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EAT - Q4 2016 Brinker International Inc Earnings Call

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OVERVIEW:

Co. reported 4Q16 revenues of $882m and EPS, before special items, of $1.24. Expects FY17 reported revenue to be down 0.5% to up 1%, reflecting 53rd week, or up 1.0-2.5% excluding 53rd week and adjusted EPS to be $3.40-3.50.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Brinker International fourth-quarter earnings conference call. (Operator Instructions). Now I'd like to turn the floor over to your host, Joe Taylor. Sir, the floor is yours.

Joe Taylor *- Brinker International, Inc. - Treasurer, VP IR*

Thank you, Dave. Good morning, everyone, and welcome to the quarterly earnings call for Brinker International's fourth quarter of fiscal 2016. I'm Joe Taylor, Vice President, Investor Relations and Treasurer. And joining me this morning here in Dallas are Wyman Roberts, our Chief Executive Officer, and Tom Edwards, Chief Financial Officer.

Our call this morning will begin with comments from both Wyman and Tom, after which we'll open the call to your questions.

And of course, before beginning our comments, please let me remind everyone of our Safe Harbor regarding forward-looking statements. During our call, management may discuss certain items which are not based entirely on historical facts. Any such items should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All such statements are subject to risks and uncertainties which could cause actual results to differ from those anticipated. Such risks and uncertainties include factors more completely described in this morning's press release and the Company's filings with the SEC.

On the call, we may also refer to certain non-GAAP financial measures that management believes in its review of the business and believes will provide insight into the Company's ongoing operations.

With that, I will turn the call over to Wyman.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Thanks, Joe. Good morning, everyone. Thanks for joining us today and thanks to those of you who were able to spend time with us at our investor day in June. I really appreciate your commitment to learning about us and the story here at Brinker.

As you would expect, given that short period of time between investor day and the end of the fourth quarter, our results were in line with what we expected. We delivered fourth-quarter earnings per share of $1.24, comp sales were down 1.8%, an improvement from down 2% we noted at our June 9 investor day. And the good news there is we continue to gain share versus the industry, and we ended the year running positive to the category.

We had a tough year in fiscal 2016. It didn't play out the way we wanted it in terms of sales and traffic, but we were still able to deliver the low end of our EPS guidance, ending the year at $3.55. And just like any other tough challenge, we faced it, we learned a lot from it, and we've used those learnings to shape our strategy going forward. We enter fiscal 2017 believing this will continue to be a tough macro environment. We're not counting on relief from a presidential election or a significant improvement in the economy anytime soon.

Until household incomes start to see some absolute growth, we believe things will continue to be a challenge for consumers and for our industry. So we took all that into account as we designed the strategies and tactics we laid out for you in June to address consumers' needs for compelling value, quality and transparency, and to maintain our strong business model.

We're moving forward with a much more aggressive and what we think a powerful strategy going into 2017, one we believe will continue to capture share in this environment. And we're already gaining traction, starting with our investments in culinary innovation.

We introduced our new Sunrise Burger and Ultimate Bacon Burger featuring great new flavor profiles and quality, transparent products like cage-free eggs and antibiotic and hormone-free grass fed patties. We also launched a new ad campaign with more media weight to share this new news, but also to tell the story of our unique Chili's heritage, to talk to consumers in a way only Chili's can. And it's interesting. Though the brand was launched in the Boomer era and we know this campaign resonates with Boomers, it's also compelling to the Millennial audience, who embrace the visuals and the music of the 1970s as a more authentic and carefree time.

We also know value is still top of mind for consumers, so we refreshed our value proposition in our new Three for Me offering, a salad, classic burger, and a miniversion of our signature molten dessert for just $10. We're reawakening consumers to the value and quality Chili's has to offer built on a flexible platform that enables us to continually bring new news to consumers to keep our value propositions fresh and relevant. Innovation, value, and messaging -- it all comes together to up our game in the short term and create more momentum for the long-term, and we're already seeing this strategy pay off.

We continue to see sequential improvement in our sales. In fact, in the first quarter, our comp sales are running around flat despite some headwinds with political conventions and the Olympics, and we're back to taking share like we've done for four years prior to fiscal 2016.

And when we talked with you in June, we've been working to implement both short and long-term strategies to elevate the bar experience at Chili's and to build on our core equities of margaritas and beer. Our latest promotional and happy hour efforts are driving continued increases in our alcohol sales and we ended fiscal 2016 with the highest alcohol mix in the brand's history. Just in fiscal July, we sold more than 600,000 Presidente margaritas. We're targeting the implementation of our new craft beer taps by the end of Q2 and we continue to evaluate more significant, longer-term enhancements to make our bars a more relevant and compelling place to visit.

On the technology front, all the work we did in fiscal 2016 to rebuild our infrastructure behind the scenes enables us now to implement consumer-facing technology that brings more convenience and speed to our guests, and drives relevance for the brand in both the short and long-term. We are on the verge of converting our proprietary online ordering system over to Olo, which gives us a much stronger engine to power the fastest growing segment of our business and also enables online pay for our guests.

We're also targeting the integration of the Plenti program into My Chili's Rewards during the second quarter, which has been a huge undertaking by our IT team. We're about to become the only partner in the Plenti system to offer guests a way to see their account balance and redeem points right at the table without needing assistance from a team member. That gives us a unique advantage, offering Plenti guests a simple way to redeem the points they've earned.

These powerful strategies only come to life with effective leadership, and I'm so pleased to have promoted Kelli Valade to President of Chili's. Kelli has been an amazing partner to me and an inspirational leader for the entire operations team. Under her leadership, the team has delivered unprecedented improvements in restaurant margins, as well as record high guest and team member satisfaction scores. During Kelli's 20 years at Brinker, she has proven across multiple disciplines her ability to motivate a team and deliver results. I'm excited for Kelli to take the team forward into fiscal 2017 and beyond.

Of course, I will continue to partner closely with Kelli, Steve, and Tom to drive Chili's, Maggiano's, and Brinker corporate strategy. And while Kelli is focused on the domestic side of Chili's, I will lead the international side and partner with the team to drive the global side of our business.

