Houlihan Lokey

Restaurants

Q1 2024 Industry Update

Notable Updates Across the Restaurant Sector

Restaurants had a tough quarter at the hands of traffic declines related to pricing fatigue and poor weather, coupled with tough comps to last year's hot first quarter; we will see how operators react to necessary price moderation as consumers make their preferences exceedingly clear.

QUARTER IN REVIEW | Q1 2024

Same-Store Sales Down Slightly

- Although weather posed a challenge at the start of the year, as noted by countless operators, industry trends improved sequentially with SSS flat in March and restaurant spending as a share of total wallet up 12.8% YoY.
- By the end of the quarter, food away from home (FAFH) CPI moderated for the 12th consecutive month to +4.2% and should continue to normalize through December, reaching ~2%–3%.
- In Q1 2024, consumer sentiment held at the industry's 10-year average, while disposable income grew ~4%.

High Prices Put Pressure on Traffic

- While consumers demonstrated greater resilience against elevated prices in 2023, that tolerance waned dramatically in Q1 2024 as measured by meaningful traffic declines throughout the industry.
- Although prices remain at seemingly all-time highs, they show signs of easing with FAFH increasing 0.4% in March (lower than overall inflation but higher than grocery spend); menu prices should continue to moderate as labor/commodity costs normalize, while "value" emerges as a critical tool to help operators alleviate margin strain.(1)

March Shows a Rebound in Momentum

- Industry SSS fell slightly in Q1 2024 (-1.7%) compared to Q4 2023 (+1.9%), bearing the effects of poor weather and subdued demand.
- Credit and debit card data further attest that restaurant spending took a hit in January/February, but March showed signs of promise with spend rebounding +3.0% YoY.
- Sales deceleration appears to have been driven in large part by lower overall check sizes as consumers show increasing cognizance of high menu prices.

LOOKING FORWARD | EXPECTATIONS FOR 2024

Annual Growth Outlook

- Underlying demand and overall share of wallet should remain resilient in the upcoming months, even if annual restaurant spend moderates against last year, noting that 2023 presents a tough comp given the year's overall strength coming fully off COVID-19 restrictions.
- Experts forecast restaurant sales to reach $1.1 trillion in 2024, marking the industry's first pass above 1 trillion and significant embedded growth opportunities for restauranteurs.

Perceived Loss of Low-Income Consumers

- Although traffic will likely recover through 1H 2024, low-income consumers may return more slowly to restaurants, having developed a preference for grocery stores and constrained by tighter wallets as a result of looming macroeconomic pressures.
- Middle- to high-income consumers, however, should continue allocating spend toward restaurants without significant reversal toward grocery (e.g., high-income spend increased 2.3% YoY in March), although QSR and fast casual may benefit from some trade-down.

California Minimum Wage Boost

- As mandated by AB 1228, the California minimum wage for restaurants increased to $20 per hour just after Q1 2024, representing an outsized 25% increase.
- QSR concepts with heavy California franchise bases, alongside other operators, may face headwinds coming into Q2 2024 in adjusting to higher labor costs.
- States with similar wage rates and high costs of living may follow California's example, presenting a challenge but simultaneous opportunity for operators to cut costs through automation.

Sources: Nation's Restaurant News, Reuters, Restaurant Business, Wall Street Research.
(1) Excluding California where the minimum wage increased on April 1, 2024. See following page for incremental detail.

