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## **Restaurants: Fear and Loathing at the Annual Restaurant Show**

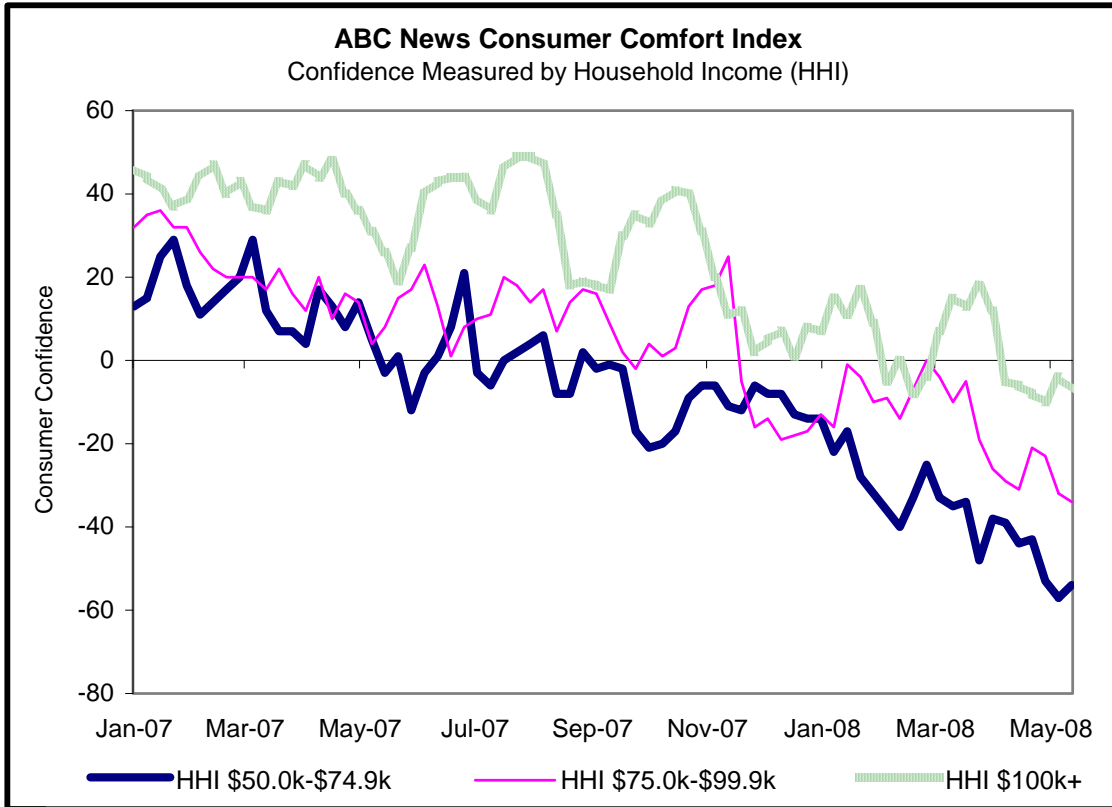
**Stephen Anderson**  
**Analyst, Restaurants**

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From our discussions with suppliers and vendors at the National Restaurant Association's annual trade show held in Chicago in late May, we sensed an almost uniform conviction that operators are getting squeezed by the "perfect storm" of high commodity prices and incremental fuel surcharges, reduced traffic counts resulting from high gas prices, and in some cases (particularly in bar-and-grill) oversupply of units. We think these pressures may have been too much as some of the vendors we saw at last year's show were absent altogether this year. Some vendors likened the current inflationary environment to the 1970s. In certain food categories, the environment may be worse today: whereas 30 year ago rising crop yields brought on by technological advances were enough to offset rising fuel and commodity costs, crop yields allocated to food are declining now because of ethanol mandates.

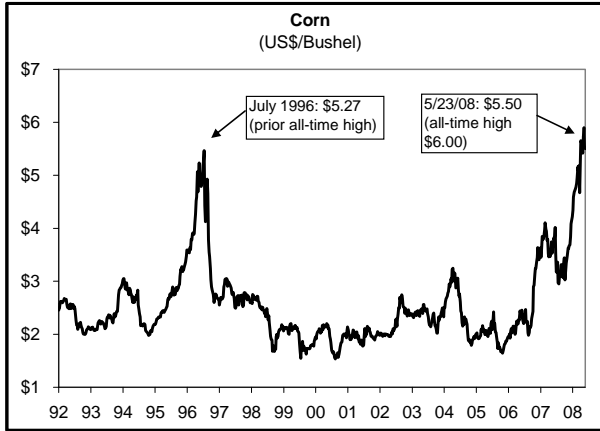
According to the vendors with whom we spoke, operators have found it necessary to be creative in dealing with these pressures. To control costs, some operators are switching to smaller plates and slightly smaller entrée portions (even if it is only by just one ounce), giving patrons the perception they still are getting value for their meal. Others are switching from fresh to frozen beef, chicken, and fish, while others are addressing inefficiencies in their supply chains by reducing the number of suppliers. To maintain sales and customer loyalty while preventing margin deterioration, proactive operators are increasing investment selectively in new product development and expanded beverage selections.