The global team continues to lead casual dining in developing new restaurants outside the US. We ended fiscal 2016 with 36 new restaurant openings with current and new partners, well ahead of our guidance of 25 to 30, and with comp sales up 0.2%.

Fourth quarter for global was negatively impacted by the shift in Ramadan, which should offset during the first quarter of this year. Fiscal 2017 will be an important year for us as we invest in the brand internationally and pursue growth in new markets like China, Vietnam, and South Africa. I'm excited to lead our global development team in those efforts.

At Maggiano's, we ended the quarter down 1.7%, driven by timing of marketing spending and some seasonal softness in the banquet business. But as we look at the business overall, Maggiano's is an incredibly strong brand with a diverse business model which gives us so many opportunities to meet consumers' needs, whether in the dining room for every day lunch or dinner, a special occasion banquet, or utilizing the convenience of our to-go and delivery business. Add those to the new menu that's doing very well in test, which we plan to roll out in the second quarter, as well as our plan to open two new restaurants and Maggiano's has a comprehensive strategy that we believe will continue to leverage the power of that brand and drive the business forward.

So, we ended fiscal 2016 in line with expectations and we begin fiscal 2017 with a solid plan to fulfill the commitments we've made to you and our shareholders. We've got great initiatives in place for Chili's domestically. We've got good growth opportunities for Chili's globally. Maggiano's has some robust initiatives around menu, delivery, and to-go, and we're pleased with early results.

Given our confidence in the business and our ability to consistently generate strong cash flow in the years ahead, we've also (inaudible) capital structure and we think it's a good time to increase our leverage to deliver greater shareholder value.

And now I will turn the call over to Tom to walk you through the details of the quarter and guidance for fiscal 2017. Tom?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Thanks, Wyman, and good morning everyone. Today, I'd like to walk through the major drivers of our fourth-quarter performance and highlights for full-year fiscal 2016. Then I'll turn to our recapitalization initiative and detailed fiscal 2017 guidance.

Our fourth-quarter earnings per share before special items was $1.24, a 32% increase over prior year. Fourth-quarter revenues were $882 million, an increase of 15% over prior year. This reflects contributions from the Pepper Dining acquisition of 8%, the 53rd week for 8%, and increased restaurant capacity of about 1%, partially offset by lower comp sales of 1.8%.

As we look at Q4 comp sales, we saw a change in momentum for the Chili's business. Chili's gap to Knapp narrowed for the quarter to 60 basis points and improved sequentially throughout the quarter, ending with a positive gap in June. We believe running fiscal 2017 with stronger initiatives to continue gaining share, and for the month of July, our gap to Knapp remained positive.

Looking more closely at Q4 sales, total Company-owned comp sales declined 1.8%. Maggiano's comp sales were down 1.7%, reflecting a softer banquet business and timing of marketing support. Maggiano's delivery and to-go business, which makes up about 10% of total sales, continued to be a bright spot with comp sales up 350 basis points.

Chili's comp restaurant sales declined 1.8%, reflecting a 4.1% decline in traffic partially offset by a 1.3% improvement in mix and a 1% increase in price. While Chili's comp traffic improved from Q3, it was still negative, in part reflecting overall industry performance. Chili's also continued to be impacted by energy related markets, which represent about 17% of our system, but we saw the first signs of stabilization in these markets. Energy markets were down 4.5% during the quarter, an improvement of about 310 basis points compared to Q3.

Chili's price increase of 1% included 1.4% of menu pricing partially offset by 40 basis points of higher expense primarily related to loyalty points redemption. This expense impact is a reduction from prior quarters and reflects our successful initiatives to improve effectiveness and reduce the cost of our loyalty program. We are encouraged by the participation in our loyalty program as we look to transition to Plenti points in Q2.

My Chili's Rewards ended the year with 5.5 million members and 20% member engagement as measured by the number of guest checks that have logged in with a Reward account. Combining with Plenti will allow Chili's to further reduce loyalty program costs and to leverage the power of both My Chili's Rewards and Plenti membership bases.

Looking at mix, Chili's delivered a positive mix of 130 basis points in Q4, driven primarily by our Margarita Madness contest in April and May. The contest increased alcohol mix by 75 basis points to a high of 14.7% during the promotion.

Now let's turn to Q4 margin performance. Overall restaurant operating margin decreased 20 basis points to 18.3%. Excluding the anticipated mix impact of the Pepper Dining acquisition, restaurant margin was up 20 basis points, primarily reflecting the impact of the 53rd week of sales that contributed a positive 80 basis points to Q4 margin.

Restaurant expense margin was favorable by 110 basis points, primarily reflecting the benefit of the 53rd week, a lower accrual for workers compensation and general liability expenses due to favorable experience trends, and lower advertising.

Restaurant labor margin was unfavorable 90 basis points, a primarily reflecting a wage rate increase of around 3% and the impact of sales deleverage. For the full year, wage inflation was 2.5%. Cost of sales margin was unfavorable by 10 basis points, reflecting 75 basis points of unfavorable mix partially offset by 40 basis points of favorable menu pricing and 25 basis points of favorable commodity pricing. Commodity pricing primarily benefited from lower burger meat and seafood costs partially offset by higher steak costs.

Now I'd like to provide a few comments about full-year fiscal 2016. For the year, we posted earnings per share of $3.55, 15% above prior year and within our original guidance range despite lower than expected comp sales. As we've noted before, the 53rd week and lower incentive compensation contributes to earnings growth in fiscal 2016 but will not carry into fiscal 2017. These items combined for $0.42 of benefit in 2016.

We also delivered free cash flow of $282 million for the year. This performance is a testament to our strong business model and supported share repurchases of $285 million during the year, including $19 million in Q4.

As Wyman mentioned, we announced our intent to increase leverage. We are targeting an increase of approximately half a turn of leverage, representing around $250 million to $300 million of incremental debt, which we believe positions Brinker to continue to execute our current capital allocation policy with strong possibility and to return additional capital to shareholders in fiscal 2017. We have concurrently increased our share repurchase authorization by $150 million and have $450 million currently available.