High Prices Suppress Traffic and Bolster the Importance of Value

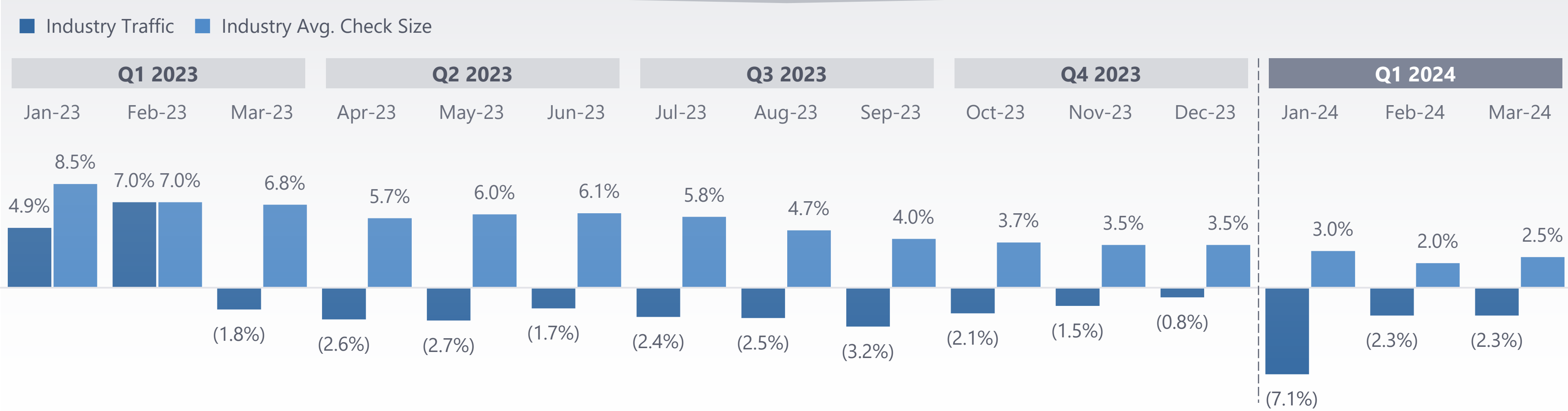
Elevated Prices Drive Down Restaurant Traffic

- Despite their role in supporting SSS growth, pricing initiatives meant to help navigate inflation and aid pandemic recovery have negatively impacted foot traffic, suggesting consumers have hit their limit with price tolerance and operators will need to find another lever to drive growth.
  - Restaurant sales increased 12% in 2023, albeit traffic decreased 8% against 2019, underlining the significant role price played in propping up sales while diluting consensus around "real" sales growth and sustainability of the ongoing price-to-volume equation.
- Consumers showed surprising resilience against hiked prices in 2023 (aided by unabetted want for out-of-home dining experiences post-COVID-19), but that tolerance waned in January as 59% of consumers reported menu prices have gone up "too much."
- The unfavorable pricing gap between FAH and FAFH CPI, lasting 13 consecutive months,(1) exacerbates the impact of elevated prices, encouraging consumers to reach for cheaper grocery alternatives; consequently, FSR traffic dropped 8% in 2023 while grocery experienced a 12% traffic increase vs. 2019.

2024 Winners Will Be Decided on Value

- Easing menu costs hint that prices may have reached their ceiling, in which case YoY volume declines threaten to exceed YoY price increases, putting many restaurants at risk of SSS declines in 2024 (particularly on tough 2023 comps).
- Consequently, value has emerged as a powerful mitigant against traffic declines, wherein consumers selectively choose where to eat based on perceived value per dollar spend, highlighting meal quality and convenience as key ingredients in successful operations.
- Competing concepts further demonstrate the primacy of value as operators with comparable menus reported markedly different SSS performance in Q1 2024 (e.g., by honing their value proposition, Shake Shack increased SSS by 2.8% while The Habit saw SSS decline 5%, and similarly, Popeyes reported a 6% SSS increase vs. the 7% decrease at KFC).
- Consumers appear to conceive value in terms of absolute price points and the quality/distinguishment of restaurant offers as opposed to extreme discounting or bundling (i.e., buy one get one, etc.).
- To put it simply, as consumers' wallets tighten, they become pickier as to where they spend their dollars; the lowest price is not always the winning choice, with operators offering the best "bang for your buck" coming out on top.

