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Darden Restaurants, Inc. (DRI)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Darden Fiscal Year 2019 Second Quarter Earnings Call. Your lines have been placed on a listen-only mode until the question-and-answer session. [Operator Instructions]

I will now turn the call over to Mr. Kevin Kalicak. Thank you. You may begin.

Kevin Kalicak

Vice President, Investor Relations & Corporate Analysis, Darden Restaurants, Inc.

Thank you, Sue. Good morning, everyone and thank you for participating on today's call. Joining me on the call today are Gene Lee, Darden's CEO and Rick Cardenas, CFO. As a reminder, comments made during this call include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. Those risks are described in the company's press release which was distributed this morning in our filings with the Securities and Exchange Commission.

We are simultaneously broadcasting a presentation during this call which is posted in the Investor Relations section of our website at www.darden.com. Today's discussion and presentation include certain non-GAAP measurements and reconciliations of these measurements are included in the presentation.

We plan to release fiscal 2019 third quarter earnings on March 21 before the market opens followed by a conference call. This morning, Gene will share some brief remarks about our quarterly performance and business highlights and Rick will provide more detail on our financial results from the second quarter and update our outlook for fiscal 2019 before we take your questions.

As a reminder, all references to the industry benchmark during today's call refer to estimated Knapp-Track, excluding Darden. During our fiscal second quarter, industry total sales growth was 2.1%. Industry same-restaurant sales grew 1.2% and same-restaurant guest counts decreased 0.2%. Now, I'll turn the call over to Gene.

Eugene I. Lee

President, Chief Executive Officer & Director, Darden Restaurants, Inc.

Thanks, Kevin. Good morning, everyone. As you've seen from our press release this morning, we had a solid quarter. Total sales from continuing operations were $1.97 billion, an increase of 4.9%, same-restaurant sales grew 2.1% and diluted net earnings per share were $0.92, an increase of 26% from last year's adjusted earnings.

As industry sales continue to improve, we made the strategic choice to further reduce our incentives during the quarter, recognizing it would likely put pressure on our same-restaurant sales and traffic. This resulted in our GAAP to the industry narrowing, however, it enabled us to build a stronger guest base and contributed to our margin improvement which Rick will discuss later.

We continue to focus on the relentless execution of our back-to-basics operating philosophy anchored in food, service, and atmosphere, and strengthening and leveraging our four competitive advantages. Olive Garden had a solid quarter, which resulted in its 17th consecutive quarter of same-restaurant sales growth.

Total sales grew 4.9% driven by same-restaurant sales growth of 3.5% and 1.4% growth from new restaurants. Same-restaurant guest counts declined 0.8%, which was a direct result of reduced incentives during the quarter.

Check average increased 4.3% this quarter, driven by 1.9% pricing and 2.4% menu-mix. Menu-mix was driven primarily by shifts in consumer preference and to a lesser extent a price increase for Never Ending Pasta Bowl and a reduction in incentives. During the quarter, Olive Garden's restaurant teams flawlessly executed their two most popular and strongest value promotions of the year. Buy One, Take One and Never Ending Pasta Bowl. Never Ending Pasta Bowl was supported for the fifth year-in a row by the sale of the Olive Garden Pasta Pass, which once again met with enthusiasm and media buzz. Much of this excitement was driven by the introduction of the Annual Pasta Pass, which entitles 1,000 annual passholders to 52-weeks of Never Ending Pasta resulting in all the passes being claimed in under a minute.

Overall preference for Never Ending Pasta Bowl and value ratings were strong even though the price was increased for the first time in five years. Olive Garden's off-premise business grew 10.3% and represented 14.6% of total sales for the quarter. They continue to focus on providing a great takeout and catering experience for their guests. I'm very pleased with this performance and their continued progress in this area.

Finally, the Olive Garden team made investments to strengthen every day value. First, they redesigned their menus to more prominently showcase two everyday value platforms. Unlimited soup, salad and breadsticks, and the Cucina Mia, create your own pasta. Second, they enhanced the value of one of their highest preference entrees, Chicken Alfredo, by adding 50% more chicken. And finally they launched their 5 for $5 beverage platform. I remain excited about the strategic investments the Olive Garden team is making to compete effectively while continuing to highlight their everyday value proposition.

LongHorn Steakhouse also had a solid quarter. Total sales grew 6.4% driven by 3.5% growth from new restaurants and same-restaurant sales growth of 2.9%, their 23rd consecutive quarter of same-restaurant sales growth. The LongHorn team continues to make the right investments in the business, focused on quality, simplicity and culture. That is why they've gone to the extraordinary lengths to continually train, test and certify their Grill Masters, which has significantly improved their steaks grilled correctly scores. They also continue to look for ways to simplify their operation. This quarter they worked to reduce complexity in their recipes and improve culinary processes to ensure their team members are able to execute every time.

And finally, strengthening LongHorn's unique culture is critical to executing this strategy. Their senior leadership team just concluded field visits with every manager in order to solicit feedback on how they can improve their guest and team member experience. These investments have resulted in a higher-level of execution in their restaurants, which drove strong sales and profit performance during the quarter. This also led to all key guest satisfaction members – measures significantly exceeding the prior year.

Cheddar's Scratch Kitchen total sales declined 1.4%, driven by a same-restaurant sales decline of 4% which was partially offset by sales growth from new restaurants of 2.6%. While I'm disappointed by the lack of progress in their top line, I am pleased with the progress that Cheddar's management team was able to make during the quarter. This included making a significant operational realignment to unify three different cultures with inconsistent operating procedures. As a result, the majority of their restaurant operators received a new leader which created a short-term disruption, but was necessary to position Cheddar's for long-term success.

