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Hot Off the Grill!

Developments in Restaurant Industry M&A and Capital Markets Transactions

October 28, 2015

MCLE Certification Information

- Most participants should anticipate receiving their certificate of attendance in 4 weeks following the webcast.
- Virginia Bar members should anticipate receiving their certificate of attendance in 6 weeks following the webcast.
- Questions regarding MCLE information should be directed to Jeanine McKeown (Gibson Dunn National Training Administrator) at 213-229-7140 or jmckeown@gibsondunn.com.

Today’s Panelists

Michael E. Flynn

A corporate partner in Gibson Dunn’s Orange County office, Mike Flynn focuses his practice on corporate and securities law. He has represented a number of restaurant industry clients in their M&A and capital markets transactions, including: CKE Restaurants, Yard House Restaurants, The Habit Restaurants, Lazy Dog Restaurants, Eureka Restaurants, Islands Restaurants, Mimi’s Café Restaurants and King’s Seafood Company. Mike was named one of the Top 100 Attorneys in California by the *Daily Journal* and has been named a “Super Lawyer” by *Los Angeles Magazine* since 2012.

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Today's Panelists

Damon S. Chandik

Managing Director, Global Co-Head of the Consumer Group, and Head of Restaurant Investment Banking at Piper Jaffrey & Co., Damon Chandik focuses on providing investment banking and M&A advisory services to consumer companies. Some of his recent restaurant transactions include: Del Taco (lead sellside advisor), The Habit (IPO/Follow-on left lead bookrunner), Portillo Restaurant Group (exclusive sellside advisor), Zoës Kitchen (IPO/Follow-on joint lead bookrunner), Dave & Buster's (IPO/Follow-on joint lead bookrunner), TGI Friday's (exclusive sellside advisor), Noodles & Company (joint bookrunner/lead sellside advisor) and Del Frisco's Restaurant Group (IPO/Follow-on joint lead bookrunner). Damon was named as one of the top 50 most influential people in the restaurant industry by *Nation's Restaurant News*.

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Today’s Panelists

Michael B. Gottlieb

Assurance Partner and Global Leader of Ernst & Young LLP’s Restaurant Services practice. Mike began his career in the restaurant industry as a restaurant operator and understands well the challenges unique to the industry. He manages services for several restaurant clients and has advised dozens of companies in connection with initial public offerings and other strategic financial transactions. Some of his restaurant transactions include Shake Shack IPO, Del Taco acquisition and going public through a special purpose acquisition company, Wingstop IPO, Yard House Restaurants acquisition by Darden Restaurant Group, Patina Restaurant Group acquisition by Delaware North, Noodles IPO, Chipotle IPO and Kona Grill IPO. Other selected restaurant clients include BJ’s Restaurants, Coffee Bean & Tea Leaf, DineEquity, Hillstone Restaurant Group and Panda Restaurant Group.

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Sean Sullivan

A Senior Associate in Gibson Dunn's San Francisco office, Sean Sullivan focuses on capital markets transactions and mergers and acquisitions. Sean serves as the lead associate in transactions representing issuers and underwriters, has advised retail and consumer clients, works with clients in connection with strategic acquisitions, and represents investment banks in connection with delivery of fairness opinions. Some of Sean's recent transactions include the IPOs of Noodles & Company and The Habit Restaurants, the acquisition of Duckhorn Wine Company, the sale of Cytosport (maker of MuscleMilk) and transactions involving Restoration Hardware, Yard House Restaurants, Del Frisco's and Amazon.com. Sean has been named a Rising Star of Northern California Securities and Corporate Finance lawyers by *Super Lawyers* magazine every year since 2013.

