Operator: Greetings. Welcome to the Diversified Restaurant Holdings Inc. First Quarter 2019 Financial Results. [Operator Instructions] Please note this conference is being recorded.

I will now turn the conference over to your host, Craig Mychajluk, Investor Relations. Mr. Mychajluk, 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 CEO; and Phyllis Knight, our Chief Financial Officer 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 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 it over to David to begin. David?

David Burke: Thank you, Craig, and good morning, everyone. As you know, as the resurgence of the Buffalo Wild Wings brand is well underway, we have elevated our game as demonstrated by our recent performance. Sales were up. We generated solid cash flow and we continue to the pay down debt. This is our second consecutive quarter with positive comparable sales reaching 4.2%, with traffic being the leading driver at 4.9%. This was despite severe weather that impacted significant portion of our footprint earlier in the quarter, including 2 entire football playoff weekends in each of our 3 core Midwest markets.

Helping offset was our focus on guest experience, loyalty attachment and the development of the delivery channel, as well as the early benefits of the new marketing, media and latest brand enhancing initiatives around March Madness. In fact, we finally saw our dine-in traffic turn positive and since those launches, our dine-in same-store sales through the end of the last week were up 3%.

Comparable sales trends have continued through the end of last week at 4.6%, and this includes the negative impact of the Easter shift. When excluding the Easter shift, same-store sales growth would have been over 7% with both traffic and average ticket up.

While our margin and earnings expansion were muted given cost of sales, labor and delivery expense headwinds, we are optimistic about the future and have taken additional steps to mitigate these issues.

Beyond the recent pricing that we took, we are taking another hard look at our G&A expenses and we will be executing reductions in the next several weeks approaching $1 million on an annualized basis. We expect these reductions to drive overhead expenses below 5% of sales for 2019 and closer to 4.5% in future years when we get the full benefit of these reductions.

As we outlined last quarter, there were significant number of new branding elements rolled out in March that enhanced our image, value perception and guest experience. This included the higher-quality menu items, new menu design, vastly improved plateware, hip server uniforms and enhancements to our bar offerings. Specifically, on the food side, the new, fresh, twin patty All-American cheeseburger has been a hit. Our guests have recognized that we have stepped up our game and the quality and value perception has been significantly enhanced and we should expect that same type of commitment in the future rollouts. We anticipate new menu items being added throughout the year.

Ramping up the delivery channel is an important part of our strategy, and delivery continues to demonstrate growth as we now offer this service at 52 of our 64 sports bars. We are also mindful of the margin impact and have been working to meaningfully drive down our delivery costs while continuing to ramp up sales. Phyllis will address these efforts in a moment.

Guest experience scores are strong and our push to improve penetration of the Blazin' Rewards Loyalty Program remains a success with attachment rates nearly 28%, still far outpacing the Buffalo Wild Wings franchise system. Our goal is to reach 35% loyalty attachment this year, so we remain focused on continuing to push growth in loyalty to increase the frequency of guest visits to our sports bars. For further details, please see **Slides 15 and 16**.

Lastly, we disclosed in mid-April that Buffalo Wild Wings will exercise its right of first refusal to acquire the 9 sports bars in the Chicago market that we had under a signed purchase agreement. While we're certainly disappointed, we recognize that this is a very attractive transaction with significant upside in a market that we share with other corporate restaurants. We believe it would be unwise to read into anything additional with this move. It was a good strategic play for DRH and it's a good strategic play for our franchisor. Because that transaction was a part of our broader debt refinancing strategy, we're now reevaluating various alternatives to refinance our existing debt. We are focused on completing the transaction between now and the end of the third quarter. We expect new terms will strengthen and stabilize the balance sheet, produce additional cash flow and drive future value creation.

As a leaner and more efficient organization, we are well positioned to leverage future improvement in sales. Given the marketing plans and other forthcoming brand enhancing initiatives, including the complete relaunch of the brand this fall, we believe there is a significant opportunity to build this momentum and achieve strong long-term growth and margin performance.

With that, I'll turn it over to Phyllis for a detailed look at the financials, and then we'll be happy to answer any questions. Phyllis?

Phyllis Knight: Thanks, David. Good morning, everyone. Sales in the first quarter totaled $40.6 million, an increase of $1.1 million or 2.6% despite one fewer restaurant when compared with the prior year period. Same-store sales increased 4.2% with traffic up 4.9%, and average check down 70 basis points.

