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Darden Restaurants, Inc. (DRI)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Darden Fiscal Year 2019 First Quarter Earnings Call. Your lines have been placed on listen only until the question-and-answer session. [Operator Instructions] This conference is being recorded. If you have any objections, please disconnect at this time.

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

Kevin Kalicak

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

Thank you, Marsha. Good morning, everyone, and thank you for participating on today's call. Joining me on the call today are Gene Lee, Darden's CEO; and Rick Cardenas, CFO.

As a reminder, comments made during this call will include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. Those risks are described in the company's press release, which was distributed this morning, and in its filings with the Securities and Exchange Commission.

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

We plan to release fiscal 2019 second quarter earnings on December 18 before the market opens, followed by a conference call. This morning, Gene will share some brief remarks about our quarterly performance and business highlights and Rick will provide more detail on our financial results from the first quarter and update our outlook for fiscal 2019.

Before we begin, I want to remind everyone that our blended same-restaurant sales figure now includes Cheddar's Scratch Kitchen as we are wrapping on the first full year that the brand was part of the Darden portfolio. Additionally, all references to the industry benchmark during today's call refer to estimated Knapp-Track, excluding Darden.

During our fiscal first quarter, industry total sales growth was 1.5%, industry same-restaurant sales grew 0.8% and industry same-restaurant guest counts declined 1.4%.

Now, I'll turn the call over to Gene.

Eugene I. Lee

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

Thank you, Kevin, and good morning, everyone. As you've seen from our press release this morning, we had a great quarter to begin our fiscal year. Total sales from continuing operations were $2.1 billion, an increase of 6.5%, significantly outpacing industry growth. Same-restaurant sales increased 3.3% and diluted net earnings per share were $1.34, an increase of 35.4% from last year's adjusted earnings.

We remain focused on our back-to-basics operating philosophy to ensure we're delivering exceptional guest experiences, while strengthening our four competitive advantages.

Olive Garden had a very strong quarter, which resulted in its 16th consecutive quarter of same-restaurant sales growth. Total sales grew 6.3%, driven by same-restaurant sales growth of 5.3% and 1% growth from new restaurants. Same-restaurant guest counts grew 1.5%.

Olive Garden significantly outperformed the industry benchmarks across these metrics. This strong performance is a result of four years of consistently improving the value proposition at Olive Garden. We continue to strengthen value and convenience, which was reflected in our two promotional offers during the quarter, Create Your Own Lasagna and Buy One, Take One. Both of these promotions, which offered our guests the opportunity to upgrade to premium entrée selections, coupled with fewer incentives and an increase in preference in our Mediterranean dishes, drove menu-mix growth of 1.9%.

Additionally, the Olive Garden team continues to improve the off-premise experience. Off-premise sales grew 13% and represented 13% of total sales for the quarter. Our strong guest count growth is a result of the team's focus on simplification and flawless execution inside our restaurants, culinary innovation that appeals to our loyal guest, creating relevant and integrated marketing and meeting our guest desire for convenience. Our strategy is working and as reinforced by the fact that our key satisfaction measures, including value, remain at all-time highs.

LongHorn Steakhouse had another strong quarter, outperforming the industry benchmark and leading to its 22nd consecutive quarter of same-restaurant sales growth. Total sales grew 6.4%, driven by 3.3% growth from new restaurants and same-restaurant sales growth of 3.1%. Same-restaurant guest counts declined 0.3%, primarily driven by the fact that we ran a non-price pointed promotion during the quarter compared to a price pointed promotion last year. That, combined with increased add-ons and fewer incentives, led to menu-mix growth of 1.8%.

LongHorn's focus on their long-term strategy continues to enable profitable sales growth, while they further invest in the guest experience. During the quarter, we implemented several initiatives to improve the quality of the guest experience, simplify our operations and protect our unique culture.

One of the ways the LongHorn team continues to leverage its unique culture is through its annual Steak Masters Series, an internal grilling competition and highly engaging training program. This year's program began with more than 6,000 culinary team members competing and ended with Grill Master, Michelle Cerveny from our Cuyahoga Falls, Ohio restaurant being crowned the Steak Master champion.

Finally, the LongHorn team continues to improve its off-premise experience as consumer demand grows. Overall, I am very pleased with the progress the team is making, executing their long-term strategy.

Cheddar's Scratch Kitchen had total sales growth of 6.5%, driven by organic new restaurant growth and franchise restaurant acquisition growth of 10.5%, and offset by same-restaurant sales decline of 4%. The original company restaurants were down 2.3% and the formally franchise restaurants were down 6.7%.

We remain focused on rebuilding the operation's foundation at Cheddar's and improving execution. Having the right leaders in the right place is fundamental to bringing our back-to-basics operating philosophy to life at Cheddar's. We spent a significant amount of time during the quarter evaluating and evolving the leadership team. As a result, we named John Wilkerson, President of Cheddar's eight weeks ago. A 25-year Darden veteran, John is a proven leader and the right person to lead the Cheddar's team. Most recently, he served as President of Bahama Breeze.