We believe it is critical to continue to implement our disciplined capital allocation policy, which, apart from audibly higher leverage, is unchanged. Our capital allocation policy includes several priorities: first, investing in the business to sustain and grow our brands; second, targeting a dividend payout around 40% of earnings and growing our dividend as we grow earnings; and finally, returning any excess cash to shareholders in the form of share repurchase. We'll provide more details as we execute our anticipated initiative to increase leverage in the near future.

Now I'd like to provide detailed guidance for fiscal 2017. This includes the three items we provided at our June 9 investor day, namely comp sales, EPS, and capital expenditures, which are unchanged. Guidance also includes the anticipated impact of our planned refinancing, which could vary based on market conditions.

We continue to forecast comp sales growth of 0.5% to 2%, including a price increase of 1.5% to 2%. We forecast Company-owned restaurant capacity growth of approximately 0.5% on a 52-week basis. We expect Brinker reported revenue to be down 0.5% to up 1%, reflecting the 53rd week, or up 1% to 2.5% excluding the 53rd week. We expect adjusted EPS of $3.40 to $3.50. This represents a reduction of 1% to 4% from 2016, but normalizing 2016 for the 53rd week and incentive compensation, our 2017 adjusted EPS range reflects growth of 9% to 12%. EPS guidance also includes the anticipated impact of refinancing, which is expected to be relatively neutral in fiscal 2017 but is anticipated to be accretive to EPS in 2018 and beyond.

As we look at margins, our reported restaurant operating margin is projected to be down approximately 50 basis points. This reflects an approximately 25 basis point impact from the 53rd week, higher advertising investment, higher labor costs, and planning incentive compensation at target partially offset by lower cost of sales.

Regarding cost of sales, we project moderate deflation, primarily led by lower costs for poultry and beef, partially offset by higher costs for produce. Currently, we are 81% contracted for commodities in Q1 with 61% contracted in Q2.

We expect wage inflation of slightly below 3% in fiscal 2017, primarily reflecting wage increases for salary and hourly team members, with a third of this increase from higher minimum wages. We forecast capital expenditures of $110 million to $120 million, reflecting investment in new restaurants, maintenance, new bar investments, and technology initiatives.

Looking more closely at technology, we are well on our way to building out our digital guest experience program, migrating to new technology platforms, and transitioning our IT and systems management to a more partner centric model. Execution of this strategy resulted in some discreet expenses in 2016 and we anticipate there will be other discreet expenses in fiscal 2017 that are not reflected in our guidance.

We expect depreciation expense to increase $3 million to $5 million, reflecting past and ongoing investments in new restaurant technology and reimage. Our G&A is expected to be $16 million to $18 million higher, primarily due to planning for incentive compensation at target partially offset by the lack of the 53rd week. Interest expense is expected to increase $15 million to $22 million due to a higher average debt balance and higher anticipated average interest rate. Excluding the impact of special items, our income tax rate is expected to be 29% to 31%, and free cash flow is projected to be $230 million to $240 million. Finally, we project a weighted average share count for full-year fiscal 2017 between 50 million and 53 million.

That concludes our guidance for fiscal 2017. And with that, I'll open up the line for questions.

Joe Taylor - *Brinker International, Inc. - Treasurer, VP IR*

Dave, we'll take questions now please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Chris O'Cull. Please announce your affiliation.

Chris O'Cull - *KeyBanc Capital Markets - Analyst*

Thanks. It's with KeyBanc. Wyman, my question relates to the ad spending. We're seeing other chains talk about increasing their ad spend, and I'm assuming it's going to be to support value messages. Does Chili's have a pipeline of value messages that it use to address may be more intense competition? I know this recent one is very flexible. Do you plan on making frequent changes to it?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Yes, I think we've actually been running multiple messages and we think that's going to continue to be our strategy, value being a primary -- one of the primary messages, obviously, in this environment. And yes, we do have and do see the need to put compelling value propositions out there. This latest 3 For Me platform is flexible. We can work within that platform, but there are also other ways we can deliver value, both on television advertising and then, again, a lot of opportunity -- and you guys see this now that everyone's pretty much got an email database or some kind of loyalty program. That's where there's also a great opportunity to use targeted value propositions for -- to drive the traffic and be real specific in this.

We get smarter and smarter about what our guests in our loyalty program are looking for, and who they are as they share more information with us. And we've got more ability to leverage that database to talk to them and offer them things that are really compelling for that individual. And that's where we're going. And when we talk about a digital guest experience, it's about getting more specific with each guest about what they're looking for. And sometimes that's value and sometimes that's maybe more around an innovation message or a product message.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

And Chris, for the year, our ad spending, as we noted in June, is going to be up 16%, so we'll have plenty of support between both traditional media as well as digital to say and spend against these messages.

Chris O'Cull - *KeyBanc Capital Markets - Analyst*

You guys saw quite a bit of mix improvement this last quarter. Should we expect -- with the focus on value, should we still expect mix to go up in fiscal 2017?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Well, if you remember last year, we had the reverse. In the fourth quarter and into the first quarter of last year, we experienced, for really almost the first time in the history of the brand, some negative mix. So we will wrap on that in the first quarter of this year. We got some of that back in the fourth quarter. We've also, though, on top of that, just -- we're getting -- our operations teams are just getting more and more focused and better at getting the team to sell effectively.

We also see things from the innovation front, whether it's the happy hour, whether it's the Margarita event on Thursdays, that are also driving positive mix for us. So, we don't anticipate maybe the same levels that you're going to see in the fourth and first quarter in terms of positive mix, but we do think it will be a benefit for us going forward, even with some of the promotional activities we've got in place.

Chris O'Cull - *KeyBanc Capital Markets - Analyst*

Great. Thanks, guys.

Operator

Sara Senatore. Please announce your affiliation.

