October 2008

Market Brief

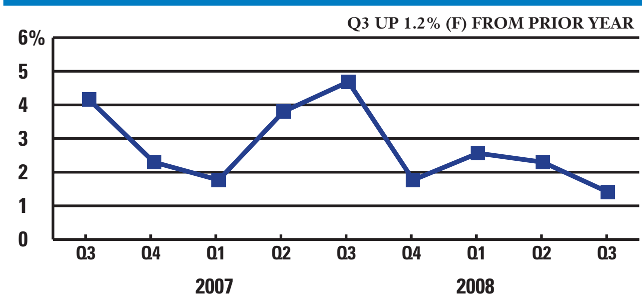
Tracking and interpreting restaurant trends

INSIDE MARKETBRIEF

THE ECONOMY

It's anyone's guess what consumer confidence numbers will show once the dust settles down from the unprecedented mid-September financial crisis. In fact, the entire future of the U.S. economy is anyone's guess. Hopefully the $700 billion financial bailout plan will go a long way toward restoring confidence in the business community, and convincing nervous consumers that they don't have to hoard every penny (and can still afford the occasional restaurant meal) as we move toward a critical holiday season and an uncertain 2009.

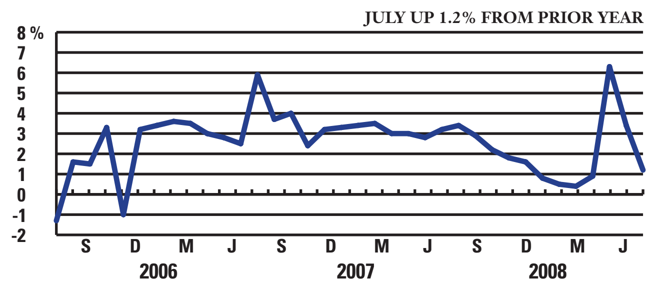
Gross Domestic Product Quarterly Rate of Increase



Source: Blue Chip Economic Indicators

U.S. gross domestic product (GDP) grew 1.2% in the third quarter compared to the growth rate in Q3 2007, according to forecast figures from Blue Chip economists. Revised figures show second-quarter growth coming in at 2.2%, far above the original estimate of 0.2%. Economic stimulus checks boosted consumer spending as planned, and exports were stronger thanks to the weak U.S. dollar.

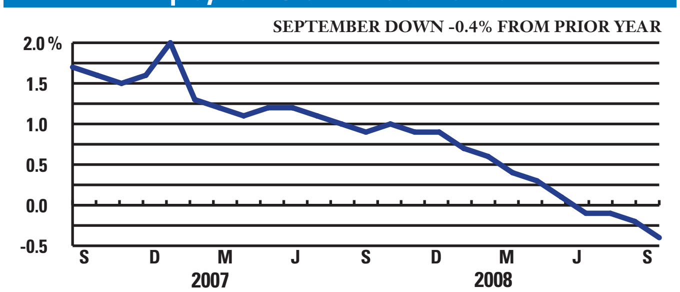
Real Disposable Personal Income Growth



Source: Bureau of Economic Analysis

U.S. real disposable personal income (DPI) rose 1.2% in July over the same month a year ago, according to figures from the Bureau of Economic Analysis. Compared to the month before, real DPI was down by 1.7% in July, after a real-dollar decrease of 2.6% in June. Both figures reflected a contrast with May, when DPI shot up thanks to $48.1 billion worth of economic stimulus checks.

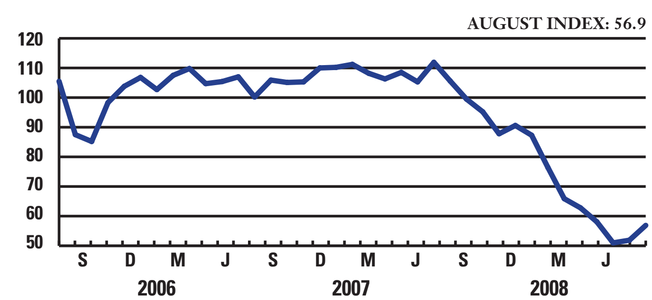
Employment Growth: Total Non-Farm



Source: U.S. Dept. of Labor

U.S. non-farm employment was down by 0.4% in September compared to prior year figures. This decline followed on the heels of a revised 0.2% decline in August compared to the same month a year ago. This new shrinkage of 159,000 jobs over the month was not enough to change the employment rate, which remains at 6.1% after jumping from 5.7% in July. Over the past 12 months, the number of unemployed persons has increased by 2.2 million and the unemployment rate has risen by 1.4 percentage points.

