicate that full-service restaurant + fast casual represent about **36-39%** of U.K. eat out market
            - Full-service restaurants represent about **50%** of the U.S eat out market
- Fact: the fastest growing segments in the U.K. are

        - Fast casual
        - Casual dining
    - Trends are:
        - British will drink out less and eat out more
        - Fast casual and casual dining will grow faster than the market
        - Branded restaurants gain market share
            - According to Allegra, service-led restaurant market: £20.38 billion
                - (in 2015)
                - Independent restaurants: £15.49 billion
                    - 3-year CAGR: **-1.6%**
                    - **76%** market share
                        - Declined from **80%** in 2012
                - Branded restaurants: £4.89 billion
                    - 3-year CAGR: **6.1%**
                    - **24%** market share
                        - Increased from **20%** in 2012
- TRG can continue opening more restaurants
    - TRG currently has 506 restaurants
        - Frankie & Benny's: 261
        - Chiquito: 86
        - Coast to Coast: 21
        - Pub restaurants: 54
        - Concessions: 61
        - Other: 23
    - TRG's expectation about its market potential: 850-950+
        - Frankie & Benny's: 350+
        - Chiquito: 200+
        - Coast to Coast: 100+
        - Pub restaurants: 100+
        - Concessions: 80+
        - Other: 60+
    - Frankie & Benny's (F&B) is already very big
        - 261 sites in the U.K. is equivalent to 1,305 sites in the U.S.
            - Few casual dining chains have more than 1,000 sites in the U.S.
                - Applebee's has 1,878 sites in the U.S.
                - IHOP has 1,441 sites in the U.S.
                - Chili's has 1,252 sites in the U.S.

            - Brinker said 34% of Chili's sites in the U.S. are operated by franchisees
            - It owns 826 sites in the U.S.
        - Olive Garden has 840 restaurants in the U.S.
        - Outback Steakhouse has 753 restaurants in the U.S.
        - Ruby Tuesday has 687 restaurants in the U.S.
- 350 sites can be a realistic target for F&B
    - Pizza Express has 443 sites
        - With similar average spend per head: £15
    - Pizza Express compete against many big Italian chains
        - Prezzo: 234 sites
        - Zizzi: 141 sites
        - Ask: 111 sites
        - Carluccio's: 98 sites
        - Bella Italia: 97 sites
- U.K. chains are predominantly Italian and pubs
    - Among the top 40 biggest casual dining chains
        - (Source: Morar Consulting)
        - These chains had a total of **4,970** outlets as of 2015
        - Pub restaurants totaled **1,902** outlets
        - Italian chains totaled **1,358** outlets
            - Including 270 Pizza Hut sites
                - Focus on pizza
        - => Italian chains and pubs account for almost **2/3** of total outlets
        - American-themed chains totaled 334 outlets
            - Including
                - F&B: 261
                - TGI Friday's: 73
            - Adding Coast to Coast result in **355 outlets**
            - These chains have similar menus
                - Pizzas
                - Burger
                - Steaks
                - Ribs
        - Japanese chains totaled **194 outlets**
            - Wagamama: 119
            - YO! Sushi: 75

                - French chains totaled **181 outlets**
                    - Café Rouge: 90
                    - Côte: 73
                    - Brasserie Blanc: 18
                - Mexican chains totaled **144 outlets**
                    - Chiquito: 86
                    - Chimichanga: 38
                    - Wahaca: 20
    - It's possible that F&B, Chiquito and Coast to Coast will continue to penetrate the market
        - There are 1,550 leisure and retail parks/schemes in the U.K.
            - 242 of these schemes have development proposal
            - 79 new schemes in pipeline from 2016 to 2021
        - Chiquito and Coast to Coast can follow F&B footprint
    - Since 2005, store-count grew **7.9%** annually
        - 2005: 237 stores
        - 2015: 506 stores
    - It's likely that TRG can open 40-50 restaurants a year
        - TRG plans to open 41 restaurants in 2016
            - Opened 44 restaurants in 2015
                - 40 restaurants in 2014
    - If TRG opens 200 restaurants in the next 5 years
        - Annual store-count growth would be 6.9%
- Same-store-sales (SSS) growth is uncertain
    - Historically SSS growth was about 3%
    - However, there's concern about overcapacity in the market
        - According to AlixPartners and CGA Peach[1]
            - The number of restaurants increased by 6.9%
                - (In the year to June 2015)
            - While the number of drink-led pubs and bars declined by 4.4%
        - For the whole year in 2015
            - The number of food-led premises rose 1.6%
                - While the number of drink-led premises declined by 1.2%
        - Restaurant openings have slowed recently[2]
            - Managed pub and restaurant businesses grew 1.5% in 2015
                - Down from 2.8% in 2014
    - Oversupply can create challenges for SSS growth

