Operator: Greetings, and welcome to Diversified Restaurant Holdings, Inc. Second Quarter 2018 Financial Results Conference Call. As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Craig Mychajluk, Investor Relations for Diversified Restaurant Holdings. Please go ahead.

Craig Mychajluk: Thank you, and good morning, everyone. We appreciate your time today and your interest in Diversified Restaurant Holdings. Joining me on the call is David Burke, our President and CEO; and Phyllis Knight, our CFO and Treasurer.

You should have a copy of the financial results that were released after markets closed yesterday, and if not, you can access it at our website, diversifiedrestaurantholdings.com. There's also a slide presentation posted on our website that we will refer to during today's call.

If you would, please refer to Slide 2. As you are aware, we may make some forward-looking statements on this call during the formal discussion as well during the Q&A. These statements apply to future events that are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from what is stated on today's call. These risks and uncertainties and other factors are provided in the earnings release as well as with documents filed by the company with the Securities and Exchange Commission. These documents can be found on our website or at www.sec.gov.

During today's call, we will discuss non-GAAP measures, which we believe will be useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with GAAP. Reconciliations of non-GAAP to comparable GAAP measures are provided with the tables accompanying the earnings release.

With that, let me turn it over to David to begin.

David Burke: Thanks Craig, and good morning, everyone. The second quarter results that we reported yesterday reflect the continuation of sales trends that we've experienced since late last year. While new ownership at the franchisor has been heavily engaged in reigniting the brand to drive the top line, we don't anticipate measurable improvements until later this year. We're extremely optimistic about the approaches being taken and the changes that are being made. Inspire Brands has quickly put together a best-in-class team that has all the right tools to drive the Buffalo Wild Wings brand forward. But before I expand on future developments in our business, I'll ask Phyllis to review the quarter. Phyllis?

Phyllis Knight: Thanks David, and good morning. Sales in the second quarter totaled $37.0 million, a year-over-year decline of 7.3% as recent trends in the business continued throughout the quarter. Same-store sales were down 6.4%, the third consecutive quarter where our sales diverged sharply from the broader industry, a trend that we believe, in large part, was driven by changes in the system-wide media and promotional strategies. Slides 4 and 5 in our deck provides further details.

Partially offsetting this negative trend was the benefit of one new restaurant opened late in the second quarter last year, a favorable calendar shift with Easter falling in the 2018 first quarter versus the second quarter of last year, and a 4.4% increase in average check size, primarily due to changes in promotional strategy and, to a lesser degree, last year's price increases. Breakdown of each of these items is provided on the sales bridge presented on Slide 6.

Adjusted EBITDA for the quarter totaled $3.7 million, and Restaurant-level EBITDA totaled $5.5 million. Despite significant improvements in our commodity cost environment, both Adjusted and Restaurant-level EBITDA margins were down 1.7 and 1.6 points, respectively, as a result of sales deleveraging on lower AUVs.

Our cost of sales benefited again this quarter from lower chicken wing prices, coming in at 28.5% of net sales. Traditional wings, as a percentage of total cost of sales, dropped to 19.5% in the quarter after peaking at 25.3% in last year's third quarter and averaging nearly 25% for all of 2017. The history is shown on Slide 13. The spot price for fresh wings is currently at a relatively low $1.36 per pound compared with a peak of $2.16 last year. As I mentioned on our first quarter call, we're optimistic that cost of sales will remain in the mid-28% range this year.

On the labor front, we continue to push productivity initiatives to offset wage inflation. However, hourly and total labor costs trended up this quarter, increasing 2 points as a percentage of net sales. This was driven in nearly equal measure by a combination of higher wages given the tight labor market, and the impact of sales deleveraging. We break the components out on Slide 14.

On the wage front, our salaried manager wages are up 5.4% year-over-year, while our average hourly rate increased 3.3%. As sales improve, we fully expect to reverse the impact of deleveraging. On the wage front, we'll continue to focus on productivity, but ultimately must recover higher wages through pricing increases.