I'm also pleased with the progress against their three strategic priorities, staff-to-win, master the tools, and standardize and simplify. To support team members staffing, they've introduced consistent and more effective methods to attract, hire, train, and retain the right talent and their teams have made meaningful progress increasing their staffing levels. Today their restaurant management teams are using our proprietary tools to forecast their business with much more accuracy, enabling them to staff their restaurants properly to better serve their guests.

And we've introduced standards to create consistency across the brand. For example, during the highest volume periods, restaurant managers are now positioned properly, with one manager at the host end, one managing the dining room and one managing the kitchen, resulting in much better throughput. With this laser focus on the strategic priorities, they are seeing higher guest satisfaction scores and those scores continue to improve each month and in time they should see better team member and management retention levels.

The Cheddar's team is also working on culinary process improvements that we phased-in over time. These efforts will lead to increased quality, consistency, and speed of service. There's still work to be done at Cheddar's to simplify the operation and consistently improve restaurant level execution. They have a strong management team in place and as they continue to implement our back-to-basics operating philosophy, they'll make significant progress throughout this year and the years to come.

Before I turn it over to Rick, I want to close by saying thank you to our 180,000 team members. The holidays are the busiest time of the year for our restaurant teams as they create exceptional experiences and lasting memories for our guests. So on behalf of the management team and the Board of Directors, thank you for all you do to help our guests celebrate this time of year and for making our company successful and I wish all of you a wonderful holiday season. Rick?

Ricardo Cardenas

Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.

Thank you, Gene, and good morning, everyone. Overall, we're pleased with our results in the second quarter as total sales grew 4.9% from the addition of 40 net new restaurants and same-restaurant sales growth of 2.1%. More importantly, with this sales growth came strong flow-through, resulting in expanded margins for the quarter with restaurant level EBITDA growing 40 basis points, diluted net earnings per share from continuing operations of $0.92 grew 26% from last year's adjusted diluted net earnings per share. We also returned a total of $154 million to our shareholders this quarter, paying out $93 million in dividends and repurchasing $61 million in shares.

Turning to the margin analysis for the quarter. Food and beverage costs were favorable by 40 basis points as pricing of approximately 2% and cost savings net of investments more than offset both commodity's inflation of under 1% and the unfavorable impact of the new revenue recognition standard which we detailed in our last earnings call.

Total labor inflation of over 3.5% and incremental workforce investments drove restaurant labor 50 basis points higher than last year, despite continued sales leverage and productivity gains. As a reminder, Q2 was the final quarter of the incremental workforce investments we introduced last January.

Restaurant expense was favorable 40 basis points as sales leverage more than offset minimal inflation. In fact, our total restaurant expense in dollars per operating week, were equal to last year. Marketing expense was favorable to last year by 20 basis points driven by sales leverage, all resulting in restaurant level EBITDA margin of 16.7% this quarter, 40 basis points better than last year.

Below the restaurant level, general and administrative expense improved 20 basis points as we lapped an unfavorable legal settlement from last year which was partially offset by incremental workforce investments. We recorded $2.7 million of impairments during quarter, which is included in our $0.92 diluted EPS. This impairment is related to a planned Olive Garden restaurant relocation and one future closing, also in Olive Garden.

Taxes were favorable to last year, as a result of tax reform. Our effective tax rate for the quarter was 14.3%, which is higher than our annual expectation of between 10% and 11%.

Turning to our segment performance. Olive Garden, LongHorn and the Fine Dining segment, all grew sales driven by positive same-restaurant sales and net new restaurants. Segment profit margin increased in each of these segments with strong flow-through and cost management, even after the incremental workforce investments. Sales for our Other Business segment grew 3.6% driven by net new restaurants and incremental franchise revenue-related to the adoption of the new accounting standard. Segment profit declined 110 basis points in this segment due to margin deleverage from negative same-restaurant sales, incremental workforce investments and the adoption of revenue recognition.

In this morning's press release, we increased our fiscal 2019 same-restaurant sales growth outlook to approximately 2.5% from the previous range of 2% to 2.5%. We also increased our EPS outlook to be between $5.60 and $5.70 from the previous range of $5.52 to $5.65. All other metrics in our financial outlook remain unchanged.

Finally, and most importantly, I want to wish all of our 180,000 team members and each of you a happy and safe holiday season. Now, we'll open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from David Tarantino with Baird. You may go ahead.

David E. Tarantino
Analyst, Robert W. Baird & Co., Inc.

Q

Hi. Good morning. Gene, just a question on the Olive Garden traffic and mix. I know you mentioned at Olive Garden you made a choice to reduce the incentives this quarter. So could you elaborate on what exactly that means? And I think this quarter was one of the first in recent memory where Olive Garden did not outperform the industry on traffic, and I know that incentive adjustment might have been part of it. But just how do you think about that GAAP versus the industry and the importance of maintaining a positive or stable GAAP on the traffic side? And then, I have a follow-up related to the mix.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Okay. We headed into the quarter feeling like the industry was in fairly good shape, and we made the strategic choice to reduce our incentives, which primarily was coming through e-mail. We ran 16 fewer weeks during the quarter. That includes some weeks we had multiple offers out there last year. We really didn't have any offers out there this year. We felt it was – with the demand environment being strong, it was a good opportunity to remove some of that incentive so that in the future, if needed be, we could add it back in.

