

THE FUTURE of CASUAL DINING

THE GOOD. THE BAD. THE UGLY.



MATTHEWSTM
REAL ESTATE INVESTMENT SERVICES

For the past decade, the casual dining industry, otherwise known as full-service restaurants, has felt the same adverse effects of e-commerce as traditional brick-and-mortar retail, department stores, and suburban mall centers. According to Bloomberg, consumer tastes have strayed from the sit-down experience model, evidenced by the rise and relative out-performance of local restaurants, fast food chains, delivery-focused companies, and fast-casual concepts — COVID-19 accelerated these problems. Full-service restaurants are desperately rethinking their business models to pivot and adapt, especially as cold weather limits outdoor dining, which has served as a last resort during the pandemic. In this article, Matthews summarizes how COVID-19 exacerbated casual dining's weaknesses and provides an outlook of the full-service restaurant sector.

The Casual Dining Landscape

Even before COVID-19, investors had begun looking at the casual dining sector more skeptically for not keeping up with consumers' changing tastes. Many attributed this to millennials, who prefer to visit fast-casual restaurants (limited-service restaurants), such as Chipotle or Panera Bread. Fast-casual restaurants often use fresh and locally sourced ingredients to prepare the same or better quality food than casual dining chains, only they provide the speed and price of a fast food chain. In many cases, limited-service restaurants have successfully marketed "healthier" menu options.

At full-service restaurants, slim or even negative margins on the sale of food items led operators to become fixated on selling high-margin items, such as alcohol. Meanwhile, technological advances in mobile ordering, delivery, or customer loyalty programs drew many to limited-service (fast-casual and fast food) restaurants. Delivery services, such as UberEats, Postmates, and DoorDash, make eating at home even more appealing, and these digital sales tend to favor limited-service restaurants. Furthermore, fast-casual meals hold much better in to-go containers for 20 minutes than more complex meals from casual dining chains, such as calamari or a Grand Slam breakfast.



50% OF CUSTOMERS say the availability of a customer loyalty reward program would make them choose one restaurant over another.

Takeout and delivery are life rafts for all restaurants during dine-in bans as consumers dine in their homes more frequently. In many ways, major casual dining brands had the edge over the smaller competitors thanks to broader resources and brand-name recognition that took customers back to a simpler time. This trend is expected to continue, but alone, these sales are not enough to keep a casual dining location afloat. Many restaurants saw dramatic same-store sales decline during the height of COVID-19.

"Quick-service franchises such as McDonald's, Taco Bell, and Dunkin' Donuts rebounded quickly and are expected to bring in just as much revenue as last year, if not more."

MARK WASILEFSKY, HEAD OF TD BANK'S RESTAURANT FRANCHISE GROUP.

According to Top Data, when the coronavirus pandemic began, casual dining restaurants saw 58 percent less traffic on average, compared to just a 30 percent decrease for fast food restaurants. As weeks went on, many restaurants that saw these declines began to see sequential improvements. However, same-store sales continued to decrease for casual dining brands, even as dining rooms were allowed to reopen. As a result, many casual dining brands have set out to change their brand to appeal more to millennials and adapt to new dining norms.

