Industry Focus

5 December 2008 | 36 pages

Restaurants

Restaurant Industry Initiation

- **Restaurant Initiation** — We are initiating coverage of the restaurant industry. We rate Burger King a Buy/Medium Risk (1M), McDonald's a Hold/Low Risk (2L), YUM! Brands a Hold/Medium Risk (2M) and Domino's Pizza a Hold/Speculative Risk (2S).
- **Secular Winds of Change** — In our view, much of the outsized growth in domestic dining out trends has largely passed, due to greater competition from non-traditional channels and moderation of growth in dual-income families.
- **Significant Longer-Term Int'l Opportunity** — The current domestic landscape is highly saturated, leaving little room for pricing power and unit growth. We feel int'l expansion, particularly into emerging markets, offers tremendous long-term growth opportunities as these areas are largely underpenetrated today.
- **Cautious Near-Term Outlook** — We are taking a cautious approach in the near-term given concerns regarding a global macro slowdown combined with commodity cost pressures. Additionally, we see potential risk from the strengthening dollar and tightening credit markets worldwide. We feel operators with large exposure to emerging markets may be at risk over the next few quarters.
- **Focus on Quick-Service** — We believe quick-service restaurants are best positioned in the long-run given greater international presence, higher mix of franchisee ownership and exposure to fast growth categories including breakfast and snacking. In the near-term, QSR's focus on value and convenience could help them navigate through the present environment.

Gregory R Badishkanian
+1-212-816-2720
gregory.r.badishkanian@citi.com

Jeffrey Hans
jeffrey.hans@citi.com

Alvin C Concepcion
alvin.c.concepcion@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

Initiating Coverage of Restaurants

We are initiating coverage on 4 restaurant companies in the quick-service category, Burger King with a Buy / Medium Risk (1M) rating, McDonald's with a Hold / Low Risk (2L) rating, YUM! Brands with a Hold / Medium Risk (2M) rating and Domino's Pizza with a Hold / Speculative Risk (2S) rating. We believe the quick-service restaurants are well positioned over the long-run, given their broad daypart exposure, focus on value and convenience, highly franchised business models and solid international exposure.

In our view, Burger King is the best positioned QSR operator going forward, as it rates most favorably on a number of important criteria, including moderating commodity costs over the next 12 months, fairly minimal exposure to international markets, which could begin to soften, a strong domestic value platform, and solid long-term growth characteristics. Additionally, we anticipate Burger King will outpace its key competitors in terms of both sales and EPS growth over the next several years. We have performed risk/reward analysis for each of our companies to help quantify downside risk and upside potential.

Risk/Reward Most Favorable for Burger King

As seen below, our bear case scenario for Burger King assumes a (-3%) SSS decline versus our current base case modeling of 1% SSS growth. This would equate to EPS of $1.55 versus our current estimate of $1.85. If we apply a 12x multiple to our bear case EPS estimate, this would yield a potential downside target of $18.60, or (-9%) from current levels. Currently, the market appears to be pricing in this type of scenario for the company. However, if Burger King generates SSS growth of 5% (equating to EPS of $2.02) we believe a higher multiple of 15x would be warranted, yielding a potential target of roughly $30 (48% upside).

Figure 1. Burger King Risk/Reward

	Bear	Base	Bull
SSS	(3.0%)	1%	5%
Calendar '10 EPS	$1.55	$1.85	$2.02
Target P/E	12.0x	14.1x	15.0x
Potential Target	$18.60	$26.09	$30.30
% Upside/Downside	(9.3%)	27.2%	47.7%

Source: Citi Investment Research

As seen below, our bear case scenario for McDonald's assumes a (-3%) SSS decline versus our current base case modeling of 1% SSS growth. This would equate to EPS of $3.78 versus our current estimate of $4.12. If we apply a 12x multiple to our bear case EPS estimate, this would yield a potential downside target of $45.36, or (-25.4%) from current levels. Currently, the market does not appear to be pricing in this type of scenario for the company. As such, we believe the market may be anticipating our current bull case scenario, which implies no slowing in business momentum. Our bull case assumes SSS growth of 5% and EPS of $4.37 and if we apply McDonald's current forward year P/E to the $4.37 estimate this would yield a potential target of $70, or roughly 15% upside from current levels.

Figure 2. .McDonald's Risk/Reward

	Bear	Base	Bull
SSS	(3.0%)	1%	5%
Calendar '10 EPS	$3.78	$4.12	$4.37
Target P/E	12.0x	15.3x	16.0x
Potential Target	$45.36	$63.04	$69.92
% Upside/Downside	(25.4%)	3.6%	14.9%

Source: Citi Investment Research

As seen below, our bear case scenario for YUM! Brands assumes a (-3%) SSS decline versus our current base case modeling of 1% SSS growth. This would equate to EPS of $1.94 versus our current estimate of $2.35. If we apply a 10.5x multiple to our bear case EPS estimate (roughly in-line with its 5-year trough), this would yield a potential downside target of $20.37, or (-26.5%) from current levels. Currently, the market does not appear to be pricing in this type of scenario for the company. If YUM! Brands generates SSS growth of 5% (equating to EPS of $2.53) we believe a higher multiple of 13.5x would be warranted, yielding a potential target of roughly $34 (23% upside). However, given our concerns regarding a global macro slowdown and its potential impact on emerging markets we would view the bull case scenario as highly unlikely.

Figure 3. YUM! Brands Risk/Reward

	Bear	Base	Bull
SSS	(3.0%)	1%	5%
Calendar '10 EPS	$1.94	$2.35	$2.53
Target P/E	10.5x	12.3x	13.5x
Potential Target	$20.37	$28.91	$34.16
% Upside/Downside	(26.5%)	4.3%	23.3%

Source: Citi Investment Research

As seen below, our bear case scenario for Domino's assumes a (-3%) SSS decline versus our current base case modeling of flat SSS growth. This would equate to EPS of $0.56 versus our current estimate of $0.82. If we apply a 4.0x multiple to our bear case EPS estimate (roughly in-line with its 5-year trough), this would yield a potential downside target of $2.24, or (-36%) from current levels. Currently, the market does not appear to be pricing in this type of scenario for the company. If Domino's generates SSS growth of 3% (equating to EPS of $0.86) we believe a multiple of 5.5x would be warranted (in-line with our base case multiple), yielding a potential target of roughly $4.73 (36% upside). We believe the bull case for Domino's is unlikely as the company is attempting to turnaround its domestic operations in an extremely challenging domestic operating environment.

Figure 4. Domino's Risk/Reward

	Bear	Base	Bull
SSS	(3.0%)	0%	3%
Calendar '10 EPS	$0.56	$0.82	$0.86
Target P/E	4.0x	5.5x	5.5x
Potential Target	$2.24	$4.51	$4.73
% Upside/Downside	(35.6%)	29.6%	35.9%

Source: Citi Investment Research

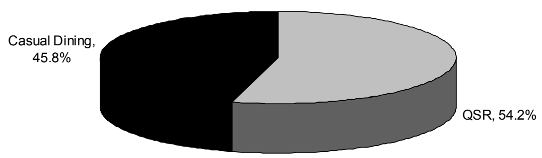
A View from Above: Restaurant Industry Overview

The domestic restaurant category has generated low to mid-single digit sales growth annually over the past 15 years, down from the high single digit range previously, owing largely to shifting demographic trends and intensified competition. More recently, the sluggish domestic macro environment combined with an unprecedented rise in food cost inflation has presented the industry with one of the worst operating environments in its history.

Industry Components

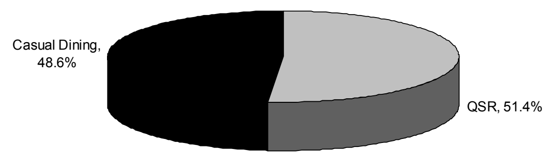
The domestic restaurant industry is highly competitive with close to 600,000 restaurants generating ~$365 billion in sales during 2007, according to industry consultancy Technomic. Large chains dominate the landscape from a sales perspective, as the top 100 chains accounted for ~53% of total sales last year, despite operating less than one-third of total domestic units. The industry can be broken down into three broad categories: quick-service restaurants (QSR), fast casual (segmented under QSR) and casual dining. As seen below, QSR has a slightly greater share of both sales and units domestically, which has been the case over the past several years. Below we outline additional differentiating points among the restaurant categories:

Figure 5. Restaurant Category Market Share by Units; 2007



Source: Technomic

Figure 6. Restaurant Category Market Share by Sales; 2007



Source: Technomic

- **Quick-service restaurants**, more commonly known as fast-food, offer the lowest price points of all restaurants, with an average check at or below $7.00. Customers have the option to dine-in, take out or use the drive-thru, though we note the vast majority of sales are typically drive-thru. QSR operators generally have a higher mix of franchisee ownership versus the other categories and are, in general, further along in terms of international expansion as well. Three of the top five largest QSR players (McDonald's, Burger King, and Wendy's) fall within the Hamburger segment and cumulatively account for ~33% of total QSR sales.

- **Casual dining restaurants** offer the highest price points, with a minimum average check of at least $14, though it can range as high as $50 at more upscale eateries. Customers typically dine-in or take-out and the majority of sales (estimated at roughly two-thirds) are during the dinner daypart. Most casual dining restaurants serve alcohol and also offer wait-staff service. In general, the majority of casual dining concepts are company-owned and have very limited international exposure. From a sales perspective, in 2007 the three largest companies were Applebee's (~$4.5 billion), Chili's Bar & Grill (~$3.7 billion), owned by Brinker International, and Olive Garden (~$2.9 billion), owned by Darden Restaurants.

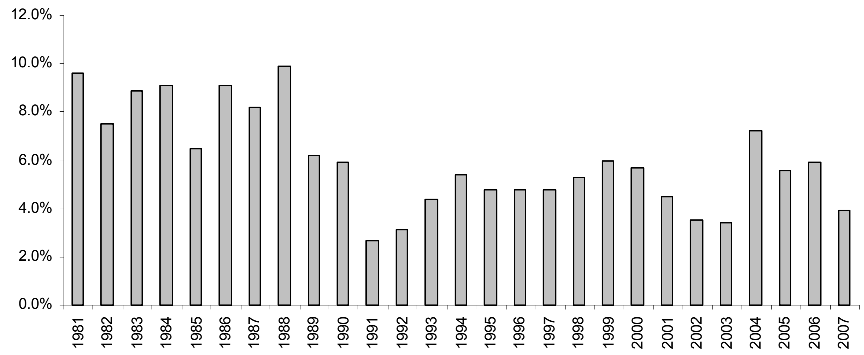
- **Fast casual restaurants** fall somewhere in between the other two categories in terms of price points, and are generally focus on higher quality food offerings (including using natural and organic ingredients). Sales are skewed more towards the lunch and dinner dayparts and customers typically dine-in or take out. There is slightly more franchisee ownership of fast casual concepts versus casual dining, though not to the degree of QSR. The category has exhibited sales and unit growth in the low double digit range over the past several years, easily outpacing that of QSR and casual dining. While we partially attribute this to growing off a small base, we believe the segment does have some staying power as consumers have shown a willingness to pay more for higher quality (relative to QSR). Additionally, fast casual offers similar quality for greater value compared to casual dining.