We also thought it was an opportunity to – really, as we think about growing our sales profitably, we just felt like the environment was right. And we can basically get to the guest count for the reduced incentives, which was more than what we were down for the quarter. So, if we had the same incentive level as we had the prior year, which has been consistently what we've been running, we would have beat the industry. So we're not that really concerned about that. What we're really focused on is building a really healthy guest base and trying to ensure that we create some opportunity in the future, if need be, to put back some of these incentives into the business.

I will add that I think the overall industry continues to perform well. The dynamics are changing. Large nationally advertised brands are taking share with the advertising budgets being increased, and the industry has grown more promotional, as check averages growth is less than 2% for the first time in a while. It'll be interesting to see whether these large brands will continue to give up margin to advertise and promote in the intensity that they've been promoting at.

David E. Tarantino
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah, and that's maybe the nature of my follow-up, Gene. On the Olive Garden, check growth has been fairly substantial for the last two quarters, and I think I understand the dynamics there. But are you seeing anything in your data that would suggest the change in the perceived value equation at Olive Garden in a negative way related to that check growth?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

No. We're seeing the exact opposite, Dave. We're seeing value go up. I mean so just a little more color on the mix change. We did make a couple menu moves halfway through the quarter to mitigate the mix growth. However, our investment in the Chicken Alfredo dish, we saw some significant increase in the mix there, and because the promotional calendar had the value promotions there, we saw a lot of trade-up out of the promotional items into that item. We also saw, with the increase in Never Ending Pasta Bowl from $1.00, we saw some trade out of that into regular higher-priced menu items. And then, when you throw the $1.00 on, that adds a little bit of contribution to the mix. And with less incentives, that also contributed a little bit to the overall mix.

So we're seeing our value scores increase. I think the consumer's healthy. They're making those choices. We're giving them plenty of optionality. We also focused on highlighting a couple other value options on our menu, made those more prominent. So I think right now I feel really good where we're at.

I think the dynamics will change a little bit in the back half of the year as our promotional calendar changes, and we'll have some more full-priced promotions and the trade will be a little bit different, so I feel really good right now about it.

David E. Tarantino
Analyst, Robert W. Baird & Co., Inc.

Q

Great. Thank you very much.

Operator: Thank you. Our next question comes from Brian Bittner with Oppenheimer. You may go ahead.

Brian Bittner
Analyst, Oppenheimer & Co., Inc.

Q

Thanks. Good morning, Gene and Rick. Question on the same-store sales guidance for the rest of the year, it implies that over the next two quarters, your business will trend as good or maybe even better than it just did in the second quarter, and this is really happening at a time when many expect the environment to soften in the next year. So what's driving your confidence in this forecast from the angle that you have?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.

A

Yeah, Brian, our forecast for the year of approximately 2.5% is driven by a few things. One is our confidence in what we've been doing for the last four years in improving our execution in the restaurants. If you look at our year-to-date same-restaurant sales, it would be – it would basically assume it's a slightly lower number than where we are today. And if you look at a few little – a few other minor things, we've got weather. Last year's weather was a typical year weather, and we expect it to not be dramatically worse than last year, so that should help versus what we've seen in the past. And we've got just slight – just slight improvements because of holiday shifts. Not major, but those are the slight differences in where we were before. We feel really good about our same-restaurant sales estimates for the rest of the year, and we're looking forward to hitting them.

Brian Bittner
Analyst, Oppenheimer & Co., Inc.

Q

Thanks, Rick. And just last question is on Cheddar's. Gene, can you just talk about any progress you expect to see there moving forward? I know during the quarter, for the first time you got all the store-level management positions filled across the portfolio, which I would assume is a pretty big deal. Is this starting to drive any type of tangible improvement in the operations that you can speak to?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, we're seeing – as I mentioned in our prepared remarks, we're seeing for the first time a leading indicator heading in the right direction, which is guest satisfaction. These scores are improving significantly each month, and we can point to things that we've done.

We're seeing significant improvement on Friday and Saturday night now that we have managers positioned in the right place. Our throughput is up significantly. We're closing the gap on same-restaurant sales on those nights, so we can see operationally some results.

Now they're just not manifesting themselves into the overall same-restaurant sales number. I will say that we've had a couple discrete issues in a couple restaurants that have really hurt the trend in the last couple of weeks of the quarter. Those things will work themselves out. But I am – I'm extremely optimistic right now with what I'm seeing.

I think operationally we had to make this reorg. We held off. We held off, but we had to make it. We had to unify these operating cultures, and our teams are really focused on the right things. And for the first time, we've got 98% of the restaurants have a managing partner or a general manager in there. We're getting close to fully staffed. We're stopping the churn. We still have the 10 restaurants that we acquired in Georgia that are still down double-digits. We expect that to lessen as we move through the year as we've stabilized those restaurants with leadership.

So overall, I mean, I think that we're moving in the right direction and I'm excited that J.W. and his team – J.W. has only been in there just over three months, so he's still just getting out there and listening to people and trying to really hone in on the operational plan. But I think we're moving directionally in the right direction and I'm seeing something for the first time that gives me confidence with these guest satisfaction scores. The next big thing is, can we see some improvement in the human resource metrics.

Brian Bittner
Analyst, Oppenheimer & Co., Inc.
Q

Thank you so much.