RESTAURANTS THAT RECENTLY FILED FOR BANKRUPTCY

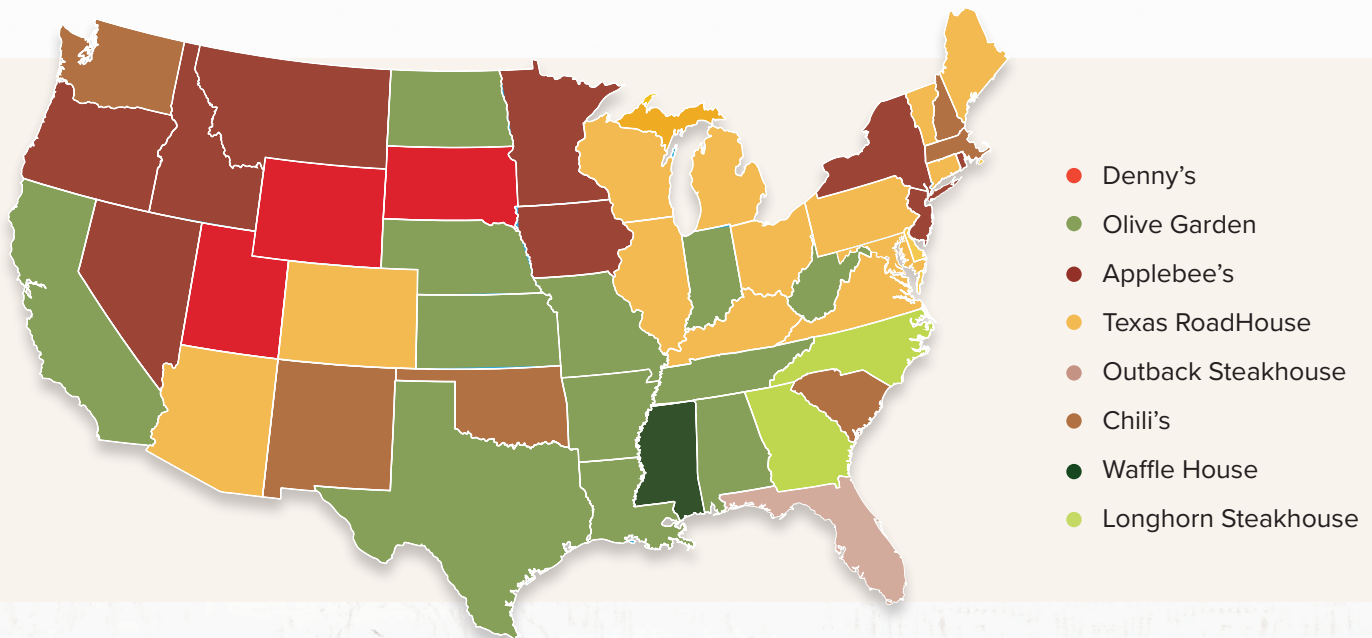
CALIFORNIA PIZZA KITCHEN
RUBY TUESDAY
CHUCK E. CHEESE
FUDDRUCKERS
NPC INTERNATIONAL (WENDY'S & PIZZA HUT)

RESTAURANTS THAT ARE CONSOLIDATING LOCATIONS

TGI FRIDAY'S
IHOP
APPLEBEE'S
DENNY'S
HOOTERS

TOP CASUAL CHAIN RESTAURANTS VISITED DURING THE CORONAVIRUS PANDEMIC

SOURCE: TOPDATA | PER STATE



Rebranding the Sector

Casual dining restaurants need to update their value offerings to attract consumers. Despite already having strong locations in many markets, the real variable of uncertainty is COVID-19's impact on consumer behavior. Consumer expectations for casual dining have certainly changed; food should be high in novelty factor, healthy, and prepared fast. Ultimately, many established casual dining brands need to invest in a fresh rebranding strategy. Casual dining investors need to distinguish the safe harbor concepts, typically those located in profitable markets, in great locations, and tenants working towards revamping their brand.



CASUAL DINING STRENGTHS

BRAND

Restaurants with strong brands will navigate through shifting industry currents while attracting customers and retaining their loyalty. In the COVID-19 environment, casual dining restaurants pivoted to outdoor dining quickly and adjusted the brand experience in response to changing consumer preferences and demands.

LOCATION

Location influences consumers, from attracting the initial customer to being convenient to visit. Today, consumers are less likely to travel far from home for casual dining, so convenient locations are key. More often than not, a casual dining restaurant is located in a shopping center, and historically casual dining restaurants have synergistic relationships with shopping centers. These restaurants benefitted from increased foot traffic and shoppers prone to ordering higher-margin items. Per a report released in July 2020 from William Blair analyst Sharon Zackafi, the restaurant concepts that have fared best during the pandemic are those with real estate footprints skewed to the suburbs.

CASUAL DINING WEAKNESSES

PRICE

Despite the prevalence of advertised deals, many consumers find casual dining entrée prices more expensive than other restaurant options. As a result, some patrons have cut back on how often they dine out.