Additionally, Dave George, our Chief Operating Officer, will continue to dedicate a significant amount of his time working side-by-side with the Cheddar's team to improve the performance of the business. It's important for me to reiterate that we are committed to improving the foundational elements of operations, stabilizing our management teams, ensuring we are hiring and retaining great team members, and developing and executing consistent standards are critical to Cheddar's success. We remain focused on long-term brand-building strategies rather than short-term tactics.

We acquired Cheddar's because it was the value leader in casual dining with tremendous growth potential. And that is as true today as it was 17 months ago. The power of this brand is reflected in its ability to maintain average weekly guest counts of approximately 6,000 per restaurant, even in the face of extraordinary change. There's a significant amount of work ahead, but with the focus and strong leadership we have today, I'm confident Cheddar's is on the right track.

Each year during the first quarter, we hold our annual leadership conference, which allows us to get in front of every general manager and managing partner across all 1,753 restaurants to discuss our plans for the year and generate excitement. These restaurant leaders hold the most influential role in our company, and I value the opportunity to engage with them and listen to those closest to the action. I was pleased to see the alignment and focus on simplification and flawless execution driven home as a central theme at each conference.

In closing, we had a great first quarter. Our strategy is working. We continue to grow our sales, increase market share and improve margins, while making meaningful investments in our people and brands. All while being able to return capital to our shareholders.

Our team members enable our success and our teams are the best in the business. So, I want to say thank you to 180,000 team members who continue to create memorable dining experiences for our guests.

And now, I'll turn it over to Rick.

Ricardo Cardenas

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

Thank you, Gene, and good morning, everyone. We had another strong quarter with total sales growth of 6.5%, driven by 3.2% growth from the addition of 52 net new restaurants and same-restaurant sales growth of 3.3%. First quarter diluted net earnings per share from continuing operations were $1.34, an increase of 35.4% from last year's adjusted diluted net earnings per share. We paid $93 million in dividends and repurchased $31 million in shares, returning a total of $124 million to our shareholders this quarter.

Before I get into the margin analysis, I want to mention that we adopted the new accounting standard on revenue recognition at the beginning of this fiscal year. One of the requirements of this new standard is to recognize revenue for sales of food and other products to franchisees with a corresponding increase in our cost of sales by the same amount. While the impact of this change is immaterial to Darden EBIT and EBIT margin overall, it does impact certain aspects of our results.

At the Darden level, it increases food and beverage expense as a percent of sales by approximately 20 basis points. This increase is subsequently offset in all other categories of the P&L, resulting in a minimal impact to

Darden EBIT margin overall. In addition, this change reduces the segment profit margin of our Other segment since this is the segment in which all of the impact is recognized.

Now, looking at the P&L, food and beverage costs were favorable 40 basis points as pricing of 1.9% and continued cost savings initiatives more than offset continued investments in food quality and the negative impact related to the adoption of the new revenue recognition standard. Commodities inflation was essentially flat this quarter.

Restaurant labor was unfavorable 70 basis points, despite continued productivity gains and sales leverage. The increase was driven by hourly wage inflation of approximately 5%, previously announced workforce investments and headwinds related to mark-to-market expenses for general manager and managing partner equity awards.

Restaurant expense was favorable 30 basis points, as sales leverage more than offset inflation. And marketing expense was favorable by 20 basis points. As a result, restaurant level EBITDA margin of 18.2% was 20 basis points favorable to last year.

G&A expense was 30 basis points higher than last year, primarily driven by mark-to-market expenses related to the significant appreciation in the Darden share price this quarter. As a reminder, due to the way we hedge this expense, it is mostly offset in the tax line.

Page 11 of the presentation we're broadcasting online and posted on our website, illustrates the impact mark-to-market had on our P&L in the first quarter. Restaurant labor was higher by $2.9 million and G&A expense was higher by $7.6 million. In total, mark-to-market reduced EBIT by $10.5 million and EBIT margin by 50 basis points this quarter.

Our hedge reduced income tax expense by $7.6 million, and the net impact of mark-to-market this quarter was a $2.9 million reduction to earnings after-tax. Due to the change in tax rate from tax reform, we were not fully hedged, resulting in approximately $0.02 of EPS unfavorability this quarter.

Looking at income tax expense, we had an abnormally low effective tax rate of 4% this quarter due to two factors. First, tax benefits from the deferred compensation hedge I just mentioned reduced the tax rate by 4.3 percentage points. Second, higher than normal stock option exercises in the quarter drove approximately $6 million of excess tax benefits, reducing the tax rate by approximately 3.4 percentage points. After adjusting for these factors, our normalized effective tax rate for the first quarter would have been approximately 12%.

Turning to our segment performance, Olive Garden, LongHorn and the Fine Dining segment all grew sales and profit in the quarter, driven by positive same-restaurant sales and net new restaurants. Segment profit margin increased in each of these segments even after the incremental workforce investments by leveraging the same-restaurant sales growth and managing costs effectively.