- **High gasoline prices are hurting consumer confidence at all income levels.** The weekly ABC News Consumer Comfort index shows consumer confidence at the lowest levels since the early 1980s. Even among higher-income households (\$100,000+), confidence has turned negative as consumers have become increasingly concerned about declines in their brokerage and retirement accounts, the loss in the value of their homes, and higher gasoline and utility bills which sap their discretionary funds. Given high consumer prices and the *perception* of declining wealth, we expect significant challenges for restaurants for the remainder of 2008.

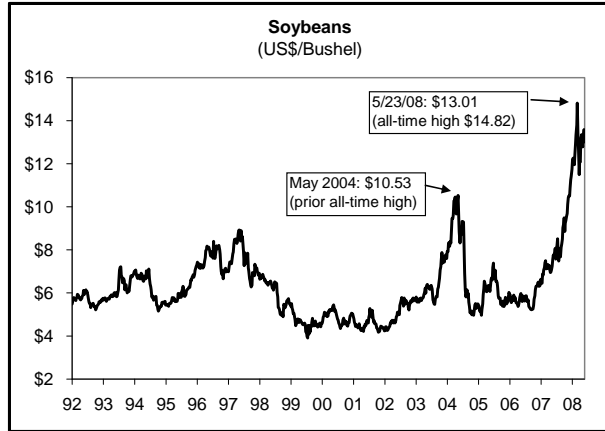


SOURCE: ABC News

- **The stimulus package is not translating to a bump for restaurants.** We perceive a greater propensity for middle-income and higher-income households to save their rebate checks than in 2001. Moreover, we think aggressive marketing by Wal-Mart (WMT, Not Rated) and other leading discounters to capture the government rebates will reduce the benefit that the stimulus checks have on restaurants compared with seven years ago.
- **Grain prices remain stubbornly high.** Increased demands from ethanol producers have pushed prices higher for not only corn, but also substitutes such as wheat and soybeans. Operators also told us they are experience greater cost pressures in derivative products such as high fructose corn syrup and soybean oil. As restaurant traffic remains soft, we think most operators are finding it difficult to pass along their customary 3%-4% menu price increases without losing additional customers.

