Operator: Greetings, and welcome to Diversified Restaurant Holdings' Third Quarter 2018 Financial Results. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Craig Mychajluk, Investor Relations.

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 Chief Financial Officer and Treasurer.

You should have a copy of the financial results that were released after the 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 as 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 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.

So with that, let me turn it over to David to begin. David?

David Burke: Thank you, Craig. Good morning, everyone.

While our third quarter results are most certainly not at the level we're happy with, they are a reflection of the challenges we faced this year. I truly believe these reflections are in the rearview mirror. We've never been more confident or excited about what's happening with the Buffalo Wild Wings brand. Inspire Brands has rapidly built a first-class management team and are in the early stages of executing a comprehensive strategy to reposition the brand. These efforts, even at this early stage, are already showing positive results, which I'm very excited to discuss after Phyllis provides a review of the third quarter results. Phyllis?

Phyllis Knight: Thanks, David, and good morning. Sales for the third quarter totaled $37.5 million, a decline of 4.5%. This was the fourth consecutive quarter where our sales diverged sharply from the broader industry, a trend we believe was driven by missteps in the system wide media and promotional strategies implemented last year.

Same-store sales were down 5.2%, with traffic down 4.9% and average check down 30 basis points. Adjusted for the huge pay-per-view boxing events that occurred during last year's third quarter and included significant cover charge revenue to offset the price to carry the fight, same-store sales were down only 3.6%, a result that we believe is more representative of the actual Q3 trend.

Slides 4 through 7 provide further details on traffic and average ticket trend as well as a bridge of period-to-period sales.

Adjusted EBITDA for the quarter totaled $3.3 million, and restaurant-level EBITDA totaled $5.3 million. Despite a 70 basis point improvement in cost of sales, largely as a result of lower traditional wing costs, adjusted and restaurant-level EBITDA margin were down 2.3 and 1.7 points, respectively, driven by sales deleveraging on lower AUVs and higher labor costs.

As I mentioned, our cost of sales benefited again this quarter from lower traditional wing costs, coming in at 28.5% of net sales, which is down 100 basis points in real terms, before the impact on cost of sales of the fight-related cover charges in last year's numbers.

Traditional wings, as a percentage of total cost to sales, did increase sequentially from last quarter to 20.7% from 19.5%, though this level is still significantly lower than the 25.3% peak hit in last year's third quarter. The wing cost environment remains favorable, even after the seasonal increases that we've seen recently. The history is shown on Slides 13 and 22.

We continue to contend with a tight labor market, which is driving higher average wages, and when combined with lower average unit volume, we saw labor costs as a percentage of sales increase 200 basis points to 27.4% in the third quarter.

Productivity initiatives have helped to offset some wage inflation and sales improved, though we fully expect to reverse the impact of deleveraging, which represents about 60% of the negative labor trend year-to-date. We break those components out on Slides 14 and 15.

Our G&A costs were generally in line with expectations and reflect our cost savings initiatives implemented last year. As a percentage of sales, G&A decreased 60 basis points to 5.3%. We expect total G&A, net of nonrecurring expenses, to come in well under $8 million in fiscal 2018. Our G&A trend and forecast is shown on Slide 16.

During the quarter, we recognized an impairment loss of $900,000, which reflects the full write-off of fixed assets at one small Missouri location that was acquired in 2015. This was a restaurant with a limited market that operates near breakeven restaurant-level EBITDA. We are reviewing our options, and we'll continue to evaluate the viability of this location, particularly in light of the brand-level changes that are beginning to take hold.

Cash and cash equivalents of $7.1 million were up $4.6 million compared with the sequential second quarter, driven by the July equity raise. Year-to-date capital expenditures were $1.3 million and were for minor facility upgrades and general maintenance-type investments as well as improvements to procure an open space for sub-lease adjacent to one of our restaurants earlier in the year.

As previously disclosed, we're not planning to build any new restaurants nor complete any major remodels this year. As a result, capital expenditures are expected to be in the range of $1.5 million this year.

Total debt at quarter end was $105.3 million, down $8.7 million for the first 9 months of this year. We were in compliance with all loan covenants in the third quarter and expect to remain in compliance over the next several quarters.

With that, I'll turn the call back to David.

David Burke: Thanks, Phyllis.

We're a little over a month into our fourth quarter, and we're seeing early success from the new, more targeted fall football advertising campaign, known as *Escape to Football*, along with many new promotions that began in early September, right around the kickoff of the NFL season.