Industry Overview

Restaurants operate in a highly saturated marketplace domestically, which is a limiting factor for meaningful expansion opportunities and pricing power for many operators. Not only has competition intensified from the advent of new restaurant categories (i.e. fast casual), but non-traditional channels such as supermarkets and wholesale clubs have also begun encroaching the segment with more prepared food offerings.

In our view, a highly competitive landscape combined with changing demographic patterns has driven a moderation in restaurant sales growth over the past two decades. As seen below, annual restaurant sales growth averaged ~8.1% throughout the 1980's, though decelerated to less than 5% from 1991-2007.

Figure 7. Annual Restaurant Sales Growth

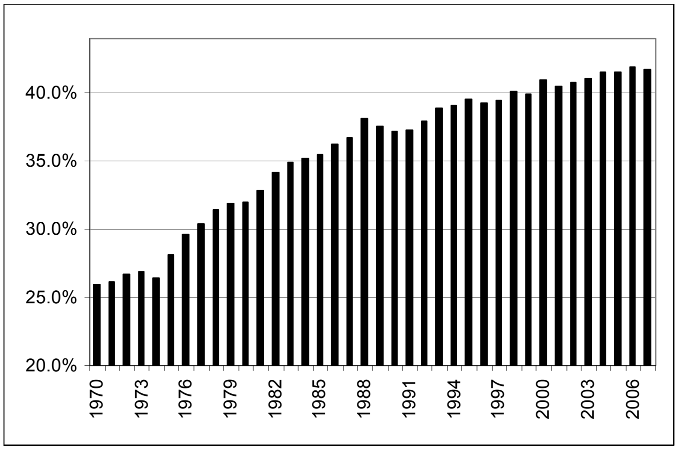


Source: Technomic

Shifting Demographic Trends – Outsized Growth Unlikely

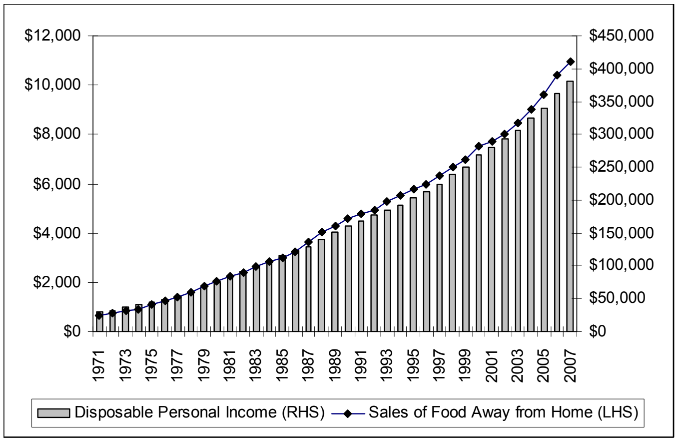
Over the past 10-15 years U.S. consumers have allocated approximately 40% of their food expenditures on food away from home. This is a marked difference from the 1960's and 1970's when consumers, on average, spent nearly 20-30% on food outside of the home. We attribute this increase to a number of factors including increased time constraints among families and rising disposable income levels, among others. We acknowledge, however, that going forward food spend away from home is unlikely to deviate much from the 40% range, owing largely to a number of secular challenges faced by restaurants including heightened competition, a less rapid increase in the number of dual income families and higher menu prices (to offset continued labor and food cost inflation) for the foreseeable future, in our view.

Figure 8. Food Spend Away from Home as % of Total Food Expenditures



Source: Economic Research Service

Figure 9. Personal Disposable Income vs. Food Sales Away from Home



Source: Economic Research Service

As seen above, food sales away from home have increased fairly consistently since the 1970's, coinciding with strong disposable income growth. This is an important distinction to make, as disposable income is a measure of after-tax dollars available to consumers and in our view is highly relevant for restaurants. As individual income levels have increased, consumers began to allocate a greater proportion of their wallet to dining out.

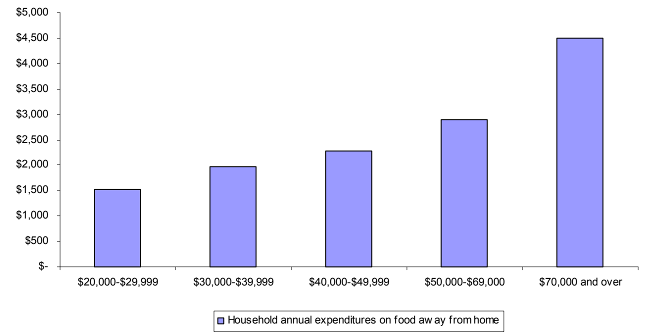
This point can be further illustrated when looking at the average household expenditure on food away from home. From 1986 to 2006 the number of households earnings $75,000 or more increased from 23% to more than 30%. Interestingly, these households have historically allocated the greatest amount of spending on food away from home.

Figure 10. Median Household Income

	1986	2006
Less than $10,000	9.3%	7.5%
$10,000-$24,999	19.4%	17.7%
$25,000-$34,999	11.8%	11.5%
$35,000-$49,999	16.2%	14.6%
$50,000-$74,999	20.2%	18.2%
$75,000 and over	23.2%	30.4%

Source: Census Bureau

Figure 11. Annual Household Expenditure on Food Away from Home



Source: Census Bureau and National Restaurant Association

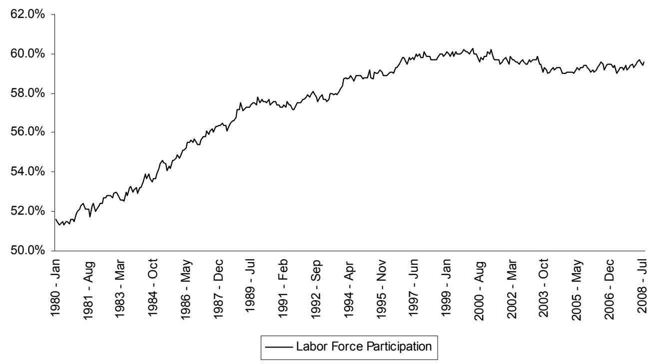
In addition to rising disposable income, we believe increased time constraints and a desire for greater conveniences were also critical in driving the sharp increase in food away from home sales throughout the 1980's and early 1990's. In our view, this is primarily attributable to the rapid growth of women participation in the labor force. From the early 1980's through the 1990's there was meaningful increase in the number of women workers domestically (i.e. labor force participation of women went from roughly 51% to nearly 60% over this period). This, in turn, drove a relatively sharp uptick in the number of total weekly hours worked for men and women combined. With families leading busier lives and earning more dollars there was less time being dedicated to food preparation and a greater incidence of families dining out. This trend has apparently continued through today. A recent survey conducted by Roper stated that nearly 75% of Americans have no idea what they would feed their family for dinner at 4:30 pm on an average day.

While there are still a relatively large number of dual-income families, the trend has leveled out. As seen below, the percentage of women participating in the labor force has been flat to down since the late 1990's. This has coincided with a stabilization of the number of weekly hours worked. At the same time food away from home sales as a percentage of total food expenditures has also been fairly constant, trending in the low 40% range over that same period. In our view, the large outsized gains in weekly hours worked has passed and thereby will likely have a minimal impact on restaurant spending trends going forward, in our view.

Figure 12. Average Weekly Hours Worked; 1976-2007

Source: Citi Investment Research

Figure 13. Women Participation in the Labor Force; 1980-Present

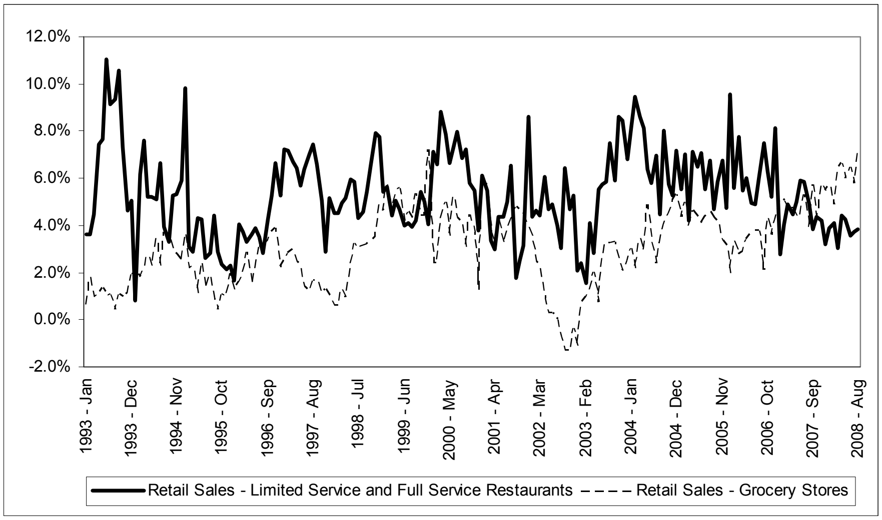


Source: Citi Investment Research

Another shifting demographic trend that restaurants are faced with is the intensifying competitive environment, particularly from non-traditional players such as supermarkets. Specifically, supermarkets have been gaining significant traction with more prepared food offerings. A recent survey by the Food Marketing Institute showed the number of grocery stores featuring prepared/freshly made food increased from ~37% in 2007 to more than 50% in 2008. In our view, these offerings have a greater perceived value (i.e. high quality at more appealing prices) than dining at a restaurant in the mind of consumers.

As seen below, sales at grocery stores have recently outpaced that of restaurants by their widest margin in at least 15 years. While some of this may be attributable to consumers curtailing discretionary spending on dining out, we argue that the supermarkets are also benefiting to a degree from greater sales of prepared foods. From a timing standpoint this has worked out quite well for supermarkets, as they were already seeing increased traffic from consumers trading out of the restaurant category altogether. In our view, if supermarkets can continue to gain traction with prepared foods they could prove to be a formidable competitor even after the current macro environment stabilizes.

Figure 14. Retail Sales – Limited Service and Full Service Restaurants vs. Grocery Stores



Source: Haver Analytics

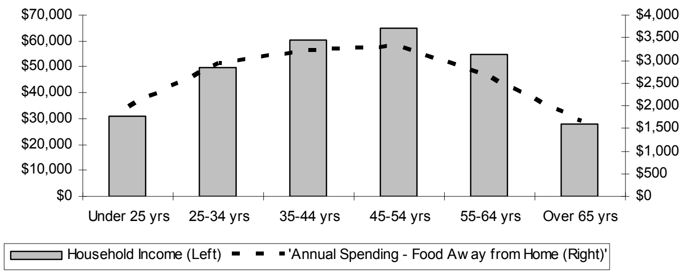
Favorable Secular Trends

As we look ahead, we expect modest annual rates of growth in domestic restaurant sales, driven largely by overall population growth, the wealthy baby boomer segment and the expanding echo boomer generation. In addition, we see an enormous opportunity for growth internationally, which a number of major U.S. chains have already begun tapping into.

Future U.S. Growth May Hinge on Baby Boomers and Gen Y

The baby boomers are the wealthiest generation in U.S. history, and we believe could continue to spend well into retirement. The U.S. Census Bureau currently forecasts that by 2030, baby boomers will control approximately 40% of the nation's disposable income. Importantly, many individuals in this segment have indicated that even once they reach retirement age they still plan on working in some sort of capacity. According to research from GE Franchise Finance, approximately 60% of baby boomers must continue to work to maintain their existing lifestyles, and with baby boomers presently spending more per person on restaurant meals than any other age group (according to the National Restaurant Association), we believe this bodes extremely well for restaurants.