Sales for our Other Business segment grew 7.1%, driven by net new restaurants and the purchase of 11 Cheddar's franchise restaurants in the second quarter of last year. Segment profit margin declined 120 basis points in this segment due to margin deleverage from negative same-restaurant sales, primarily at Cheddar's, incremental workforce investments, and the adoption of revenue recognition I previously mentioned.

Finally, in this morning's press release, we announced an increase to several components of our fiscal 2019 financial outlook. First, we increased both our total sales outlook to be between 5% and 5.5%, and same-restaurant sales outlook to be between 2% and 2.5%.

Next, we updated our effective tax rate to be between 10% and 11% for the full fiscal year. We also increased our outlook for diluted average common shares outstanding for the year to approximately 126 million, related to higher than normal stock option exercises and increased share dilution due to our stock price increase, all culminating in an increase in diluted net earnings per share to be between $5.52 and $5.65.

And with that, we'll take your questions.

QUESTION AND ANSWER SECTION

Operator: Certainly. We will now begin the question-and-answer session. [Operator Instructions] Okay. The first question comes from David Tarantino of Baird. Your line is now open.

David E. Tarantino

Analyst, Robert W. Baird & Co., Inc.

Q

Hi. Good morning. Congratulations on a great start to the year. My question is on the Olive Garden comp, and specifically on the mix components, looked very positive. And I know, Gene, you mentioned that people were upgrading to more premium offerings. So, I wanted to ask you about the sustainability of that trend. Was that something you would attribute to the promotions you ran this quarter? Or do you think that that is something that can continue as you look forward?

Eugene I. Lee

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

A

Yeah. Good morning, David. It's our intention to moderate this positive mix. As we move forward, we'll continue to make investments into the menu. I really don't want to talk about what we're going to do there, but I would say contemplating our guidance as we look forward is a moderation of that menu-mix.

I think this quarter was a confluence of a few different things, as I said in my prepared remarks. We had a good promotion. We had some real high value options that were a little bit more expensive that people could trade up to that we felt good about people trading up to inside those promotions. We changed some merchandising on our menus, and we saw the increase in our Mediterranean platform that drove some mix and our ability to pull back some incentives. So, it was a combination of a few things, and we'd like to see that moderate a little bit as we go forward. And I think that's definitely contemplated in our outlook.

David E. Tarantino

Analyst, Robert W. Baird & Co., Inc.

Q

Great. That's helpful. And if I could squeeze one in on Cheddar's. I guess at a high level, Gene, I know you mentioned you're focused on sort of fixing some of the longer term operational and brand elements there. But, I guess how would you encourage us to think about when you would start to see progress on the top line? I know it could be a slow process, but just to level set, when do you think you might start to turn the dial?

Eugene I. Lee

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

A

I think, David – I think that's a good question. And I think that we're starting to see progress on a daily basis. We measure the number of restaurants every day that are positive. That number's starting to increase. We're very pleased with the restaurants that have really strong leadership. We can see the retention numbers are stronger at the employee level, the execution numbers are higher, those restaurants are growing.

And so – as we think about it, this is really about trying to improve the fundamentals. The framework that we're using to try to drive improvement in this business is based on the whole notion of strategy or process measurement. And I'd say that we're pretty aligned that we've got the right strategy for this business.

And we spent the last 90 days really working on the organizational structure and to make sure we had leadership in the right place. I think the team now is going to focus on process, and they're going to focus on trying to simplify the operation and standardize it. With the acquisitions of the two franchise groups, there's a lot of differential and processes and procedures, and we need to standardize it, and we think there's some opportunity inside the original Cheddar's to standardize.

And then, once we get that set, then we'll figure how we're going to measure it. I think one of the big opportunities in this business is to increase accountability. I think it's important to note that there's a lot of great people working in this brand, and once we get them aligned on what we want them to do and how – and give them the tools to do it well, I think we're going to see some improvement. I'm not going to tell you that's third quarter, fourth quarter, or first quarter next year. What I'm looking for every single day, and I meet with Dave every day on this and I get a report, are we getting better day-to-day, week-to-week, and I would tell you that we are seeing that happen right now.

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

Great. That's helpful. Thank you.

Operator: Thank you. The next question comes from Gregory Francfort from Bank of America. Your line is now open.

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

Hey, Gene, I had a question for you, kind of on the macro. It seems like casual's doing a lot better right now and everything we've been hearing out of the quick service backdrop is it's a little bit softer. Are you seeing trade-up from lower income consumers to middle income consumers or do you have any other diagnosis for maybe what might be driving that sort of broader based industry shift?

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

Yeah. We're not seeing anything that's conclusive that I can make that statement right now. When I think about what's going on with the consumer, obviously, consumer confidence is at an all-time high. People are feeling good. However, I don't think this is a tide where all the boats are rising. I think well positioned brands that are executing are performing really well, and I think you're continuing to see that as others announce their results.