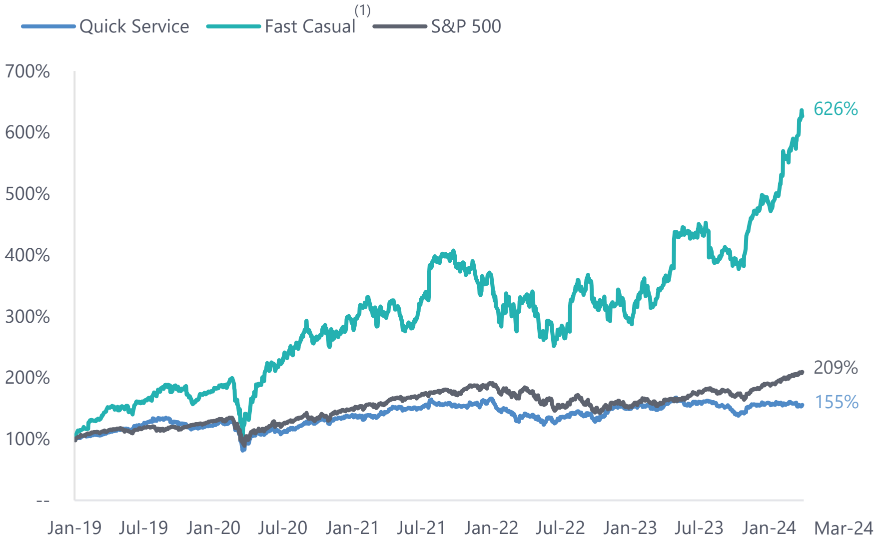
Slowing Check Size Growth Provides a Clear Warning as Restaurants Hit the Cap on Price and Traffic Continues to Tumble



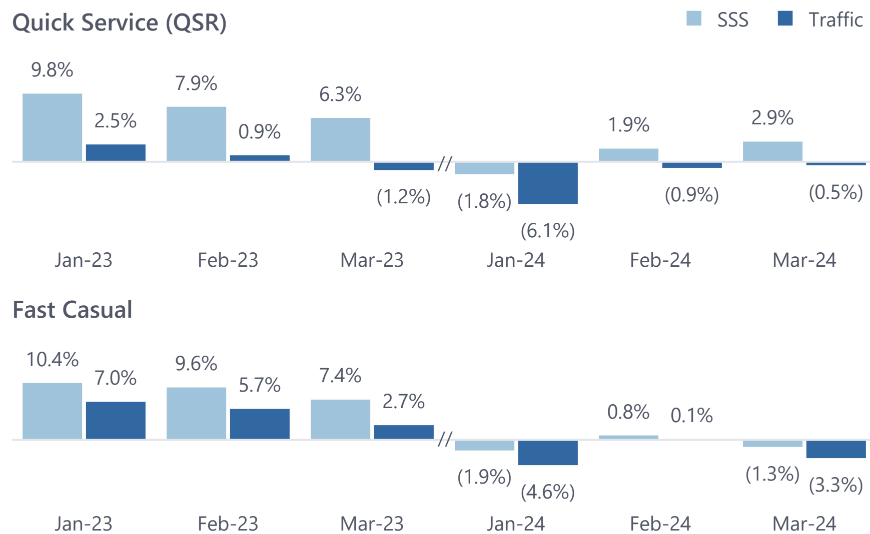
Sources: Restaurant Business, Wall Street Research.
(1) As of March 2024.
(2) As reported by restaurant operators in the U.S.

Limited-Service Operator Update

Public Market Performance



Recent Same-Store Sales Trends: LSOs[(2)]