Operator: Thank you. The next question comes from Will Slabaugh with Stephens, Inc. You may go ahead.

Will Slabaugh
Analyst, Stephens, Inc.
Q

Yeah, thanks, guys. You mentioned this is the last quarter for the incremental workforce investment. Could you talk about what that headwind has been, if that's been different quarter-to-quarter, and maybe what we should expect kind of the last headwind to look like, like going forward?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

Yeah, Will, the overall incremental investments are about $9 million a quarter in the first quarter and in the second quarter. And if you'll recall, we started that last year in Q3. So we shouldn't have incremental investments in the back half of the year. So the run-rate investments are about $35 million, and if you recall, we did about $20 million last year. So we should be wrapping on that with no problem.

Will Slabaugh
Analyst, Stephens, Inc.
Q

Okay. Appreciate that. And just following back up on the Cheddar's comment. It sounds like you're pretty pleased with what's happening kind of behind-the-scenes and obviously you want that to come through in the top line eventually. But I'm curious if you think at some point that may require additional investment of some sort. It sounds like much of that has been made. I'm just curious, as we think about these investments going away, if there might be anything to replace that or not.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

No, I don't think there's anything additional from a big investment standpoint. We do think that some of those very large brands that are promoting real heavily right now in advertising is having a little impact on Cheddar's top line, so we're trying to figure out maybe how we might market the business maybe a little bit differently to increase our share of voice while everybody else is out there pretty loud right now. But we don't see anything major.

I mean, we're – one of the things that's also exciting, I didn't mention, is the cost management's improving dramatically with our tools in place. We're seeing food waste come down. We're just getting our labor management system up and running, so we think that we're going to see some cost benefits as we move forward in the next 12 months. The teams are really doing it good job in getting accustomed to our tools. So another thing that we're excited about.

Will Slabaugh
Analyst, Stephens, Inc.
Q

Great. Thank you.

Operator: Thank you. The next question comes from David Palmer with RBC Capital Markets. You may go ahead.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Hi. A quick follow up on the price promotions over at Olive Garden. You mentioned that, heading into the back half, you have some full-price promotions coming up and you feel good about those. Are you generally implying that you're going to have a little bit more comparable promoted price-points? And perhaps a little bit different and more even balance between traffic and check in the coming months?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

I don't know if I [indiscernible] (26:08), my point that I was trying to make there was the big change we made with our Chicken Alfredo dish and the positive mix that had – change that had in Q2 was primarily because we had lower price promotions. As the promotional calendar goes up and the price point goes up in the third and fourth quarter, you'll have less trade. The trade will be less beneficial. And so that was the point that I was trying to make. I feel good about our promotional calendar in the back half of the year. We're usually not as – we're starting – usually starting at price point to headline our promotions versus the deep value promotions.

I think, lastly, on that question, David, is as we try to develop our incentive strategy in the back half of the year, these levers are pretty easy for us to pull and can do it pretty quickly. But if demand stays strong in the industry and we can achieve our same-restaurant sales targets, we will still not be using this lever a whole lot in the back half of the year.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Got it. And just a quick question on delivery, you can see everybody's grabbing a digital delivery partner these days. You still have the double-digit off-premise growth at Olive Garden, but what do you think – how is your – has your thinking shifting with regard to delivery for those not, catering delivery but ultimately individual delivery for Olive Garden? Thanks.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

David, I have really no update on third-party. We continue to test a small group of restaurants and monitor the results. All I'll say is the economics of this has to change, along with the execution. The execution of the third-parties has to improve dramatically. The satisfaction of the guest is not great, that's using these services, and we're focused on creating a great off-premise experience for our consumer. We'll encourage them to come pick it up. We're still growing at a good rate. I really like what's happening in that business. Satisfaction of our consumer using that experience is really high, and so at this point, we have no additional update really on third-party.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Thank you.

Operator: Thank you. The next question comes from Jeffrey Bernstein with Barclays. You may go ahead.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Two questions. One, just Gene, on the industry, the competitive landscape, I'm surprised to hear you say that despite the broader industry being better that you think you're seeing maybe a ramp-up in discounting at the competition. Just wondering if your expectation over the next couple of quarters maybe is that you would start to expect the industry to pull back on the incentives, similar to what you did, and perhaps where you see the industry comp over the next six months relative to what seems to your forecast in that kind of 2.5% range. And then I had one follow up.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, as we look at what the industry is doing, we see increased advertising spending, significant increase in advertising spending. The products that they're promoting are pretty aggressive in price, and therefore you're seeing check average for the industry get below 2%. We haven't seen that in a long time for any extended period of time, and so we'll continue to monitor.

I mean, this is putting tremendous pressure on their margins, and we'll see how long they're willing to eat into their margin growth to have this kind of intensity out there.

We think we're nimble enough that we can adjust to what's happening, and it'll be interesting for us to see what they do. We feel we have levers that we can pull and we can compete effectively against them. Right now, we think the consumer is in a really good place. We're operating in the lowest unemployment in 50 years. Confidence remains high. As we watch the guests, they continue to buy across our menu. They're adding on to their entrees, they're buying up. It feels like it's a really good environment, so we think it's prudent to have the strategy that we have right now.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

Understood. And then in terms of future potential tailwinds, there's a lot of talk about the expectations in terms of tax refunds over the next few months, which I guess could be a significant tailwind for some, maybe not for others. I'm just wondering with your diverse brands across I guess the consumer income spectrum, what are your thoughts in terms of how tax refund will have an impact?