I do believe moving forward, the biggest challenge in the industry is going to be the war for talent. Brands that can hire, train and retain frontline employees to bring their brands to life are going to win and the dynamics inside the industry are changing dramatically. And I think that's where we're focused. And that's I think where the winners will be focused is, how do they continue invest in their team members and how to ensure that you're properly staffed to execute against this increased demand. But back to your original question, I'm not in a position to make a conclusive statement on that at this time.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch

Q

And maybe just going back to that, how much of the wage pressure right now in the industry do you think is coming from the labor reinvestments that are being made on tax reform? Is that a big driver of the current – the 5% step-ups that you're seeing and I guess, the follow-on to that would be once that sort of rolls off for a year, do you expect that level to come back in at all?

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

A

No. I don't think the 5% really is being driven by the investment. I think the 5% is being driven by just a situation where as the employment environment gets better, historically, less employees come out of the restaurant space and into other opportunities. So, there's just a shrinking of a work pool here, and that – we're committed to staying, you know, hiring the best possible people to bring our brands to life.

Our retention rates are actually improving, and I think part of that is because that we're willing to make the appropriate pay decisions to keep our people. And that's what we've instructed our operations teams to do.

I firmly believe that to win in this environment, you're going to have to have great team members, and we're going to do what we need to do to maintain and keep our team members. But I think the wage pressure is going to be there for a while and we're going to continue to find ways to offset it. But first and foremost, we have to have the best team members closest to the action to bring our brands to life.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch

Q

Understood. Thank you.

Operator: Thank you. The next question comes from Will Slabaugh from Stephens Inc. Your line is now open.

Will Slabaugh
Analyst, Stephens Inc.

Q

Yeah, thanks, guys. I had an Olive Garden question to start, and then maybe a broader topic to hit on. So, this is your best Olive Garden comp since 2008 from what we can find, and I realize, Gene, you weren't CEO at Darden then, but can you talk about what you're seeing in guest behavior from your perspective now versus what you saw back then in the industry?

And to what degree, is there any euphoria in the mind of the consumer versus simply a healthy consumer and a stronger, better positioned Olive Garden that's just capable of putting up these one and two-year comp numbers?

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

A

Yeah, I think it's – overall, it's a healthy consumer, and I think the work that we've been doing for the last four years since Dave took over Olive Garden, and our focus on the core consumer and continuing to put value back into the menu has just all kind of come together and we were able to put up a great quarter.

And I think that what I'm most excited about is that we're continuing to find new ways to improve the value proposition for the Olive Garden consumer and do it in a way that is engaging and relevant. And the brand continues to really be well-received by many different cohorts, consumer cohorts out there, especially millennials. This is a brand that's very social, that performs very well in social media. So, I think this is just a culmination of a strong consumer and four years of really focused work on trying to improve our value proposition to our core guest. And I think staying true to who we are is probably the most important thing that we're doing.

Will Slabaugh
Analyst, Stephens Inc.
Q

Got it. And if I could follow-up on the comments you made on Cheddar's earlier. It's good to hear you're seeing some improvements at the brand, as you mentioned. My question is around an eventual acceleration in unit growth. What are you looking for from a metric standpoint, maybe outside of same-store sales or whether it be team feedback or whatnot, before you'll be ready to ratchet up the growth of that brand?

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

I want to see the retention numbers at management and the hourly level getting much closer to Darden norms. We have been doing this long enough to know that we can't grow rapidly without strong management retention and having an employee proposition that the employees stay with us. That's the key to driving sustainable growth.

Will Slabaugh
Analyst, Stephens Inc.
Q

Got it. Thank you.

Operator: Thank you. The next question comes from John Glass of Morgan Stanley. Your line is now open.

John Glass
Analyst, Morgan Stanley & Co. LLC
Q

Thanks. Thanks very much. Just on your comments on the labor inflation this quarter ticking up, and I think earlier in the year or at the beginning of the year you talked about more – a little bit less labor inflation. Is that now your base case that it remains at 5% in your new guidance or do you think this quarter was maybe an anomaly, turnover at Cheddar's or whatever else that may have driven it specifically?

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

Hey, John. Yes, when we guided earlier in the year, we said that our total labor would be 3.5% to 4.5%, but wage inflation would be approximately 5%, and that hasn't changed. So, this is really right on where we guided in the beginning of the year.

John Glass
Analyst, Morgan Stanley & Co. LLC
Q

And then if you could just – what was the impact to overall restaurant margins from Cheddar's specifically? In other words, how could we think about where restaurant margin could go if Cheddar's was back on its game and comps were positive again?

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

A

Yeah, John, we're not willing to talk about the actual margin for the brand itself. We did talk about the overall margin for the Other segment, but they did have negative same-restaurant sales growth, so you would anticipate a little bit of a decline in margin at Cheddar's for this quarter.

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Okay. Thank you.

Operator: Thank you. The next question comes from Nicole Miller of Piper Jaffray. Your line is now open.

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

Q

Thank you. Good morning. So, it's clear you have an advantage in value. Could you talk about the benefits or the advantage of scale in the current environment? And I'm thinking about some of the comments you've made about marketing, the war on labor, and maybe also as it relates to off-premise and specifically delivery? Thanks.

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

A

I'm sorry. You were breaking up a little bit, Nicole. Could you just repeat your question?