Figure 15. Median Household Income vs. Food Spending Away from Home; 2006



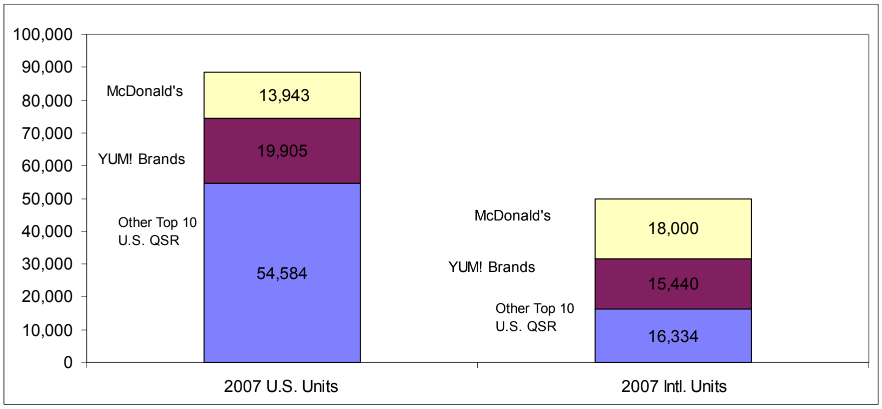
Source: Bureau of Labor Statistics

In addition to baby boomers, we believe future restaurant growth will also be supported by the echo boomers (Gen Y) demographic. These individuals are the children of the baby boom generation and presently account for ~25% of the entire U.S. population. Gen Y-ers have exhibited a high propensity for consuming food away from the home. While echo boomers earn among the lowest levels of income relative to other age groups, they allocate a greater percentage of their food spending on dining out (close to 50%). Individuals in this age bracket are viewed as core customers to the QSR category. As such, we believe QSR operators have a great opportunity to continue building high brand relevance in these consumers' minds in order to keep these individuals loyal to the category as they grow older.

Massive International Opportunity

Finally, as we look outside the U.S. we see a significant opportunity for restaurant companies to expand their footprint in what is a generally underpenetrated global market. The international landscape is largely untapped in terms of global restaurant chains. Outside of YUM! Brands and McDonald's, the other top 10 QSR operator's international presence is approximately one-third of their domestic exposure. As such, we see a potentially long runway for chain unit growth overseas in the years ahead.

Figure 16. QSR Unit Breakout; Domestic vs. International



Source: YUM! Brands Company Reports and Technomic

Note: Top 10 QSR includes Burger King, Wendy's, Subway, Arby's, Domino's, Hardee's, Jack in the Box, Papa John's, Popeye's, and Sonic

In our view, one of the biggest opportunities for restaurant expansion is in China. Mainland China has a total population of 1.3 billion and an urban population alone of 500 million, which is already well above the U.S. (~300 million). Additionally, recent Chinese government studies imply that the middle class in mainland China has reached approximately 250 million, which is equivalent to the total U.S. population in 1990.

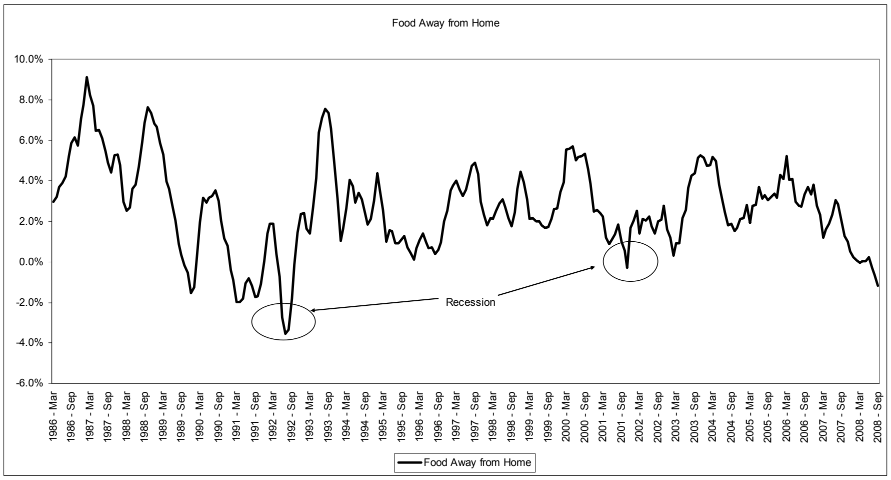
Importantly, western-style restaurants continue to become more prevalent in developing countries, such as China, given the rapid growth in the number of both urban and dual-income households. According to Euromonitor, foodservice industry sales in China almost tripled from 2001 to 2006, growing from $4.6 billion to $12 billion (+21.3% CAGR). Additionally, urban disposable income growth has maintained at least 10% growth annually over the past three years, according to the National Bureau of Statistics of China. We believe this bodes well for future restaurant sales growth, assuming as income levels increase more dollars will be spent on dining out, similar to trends in the U.S.

To get a sense of the potential market opportunity, we looked at YUM! Brands and McDonald's current exposure and compared it to their domestic presence. Specifically today in the U.S., YUM! Brands operates nearly 66 restaurants per million people (a total of ~20,000 domestic units with a population of ~300 million) versus ~2.4 restaurants per million people in China (a total of ~3,100 restaurants in China with a population of ~1.3 billion). Meanwhile, McDonald's operates roughly 47 restaurants per million people in the U.S. compared to less than 1 per million people in China. Keep in mind these two operators are meaningfully larger than any other multi-national chain in the country. As such, we believe the market opportunity is massive.

Current Factors Affecting the Industry

While we see a number of favorable long-term secular trends for the industry, there is no doubt that the current environment could be among the most challenging ever faced by restaurant operators. Key input costs including labor and wages remain stubbornly high and softening consumer trends and menu price increases continue to weigh on traffic growth. All in, these factors have combined to dampen restaurant sales and profitability over the past 12-18 months and reduce visibility in the near-term as well. As seen below, real sales of food away from home recently slid to their lowest level since the consumer-led recession of the early 1990's.

Figure 17. Real Sales of Food Away from Home (Y/Y Change)

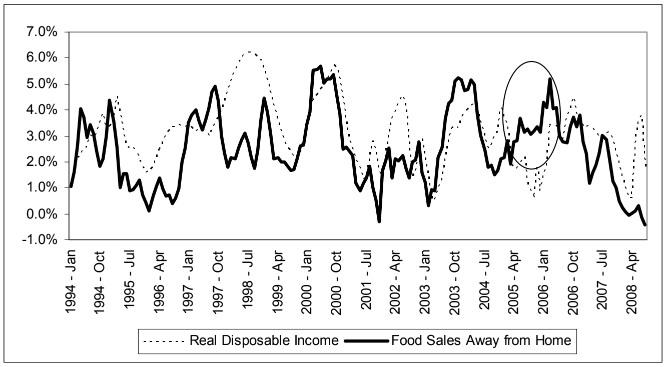


Source: Haver Analytics

Macro Trends Weighing on Results

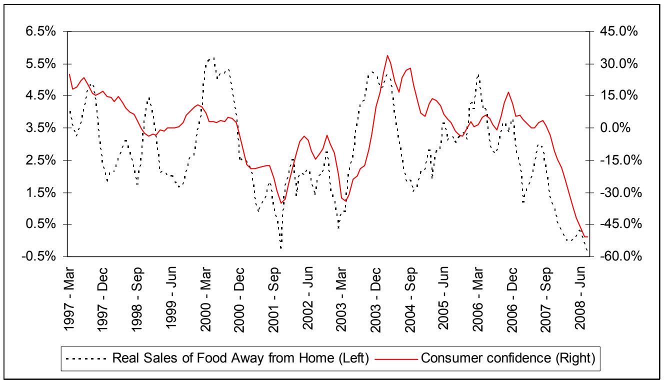
In our view, consumer confidence has historically been a good barometer for overall restaurant industry sales. As seen below, the directional change in consumer confidence has tracked fairly closely with changes in spending on food away from home (correlation of 0.63). As such, issues such as disposable income, employment, and wage growth have all been important factors influencing consumer's decision to dine out.

Figure 18. Real Disposable Income vs. Real Food Sales Away from Home – 3 Month Rolling Average



Source: Citi Investment Research

Figure 19. Real Sales of Food Away from Home (Y/Y) vs. Consumer Confidence (Y/Y) – 3 Month Rolling Average



Source: Citi Investment Research

We believe present macro pressures are showing minimal signs of abating. While gasoline prices have moderated, employment continues to worsen, credit markets remain tight and retail sales are weakening. This comes at a time when other industry-specific challenges have mounted, including intensifying competition from non-traditional channels and restaurants ability to offset higher labor and food costs.

Additionally, we believe that housing market woes will continue to weigh on consumer trends. As seen above, during 2005 and 2006 growth in food sales away from home outpaced disposable income growth by a fairly wide margin. This marked the longest period of time and the widest margin of outperformance over at least the past 10 years. We attribute this to the housing-related bubble that formed throughout the U.S., creating a perceived level of wealth for many individuals. This trend has already reversed, coinciding with the decline in the housing market, and could have further to go, in our view, depending on the length and severity of the housing market correction and its implications on financial conditions.

Food and Labor Costs Remain Burdensome

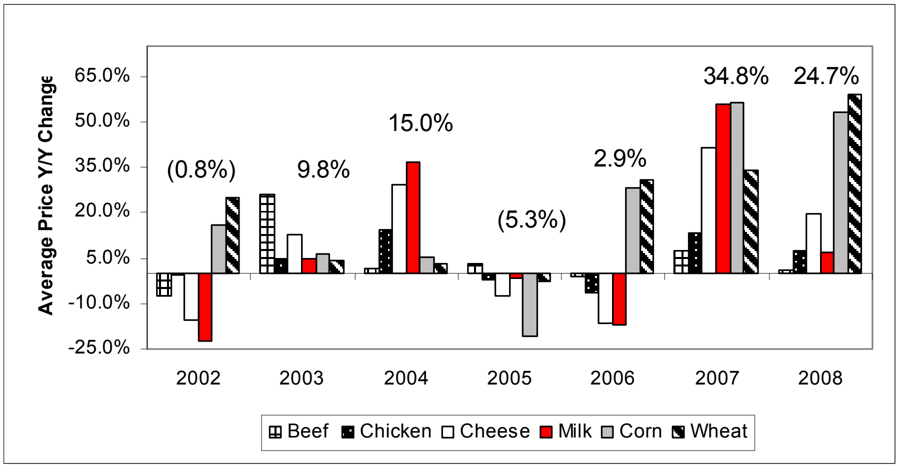
As mentioned earlier, food and labor cost inflation together have weighed on restaurant operators profitability. We believe these two components combined account for slightly less than two-thirds of overall costs for most restaurants, and as such, are critically important.

We attribute the rise in food costs to the secular shift in worldwide demand for grains and oilseeds. Specifically, domestic provisions that require massive amounts of corn-based ethanol have had multiple implications throughout the agricultural commodity universe. With greater amounts of corn being utilized for ethanol, there is a meaningful scarcity of worldwide corn used for consumption (i.e. animal feed). Additionally, with greater acreage (particularly in the U.S.) dedicated to corn plantings this has led to a shortage of other key crops, such as soybeans. Tight global inventories combined with robust demand for proteins and other key agricultural commodities have translated into unprecedented food cost inflation on a worldwide basis.

