Turning the Tables:

A Menu for Success in a Tough Economy

By Todd L. Hooper, Partner

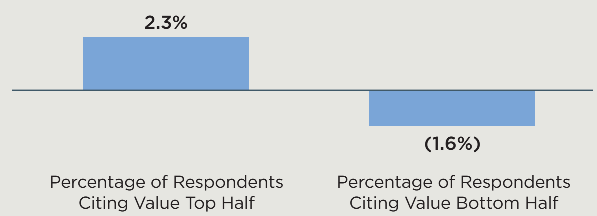
While many restaurant chains and foodservice distributors were braced for a continued slow-down in consumer spending, few fully anticipated the structural shift in consumer spending habits due to the unprecedented economic events of recent months. Credit-based consumption is out, and savings, debt reduction and value shopping are in. Consumers are de-leveraging and changing where and how they buy.

Between 1997 and 2007, the total consumer dollars available for spending from personal income, consumer credit and home equity increased an average of $372 billion each year. In 2008, total consumer dollars won't increase. They will actually drop an estimated $36 billion, and the downward trend is expected to continue into 2009. Based on this drop and recent inflationary pressure on non-discretionary items, Kurt Salmon Associates projects a decrease in discretionary spending of 3% to 6% in the next year. Further, as economic events continue to unfold, these projections may prove to be optimistic. This change in consumer behavior poses significant challenges for the foodservice industry.

Consider this: In our recently completed 2008 Retailer Brand Survey, KSA found that in the third quarter of 2008, restaurants that consumers recognized as having a strong value proposition experienced same-store sales growth of 2.3% above the category[1] average, while chains with a lower consumer rating on value had same-store sales growth of (1.6%) below the category. In this challenging economic environment, consumers are directing their foodservice dollars toward those restaurants that offer the most value.

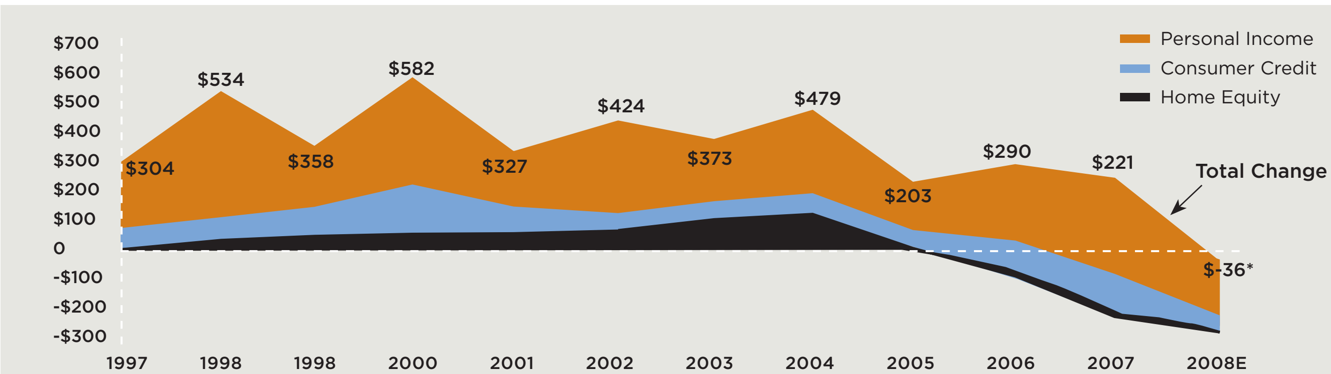
[1] Defined as quick-service and full-service restaurants

3Q2008 Median Same-Store Sales Growth Versus Category Average[1]



Note: Survey sample, n=25

Annual Change in Money Available for Consumer Spending ($ Billions, Real 2007 Dollars)



*Includes tax rebate income of $100 billion

In an environment of falling discretionary spending, foodservice operators will have to be more competitive. Based on KSA's work with leading chains, the companies that are best positioned to successfully emerge from this tumultuous period will be those that adopt the following five mandates:

> **Optimize value propositions**
> **Maintain brand integrity**
> **Leverage customer loyalty**
> **Manage costs aggressively**
> **Maintain liquidity**

Optimize value propositions

Given the current economic instability, consumers are eating at home more often. Still, restaurants offer real convenience in our time-crunched world. Eating out is built into the daily routines of millions of coffee drinkers and weekday lunchers and into the lifestyles of families, empty nesters and singles alike. Many of these occasions will continue, though people will be looking to spend less. Successful restaurant operators will need to highlight how they deliver value without destroying unit-level profit potential or brand positioning.