Sara Senatore - *Bernstein - Analyst*

Thank you. Bernstein. And one follow-up question and then a question about the franchisees. So, the follow-up question is about the big step up in marketing spend and just thinking about the context of your margin algorithm, earnings algorithm, going forward. So, there's going to be offset by food costs next year, but typically speaking, when food costs are deflationary as we are all seeing now, it's not great for top line. I guess I'm just trying to understand, going forward, should we be expecting fairly rapid growth in marketing spend and things like labor? And does the earnings growth algorithm still work when you're doing this, or is this more just like a normalization on those lines and you think you'll get back to a more modest pace of growth on some of these expense lines after next year?

And then if I could just ask on the franchisees. Sales were a little bit lower than we might have thought. Is that just because comps were not as good? Or maybe just talk a little bit about the health of the franchisee base, please.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Sure. Sara, it's Tom here. I can take the first question. I believe, on the pricing side, we believe between 1.5% to 2%. We can manage and pass through that pricing as we have done in Q4 and in the past, while still managing, even in this deflationary environment for food costs because we don't believe that that will remain necessarily in place over the longer term.

In terms of the advertising spend, we have taken it up because we had it down in the prior year to help fund the loyalty program, and we have added to that over the past. And I would expect that, as we look into 2018, we'll determine what the best optimal mix is to drive sales and revenue, and make our decisions at that point. But right now, we have the mix I think aligned between the margin investment that we're making in advertising and the top-line growth that we're forecasting for fiscal 2017.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Sara, I'd just add, on the marketing front, we're not saturated. We've got opportunity, and so the increasing spend, we watch it very closely and we believe and we think we see incremental sales driven from those spends. And we'll continue to look at the channels and put those dollars where they are the most effective, whether it's in the digital space or whether it's in the more traditional. Being a national marketer, that's one of the benefits of Chili's that we will leverage and continue to leverage. But we'll watch it closely to make sure that it's driving the incremental traffic necessary to get the right return on it, but we don't believe we're at a saturation point, that this increase in spend will drive incremental traffic necessary to make that work for us.

On the franchisee side, again, if you're looking at the US franchisees, very similar sales patterns to the Company-owned restaurants in the US. So, I don't think there was a significant difference there. If you're looking at the total franchise environment, you can see that big drop in the international franchise, and that's all driven by that shift in Ramadan late in June, moving out of July last year into June this year, which caused the a fairly significant impact to the comp sales numbers in our Middle East restaurants, which are significant for us. We're getting that back already in July because, again, the flip in the holiday. So we'll see most of that come back to us first quarter of this year.

Sara Senatore - *Bernstein - Analyst*

Thank you.

Operator

Robert Derrington. Please announce your affiliation.

Robert Derrington - *Telsey Advisory Group - Analyst*

Thank you. Bob Derrington with Telsey Group. Wyman, could you help us understand for a second? As we think about the advertising, the spots you've been running recently have been a little bit different in that you've been talking a little bit more about the heritage of the brand versus food. A, are you satisfied with the spots and how they're delivering? And should we anticipate that they may migrate back towards more food focus to be more aggressive at bringing traffic in? How should we think about that?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

No, we're absolutely happy with the way this campaign is working for us, Bob, on all our internal metrics. And we did a lot of work going into the rollout of this campaign with consumers in all segments, and then some external research from the advertising industry has confirmed the effectiveness of these ads.

So we think there's two things that are important for Chili's. One is to start to talk to the consumer in a way that gets them to rethink the proposition and just break through. It's a brand that's been around a long time. It's a great brand. But everyone is using the same food photography and it starts to become a sea of sameness on-air. And these commercials are definitely doing that. They're breaking through, and they're resonating. And while there's not as -- maybe if you were to parse it out second to second, there may not be as many food segments or seconds in this spot, there's a lot of good food photography in there. And the offers are coming through and the messages are coming through. So in the spot where we talk about grass-fed patties, they're getting that. In the spots where we talk about our value proposition, the 3 For Me, they are getting that very clearly, too. So we're absolutely excited about this approach and we anticipate continuing to leverage this thinking because it's also something nobody else can do in this space. We did start as hamburger hippies 40 years ago, and there is a heritage to this brand that I think has gotten lost. And the marketing group and the agency has done a nice job uncovering that and it resonates with consumers. They are looking for something that's real, and this brand has that in its DNA.

Robert Derrington - *Telsey Advisory Group - Analyst*

If I could follow up real quick, as we think about the Chili's brand and some of the messaging and the value promotions, et cetera, you've been running recently, and we know you have a lot of programs in the months to come. Wyman, should we directionally be thinking in terms of a sequential build for the business through the course of the year? I know you don't like to get into details like that, but just trying to think through some of these things.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Yes, I think that's fair to say, that, again, we started it really in the fourth quarter and you've seen from third to fourth and we anticipate continuing that kind of momentum, sequentially building into the back end of the second and third, where we struggled last year in the second and third quarter. And we see our opportunities to really come back on top of that with the campaign. With all the things we talked about with Olo, with Plenti in the back half, we think we will continue to move this -- use that as momentum to sequentially build the business.

Robert Derrington - *Telsey Advisory Group - Analyst*

Terrific. Thank you.

Operator

Nicole Miller, please announce your affiliation.

Nicole Miller - *Piper Jaffray & Co. - Analyst*

Piper Jaffray. Good morning. Just a real quick technical question with a follow-up. With the shares outstanding in the prior guidance at the analyst day, is it -- or was it not -- and then is it in the guidance, the earnings guidance, now? I just want to make sure we model that out appropriately.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Yes, shares outstanding was (multiple speakers) --.

Nicole Miller - *Piper Jaffray & Co. - Analyst*

The share buyback. I'm sorry. You know what I'm saying, sorry.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Oh, you're talking about the increased leverage then. That was not in that guidance. We have now included it in the guidance so you can see the interest expense is higher. We didn't provide that specific item June 9, and shares outstanding lower, but it was not included. It's now been included in that.

