**Operator:** Greetings, and welcome to the Diversified Restaurant Holdings, Inc. First Quarter 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I'd like to turn the conference over to your host, Craig Mychajluk, Investor Relations. Thank you. You may begin.

**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 Chief Executive Officer, 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 is 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 other documents filed by the company with the Securities and Exchange Commission. These documents can be found on the company's 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 the call over to David to begin. David?

**David Burke:** Thanks, Craig, and good morning, everyone. So with Buffalo Wild Wings under new ownership as of the first quarter, we're very energized by the dynamics and the drive of our franchisor and excited about what it means for Diversified. But before I expand on forthcoming changes in our business and our expectations as to how we can benefit, I'll ask Phyllis to provide a quick review of the first quarter.

**Phyllis Knight:** Thanks, David, and good morning, everyone. We continue to be excited about the many upcoming changes at Buffalo Wild Wings; however, as expected, the initial efforts are still early stage and impactful changes will not likely be forthcoming until later in the year.

Our first quarter results were more reflective of the recent past, including negative changes to corporate promotional, marketing and media strategies that carried over from the latter-half of last year. The related detrimental impact to our traffic was a major factor in our sales decline in the first quarter.

Additionally, the quarter was negatively impacted by two significant calendar shifts. First, the Easter holiday, a day on which our restaurants are all closed, fell in the first quarter of 2018 versus the second quarter of 2017. This shift had a 1 point negative impact on same-store sales for the quarter.

Second, the week between Christmas and New Year's Day, which is a very significant sales week, fell in the first quarter of 2017, which we're comparing against, but was not in the first quarter of 2018 as a result of the 53rd-week in fiscal 2017. Partially offsetting these items was the benefit of one new restaurant, opened in 2017, and a 7.8% increase in average check size, which was driven by changes in the promotional strategy and to a lesser degree last year's pricing increases.

You can see the breakdown of each of these items under the sales bridge included on Slide 4. We commented on our last call that a catalyst for meaningful change was not expected in the first quarter and clearly, that was the case. While our commodity cost environment improved, adjusted EBITDA margin was still down 1 point to 12.9% as a result of the impact of sales deleveraging on lower AUVs.

Following a tough year with inflated wing costs, we have turned the corner on cost of sales, which fell to 28.2%, a level more consistent with past performance. Traditional wings as a percentage of total cost of sales were 21.5% in the quarter, which compares favorably with the 24% to 25% range that we saw in 2017.

The spot price for fresh wings is currently at a relatively low $1.29 per pound compared with a peak of $2.16 last year. While wing prices have been volatile recently, we're optimistic that cost of sales will remain in the 28% range this year.

Restaurant level EBITDA was $6.9 million, or 17.4% of sales, a sequential increase when compared with 17.1% last quarter, but down year-over-year as sales deleveraging more than offset the more favorable cost of sales environment. Hourly and total labor costs trended slightly up this quarter, as anticipated, as wage pressures, primarily in our fixed cost manager ranks, have resulted in higher salaries, further exacerbated by current sales trends.

Slides 5, 6 and 7 provide additional details on the changes in EBITDA margins and cost of sales. We generated $3.5 million of cash from operations during the quarter and free cash flow of $3.2 million. We used this cash flow to reduce our debt level by nearly $3 million this quarter and, at quarter-end, total debt was $111.1 million.

As mentioned on our last call, we worked with our lenders during the first quarter to reset the financial covenant levels on our debt facility through the end of 2019. This allowed DRH to maintain its existing debt structure, amortization schedule and favorable interest rates despite the current sales headwinds in our system and the resulting pressure on our earnings in the short term.

We were in compliance with our loan covenants in the first quarter and expect to remain in compliance throughout the year. Cash and cash equivalents of $4.5 million were up slightly at quarter-end. Capital expenditures were $0.5 million and were mainly for minor facility upgrades and general maintenance type expenses. In addition, nearly 40% of that capital spend related to non-recurring improvements to prepare an open space adjacent to one of our restaurants for sublease.