QUALITY

For the price, the food quality at casual dining restaurants doesn't match consumer expectations. These brands successfully lure a type of customer who may have previously avoided fast dining options altogether as they were considered unhealthy and opted for casual dining restaurants instead. As consumer expectations for fast-casual have risen, the casual dining market is now affected by the same rising tide.

CONVENIENCE

Consumers typically gravitate to quick-service restaurants, fast-casual, and drive-thrus compared to casual dining due to speed, taste, efficiency, and value. The average waiting time between a drive-thru and casual dining takeout differ dramatically.

SOCIAL DISTANCING

Most casual dining brands have built-in seating or booths, which hinders the ability to allow for flexible seating layouts during the COVID-19 environment. Further, many casual dining sale-leasebacks were set with a pre-COVID-19 rent factor, accounting for 100% use of the gross leasable area. Even just a minor decrease in revenue or seating capacity will hamper profitability margins.



Current On-Market Data

In Q1 2020, national asking cap rates in the casual dining sector increased to 6.59 percent. This is a 27-basis point increase compared to Q1 2019. However, cap rates didn't increase evenly across the industry. Casual dining properties with corporate guaranteed leases generated cap rates of 6.25 percent, while franchisee leased properties had cap rates of 7.00 percent. Of course, this was almost entirely before the pandemic took hold in the United States.

COVID-19 has undoubtedly accelerated the problems that the weaker brands had to a large extent. The COVID-19 shutdown drove the softening in casual dining, and the casual dining sector is currently priced at a discount, 44-basis points, to the overall net lease retail market.

The table below shows NNN transaction data for full-service tenants, IHOP, Hooters, Denny's, Chili's, and Applebee's. The exponential growth in days-on-market, cap rate, and sale discount, indicate a bearish outlook on future pricing. In 2020, 45 NNN properties were leased to the full-service tenants below and transacted with an average sale cap rate of 6.62 percent and 183 days-on-market. As of November 6th, 2020 there were 91 properties for sale leased to the same five full-service restaurant tenants with an average list cap rate of 6.63 percent and 212 days-on-market. By looking at these numbers, there is an apparent disconnect between buyers and sellers.

CASUAL DINING BY THE NUMBERS

SOURCE: MATTHEWS™ RESEARCH

| | All | IHOP | Hooters | Denny's | Chili's | Applebee's |
|------------------------------|-----------|-----------|-----------|-----------|-----------|------------|
| # Of Transactions In 2018 | 85 | 20 | 7 | 22 | 9 | 27 |
| # Of Transactions In 2019 | 153 | 43 | 11 | 21 | 35 | 43 |
| # Of Transactions In 2020* | 45 | 15 | 4 | 6 | 5 | 15 |
| 2018 Avg Cap Rate | 6.60% | 6.32% | 7.20% | 6.17% | 6.25% | 6.90% |
| 2018 Avg Days On-Market | 166 Days | 139 Days | 263 Days | 151 Days | 156 Days | 174 Days |
| 2018 Avg Price Per SF | \$524/SF | \$636/SF | \$520/SF | \$456/SF | \$471/SF | \$520/SF |
| 2019 Avg Cap Rate | 6.43% | 6.07% | 6.66% | 6.25% | 5.77% | 7.26% |
| 2019 Avg Days On-Market | 195 Days | 192 Days | 215 Days | 126 Days | 171 Days | 244 Days |
| 2019 Avg Price Per SF | \$527/SF | \$521/SF | \$559/SF | \$434/SF | \$616/SF | \$487/SF |
| 2020 Avg Cap Rate | 6.62% | 6.59% | 6.24% | 6.65% | 5.40% | 7.04% |
| 2020 Avg Days On-Market | 183 Days | 129 Days | 100 Days | 98 Days | 221 Days | 249 Days |
| 2020 Avg Price Per SF | \$572/SF | \$700/SF | \$540/SF | \$597/SF | \$404/SF | \$521/SF |
| # of Properties On-Market | 91 | 13 | 12 | 11 | 9 | 46 |
| On-Market Avg Cap Rate | 6.63% | 7.20% | 6.61% | 5.94% | 6.20% | 7.20% |
| On-Market Days Listed | 212 Days | 128 Days | 251 Days | 243 Days | 245 Days | 195 Days |
| On-Market Avg Price Per SF | \$540/SF | \$500/SF | \$515/SF | \$575/SF | \$552/SF | \$546/SF |
| Average Sale Discount 2018 | 5.58% | 8.20% | 4.60% | 4.35% | 6.35% | 8.20% |
| (list price less sale price) | \$128,900 | \$147,300 | \$117,000 | \$59,000 | \$186,300 | \$147,300 |
| Average Sale Discount 2019 | 4.14% | 3.86% | 3.63% | 4.51% | 4.20% | 4.21% |
| (list price less sale price) | \$127,000 | \$109,400 | \$107,300 | \$82,500 | \$170,400 | \$114,100 |
| Average Sale Discount 2020 | 6.20% | 7.48% | 6.75% | 6.06% | 6.18% | 4.60% |
| (list price less sale price) | \$175,625 | \$223,300 | \$228,000 | \$167,000 | \$130,000 | \$120,000 |