Nicole Miller - *Piper Jaffray & Co. - Analyst*

Thank you for specifying that. And I do think I missed this. If you said it, I apologize. But restaurant expense line had been up to flat until 4Q then it was down. Could you breakout the pieces? And again, I just want to make sure we model that appropriately. That's where marketing will be, so that's where we should make sure we reflect that increase appropriately. So, could you help me understand some of the pieces that help bring that down?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Nicole, are you referencing Q4 or 2017?

Nicole Miller - *Piper Jaffray & Co. - Analyst*

Q4, yes.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

In Q4, we saw cost of sales slightly negative, and that was more due to mix, due to selling some higher protein and higher cost items. Restaurant labor was down, and that was about 90 basis points. And that was primarily due to higher wages and deleverage. So we were still in a deleverage environment in Q4.

And restaurant expense was favorable 110 basis points. A large part of that was the 53rd week, as well as some of the benefit from workers comp and general liability insurance, about 30 basis points and 20 basis points from advertising. So those are the main components of Q4 for margin.

Nicole Miller - *Piper Jaffray & Co. - Analyst*

And I just wanted to -- it was just on that restaurant expense line, the last one you mentioned. So we don't want to model out how Q4 looked. We want to look more like the other quarters and then take into account the things you've talked about, the marketing spend, whatnot, and model off of that. Is that correct?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

That's correct. You'd see and expect to see cost of sales favorable in 2017. Restaurant labor may be moderately negative, and restaurant expense would reflect our investment in advertising.

Nicole Miller - *Piper Jaffray & Co. - Analyst*

Thanks. Have a good day. Thank you. Appreciate it.

Operator

John Glass. Please announce your affiliation.

John Glass - *Morgan Stanley - Analyst*

Thanks. It's Morgan Stanley. First, just following up on the question about current trends, did traffic improve or is this just a -- not just, but is it a function of mix, or did traffic actually improve in June and July when you're talking about closing the gap to the industry?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Yes, John, we did see -- we started the quarter with pretty much the same trends that we ended third quarter with, because nothing had really -- we really didn't start getting into the change of the marketing strategy, getting more aggressive with the rib bundle until May and June. So, through May and June is where we started to see the trend changes, both on traffic and on top line. And that's where we started to move forward to take share from the industry, really in that back half of Q4.

John Glass - *Morgan Stanley - Analyst*

Got it, okay. And then, Tom, just on your comments about that the buyback doesn't really add to the 2017 guidance, why is that? You're lowering -- I understand there's a trade-off with the higher interest and lower shares, but I would assume that you'd get some benefit from it. Are you going to take all the debt out early and then ratably buy back at a much slower rate? Or how do the mechanics of that work that it doesn't add much, if anything, to the year?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

John, you mentioned the two components: higher interest costs offset by buyback. The buyback would occur, and we wouldn't get the full weighted average benefit of that in 2017 versus obviously in 2018 it would be full for the year. So it depends on the timing of execution, the market conditions, and rates we get on execution, and then subsequent timing of share repurchase. So we're modeling it as modest, a very modest, impact to 2017 at this point but accretive going forward. So that will vary based on timing and market conditions. We'll update you as soon as we're out there with more news on that.

John Glass - *Morgan Stanley - Analyst*

Great. Thank you very much.

Operator

Karen Holthouse, please announce your affiliation.

Karen Holthouse - *Goldman Sachs - Analyst*

Karen Holthouse from Goldman Sachs. Just a question with the deleverage that's expected on the G&A line this year. How should we think about those investments as one-time versus ongoing? Do we get some of that deleverage back in a year or two, or is that just a new normal that we should think of modeling off of going forward? Thanks.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Well, deleverage, as we grow sales, we expect that part to not be part of the components of our drivers of margin going forward. So we did see that in most of our quarters in fiscal 2016. We definitely are not reflecting that in our forecast for 2017.

Karen Holthouse - *Goldman Sachs - Analyst*

So, I was asking more beyond fiscal 2017, when the investments that are accounting for the increase in G&A spending. Sort of is that all recurring spend or some upfront spend, particularly on the technology stuff? I would imagine that that's -- there's a combination of those two things that go into it.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Sure, Karen. As we look forward past 2017, we'd be looking in things that we're building up the base and grow expenses as needed based on how we want to drive sales. So technology, there's certainly an upfront investment in specific items, but we expect a relatively constant spend over time on those areas to maintain and grow and add new capabilities, for instance like the hand towels we're testing now and would anticipate rolling out. There are other projects along those lines that will continue to have benefits, both productivity and sales related benefits. So, I would look at it along those lines.

Karen Holthouse - *Goldman Sachs - Analyst*

All right. Thank you.

Operator

John Ivankoe, please announce your affiliation.

John Ivankoe - *JPMorgan - Analyst*

Great, thank you. Since your June 9 analyst day -- and I assume that you guys did a very full and comprehensive strategic review for that analyst day, and certainly with the Board going into that, the increase in leverage is actually a pretty significant event for Brinker. So can you frame maybe what's changed over the last couple of months, and with that additional debt, if you expect to remain an investment grade company, or you are willing to accept high-yield, at least temporarily, as we think about refinancing needs over the next couple of years?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Hey, John, Wyman. It wasn't like we haven't been looking at our capitalization and leverage forever. We're always looking and evaluating how to generate incremental returns for our shareholders in an appropriate way that still gives us all the flexibility we think we need to grow the business organically. And so, as we look at where we sit today and where the markets are and everything that's in front of us, we thought this would be a good opportunity to take advantage of a little bit more leverage. And so, again, it's always something we continue to look at. We'll look at it, as most people do, on an ongoing basis, and the timing just looks right for us now given how we see our future and the flexibility we have and how consistent we have been generating cash over the last five years. So, that's kind of what drove the timing of this decision, but it wasn't something that just kind of between -- believe me, we were looking at it in June. We just weren't ready to announce it at that point in time. So it's well thought out and really some great work done by Tom and the team to get us to this point.