As seen below there has been a clear upward bias in many of the key commodities utilized by restaurants either directly or indirectly (i.e. corn is used for animal feed). In our view, this could be more of a secular shift than a cyclical upturn, and as a result, we believe both restaurants and consumers could have to deal with stubbornly higher food costs in the years ahead.

We note, however, that many soft commodity prices and crude oil are well off of their peaks experienced back in July. We attribute this to a number of factors including the strong U.S. dollar and concerns about a global recession. In our view, these issues could continue to weigh on commodity prices in the near-term, which we believe would be a positive for those companies negotiating contracts for 2009, particularly as comparisons begin to ease. With that said, however, we are taking the approach that the recent pullback is temporary and that food costs in 2009 will be at best flat versus 2008 levels.

Figure 20. Key Commodity Costs; 2002-2008



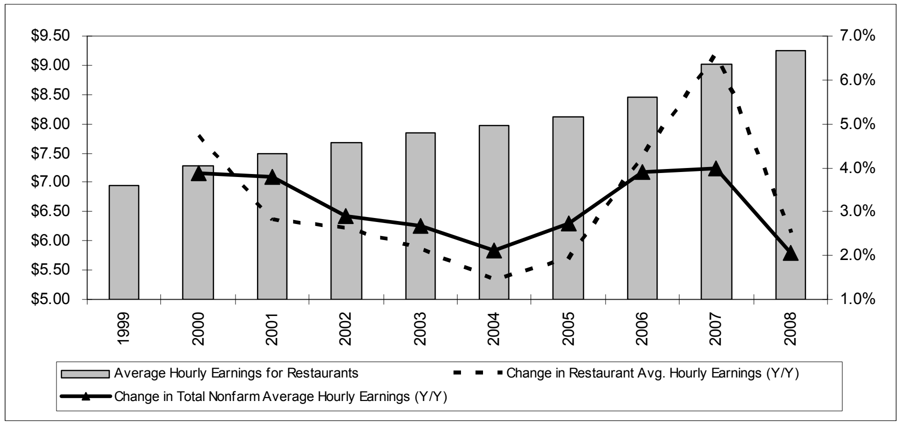
Source: Citi Investment Research and Foodservice.com

Note: 2008 data is as of October 31, 2008

Note: Stated values are an average of all the commodities

The restaurant industry has experienced fairly steady increases in labor costs over the past several years. As seen below, while restaurant wage inflation has generally trended below total nonfarm wage inflation through the early 2000's, this trend has reversed from 2006 through the first half of 2008. The federal minimum wage rate is anticipated to increase again during the summer of 2009 for the third time in as many years as part of the recently revised Fair Labor Standards Act. Interestingly, on a state by state basis, the U.S. Department of Labor is currently forecasting that nearly 20 states will be raising their minimum wage rates by upwards of 20% over the next 12 months. As such, we see higher wages remaining a potential headwind for many multi-chain operators.

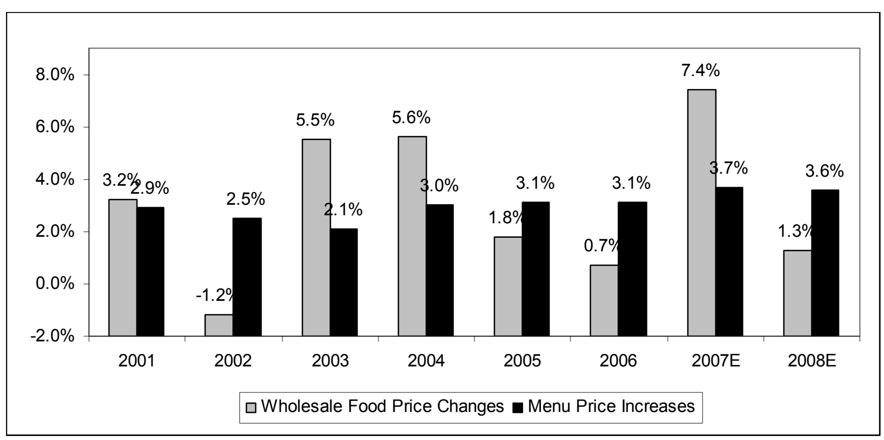
Figure 21. Average Hourly Earnings for Restaurants



Source: Bureau of Labor Statistics

Many investors have questioned whether restaurant trends are being impacted most by either cost inflation or the lethargic consumer environment. While there is no simple answer, we argue that in a normalized macro environment restaurant operators would at least be in a better position to offset cost inflation with sales leverage from traffic growth in addition to menu price increases. Restaurants have been fairly aggressive in raising prices throughout 2007 and according to the National Restaurant Association this trend will likely continue through the foreseeable future. As seen below, restaurants raised menu prices by 2.8% on average from 2001-2006, more than covering the 2.6% average increase in wholesale food costs during that period. However, with food costs estimated to have risen 7.4% in 2007 and another increase of 1.3% expected in 2008, it could be years before restaurant operators recapture these costs (keep in mind this does not factor in wage inflation).

Figure 22. Menu Price Increases vs. Wholesale Food Cost Increases



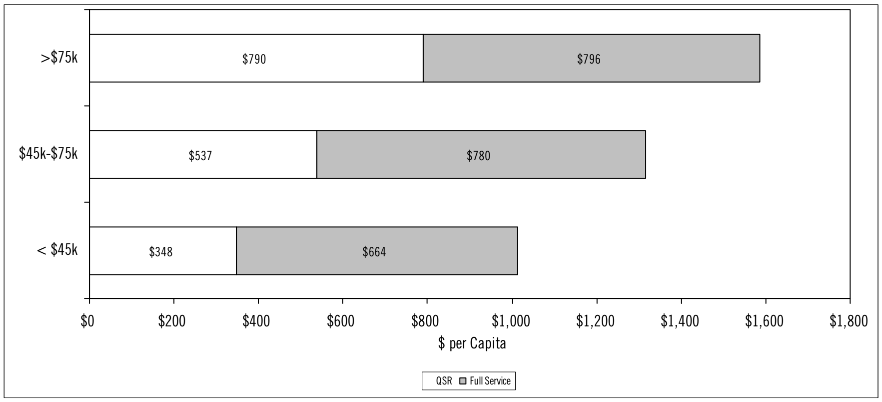
Source: Bureau of Labor Statistics and National Restaurant Association

Given limited visibility on the domestic macro environment we believe restaurant sales will likely remain sluggish in the near-to-intermediate term. In our view, the concepts best positioned to navigate through this environment are the QSR operators, given their focus on value and convenience, greater menu diversity and daypart exposure, and highly franchised business models.

A Deeper Dive into QSR

As mentioned earlier, the QSR category dominates the domestic restaurant landscape from both a sales and unit perspective, according to Technomic data. We believe these restaurants offer a distinct competitive advantage over casual dining chains, given more balanced daypart options (casual dining sales are skewed heavily towards dinner), greater convenience and value proposition, and recently broadened out menus that include healthier and higher quality offerings. In our view, this has helped QSR chains capture market share at the expense of casual dining restaurants. As seen below, 2006 marked the first time that individuals who earned at least $75,000 annually spent nearly equal dollar amounts on fast food and full service. Interestingly, these consumers typically have a 25% higher average check than the individuals in the lowest income bracket.

Figure 23. Restaurant Spending by Income Level



Source: NPD Group

Operational Excellence

In our view, the best positioned QSR companies are those that are keenly focused on driving operational improvement at the restaurant level. In turn, this creates a favorable dining experience for customers and potentially increases the likelihood of return visits, which is critical in a highly competitive industry. For QSR companies, we believe one of the best metrics to measure operational excellence is efficiency at the drive-thru. With nearly two-thirds of overall sales coming via the drive-thru we believe this is a reasonable proxy for overall operations.

According to QSR Magazine's 2008 Consumer Drive-Thru Survey, order accuracy, easy-to-read menus and speed of service were ranked among the highest in terms of customer importance. In an effort to improve upon these areas, many concepts are implementing new technologies, remodeling units, and adding more efficient kitchen equipment.

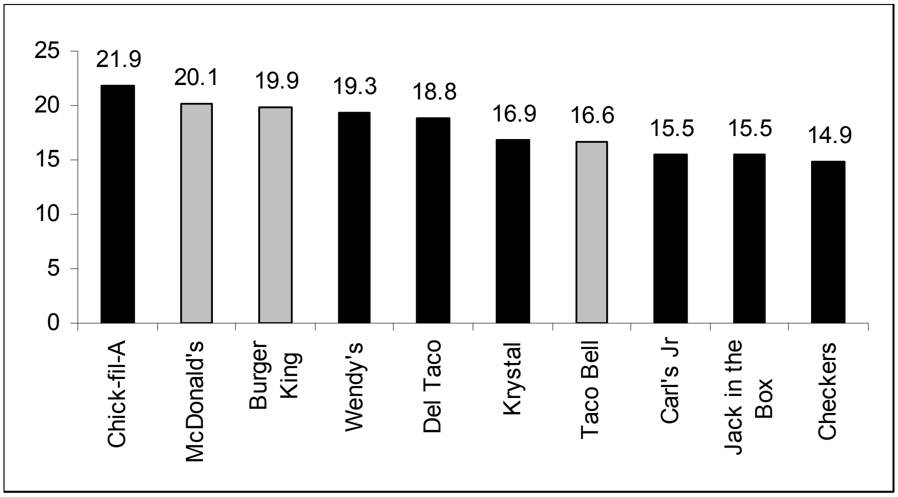
Figure 24. Methods to Improve Restaurant Operations

Initiative		Benefit
POS/Cashless Payment	=>	Improve Speed of Service
	=>	Improve Order Accuracy
Remodels	=>	Redesign Menuboards
	=>	Refresh the Look of the Restaurant
New Kitchen Equipment	=>	Improves Speed of Service
	=>	Improves Food Quality
Dual Drive-Thru Lane	=>	Improve Speed of Service
Order Confirmation Board	=>	Improve Order Accuracy

Source: Citi Investment Research

Below we outline the top 10 QSR chains based on QSR Magazine's "America's Best Drive Thru of 2008" analysis. Of the companies we are initiating coverage of, McDonald's and Burger King ranked second and third respectively, while Taco Bell (owned by YUM! Brands) finished in seventh. The study combines overall rankings from a number of criteria, including service time, order accuracy, speaker clarity and menuboard appearance.

Figure 25. QSR Magazine's America's Best Drive Thru of 2008



Source: QSR Magazine

Menu Innovation

In addition to improving operations, we believe those QSR operators who have a solid track record of delivering innovative new products are also well positioned to drive solid sales growth. Given the highly competitive landscape, we believe new product introductions are critical in helping concepts differentiate themselves. Additionally, we see a number of other potential benefits including generating trial from new customers and potentially repeat purchases (with limited time offerings), improving product mix (i.e. offering higher price point and higher margin products), and broadening out menus to help eliminate the veto vote (i.e. in the case of a fried chicken concept, when a group of people do not dine at a restaurant because one individual wants something other than fried chicken).