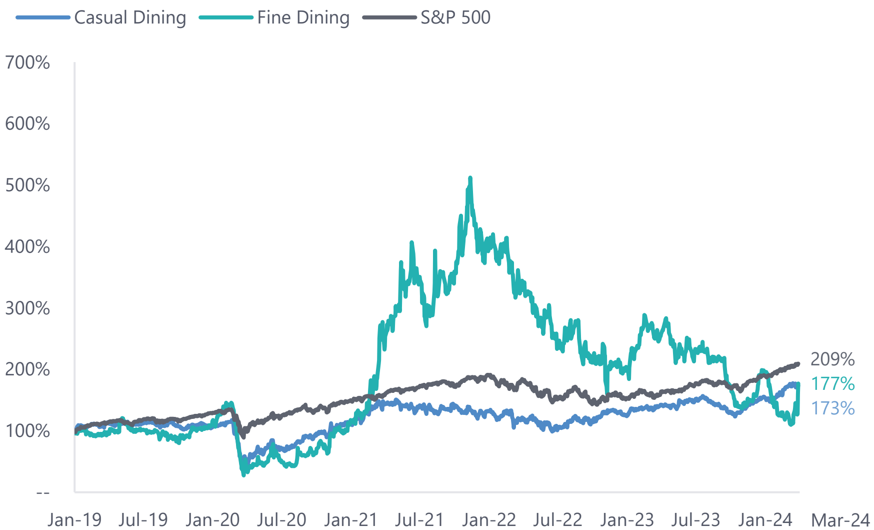
Industry Trends

- Limited-service operators (LSOs) saw mixed results in Q1 2024, bearing the weight of high prices, which increased 5% in March and contributed to a meaningful slowdown in traffic, partially due to the category's dependence on consumers in the low- to middle-income bracket who expressed greater aversion to elevated costs.
  - Compared to 2019, QSR prices were up 33% in March while grocery increased 26%, inciting a 3.5% YoY traffic decline for QSR in Q1 2024.
- Results improved slightly for QSR in March. However, as SSS increased by 1.0% m/m to 2.9%, driven primarily by growth in check size. On the other hand, fast casual saw SSS decline 2.1% m/m to 1.3% as an effect of the 3.4% dip in traffic that considerably surpassed check growth of 1.1%.
  - Fast casual may experience some weakness in Q2 2024 as a result of trade-down into QSR; traffic showed early warning to this effect as attendance decreased 3.3% across fast casual brands compared to 0.5% for QSR in March.
- That said, some of the most inexpensive meals cost significantly more than what they once did, and customers view affordability/pricing power in relative terms; the clear evidence of price change across "cheaper" menus could potentially provide protection for fast casual concepts who lean into value over the coming months.
- QSR operators in California, which constitute the greatest share of all U.S. fast food restaurants (~13%), may face the most difficulty in resolving the price-to-volume equation, wherein April's 25% increase in minimum wage reinforces high menu prices as necessary to protect operators against their own high ingredient/labor costs.
  - Wage inflation (+4.1% for QSR as of March) could increase further if additional states follow California's example, making it important for operators nationwide to assess efficiencies and cut costs, arousing greater interest/investment in automation that confers significant opportunities to reduce labor costs.

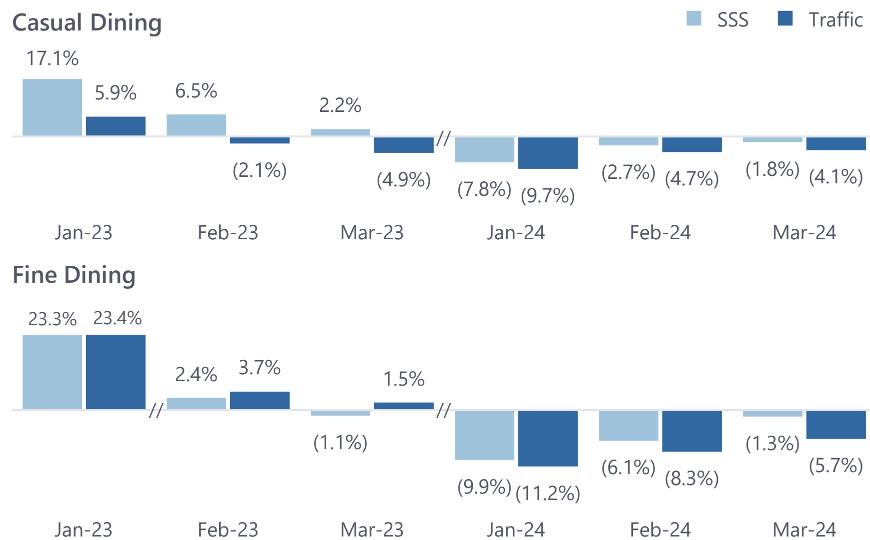
Sources: Wall Street Journal, Wall Street Research.
Note: Companies included in each category have been trading from January 1, 2019, through March 31. 2024. Pricing as of March 31, 2024.
(1) Fast casual index led by strong performance from Chipotle (+656%) and Wingstop (+595%).
(2) Summarizes SSS performance as an equal-weighted average of the foremost public brands in each respective category.