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

Q

I'm sorry, Gene. I want to ask about the advantage of scale. So, you talk a lot about the advantage of value, but I want to ask about the advantage of scale in the current environment, as it relates to things like marketing and labor, off-premise and delivery?

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

A

Yeah, scale is one of four competitive advantages. And I think that we continue to focus on becoming more efficient with everything that's non-consumer facing that allows us to make investments into the consumer facing side of the business. I also think one of the big advantages of scale is the perspective we have on the industry, and we can see how consumers behave all the way from Cheddar's to Capital Grille. And I think we can make investments that others can't make, and I think we have some better insight into where to make those investments. So, scale is an important part of what we're doing.

I think it's a very important part of the employment proposition. We talked a lot about scale and how we – what it does for the consumer proposition, but scale provides our employees a lot of value. And we'll continue to find new and innovative ways with our scale to improve the employment proposition. We're making sure that we're spending as much time talking about the employment proposition as we are talking about the consumer proposition. And I think that that's different than maybe where we were at three, four years ago in a different environment. And so, I really want to go back to a statement I made earlier. The brands that can hire and attract and retain the best people are going to win it – are going to accelerate their success in this environment.

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

Q

And given the strength of Capital Grille and Eddie V's, could you talk about the Fine Dining trends? And is check or traffic really the driver behind that performance? Thank you.

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

A

Yes. Fine Dining continues to perform fairly well. You've got both a little bit of traffic growth and a little – and some check growth in there. We always have trouble reading our upscale brands on check and traffic because the consumer – our traffic numbers are generated from entrée counts, and both businesses do a lot of bar business and generate a lot of traffic that's not always related back to an entrée count. But those businesses feel healthy. There's no geographical differences. We're excited about some opportunity in Capital Grille to increase some capacity in restaurants that are at full capacity right now. And so, we're really excited about the performance of our upscale businesses, and they continue to do really well. We think they're really well positioned, and we're looking forward to being able to grow Eddie V's a little bit quicker into the future as that base gets bigger.

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

Q

Thank you, and congrats on a great quarter.

Operator: Thank you. The next question comes from David Palmer from RBC Capital Markets. Your line is now open.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Thanks. Good morning. Last year, I think you said there was a hurricane drag of 30 basis points in fiscal 1Q and 60 basis points in the second quarter. How much hurricane noise do you think there was this quarter, this fiscal 1Q this year net of last year? And knowing about last year's drag and Florence this year, how much do you anticipate for fiscal 2Q?

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

A

Yeah. Last year, we did say 30 basis points in Q1. I think what we said in Q2 was the impact of the hurricane net of any bounce back was pretty much negligible in Q2. It might have been an initial shock and then the bounce back caught up. So, this year, we basically have a hurricane that happened in the earlier part of our quarter, but we should anticipate some bounce back over time. All of that is contemplated in our guidance. So, the 2% to 2.5% same-restaurant sales includes the impact of the hurricane for the quarter.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Okay. For Olive Garden, that wider gap to the industry, how much of that was Buy One, Take One being more effective and perhaps running a little bit longer in the quarter versus what you see as other drivers in that brand? Thanks.

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

Yeah. David, again, I go back to Buy One, Take One ran – I don't know if it ran any more weeks during the quarter because I think it bridges first and second quarter. I think the big thing is that there may have been some pent-up demand because we didn't run it in the fourth quarter last year. So, we had one extra week in the quarter for Buy One, Take One. I think it was the excess demand.

And I would caution anybody to point to one thing that drove the overall Olive Garden acceleration in comps and improved gap. I want to keep coming back to this is a confluence of a lot of hard work, a little bit – extra increase in mix, strong promotions with good add-ons, but overall, I wouldn't want to promote – point to just a promotional impact.

David Palmer
Analyst, RBC Capital Markets LLC
Q

Thank you.

Operator: Thank you. The next question comes from Jeffrey Bernstein of Barclays. Your line is now open.

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

Great. Thank you very much. Two questions. One, just on the restaurant margin. It seems like it was relatively flat this quarter despite the north of 3% comp, and obviously, a very strong comp at Olive Garden. Just wondering how you think about that going forward? What perhaps is implied in your guidance? And what type of comp and/or price might you need to actually see expanding margins? Or should we just assume that with labor up, maybe mid-single digits a flattish type margin would be considered a success?

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

Hey, Jeff. Just remember, our margin did include 50 basis points of unfavorability from mark-to-market this quarter, which was significant. Even with that, we had 20 basis points of margin improvement at the restaurant level this quarter. We did anticipate the wage rate that we had in our initial guide and we still anticipate our labor – I'm sorry, wage inflation to be about 5%.

And also this year in the first quarter, we had workforce investments that we didn't have last year. Those were previously announced. So, we're really happy with where our restaurant level margin came in. And I'll take you back to our long-term framework. Our long-term framework is 10 basis points to 30 basis points of EBIT margin expansion, and we still anticipate to be somewhere in that framework this year.