And separately, I think fiscal 2020 for you, has a 53rd week. I was wondering if you would offer any directional color on the potential EPS impact. Thank you.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

I'll let Rick answer the 53rd week. That's too complex for a CEO. So what was the first...

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

The tax refund potential impact across your brands?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

It's all tailwinds. Yeah, Jeff, we do know that there's going to be – if we're naming numbers, $60 billion out there in the first quarter tax refunds. We'll see how that plays out. Obviously, that's a positive. I think that – we don't have the same tailwinds that we had going into this fiscal – our fiscal 2019, the first half. And the second half, I mean, we've got some on the first half. I just think overall, the biggest tailwind of all is 3-point – sub-4% unemployment, which is a real positive. As long as the consumer feels confident that they're going to keep their job and their wages are going to grow, I think that the restaurant environment should be pretty positive.

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

Yeah. And as it relates to the 53rd week, that is our last fiscal week of next year and it's roughly about a 2% increase in EPS. It's one week out of 52, and that's really how it flows.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.
Q

Great. Thank you.

Operator: Thank you. The next question comes from Matt DiFrisco with Guggenheim. You may go ahead.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Thank you. I just have a follow-up question on some of the margin questions here. I know you had on the slide here in your presentation the labor, and you broke that down. It's very helpful. Just curious, Rick, on the 1.2% inflation for Q2, what's sort of embedded in your outlook for the remainder of the year?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

For the remainder of the year, we still expect total labor to be about 4.5% to 5.5% for the year. So if you just get the midpoint of that, about 4%, which is what we've been running. So as we said, it's a little over 3.5% for the last quarter, and so we don't expect it to dramatically change. And we haven't changed our outlook for overall inflation. Our overall total inflation outlook is still 2%, which includes labor and commodities.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Okay. So when you look at the labor line where you have the 1.2%, you're netting that number then? So the 4% you're just netting that versus the comp basically?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

No. The 1.2% is the labor percent impact of inflation.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Got it. Okay.

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

So that was the impact. And, again, it was a little over 3.5% labor inflation. That shows up to 1.2% labor percent.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Understood, understood. And then just looking at the productivity in Other, assuming that those are related more so to ongoing things and momentum behind the business? Or were those somewhat related to specific to this current period with less incentives and less discounting? Or are those new processes in place that you think continue throughout the year?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

No, those are things that we've been working on for the last few years. All of the productivity enhancements, as you remember, we had done a lot of work at Olive Garden. We've been simplifying the menu at LongHorn. We're starting to do some work at Cheddar's. We would expect that our productivity would continue to improve. Whether it's 40 basis points going forward or 20 or 60, I can't answer that question, but we do expect to continue productivity improvements going forward.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Okay. Thank you so much.

Operator: Thank you. The next question comes from Sara Senatore with Bernstein. You may go ahead.

Sara Harkavy Senatore
Analyst, Sanford C. Bernstein & Co. LLC
Q

Thanks. I have a question on Olive Garden comps and then a quick follow-up on the Other segment. Just on Olive Garden, obviously, you seem very confident in the comp drivers through the year. But I'm wondering if you could put it into context over the last few years in the sense that you noted 17 quarters of positive comp, which roughly corresponds to when you took the helm and refocused on value. So is there any risk that there was a lot of low hanging fruit on that front? And then perhaps it gets just more difficult from here or just more about basic blocking and tackling in the sense of improvement in customer scores or satisfaction is somewhat asymptotic and you've kind of leveled out? Just trying to get a sense of how you think about this sort of run of very strong comps in historical context. And then again, I have a follow-up question.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Okay. Good morning, Sara. You brought up a lot of good points there. I mean, we have done a lot over the last four years with Olive Garden to re-establish the brand as the value leader. However, I still believe today there's a lot of opportunity for us to improve across our fleet of restaurants. We think that scale gives us a competitive advantage in Olive Garden. We're able to continue to find productivity enhancements. We think there are future investments that we continue to make – can continue to make to increase value. I think the big difference between where we are today in this cycle versus where we were maybe seven, eight years ago when Olive Garden was into a good growth cycle is that we're making investments back into the business.

When I studied the history last time, Olive Garden started to drift maybe a little upscale and really didn't focus on what gave them the great advantage. I think that the team – the decision the management team made to increase the Chicken Alfredo portion by 50% in protein is an example of what we'll continue to do to be able to increase value and drive guest counts and sales into the future. We think we have some other opportunities. We're being innovative from a marketing standpoint. I think our marketing is as relevant today as it has been in a long time.

And more importantly, I think the younger consumer, the millennials, they really enjoy Olive Garden. They enjoy the value in it. They enjoy the communal piece of it, of coming together and enjoying a meal, so I think it's really well-positioned. And we're going to continue to double down on simplification and value, and so we think that we're well-positioned to continue to compete effectively into the future.

Sara Harkavy Senatore
Analyst, Sanford C. Bernstein & Co. LLC
Q

That's very helpful. Thank you. And then just on the Other Business segment. I mean, I noticed that Yard House is obviously small, had a negative comp in the quarter, which we hadn't seen in a while. I guess I was just trying to understand if there's something about varied menu that's particularly competitive. Or is there any risk that maybe Cheddar's is perhaps taking managerial attention or resources away from the other brands? Just trying to understand if there's anything to kind of read into that.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Yeah. Let me be very clear about this. Cheddar's is not taking any managerial focus away from any of the other brands. I mean, these other brands have full presence, full management teams that have nothing to do with Cheddar's. I'll just say on Yard House we had a positive two-year comp. We had a couple high-volume restaurants that had some pressure. For those who are familiar, [ph] the Lincoln (38:41), LA, they had scaffolding all around our building as they were building a zip line in from some place to drop people off in front of our restaurants, which had an impact. California was a little soft. We had some restaurants in Florida that were a little soft towards the end of the quarter.