Our G&A costs were in line with expectations and reflect our cost savings initiatives implemented in 2017. We expect total G&A, net of nonrecurring expenses, to come in under $8 million in fiscal 2018. Our G&A trend and forecast is shown on Slide 16.

Total debt at quarter end was $108.2 million, down $5.7 million through the first six months of this year. We were in compliance with all loan covenants in the second quarter and expect to remain in compliance throughout the year, primarily as a result of the recent equity raise, which will supplement actual EBITDA in our covenant calculation as negotiated in our credit facility amendment earlier this year.

Cash and cash equivalents of $2.5 million were down $2.0 million compared with the first quarter. Consistent with past trends, the first and fourth quarters of each fiscal year are our strongest in terms of cash generation.

Year-to-date capital expenditures were $900,000 and were for minor facility upgrades and general maintenance-type investments, as well as improvements to prepare an open space for sublease adjacent to one of our restaurants earlier this year. As previously discussed, we're not planning to build any new restaurants nor will we be completing any major remodels this year. As a result, capital expenditures are expected to total approximately $1.5 million this fiscal year.

As I mentioned a moment ago, on July 24, we closed the successful underwritten registered public offering of DRH common stock, raising net proceeds of approximately $4.7 million. This added capital provides necessary flexibility in the current operating environment for purposes of satisfying our expected use of cash over the summer months, including debt amortization, and to provide assurance around debt covenant compliance until earnings recover. We believe that our current cash balance, in addition to our cash flow from operations, will be sufficient to fund our operations and meet the commitments on our debt through 2019.

And with that, I'll turn the call back over to David.

David Burke: Thank you, Phyllis. While it's extremely disheartening to report another quarter with such a significant drop in sales, it's equally exciting to see the momentum with the brand that's happening right now behind the scenes.

On August 30, Buffalo Wild Wings will launch a new football-centric campaign with a new creative agency and a significantly increased spend over 2017 in media that's focused on sports programming. To support the campaign, they will also be launching consumer-focused activations that will bring the creative to light and drive home the message that if football is on, you have to be at Buffalo Wild

Wings. The fall and winter sports seasons are critically important to our restaurants, and our franchisor partner is committing significant resources to a rebound.

We're also excited about the many other changes either being developed, tested or in the process of implementation. While some of these initiatives might not be needle movers individually, collectively, each represent a step in the right direction as we improve the value proposition and focus on reigniting the brand.

One avenue that we're particularly excited about is the potential for e-gaming events in our restaurants. It's no secret that e-gaming is exploding in popularity among teenagers and young adults that are not only playing but watching gaming events and tournaments at an increasing pace. Buffalo Wild Wings is very well positioned to participate in this new trend, and we've been devoting significant resources to it.

At DRH, we've begun testing e-gaming tournament events and had terrific success thus far. Recently, at our Ybor City store in the Tampa market, we've partnered with Buffalo Wild Wings on a GuardianCon e-league sports tournament where we set up a private viewing area on our patio and ran specials for attendees. This four day event drew significant guest traffic, and our same-store sales were up 67%. We're optimistic that the potential for e-gaming system-wide is significant.

It's important to note that we're not just waiting on changes from the franchisor partner. Beyond running best-in-class operations, our team remains focused on driving traffic with renewed attention to our customer experience and local restaurant marketing initiatives that enhance our connection with each community. To that end, we have made great progress, as outlined on Slides 19 and 20. Guest experience scores are strong and trending up as we look at first half of this year versus the same period last year. And our significant push to improve penetration of The Blazin' Rewards Loyalty Program has been successful, as attachment rates were north of 25% in June, far outpacing the Buffalo Wild Wings franchise system. Our goal is to reach a 35% loyalty attachment by the end of the year, which multiple loyalty programs studies suggest is a rate at which the restaurant obtains maximum benefits through higher frequency visits from less regular guests.

We are nearing the halfway point of our third quarter and are seeing some improvement in the form of less severe declines, but continue to believe that the more substantial efforts will begin to be realized in our results later in the year as the changes are implemented and gain traction. Third quarter to date same-store sales through last Sunday are down 3.6%. We truly believe better times are ahead for Buffalo Wild Wings and Diversified Restaurant Holdings.