We implemented an average 1.5% price increase with the new menu rollout in mid-March so we only saw a few weeks of benefit from that in our numbers. There was a favorable calendar shift in the quarter as Easter, a holiday on which our restaurants are closed, fell within the 2018 first quarter versus the second quarter in 2019. It's not a completely straightforward calculation to determine the impact that this shift had on our quarter, as that particular Sunday this year fell during the Elite Eight round of NCAA tournament and had some significant games that drew traffic, whereas Easter Sunday last year was the day between the Saturday final 4 semifinal games and the Monday championship game, because the NCAA tournament was one week later this year. As such, it would be misleading to simply exclude sales from that Sunday to get to an adjusted number. However, using an average non-NCAA tournament Sunday would imply about a 1% impact on same-store sales for the quarter as a result of this shift.

Please see **Slides 4 and 5** for average check and traffic trends in the first quarter sales bridge.

Delivery has been a significant contributor to our top line growth for the last 2 quarters. In the first quarter, delivery contributed $2.6 million in sales at 52 locations, a $2 million increase over last year's first quarter. We believe delivery is a critical channel with significant upside and one that our products and processes are well suited for. We've made investments in our stores to facilitate a smooth operation and have implemented numerous process improvements to perfect our execution, and these investments are paying off. We expect delivery sales will continue to experience strong growth in 2019.

So as David said, we're aggressively working to improve the margins in this channel and we've seen great improvement over the last few months. We're implementing additional changes in May and June that will see our net delivery expense improve significantly. Because we're a great partner for the third-party delivery service providers with the high average check and top tier execution, we've been able to consistently improve the economics of these relationships.

While we will not always provide this level of information, **slide 7** gives a snapshot of the sales and expense trend from inception of our delivery programs through April. We thought it was important to provide this trend data because earnings in the last 2 quarters saw both strong growth from delivery sales and a negative overall impact on margins. The good news is we expect the current quarter could be the last with negative margin percentage impact from this channel.

Adjusted EBITDA was $4.5 million or 11.1% of net sales and restaurant-level EBITDA was $6.4 million for a margin of 15.7%. Higher sales and lower G&A expenses helped to partially offset increased labor costs, wing costs and delivery expenses.

We also incurred one-time expenses during the quarter related to major brand initiatives including new menus, new plateware, new uniforms and new product launches. We made a significant investment in training and this had a noticeable impact on our labor in the quarter.

Slide 6 shows the EBITDA bridge, calling out these items and **Slide 8** provides a breakout of our historical quarterly restaurant-level margin. Cost of sales was 80 basis points higher than last year as wing prices increased throughout the quarter, driving food and beverage costs to 28.8% of sales.

Traditional wings as a percentage of total cost of sales increased to 23.9%, close to the 24% level we saw in the first quarter of 2017. So this was also impacted by a mix shift toward more traditional wings as prices were below 2017 in the first quarter. Wing prices in March, April and May are not only well ahead of 2018 prices, they're higher than 2017 as well.

While it remains to be seen how wing prices will trend in the typically lower summer months, we're concerned about this current market and taking an off-cycle price increase on wings to help combat the pressure. This will be in effect by the end of this month, but not soon enough to alleviate much of the pressure on cost of sales in the second quarter. And it is good to see that wing prices did finally begin dropping last Friday. Our historical expense trends are presented on **Slide 10** and historical wing prices on **Slide 11**.

Compensation costs increased 120 basis points to 26.9% of sales due in large part to the continued tight labor market driving inflationary pressure on hourly costs. We expect that Q1 of this year versus Q1 of last year will see the most severe impact from wage inflation that we experienced throughout 2018 as hourly wages for the quarter were up 6% compared to last year.

As I mentioned a moment ago, we also incurred some additional labor costs related to training in the quarter due to the new products, new plateware and menu launches.

We present a year-over-year labor bridge on **Slide 12**.

We implemented a 1.5% average menu price increase in mid-March, in addition to the further increase on wing prices, which I just mentioned will take effect later this month. Other operating costs were up 20 basis points to 21.4% of sales due to higher delivery fees on increased sales, as previously mentioned, and costs associated with the new uniform rollout.

Our G&A costs as a percentage of sales were down 20 basis points to 5.5% due to lower corporate overhead and other efficiency initiatives, partially offset by higher incentive accrual. As David mentioned, for the full year of 2019, we're targeting G&A expenses below 5% of sales excluding nonrecurring items.