According to KSA's 2008 Retailer Brand Survey, when a customer advocates a restaurant because of a specific dish, 30% of the time it is because of a favorite side, dessert or drink.

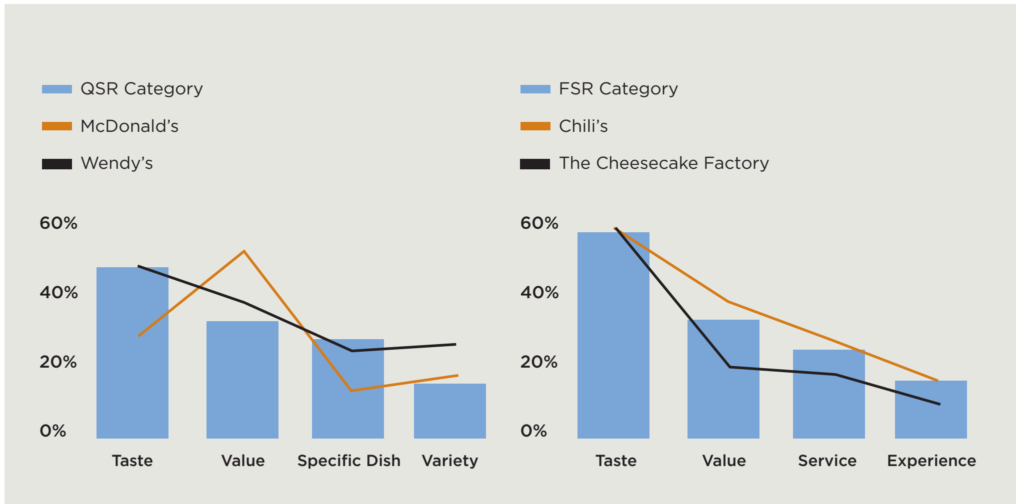
> **Take advantage of customers trading down.** Quick-serve restaurants (QSRs) need to take advantage of full-service restaurant (FSR) customers trading down by adding premium menu items that offer good value compared to an FSR meal, such as Burger King's new Steakhouse Burger. FSRs should highlight value-oriented entrees and broaden the selection of lower-priced items, as The Cheesecake Factory has done with its new value-oriented menu.

> **Maximize the power of sides.** Among QSRs, value menu items are well established, as are bundles that push up rings. Providing variety in these offerings, especially sides, is necessary to keep consumers coming back. FSRs, on the other hand, may benefit from unbundling salads and sides to allow consumers to manage their tabs.

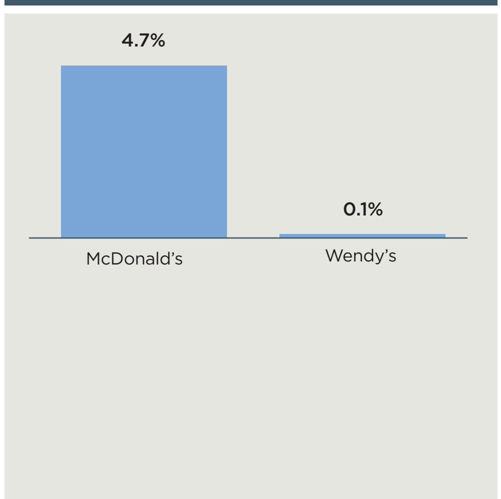
> **Entertain for value.** For some FSRs, the experience is an essential element. Accentuating the entertainment factor can drive strong value as budget-conscious consumers may need to cut back on other entertainment options, such as sporting events or concerts.