I'm focused on total growth on Yard House, and we're opening a lot of restaurants, which also creates some churn inside the system. Overall, Yard House is an extremely strong brand, and I do think that from time-to-time will fluctuate, especially with some of these high-volume restaurants. They can swing the comp a little bit, but I feel really good about where Yard House is positioned. We're opening some great restaurants, and I'm really excited about their future.

Sara Harkavy Senatore
Analyst, Sanford C. Bernstein & Co. LLC
Q

Got it. Thank you.

Operator: Thank you. Our next question comes from Peter Saleh with BTIG. You may go ahead.

Peter Saleh
Analyst, BTIG LLC
Q

Great. Thanks. Gene, just wanted to come back to the Cheddar's commentary. Is this the first quarter that you're seeing the guest satisfaction scores improve at Cheddar's? And is this the highest they've been since you guys acquired the brand?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

They've been improving for the last six months, but right now they're at the highest they've been since we've acquired them. Our value ratings are still extremely strong in this business, and so we feel really good about where we are. We know hour-to-hour today we're running these restaurants better than we were six to nine months ago. And we can see it in the results.

Peter Saleh
Analyst, BTIG LLC

Q

And then historically, when you look at your other brands, what has been the lag between seeing the improving guest satisfaction scores and then starting to see the top line starting to trend better as well?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Well, I'm not so sure that there's a perfect correlation in any of that because there's marketing, there's other things, the environment. All I know is that once – in all my years of experience, once we get the leading indicators going in the right direction, sales will follow.

Peter Saleh
Analyst, BTIG LLC

Q

All right. Thank you very much.

Operator: Thank you. The next question comes from John Glass with Morgan Stanley. You may go ahead.

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks very much. First, just on the off-premise business. It's been growing strongly for a number of quarters. It didn't grow quite at the same rate this quarter. Is one, that's just a function of the base effect? It's just a bigger business, so compounding is harder? Did some of the changing and promotional activities maybe impact that business as well as your – the dine-in business? And can you just talk about your current views on the incrementality of that business? Is that still very strong sort of different customer or different occasion? Or how do you measure incrementality of the off-premise business?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, hey, John. I think the answer to your question is a yes and yes. I think as this gets bigger, it's going to be harder to continue to grow it at a compounded growth rate. I'm thrilled with 10%. I mean this is a big business now, and yes, we did pull back on some incentives that had some impact on off-premise. This time of year, I mean, off-premise gets to be pretty strong, and so we definitely want to make sure that we're taking advantage and we're getting full-price.

The incrementality of this business is always hard to really measure. We do know by looking at the demographics of the people that are using us is that a lot of these off-premise customers are only off-premise customers, and they don't really dine inside in Olive Garden all that much. They're probably using a chef-driven restaurant or a higher-end restaurant. So we believe all that's incremental. But the bottom line, the way I think about it is, you're in the top-of-mind for that occasion.

And what you need to win the occasion, as many occasions that you possibly can, and whether that impacts you into the future, I don't know. I just think those are two totally different occasions, and what we work hard as being top-of-mind in each of them. And we'll never know for sure what's incremental and what's not. We just know we want to play. We want to be very, very good, the best at off-premise and try to create a frictionless experience. And we want to be the very, very best of in-restaurant that we can possibly be, and that's what we're working hard at.

John Glass
Analyst, Morgan Stanley & Co. LLC
Q

Thank you. And then just to follow up, what is the current date of the estate for maybe for the two major brands? We've seen a lot of capital going into the limited-service restaurant industry I think some of your competitors are continuing to upgrade their assets. How do you feel relative to the competitive set and relative to your own expectations about the estate, both at Olive Garden and LongHorn? And remodel possibilities if there is one over time?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Yeah, we feel pretty good. We've been working hard at the Olive Garden. We've done approximately 230 remodels to date in the last four years. We did 28 in the quarter. We've got a few more to do. We have another 70 to do to get that fleet up to speed. Then we're going to start just freshening the farmhouses, which will not take nowhere near the capital that the Revitalia restaurants needed. So we feel like that fleet's in really good shape.

We think LongHorn has got a little bit more of a timeless decor. The capital that we're putting into LongHorn right now is really to upgrade the off-premise experience, so we're putting a little bit of capital in there to create a space for the consumer to be able to make the experience a little less frictionless than it has been in the past. So we feel good.

We think our buildings stood the test of time. The other thing I would add I think that – and this is pre this management team and we've been able to continue it on, is Darden's always done a great job with its maintenance capital and keeping its restaurants looking fabulous. There's times I walk into – and Olive Garden that's 25 years old, that really hasn't been remodeled recently, and I'll look around and say, boy, this place looks great. We've got good furniture, we're well-painted, it looks clean, and so we've done – our team's done a great job keeping these buildings in outstanding condition.

John Glass
Analyst, Morgan Stanley & Co. LLC
Q

Great. Thank you.