In our specific company reports we outline some of the recently successful new product introductions at each concept. In our view, McDonald's has been the most innovative over the past several years, though both Burger King and YUM! Brands have demonstrated some recent successes. While Domino's has been less innovative of late, we believe the company is aggressively testing new products in an attempt to reinvigorate domestic sales growth. Below we have compiled a list of some of the innovative new products introduced by our companies:

McDonald's: The company has had many recent successes with new product introductions. Some of these products complemented the company's already robust breakfast business (i.e. Premium Coffee and McGriddles), helped round out its menu with healthier fare (i.e. Premium Salads) and created new menu tiers with very favorable margins (i.e. Snack Wraps). Going forward, the company's national rollout of its combined beverage initiative is anticipated to be a solid contributor to overall sales growth.

Figure 26. McDonald's Recent New Product Introductions

Year	Key New Product Introductions
2003	Premium Salads and McGriddles
2004	Chicken Selects Chicken Strips
2005	Premium Chicken Sandwiches
2006	Spicy Premium Chicken Sandwich
2007	Premium Coffee, Snack Wraps, McSkillet Burrito
2008	Specialty Coffee and Southern Style Chicken

Source: Citi Investment Research and Company Reports

YUM! Brands: After generating lackluster growth at all three of its domestic concepts during the past few years, YUM! Brands went on the offensive in 2008 with new product introductions at each of its three major concepts: Taco Bell, Pizza Hut and KFC. Our early checks suggest that Taco Bell's Why Pay More value menu and Frutista Freeze beverages have been solid traffic drivers for the concept through the summer months. Separately, we sense that Pizza Hut's newly created Tuscani Pasta has been an incremental sales driver, while its Pizza Mia product has apparently gained traction among more value-conscious customers. Trends at KFC have been less than impressive, however. We note the concept is making a big push with grilled chicken on the bone, which is expected to be rolled out nationally in 2009 at the earliest.

Figure 27. YUM! Brand's New or In-Test Product Introductions

Concept	New Products
Taco Bell	Why Pay More Value Menu
	Fresco line of Tacos/Burritos
	Frustisa Freeze beverages
	Testing Breakfast
Pizza Hut	Pizza Mia
	Tuscani Pasta
	Whole Wheat Dough Pizza
	Tuscani Pasta
KFC	Snackers & Snack Box
	Toasted Wrap
	Testing Grilled Chicken on the Bone

Source: Citi Investment Research and Company Reports

Burger King: Many of Burger King's new product launches have been centered around four segments: value menu, premium, breakfast and snacking. After years of fairly lackluster menu innovation, our checks indicate that the company's newly launched premium (i.e. Indy Whopper and Steakhouse Burgers) and value menu products (i.e. Cheesy Bacon Wrap) have provided an incremental lift to sales this year. Going forward we believe the company will focus largely on the high growth categories within QSR including breakfast and snacking, though we do not expect Burger King to lose sight of its value menu and premium product focus either.

Figure 28. Burger King's New Product Introductions

Value:	Spicy Chick'n Crisp	Cheesy Tots	Ham Omelet Sandwich
Premium:	BBQ Bacon Tendercrisp	Steakhouse Burger	* Angry Whopper
Breakfast:	Cheesy Bacon Wrap	Homestyle Melt	BK Mocha Joe
Snacking:	Apple Fries	Mac & Cheese	* Sundae Shake

* in test

Source: Citi Investment Research and Company Reports

Domino's Pizza: As mentioned earlier, Domino's Pizza has been fairly quiet on the new product introduction front, though management has acknowledged it has been aggressively testing products. The company is seeking to broaden out its daypart mix (the majority of its sales are derived at dinner) and focus on tiering (i.e. value, core and premium products) its menu along the lines of some of the successful QSR Hamburger operators. Going forward we expect new product introductions to be largely focused on these areas and we expect the company to be fairly aggressive with new product introductions over the next 12 months.

Figure 29. Domino's Pizza Recent New Product Launches

Value	444 Deal
Daypart & Menu Expansion	Toasted Sandwiches Pasta Perfecta *
Premiumization	Local Legends Pizza *
Core Menu	Improve pizza ingredients

* in test

Source: Citi Investment Research and Company Reports

Highly Franchised Business Model

As mentioned earlier, it is not uncommon for many QSR restaurants to have franchising structures in place. In our view, this structure is quite advantageous for an operator, as it generates steady streams of high margin cash flow (i.e. royalty rate based on a percentage of gross revenue) and is a means by which a company can expand its business without committing capital. Below we outline some of the pros and cons of this model for both franchisees and franchisors:

Figure 30. Pros and Cons of a Franchised Business Model

	Franchisor	Franchisee
Pros	Transfers operational risk to franchisee	Operating a well known brand
	Expand without committing capital	Support functions from parent company (i.e. training)
	Generates high margin cash flow	Good supplier relationships from parent company
Cons	Not managing daily operations	Taking on operational risk of running a business
	Reluctance from franchisees to reinvest	Must comply with corporate mandates (i.e. new equipment)
		High initial start up costs

Source: Citi Investment Research

In addition, this model typically generates fairly steady profitability for a franchisor, as it collects a high margin royalty stream from the operator. In the table below we examine a hypothetical model of a franchised restaurant relative to a company-owned restaurant. We assume the franchisee pays a 4% royalty rate and G&A for the franchised unit is meaningfully less than the company owned restaurant, given the generally lower costs required to support these restaurants (i.e. one regional or district manager can oversee a large number of franchisees). While the dollar profitability is meaningfully lower, the majority of the royalty streams essentially flow through to the operating income line. As such, companies with a higher mix of franchised units are generally less vulnerable from a profitability standpoint from volatile swings in commodity costs and rising wage rates, in our view.

Figure 31. Hypothetical Operational Structure of Franchised Business Unit

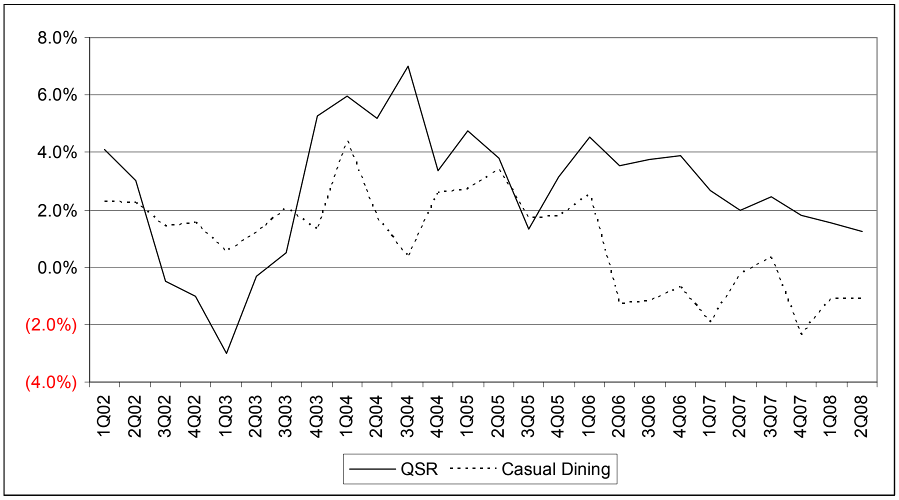
	Company Operated Unit	Franchised Unit
Sales	$1,000,000	$1,000,000
Royalty Rate	0%	4%
Actual Revenue Stream	$1,000,000	$40,000
Operating Expense assume 20% margin	$800,000	$0
G&A Expense	$50,000	$12,500
Operating Profit	$150,000	$27,500
Margin	**15.0%**	**68.8%**

Source: Citi Investment Research

Is QSR Recession Resistant?

There has been tremendous debate about whether QSR is recession proof, given the theory that consumers will "trade down" within the restaurant channel from casual dining. While we note that QSR sales trends have actually held up relatively well compared to casual dining trends, we actually do not believe this is attributable to a trade down effect. Rather, we believe QSR operators are benefiting from solid growth in a number of key categories, including breakfast, snacking, and late-night. Additionally, we believe QSR operators are seeing trade down within their menu to more value-oriented items, which has helped sustain same store sales growth, albeit at lower penny profits. In our view, all these factors have contributed to the relative outperformance of QSR same store sales relative to casual dining sales.

Figure 32. QSR vs. Casual Dining SSS Trends; 2002-Present



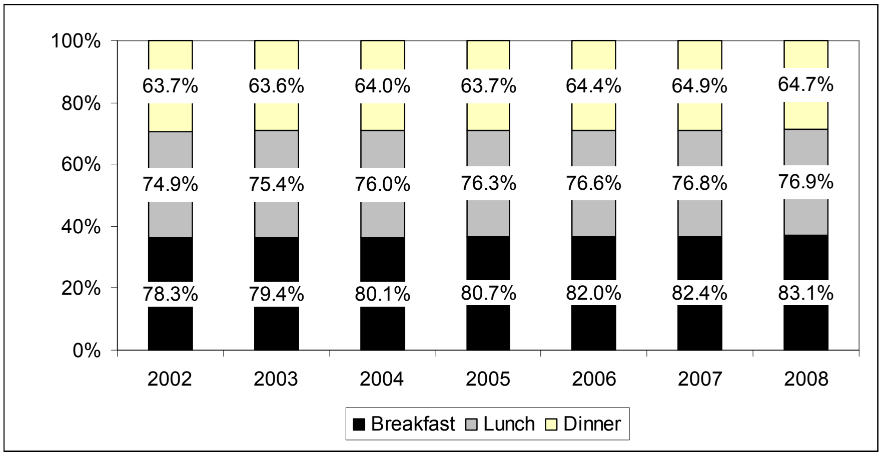
Source: Company Reports and Citi Investment Research

Note: QSR Composite includes Burger King, Carl's Jr., Hardee's, Domino's Pizza, Jack in the Box, McDonald's, Papa John's, Sonic Corp, Wendy's, and YUM! Brands

Note: Casual Dining Composite is based on Knapp-Track data

In our view, if consumers were actually trading down from casual dining to QSR we would expect to see a spike in dinner sales at QSR. The rationale is that the dinner daypart accounts for nearly two-thirds of casual dining sales, so in theory consumers would eat dinner at a QSR establishment instead. However, recent NPD data continues to suggest that dinner sales at QSR remain quite lethargic, with most sales growth being derived during the breakfast and late-night dayparts. As seen in the chart below, QSR traffic share gains since 2006 have largely come from breakfast, expanding nearly 110 bps compared to 30 bps of share gains at dinner and at lunch. While there may be an element of "trade down" going on based on this information, we feel QSR is benefiting from other factors as well.

Figure 33. QSR Share of Traffic by Daypart, 2002-2008



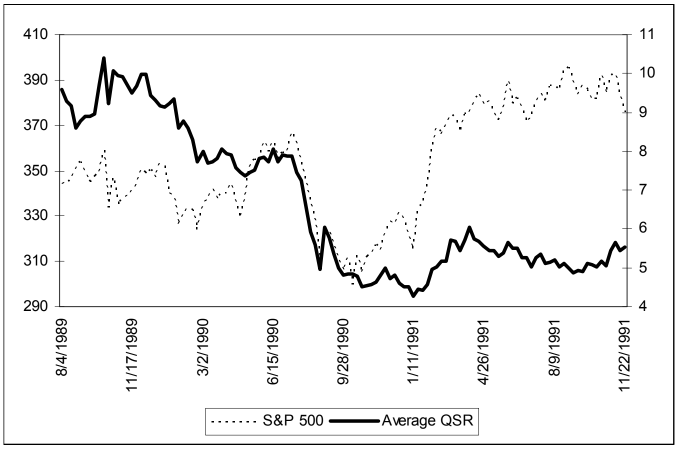
Source: NPD Crest

With that said, we still believe QSR operators are relatively well positioned in the presently uncertain commodity cost and domestic macro environment. Overall, the quality and breadth of QSR product offerings have improved significantly over the years, value menu proliferation has helped keep customers from leaving the category and many operators have become less reliant on the more discretionary lunch and dinner dayparts. Additionally, we believe high levels of franchisee ownership and a strong international footprint provide a degree of insulation. That is not to say the category is without risks. Any material slowdown internationally would likely dampen investor sentiment, while external factors such as obesity concerns and negative media headlines can also wreak havoc on sales trends.