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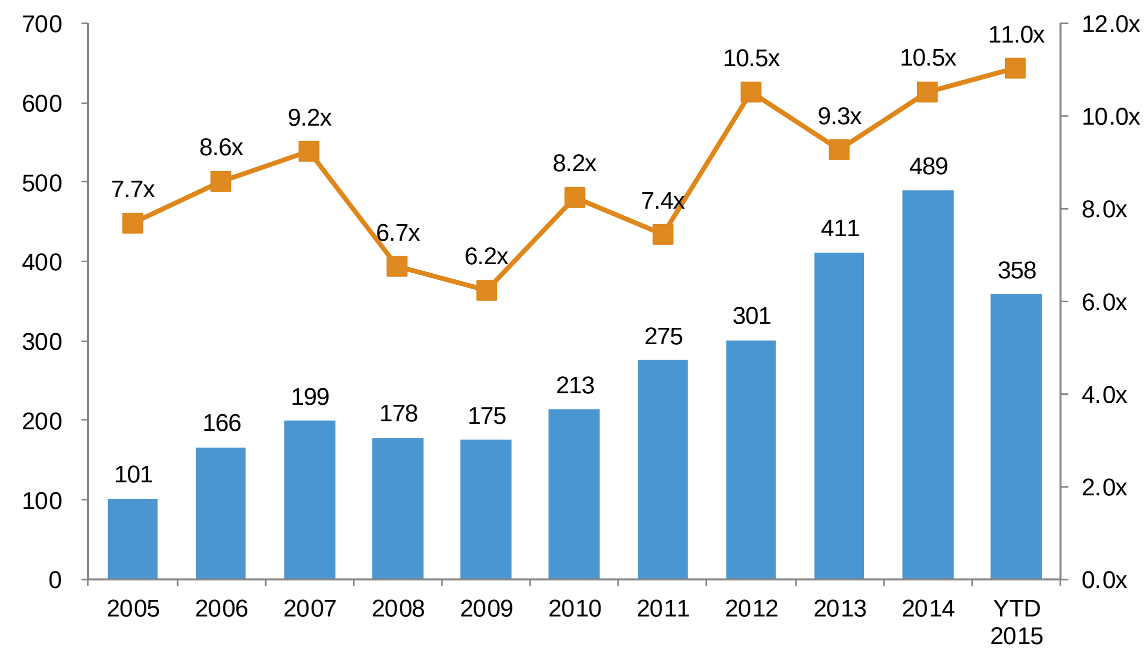
Putting the Story in Context: Historical Restaurant M&A Trends

- Restaurant industry M&A deal volume has surged, growing at a nearly 23% annualized rate since its recession-driven low point in 2009
- Valuation multiples have increased concurrently, peaking at an average of 11.0x LTM EBITDA through September of 2015
  - Multiple expansion fueled by proliferation of emerging high-growth concepts, coupled with increased competition from historically attractive equity markets

Historical Restaurant Industry Transactions and Valuation Multiples

(number of deals) *(average EV / EBITDA)*



Average target enterprise value *($ in millions)*

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD 2015
$253	$361	$206	$264	$64	$416	$187	$418	$118	$834	$199

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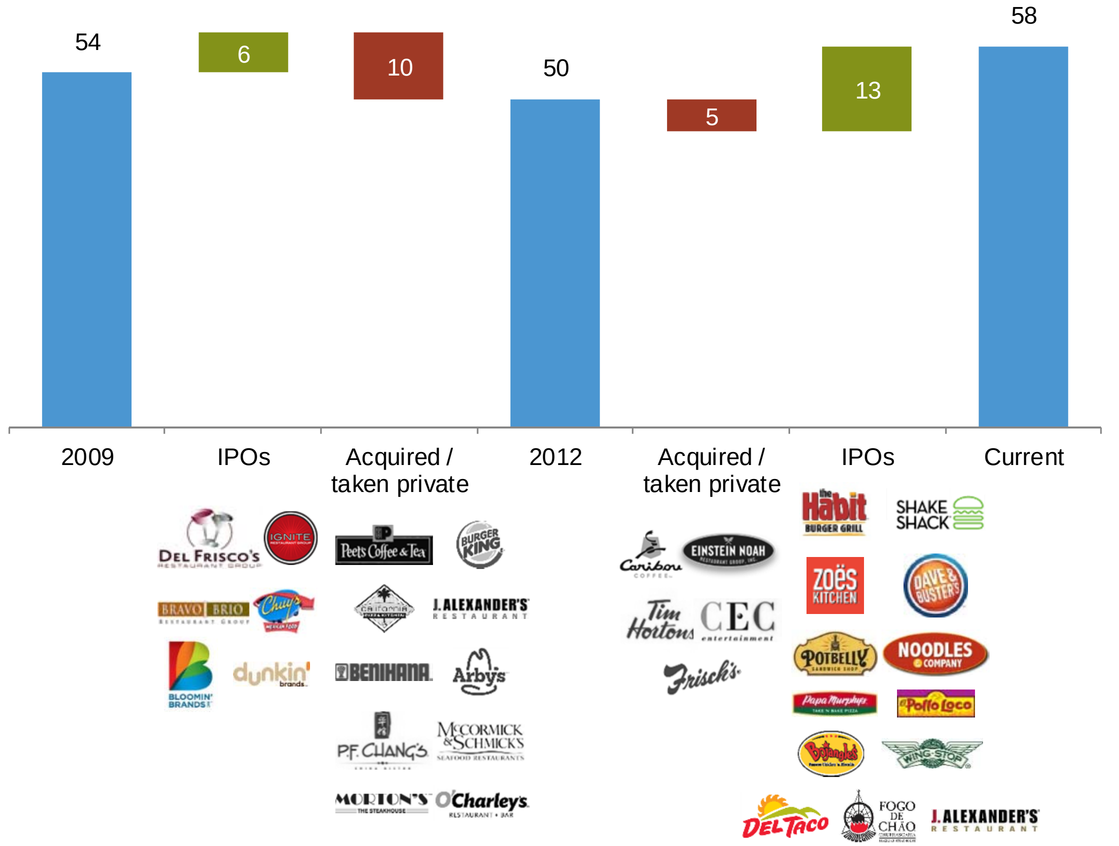
Current State of the Industry: Equity Capital Markets

