Corrected Transcript

02-Mar-2023

Portillo's, Inc. (PTLO)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

Barbara Noverini
Director-Investor Relations, Portillo's, Inc.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

OTHER PARTICIPANTS

Sara H. Senatore
Analyst, BofA Securities, Inc.

Sharon Zackfia
Analyst, William Blair & Co. LLC

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

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Dennis Geiger
Analyst, UBS Securities LLC

Andy Barish
Analyst, Jefferies LLC

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Brian H. Mullan
Analyst, Deutsche Bank Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Greetings. Welcome to Portillo's Fourth Quarter of Fiscal Year 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Barbara Noverini, Portillo's Director of Investor Relations. Please go ahead.

Barbara Noverini
Director-Investor Relations, Portillo's, Inc.

Thank you, operator. Good morning, everyone, and welcome to our fiscal fourth quarter 2022 earnings call. With me on the call today is Michael Osanloo, President and Chief Executive Officer; and Michelle Hook, the company's Chief Financial Officer.

Let me also remind everyone that part of today's discussion will include forward-looking statements. These statements are not guarantees of future performance and should not be unduly relied upon. We do not undertake to update these forward-looking statements, unless required by law; and refer you to today's earnings press release and our SEC filings for more detailed discussion of the risks that could impact Portillo's future operating results and financial condition.

Our remarks also include non-GAAP financial measures, such as adjusted EBITDA and restaurant-level adjusted EBITDA. We direct you to our earnings release issued this morning, which is available on our website, for the reconciliations of these non-GAAP measures to the most comparable GAAP measures. Any non-GAAP financial measure should not be considered as an alternative to GAAP measure, such as net income or operating income, or any other GAAP measure of our liquidity or financial performance. Finally, after we deliver our prepared remarks, we will open the lines for your questions.

Now, let me turn the call over to Michael Osanloo, President and Chief Executive Officer.

Michael Osanloo

President, Chief Executive Officer & Director, Portillo's, Inc.

Thank you, Barb, and good morning, everyone. We appreciate you joining us for our year-end earnings call. Portillo's had a great first full year as a publicly-traded company. Our brand is synonymous with quality and value; and true to form, we closed 2022 with solid financial results. And we're off to a great start for 2023. I'm excited to share more about what's on the horizon for us, give you a preview of this year; but before I do, let me recap our fourth quarter financial results.

In the fourth quarter of 2022, total sales increased 8.6% to $150.9 million. Same-restaurant sales grew 6%. For the fiscal year of 2022, total sales increased 9.7% to $587.1 million. Same-restaurant sales grew 5.4%. We ended the year with an average unit volume of $8.5 million per restaurant. Restaurant-level adjusted EBITDA margin was 21.2% for the quarter and 22.6% for the fiscal year. Now, Michelle will go over our financial results in more detail, but let me discuss the underlying drivers of our performance as we closed out the year.

People love Portillo's. Many fans bring us into their homes for holiday gatherings and celebrations, and we certainly lost a little bit of momentum during Winter Storm Elliott that week of December 23rd. But weather never keeps Portillo's fans away for very long. As you'll see in a graph provided in our earnings supplement, sales bounced right back the following week, and we maintained strong sales since.

Our entrées sold and transaction metrics are both up year-to-date in 2023. Now, that includes some pent up demand from the storm, but it also gives us confidence that our price laggard strategy is working well. Again, Michelle is going to give you more detail in a moment, but we feel really good about where we're priced compared to competitors, and the value proposition that creates for our guests.

Let's pivot to where it's a little warmer and talk about what's been happening in the sunbelt. Recent openings of Kissimmee, Florida; The Colony in Texas; and Tucson, Arizona get us nearly through the Class of 2022, with Gilbert, Arizona on deck to open. And let me express how good that little bit of sunshine feels. In particular, we're thrilled with the reception we've received at our first restaurant in Texas. Since our grand opening on January 18, The Colony has been the number one restaurant across the entire system. This means it's been matching the volumes of restaurants in Chicago that have been open for decades.

Specifically, The Colony has averaged $48,000 in sales per day since the grand opening. Now, that annualizes to $17 million per year; and that's a crazy number, so please don't model that. It's definitely coming down. But we feel really good that this restaurant will significantly exceed our underwriting expectations and sets us up for further success in Texas as we continued to expand.

We took the time we needed to make sure that this restaurant opened well, with everything and everyone in place to be successful. In its first 30 days, guest satisfaction scores at The Colony have outperformed the 30-day average of all the restaurants we've opened since 2021. This early outcome validates what we've learned along the way: that disciplined openings set up our new restaurants for success.

We're also getting a really good read on our other restaurants in the Class of 2022. Our Portillo's pickup location in Joliet, Illinois has just over a year of operating history now. St. Pete is about to reach its first anniversary, and Schererville, Indiana has been operating for over a quarter. All these restaurants are performing well, and all are exceeding our underwriting expectations. We expect that to continue for the full Class of 2022.