The game day menu has a number of items for $5, including burger and bratwurst, fries, domestic pitchers, select craft beers and a number of specialty cocktails. This promotion has been a hit with our guests and is currently expected to run through the end of the football season. As a result, we're beginning to see a nice uptick in sales, particularly on the weekends, from higher traffic and, importantly, an average check that has been holding up well as guests spend more time in our restaurants.

Same-store sales for the month of October was a positive 1.6%. This performance in the first month of the fourth quarter is certainly a step in the right direction. We are optimistic that we can maintain this positive momentum throughout the fourth quarter. If it holds, this would be our first quarter of positive same-store sales in over 2 years and a strong indication of improved top line performance into 2019.

It is important to note that we are in the early stages of the brand revitalization, and we continue to believe that the more substantial efforts will be realized throughout 2019 as more impactful changes are implemented and gain traction. This includes improvements to the menu and food presentation, information technology and continued enhancements around advertising and promotions, especially as we move into the March Madness period early next year, another significant sales environment for Buffalo Wild Wings.

And current plans call for a complete relaunch of the brand as we approach the fall of next year. There are a lot of exciting initiatives in the horizon. In the meantime, we will continue to run a best-in-class operation that focus on the controllable aspects of our business.

Our team continues to drive traffic through renewed energy around customer experience and our local restaurant marketing initiatives. Guest experience scores are strong and trending up, and our push to improve penetration of the Blazin' Rewards loyalty program remains successful with attachment rates north of 23% in September, far outpacing the Buffalo Wild Wings franchise system. Our goal is to reach 35% loyalty attachment, so we remain focused on continuing to push growth in loyalty. See Slides 19 and 20 for additional details.

In conclusion, we remain extremely bullish about the direction Inspire Brands has taken the Buffalo Wild Wings brand. As a franchisee, we've been involved and engaged with the new leadership, consulting on many decisions. They have done a significant amount of due diligence and are now firmly in execution mode on all facets of the brand strategy. We are confident that, together, we will revitalize the brand and get back to being the Great American Sports Bar.

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

Operator: [Operator Instructions] Our first question comes from the line of Jeremy Hamblin from Dougherty & Company.

Jeremy Hamblin: Great. Congratulations on getting back to positive territory on comps. Let's hope that continues. I wanted to first come back actually to Q3, and I had a question just in terms of the cover charges associated with last year's fight. I think you said it hit other operating expenses. Or is that where you saw that reflect in margin?

Phyllis Knight: The cover charges would have been part of the sales line, Jeremy, but the expense to carry the fight was in OpEx.

Jeremy Hamblin: Okay. I have to ask a little bit about forward-looking here. This change in sales trend to getting back to positive. Some of that I would guess is being driven by the new Game Day Menu, obviously some nice promotions there. Can you give us a sense for how it's impacting the P&L? Wing prices are off the lows, but still lower on a relative basis. How is this change in same-store sales trend impacting overall profitability?

David Burke: It has actually been beneficial for us. I mean, net-net, this promotion has been very favorable for us, not only the way it is contributing to the traffic-driving nature, but it's not all completely offset with price. I mean, there's clearly going to be some price erosion, but it is offset by traffic. Overall, we are pretty pleased with it. Now, I don't think that's the silver bullet. I think our team has worked very hard this year to improve our quality of service since, basically, this time last year, and I think that's also contributing, but it takes a little bit more time. Then, obviously, we're comping over a relatively weak prior year. All of these factors, I think, are contributing to the subject of traffic.

Jeremy Hamblin: Okay. But, overall, the net gains on comps now is having a positive impact overall on profitability?

David Burke: Yes.

Jeremy Hamblin: Okay. Where does menu pricing stand in the fourth quarter on a year-over-year basis?

David Burke: We've been reluctant to take price and very cautious in the most recent past and we're aligning ourselves with the Buffalo Wild Wings strategy. I think we discussed this briefly in March for the March Madness campaign. That's going to entail some updates to the menu, et cetera. There are some new food items, but it's really an opportunity for us to revisit the pricing, and since we haven't taken price in a little while, we're starting to see the momentum. We are being saddled with some inflationary pressures right now. There's no question if we want to be taking price during next year.

Jeremy Hamblin: Okay. The other thing that seems to be resonating with customers is certainly the $5 domestic pitchers. I wanted to get a sense for the change that you're seeing maybe in mix contribution and whether or not the downside from the promotion on, let's say, a burger and fry basket or brat and fry basket is being offset by maybe higher alcohol as a percent of total sales. Can you give me any color on where alcohol stands as a percent of total sales today? And then, what have you been seeing now over the last, let's say, 6 weeks since the promotion was put in play?