- But restaurant chains are sensitive to SSS growth
  - It's unreasonable to expect them to continue opening stores
    - When SSS declines
  - Overcapacity may have a smaller impact on TRG than on competitors
    - Independent stores are the most vulnerable
      - They have lower margins
        - Sales per outlet is ½ that of branded outlets
        - They're likely to have lower sales per square foot
    - Other chains are mostly owned by P-E firms
      - Have a lot of debt
    - Supply is more controlled in TRG's locations
  - => unreasonable to expect TRG's SSS to decline in the long run
    - Reasonable expectation: 1-3% growth

- Conclusion
  - TRG can grows in the high single digit over the next 5 years
  - TRG can double its sales in the longer term
    - 850-950 sites

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[1] "**Despite the continuing closure of pubs across Britain, the eating and drinking out market saw a net 1,770 new restaurants open in the last 12 months**, according to latest data compiled for the new Market Growth Monitor from AlixPartners and CGA Peach.

The contrast between the 6.9% growth in restaurant sites and the 4.4% decline in drink-led pubs and bars – including a 5.1% fall in community pub numbers – in the year to the end of June reflects the continuing shift in consumer preferences towards eating-out occasions.

The first quarterly Monitor figures show that **there was growth too in numbers of wine bars, café bars and food-led pubs – the latter increasing by 1.1% over the last 12 months. Branded food pubs saw a 9% growth in numbers – and the bulk of the overall growth in restaurants came from the, largely branded, chain restaurant market**." – New Restaurant Openings top 1,700, Peter Margin, Market Growth Monitor, September 2015

[2] "**The Monitor's data from CGA's Outlet Index shows Britain's number of drink-led licensed premises fell by 1.2% in the year to December 2015 – equivalent to 808 sites**.

However, **the number of food-led premises rose by 1.6% during the same period, thanks largely to the roll-out of casual dining operators around the country**.

The net result is Britain had more than 124,000 licensed premises in December, up by 0.1% on the same point a year earlier.

After years of steady decline driven by the closure of drink-led pubs, the figures show restaurants have restored the licensed trade to expansion mode. **But overall growth of 0.1% is significantly lower than the totals revealed in the previous two editions of the Market Growth Monitor**.

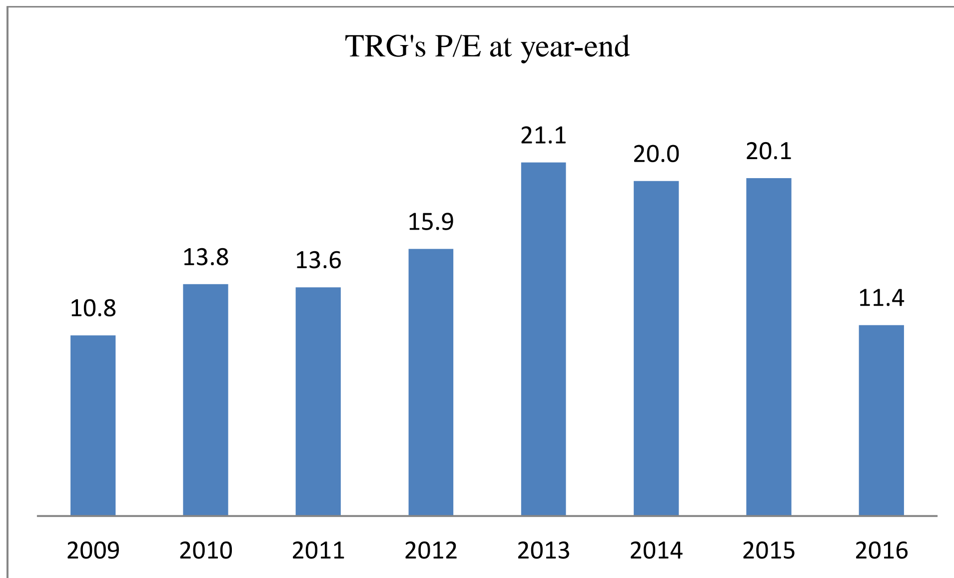
This indicates the pace of restaurant openings is slowing due, in part, to fragile consumer confidence and the availability and costs of property. The findings on supply echo similarly modest trends in sales during the past year.