Full-Service Operator Update

Public Market Performance



Recent Same-Store Sales Trends: FSOs[1]



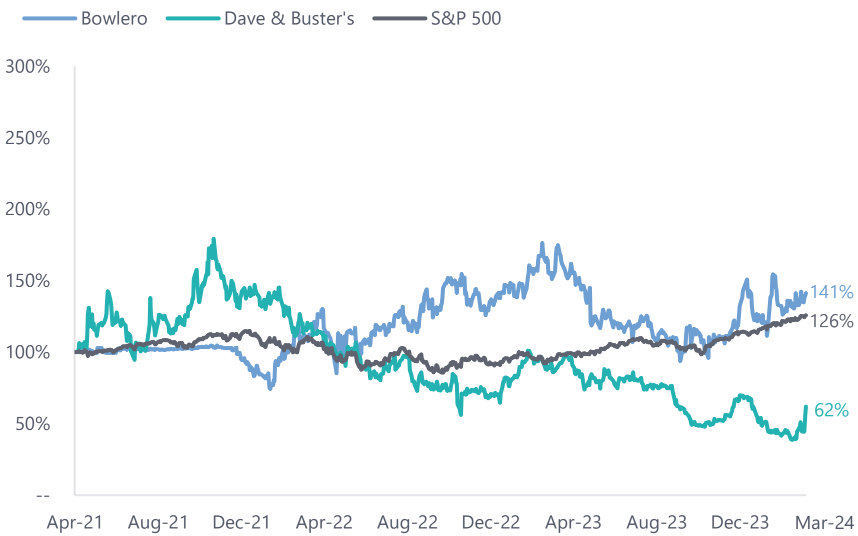
Industry Trends

- Full-service operators (FSOs) faced some difficulty in Q1 2024, explained by similar factors that pressured the broader industry but were felt more intensely by the category due to the nature of FSOs as inherently more expensive and less "convenient" (worsened further by poor weather).
- Casual and fine dining restaurants saw declines in SSS YoY January through March, although both categories experienced improvements sequentially; as of March, SSS decreased 1.8% for casual dining while fine dining modestly decreased 1.3%.
- Traffic followed a similar trend, down each month from the year previous but increasing slightly on a month-to-month basis, likely in accordance with weather improvements.
  - In March, casual dining restaurants reported a 4.1% decline in traffic while fine dining dropped 5.7%; as the price apex of the restaurant industry, fine dining experienced the most significant traffic decreases each month.
- Abiding by the price-to-volume thesis, average check increased through Q1 2024, demonstrating the power of raised prices to counteract reduced traffic; unfortunately, those elevated checks only reinforce the sentiment that there will likely be trade-down into LSOs.
  - Fortunately, FSOs have already begun reversing pricing trends as indicated by moderation in the FSR CPI by -0.7% to +3.2% in March.
- Within the top 500 chains, FSOs managed to grow sales by 5% in 2023 to $88 billion and unit count by 0.3% (although still ~3% below 2019 levels); looking at the year ahead, trends for the sector should improve from Q1 2024 as comps ease further and operators embrace the notion of dining for value.

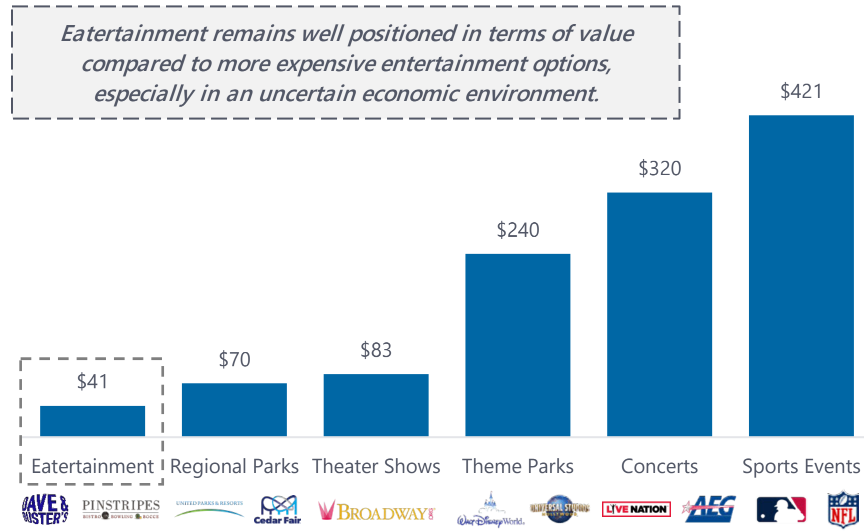
Source: Wall Street Research.
Note: Companies included in each category have been trading from January 1, 2019, through March 31, 2024. Pricing as of March 31, 2024.
(1) Summarizes SSS performance as an equal-weighted average of the foremost public brands in each respective category.