You'll notice a bit different look to our balance sheet this quarter as we implemented the new FASB leasing standard and restated for 2018 so that the effects were comparative. Because we lease all of our facilities, the impact of the new standard on our balance sheet is material. I'll defer on discussing any specifics here to the Q&A session or follow-up calls.

Cash and cash equivalents were $6.5 million at quarter end. We generated $4.7 million of cash from operations during the quarter and used this cash flow to reduce our debt level by $3 million to $99.5 million. The core element of our capital plan is to further reduce our debt by maintaining a low level of capital spending and continuing to focus on generating strong free cash flow. Capital expenditures were about $600,000 in the quarter and were for minor facility upgrades and general maintenance type investments. Also included was approximately $200,000 invested in the new plateware rollout.

We do not expect to build any new restaurants or complete any major remodels this year. As a result, we expect CapEx to approximate $2 million in 2019.

The franchisors are in the process of developing a new building design standard and testing a variety of remodel options. They've communicated to us that they're targeting a 3-tier remodel program with costs ranging from $250,000 to $650,000 depending on the size and revenue profile of the restaurant.

Currently, we don't expect to be reinvesting into our locations with the new format until sometime in 2020.

With that, operator, we can now open the line for questions.

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

Jeremy Hamblin: In terms of the debt refinance, I wanted to just get a sense -- it sounds like that's something that you're working on currently and it sounds like that is an opportunity to get something done, I gather, over the next couple of quarters. Could you provide any more clarity in terms of expectation around that particular change to your capital structure, and the type of discussions that you've had so far and potential impact on ongoing interest rates moving forward?

Phyllis Knight: Good morning Jeremy, it's Phyllis. There's not a lot more that we can really say about that at this point in time. I think we'll have greater clarity in the next 5 to 6 weeks. We're out with an investment banking partner helping us source term sheets in a couple different markets. We're looking at the bank market and looking outside the bank market to really maximize what we can get from a refinance perspective, looking at trade-offs between interest rate and amortization, and net impact on cash flows over the next couple of years. I expect we'll be in a position to make a decision which way we're going to go probably within the next 6 weeks. Then, depending on trends in the business and what's going on in the market, I would guess we'll have a transaction done either sometime in July or it will push out into September just because the markets tend to go into a lull in the late summer months. We're not in a huge hurry here, but obviously, we'd like to have something done before end of September/October time frame, worst case.

Jeremy Hamblin: Okay. I understand you can't provide tons of additional color, but in terms of trying to figure out the most important aspect, getting the feature with the amortization and principal pay down, I assume that, that's kind of a priority in terms of refinancing and looking to negotiate on that particular term?

Phyllis Knight: Yes, absolutely. If you look at where we sit today, our debt service is roughly $18 million a year and that's the amortization on what was a $150 million facility when it was redone back in 2015. Certainly, we're looking to meaningfully decrease that number so that it absorbs less of our free cash flow.

Jeremy Hamblin: Understood. And then why not come back to the wing pricing comments in terms of change on that moving forward. What type of change, on a percentage basis, are you looking at for that particular food item? I guess, in terms of offsetting, if we don't see any reduction in wing prices moving forward, from a basis point standpoint - the change that you're taking on price, how much of that -- how many basis points would be offset by that change in pricing? In other words, would it absorb all of the change in cost?

Phyllis Knight: Yes. It's obviously hard to say what's going to happen here with wing prices. They have been volatile. We buy on a corporate contract. There is not really any effective hedging strategy other than a 30-day look back. As I said, wing prices in April and May have been very high, and that's what caused us to take a more aggressive approach. When we did the menu price increase that went in effect mid-March, we didn't touch wings at that time, so wings became a follow-up item. What you're going to see with that price increase, that hopefully we can get in effect here by the end of May, is about a 1% impact overall.

Jeremy Hamblin: Okay. So 100 basis points that you're going to get back just from the wing price change.

Phyllis Knight: Yes. Correct. The good news is that seasonally, typically, by early April, you start to see the wing market give you some relief, or at least by mid- to late April. But wing prices remained really sticky high through the entire month, which is what drives our May pricing. Now the good news is, and I don't know if 3 days makes a trend, but last Friday, Monday, Tuesday, on each of those 3 days, we saw a $0.02 drop in the index. So it looks like the start of a trend. A commentary around the wing market is definitely that there's some softening, so hopefully, we get a combination of price and some relief here. It will not help us much in Q2 but should have a nice impact in Q3.