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

Understood. And then, just thinking about – from a modeling perspective, 53rd week, is that something we should be anticipating in fiscal 2020 and factoring into our models at this point?

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

Yeah. I believe the 53rd week is fiscal 2020.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much.

Operator: Thank you. The next question comes from Matthew DiFrisco of Guggenheim Securities. Your line is now open.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC

Q

Thank you. I just had two questions. One on, I know you said in prior calls you were look at testing delivery. I think we've seen you test a couple of stores and brands, both Uber and Grubhub. Just curious if you can give us some updates on that? What you've seen in early indications such as greater off-premise sales, et cetera?

And then also Gene, I had a question with respect to value. I guess OG rewards has been out there for a little while. Can you talk about that? Is that something that in casual dining could be something that could be the next leg of value? And are you seeing that grow at an accelerated pace faster than the rest of the sales?

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

A

Let's start with third-party. We continue to test with the third-party delivery services of scale. We're monitoring, we're learning as this business starts to mature. But for us there's significant hurdles that we still have to work through. We're not sure that it enhances our brands. We're concerned about how it's executed. We're concerned if it can create incremental growth at scale. We're not happy with the economics. We still have the issue of the data.

And lastly, we have to get our arms around how we protect the profitability of our large and growing current off business premise, which would be difficult to deal with. So, for right now, we don't anticipate entering into a third-party delivery space in a meaningful way. We'll continue to analyze and look at our options going forward. But we have a very large off-premise business today that's growing double-digits that the consumer rates us extremely high on, and we're going to continue to make sure that experience is the best it can be, and we'll look at third-party. We just don't see this as something that we want to get involved in today with the current way it's being executed.

On OG rewards, OG rewards is a very small test in a multi-brand – in a market with all of our brands. It's something that we're looking at. At this point, it's a test, and I don't really want to talk too much further about the test and its results. And if and when this becomes something that is worthy of further discussion and roll out, we'll talk about it at that time.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC

Q

Thank you.

Operator: Thank you. The next question comes from Greg Badishkanian of Citi. Your line is now open.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Hey, guys. It's actually Fred Wightman on for Greg. I think a few weeks ago it came out that there was a cyber-attack at Cheddar's. Just wondering if there were any reserves for that that showed up in the quarter?

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

A

Hey, Greg. First of all, I just want to make sure that we understand that we take this privacy and security of our guests' personal information very, very seriously and regret this incident occurred. It's important to note that this incident occurred on a Cheddar's former POS system that was permanently disabled in April when we completed the implementation of our proprietary POS system, and Darden systems and networks were not impacted. I will say that we did reserve what we believe will be the cost in the first quarter, and that is included in our G&A expense.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Okay. And could you quantify that specific price, or do you just want to leave it a bit more vague?

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

A

I'll just leave it as is in our G&A expense for the quarter.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Perfect. Thank you.

Operator: Thank you. The next question comes from Chris O'Cull of Stifel. Your line is now open.

Mitch Van Zelfden
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Hi. Good morning, guys. This is actually Mitchell on for Chris. Just on Cheddar's in a follow-up on an earlier question on its unit growth, could you just discuss your strategy to grow that brand's unit base? Once you iron out all the integration work, do you expect to materially accelerate the pace?

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

A

Well, I think once we get the fundamentals in place and we've got the employment situation what I would call in line with our other businesses, we'll start to grow it. We'll ramp it up from where it's at today. We're going to use a backfill strategy, and we'll get – we really don't know how fast we can go. We've got to learn more about the growth potential of the business and we'll grow as fast as our human resources allow us to grow.

We think that getting up towards that 7% to 10% unit growth is kind of a barrier, and we'll give you more guidance as we get to that point in the cycle.

Mitch Van Zelfden
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Okay. Great. Thank you.

Operator: Thank you. The next question comes from [ph] Neil Vasquez on (41:35) behalf of Sara Senatore of Bernstein. Your line is now open.

Q

Yeah, thank you. I have a question on the 2019 forecast, and then a follow-up on LongHorn. So, on the forecast, is it fair to assume that the top line trend you saw in first Q have persisted, or was it just meaningful enough that even if the rest of the year reversed your initial forecast, you can still meet updated guidance?

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

We're not going to talk about where we are for the quarter to date. I will just say that all of the information we know as of today is included in our forecast, and as you remember, as you recall, Gene said in his remarks the mix growth that we had in the first quarter, we are going to have some things to help moderate that, so that we can continue to improve our value proposition. And again, that's why that's in our guidance.

And I do want to make a clarification on Jeff Bernstein's question on labor – or on restaurant expense. Our restaurant margin favorability – unfavorability for mark-to-market workforce was 40 basis points. So, with the 40 basis point reduction, we still had a really good restaurant labor. I just want to make sure that I clarified that.

Q

Thank you. And on LongHorn, if you could give a little bit more clarity on the LongHorn components because same store traffic was more negative than we would have expected given the ease of the comparisons. And we were wondering at what point do you pivot towards more of a traffic driven strategy?