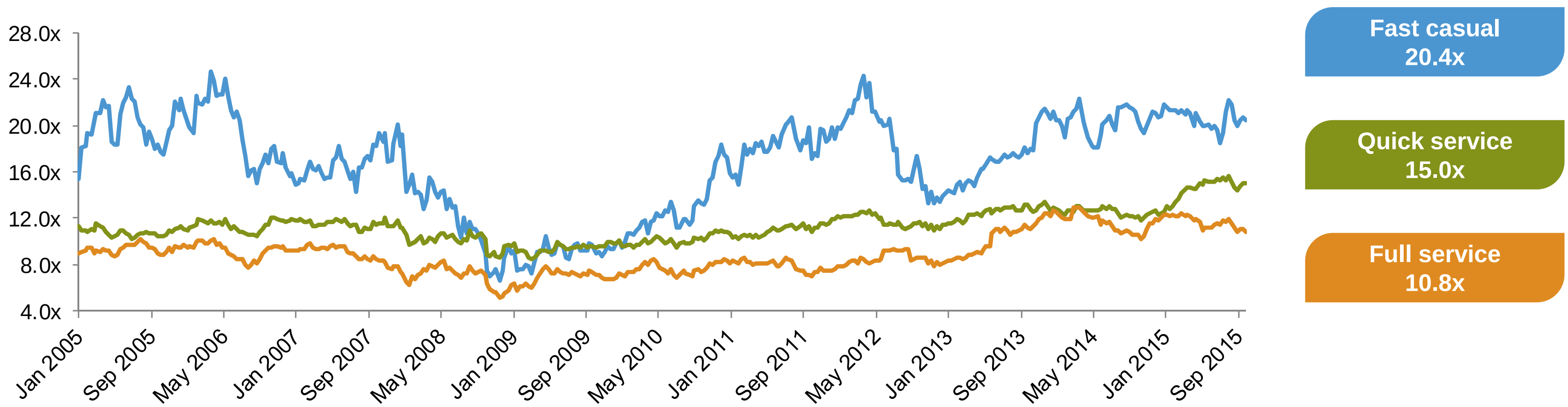
- Sustained valuations near all-time highs are encouraging many restaurants to explore the public markets
- Recent historic performance of growth-oriented IPOs underscores the premium investors are willing to pay for high-quality concepts with considerable potential to expand
- Companies utilizing unconventional methods, such as SPACs and spin-offs, to capitalize on equity premium
- The recent resurgence of restaurant IPOs looks poised to continue for the foreseeable future
  - Success of recent 2015 IPOs such as Shake Shack, Habit Burger, Bojangles', and Wingstop evidence the considerable investor demand for the sector
  - Numerous other companies are rumored to be seriously considering an IPO

The Return of the Restaurant IPO



Current State of the Industry: Emergence of Fast Casual

Total Enterprise Value / LTM EBITDA by Restaurant Sector



- Restaurant industry innovation has largely been driven by emerging fast casual concepts aligned with evolving consumer preferences
- Pervasive appeal of fast casual, particularly among Millennials, has caused many established concepts to change strategies in attempt to reposition their brands to capitalize on the segment's success
- Fast casual companies trade at a significant premium to both quick service (37%) and full service (90%) segments
- Considerable success of recent fast casual IPOs, such as Shake Shack, Habit Burger and Zoe's, fuels investor support and will continue to attract high-quality growth concepts to the public markets