The importance of value perception can be seen in both the QSR and FSR segments. McDonald's and Chili's have established strong value perceptions among customers, resulting in third quarter 2008 same-store sales growth of 4.7% and 3.0%, respectively. This is well above category averages during the same period, which were 0.7% for QSRs and (3.2%) for FSRs. By comparison, Wendy's and The Cheesecake Factory have lower value perception among customers, contributing to lower same-store sales growth of 0.1% and (4.8%) for the same period.

Drivers of Advocacy for QSRs (Attributes as a Percentage of Responses)



3Q2008 Same-Store Sales Growth



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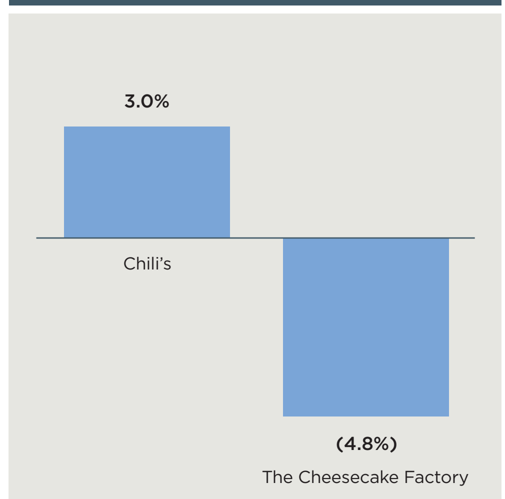

Maintain brand integrity

With so much pressure to drop pricing, it is easy to employ tactics inconsistent with the brand, such as competing on discounts or skimping on service or food quality. But this undermines the chain's brand equity and risks its long-run financial performance, particularly for those brands that are built primarily on taste and service rather than price.

Although the steps required to maintain the integrity must be aligned with each brand, there are a few lessons in enhancing value perception while maintaining the brand that apply across concepts.

According to KSA's Retailer Brand Survey, when customers strongly advocate a QSR, 29% of the time it is because of a specific dish.

The number of new products introduced in October 2008 was 40% higher compared to the previous year's monthly average. Of these, 36% were limited-time offerings.

KSA's Retailer Brand Survey shows that customers definitely care about service, as it is cited by 25% of advocates of full-service restaurants.

> **Change the mix; maintain the quality.** Failing to deliver expected product quality can be disastrous for a brand. Smarter approaches include adding new items that can hit lower price points with good margins. Rotating lower-price, higher-margin items to the front of the menu can also reshape the product mix and increase profitability.

> **Promote wisely.** Promotions, discounts and giveaways are completely consistent with the branding of many concepts. While the current economy favors such brands, these businesses still need to be careful. Engaging in discount wars to gain share can empty profit pools in the short-term and can cheapen the brand in the long-term. Brands for which promotions and discounts are less consistent on the face can still build special prices into their offerings. Promoting new day parts or occasions or new products for limited periods of time can add promotional buzz without indelibly discoloring the brand.

> **Increase prices if necessary.** Unfortunately, rising commodity prices are coinciding with greater demand for value from consumers. When the bottom line becomes unsustainably low, operators may need to make price increases rather than lowering the quality of the product or experience. While traffic may decline somewhat as a result, these price increases can be masked with promotional moves and may be a sound decision for brands with strong taste appeal and key menu items not available elsewhere.

> **Maintain the Q or the F.** Quick or full, the service that people expect is the service operators need to deliver. Consumers will not tolerate reductions to frontline staffing that risk these standards. That is not to say there are not concepts that can benefit from better staffing decisions. Hours of operation should also be reviewed, and the staff activity during slow periods must ensure maximum productivity.

Leverage customer loyalty

The people eating in your establishment today represent not just immediate revenue but are also the best source for future revenue. This is particularly important during economic contractions, when existing customers are most tempted to switch to another option. Every customer needs to be treated with that in mind.