John Ivankoe - *JPMorgan - Analyst*

Absolutely. And in terms of -- do you expect to stay investment grade? Are you okay going high-yield? Obviously, that's a very big corporate decision to be one or the other. What's right for Brinker as we look forward?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

John, it's Tom. Ultimately, we'll let the rating agencies provide their feedback and direction on investment grade or non-investment grade. What we were targeting and will be targeting going forward is a leverage range about that half a turn higher, which, as Wyman mentioned, it allows us to balance everything that we're currently doing and we'll be able to continue to do it on capital allocation. So in addition to buying back some additional shares within 2017, we'll be able to continue our ongoing share repurchase program, for instance. And we won't be targeting so much a specific rating. As we work through the transactions, I know and expect that we'll get that feedback from the rating agencies.

John Ivankoe - *JPMorgan - Analyst*

And if I may, in the press release, you talked about $250 million to $300 million of incremental leverage. So, does that include any potential refinancing of your existing securities that are on the balance sheet? And what kind of flexibility do you have to add more leverage in addition to your current notes and revolver that you already have?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

John, we've put together what we think is a very good set of financing opportunities, but we need to go to the market for that. So, I would just hold off at this point with any specifics, as we'll work through that. But it will come out at the other end. Our anticipation is, with adequate flexibility from a liquidity perspective and the right cost effective vehicles, to add incremental debt.

John Ivankoe - *JPMorgan - Analyst*

Okay, great, guys. Thank you.

Operator

Jeffrey Bernstein, please announce your affiliation.

Jeffrey Bernstein - *Barclays Capital - Analyst*

Great, thank you, from Barclays. Two questions, please. First, Wyman, it's what seems to be a pretty good trend in terms of going from lagging to leading the industry. I'm just wondering whether you could prioritize. I know you've listed a few drivers, but what you thought was the biggest factor that led to that reversal, and maybe just layer in some color just on the category from a competitive and a discounting perspective. Again, seeing your change in trajectory, I know you listed value and burgers and alcohol and a variety of other things. Just wondering how you size up the industry and how you reverse that trend. And then I had one follow-up.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Hey, Jeff. Yes, I think -- well, let me take the second question first. How do we see the industry? We see it as being very competitive out there. And obviously casual dining in our fourth quarter and really into the third and fourth quarter has seen some headwinds that I think were unexpected. Given these macroeconomic indicators, especially around unemployment, they just don't seem to be holding like they have in the past. So we don't anticipate the industry getting a whole a lot of support. It looks like, even with QSR more recently, some of the things that they did in our Q3 that drove their performance aren't working as well even now.

So there's definitely an anxious consumer out there that's looking for value propositions but also just it looks like making the, as Malcolm Knapp likes to say, making that allocation decision more and more often. So, it's going to be competitive out there.

That said, how did we turn the tide and how are we getting back to the kind of performance that has historically been the case at Brinker? It's a multiple pronged approach and it is a lot of the things you mentioned. So first, we'll take the mix thing, getting back to selling more effectively in restaurant and getting our merchandising and our operations teams to really focus on providing great offers for our guests and giving them a lot of incentive to enjoy things in the restaurant. It's putting a more effective value proposition out there with 3 For Me and the rib bundle that has a value that is really exemplary in the category, we believe, and consumers are telling us. And then it's the campaign and the media spend behind it. So all of those things come into play.

Our learning from 2016 was that we probably put too many -- we've had basically too few eggs in one basket. And this year, we're going with multiple approaches to addressing the consumer across a variety of needs. So it's not just going to be, hey, let's lower prices and go get them that way. It's going to be a combined effort around better execution, better innovation, a strong value proposition, communicating with new messages that break through. All of those things are going to be necessary -- revamping the technology to the next level, which we think we're already leading the industry in that sense from a casual dining perspective, but how do we take it to the next level. All of those things are going to be necessary to win in this environment, and we're confident we can do that. But we don't think it's going to be a rosy environment, necessarily. It's still going to be some tough sledding we think, but we're up for it.

Jeffrey Bernstein - *Barclays Capital - Analyst*

Understood. And Tom, just because you gave all that color on the fiscal 2017 guidance, just to provide a little bit more clarity, I know you said the comps are running flattish in the first quarter. I believe that's what you said. But between comps and EPS directionally, should we assume slow in

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the first half, accelerating in the second? Are there any particular quarters where we should know of any unusuals, or is it fairly straightforward, more back-end weighted across the top and bottom line growth?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

Now, I believe the comment that Wyman was referencing the sales trajectory, so I think that that would be a little bit stronger in the back half. In terms of other items, normal seasonality on margins should tend to be lower in our lower volume first quarter and stronger in the second half on higher restaurant margins, but that's in line with history. Otherwise, we haven't provided real specifics on the quarters.

Jeffrey Bernstein - *Barclays Capital - Analyst*

Great. Thank you.

Operator

Andrew Strelzik, please announce your affiliation.

Andrew Strelzik - *BMO Capital Markets - Analyst*

BMO Capital Markets. Thanks for taking the question. I wanted to ask about the pricing, which -- 1.5% to 2%, which you reiterated from the analyst day. And I understand that you are pursuing the value, but we've heard some other of your peers talk about taking less pricing. You're talking about commodity deflation again and this whole conversation with groceries. So I just want to -- if you could provide some perspective as to that thought process and why you'd be taking more pricing now than you have in the past. Is it just in conjunction with some of the other initiatives that you can absorb that, or just why now is the time to do that? Thank you.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Hey, Andrew. The 1.5% to 2% is pretty much what we have always -- well, not always, but for the last five years has been our strategy. We are of the opinion that we price for while commodities are down, we are experiencing labor costs and other costs, we've got price for cost increases. And doing that at a consistent 1.5% kind of range is the best way to go after it versus taking consumers on a little bit more of a roller coaster ride in the restaurant business. It's a little different in retail, where you just re-sticker the product every day. But for us, we believe that it makes more sense to be more consistent in your pricing. And if we have to give some back in promotion or in discounting through some marketing efforts, we can do that more or less aggressively, but that's our strategy from a base menu.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

And two other points. Overall inflation is running around that level, Andrew. And the food away -- or food at home pricing, which had a step down, fairly material, in the last several quarters, we don't anticipate that that will have an additional step down. So that does we believe support the 1.5% to 2%.