Operator, we can now open the lines for any questions.

Operator: Thank you. At this time, we will be conducting a question-and-answer session. Our first question comes from the line of Jeremy Hamblin with Dougherty & Company.

Jeremy Hamblin: Good morning, and thanks for taking the question. Wanted to follow up here on the last point that you made on quarter to date trends. It sounds like a really nice improvement that you've seen thus far compared with Q2 and Q1. In terms of just recollecting what happened last year, if I'm not mistaken, your compares actually ease. I think September was maybe your weakest month of the quarter in Q3 last year. Can you just confirm in terms of comparative trends?

David Burke: Well, through Q3 of 2017, we definitely started seeing further erosion throughout the year. I think we were at 4.4% down in Q3 last year. There's definitely opportunity for that to ease.

Jeremy Hamblin: Was September the weakest month of the quarter?

David Burke: Not substantially. Overall, it was a pretty weak quarter for us.

Jeremy Hamblin: Okay. I wanted to just see if we could expand a little bit. It sounds like pretty exciting news on the August 30 new ad campaign to get football season kicked off. Could you just provide us with a little bit more detail on maybe what you think was the change in strategy last year that didn't work and resulted in weak comps and what they're doing this year? And if I heard you right, it sounds like the new ownership group is also kicking in some of their own money to enhance the campaign. Can you provide some more color on that?

David Burke: Yes, sure. From a strategic standpoint, last year, the circumstances were a lot different, to be frank. We had an issue with our chicken wing cost, some promotional activity, et cetera. They shifted gears. And this is the old management team prior to Inspire. Really, we got out of the sports-focused television media. So that strategy has changed for this year. As we announced in the prepared statements, they're really all in, and want to own football in partnerships with a lot of the sport networks. We're very excited about that. Frankly, this is the strategy we've done in the past. I think this is a hiccup that we're still paying for, but I have a lot of confidence that's going to reverse itself in the end of the fall here starting on August 30. This new campaign is getting boosted with some more spend relative to last year. It's not in the hands of franchisees necessarily. We're not contributing any more money. This is just budgeting and the allocation of the funds. But they're obviously going to put some more concentration into the fall in the football campaign because that is one of the most important seasons for the brand.

Jeremy Hamblin: Okay, great. I also wanted to follow up on the commentary around e-gaming events. I'm definitely not an expert on that particular field, but 67% improvement in comps over that four day stretch. How frequent are the e-gaming events? How frequent do you think that you could host them without potentially having any negative effects? It seems like a great opportunity in off football months. Is this something that can run concurrently maybe as a replacement, let's say, on Tuesdays or Wednesdays when you have fewer football TV coverage? Is this something that you see maybe as an opportunity to continue to drive traffic on those non-key days?

David Burke: I do. I think we're in the infant stages of exploring these types of relationships. But just to be clear, we're learning as we go. I'm not as well versed as I'd like to be in it, but we definitely recognize it as an opportunity for the brand and for Diversified in general. This particular situation we referred to is more of a larger event that happened to take place in Tampa, and there was a sponsorship by Buffalo Wild Wings. I think this is the first step in engaging with this community. We were very fortunate to be involved, given the participation that we had. We're learning how the consumers react to it. We're learning what the actual demand is in terms of viewership versus, actually, game play, et cetera. And we're experimenting with both. But I think generally speaking, I do view this as a way to fill the gaps and create another experience daypart for the brand that's outside of your more traditional sporting event viewership.

Jeremy Hamblin: Okay, great. Phyllis, I wanted to also just clarify something on the wing prices. Slide 13, I think you indicate cost per pound was $1.66. Just in terms of presentation on that, that includes the distribution costs of roughly $0.30 a pound. Does that mean that in Q3 right now, we're running pretty consistent with the realized prices that we had in Q2?

Phyllis Knight: Yes, the current price, I believe, is $1.36 a pound, and so you add the distribution to that. It's been relatively stable in Q2 and now in Q3.