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

Yeah, as I said in my prepared remarks, the primary driver of the slight decrease in guest traffic was driven by not running a price-pointed promotion. And we also had less incentives out there. So, our overall profitability improved significantly throughout the quarter. So, I think our strategy is working. We continue to remove or eliminate a discounted consumer that's taking up space on a busy night. And I'm thrilled with the components of the LongHorn business and to be able to get those incentives out and pull back on the price-pointed promotion. So, I thought it was a great quarter for LongHorn.

Q

Thank you.

Operator: Thank you. The next question comes from Jake Bartlett of SunTrust Robinson Humphrey. Your line is now open.

Jake Rowland Bartlett
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Great. Thanks for taking the question. My first question is on the 2019 EPS guidance. If I just look at what you increased the same-store sales guidance, but the EPS guidance isn't up as much as I would have thought. I believe some of the difference is going to be the mark-to-market, maybe the stock options. But if you could just clarify what the moving pieces are to mute the EPS guidance kind of growing with the same-store sales?

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

A

Yeah, Jake. Basically, if you think about the guidance that we have for the year for EPS growth of $5.52 to $5.65, it's impacted by a couple of things. One is, we are increasing our same-restaurant sales, as you mentioned. But we have higher share count than we had in our original guidance of 1 million shares, roughly, and that actually impacts us by about $0.04 unfavorable. And we had such a great tax rate in the first quarter at 4%, while our annual guide tax rate is going to go down by 100 basis points, it's still an increase in tax rate from this first quarter.

Jake Rowland Bartlett
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. But when we think about the mark-to-market in the first quarter for the restaurant level margin, is that effect going to flow through for the rest of the year? And the same I guess goes for stock comp kind of going up pretty significantly. Is that also a meaningful headwind for – on G&A?

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

A

Jake, the mark-to-market all depends on what happens with the stock price and what happens with the market price of just basically the general market. So, we aren't really necessarily forecasting what's going to happen to our stock price. We just – in regards to our option exercise, we just had a lot of options exercised in the first quarter, much more than we typically do, and the majority of those were exercised by retirees, not necessarily people here. And so, as we look at the option exercise for the rest of the year, we would anticipate it'd be a more normal rate than it was in the first quarter.

Jake Rowland Bartlett
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. And, then Gene, just a question about the environment. We're seeing restaurant sales, if you look at the kind of the government retail numbers, up 10% year-over-year in July and August. It seems like that would imply some of the smaller chains or some of the independents are gaining share. Are you seeing that? And then how do you kind of – how does that jive with this need to retain talent and attract talent? I would think that the larger chains have a better ability to do that. So, I'm just trying to understand one, the dynamic of who's gaining share in this kind of very strong demand environment? And then, also why they might be?

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

A

Yeah, I've seen no evidence that says independents or small chains are gaining share. Our data on that is a little lagging, but I believe that when I look at the data and the industry, again, the well-positioned bigger players are continuing to really outperform. And I think that's going to continue to be true as we move forward.

And again, I haven't seen anything that says that the large players are losing share. I just think that when we think about employment, I think it's really hard for lower volume businesses to attract great team members because there's just not enough income to share at the service level and freedom in the business model to pay what you need to pay to attract really good talent in the back of the house. And so, I think our brands have a distinct advantage there where our business model enables us to create employment proposition that works for our team members.

Jake Rowland Bartlett Q
Analyst, SunTrust Robinson Humphrey, Inc.

Great. Thank you very much.

Operator: Thank you. The next question comes from John Ivankoe of JPMorgan. Your line is now open.

John William Ivankoe Q
Analyst, JPMorgan Securities LLC

Hi. Thank you. I think you said off-premise was 13% of sales and was growing around 13%. So, how much of that growth is incremental to the business? How much can off-premise grow as a percentage of sales without delivery? And Gene, I know you're being dismissive at least in the near term around some of the delivery services, but how far are you thinking about maybe leveraging some of Olive Garden particular scale and doing some in-house delivery yourself, especially for some of the smaller, more individual size or family size deliveries?

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

Yeah. And – as you know, we do delivery for catering for a minimum $100 order, 24 hours in advance. It's a very, very good business for us with a great check average and incredible satisfaction scores. We'll continue to look at whether $100 is the right place to be on that. Right now, we have no interest in delivering a $10 meal to an individual meal to an individual household. That's just not a business that we think we want to be involved in right now.

As far as where do we think to-go and off-premise can go to and that's a lot to do with what the consumer and what the consumer demand is for it. We'll continue to come up with innovative product offerings. We'll make the process less – have less friction in it through technology. We think we do an exceptional job in Olive Garden with packaging and process. Our on-time and correct orders continues to improve. So, we're feeling really good about where we're at.

And my goal, our goal, and our team's goal is to create a compelling offer to that consumer, so that they're still willing to come pick it up at our restaurant. And our growth in this business is reinforcing that we're doing a good job with it. And so, that's where I want to be. And I've said publicly, if the consumer goes – wants to continue to go there, we could see Olive Garden get to 20% off-premise sales over time.