Current State of the Industry: M&A

- Private equity funds are extremely active
  - Considerable dry powder and borrower-friendly credit markets
  - No constraints on exit opportunities, with M&A, IPO, and dividend recaps all equally viable and attractive
  - Non-traditional restaurant investor activity (e.g., Revolution Growth / sweetgreen) evidences compelling opportunity offered by the industry
- Strategic buyers displaying elevated interest as well, as mature companies seek additional growth concepts to supplement established business
  - Headlined by Burger King's $12-billion acquisition of Tim Hortons in December 2014
  - Many strategic buyers looking to emulate Buffalo Wild Wings' strategy of investing in emerging fast casual brands

Emerging High Growth		Mature Moderate Growth	
Target	**Buyer**	**Target**	**Buyer**
Eureka!	KarpReilly LLC	The Portillo Restaurant Group	Berkshire Partners
lemonade	KKR	Del Taco	Levy Acquisition Corp.
Tender Greens	Union Square Hospitality Group; Alliance Consumer Growth	TGI Fridays	Sentinel Capital Partners; Tri-Artisan Capital Partners LLC
sweetgreen	T.RowePrice Invest with Confidence; revolution	Jack's	ONEX
CAVA Mezze Grill	revolution; INVUS	CKE Restaurants	ROARK Capital Group
Piada Italian Street Food	Catterton partners	Romano's Macaroni Grill	Ignite Restaurant Group
the Lazy Dog Cafe	Brentwood Associates Private Equity Investments	Tim Hortons	Burger King

Areas of SEC Focus in Restaurant IPOs

- **Use of non-GAAP figures**
  SEC comments consistently focus on the use of non-GAAP measures, and comment letters frequently request specific, circumstances-based explanations for the use of these measures and more detail with respect to the reconciliation of non-GAAP measures to comparable GAAP measures.
- **Dependence upon a single supplier**
  SEC comments have consistently honed in on the use of a single supplier, often requesting disclosure with respect to what that supplier provides to the business as well as the risks that dependence upon a single supplier for all or a substantial portion of particular goods or services poses to the company's operations.

Areas of SEC Focus in Restaurant IPOs

- **Substantiation of statements and data**
  SEC comment letters frequently request the removal of marketing language that is non-substantiable (e.g., "unique market positions" and "powerful growth strategies"), and the Staff also focuses on specific claims (e.g., "we use higher-quality beef than our competitors" and "our staff provides superior service").
- **Related party transactions**
  SEC comment letters frequently request additional detail with respect to certain related party transactions, and new standards for auditor review are now in place.
- **Segment Reporting**
  SEC comment letters continue to question company judgments about when segment reporting is appropriate.

SEC Focus on Accounting: Build to Suit

- Restaurant companies are frequently involved in the construction of new stores which they lease.
- In 'build-to-suit' lease transactions, various forms of lessee involvement during the construction period raise questions about whether the lessee is acting as an agent for the owner-lessor or is, in substance, the accounting owner of the asset during the construction period.
- Once construction is complete, the company performs a sales lease back analysis to determine if the asset and obligation qualify to be removed from the balance sheet.
- This is a highly-complex area of accounting that many restaurant companies may have insufficient expertise to address.

SEC Focus on Accounting: Deferred Rent

- Leases that include stated fixed rent increases need to be straight-lined, including cancelable renewal option periods where failure to exercise would result in an economic penalty
- We have seen that restaurant companies have frequently had problems with understating expense through not recognizing the renewal options and rent increase clauses in their rent expense calculations
- Some restaurant companies have also had issues in straight-lining rent expense over the initial term, but including renewal option periods in calculating the depreciation life of assets, resulting in a misalignment of these periods and understating expense

The Dual-Track Process: Benefits and Drawbacks

What are the benefits?

- Companies can flush out potential bidders
- Process can maximize exit proceeds by increasing competition during an M&A process
- Theoretical increase in transaction certainty for seller, as owner companies are not necessarily reliant on third party acquirors
- Companies can hedge their bets and leave the final exit decision as late as possible

What are the challenges?