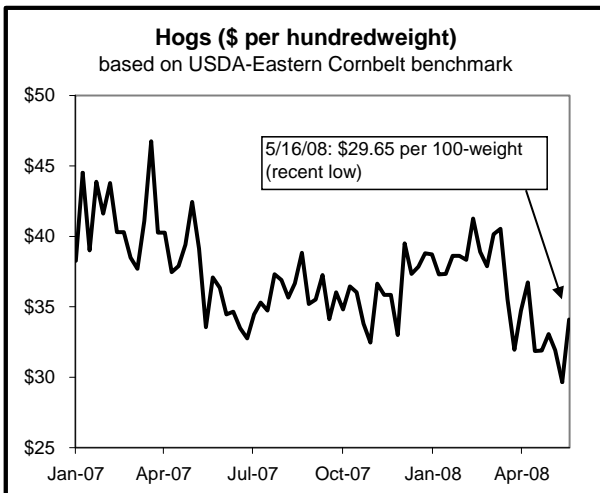


SOURCE: Bloomberg

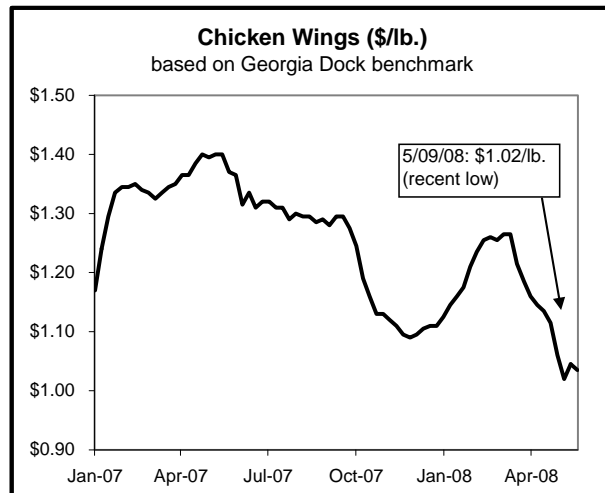


SOURCE: Bloomberg

- Livestock prices are poised to increase.** High feed costs are driving livestock producers to slaughter more animals. According to the U.S. Department of Agriculture (USDA), the number of hogs slaughtered year-to-date is up 10.8% through the week of May 23, 2008, and supplies of chicken also have increased amid rising corn prices. As these higher supplies are worked down, we expect livestock prices to rebound in 2H and continue rising into 2009 amid dwindling supplies. Given the pain currently being felt by producers, we think restaurant operators are unlikely to receive the favorable terms they received in recent years when their contracts are due for renewal. We also think operators highly leveraged to pork and chicken prices such as Bob Evans Farms (BOBE, NEUTRAL rated) and Buffalo Wild Wings (BWLD, NEUTRAL rated) are vulnerable in the next two to four quarters.



SOURCES: U.S. Department of Agriculture, MKM Partners



SOURCES: Bloomberg, MKM Partners

We think these consumer and commodity pressures are unlikely to relent much in 2H08. Although little can be done to change consumer sentiment or reverse rising prices, we consider operators with favorable economies of scale and efficient supply chains such as Darden Restaurants (DRI, BUY rated), and those reducing their operating exposure such as Denny's (DENN, BUY rated) and IHOP (IHP, Not Rated) will be best able to weather the impending storm. In contrast, we think independent restaurants and smaller chains without these economies of scale are more susceptible to these factors.

**RESEARCH COVERAGE UNIVERSE**

**Stephen Anderson - Restaurants/Casual Dining; sanderson@mkmpartners.com; (203) 987-4056**

Ticker	Rating	Price 5/31/2008	Mkt Cap (\$ Million)	12-Month Fair Value	Sales FY08E (\$ Million)	EPS (PF)	P/FCF	P/E	Sales FY09E (\$ Million)	EPS (PF)	P/FCF	P/E
BOBE	NEUTRAL	\$ 29.52	\$ 915	\$ 29	\$1,825.9	\$2.06	106.2	14.3	\$1,913.1	\$2.40	6.6	12.3
BWLD	NEUTRAL	\$ 33.98	\$ 605	\$ 28	\$404.5	\$1.35	106.2	25.2	\$494.5	\$1.57	17.2	21.6
CAKE	NEUTRAL	\$ 20.10	\$ 1,348	\$ 19	\$1,657.2	\$1.08	14.8	18.6	\$1,810.0	\$0.88	12.9	15.7
CHUX	NEUTRAL	\$ 11.36	\$ 249	\$ 10	\$963.1	\$0.69	3.6	16.5	\$997.6	\$0.88	3.4	12.9
CPKI	NEUTRAL	\$ 14.20	\$ 360	\$ 14	\$695.6	\$0.69	10.9	20.6	\$750.9	\$0.91	10.1	15.6
DENN	BUY	\$ 4.01	\$ 381	\$ 5	\$773.9	\$0.23	2.1	17.4	\$652.0	\$0.38	2.0	10.6
DRI	BUY	\$ 34.55	\$ 4,819	\$ 36	\$7,353.5	\$3.07	9.0	11.3	\$7,786.8	\$3.46	8.6	10.0
RT	NEUTRAL	\$ 7.71	\$ 399	\$ 7	\$1,391.2	\$0.63	12.4	12.2	\$1,374.2	\$0.66	4.4	11.7

(1) Current fiscal year for BOBE and DENN is FY09.

**Patrick McKeever - Discounters; pmckeever@mkmpartners.com; (313) 343-0423**

Ticker	Rating	Price 5/31/2008	Mkt Cap (\$ Million)	12-Month Fair Value	Sales FY08E (\$ Million)	EPS	Price/Sales	P/E	Sales FY09E (\$ Million)	EPS	Price/Sales	P/E
NDN	BUY	\$ 8.46	\$ 593	\$11.50	\$1,199.6	\$0.10	0.5	84.6	\$1,300.9	\$0.24	0.5	35.3
BIG	NEUTRAL	\$ 30.66	\$ 2,495	\$ 31	\$4,735.4	\$1.85	0.5	16.6	\$4,830.1	\$2.05	0.5	15.0
CTR	NEUTRAL	\$ 15.66	\$ 433	\$ 16	\$868.7	\$0.92	0.5	17.0	\$904.0	\$1.08	0.5	14.5
CTRN	NEUTRAL	\$ 19.25	\$ 271	\$ 20	\$513.3	\$1.20	0.7	16.0	\$600.5	\$1.45	0.5	13.3
DLTR	NEUTRAL	\$ 37.99	\$ 3,419	\$ 39	\$4,650.3	\$2.38	0.7	16.0	\$5,063.7	\$2.60	0.7	14.6
DSW	NEUTRAL	\$ 14.60	\$ 237	\$ 14	\$1,469.5	\$0.80	0.2	18.3	\$1,649.5	\$1.05	0.1	13.9
FDO	BUY	\$ 20.87	\$ 2,915	\$ 24	\$6,904.3	\$1.56	0.4	13.4	\$7,148.3	\$1.65	0.4	12.6
FRED	NEUTRAL	\$ 12.10	\$ 483	\$11.50	\$1,803.0	\$0.70	0.3	17.3	\$1,878.5	\$0.80	0.3	15.1
ROST	BUY	\$ 36.79	\$ 4,903	\$ 41	\$6,517.3	\$2.25	0.8	16.4	\$7,116.5	\$2.55	0.7	14.4
TJX	BUY	\$ 32.18	\$ 13,667	\$ 36	\$20,133.3	\$2.25	0.7	14.3	\$21,414.9	\$2.46	0.6	13.1