Operator: Thank you. The next question comes from Greg Francfort with Bank of America. You may go ahead.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch
Q

Hey. I had two margin questions. The first one is for Rick. I think in the first quarter you had said wage inflation was 5%, and this quarter it was just over 3.5%. Are those comparable numbers? And what are you seeing in terms of that step-down in terms of your wage pressure?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

Yeah. What we said in the first quarter I believe is that hourly wage inflation was about 5% but total inflation was closer to 3.5%. But – so these are comparable. The 3.5% – a little over 3.5% is very comparable to what we've been seeing before.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch
Q

Understood. Thanks. And then, Gene, one thing we've seen, I think it's been a multiyear story for Olive Garden and Darden, has been marketing dropping as a percent of sales. I guess what's the strategy there and sort of what level are you looking to see or trying to get to in terms of marketing and maybe where are you cutting back and where are you reinvesting?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Yeah. You broke up a little bit. I hate to ask, can you just – can you repeat the question?

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch
Q

Yeah, no worries. Just marketing as a percent of sales has kind of been dropping for a few years, and I guess what's the overall strategy? What's the long-term goal, and maybe where are you trimming back, where are you reinvesting on that front and where do you maybe see that going over the long term?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Yeah, I mean, first of all, it's been dropping at the Darden level because of brand mix. As the smaller brands start to grow with a little less of a marketing spend, it's levering that down a little bit. We've worked hard over the last four years to decrease our non-working media. That was an area I thought that was a big opportunity inside Darden, so we've been able to eliminate some of those costs, and some of those non-working costs we transfer to working and some of them we've been able to just put back into the P&L.

We've got to continue with our big brands, really honing in on our advertising, improving our messaging, getting our messaging in the right place at the right time. And so we think that our current spending levels are appropriate to support these businesses. I think that's why new unit growth in Olive Garden is so important because we get to leverage the advertising spend, and in some situations, the same for Olive Garden. And we'll continue to find ways to appropriately spend for our smaller brands.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch
Q

Okay. Thank you.

Operator: Thank you. Our next question comes from Chris O'Cull with Stifel. You may go ahead.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Thanks. Good morning. Rick, the earnings guidance seems to imply the growth in restaurant-level costs per operating week would be greater or be at a greater rate in the back half of the year than maybe what you saw in this last quarter. I understand commodity costs may be higher, but why would labor costs and restaurant expenses on a per-operating week start to grow at a faster rate?

Ricardo Cardenas
Chief Financial Officer & Senior Vice President, Darden Restaurants, Inc.
A

Well, this quarter, the restaurant expenses actually were flat, so they didn't grow at all. So we would expect normal inflation to happen in the restaurant expense line. As we've said, we've had very minimal inflation on the food and beverage line, and we expect our inflation to kind of tick up in the back half of the year.

We're also making investments. Gene mentioned the investment that Olive Garden made in the Chicken Alfredo.

And finally, we've got a little bit of timing in the marketing line. We would expect our marketing as a percent to lever year-over-year, but it might be a little bit higher than it was in the last quarter.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Okay. And then – that's helpful. Gene, were the leadership changes at Cheddar's recruited from within Darden, or outside the company? And maybe can you discuss if you've made any changes to the operator's bonus metrics or how they're incentivized?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.
A

Yeah. Everybody that's on the Cheddar's management team and senior levels are Darden employees, long-term Darden employees who understand our systems, understand our thought process, understand our branding. And as far as bonus, we have – Cheddar's this year is on the bonus program that all our other restaurant brands are on for the first time, which heavily incentivizes sales growth and profit growth.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Great. Thanks, guys.

Operator: Thank you. The next question comes from Andrew Strelzik with BMO. You may go ahead.

Andrew Strelzik
Analyst, BMO Capital Markets (United States)
Q

Hey. Good morning. Two questions for me. Last quarter, you mentioned an improvement in the retention rates at Cheddar's, and it sounds like maybe they took a step back this quarter. And I'm just wondering, what are some of the challenges that you're finding with respect to the HR metrics and retention specifically at Cheddar's.

And number two, we all know about the cost environment in the restaurant space and you mentioned about the importance of advertising budgets with respect to driving sales. So I'm just wondering if you could comment a little bit more about maybe what you're seeing in the independent restaurants. Are you seeing accelerated closures, given the cost side? Or any change in behaviors there that would – could be helpful color?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Okay. On Cheddar's retention, we haven't seen – it hasn't gone backwards. It hasn't made the improvement I was hoping for. I think what we're struggling with, both at the team member and management level here, is expectations, right? We've come in. We're starting to put in some structure and some processes. The expectations are a little higher. And so when you go through this kind of turnaround, you do end up losing some management along the way. Some of the management that was in the system was tethered to the old management. They had worked with them before, and when you make those changes, those folks leave. So I'm confident that we will start seeing the Cheddar's human resource metrics start to come towards the Darden norms. And when we see that, I think our operations will improve.

It took us a couple years to make those improvements happen in Yard House, and I expect that we'll make progress here over the next 12 months. Its basic things and I know I keep coming back to this but we didn't have an effective way to train new employees. We don't have a great certified trainer program that we have in all of our other businesses. Now, we're developing that and we're implementing that. We have to ensure that everybody that we hire goes through a great training program.

On the independent restaurant scene, I mean, again, the CREST data has been saying for years that large brands are taking share from smaller brands and independent restaurants. We've seen some closures out there for independent restaurants. But as I said before, for most of the time, once a restaurant's a restaurant and stays a restaurant, it just flips its name. And it goes down for two or three months and then someone else comes in and tries to make it work. So – and again, we're – also – we're in an up cycle, which is when a lot of people think they want to be in the restaurant business. So independents are there. I think it's tough for them to compete in this environment.