- Although synergies of the two processes exist, dual-track process increases expense and management time on transaction matters
- Electing an IPO does not result in a full exit for owners in most situations
- Often a longer process
- Logistical and visibility issues make targeting IPO market windows challenging

The Dual-Track Process: Timing and Other Considerations

Full M&A Process / No IPO Consideration	Full M&A Process / Mention IPO as an Alternative	Full M&A Process / Threaten to File IPO	Dual Track – IPO / Full M&A Process	IPO / Approach Targeted Potential Acquirors	IPO / Receptive to Inquiries from Acquirors	IPO / No Interest in Sale

Pure M&A → **Hybrid** → **Public Equity**

Process Considerations

Pure M&A	Hybrid	Public Equity
• No continued business execution risk • Low participation in future upside • Potential exposure of information to competitors • Complete and most immediate liquidity benefit	• Most thorough process • Provides assurance that the highest valuation was generated • Most time and resource intensive for management • Highest deal costs	• Ability to participate in future upside • Greatest exposure to equity market fluctuations • Continued business execution risk • Exposure to scrutiny of public markets and SOX compliance • Partial liquidity issue

Non-GAAP Metrics: Compliance with Law

- **Regulation G requires that whenever an issuer publicly discloses any material information that includes a non-GAAP financial measure it must provide:**
  - A presentation of the most directly comparable GAAP financial measure
  - A quantitative reconciliation of differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure

- **Item 10 of Regulation S-K requires companies using non-GAAP financial measures in SEC filings to provide:**
  - Presentation, with equal or greater prominence, of most directly comparable GAAP measure
  - The same quantified reconciliation as required by Regulation G
  - A statement disclosing the reasons why the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations
  - A statement disclosing the additional purposes for which management uses the non-GAAP financial measures

Non-GAAP Metrics: Trends in the Industry

Metric	Purpose	Reported by
Same-store sales growth	• Regularly updates investors on the health and performance of a concept's core units (typically those operating for at least 12 or 18 months)	• All restaurant companies, on both a quarterly and annual basis
System-wide sales	• Gives sense of a concept's overall scale, independent of unit ownership	• Companies with significant franchised component (~50%+)
Average unit volume	• Highlights standalone units' revenue generating potential	• Majority of companies (annually) • Limited number (primarily very heavily franchised) do not report
Cash-on-cash returns	• Estimate of new unit returns • Historically company-owned focused, increasingly reported by franchised concepts to highlight ability to attract franchisees	• Select companies with attractive returns, though increasingly common from both company-owned and franchised models
Adjusted EBITDA	• Used as gauge of recurring earnings generated by company's core business and as a proxy for operating cash flow	• All IPOs since 2014 • Historically less of a focus, though other public concepts beginning to report as well

The Power of Millennials

- **Millennials' eating habits and preferences are notably different from their parents:**
  - **53%** eat out once a week, compared with 43% of the general population
  - Millennials care more about food that is "fresh, less processed and with fewer artificial ingredients" than prior generations
  - Fast casual is the preferred format: Millennials comprise **51%** of fast casual customers
  - Millennials are more likely than their parents to express interest in companies with good social ethics

- **Millennials have specific focus areas in selecting restaurants, and the industry is working to address their preferences:**
  - **55%** of Millennials prefer communal tables at restaurants
  - **68%** of Millennials ask friends before selecting a restaurant
  - **40%** of Millennials will order something different every time they visit the same restaurant
  - **30%** of Millennials eat foods that are certified organic
  - **87%** of Millennials will spend money on a nice meal, even when money is tight

The Focus on Healthy Options

- **88%** of individuals recently surveyed by Nielsen are willing to spend more for healthier foods
- Research conducted by the National Restaurant Association indicates that **70%** of adults are trying to eat healthier than they did two years ago
- **80%** of restaurant operators report that their guests focus more on the nutrition content of food than guests did two years ago
- **Gluten-free, low-carbohydrate** and **high-protein** options
- The emergence healthy fast-casual:
    - Organic food-focused restaurants, salad and specialty options
    - Whole Foods' recent investment in Mendocino Farms further illustrates the broad appeal of fast-casual and the desire of even non-traditional restaurant investors to involve themselves in the segment

Our Questions as We Look Forward

- With today's high valuations, sellers will be attracted to selling smaller concepts, but buyers are concerned about the cost and the financing options. How will that struggle play out?
- Will high valuations be the rule or will turbulence in public companies bring down valuations across the segment? And how will public companies perform hitting earnings targets?
- The new interest in the sector by non-traditional industry investors: Is this an anomaly or a trend? Is grocery blending into restaurants?
- How will restaurants use social media in the coming year?