As we discussed on the last call, we expect a reduced level of capital spend this year in order to focus free cash flow on debt reduction. We're not planning to build any new restaurants nor are we expected to complete any major remodels. As a result, capital expenditures are expected to be approximately $1.5 million or perhaps slightly less this year.

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

**David Burke:** Thanks, Phyllis. We truly believe that better times are ahead for Buffalo Wild Wings and DRH. New franchisor ownership is creating renewed energy and excitement behind the brand. We are seeing progress behind the scenes on many fronts, including marketing, advertising, information technology, menu development and much more.

We expect that these efforts will begin to be realized in our results later in the year as the changes are implemented and gain traction. In the meantime, given the circumstances, our team remains focused on driving traffic through renewed attention to best-in-class customer experience and local restaurant marketing initiatives that enhance our connection with each community.

We believe we're able to strike the delicate balance between operational efficiencies and superior customer service. Over the past 18 months, we implemented significant sustainable reductions of overhead and meaningful impacts with our productivity initiatives and other cost controls. We expect to see further reduction of G&A cost of approximately $0.5 million this year to just under $80 million. We have measurably improved our operating leverage and increases in revenue should yield a profit conversion of over 40%.

We like the promotional plans our franchiser is introducing. As you know, the restaurant space, especially in the quick serve space, is very competitive and value for the customer is the leading driver for traffic. In fact, in partnership with our franchisor, this last month, we have been testing an *Everyday Value* promotion in our St. Louis market, where dine-in guests can receive discounted boneless wings any day of the week versus our traditional one day a week promotion.

Early indications and feedback have been very positive. Corporate has also provided television advertising in our market to support the test. We also are looking forward to the roll out of a new media strategy this fall and all signs point to a relaunch of the brand sometime in early 2019.

While a lot of change is underway, I'm impressed by the pace of the thoughtful and methodical approach being used. We believe there is a lot of upside with food presentation and product development that is in the works. It is about getting back to basics, focusing on our customers, the right products and improved marketing to drive traffic. And as these changes take hold and gain traction, we expect we will benefit as our operating leverage translates sales growth to our bottom line, cash generation and, ultimately, debt reduction.

Operator, we can now open the line for questions.

**Operator:** Thank you. At this time, we will be conducting a question-and-answer session. [Operator Instructions] And our first question is from Jeremy Hamblin from Dougherty & Company. Please go ahead.

**David Burdick:** Hi, good morning. This is David Burdick on for Jeremy. Thanks for taking my question.

**David Burke:** Good morning, David.

**David Burdick:** So on that promotion you just mentioned, can you explain that *Everyday Value* promotion a little more?

**David Burke:** Yes, sure. It's a test promotion that we're doing alongside our franchisor. This was one of the innovative things they are doing right upfront immediately, when they started looking at some alternatives. The premise behind it is to do an "everyday value" instead of doing an individual day. It's more efficient from a marketing perspective and we're experimenting with getting away from a single day promotion.

We were fortunate enough to be one of the franchisees, with just one other, to test this and we're doing it still in our St. Louis market. The value is six boneless wings for $4, but it's for dine-in only, so that is one difference that we're working with versus allowing it for take-out as well. We really want to keep customers in the restaurant. It's a great value message and it's every day, all day, so we're not forcing people to come in on a Tuesday or at certain parts of the day, etc. to see how that resonates with guests.

**David Burdick:** I know it's probably still early, but how is that done in terms of like mentioned?

**David Burke:** Yes, it is really early, and it's difficult to tell, because there's a lot of noise. Over the last three weeks, we were confident over St. Louis Blues' playoffs last year. They did not make the playoff this year, so that creates a lot of noise in trying to see a normalized week.

So really, starting this week, we have a normalized week; plus, it's still relatively new. With the media behind it, it's been going on for maybe five weeks. I was out in the market two weeks ago and the feedback from the management team and the team members, the servers and the bartenders, was really positive. It's gaining a little traction. It is a new message. It's different.