Andrew Strelzik
Analyst, BMO Capital Markets (United States)

Q

Great. Thank you very much.

Operator: Thank you. The next question comes from Brandon Sonnemaker with JPMorgan. You may go ahead.

Brandon Sonnemaker
Analyst, JPMorgan Securities LLC

Q

Great. Thanks for taking the question. Just to clarify. Labor costs in the quarter, they came in better than expected relative to our model. I mean, obviously you experienced 50 bps of labor deleverage this quarter. Once the 30 bps of workforce investment rolls off, you mentioned the productivity savings will continue to improve. Just to be clear: is it your expectation that the amount of labor deleverage moderates in the back half?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, just a little bit.

Brandon Sonnemaker
Analyst, JPMorgan Securities LLC

Q

Okay. Great. And then you mentioned the two promotions during the quarter, Buy One, Take One, Never Ending Pasta. I believe these were also running during the same period last year. Would you mind sharing if these were run for less weeks relative to last year? And could you also clarify your expectation for the back half of the year? Will you have more or less promotions relative to last year?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, you broke up again for some reason. Could you repeat that question?

Brandon Sonnemaker
Analyst, JPMorgan Securities LLC

Q

Yeah, just Buy One, Take One and Never Ending Pasta Bowl during the quarter. I believe those were run during the same period last year. Would you mind sharing if those were run for less weeks relative to last year? And then your expectation for the back half, whether promotions will be up or down relative to last year.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, Buy One, Take One, Never Ending Pasta Bowl were the exact same as last year, and we expect our media promotional calendar to mirror pretty much what we did last year in the back half of the year.

Brandon Sonnemaker
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thanks.

Operator: Thank you. The next question comes from Nicole Miller with Piper Jaffray. You may go ahead.

Nicole M. Miller Regan
Analyst, Piper Jaffray & Co.

Q

Good morning. I wanted to understand a little bit more about the relatively higher-end concept. So could you talk about Cap Grille, Eddie V's, and the performance there, is that driven mostly by check or traffic? And then the second part of the question, is it coming from the main dining room, or is there something in private dining that would account for those trends? And then anything you'd be willing to share on the holiday progression so far? Thank you.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

Yeah, we had another strong quarter in our upscale businesses. Capital Grille had a great quarter, continues to focus on driving guest counts. I would say there's guest counts and check in those numbers. Capital Grille is adding a little bit of capacity in a few restaurants, which has been helpful. We've got a lot of restaurants at full capacity, so we're managing full capacity and price. But the business is performing well.

We're making meaningful progress in Eddie V's. We're real excited about the progress we've made there, especially on the income statement. That P&L is starting to look more like a Capital Grille P&L over time as the cost structure comes into line. So we think there's tremendous upside there. We've got a pretty good pipeline for Eddie V's and we've got some good pipeline for Capital Grille in the future which we'll discuss in an upcoming call, so we're excited about that.

I'm not going to talk about private dining in December. Just know those businesses are healthy. They're running good. Let me sneak a comment in here about Seasons also, because we're making great progress in Seasons. Although same-restaurant sales were down for the quarter, guest counts were positive. We're making the strategic choice to bring check average down a little bit, and I would also – I'm also thrilled with John Martin's overseeing that business right now and he's taking a lot of costs out of the business that needed to be taken out, and year-over-year profitability is up. So I'm excited about the direction of Seasons 52.

We've got a good pipeline there and I think that business is well-positioned to really start to make a meaningful growth push into the future.

Nicole M. Miller Regan
Analyst, Piper Jaffray & Co.

Q

And just a quick follow up. When you talk about capacity, do you make additions at the bar, the main dining room, or private dining?

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

We've enclosed a few patios, which have given us an extra 25 seats in restaurants, so that gives us full utilization of that space year around.

Nicole M. Miller Regan
Analyst, Piper Jaffray & Co.

Q

Thank you.

Operator: Thank you. Our last question comes from Stephen Anderson with Maxim Group. You may go ahead.

Stephen Anderson
Analyst, Maxim Group LLC

Q

Yes, this is a follow up to Nicole's question on the Capital Grille. Have you seen any kind of – with the recent volatility in the financial markets, have you seen any declines in the business in some of the walk-in business for Capital Grille, and maybe to a lesser extent, Eddie V's? I wanted to see – hear your thoughts about that.

Eugene I. Lee
President, Chief Executive Officer & Director, Darden Restaurants, Inc.

A

No, see, we haven't seen any of that. I mean, it's – again, 3.7% Cap Grille for the quarter. It's been strong, and we've got some restaurants in New York City and it's been strong, so we haven't seen anything correlated to what's going on in the markets.

Stephen Anderson
Analyst, Maxim Group LLC

Q

Right. Thank you.

Operator: Thank you. And there are no further questions. I'll now turn it back to Kevin Kalicak for any closing remarks.

Kevin Kalicak

Vice President, Investor Relations & Corporate Analysis, Darden Restaurants, Inc.

Thanks again, Sue. That concludes our call, and I'd like to remind everyone that we plan to release third quarter results on Thursday, March 21 before the market opens, with the conference call to follow. Thank you for participating in today's call.

Operator: Thank you. That does conclude today's conference. All participants may disconnect.