Jeremy Hamblin: Okay, great. Inspire now obviously has significantly higher buying power, and that would seem to be potentially an opportunity for all the franchisees of Buffalo Wild Wings. David, could you speak at all to this potential opportunity moving forward, where you think that enhanced buying power could benefit the franchisees?

David Burke: Yes, I agree. I think without question there's going to be some opportunities for cost savings for the brand, for the system, which will obviously trickle down to Diversified. Little doubt that will take place. Timing-wise, it's difficult to really assess precisely what that is. There's so many opportunities to really nail one down. We don't want to mention specifics at this point. It's going to revolve around the low-hanging fruit, I think, of larger contracts where there's some synergies across brands. I think it's been pretty evident as you think through it in certain food and beverage areas, where there's some shared resources or shared vendor partnerships, where we can get significantly more buying power as a result of operating Inspire to different brands.

Jeremy Hamblin: Okay, great. The other thing related to that a little bit is, in terms of just support, overall support, you seem fairly optimistic about initial discussions with new franchisor ownership group. Can you speak to just the support that you're getting now, maybe potential changes, how that's compared? I imagine that as the prior ownership team went through kind of an activist battle at corporate, the departure of a long-time CEO, it seemed that was the story without a captain of the ship. And now we've got a really strong leadership team in place. Can you just talk to the support that you're getting or potential areas where you're seeing changes in opportunities going forward?

David Burke: Sure. We couldn't be more excited. The relationship that we've built thus far since the acquisition has been fantastic. The level of communication is substantially higher, particularly with the executive team and a lot of the new executives that have been brought on board recently. We're engaged on a very frequent basis and understanding what the plans are going forward. They're getting our feedback, which is incredible, and tapping into us as a resource, which I think all the franchisees appreciate. I think it's worth mentioning that they're going to welcome a new incoming management team, specifically the President and CMO. They will onboard within the next few weeks. Both have deep experience, a track record of success in their former companies. I can't get specific with that. There's also a new VP of Culinary, VP of Advertising, VP of Restaurant Experience. They're all now in place currently. That just gives you an example of how quickly they're moving and the types of leadership position they put in place that we're already connected with and communicating with at this point in time. A lot of this is driving the success of getting an August 30 new promotion off the ground, which given the time they've had to do a new creative, a new campaign, et cetera, and reassess the media buy is an impressive feat in and of itself. We're really excited about what's to come with it.

Jeremy Hamblin: Great. The last thing that you mentioned was some new culinary leadership. Any notable menu changes that you could call out at this point in time? Or is it a little too early to speak to that?

David Burke: It's too early. The culinary side of it is coming up with creative ideas on what we want. It's sourcing the product in the partnership relationships that is going to take some more time. It's too early to comment. Rest assured, there will be some significant changes coming down the pipeline.

Jeremy Hamblin: Great. Last item is, just in terms of the capital structure, the equity rate, can you give me some sense in terms of funding? We believe this gives you some visibility through your obligations through 2019. Could you just address that in terms of your capital situation and your projected cash flows, how this sets you up moving forward here for the rest of '18 and through '19?

David Burke: Yes. I think as we've stated it, it gives us the liquidity we need. This is somewhat of an insurance policy for us, to do this raise, to ensure that we have liquidity that we need through '19; and also just given the circumstances with some of the depressed sales that we've seen. Although we are very optimistic about that turning around, you can't be too sure, and we can't take that risk. That liquidity is obviously very much related to our debt service. We want to continue to pay down debt as quickly as possible. We have very little interest in a lower amortization. We want to keep that in check.

And this is one of the strategies to go about doing that. And longer term, this is the best way to go about it, getting just enough equity, just what we need really, to ensure that we have that liquidity to keep our debt service in check and keep us out of any covenant issues going through into next year.

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session. I would like to turn the call back to management for closing remarks.

David Burke: Thank you, everyone, for joining us on today's call and your interest in Diversified Restaurant Holdings. For those in the Minneapolis area, we will be presenting and available for investor meetings at the Dougherty conference on September 6. In the meantime, please feel free to reach out to us at any time, and we look forward to talking to you again after our third quarter results. Again, thanks for your participation, and have a great day.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.