Analysis of Prior Recessions

Given the current challenging economic environment we felt it would be worthwhile to examine how restaurant stocks, particularly QSR, have performed relative to the S&P 500 during prior recessionary periods. We felt the 1990 consumer led-recession and the 2001 business-led recession were the most relevant periods to analyze, though we note there are different takeaways from each period.

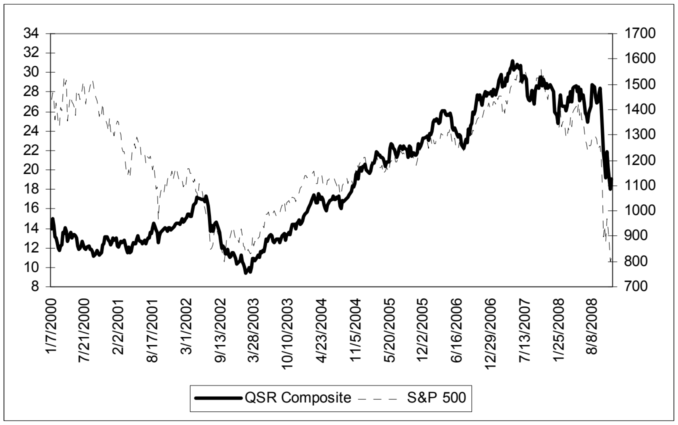
Figure 34. QSR Restaurant Composite vs. S&P 500; 1990-1991 Recession



Source: StockVal

Note: QSR Composite consists of MCD, CKR and WEN, which were only major publicly traded QSR's at the time

Figure 35. QSR Restaurant Composite vs. S&P 500; 2001 Recession



Source: StockVal

Note: QSR Composite consists of MCD, CKR, WEN, YUM, SONC, DPZ

During the early 1990's, a composite of QSR restaurant stocks declined roughly 60% from peak to trough, whereas the S&P 500 declined 18% from peak to trough. Additionally, the S&P 500 recovered fairly quickly, accelerating 25% over the next 12 months, which was roughly in-line with the percentage gain in the QSR stocks over the following 12 months. Interestingly, QSR stocks began to decline approximately 8 months before the market began to sell off, and did not reach trough levels until roughly 1 year after the market had bottomed.

However, this relationship actually changed during the most recent recession in the early 2000's. As seen above, investors rotated into the QSR stocks in the early 2000's when the market began its steep descent. From March of 2000 through May of 2002 the S&P 500 lost 29% whereas a composite of QSR stocks gained 53%. However, this trend reversed as both the S&P 500 and the QSR stocks declined coincidentally over the next year. After reaching trough levels in 2003, the QSR stocks have essentially traded lock-step with the market, although we note in the current downturn that QSR has held up much better on a relative basis.

Our takeaway is that investor perception has changed regarding QSR stocks over the past 20 years. During the early 1990's we believe QSR companies were viewed as highly discretionary, whereas more recently investors have come to view QSR as more staple-like. We think this speaks to QSR's focus on value and convenience, their strong brand recognition, in addition to their expanding international footprint and highly franchised business models.

During the current market pullback, large multi-national QSR companies such as McDonald's, YUM! Brands and Burger King have all outperformed the S&P 500 and based on our view that these companies are more defensive we believe relative outperformance may continue in the near-term.

Negative Risks for QSR

Ability to Secure Financing

Many investors have expressed concern regarding the potential impact to restaurants from tightening credit conditions, particularly as it relates to franchisees ability to access capital. As seen below, each of our companies have ongoing initiatives that are contingent on their franchisees securing financing, with Domino's likely the most critical as it is a meaningful part of the company's present turnaround plan. For McDonald's, Burger King and YUM! Brands, however, we would not view this as a material risk as none of these initiatives are absolutely critical to their immediate success or continued growth.

Figure 36. Specific Company Initiatives as it Relates to Accessing Capital Markets

Company	Initiative	Timeframe	Comment
McDonald's	Combined Beverage Initiative	Complete by end of '09	CBI should have longer-term benefits. We are not modeling in any sales benefit in '09.
	Refranchising 1,000-1,500 Units	3-5 years	Multi-year initiative. No real impact to our model.
Burger King	Franchisee unit growth	Annual net unit growth	Most franchisees own the land/building, which they use to secure loans. Not an issue thus far.
YUM! Brands	Refranchising	2,000 units by 2010	Seeing some delays in deals getting done, but on track to meet target of 500 units for '08.
Domino's	Facilitate restaurant acquisitions	Ongoing strategy	Difficulty for franchisees to get credit. DPZ working with lenders to assist in structuring deals.

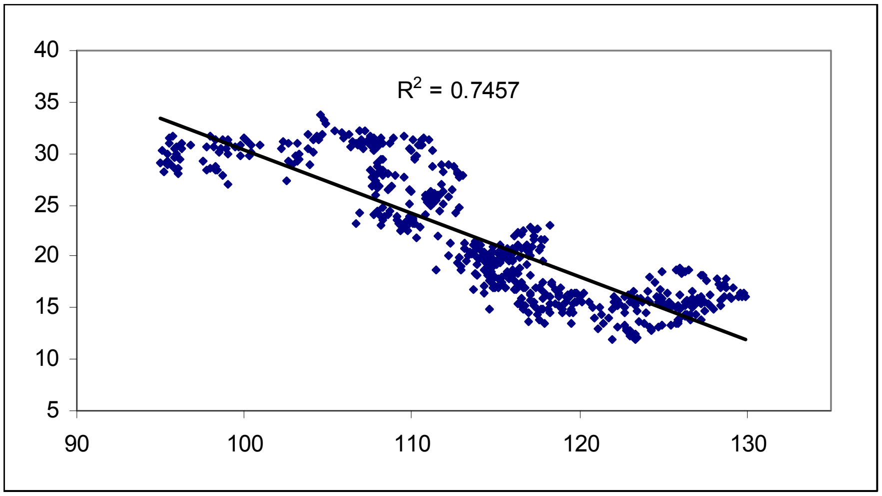
Source: Company Reports and CIR Estimates

We continue to hear mixed reports on the availability of credit to franchisees. Specifically, the industry's largest franchisee lender, GE Capital, announced in late September that it would curtail new loans to restaurant operators, though it would continue to honor pre-existing loans. This does not appear to be the case for many smaller local and regional banks, however, as they have stepped up as a lender of last resort for many restaurant operators. Our sources indicate that in some instances where a franchisee is unable to obtain credit from a larger-scale lender they will often have success turning to local banks. Additionally, we believe franchisees that own the land and building are also not having much of an issue procuring capital, as banks appear willing to lend against these assets. This is a positive for Burger King, as management estimates its franchisees own the land and the building on nearly half of the 6,500 domestic franchised restaurants.

Overall, while weak credit market conditions have made accessing capital more difficult for many franchisees we do not believe it will completely dry up, particularly for those operators with a long track record of solid sales growth and cash flow generation. Ranking our companies from least concerned to most concerned as it relates to this issue: 1) Burger King; T-2) YUM! Brands and McDonald's; and 3) Domino's.

Foreign Exchange Headwinds

Figure 37. Weekly U.S. Trade Weighted Dollar vs. QSR Composite Stock Price

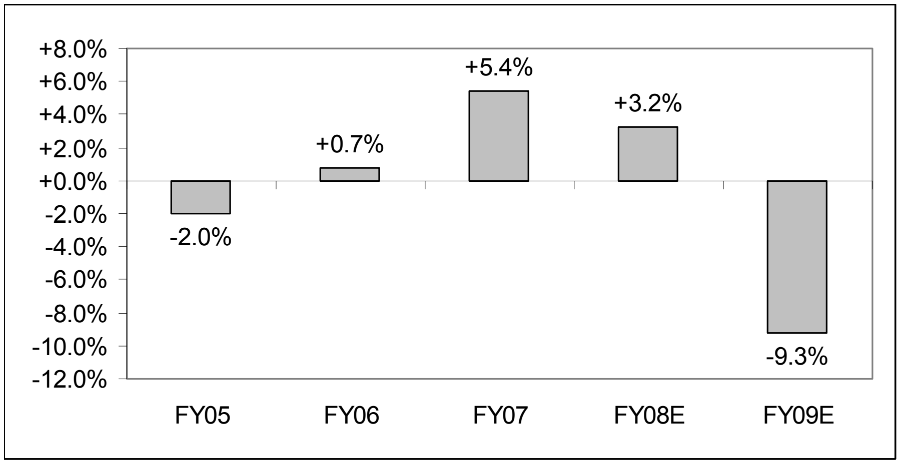


Source: Citi Investment Research

Note: QSR composite contains McDonald's, YUM! Brands, Domino's Pizza, Papa John's, Burger King, Starbucks

Looking at a composite of global QSR companies there appears to be a fairly high inverse correlation between average stock price and the U.S. trade-weighted dollar. This is not altogether surprising as fluctuations in currencies have historically impacted most of these companies top-line results and profitability. More recently over the past few years our companies have benefited to a degree from a weakening U.S. dollar, although this trend has reversed a bit in the third quarter, and thus far in the current quarter it appears that foreign exchange could present a real headwind. As seen below, if we assume that a composite of key foreign currencies remains unchanged from present levels throughout 2009 this would imply a potential translation headwind of (-9%). Clearly results will vary by each company depending on the extent of their direct country exposure, but this is illustrative of the potential risks faced by our companies in 2009 and beyond.

Figure 38. Average of Key Foreign Currencies



Source: Company Reports and Citi Investment Research
Note: Foreign Currency Average is equally weighted basket of Euro, British Pound, Canadian Dollar, Australian Dollar, Japanese Yen, Mexican Peso, and Chinese Renminbi
Note: FY'09 figure assumes current rates remain constant through 2009.

It is important to note that for each of our companies most of the risk lies in translation, rather than transaction (the table below outlines key currency exposure for our companies). Most of our companies business is locally sourced (though many will hedge their balance sheet and cash flow exposure with derivative instruments as well), so everything from revenue to cost of goods is calculated in local currencies. As such, there is a direct effect when these results are translated over to U.S. dollars. For the fourth quarter of 2008 and the full year 2009 we are modeling negative foreign currency translation for each of our companies. Our assumptions are largely predicated on Citi Currency Strategist Stephen Halmarick's outlook for the U.S. Dollar to remain strong relative to the Euro, the British Pound, the Yen, the Canadian Dollar and most Asian currencies over the next 6-12 months.