David Burke: I think you may be surprised. I mean, the promotion is working in that it has a great value message to the guests, but also keep in mind that there's new creative out there that's driving some awareness in the brand experience, and driving the line of traffic as well. There has not been a substantial mix change as a result of this promotion. We are clearly, from a unit perspective, selling more burgers than we did prior to the promotion. We didn't have brats, so we're selling more of those. We did not have pitchers, so we're clearly selling more of those. We also have some tall drafts built into that, which actually unit-by-unit are selling a little bit more than the pitchers. Although it is popular, from a total product mix perspective, it's not really moving the needle that much. That's a good thing, in my opinion, just from a cost of sales perspective.

Jeremy Hamblin: And within your system specifically, what is alcohol as a percent of sales today?

David Burke: From a total sales perspective, it's right around between 17% and 18%, but keep in mind that we continue to drive carry-outs and delivery traffic and you don't have any alcohol that goes along with that bill. I haven't done the calculations for Q3 yet, but we're in the low 20% from a dine-in perspective, probably about 22-ish or so.

Jeremy Hamblin: Okay. And then, as we look forward to the strategy, it appears as though we're moving as a brand a little more back to a traditional sports bar environment. Is that an opportunity that you expect, new ownership to be driving alcohol mix higher? Is that part of the overall goal?

David Burke: Yes. Definitely. I think the entire system has recognized that it has deteriorated over time, and we have the right, frankly, as a brand as the Great American Sports Bar to have an alcohol percentage that's higher than where it is today, despite the increase in delivery and carry-out in general. There's no question. We're working on not only enhancing the beer program, but also enhancing a relatively nonexistent spirit program within the brand. I think the two of those go together. It's not just about the alcohol program itself, but it's the experience in in-store and making adjustments to make the bar a little bit more enticing and more appealing to the guests, just to drive overall alcohol sales.

Jeremy Hamblin: Okay. In terms of what we're seeing either from digital ordering or carry-out, and I may have missed it, but we went through a lot of stuff, what is that as a percent of sales today versus a year ago?

David Burke: Are you talking about total carry-out, total non-dine-in sales?

Phyllis Knight: Including delivery?

Jeremy Hamblin: Yes.

Phyllis Knight: It's running 22%, 23% in total delivery and carry-out combined, which has been fairly consistent. I mean, we are seeing some uptick in our delivery business, and we have a lot of work to do in the fourth quarter, I think, to look at the various programs that are out there and make sure that we're doing the best thing we can, both for driving sales and managing margins. The latest number is 50 of our restaurants on delivery now and we've continued to push it up. The fact that carry-out and delivery as a percentage has stayed somewhat consistent would tell you that you could guess there's probably a little bit of cannibalism on the carry-out side right now. We're doing some work to assess and see how we can try to mitigate that.

David Burke: Strategically, I'm a firm believer in the upside of whether you want to be in the delivery game or not, right? I would much rather be in it, because the decision-making process for guests is not, hey, I want to go to Buffalo Wild Wings, and then I'm going to make a decision of whether I actually go there or I want to get it delivered. First, you make a decision on I'm going to get delivery; and then, you determine where you're going to get the delivery. There is definitely a cost to that, I think, as we scale up and those match the work. 80% of the restaurants plus have delivery now between Uber Eats, Grubhub, DoorDash and then some mom-and-pops that we're slowly filtering out. We're learning every day how to improve that whole process and increase the experience for the guest; then, at the same time, from a P&L perspective, ensure that you mitigate any cost pressures. Everyone knows from a margin perspective, it's expensive, but we do believe that is incremental in nature. You can look at this from a contribution perspective, but we have to be cautious about it as well.

Jeremy Hamblin: Okay. The other thing I want to ask about that's new is the DraftKings partnership kind of game-day game that they have. That doesn't seem like it has been supported a ton in terms of any advertising and awareness. It still appears to be fairly low on that. Could you provide any commentary or insight on that partnership, the type of impact that it's having maybe on loyalty program sign-up? Any color you can provide would be helpful.

David Burke: Yes. I hear you. We see the same, and it's going to be addressed. There's going to be an evolutionary process to this. We were all excited that we actually got it placed prior to football, and I think that's an incredible accomplishment given the amount of time that they had. On the same token, the amount of time they've had to really plan it out and the complexities that can arise from it, I think it's just a matter of taking some baby steps to walk in there and understand what problem we're trying to solve. There has been discussion around potentially simplifying a little bit for non-fantasy sports players, right? It's complicated to walk into that if you're not familiar with it. I think there has been some opportunity there to simplify a little bit to try to attract people who normally wouldn't do that.