So it does take a little time for guests to understand what that means and, really, just to see and feel the value as they come in, in hopes of getting a higher frequency of traffic in the longer-term.

**David Burdick:** Great. And then, in terms of the changes Corporate is making, what are you seeing on the ad front? Are the menu changes focusing on lunch? Is it happy hour or late night? And then, if you could just touch on maybe the initial relationship, how it's been with Corporate. Are you working closely with them?

**David Burke:** Well, overall, I can't really give specifics on that. I can tell you that they are moving very quickly with change across pretty much all of the touch points. I've mentioned the marketing and advertising, which includes promotional strategy, which is very important. But these things are going to take a little time, particularly with new product development and the menu, etc., and it isn't necessarily specific to any part of the day or anything.

We'll be looking at the alcohol menu, the marketing, the look and feel of the bars, and the menu in general to try to amp-up our value proposition, and that goes everywhere from the actual quality of the product to the operational side of it in terms of cook time.

So we can have a more efficient process to get the food out faster, as well as the presentation of the food. So it's very holistic approach. But like I mentioned in – before, it's not going to happen overnight. But I can attest the fact that they are moving very quickly. I'm seeing that on the development and discussions that are going on behind the scene. They are really taking a look at the brand in its entirety, not just taking one specific piece of it.

The relationship has been great. They are very attentive. They listen to the franchisees, not just us, but all of them. I'm fortunate to be on the FAC, the advisory committee, so I get a lot more face time with the new leadership team than some of the other franchisees. They've been nothing but, I guess, open ears and really listening to the franchisees and what they have to say to understand the history of the brand, etc. We're working hand and we all have the same common goals.

**David Burdick:** Okay. And then, I just want to touch on the G&A. It seems like that might be happening a little quicker than some of the changes Corporate is making, but you mentioned a little leaner and more efficient organization. I believe the forecast in the slide deck was $7.6 million for the year, but I'm not sure if that's lower than what it was in Q1. Could you just touch on some of the details and the changes you're making?

**Phyllis Knight:** Yes, David, it's Phyllis. On the G&A front, we really haven't done anything new in the first quarter there. You're just seeing the impact of reductions that we put in place last year coming through. The Q1 number has a big bank amendment fee in it, which is what you'd see in our EBITDA reconciliation as the add-back. If you take that out of the G&A number, I think, the run rate in Q1 is actually a little bit less than what we're showing for the full-year estimate, and some of that's just going to be the timing. There's a little bit of marketing spend that goes in G&A that's above the store level, and that can vary from quarter-to-quarter. We feel pretty good about the full-year estimate, and I think the run rate in Q1 definitely supports that.

**David Burdick:** Okay, great. And then, one last question. As you move into Q2, would you be able to comment on how current trends are?

**David Burke:** We really can't. I mean, at this point, we don't really like to comment going forward, unless by a forward-looking basis, but we are very excited about what we're seeing from the change perspective. As we mentioned in the prepared statement, that's really going to start hitting home later in the year in terms of getting some really good impact. We're very much looking forward to that.

**Phyllis Knight:** In April, you'll notice the benefit of the opposite of the Easter shift that hit us in March.

**David Burdick:** Okay, great. Thanks for taking my questions. Good luck.

**David Burke:** Thank you.

**Operator:** [Operator Instructions] Our next question is from John Bair from Ascent Wealth Advisors. Please go ahead.

**John Bair:** Good morning. This is kind of an SG&A question. You mentioned in the prepared comments that salary costs were a little bit higher, if I heard that right, as far as the managers go. So the question is in reference to how your staffing situations are. Do you have a lot of turnover? And if so, how is that impacting efficiencies in your stores? Is that an issue?

**David Burke:** I'm going to break it down into two levels. From the store level, we have the management team's salaries and the team members' hourly pay. Turnover in the hourly hovers between 90% and 100%. Historically, that has always been the case and I don't think that's going to change very much going forward. It's the nature of the business.