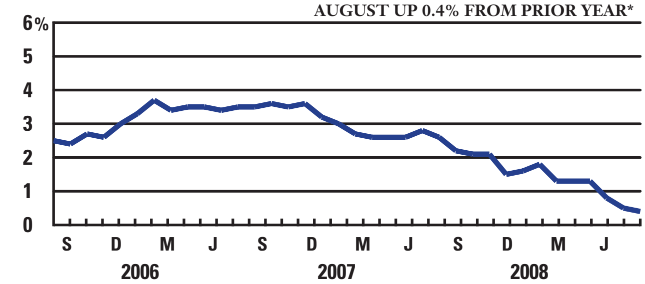
Consumer Confidence Index (Base 1985=100)



Source: The Conference Board

The Conference Board Consumer Confidence Index, which had improved moderately in July, made further gains in August to stand at 56.9 (1985=100), up from 51.9 in July. While consumers' analysis of the present economic situation was somewhat bleaker than the month before, the index of consumer expectations for the future shot up by more than 10 points. The cutoff date for August's preliminary results was August 19th.

12-Month Moving Average (Foodservice & Drinking Places Real Sales)



Source: U.S. Census Bureau

The moving average for sales of foodservice establishments (including restaurants, bars and taverns, and onsite foodservice) rose at a real-dollar rate of only 0.4% in August over the same month a year ago, indicating that sales growth continues to slow. The latest uptick in sales may be tiny, but the industry is still showing nominal gains even in a severely contracting economy, thanks in large part to value deals, combo meals and enhanced "experience" factors to make restaurant and foodservice meals more attractive to consumers.