And we've talked about the future, what it holds. Obviously, there's a lot we're just working through right now, but I think it's pretty evident just given what DraftKings' platform looks like and all the other sports that you can evolve over time once we get out of football season and how we can evolve that process. Keep in mind that the loyalty program platform, a lot of these things are relatively new. The Inspire team and Buffalo Wild Wings are taking all that together and integrating it to really make them leverage a much more powerful system going forward. I have every bit of confidence that, at this point, it will gain more traction as we go along. We're doing more in-store promotional activity to help incentivize our management teams to push it a little bit more, get them better training, et cetera, so that it does get more traction as this football season evolves.

Jeremy Hamblin: Okay. Great. I'll ask just one more and then hop off to let others ask questions. The wage inflation year-to-date is running at what level?

Phyllis Knight: 4% to 5%.

Operator: Our next question comes from the line of Jason Smith from Kanen Wealth Management.

Jason Smith: I just have a quick question about the loan covenants and compliance. We were compliant this quarter. How close were we to violating them? And then, also, how are those evaluated? Is it per quarter? Is it trailing 12 months? That's it.

Phyllis Knight: It's a trailing 12-month calculation. I mean, we were in compliance with Buffalo Wild Wings, and the reason for that, as we've talked about before, is the equity raise. We basically had an equity cure-type mechanism built into the covenants; therefore, the close to $5 million of net proceeds that we took in from the July equity raise kind of buffered the covenants and will buffer it from Q3 of this year through Q2 of next year on that trailing 12-month basis.

Operator: Our next question comes from the line of John Sturges from Oppenheimer & Co.

John Sturges: I'm curious about the loyalty attachment rates. What execution process are you using that makes you roughly twice what the franchise system is currently seeing? Then, of course, the follow-up is how do you get to 35% from your current 23%?

David Burke: Well, we incentivize it. We pushed having loyalty as a component of the quarterly bonus. We talk about it all the time, and we've set some goals for the teams to get there. That's really about it, the constant communication and pushing the teams to do it. Explaining the benefits, not just to the company, but to the servers on how they can make more money from a tip perspective if the average ticket is a little bit higher, et cetera. That's enough to bolster it, to be frank.

And as to how we get to 35%, we just continue doing what we're doing. There are other incentive programs we can put in place, and Buffalo Wild Wings also has some incentives that they are lying on top of that, which is system wide for our management teams. It's competitive, it's fun and good-natured, which I appreciate. I think as it goes forward and people start seeing the fruits of their labor, it will gain more and more traction. In addition to that, some of the other added benefits to it as we improve the offerings, not necessarily food offerings, but the merchandise-type offerings, as we integrate the fantasy program a little bit more, and that gains more traction. A lot of other elements will come to life and make it a much more valuable experience and more attractive for people to utilize.

John Sturges: Okay. While we're talking about this, will that be a seasonal peak that we'll see? I mean, will it be in the fall that we see that peak? I'm just curious.

David Burke: What do you mean when you say seasonal peak? The 35%?

John Sturges: Yes, right.

David Burke: Frankly, we hope to be there before the fall of next year, but we'll spend the rest of this year and the beginning of next year really trying to get that up.

John Sturges: Okay. Can you reveal some of the details of how you actually measure loyalty? What are some of the factors that get in there?

David Burke: Well, the calculation that we're talking about is attachment rates, so it's literally the number of tickets that have a loyalty number attached to it, the buy-to-buy that holds a ticket. 1 in 4 people are loyalty members or loyalty customers.

Operator: Our next question comes from the line of Mike Wallace from White Pine Capital.

Michael Wallace: I'm thinking about the impact that the same-store sales improvement could have on EBITDA and EBITDA margins. Could you give us some sense of how much of that flows directly through to EBITDA and the margin impact?

David Burke: Yes. We discuss it at a high level. Particularly with dine-in, you can see contributions upwards of 40%. Now there's probably mix in carry-out and mix in delivery that may be pushed down a little bit. Conservatively, I think you could look at 35% as a nice contribution in total, and that's without any price. We have some pretty heavy inflation on the labor side right now, but we'll tend to offset that part next year.

Michael Wallace: And the EBITDA number? 1/3 of the improvement in sales would flow right down to EBITDA?

David Burke: Yes, that's about right.

Michael Wallace: It flows through. So you're saying October ran at 1.6%?

David Burke: Yes.

Michael Wallace: Any sense on the first few days of November, are we trending similar range or better?

David Burke: Frankly, the quarter-to-date is about the same.

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: I'd like to thank everyone for joining us today on the call and for your interest in Diversified Restaurant Holdings. Feel free to reach out to us at any time, and we look forward to talking to you again after the fourth quarter results. Thanks, again, and have a great day.

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