**John Bair:** Is that on an annual basis?

**David Burke:** It is, yes. I think that's very typical of any restaurant. So, we're feeling the pressure from a wage perspective on the hourly side. This is pervasive in pretty much every industry that I've looked at or talked to people in, really having a difficult time finding hourly employees that want to do the work. It's a challenge, but it's not a new challenge. We've had this challenge pretty much all last year as well. That's causing some inflationary pressures on the average wages that really has nothing to do with the state minimums. It's really just supply and demand and retaining some good talent.

Now, talking to the operations team side, I've given them some latitude if they listen as we really need to retain here, because there is obviously a cost for turnover and it's not just monetary. There is a lot of other costs associated with that in terms of training and having good people and good staff and people that you can rely on. So, it makes a lot of sense to pay a little bit more to get the right people in there and retain them a little bit longer. Turnover varies depending on the positions as well. It's a little more complicated.

From a manager standpoint, salaries… similar situation. Turnover is obviously not nearly as bad, but, from an inflationary standpoint, it is getting more and more difficult to find managers. And the turnover isn't necessarily a direct result of underperformance or disgruntled employees. A lot of it has to do, again, to supply and demand as other industries are pulling from the restaurant industry.

If you have a lot of hard working people who understand customer interface and know how to work hard, obviously, and manage and lead people and lead a team, then they're sought after for other industries as well. So, we're up against that, and that's another driver of some inflationary pressures on the salary side of things. Does that help you?

**John Bair:** Yes. So along those same lines then, have you given any consideration to some sort of retention incentives to try to reduce that? I mean, I realize if you have a tight market of labor, it's not necessarily just getting a higher paycheck somewhere else or whatnot. Maybe if some sort of an incentive thing in place was considered, it might help reduce that, because there is a big cost in retraining and comparing the ideas and message that you're trying to get across to encourage people who have a good experience at your specific outlets to stay…

**David Burke:** Yes, certainly. There is a number of things that we're working on with our ops team regarding how to defend this. And yes, there are forms of incentives that we're using. A lot of it has to do with added responsibility, their ability to be promoted, etc., because it's a younger person's job. If they've been doing this for 10 or 15 years, it's difficult to retain or keep them at the MP level, the General Manager level.

We're working through some options to give them a little bit more of a career path, leveraging people who have other skill sets to give them some added responsibilities within the company. So if they are not just focused on the restaurant, then we can leverage them in other ways and get them out in the market a little more, if they have a good skill set from a sales and marketing perspective.

So, we've added layers and layers of other benefits. Every year, we revisit the common benefits (health benefits, loan benefits, those types of things), to see how we stand up against the market and other competition, to ensure that we're attractive – and we're more attractive than most other restaurant companies.

So it's top of mind for us, for sure. We believe we have a very, very good bonus compensation plan. That's a pretty high variable component. So, the ability to make a lot of money is there if that is the driving factor, but it's not always the driving factor that we've found for these groups. A little bit of work-life balance is built into that. There are some strategies there to ensure that they have somewhat of a balance in their lives, that they're putting in the hours.

**John Bair:** Well, I'll throw this out there. I know from the investor standpoint, we don't like the concept of dilution, but at $1.30 or thereabouts, if you get this thing turned around, stock options - at the server level even - might provide some pretty interesting incentives to stick around.

I'm just throwing that out there.

**David Burke:** No, we actually had planned the plate, not down to the server level, but that is definitely something that we can consider. I appreciate that.

**John Bair:** Yes. All right. Well, good luck. Thank you.

**David Burke:** Thank you.

**Operator:** Thank you. This concludes the question-and-answer session. I'd like to turn the floor back over to management for any closing comment.

**David Burke:** Thanks, everyone, for joining us today and for your interest in Diversified Restaurant Holdings. We'll be attending the Oppenheimer Annual Consumer Conference in Boston on June 20, or please feel free to reach to us out any time. We look forward to talking to you again at the second quarter results. Have a great week.

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