(* As of November 6th, 2020—It is estimated that no less than 35% of the 45 transactions were closed in Q1 2020, pre-pandemic)



Lender & Financing

The lending markets for the restaurant and casual dining sectors have dramatically shifted in 2020. Already undercapitalized and with thin margins, restaurants cannot function profitably when foot traffic is down 50 percent, or even 35 percent, said Benjamin Sebraw, managing director for SMS Financial LLC. According to OpenTable, restaurant bookings in some states were down as much as 94 percent year-over-year at the end of Q2 and beginning Q3 2020. Locations without \$4 to \$5 million in sales do not have the margins to entice lenders or restaurant operators in the current market.

With dampened performance leading to a cycle of deteriorating liquidity and solvency, and the inability to secure additional financing, the sector will face challenges in the coming months. The largest U.S. lenders have significantly reduced their exposure to restaurant lending deals. Citizens Financial Group and Trust Financial Corporation, the nation's second

and third-largest restaurant lenders, decreased their \$3 billion loan exposure by ten percent, collectively. Further, the top 20 largest U.S. restaurant lenders have reduced their exposure by as much as 15 percent. Lenders still considering new deals have dramatically shifted away from the "hunt for yield" notion, as pursued throughout the last decade; now they seek deals with less existing leverage, more equity contribution, and fewer borrower-friendly legal provisions or covenants. As of Q3 2020, Regions Financial Corporation's management, the fourth-largest U.S. restaurant lender, identified 30 to 40 percent of full-service restaurants as "criticized," and four percent were in a complete deferral. Maryland-based restaurant lender, Eagle Bancorp, works with restaurant borrowers to explore pivoting business models to restore cash flow to avoid defaults. However, despite their efforts, 42 percent of Eagle Bancorp's total outstanding restaurant loans were also in deferral.

Operator Performance

Without liquidity, the undercapitalized industry is poised for further decline. Morgan Stanley analysts note that in their bear case scenario, the model indicates the best-capitalized restaurant companies, at current cash-burn rates, can exist for six months at best, and at worst, two months. Assuming pre-crisis balance sheets (not accounting for limited CARES Act funding), and with relative consideration

to EBITDA forecasts, Brinker International, Bloomin' Brands, Red Robin Gourmet Burgers, and The Cheesecake Factory will all face issues under existing covenants. Darden Restaurants and Bloomin' Brands, two of the largest U.S. casual dining operators, have seen a deterioration of performance and short and long-term liquidity issues.

| Darden Restaurants | 2019A | 2020A | % Change |
|---|---------|-------------|----------|
| EBIT | \$851.5 | 292.6% | -65.6% |
| Cash from operations/current liabilities | 0.9x | 0.4x | -55.6% |
| Interest coverage ratio (EBIT/Interest Expense) | 15.8x | 4.7x | -70.3% |
| Total Debt/Equity | 46.1% | 257.8% | 459.2% |
| Bloomin' Brands | 2019A | LTM(9/2020) | % Change |
| EBIT | \$202.5 | \$19 | -90.6% |
| Cash from operations/current liabilities | 0.3x | 0.2x | -33.3% |
| Interest coverage ratio (EBIT/Interest Expense) | 4.1x | 0.3x | -92.7% |
| Total Debt/Equity | 1421.9% | 20629% | 1350.8% |