Eatertainment Update

Public Market Performance



Clearly Differentiated Entertainment Value[1]



Industry Trends

- Demand for experience surmounted post-COVID-19, helping explain the recent strength of eatertainment concepts that synthesize high-value food and beverage offers with an enticing base of activities (e.g., bowling, arcade rooms, billiards, etc.).
- In Q1 2024, consumer confidence reached its highest level in nearly two years. That said, enduring inflation has simultaneously encouraged consumers to adapt their purchasing behaviors so that their dollars stretch further.
- As a result, ~77% of consumers exhibited trade-down activity in Q1 2024, but this trend seemingly favors eatertainment venues, which constitute cut-price, convenient alternatives to more traditional entertainment/leisure concepts (e.g., concerts, travel, etc.) as well as FSOs.
  - Of note, 78% of millennials expressed preference for eatertainment over other consumer products while 70% of all consumers indicated preference for eatertainment over casual dining, revealing meaningful diversion of spending activity toward eatertainment from a variety of original sources.
- Although grocery maintains pricing power over restaurants, sales growth across food *and* drinking places (which more broadly encompasses eatertainment venues) continues to outpace grocery; food and drinking place sales were up 7.0% in March while grocery increased a mere 0.9%; in March, food and drinking places generated $61.2 billion in sales, marking a post-pandemic high.
- While traffic remains a reasonable concern heading into Q2 2024, the diversification of eatertainment's revenue base supports higher average check sizes (elevated menu prices aside), which should uniquely support the category as it confronts industry constraints, not to mention inherently more competitive value propositions compared to other restaurant sectors.

Sources: Roller, Broadway, McKinsey & Company, Wall Street Research.
Note: Companies included in each category have been trading from April 23, 2021, through March 31, 2024. Pricing as of March 31, 2024.
(1) Reflects illustrative pricing per person across core entertainment categories.

Restaurant Industry Market Map

Limited-Service Restaurants

Quick-Service Restaurants

~$2B+

McDonald's, Starbucks, Chick-fil-A, Taco Bell, Wendy's, Dunkin', Burger King, Subway, Domino's, Sonic, Panera Bread, Pizza Hut, KFC, Popeyes, DQ, Arby's, Jack in the box, Little Caesars, Papa John's, Panda Express, Whataburger, Raising Cane's, Jimmy John's, Jersey Mike's Subs

~$250M+

Culver's, Hardee's, Bojangles, Carl's Jr., Firehouse Subs, Krispy Kreme, Checkers, Rally's, Tropical Cafe, Marco's Pizza, Del Taco, El Pollo Loco, McAlister's Deli, Steak 'n Shake, Tim Hortons, Baskin Robbins, Church's, Smoothie King, Jason's Deli, Auntie Anne's, Portillo's, White Castle, Jamba, Dutch Bros, Charleys

~$50M+

Jet's Pizza, Taco John's, Cold Stone, Corner Bakery, Peet's Coffee & Tea, Krystal, Wienerschnitzel, Long John Silver's, Donatos, Wetzel's Pretzels, Cinnabon, Biggby Coffee, Cook Out, Rita's, Sbarro, Sarku Japan, Au Bon Pain, Daylight Donuts, Great American Cookies, Yogurtland, Pret, Pei Wei