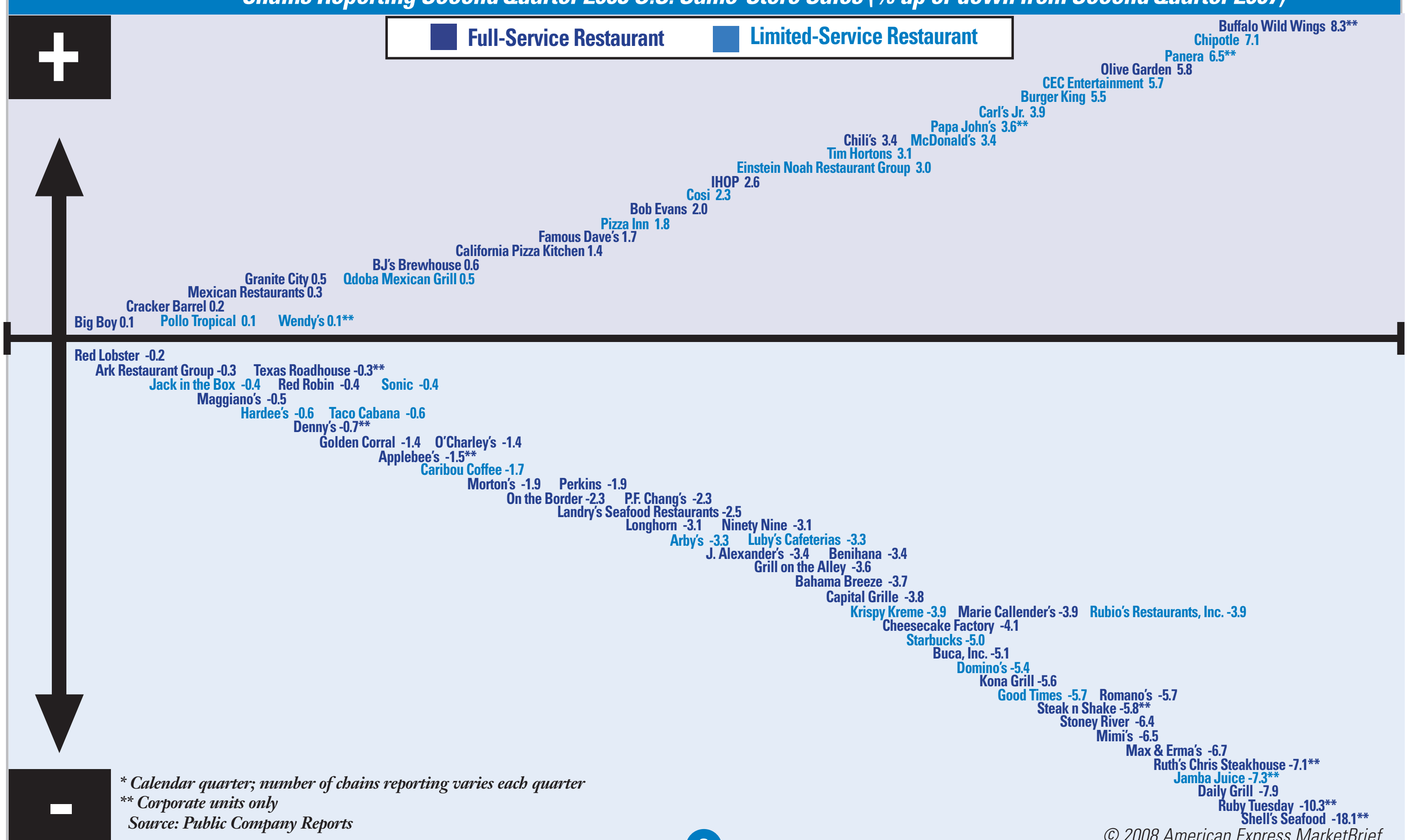
SAME-STORE SALES Q2 2008

Second-quarter same-store sales figures of public chains indicated an industry stuck in neutral. The weighted average showed a 0.1% decline in sales from the same quarter a year ago. In full service, the weighted average was down 0.7%. The weighted average for limited service was up 1.5%—although it came to just 0.4% without McDonald's (which grew U.S. unit sales 3.4% compared to year-before figures).

Buffalo Wild Wings soars. A few chains, however, continued to dramatically outperform their sectors. In full service, the winners included Buffalo Wild Wings, which increased sales 8.3% over year-before numbers at corporate units, as well as Darden's Olive Garden, which tallied comps up 5.8% over year-before figures. In limited service, standouts included Chipotle, which brought in 7.1% more than a year ago in comparable stores. Chipotle, however, has since warned its investors to expect third-quarter sales growth "in the low single digits" as the economy slows. Another leading fast-casual chain, Panera, showed a second-quarter spurt, with same-store sales up 6.5% in company stores.

▶***Bottom line:*** ***It's no longer just full-service restaurants that are having trouble keeping up traffic and check averages; as the economy contracts, the limited-service sector is also feeling the effects. But the persistence of growth in a few chains shows that they have cracked the subtle code of consumers' new value equation—something that's possible to achieve in any menu niche and at any price point.***

Chains Reporting Second Quarter 2008 U.S. Same-Store Sales (% up or down from Second Quarter 2007)*



** Calendar quarter; number of chains reporting varies each quarter*
*** Corporate units only*
Source: Public Company Reports

Q2 KEY FINANCIAL METRICS – PUBLIC COMPANIES

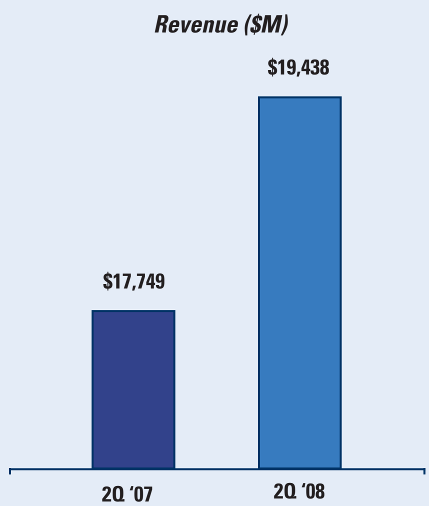
Public chains' revenues rose in the second quarter, but net income and margin rates are down. Technomic's weighted average for 71 chains reporting quarterly results (excluding McDonald's) showed topline revenues up a nominal 9.5% over year-before figures. Even if the figures are discounted by the inflation rate—latest figures show the Consumer Price Index for all items up 5.4% and that for food up 6.1% over the year before—the numbers indicate significant growth. Though many companies are having trouble maintaining same-store sales at last year's rate, chains continue to grow revenues by opening new units and selling franchises.