The Coffer Peach Business Tracker measured 1.5% growth for managed pub and restaurant businesses in 2015, well down on the 2014 figure of 2.8%.

It has prompted speculation although many casual dining chains continue to expand, restaurant supply might soon start to outstrip demand in some places." – CGA's Peach Market Growth Monitor – pace of restaurant openings slows, Eat Out Magazine, 26 February 2016

Misjudgment

The U.K. Stock Market Doesn't Know How to Value The Restaurant Group



TRG was expensive in 2013-2015 but cheap in other periods

- **Biggest Negative**:
  - TRG has a new chairwoman
- What is the impact of higher minimum wage?
  - Minimum wage was
    - Apprentice: £3.30
    - Under 18: £3.87
    - 18-20: £5.30
    - 21 and over: £6.70
  - Current minimum wage (from April 2016)
    - Apprentice: £3.30
    - Under 18: £3.87
    - 18-20: £5.30
    - 21-24: £6.70
    - **25 and over: £7.20**
  - The U.K. government plans to increase minimum wage to £9 per hour
    - By the end of the decade
  - For 2016, TRG expect £2 million direct cost impact
  - It's unclear what the long-term impact is on the restaurant industry
    - The industry may use less labor

- Waiters don't like their employers to hire more workers
  - They want to work on as many table as possible
    - To maximize tips
- The industry may pass prices on to customers
  - And experience slower growth
- Or the industry may have lower profit
  - This might be a reason to be negative on the industry
  - But Greggs is trading at
    - 1,097 pence per share
    - 9.4 EV/EBITDA
    - 14.5 EV/EBIT

- TRG has a new chairwoman
  - Alan Jackson retired recently
    - He had informed shareholders of his retirement in 2014
  - Alan Jackson and Andrew Page were responsible for TRG's success[1]
    - Alan Jackson was appointed Executive chairman in 2001
    - Andrew Page joined as finance director
      - 2 months later
    - Alan Jackson became non-executive chairman in 2006
      - When Andrew Page was promoted to CEO
    - TRG was facing troubles at the time
      - Had too many brands
      - Its biggest brands was declining
        - Deep Pan Pizza
      - Other high street brands was struggling
    - Andrew Page helped change the culture and mindset at TRG
      - Focus firmly on cash flow and generating returns
      - Focus on out-of-town leisure and retail site
  - Andrew Page retired in 2014
    - He was succeeded by Danny Breithaupt
    - Breithaupt had started off at the bottom at the Casual Dining Group
      - Casual Dining Group was acquired by Whitbread
      - => he worked with Whitbread from 1995
        - For a number of year
        - They had a fantastic development program
    - Breithaupt also joined TRG in 2001[2]
      - He held a number of senior positions within Frankie & Benny's