Casual Dining Outlook

Diminished investment in real estate operations means that the net lease world is likely to observe an increase in stores going dark. Operators and parent companies are bearish on acquiring operations, or same-concept franchisees, in the hope of a value-add comeback. A combination of uncertainty and patience of a potential wide-scale modernization of full-service restaurants has left investors on the sidelines. Placing the pandemic aside, “raising money to buy distressed restaurants is tough, as casual dining traffic has been down 65 out of the past 66 months,” said Michael Halen, senior restaurant analyst at Bloomberg Intelligence.

In 2021, investors in the sector will seek out restaurants that successfully navigate the many new dining restrictions. Some full-service casual dining chains have started implementing creative solutions, such as Shareable Family Packs from Denny’s and all-new virtual brands like “It’s Just Wings” from casual dining company Brinker International. The key metrics investors will look at as they decide whether to move back into the market include in-place rents, sales performance, residual real estate, and the lease guarantor and restaurant brand’s strength. Casual dining tenants must prove to net lease investors a sales trajectory of pre-COVID levels for transaction velocity and pricing to return to 2018 levels.

Casual dining brands with ongoing business models that can take advantage of increased curbside services offered during the current COVID-19 period will find success. Speed of service and convenience are becoming increasingly important for consumers; therefore, it is encouraged that casual dining investors lookout for brands moving in this direction. Corporately guaranteed leases or large franchisees with strong financials will remain in the highest demand among private investors.

THE TREND OF SHAREABLE FAMILY PACKS

Due to many supermarkets being hard-pressed to deliver many items, the restaurant space stepped in to fill the void. Restaurant operators reported increased dollars per transaction as consumers spent more on family bundles and higher-priced entrees searching for convenient yet affordable meals.

SOURCE: NPD

MORGAN STANLEY ANALYSTS

anticipate the future of casual dining as the downsizing of physical locations and reliance on digital sales.

90% OF FULL-SERVICE RESTAURANTS

that reopened after temporary pandemic closure, reported the sales mix is comprised

OF 45% TO 50% DIGITAL GROWTH

from takeout orders and online ordering.

As the pandemic has required restaurants to close in-store dining, operators require less labor to run the business. “Now, we’re seeing operators with a drive-thru only business. It’s a more efficient labor model,” said Cadence Chairman and CEO, Paul Murphy. “Some of the operators are making comments that in the future, restaurants will be smaller, and off-premise will be bigger.”

A LOOK AT 10 CASUAL DINING BRANDS



THE CHEESECAKE FACTORY

According to The Cheesecake Factory, many consumers are eager to dine out despite the coronavirus pandemic. The restaurant is enjoying considerable wait times (up to 60 minutes) on the weekends at open units. With the large restaurant footprint (ranging from 5,500 to 10,000 square feet), The Cheesecake Factory allows flexible seating layouts, enabling the chain to recapture meaningful sales levels despite capacity restrictions. While same-store sales at The Cheesecake Factory restaurants were down 56.9% in Q2 2020 with the COVID-19 impact, Cheesecake units with reopened indoor dining rooms capture about 80% of prior-year sales levels in the quarter to date. The Cheesecake Factory, however, is a tenant that said they wouldn't be paying rent in April because they have a lot of leverage. The units are so customized that it would have to be knocked down to be repurposed. The units are also large, so it would be hard for a landlord to fill that amount of space. According to Black Box Intelligence, full-service chains saw a 60% decline in same-store sales, but some brands beat the average. For example, The Cheesecake Factory experienced only a 46% decrease in same-store sales in March and had managed to boost off-premise sales by 85% since the final quarter of 2019.