Andrew Strelzik - *BMO Capital Markets - Analyst*

That's helpful. I appreciate it. And if I could sneak one more in. Are you guys able to measure your share of voice in terms of TV advertising? And I'm just wondering how that's trended. And obviously, with the national advertising being down last year and up meaningfully this year, does this get you back to where you were? Have you not lost as much as maybe those numbers would indicate? Any commentary on that would be helpful.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Yes, Andrew. We do measure our share of voice relative to other competitors. And while we took a decrease last year, other folks were adjusting their media budgets as well. So we track it. We obviously felt that, in looking at how we were performing and what was happening in the space, that we may have given up too much there, so we're back up with a stronger budget this year. We will continue, like I said, to evaluate how that investment performs for us and we'll modify its effectiveness through the different channels. So, we do watch share very closely and we're confident that this investment level, this increased level of marketing spend, will get us back to a place where we'll be competitive.

Andrew Strelzik - *BMO Capital Markets - Analyst*

Great. Thank you very much.

Operator

Peter Saleh, please announce your affiliation.

Peter Saleh - *BTIG - Analyst*

Yes, BTIG. My question is on the advertising, the spend. Again, just coming back to that. I know the new media campaign kicked off in July, and I know you guys have a pretty significant increase on the ad spend. Has that ad spend, the incremental dollars, has that already begun, or is that going to be more into 2Q and into the back end of the year?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

We'll be increasing our advertising, both traditional media and digital, across the year and across the quarters. So, we did have some additional spending and kicked off the new campaign with [30s] as well as [15s], we will be posting those [30s] on later in the year as well. So the intent is to have a positive impact over the course of the year.

Peter Saleh - *BTIG - Analyst*

Do you guys anticipate any lull in ad spend around the elections, maybe in the October time frame, early November?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

No, Peter, we haven't -- again, most of the challenge in the advertising space around the election is probably going to take place in the local markets, so in Florida and the contested states. Probably. We're a national advertiser and so we don't anticipate some of the challenges that you might face that might compel you to maybe not get into those local market advertising spaces because there could be some -- historically you've seen high costs during some of these elections. But again, we're a network advertiser, buy a lot of it up front, so we're confident that we can run the appropriate levels through the year. And whether or not we flex those levels during the height of the campaign is something we probably wouldn't want to share on this call anyway, but we'll evaluate it. But we won't be driven by the campaign as much as the local markets.

Peter Saleh - *BTIG - Analyst*

And then just last question, I think you said Plenti is going to launch I think you said in 2Q if I'm correct. Will you be transitioning some of the ad message towards Plenti, or are you guys going to stick with the same ad campaign going forward?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

From a television standpoint, we don't anticipate the Plenti conversion being a big national television message. It will be more targeted and more direct.

Peter Saleh - *BTIG - Analyst*

Okay, great. Thank you very much.

Operator

Will Slabaugh, please announce your affiliation.

Will Slabaugh - *Stephens Inc. - Analyst*

Thanks, with Stephens. I wanted to ask about the value initiatives. It seems like, with the recent initiatives that you've launched, you included a quality aspect there, such as the grass-fed beef, et cetera. So given the initial results, which is down pretty positive, should we assume that you are looking to continue upping the quality of your product to drive more meaningful and impactful messaging throughout the year? And if so, would that be impactful enough to negate some of the food cost savings you're expecting to get for next year?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Well, we think that consumers are interested in transparency and having options, and so we will continue to build out our food pipeline and innovate around that belief. Some more -- we will do more with these kind of ideas. Whether they're -- what the implications are and in the menu, it will depend on how aggressive we want to get with that. And so I can't really give you a message there. We're committed to keeping our business model intact. I can say that. And we're charging a premium for the grass-fed patty and having no problems with it and guest feedback has been outstanding. So we will continue to, as we get more and more involved in this journey, to understand where the consumers' heads are at and what the appropriate level of pricing is for some of these products.

Will Slabaugh - *Stephens Inc. - Analyst*

Got it. And just a follow-up if I could on the labor inflation. Could you repeat what you said it was this quarter and then what is embedded into your fiscal 2017 guidance?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

For this quarter, it was a little over 3%, just reflecting timing of some minimum wage changes. And the guidance is slightly below 3% for fiscal 2017.

Will Slabaugh - *Stephens Inc. - Analyst*

Thank you very much.

Operator

Joseph Buckley, please announce your affiliation.

Joseph Buckley - *BofA Merrill Lynch - Analyst*

Bank of America Merrill Lynch. A question on the alcohol mix. Were you able to sustain the higher alcohol mix after the margarita contest was over? And do you have to invest a little bit more in labor as you are asking the servers to sell the product a little bit more?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Well, first, the absolute number -- whenever we put a more concentrated server driven initiative out there, we pop it a little bit more, Joseph, from an absolute standpoint. We see those a little bit of a bump up, but the relative improvement over prior year has continued. So we are selling -- doing a better job every day with what we offer and our operations teams really getting out there and getting their team excited about the innovation that we're bringing.

We really are encouraged by what we're seeing in the handfuls of restaurants that we have rolled out the craft beer initiative in. And so as we accelerate that through this quarter and hope to have almost all of our restaurants with almost double the number of taps with craft, local craft beer offerings, again, those are the kind of things that we don't have to add labor or servers to get excited about those products. The consumers get excited about having those products available at Chili's and that's another source we anticipate and are counting on continuing to improve our alcohol mix.

Joseph Buckley - *BofA Merrill Lynch - Analyst*

And Wyman, do you have to invest in table servers to give the table servers time to engage with the guests to sell the product or is that not --?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

No, we have -- our servers have plenty of time to do that. With the introduction of Ziosk, for example, a lot of time that the server spent getting the check and running back and bringing it back to the guest to cash them out, that all happens now by the guest pretty much and frees up that time for the server. So we have opened up opportunities for servers to have more time with our guests. It also has allowed us to be a little bit more efficient, but as we leverage technology and we figure out how to merchandise effectively, we feel like our guests' and our servers' interaction hasn't suffered. And of course we track it with, again, with all the feedback that we get through our 25% of our guests that give us guest satisfaction surveys every day. We have a pretty good sense for are they having the kind of interaction we think we need to continue to have to make people feel special and to drive that intent to return number to where it needs to be for us to be successful.