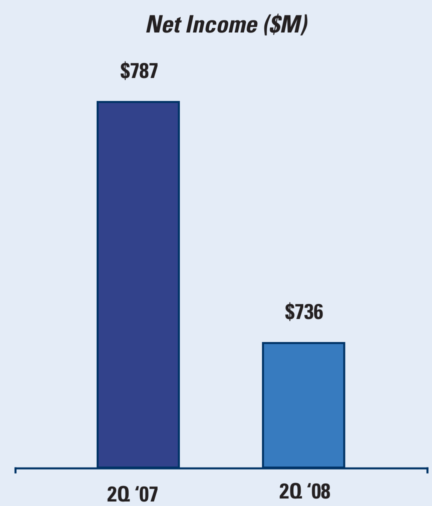
The chains' collective net income, however, was down by 6.4% from year-before figures. The bottom line is being impacted by higher commodity prices and weak customer traffic.

▶***Bottom line:* *Overall, public chain restaurants were still making money in the second quarter, though income and margins were down. A few standout chains pulled up sector averages in both full service and limited service, however, showing that solid management, savvy innovation and cautious growth can still pay off.***

Public Company Second Quarter 2008 Industry Summary Results*

	QUARTERLY REVENUES ($ M)			QUARTERLY NET INCOME ($ M)			MARGINS %	
	2008	2007	% CHANGE	2008	2007	% CHANGE	2008	2007
GRAND TOTAL – 72 companies								
LSR total – 34 companies	17,360.04	16,288.83	6.6%	1,707.13	(115.09)	N/A	9.8%	(0.7%)
Excl. McDonald's	*11,284.74*	*10,449.43*	*8.0%*	*516.63*	596.61	*(13.4%)*	*4.6%*	*5.7%*
FSR total – 38 companies	8,153.11	7,299.22	11.7%	219.69	190.09	15.6%	2.7%	2.6%
GRAND TOTAL	**25,513.15**	**23,588.05**	**8.2%**	**1,926.82**	**75.00**	**2469.1%**	**7.6%**	**0.3%**
Excl. McDonald's	*19,437.85*	*17,748.65*	*9.5%*	*736.32*	*786.70*	*(6.4%)*	*3.8%*	*4.4%*





* *Calendar quarter; number of chains reporting varies each quarter*
Source: Public Company Reports

ORGANIC GROWTH?

One of the hottest trends in foodservice in recent years has been the rapid growth of the organic and "all-natural" categories on menus. Technomic's MenuMonitor database, which tracks menu changes over time, shows a 40% increase in "organic" items listed between the first half of 2007 and the first half of 2008, while the number of chains menuing organic items rose by 17%. From 2004 to 2008, the number of organic items on menus almost quadrupled.

A significant and growing segment of consumers places value on organic and natural items. In a consumer survey conducted for the August 2008 issue of MarketBrief, 59% of consumers said they find organic foods appealing, and 43% said they order them in restaurants when they're available. In a comparable poll a year earlier, only 48% had said they find organic foods appealing.

Recent industry news confirms that the organic and natural trends are still growing. **Pizza Hut** is testing a line of Natural Pizzas, featuring a multigrain crust and toppings free from artificial flavors, colors or preservatives, including pepperoni, mushrooms, pineapple, green peppers, red onions and diced tomatoes. **ZPizza** announced that it would switch to organic flour for all of its pizzas. **Jason's Deli** added a Fresco Garden Pasta, made with organic spinach over bowtie pasta. **Silver Diner** opened its first **Metro Diner**, a small-format, fast-casual concept with better-for-you items such as organic greens. **Pomodoro** (formerly Pasta Pomodoro) added organic and natural items to its menu as part of its rebranding initiative; menus now include Fulton Valley free-range chicken, Niman Ranch beef, organic whole-wheat fusilli, and organic salads including Organic Mixed Lettuces, Organic Spinach and Organic Farro.

Entire restaurant concepts are now being developed or redeveloped around natural and organic foods. There's a growing niche of natural and organic burger concepts, including **Burgerville, Elevation Burger, Evos** and **O!burger**. Evos, based in Florida, uses naturally raised, hormone-free beef and natural Cheddar cheese. Virginia-based Elevation Burger builds its burgers from organically raised, grass-fed, free-range cows. O!burger in Hollywood, CA, claims that "buns, sauce, vegetables, meat, ketchup, mustard, fries and salad dressing all are completely organic."