OLIVE GARDEN

Olive Garden saw same-store sales drop by 39.2% for the fourth quarter in a row, ended May 31st, which CEO Gene Lee said was due to social distancing rules constraining the casual dining chain's capacity. Lee said off-premise business helped the company reach positive same-store sales at about 10% to 15% of Darden's units, the multi-brand restaurant operator. Olive Garden provided value by reducing delivery fees or rolling out value meal promotions. Promotional pricing was a strategy that casual dining chains relied upon heavily during the Great Recession and is likely to continue influencing the industry through the recovery.



BJ'S RESTAURANT & BREWHOUSE

At BJ's Restaurants, same-store sales fell 57.2% in the second quarter ended June 30th. In late July, the number of units with open dining rooms fell to 70% from 95%, as many had to reclose amid spikes in the number of coronavirus cases.



BLOOMIN' BRANDS

(Outback Steakhouse, Carrabba's Italian Grill, Bonefish Grill, Fleming's Prime Steakhouse & Wine Bar, Aussie Grill)

Combined same-store sales for Bloomin' Brands' four restaurant chains were down 63.9% in the second quarter ended June 28th. The company didn't lay off any workers during the height of the pandemic, which it said was helping sales bounce back as restaurants reopened.



BUFFALO WILD WINGS

The brand opened its first "GO" concept restaurant in May in Atlanta, explicitly designed for takeout and delivery orders. This 1,800-square-foot facility featured a walk-up counter, digital menu boards, condensed seating, and TVs to entertain guests. Guests who call ahead can pick up their orders from heated takeout lockers for a contactless experience. Although launching a new restaurant may seem risky in the age of COVID-19, this takeout-focused format may position Buffalo Wild Wings to see substantial traffic.



DINE BRANDS GLOBAL

(IHOP & Applebee's)

During the quarter ended June 20th, Dine Brands Global saw same-store sales fall 49.4% at Applebee's and 59.1% at IHOP. Although the quarter was bad, it was not as bad as management expected, and CEO Steve Joyce said the challenging restaurant climate could provide the opportunity to acquire more concepts.



BRINKER INTERNATIONAL

(Chili's Grill & Bar, Maggiano's Little Italy)

For the fourth quarter and fiscal year 2020 ended June 24th, Brinker International swung to a net loss of \$49.1 million, or \$1.20 a share, from net income of \$46.7 million, or \$1.25 a share, in the same period a year ago. Revenues fell 32.5% to \$563.2 million from \$834.1 million in the prior-year quarter. As of June 24th, Brinker owned, operated, or franchised 1,663 restaurants, including 1,610 Chili's and 53 Maggiano's Little Italy units. In June, the company introduced in 1,050 units the DoorDash-delivery-only "It's Just Wings" virtual concept.



DENNY'S

For the second quarter ended June 24th, Denny's continued to see low same-store sales – down about 39% in June due to reduced operating hours. About 30% of the brand's U.S. units were operating at the full 24 hours. The brand added Shareable Family Packs and streamlined menus to its toolkit.



RED ROBIN

Red Robin Gourmet Burgers reported a same-store sales decline of 41.1% for the second quarter ended July 12th, with off-premise sales increasing 208.7% and accounting for 63.8% of total sales. The casual dining chain resumed its pre-pandemic turnaround plan, including remodels, a new prototype store, and expanded outdoor dining. They are planning to continue adding tents to restaurants, even as indoor dining resumes at most restaurants. Preliminary mid-year figures showed that the brand sees sequential same-store sales improvements, especially at restaurants open for on-premise dining. Restaurants with expanded outdoor seating are seeing improved sales results. For the week ended September 6th, company-operated restaurants reported a 21.9% drop in same-store sales. However, restaurants with limited indoor dining saw comps declining by 16.1%. Red Robin is undertaking the investment in technologies to improve the guest experience. These upgrades include a digital ordering platform and voice technologies to optimize the speed of service and improve the accuracy of online and phone order promise times.

The overall outlook for casual dining restaurant sales is meager. If brands do not pivot to changing consumer needs, there will be further consolidation in the industry. In 2021, full-service restaurants adapting to new-norms will closely mirror that of fast-casual, as many continue to incorporate delivery and new menu offerings. Investors in the casual dining space will either move out or trade into brands that address the pandemic's restrictions accordingly and provide customers with a modernized dining experience.

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