        - Became
            - Operations Director in 2003
            - Managing Director in 2009
        - Grew Frankie & Benny's from 75 to over 200 units
        - He launched Coast to Coast
            - In 2011
        - He became MD of TRG's leisure division
            - In 2012
        - He became CEO in 2014
- Danny Breithaupt can be a good CEO like Andrew Page
- Alan Jackson retired
    - Debbie Hewitt is the new non-executive Chairwoman
    - Debbie Hewitt served as the Managing Director of RAC Plc.
        - A British automotive service company
    - She also worked at Mark and Spencer
    - She's chairman of Moss Bros Group
        - One of the U.K.'s top menswear stores
        - Market cap: £94 million
        - Revenue: £115 million
        - EBIT: £5 million
    - She's non-executive director of Redrow plc. since 2009
        - And has been its Senior Independent Director since 2014
        - Redrow is a residential development company
            - Market cap: £1.5 billion
            - EV: £1.7 billion
            - 2015 Revenue: £1,150 million
            - 2015 EBIT: £213 million
    - She has been Senior Independent Non-Executive Director of NCC Group
        - An information assurance company, providing
            - Escrow and verification
            - Security consulting
            - Web performance
            - Domain services
        - Market cap: £676 million
        - EV: £749 million
        - Revenue: £134 million

        - EBIT: £23 million
    - She may know nothing about TRG's business
- Will U.K. restaurants make lower margin?
  - It's possible that U.K. restaurants don't really make higher ROIC than U.S. restaurants
    - They have lower asset turnover
    - Sales/Average NTA:
      - U.K. chains:
        - TRG: 2.35x
        - Gondola: 2.20x
        - Prezzo: 1.61x
      - U.S. chains:
        - Bloomin: 3.92x
        - Bravo Brio: 2.93x
        - Brinker: 2.75x
        - Cheesecake: 2.73x
        - Darden: 2.67x
        - Chuy's Holdings: 2.53x
        - Ruby Tuesday: 1.53x
  - TRG is just an outperformer
    - TRG has one of the highest EBITDA margin in the industry
  - If there's a decline in margin
    - There's must be a lot of openings
      - The industry must expand
    - New openings may hurt TRG's competitors more
      - Independent stores are the most vulnerable
        - They have lower margins
          - Sales per outlet is ½ that of branded outlets
          - They're likely to have lower sales per square foot
      - Other chains are mostly owned by P-E firms
        - Have a lot of debt
      - Supply is more controlled in TRG's locations
- The market seems inefficient
  - TRG's share price was sensitive to like-for-like sales growth
    - On January 04, 2008, share price declined by 31%
      - From 176 pence per share
      - To 120 pence per share

        - On January 14, 2016, share price declined by 14%
            - From 638 pence per share
            - To 550 pence per share
            - Reasons: like-for-like sales growth trended lower
                - Grew just 1.5% in December 2015
        - On March 09, 2016, share price declined by 17%
            - From 540.5 pence per share
            - To 446 pence per share
            - Reason: like-for-like sales declined 1.5% for the first 10 weeks of 2016
        - TRG was expensive in 2013-2015
            - P/E was between 19 and 25
            - Analysts were optimistic
            - Just in December 2015, UBS set TRG's price target at **860** pence per share[3]
                - Expected over 1,000 possible additional locations
                    - Vs. management's target of 250 additional sites
                - The least optimistic analyst set target at 635 pence per share
                - TRG was trading at **676.5** pence per share that day
                    - Declined to less than **390** pence per share today
                    - Within 3 months
        - TRG wasn't expensive in the 2009-2013 period
            - P/E was between 9 and 13
            - "TRG appears less racy than its high street rivals"[4]
    - A similar story:
        - Over 90% of Greggs stores were on high streets
        - The great recession came
        - Greggs also faced competition from supermarket in traditional bakery
        - Like-for-like sales growth was weak
            - 2009: 0.8%
            - 2010: 0.2%
            - 2011: 1.4%
            - 2012: -2.7%
            - 2013: -0.8%
        - People started thinking that Greggs became obsolete

            - Share price stay below 500 pence per share for years
            - P/E stayed in the 12-13 range
        - But Greggs transformed into a food-on-the-go chain
            - It opened stores away from high street
                - Retail parks
                - Bus terminal
                - Train stations
                - Industrial estates
                - Where people are at
                    - Work
                    - Travel
                    - Leisure
            - Greggs refitted its stores
                - Removed things like bread slicer or bread ovens
                - Add seating to the stores
            - Revamped its menu
                - Added "healthy sandwich" range
                - Relies less on traditional bakery products
                    - Sandwich: 1/3 of revenue
                    - Savory: 1/3 of revenue
                    - Drinks: 1/6 of revenue
        - Result:
            - Same store sales grew again
                - 2014: 4.5%
                - 2015: 4.7%
            - Share price more than doubled to 1,000-1,200 pence per share
                - 18-20 P/E

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[1] "**With the support of the new chairman, Alan Jackson, who had joined CCR two months earlier, Page set about changing the culture and mindset of the business**, which owns the Chiquito, Frankie & Benny's, Garfunkel's, Est Est Est, and Caffé Uno brands.