Figure 39. QSR Currency Exposure

Burger King	Domino's Pizza	McDonald's	YUM! Brands
Australian Dollar	Australian Dollar	Australian Dollar	Australian Dollar
Brazilian Real	British Pound	British Pound	British Pound
British Pound	Canadian Dollar	Canadian Dollar	Canadian Dollar
Euro	Japanese Yen	Euro	Chinese Renminbi
Mexican Peso	Mexican Peso	Japanese Yen	Japanese Yen
		Mexican Peso	Korean Won
			Mexican Peso
			South African Rand

Source: Citi Investment Research

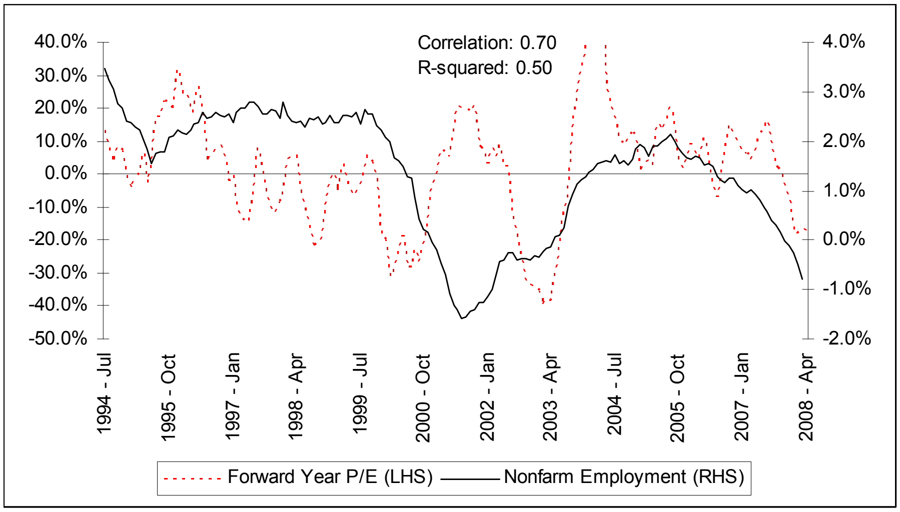
Global Macro Slowdown

In our view, the weak domestic macro environment is fairly well understood by investors; however, while U.S. retail sales trends have been generally lethargic of late some of the major QSR operators, including McDonald's and Burger

King, have yet to really exhibit any sustainable weakness in their domestic business. We attribute this largely to employment trends only recently beginning to deteriorate, echoing similar comments made by McDonald's management over the summer that in the past its U.S. business had struggled during periods of meaningful job losses.

Over the past decade, the QSR Composite forward year P/E has closely tracked nonfarm employment trends by a 7 month lag. In other words, QSR restaurant stocks have historically discounted softening employment trends by about 6-7 months. Given our U.S. economist's view that over the next 12 months the unemployment rate could trend ~200 bps above the October rate of 6.5% we believe near-term stock price performance could remain generally lackluster for QSR stocks.

Figure 40. QSR Composite Forward Yr. P/E (Y/Y) vs. Change in Nonfarm Employment (Y/Y) – 7 month lag

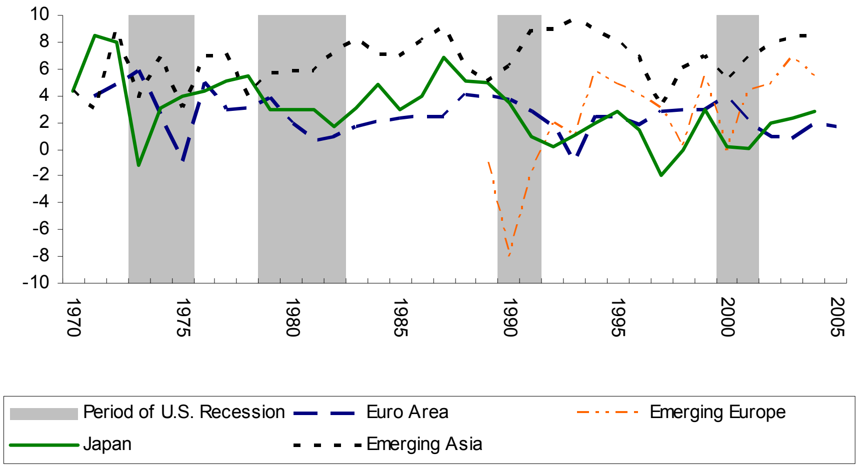


Source: Haver Analytics and Citi Investment Research
Note: QSR Composite is equally-weighted and consists of MCD, BKC, CKR, AFCE, DPZ, JBX, PZZA, SONC, THI, YUM

Another relevant issue, in our view, is the potential impact on results from a global macro recession. With our companies increasingly focusing on expanding internationally, we believe any hiccup in business trends overseas would likely pressure valuations. Thus far, we have yet to hear any indications from our companies that international trends are moderating. However, our primary concern is that ultimately the weakness in the U.S. spills over into international markets. We believe restaurants in emerging markets could potentially be the most susceptible as dining out occasions in these regions tend to be more aspirational, in our view. We looked back at prior U.S. recessions to get a sense of how specific international economies fared, and we came away with mixed results.

During prior U.S. recessions, real GDP growth in mature markets (e.g. Japan, Western Europe) and emerging markets in Europe tended to decline almost lock-step with the retrenchment in the U.S. Of the companies we are covering, McDonald's has the largest European exposure with ~6,500 restaurants. This is followed by YUM! Brands and Burger King who each have approximately 2,000-3,000 total units in Europe, and Domino's with less than 1,000.

Figure 41. Y/Y GDP Growth in Foreign Economies



Source: Citi Investment Research, World Bank, IMF

Notably, real GDP growth in emerging markets in Asia actually remained relatively resilient to a slowdown in the U.S. economy. Presently, Citi emerging market economist Don Hanna is forecasting GDP growth in emerging markets to decelerate from 7.4% in 2007 to 6.2% in 2008 and 4.5% in 2009. This is down from the January 2008 forecast of 6.6% in 2008 and 6.4% in 2009 and now factors in a global recession. Regarding China, Citi economist Minggao Shen currently forecasts GDP growth of 9.6% in 2008 and 8.8% in 2009, down from 11.9% in 2007. Notably, these forecasts have been revised downward from prior periods. Specifically, as of October 2007, Citi had forecasted 11.2% growth in 2008 and 11% growth in 2009, and as of January 2008, forecasted 10.5% growth in 2008 and 10% growth in 2009.

While the chart above indicates emerging Asian economies have been fairly resilient during prior U.S. recessions, we believe there is risk of moderation during the current global recession, particularly as the U.S. has become more relevant for many of these economies in recent years. While trends in emerging markets such as China may not dissipate as much as in the U.S., we believe it is prudent to expect some weakness For investors looking to capitalize on a global macro slowdown, particularly in emerging markets, we believe YUM is worst positioned, while Burger King is best positioned.

Headline Risks

We believe there are also a number of potential headline risks that could tarnish the image of restaurant companies, including concerns over animal cruelty and the growing obesity epidemic.

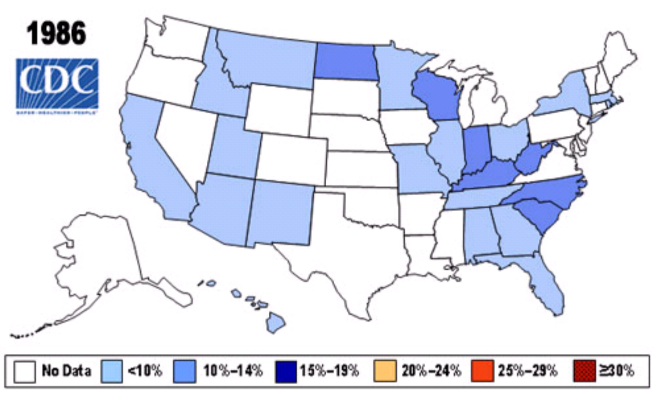
A number of consumer activist groups, most notably PETA (People for the Ethical Treatment of Animals), have raised concerns in the past regarding the inhumane treatment of animals from restaurant chains or suppliers to these chains. PETA has gone as far as filing lawsuits in addition to boycotting specific restaurants. Additionally, PETA has launched web campaigns to help raise awareness, with YouTube videos demonstrating animal cruelty and the creation of specific websites (i.e. www.kfcruelty.com).

More recently, PETA has attempted to drive changes at companies by passing through shareholder resolutions. PETA presently owns shares in more than 80 companies, with the primary focus being QSR and grocery store chains, according to its assistant director of corporate affairs, Matt Prescott. If a company does not adhere to PETA's requests (i.e. sourcing from suppliers that use less cruel methods), the resolution will be printed in the company's proxy statement.

According to the organization there have been a handful of companies that have given purchasing preference to suppliers that utilize more humane slaughtering methods, including Chipotle, Burger King, Wendy's, Carl's Jr., Hardee's, Popeyes, and Safeway. Burger King, Carl's Jr. and Hardee's purchase a small portion of their eggs from suppliers that use cage-free chickens. Meanwhile, Safeway recently agreed to double the amount of cage-free eggs sold in its grocery stores.

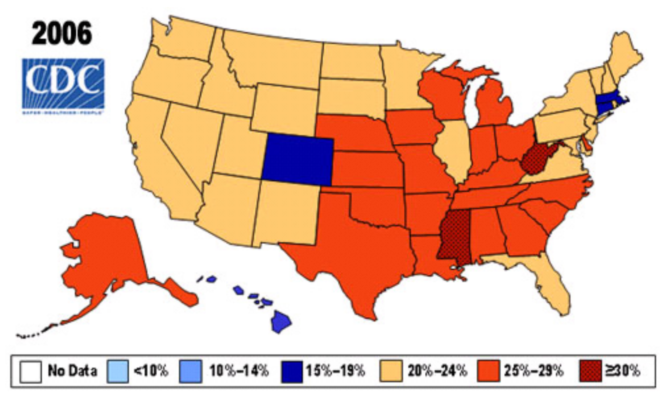
Another key issue for QSR operators is the growing obesity epidemic in the U.S. According to the recent National Health and Nutrition Examination Survey (NHANES), the prevalence of obesity in adults (20-74 years old) increased from 15% from the 1976-1980 period to 34% in the most recent survey conducted in 2005-2006. The maps below illustrate how the trend has broadly accelerated throughout the U.S. over the past 20 years. In 1986 no state had more than 10-14% of its population classified as obese, whereas in 2006 there were 47 states with obesity rates ranging in the 20% to over 30% range.