Joseph Buckley - *BofA Merrill Lynch - Analyst*

One more on the leveraging event. Tom, what are the key ratios you're thinking of? Do you think about your debt ratios as lease adjusted debt to EBITDAR? And where will this incremental debt take you?

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

We are looking at a rent-adjusted leverage, so that would be an EBITDAR base. And it's currently running around any given quarter 3.25, but another half a turn to 3.75. And those are ranges, so they can vary, but that broadly is some direction.

Joseph Buckley - *BofA Merrill Lynch - Analyst*

Okay. Thank you.

Operator

Howard Penney, please announce your affiliation.

Howard Penney - *Hedgeye Risk Management - Analyst*

Hedgeye Risk Management. Thanks so much. Wyman, it feels like there's been two changes on the margin, bigger picture changes, that occurred in the last six months, one on your analyst day where you talked about transparency. I know you were asked about this once already, but where do you think the supply chain is and what products do you think you could go to in an effort to bring more transparency to the menu?

And then the second question is on the leverage and the increased leverage. Again, it feels like there's a change on the margin in terms of your ability or comfort level with higher leverage. So I was just wondering if there's another aspect of the business model that goes along with higher leverage that you might be thinking about differently in terms of other structural changes to the way Brinker is run today. Thanks.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

With regard to transparency and where the supply chain is, I think it's coming along. I think the consumer is forcing the supply chain to move itself to a point where more of the products that certain segments of the population are interested in are available, not just in grocery but also in various restaurant environments. So, that's encouraging. We're working with partners and with actual growers to say, hey, listen, this is the kind of thing we're hearing and seeing and we need to have those alternatives for us. And again, I think the grass-fed patty is a great example of us and our supply chain team finding a supplier that can make that available to us. And I think there will be this transitional period to some degree around is it a full swap out or is it an option like we're making available now within the burger category as consumers weigh the costs associated with some of this product, which can sometimes be a little higher. And then just how important it is for them specifically. So we think it's moving and we're excited about leading some of that with our partners.

Tom Edwards - *Brinker International, Inc. - EVP, CFO*

And Howard, it's Tom here. On your second question, we're comfortable with our current business model and the cash flow that it generates to support the leverage. We obviously will continue to evaluate other options over time, but believe the best value creating opportunity now is to continue to drive the Chili's business and this leverage event.

Howard Penney - *Hedgeye Risk Management - Analyst*

Great. Thanks. I guess I was trying to hope -- I guess I was hoping to elicit a response that you might be willing to sell stores, but I guess I didn't ask the question properly, but thanks so much.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

We understood, Howard (laughter).

Howard Penney - *Hedgeye Risk Management - Analyst*

I knew you did, but I just needed to say it. Thank you.

Operator

Jeff Farmer, please announce your affiliation.

Jeff Farmer - *Wells Fargo Securities, LLC - Analyst*

Thank you. Wells Fargo. A couple of questions. What casual dining segment traffic growth assumption is reflected in your 0.5% to 2% same-store sales guidance for the full year? I know that's a tough question, but just any parameter would be helpful.

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Hey, Jeff, Wyman. Obviously, we have a number. I'm not sure I want to share it on a call because everyone should be working on their own set of assumptions and I don't really want to give -- I'm more than happy to give you it, but I don't want to give anyone else that number. We'll just leave it to we don't anticipate, like I said, that this is going to be a whole -- that the category is going to get a whole lot healthier in the near future. And so our expectations is that we are going to take share, so obviously we think the category is going to be less than that, and exactly how much softer is kind of everyone's guess.

Jeff Farmer - *Wells Fargo Securities, LLC - Analyst*

Okay. And then unrelated, you guys have obviously lived through the last decade, sort of the postrecession efforts that a lot of these casual dining companies have made to win some market share. But history clearly does show that if you have success with a bundled value offer or strategy, someone's going to quickly come behind you and essentially copycat it. So it's early, but it does sound like that 3 For Me has gained some traction for you guys. So the question is how can you maintain that traction, especially if peers begin to follow suit?

Wyman Roberts - *Brinker International, Inc. - President, CEO*

Yes, I think it's that whole idea of it's not one approach. So the value message -- we are on TV today with, at any point in time, two or three different messages: a lunch message, a dinner message, a brand message. We've got technology in the mix. We've got food innovation in the mix. There's a lot of things that we're bringing to the table -- new to-go, the rollout of Olo and leveraging, again, the fastest-growing piece of our business, which is that to-go piece with a much more we think consumer friendly and really it's an engine that we can actually market and push harder.

So, we've got a lot of things in the mix that we think we're going to have to push to stay ahead of the competition. There's a lot of good competitors out there. And you're right, everyone -- there's a lot of transparency, especially when you're on TV, so there's no real secrets. It's about who can execute and who's got the resources. I think that's a big part of who's going to win in the future. And we have the resources where we've shown our willingness to invest in things and like technology and in innovation and we're going to continue to that. And so that's how we plan to stay ahead, is to not just rely on one promotional idea like 3 For Me, although it's a great idea.

Jeff Farmer - *Wells Fargo Securities, LLC - Analyst*

All right. Thank you, guys.

Joe Taylor - *Brinker International, Inc. - Treasurer, VP IR*

Okay. Well thank you, Dave, and thanks to everyone for participating this morning. I want you to note that our first-quarter fiscal 2017 earnings call is scheduled for October 25, 2016, and we look forward to all of you joining us then. Have a great rest of the summer and good day. Thank you.

Operator

Thank you very much. Ladies and gentlemen, this concludes today's call. You may disconnect your lines and have a wonderful day. Thank you for your participation.