By placing the emphasis firmly on cash-flow and generating returns, along with career development and reward programmes for staff, he initiated 18 months of pain, but an approach that ultimately led to last month's confirmation of recovery with a great set of interim results.

Now called The Restaurant Group, the company showed record pre-tax profits for the six months to 30 June, up 40% to £9.8m on sales of £118m.

With the turnaround complete, The Restaurant Group is ramping up its expansion programme. Page aims to grow the group from 260 to 300 sites by the end of 2005, building on its lucrative presence in leisure-park sites by moving into out-of-town retail sites, which are growing at the expense of the high street." – *From Pariah to a City Trading*, Karl Cushing, Caterer & Hotelkeeper, 07 October 2004

[2] "TRG has a new chief executive who's already making his mark with some exciting developments at TRG, the group he's worked for since 2001. Andrew Pring talks with Danny Breithaupt about why he's "Proud to be TRG"

Danny Breithaupt became Chief Executive of The Restaurant Group in September last year. He joined TRG in 2001, within the Frankie & Benny's division, becoming Operations Director in 2003 and MD in 2009 and growing it from 75 to over 200 units. In 2011 he launched Coast to Coast and in 2012 was appointed MD of TRG's Leisure division." – *Interview with Danny Breithaupt*, Eat Out Magazine, 10 January 2015

[3] "Last month, the company said it had opened 25 new restaurants at that stage in 2015, and expected to open between 43 and 45 in the year as a whole, up from 40 in 2014. It expects to open as many again in 2016.

UBS thinks the opening plan could continue for the next five years.

"Management has a track record of delivering strong returns through value-creating new site additions**. Our detailed analysis of the existing restaurant locations of its key brands F&B, Chiquito and Coast to Coast versus town population density suggests over 1,000 possible additional locations (280% site uplift), versus the circa 250 sites that management targets (c70% site uplift)**," writes Analyst Heidi Richardson.

"While our base case is more conservatively set, the analysis supports our view that TRG could accelerate its restaurant roll-out rate, adding 45-50 sites per annum through the forecast period, and highlights the scale of the group's potential medium-term upside," she adds.

If the company does manage to meet the UBS forecast for new openings, then this would drive double-digit revenue growth for 18 years assuming 2.5% like-for-like sales growth, Richardson says.

“We believe that a combination of management initiatives to continue driving volume, and a more favourable pricing environment, will see sustainable like-for-like sales growth going forward, following the average 2.6% like-for-like growth posted in 2011-14. **We also see limited risk from wider market supply growth given that total restaurant numbers in the UK are declining, while TRG’s predominantly out-of-town locations provide a controlled supply environment**,” she writes.

UBS is forecasting that the company will report 10.5% compound annual revenue growth between 2015 and 2019, and 12.0% compound earnings growth over the same period.

It is starting coverage of the stock with a Buy rating and a 860 pence target price.

Restaurant Group shares are up 3.2% at 676.50 pence on Friday, meaning they are up 2.5% for the year-to-date.

The wider analyst community is overwhelmingly positive about the stock. **Four have it at Strong Buy, six at Buy, three at Hold and just one at Sell, according to data compiled by Thomson Reuters**.

Nomura is the bank with a Reduce rating on the stock. It downgraded it in November from Neutral, **warning that the impending introduction of the National Living Wage would hit Restaurant Group’s margins**. It thinks the market is under-appreciating the impact the higher wage bill will have on the company.