STILL FRESH?

Recent developments in the food retail world, however, suggest that in financially perilous times, consumers may no longer be so willing to pay premium prices for organic and natural fare:

- **Whole Foods Market**, the retail leader in healthy foods, said it would slash 49 corporate positions as the company battles slowing sales. The company has also cut back on new store development. Meanwhile, in an attempt to battle its "Whole Paycheck" consumer perception, Whole Foods has launched a "Real Deal" national discount program for shoppers in search of lower prices on organic and natural foods, including a quarterly value guide with deals, coupons, recipes and meal plans. In-store "Real Deal" signage will alert shoppers on produce discounts.
- At the other end of the grocery price spectrum, **Wal-Mart** slowed down its development of the organic food category, abandoning previously announced plans to more than double the number of organic items available in stores. Instead, Wal-Mart is now emphasizing more locally sourced fruits and vegetables and the role of local sourcing in keeping produce prices affordable.

Are hard-pressed consumers still willing to pay more for foods that they believe to be higher quality? Restaurateurs have been betting both ways, continuing to seek quality innovations for which consumers will be willing to open their wallets—including more natural and organic items—while adding new value combos and deals to keep traffic coming in the door. McDonald's, for instance, is emphasizing both its Dollar Menu and its premium-priced fresh salads served with Newman's Own organic dressings.

HOW MUCH WILL CONSUMERS PAY?

It's difficult to answer the question of whether and how much to promote organic and natural foods in a slowing economy. Consumer research conducted for Technomic's recent Healthy-by-Design Foods Report helps restaurateurs analyze whether and how organic and natural foods will work on their specific menus.

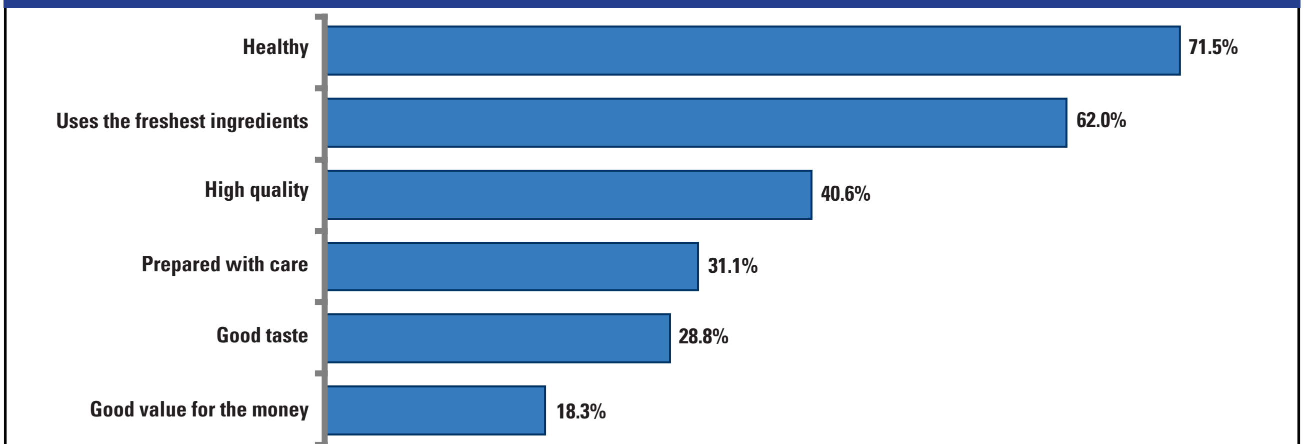
One of the most crucial findings was that only 18% of consumers see organic, natural and sustainable foods as "a good value." Consumers are aware that these products command price premiums of as much as 50% over the cost of conventional versions of the same foods.

In order to justify paying the premium, customers are seeking quality that surpasses that of conventional products. Most consumers describe quality as a combination of factors including healthfulness, freshness, appearance, flavor, texture, and consistency. For many consumers, organic and natural foods just don't represent a value equation they'll buy. Only 41% associate organic, natural and sustainable ingredients with a perception of quality.

For the most part, consumers recognize and accept that organic and natural products will cost more than conventional products. There seems to be a 10% to 15% premium threshold. In most categories, 80% of organic and natural consumers will not pay more than a 15% premium.

When Technomic asked non-users of organic or natural foods and beverages why they didn't consume these products, price was the central deterrent.

