INFLATION RUNNING UNDER 2% ? - UNLESS YOU WANT TO EAT ! - THE FACTS

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I've listened to a lot of conference calls lately describing Q4'18 and describing prospects for calendar '19. It's clear to all of us that restaurant operating costs are rising, labor being the most conspicuous line item. Higher expenses, sooner or later require price adjustments, in the hope of maintaining operating margins. The problem is that there continues to be intensive competition that precludes the necessary menu price adjustments. The results over the last couple of years have demonstrated that traffic decreases have predictably offset price increases and resultant revenues (same store sales) have mostly been flat. The following capsules, relating to company operated chains, provide a picture of current pricing, the resultant effect on profit margins, and what we can expect going forward. Our commentary, unless otherwise noted, is relative to the most recently reported quarter.

BJ’s Restaurants: Perhaps the most notable exception to the trends described below. Their menu has been revamped and upgraded, Prices are up 4.4% while maintaining traffic and store level operating margins. Wage expense will still be a challenge, up 5% in ’19, but ’19 is expected to be more of the same in terms of strong results on an absolute and a relative basis.

Brinker International: Managing Chili’s and Maggiano’s, prices were down 0.1% and up 0.5%, respectively. There have been major menu changes, especially at Chili’s with a strong focus on value, so transactions have been maintained. Unfortunately, there has been margin erosion at the restaurant level. It remains to be seen whether the aggressive value orientation will pay off over time, in terms of rebuilding margins. Menu pricing is expected to be up about 1.5% going forward.

Cheesecake Factory: Has been running about 3% price, which they expect to be the ongoing case. Resultant traffic has been roughly flat. Unfortunately, restaurant margins have been damaged, for the quarter and the year. Wages are expected to be up 6% going forward, especially in California, where pricing is also higher. There is no reason to expect restaurant margins to improve.

Cracker Barrel: Has been running about 3.7% price, traffic close to flat. Menu prices were increased 10% at Thanksgiving and Christmas. Pretax operating earnings were flat for the qtr and six months. Wages are expected to be up 3.3% plus higher training expense. Again, no reason to think that restaurant margins will expand.

Chipotle: Prices are running up 4.1%, with traffic up by about a point, menu prices to increase about 1.7% going forward. Wages are going up by 4-5% in '19. A great number of moving parts here, still trying to bounce back from the health incidents over three years ago. Traffic is hardly better than it was then and margins have a long way to go.

Pollo Tropical: Owned by Fiesta Restaurant Group, had a price increase of 4.4%, as the brand is repositioned. Transactions were down 6.3%. Appears that adjusted EPS and EBITDA are stabilizing but a lot of moving parts here. Time will tell.

Taco Cabana: Owned by Fiesta Restaurant Group, had a price increase of a massive 9.6%, as the brand is repositioned. Transactions were down 4%. Once again, lots of moving parts and it will take time to see how this re-invention plays out.

Shake Shack: Pricing was up 2.6%, expected to move up another 1.5% in calendar '19. Transactions were down over 1%, for a couple of years now. Store margins are coming down, not just from higher expenses but because lower volume stores are opening. Wages are expected to rise by about 5% in '19, continuing the trend that has seen a 43% increase in minimum wage in NY since 2016, 20-30% in other key markets.

McDonald's: While highly franchised, McDonald's has thousands of company operated stores. US stores had a 4.7% price increase in '18 and traffic was flat. Company operated US stores had a store level EBITDA of 17.5% in '18, down 70 bp, so the price increase did not offset the higher expenses.

Red Robin: Still trying to re-invent themselves, with a heavy emphasis on value, menu prices were down 0.1% (Price was up 1%, discounting took it down), expected to be up 2%+ in '19. Too many challenges here to use this one as a generalized indicator.

Starbucks: Pricing up 4%, traffic flat. Should look the same in '19, though higher traffic is the hope. US operating margin was only up 3% on a 8% revenue increase, so came down materially on a percentage basis. No reason to expect an increase in store level profits unless traffic increases materially.

CONCLUSION:

With the exception of BJ's, which is firing on virtually all the relevant cylinders, just about everybody else is "margin challenged". Relative to menu pricing, the largest companies in QSR, represented here by McDonald's and Starbucks, are raising prices about 4% annually. Cheesecake and Cracker Barrel, among the largest casual diners, are increasing prices in the 3-4% range annually, and their margins are down and flat respectively. Chains that are either sharply below, or sharply above these ranges, such as Chili's and Red Robin, or Taco Cabana and Pollo Tropical, are going through their respective repositioning, and time will tell how they do.

In any event, one of our conclusions is that a 3-4% menu price increase is not enough, in the absence of higher traffic as well, to rebuild EBITDA “profit” margin at the store level, not when wages are going up by 5% which alone costs about 150 bp on the income statement. At the same time advertising, insurance, rents, and most of the rest of the 15 points of “other operating expenses” are trending up as well. This is all you need to know as to why franchisees of major systems, McDonald’s, Jack in the Box, Tim Horton’s to name just a few that so far have gone public with their dissatisfaction, are asking for a larger voice.

Another conclusion is that every chain must be prepared to invent (if they are young) and reinvent (if mature) themselves in terms of the employee culture, the customer experience, the hospitality quotient, in essence: *you must differentiate your commodity*. Absent that, customers will feel no need to dine with you (Domino’s still delivers), or call Doordash (with a lower margin for you), or grab and go at no shortage of prepared meal purveyors.

Roger Lipton