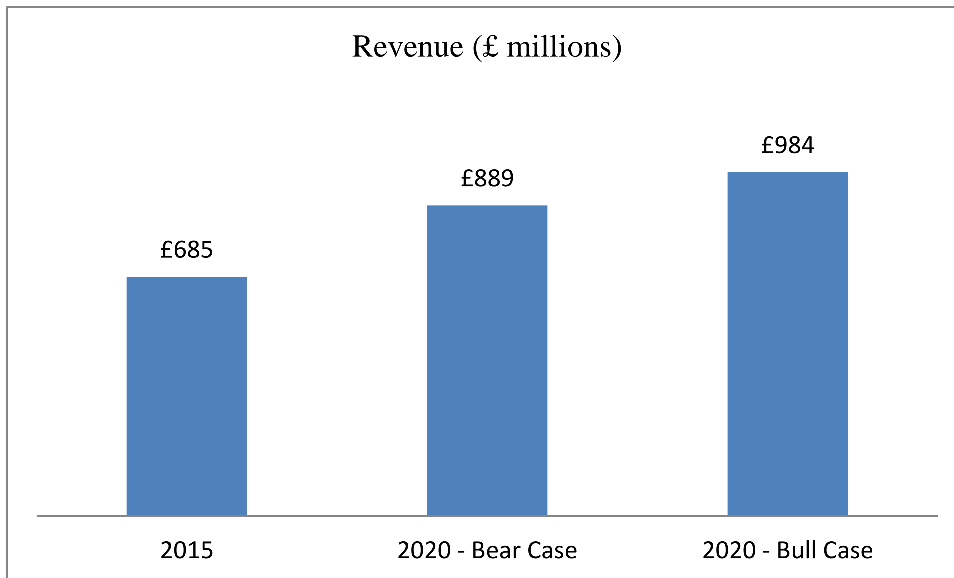
It thinks the UK restaurant industry will try and pass higher wage costs on to customers, but thinks this would put pressure on like-for-like sales growth.

Nomura cut its price target on Restaurant Group to 635 pence when it downgraded the stock last month.” – *Restaurant Group growth set to continue as it plans more openings*, 18 December 2015 News Markets

[4] “**TRG was the only listed restaurant group to increase earnings in 2009. Yet this does not appear to be reflected in its rating. The shares are trading on about 11.4 times 2010 pre-tax profit of 49.6m, compared with Clapham House's 16.9 times or Carluccio's' 16.5 times. One reason could be that in terms of brand TRG appears less racy than its high street rivals**. But investors ignore TRG at their peril. The current year has started well and with the group likely to pay off all its debt in three years or expand, it is well positioned to create further value.” – *Blockbuster Films Help TRG Defy Recession*, Pan Kwan Yuk, Financial Times, 03 March 2010

Future

TRG Will Make £1 Billion Revenue Someday



TRG can grow revenue by 30-40% over the next 5 years

- **Biggest Negative**:
  - Like-for-like sales growth can be weak
  - Margin can decline
- In the next 5 years, TRG will
  - Keep opening new restaurants
  - Maintaining 50% or more dividend payout
    - As store count growth declines
- Opening 150 stores over 5 years is very likely
  - TRG may have 656 stores by 2021
  - And it can still open 40-50 stores for several years
- Margin and same store sales growth are less certain
- In a bad scenario
  - Restaurant openings in the industry continues at a high rate
  - Higher minimum wage hurts the industry
  - TRG may have flat same store sales growth over the next 5 year
  - Industry margin declines by 3%
    - TRG's EBIT margin declines to 10%
      - The level TRG made in 1998-2005
  - Today's sales per store is £1.355 million per store

- In 2021, TRG would make
  - £889 million revenue
  - £89 million EBIT
    - Assuming 10% EBIT margin
  - £71 million after-tax earnings
  - At 15x earnings, TRG will be worth £1,065 million
    - => 13.7% annual growth from today's EV of £560 million
    - Adding 4.1% dividend yield
      - => **17.8%** return

- In a more reasonable scenario
  - 2% annual sales store growth
  - EBIT margin is stable around 13%
  - Sales per store would be £1.5 million in 2021
  - => total revenue: £984 million
  - Potential EBIT: £128 million
  - Potential after-tax earnings: £102 million
  - At 15x earnings, TRG will be worth £1,530 million
    - => 22.3% annual growth from today EV of £809 million
    - Adding 4.1% dividend yield => **26.4%** return