David Burke: Right. And we look at it this as a pricing forward a little bit here, since we didn't take price specifically on the wing menu items back in March. We have another menu price increase that typically comes in mid-August, right before the fall season. Just given the market with the wings, we have decided to go ahead and pull that forward. We have the option now in August whether we want to maintain that or take further price on the wings side. It just feels like it's the right thing to do given the unexpected market dynamics of the wings at this point.

Jeremy Hamblin: Okay. And sticking with food cost for a second here. Obviously, this recent outbreak in the Asian swine fever, what type of potential risk factor is that, as you see that there's been recent spike, certainly, in pork prices? That seems to be having also a trickle-down effect even on beef prices as well. What type of risk or exposure do you see in terms of that factor?

David Burke: Yes. This comes down as substitution of proteins, right? Clearly, we have seen a drop in wing prices here, about $0.06 over the last 3 days, and that's right after that news of the swine issue. I don't see the wing product as a substitution product for any pork. Chicken breast I think you could argue. So there's potential for more exposure of the chicken breast market. I think you'd have more of a discussion case for that, but I really don't see that much risk associated with that.

Jeremy Hamblin: Okay. And then turning here to labor. Obviously, you had quite a bit of training that was done with the rollout of the brand initiatives in the quarter. What type of carry-through would we see on that here in Q2 and potentially the remainder of the year as compared to the impact that you saw in Q1?

David Burke: Yes. There will be a little bit of carryover in Q2. With training of the new products and then also with the brand champ, which is another factor of what we're trying to really train our employees a bit more about the brand itself. So we'll see some of that impact in Q2. I see through the summer and Q3 mitigating that. There will be new product rollouts as we've talked about throughout the year. But some, like for instance, the boneless wing, are really no substantial change to the process, frankly, at all, just a new product. It goes into the fryer just like the old boneless, just a higher-quality product. So I think that's going to be reduced. With this training, we were really talking about the new rollout with the burger, and that was a significant new build. A brand new big double patty, fresh versus frozen so a lot more complexity with that particular product.

Jeremy Hamblin: Okay. And a follow-up question to that. You've seen a pretty significant turnaround here in brand results and company results. Are you seeing retention rate improve here as momentum is obvious behind the brand? Is that having any impact on turnover within your locations?

David Burke: It's a little soon to tell. We've turned the corner, obviously, but it's only been a couple of quarters. On the hourly side of things, you're really not going to mitigate that with brand. I mean, that's just a function of the positions with servers and cooks. You're still going to have a high turnover rate there. On the management side, I think as a company, we've made a lot of effort to obtain higher retention rates, particularly at the junior manager level. We're seeing success, but that all starts at the top, and that's more cultural in nature. But for sure, as we start to see the brand change, the tone down at the restaurant level, the excitement revolving around new products and the changes going on with new uniforms, new plating, it's definitely more appealing I think to stick around and work with Buffalo Wild Wings, and DRH for that matter. Again, it's a little soon to really talk about trends, but the tone now at the restaurant level is making a more attractive proposition as a brand and as a company.

Jeremy Hamblin: Okay. Last one for me. I want to come back to comps. Obviously, really nice bright spot here and the turnaround on that. And just clarify the commentary around Q2 quarter-to-date trends, pre- and post-Easter. I wasn't sure whether comp trends first 3 weeks of April were up 7.7% or you're saying if you exclude Easter that they were up 7.7% rather than the interpretation of post-Easter it's been 4.6%?

Phyllis Knight: Well, I think through the end of last week, comp sales were up 4.6%. If you just adjust for April 21, the one Sunday that was Easter this year, and pulled last year's sales out of the comp base, it takes comps for that period up 7.7%. So I think you're right. Generally speaking, if we hadn't had that one day interruption, we would have been seeing north of 7% up for the quarter. It's continued really strong into this week.

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

John Sturges: My question was really going to be on the fact that you had stressed, in the last quarter, the cost of labor turnover, but I think you've already answered that.

Operator: We have reached the end of the question-and-answer session. And I would now like to turn the call back to management for closing remarks.

David Burke: All right. Thanks, everyone, for joining us on today's call and your interest in Diversified Restaurant Holdings. We look forward to talking with you again after our second quarter results. But as always, please feel free to reach out to us at any time between now and then.

Again, thanks for participating, and have a great day.

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