According to KSA's consumer research database, convenience is the most commonly cited reason that consumers visit a restaurant frequently.

> **Reinforce routines.** Many foodservice purchases are regular if not daily in nature. These routines can be altered, however, by the economy or competitors. Loyalty programs permeate many aspects of consumers' lives and are a potent tool for restaurants. Offering savings through loyalty program rewards that are good for the next visit is a smart way to promote while ensuring customers return.

> **Increase convenience.** Make it easier for consumers to be loyal. This can be done by launching or improving online systems that facilitate customers' ordering and by making it easier to pay for take-out or curbside pickup. California Pizza Kitchen, for example, recently made online ordering available for all of its full-service restaurants.

> **Trump the competition.** Restaurant chains need to understand their competitive position trade-area by trade-area, including proximity to competitors and consumers, local category drivers, impact of traffic patterns and demographics. These insights can be used to strengthen loyalty and gain share through localized pricing, merchandising and promotional programs and to focus on those stores best positioned to take share from weakened competitors.

Manage costs aggressively

The pursuit of productivity improvements and expense reduction is often the mark of the best operators. When the top-line is pressured by macroeconomic factors, costs should be managed zealously.

> **Improve the basics.** Company-owned systems can aggressively pursue best demonstrated practices across units, markets and regions. Augmented by external benchmarks, these efforts can drive efficiencies and productivity in processes, including hiring, training, staffing, local marketing, add-on sales, delivery frequency and in-store yields (waste). As suggested earlier, menu management, labor scheduling, off-peak duties and hours of operation are also areas for potential cost savings. Franchise and company-owned systems can explore improved contract terms for food and paper given broader economic weakness.

> **Optimize marketing.** Too few chains measure their return on marketing investment, which can typically be calculated at a national, regional or market level for any campaign. The true returns associated with new products and new messages can also be measured. This analytical insight can be used to increase the impact of marketing investments or to reduce such spending while maintaining the impact on consumers.

> **Reduce overhead.** Even healthier companies are implementing "hiring frosts" across management while others have moved to reduce staffing. Spans of control can be flexed. Areas where redundancies may be addressed include development (assuming slowed new-store development) and traditional back-office functions that may have expanded during the recent period of growth.

Maintain liquidity

In uncertain times, capital is especially precious (for chains and, if applicable, franchisees). Various strategies can contribute to its conservation.

> **Focus on low-capital growth.** New units are important for penetrating and protecting existing markets, even in tough times. Smaller footprint formats often offer these benefits with less capital. Leveraging development partners' capital more aggressively can also ensure critical locations are secured even when capital is scarce. New equipment to enhance productivity should have short paybacks, and new equipment for new products should be limited to well-tested, high-impact introductions. Coffee shops have historically been leaders in this area, establishing low-capital formats such as kiosks. Larger format chains can consider scaled down opportunities in unconventional locations such as hospitals and airports, as well as combining multiple brands under the same roof.

> **Leverage the current economic environment.** Landlords will face difficult decisions in the coming years. The potential for all sorts of retail doors going dark is very high, and landlords have balance sheets of their own to worry about. Leases approaching renewal dates open opportunities to renegotiate a range of new terms, especially in mall locations.

> **Rationalize units.** A clear understanding of store economics, competitive landscape and proximity of core customers can identify store closure candidates. Knowing the drivers of store performance will help avoid closing stores that are underperforming because of poor execution despite an attractive location.

Preparing for Better Times

Foodservice was one of the first sectors hit by the recession, now officially having started in late 2007. Renewed stability for many concepts depends on both a recovery in traffic and improved margin structures.

Unemployment projections suggest that the sector needs to be prepared for tough times throughout 2009. Some concepts will not survive the downturn, though their demise has the silver lining of freeing up market share for the survivors.

Thus, a focus on costs is critical. Low costs not only help weather current conditions, but they also hold promise of strong margins when efforts to revive the economy kick in and push up consumer prices faster than commodities. This will likely precede the strong return of traffic and overall consumer demand, but this too will certainly happen.

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