Figure 42. Percent of Obese in U.S. Adults; 1986



Source: CDC

Figure 43. Percent of Obese in U.S. Adults; 2006



Source: CDC

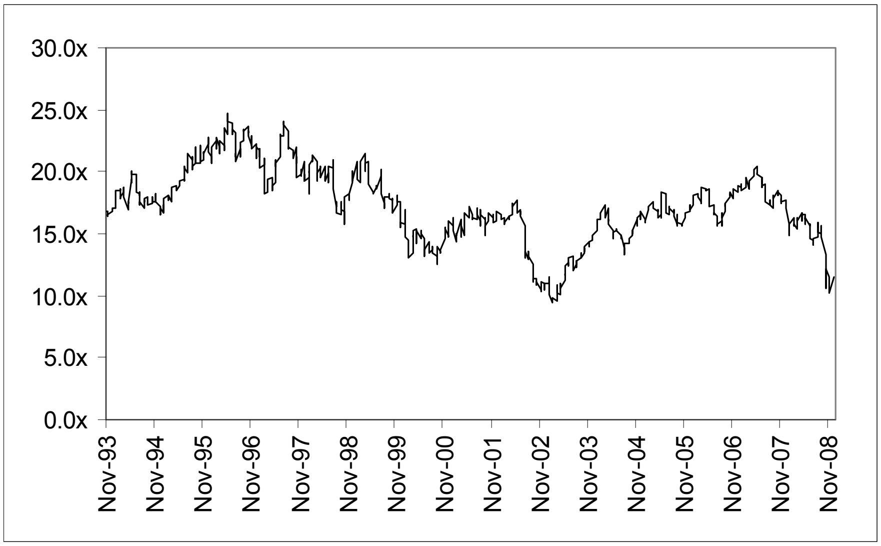
Partially in response to growing concerns over obesity, some QSR operators have balanced out their menus to include more healthful options. While these offerings are generally not critical growth drivers, they do have the dual benefit of eliminating the "veto vote" for individuals within a group that may be seeking healthier menu items and driving modest incremental sales from individuals who may ordinarily abstain from eating fast food (i.e. a mother that takes her child to a fast-food restaurant).

Of the company's were are initiating on, McDonald's has done an admirable job introducing healthier items, such as salads, grilled chicken sandwiches, and apple slices for children. YUM! Brands has recently introduced several initiatives aimed at broadening its menus at all three domestic concepts to include healthier fare. This includes the Fresco line of products at Taco Bell, which substitutes cheese and sour cream with low fat pico de gallo and salsa, the Natural Pizza at Pizza Hut, which is made with multigrain crust, organic tomato sauce and all-natural cheese, and the introduction of grilled chicken on the bone at KFC, which is expected to be fully rolled out in 2009. In addition, KFC has recently switched to non-trans fat cooking oils. Burger King is presently testing new salad offerings, and recently introduced a healthy blend of macaroni and cheese and apple fries targeted at children. Domino's has not focused much attention on rolling out healthier fare.

Valuation

From a valuation perspective, a composite of equally weighted QSR stocks is trading at 11.5x forward year consensus estimates, which is only modestly above the trough levels exhibited during 2002-2003. In our view, QSR appears much better positioned today relative to prior recessionary periods due largely to greater international mix, better menu innovation around faster growth categories (i.e. breakfast, snacking, beverages, etc.), and more extensive value offerings that have helped sustain traffic levels. As a result, we do not see significant downside risk from current levels, though we note QSR stocks could remain volatile, particularly if macro trends materially worsen.

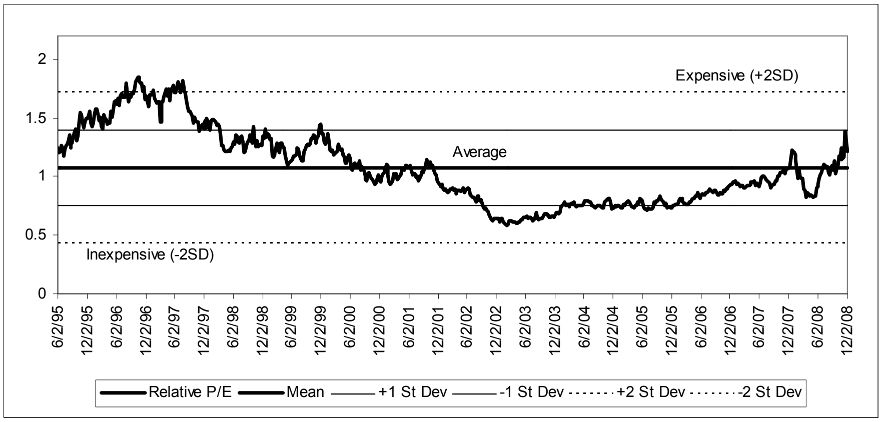
Figure 44. QSR Composite Forward Year P/E (equally weighted)



Source: Citi Investment Research and StockVal

That said, we believe the industry could experience potential upside relative to a composite of casual dining stocks. As seen below, QSR stocks are presently trading at one standard deviation above their long-term median relative to casual diners. In our view, casual dining tends to be more discretionary than dining at QSR, given higher average check and a greater focus on the dinner daypart (as estimated two-thirds of casual dining sales). As such, we believe declining disposable income and lower consumer confidence is likely to have a greater impact on casual dining fundamentals, and believe QSR is in a better position to navigate through the presently challenging environment.

Figure 45. QSR Composite Forward Year P/E vs. Casual Dining Forward Year P/E



Source: Citi Investment Research and StockVal

Appendix

Figure 46. CIR Leisure/Healthy Lifestyle & Staples/Restaurant Comp Sheet

Company Name	RIC Code	3-Dec-08 Price ($)	Market Cap ($mm)	Dividend Yield (%)	Target Price	Rating / Risk	EPS ($) 2007A	EPS ($) 2008E	EPS ($) 2009E	EPS ($) CY07	EPS ($) CY08	EPS ($) CY09	PE (x) 2007A	PE (x) 2008E	PE (x) 2009E	EV/EBITDA 2007A	EV/EBITDA 2008E	FCF Per Sh. 2007A	FCF Per Sh. 2008E
Leisure																			
Fleetwood	FLE.N	0.21	18	0.0%	0.20	2S	(1.17)	(0.50)	(2.23)	(0.70)	(1.70)	(1.26)	(0.2x)	(0.5x)	(0.1x)	(10.5x)	73.3x	(0.71)	(0.74)
Hasbro	HAS.N	27.11	3,754	2.7%	31.00	2H	2.04	2.23	2.39	2.04	2.23	2.39	13.2x	12.1x	11.3x	5.5x	5.6x	3.06	2.15
Harley-Davidson	HOG.N	16.62	3,739	8.0%	18.00	3M	3.74	3.02	2.85	3.74	3.02	2.85	4.3x	5.3x	5.6x	2.6x	3.6x	3.52	2.87
International Speedway	ISCA.O	26.97	735	0.4%	33.00	2H	2.85	2.80	2.60	2.85	2.79	2.61	9.4x	9.5x	10.3x	4.1x	4.8x	3.08	3.75
Mattel	MAT.N	13.20	4,968	5.7%	15.00	2H	1.43	1.35	1.56	1.43	1.35	1.56	9.7x	10.3x	8.9x	5.3x	5.7x	1.06	2.89
Monaco Coach	MNC.N	0.77	21	17.2%	2.40	2H	0.41	(1.70)	(0.15)	0.41	(1.70)	(0.15)	1.7x	(0.4x)	(4.5x)	1.5x	(1.0x)	0.68	(0.77)
Polaris	PII.N	29.65	926	5.3%	47.00	1M	3.10	3.49	4.05	3.10	3.49	4.05	9.2x	8.2x	7.0x	4.4x	4.1x	4.08	4.19
Thor Industries	THO.N	14.04	747	16.9%	18.00	1H	2.41	1.66	0.20	2.10	1.05	0.41	5.6x	8.1x	67.9x	2.2x	2.9x	3.93	1.90
Winnebago	WGO.N	6.00	159	8.8%	7.50	2H	1.32	0.24	(0.27)	0.98	0.07	0.04	4.1x	22.5x	(20.6x)	0.1x	12.0x	0.50	(0.82)
Mean				**7.2%**									**6.3x**	**8.3x**	**9.5x**	**1.7x**	**12.3x**		
Median				**5.7%**									**5.6x**	**8.2x**	**7.0x**	**2.6x**	**4.8x**		
Healthy Lifestyles/Staples																			
Hain Celestial Group	HAIN.O	16.15	634	0.0%	31.00	1H	1.17	1.40	1.58	1.29	1.49	1.70	13.4x	11.2x	9.9x	7.5x	7.0x	1.43	0.11
Hansen Natural	HANS.O	27.82	2,530	0.0%	26.00	2S	1.51	1.71	2.00	1.51	1.71	2.00	18.1x	16.0x	13.7x	10.4x	8.9x	1.35	1.82
Jarden	JAH.N	12.56	943	0.0%	22.00	1S	2.32	2.81	2.81	2.32	2.81	2.81	5.3x	4.4x	4.4x	5.5x	5.3x	3.04	4.20
Lifetime Brands	LCUT.O	3.12	39	0.0%	6.00	2S	0.60	(0.02)	0.76	0.60	(0.02)	0.76	5.5x	(152.7x)	4.3x	4.9x	12.2x	1.67	1.26
NBTY	NTY.N	14.03	859	0.0%	19.00	2H	3.03	2.47	2.47	2.89	2.47	2.53	4.6x	5.6x	5.6x	2.7x	3.7x	2.55	1.84
Nutrisystem	NTRI.O	14.66	402	0.0%	15.00	1S	2.98	1.80	1.80	2.98	1.80	1.80	4.6x	7.5x	7.5x	2.0x	3.7x	2.54	2.32
Sysco	SYY.N	21.90	13,193	3.7%	30.00	1M	1.60	1.81	1.88	1.70	1.85	2.01	13.8x	12.2x	11.7x	7.1x	6.5x	1.30	1.79
United Natural Foods	UNFI.O	17.06	705	0.0%	22.00	1H	1.22	1.13	1.35	1.18	1.22	1.44	13.4x	14.5x	12.2x	7.6x	8.4x	(0.26)	(0.98)
Weight Watchers	WTW.N	27.63	2,051	2.6%	33.00	2H	2.50	2.76	2.96	2.50	2.76	2.96	10.7x	9.7x	9.0x	7.2x	8.1x	3.68	0.55
Whole Foods	WFMI.O	10.19	1,421	7.7%	13.00	2M	1.29	0.91	0.71	1.19	0.86	0.74	7.9x	11.1x	14.2x	3.5x	4.5x	(1.19)	(1.48)
Mean				**1.4%**									**9.7x**	**-6.0x**	**9.3x**	**5.8x**	**6.8x**		
Median				**0.0%**									**9.3x**	**10.4x**	**9.5x**	**6.3x**	**6.7x**		
Restaurants																			
Burger King	BKC.N	18.78	2,762	1.2%	26.00	1M	1.09	1.38	1.50	1.24	1.44	1.64	18.8x	14.8x	13.7x	8.9x	7.5x	0.25	0.48
Domino's Pizza	DPZ.N	3.65	198	0.0%	4.50	2S	1.03	0.72	0.74	1.03	0.72	0.74	3.4x	4.8x	4.7x	6.0x	8.7x	0.65	1.26
McDonald's	MCD.N	59.55	67,809	2.7%	63.00	2L	2.90	3.61	3.80	2.90	3.61	3.80	20.9x	16.9x	16.0x	11.0x	9.7x	2.42	3.16
YUM! Brands	YUM.N	27.04	12,817	2.6%	29.00	2M	1.68	1.89	2.05	1.68	1.89	2.05	16.5x	14.7x	13.5x	7.8x	7.5x	1.52	1.75
Mean				**1.6%**									**14.9x**	**12.8x**	**12.0x**	**8.4x**	**8.4x**		
Median				**1.9%**									**17.7x**	**14.7x**	**13.6x**	**8.4x**	**8.1x**		
S&P 500		**870.74**					**84.46**	**72.50**	**62.00**				**10.3x**	**12.0x**	**14.0x**				

Source: Citi Investment Research

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Appendix A-1

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