(1) Current fiscal year for FDO is FY08

**Linda Tsai - Apparel/Children, Tweens, and Teens; ltsai@mkmpartners.com; (203) 993-9372**

Ticker	Rating	Price 5/31/2008	Mkt Cap (\$ Million)	12-Month Fair Value	Sales FY08E (\$ Million)	EPS	Price/Sales	P/E	Sales FY09E (\$ Million)	EPS	Price/Sales	P/E
AEO	NEUTRAL	\$ 19.05	\$ 3,920	\$ 21	\$3,239.0	\$1.50	1.2	12.7	\$3,667.0	\$1.70	1.1	11.2
ANF	NEUTRAL	\$ 74.07	\$ 6,403	\$ 80	\$4,203.0	\$5.73	1.5	12.9	\$4,794.0	\$6.40	1.3	11.6
ARO	BUY	\$ 35.78	\$ 2,393	\$ 38	\$1,870.0	\$2.12	1.3	16.9	\$2,098.0	\$2.47	1.1	14.5
GYMB	BUY	\$ 47.42	\$ 1,350	\$ 55	\$1,042.0	\$3.19	1.3	14.9	\$1,164.0	\$3.67	1.2	12.9
PLCE	NEUTRAL	\$ 35.01	\$ 1,025	\$ 20	\$1,654.0	\$1.82	0.6	19.2	\$1,783.0	\$2.54	0.6	13.8
PSUN	NEUTRAL	\$ 9.56	\$ 678	\$ 10	\$1,382.0	\$0.59	0.5	16.2	\$1,342.0	\$0.71	0.5	13.5
TWB	NEUTRAL	\$ 20.64	\$ 511	\$ 21	\$1,128.0	\$1.81	0.5	11.4	\$1,237.0	\$2.03	0.4	10.2

**Richard Sherman - SOA Infrastructure/Technology; rsherman@mkmpartners.com; (203) 428-1300**

Ticker	Rating	Price 5/31/2008	Mkt Cap (\$ Million)	12-Month Fair Value	Sales FY08E (\$ Million)	EPS	Price/Sales	P/E	Sales FY09E (\$ Million)	EPS	Price/Sales	P/E
BCSI	(1) NEUTRAL	\$ 17.67	\$ 676	\$ 20	\$305.4	\$1.36	2.2	13.0	\$479.9	\$1.01	1.4	17.5
BMC	BUY	\$ 40.40	\$ 7,762	\$ 43	\$1,731.6	\$2.00	4.5	20.2	\$1,945.6	\$2.19	4.0	18.4
CA	(1) BUY	\$ 26.21	\$ 13,456	\$ 28	\$4,277.0	\$1.19	3.5	22.0	\$4,546.0	\$1.51	3.0	17.4
CTXS	BUY	\$ 34.44	\$ 6,321	\$ 41	\$1,638.8	\$1.61	3.9	21.4	\$1,937.8	\$1.95	3.3	17.7
FFIV	NEUTRAL	\$ 29.00	\$ 2,375	\$ 28	\$640.5	\$1.38	3.7	21.0	\$770.8	\$1.72	3.1	16.9
OPNT	NEUTRAL	\$ 9.61	\$ 196	\$ 10	\$101.4	\$0.02	1.9	480.5	\$119.9	\$0.21	1.6	45.8
PKTR	NEUTRAL	\$ 7.08	\$ 258	\$ 7	\$162.1	\$0.08	1.6	NA	\$179.9	\$0.21	1.4	33.7
QSFT	NEUTRAL	\$ 16.80	\$ 1,746	\$ 16	\$718.5	\$0.98	2.4	17.1	\$779.6	\$1.03	2.2	16.3

NOTE: All EPS estimates are pro forma unless marked with an \*, which indicates GAAP EPS

(1) FY08 results are actuals

Source MKM Partners

See last page for analyst certification and important disclosures

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