Fast Casual

~$250M+

Five Guys, Chipotle, Zaxby's, Wingstop, Qdoba, Papa Murphy's, Shake Shack, Moe's, Freddy's, Noodles & Company, The Habit Burger Grill, Potbelly, Dickey's Barbecue Pit, Boston Market, MOD, Blaze Pizza, Godfather's Pizza, Schlotzsky's, Cafe Rio, Mountain Mike's Pizza, Smashburger

~$100M+

Golden Chick, Fazoli's, Slim Chickens, Taco Cabana, sweetgreen, Newk's, Zoës Kitchen, Fuzzy's, Burgerfi, Bonchon, L&L, CAVA, Taco Bueno, Mission BBQ, Pizza Pro, Farmer Boys, Pieology, Torchy's Tacos, Wayback Burgers, Peter Piper Pizza, Tijuana Flats, Fish Grill, Nathan's, Freebirds, Imo's Pizza, Lee's, Mazzio's, Runza

~$50M+

Capriotti's, Ono Hawaiian BBQ, Teriyaki Madness, Bush's Chicken, Baja Fresh, Dion's, Pizza Patrón, Taco Casa, Rosati's, Tazikis, bb.q Chicken, Nando's, Giovanni's, Rudy's

Full-Service Restaurants

Casual Dining

~$500M+

Olive Garden, Chili's, Applebee's, Buffalo Wild Wings, IHOP, Texas Roadhouse, Denny's, Cracker Barrel, Outback Steakhouse, Red Lobster, The Cheesecake Factory, LongHorn Steakhouse, Waffle House, Golden Corral, Red Robin, BJ's, P.F. Chang's, Dave & Buster's, TGI Fridays, Carrabba's Italian Grill, Hooters, Bob Evans, Cheddar's Scratch Kitchen, Bonefish Grill, Yard House

~$250M+

Captain D's, First Watch, California Pizza Kitchen, Chuck E. Cheese, Perkins, Jefferson's, Ruby Tuesday, Cooper's Hawk, Fogo de Chão, Chuy's, Twin Peaks, Miller's Ale House, Mellow Mushroom, Saltgrass Steak House, O'Charley's, Famous Dave's, Black Bear Diner, Benihana, Braum's, Ninety Nine, Village Inn, On The Border, Logan's Roadhouse, Bahama Breeze, Fazoli's

~$100M+

Rosati's, Texas de Brazil, Huddle House, Jack's, Hard Rock Cafe, Old Chicago, Sonny's BBQ, Bar Louie, Firebirds, 54th Street, Walk-On's, Lazy Dog, Pappadeaux, Uno Pizzeria & Grill, Beef 'O' Brady's, LaRosa's, Smokey Bones, Roosters, Bill Miller, Sizzler, North Italia, Red Lobster, Buck's, Eddie V's, Friendly's

Fine Dining

~$250M+

Fleming's Prime Steakhouse & Wine Bar, Ruth's Chris Steak House, The Capital Grille, Mastro's Restaurants

~$100M+

Maggiano's Little Italy, Seasons 52 Fresh Grill | Wine Bar, Morton's The Steakhouse

~$50M+

McCormick & Schmick's est. 1974, Chart House, Flanigan's

Eatertainment(1)

Cicis Pizza, T-Squared Social, Chuck E. Cheese, Dave & Buster's, Topgolf, Andretti Indoor Karting & Games, Bowlero, Main Event, K1 Speed, Pinstripes, Pop Stroke, Pizza Ranch, Gatti's Pizza, Funlab, Drive Shack, Puttery, Round1, Punch Bowl Social, Puttshack, Swingers, Round Table Pizza, Ten, Chicken N Pickle

(1) Given a more limited pool of existing operators, the eatertainment category confronts significant whitespace opportunity.

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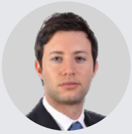

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2	Rothschild & Co	349
3	Goldman Sachs & Co	300
3	JP Morgan	300
5	Morgan Stanley	253

Source: LSEG (formerly Refinitiv).
Excludes accounting firms and brokers.

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3	Rothschild & Co	51
4	Lazard	37
5	Evercore Partners	27

Source: LSEG (formerly Refinitiv).

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5	Morgan Stanley	716

Source: LSEG (formerly Refinitiv).
Announced or completed transactions.

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