Thinking about items on a restaurant menu, which would you associate with natural, origanic and sustainable items?



Base: 1,161 respondents aged 18+
Source: Technomic Healthy By Design Consumer Trend Report

HEALTHY, YES—BUT TASTY?

Consumers see natural, organic and sustainable foods as healthy. Seven out of 10 survey respondents (71%) associate natural, organic and sustainable menu items with healthfulness, and nearly as many (62%) connect them with using the freshest ingredients. This is a powerful connection, since most consumers think their diets could be healthier. Natural and organic items are some of the strongest associations with "better for you" foods.

But consumers are not convinced that organic and natural foods taste good. Only 29% of respondents associate "good taste" with natural, organic and sustainable items. Before foodservice operators and suppliers can cash in on the organic and natural trend, there are significant challenges for R&D and the marketing department—or both.

DISSECTING THE MARKET

Interest in natural and organic foods varies by demographic segments. The research showed that:

- **Women** place significantly more importance on being able to select from a wide variety of natural, organic and sustainable food offerings when shopping for food or dining out, so marketing campaigns for "healthy" food categories may find greater success if targeted by gender.
- **Younger consumers** seem to have a stronger affinity for natural, organic and sustainable menu items. Even though older Americans have particular concerns about health and specific diet-related health issues, they may, in fact, represent the slowest adopters of organic and natural foods.

▶***Bottom line:*** ***Adding organic and natural foods to the menu is not a foolproof way to increase consumer perceptions of quality and value, particularly in a more difficult economic climate. These words still work their magic, but only with certain consumer segments, and only when marketed thoughtfully.***

BUSINESS-BUILDING IMPLICATIONS

- **Menu additions and marketing of organic and natural foods must be targeted to the right audiences.** These audiences include women, who place more value on these items and on healthful fare for themselves and their families. Younger consumers associate "healthy" fare with organic and natural ingredients to a much greater extent than do older consumers.

- **Trust is a major consideration.** As the foodservice channel expands its organic and natural offerings, consumers are skeptical. They're happy to see organic and natural offerings, but many would like to know more about the brands being used in foodservice kitchens and doubt that restaurants are actually using the ingredients stated on menus. Branding of organic and natural products in restaurants should be considered as one way to help consumers develop trust in menu items.

- **Consumers are confused about "natural" and "organic" and what they're willing to pay for.** The majority of consumers are misinformed about what constitutes an "organic" or "natural" product—either they have organic and natural definitions reversed, or they consider the two to be the same. Since criteria for organic products are government-defined and far more stringent, organic products cost more. The definition of "natural" is open to interpretation, and these products are not necessarily as expensive. (They are also more widely available to restaurants.) "Natural" products may appeal to a wider consumer demographic and meet less price resistance. Operators marketing organic products may need to include an educational component in their marketing plan.

- **Even a single organic item can add a "health halo" to the menu.** Examples include Jamba Juice's use of organic granola to top its breakfast smoothies, and McDonald's use of Newman's Own organic salad dressings. Bakery-café concept Le Pain Quotidien promotes the fact that it uses flour from certified organic farms for all of its signature sourdough breads.

- **Consider other menu terms that mean "healthy."** For the 78 million Baby Boomers, menu positioning of items as organic or natural may be lost in translation. If customers aren't sold on these foods as "better," the message is lost. Linking other positioning statements, such as "heart healthy," might increase the perceived relevance of natural and organic foods to these older consumers.

- **Operators in four categories are being heavily impacted by the trend to organic and natural foods.** These are upscale dining (where customers are less price-sensitive and independent operators strive for differentiation); fast-casual chains (with leaders such as Panera and Chipotle promoting natural and organic foods to differentiate themselves from fast-food restaurants); supermarket foodservice (with Whole Foods leading the drive for quality and variety in both dine-in and takeout fare); and colleges and universities (with 50% of colleges currently using these products, and strong student demand expected to drive usage to 70% by 2010).

About MarketBrief *Through* MarketBrief, *American Express provides chain restaurants with research-based analysis of key industry developments. Data is collected and analyzed by Technomic, Inc. Past issues of* MarketBrief *are available online at: www.technomic.com/operator/amexmarketbriefs. If you have questions, comments or topic suggestions, please contact Kimberly Perman at kperman@technomic.com or directly at (312) 506-3831.*

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