John William Ivankoe Q
Analyst, JPMorgan Securities LLC

And that is largely without delivery, so that's [ph] still (50:29) $100 minimum delivery that you currently have?

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

Yes. As I said, John in my – I don't anticipate entering into a third-party delivery agreement in a meaningful way. There are things that I really don't like about that business.

John William Ivankoe
Analyst, JPMorgan Securities LLC
Q

Understood. And of that 13-point growth in this quarter, how much incremental business do you think that growth is giving you?

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

Well, it was about 30% of our total growth for same-restaurant sales at Olive Garden this quarter. So, remember, we still grew in restaurant significantly. To determine exactly how much is incremental, it's a difficult proposition, but it was only 30% of our same-restaurant sales growth.

John William Ivankoe
Analyst, JPMorgan Securities LLC
Q

Understood. Thank you.

Operator: Thank you. The next question comes from Andrew Strelzik of BMO. Your line is now open.

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

Hey, good morning. I have two questions. The first one, I'm wondering about the relative margin progression at Olive Garden versus LongHorn. With Olive Garden, obviously, out-comping LongHorn by a reasonable degree, they both expanded margins at the same rate. So, I guess, I'm wondering is there anything kind of with respect to the models or maybe the mark-to-market that was disproportionate or even the promos – or investments, anything like that that limited or drove the conversions of the margin progression this quarter?

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

Yeah, Andrew, the easy answer is Olive Garden had higher food inflation than LongHorn did. LongHorn's inflation was lower than Olive Garden's, so food cost favorability at LongHorn was greater than Olive Garden's.

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

Okay. That makes sense. And my other question, maybe Cheddar's isn't exactly where you want it to be right now, but you've made a lot of progress on the integration. And I saw yesterday in the press release about the change to the board comment, touting the M&A expertise there. Kind of what are the sign posts you're looking for before you're ready to make another deal? And maybe if you could comment on the M&A environment right now would be great too?

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

Yeah. We're focused right now on stabilizing and really getting after the Cheddar's business. We're not interested in doing anything else at this point in time. I'm not sure – I'm not going to comment on the M&A environment. I'm not really involved in it, so I don't really know. I don't have an opinion of it.

Our focus is, we made an investment, and to get to bring Cheddar's into our portfolio to take advantage of our platform. I actually believe in my heart that the operational challenges we've had to face are making us really go back to the foundation of this business and get it right. And if we didn't face these challenges and things may have been a little bit better, we may have gotten to the growth aspect a little quicker and not been able to sustain that into the future because there were real cracks in the foundation. And we've uncovered those cracks and now we will fix them to build a sustainable business.

So, I'm real excited about that. But our focus right now is, let's get Cheddar's moving in the right direction. When that's going in the right direction, we'll pull back, we'll look at our opportunities from an M&A standpoint, and we'll decide what we want to do.

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

Great. Thank you very much.

Operator: Thank you. The next question comes from Karen Holthouse of Goldman Sachs. Your line is now open.

Karen Holthouse
Analyst, Goldman Sachs & Co. LLC
Q

Hi. Thanks for taking the question. Another question on guidance for the year. It does embed a little bit of a deceleration in comps as we move through the year. I know you mentioned the sort of intentional plan to try and pull back on check mix – or the check contribution at Olive Garden. Is there anything else we should have on our radar, either in terms of compares or some conservatism around weather and winter or anything that would also be kind of impacting the cadence through the year in guidance?

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

Yeah, Karen, a couple of things. One, we did have the hurricane this quarter that offset last quarter's hurricane impact from last year of 30 basis points. Gene, did mention the check moderation that we're trying to go forward with. And then, we do have a little bit of a tougher compare in the back half of the year.

But our guidance is still in the higher end of our long-term framework. It's 2% to 2.5%, including Cheddar's, the drag on Cheddar's that we've had so far. So, we feel really confident in the guide that we have and feel like it's actually an appropriate number.

Karen Holthouse
Analyst, Goldman Sachs & Co. LLC
Q

Great. Thank you.

Operator: Thank you. The next question comes from Stephen Anderson of Maxim Group. Your line is now open.

Stephen Anderson
Analyst, Maxim Group LLC

Q

Yes. Good morning. And I wanted to follow up with the prior question that was asked about food costs at both Olive Garden and LongHorn. Last earnings quarter you talked about 2% food cost inflation. Looking at some of the areas, actually you're looking at poultry, well below year-ago levels, corn prices are down, maybe a little bit of lift in beef, but overall, are you looking at any change to your 2% overall inflation outlook?

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

A

No, we're not seeing any change to our overall 2% inflation. But remember that our outlook was zero to 1% for food and beverage costs.

Stephen Anderson
Analyst, Maxim Group LLC

Q

Okay. Thank you.

Operator: Okay. Thank you. Right now, speakers, we do not have any questions in queue. You may now proceed.

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

And that concludes our call. Thank you for participating. I want to remind you that we plan to release second quarter results on Tuesday, December 18, before the market opens with a conference call to follow. Have a great day.

Operator: Thank you. That concludes today's conference. Thank you all for participating. You may now disconnect.