Looking ahead, we're committed to opening nine new restaurants in 2023 with a heavy emphasis on the sunbelt. We're already out of the gate in Texas. We recently announced our next locations in Allen and Arlington, and we've started work on both sites. As we continue to navigate the new normal in the restaurant development lifecycle, our 2023 openings will still be back-half loaded. However, we're already planning to better balance our 2024 restaurant openings across the four quarters.

As we continue to bring Portillo's to both new and longtime fans across the nation, we remain focused on creating value for our three core constituents. We're taking care of our guests by delivering delicious food at an unbeatable value. We're providing unrivaled work and personal growth experiences for our team members. And, for our shareholders, we're committed to improving our already healthy restaurant-level margins despite the flurry of restaurant openings in 2023.

With that, let me hand it over to Michelle.

Michelle Hook

Chief Financial Officer, Portillo's, Inc.

Great. Thank you, Michael, and good morning, everyone. Before we discuss our fourth quarter financial results, let me address our November 2022 secondary offering.

We completed the sale of approximately 8 million shares of Class A common stock at an offering price of $22.69 per share. We used the proceeds to purchase shares, primarily from the private equity firm that acquired Portillo's in 2014 and subsequently sponsored our IPO in 2021. The transaction allowed them to monetize another portion of their holdings in Portillo's. This is a common and expected course of action. In private equity-backed IPOs, sponsors will reduce their ownership over time for the simple purpose of returning capital to their limited partners. No one from Portillo's management teams sold shares in the offering.

We completed two secondary offerings in 2022 which have collectively increased the liquidity of our Class A common stock and diversified our shareholder base. Since the end of Q2 2022, we've increased the amount of publicly-traded Class A shares from 50.4% of total shares outstanding to 67% of total shares outstanding. Note that these transactions only caused the ratio between our publicly traded Class A and privately-held Class B shares to shift, but total share count remains the same. These transactions have not been dilutive to existing PTLO shareholders.

Now, turning to the results of our fourth quarter 2022 where we saw strong top line growth. During the fourth quarter, revenues were up $150.9 million, reflecting an increase of $12 million, or 8.6%, compared to last year; driven by a 6% increase in same-restaurant sales, combined with the opening of five new restaurants since the beginning of the fourth quarter of 2021.

The same-restaurant sales increase of 6% was primarily driven by an increase in the average check of 6% and a 2.3% impact from the change in recording third-party delivery pricing. This was offset by a 2.3% decrease in transactions. The higher average check was driven by an approximate 7.9% increase in certain menu prices, partially offset by lower items sold per transaction.

We experienced positive trends through the quarter until Winter Storm Elliott significantly disrupted sales during the last week of our fiscal quarter. We estimate that the storm had a negative impact of at least 70 basis points on our same-restaurant sales growth in the fourth quarter of 2022. Subsequent to the fourth quarter of 2022, we have seen improvements in our sales trends, as same-restaurant sales grew 12.3% in our first fiscal period of 2023, and we estimate same-restaurant sales to grow 7.9% in our second fiscal period of 2023.

We currently anticipate our same-restaurant sales growth to be in the range of 8% to 10%, and total revenue growth to be in the range of 16% to 18% for the first quarter of 2023. We expect to open nine new restaurants in the Class of 2023 in the back half of this year, with three to four targeted openings in the third quarter, and the remainder in the fourth quarter.

Now, let's look at our costs. Cost of goods sold, excluding depreciation and amortization, as a percentage of revenues, increased to 35% in the fourth quarter of 2022 from 32.6% in the fourth quarter of 2021. This increase was largely driven by 14.5% average increase across most commodities, especially in beef and chicken. Additionally, cost of goods sold was negatively impacted by 1.4% resulting from the change in recording third-party delivery pricing. These increases were partially offset by the increase in our average check.

In 2023, we expect our overall commodity inflation will ease and are currently estimated mid-single digit commodity inflation for the full year. As you would expect, it will start high and taper down over the course of the year. For reference, Q3 of 2022 was up 15.4%, and Q4 of 2022 was up 14.5%. Q1 of 2023 will be a sequential improvement from these past quarters.

Now, let's look at labor. Labor as a percentage of revenues increased to 26.5% in the fourth quarter of 2022 from 26.2% in the fourth quarter of 2021. The increase was primarily driven by incremental investments to support our team members, including hourly rate increases made in Q3 2022 and higher variable-based compensation expense. These increases were largely offset by an increase in our average check and operational efficiencies. We anticipate making continued wage investments in 2023, and remain committed to providing a competitive total rewards package for our team members.

Other operating expenses increased $3 million, or 20%, in the fourth quarter of 2022, which was primarily driven by new restaurant openings in 2021 and 2022, as well as increases in repairs and maintenance expenses. Occupancy expenses were flat as a percent of sales. As a result of the above, restaurant-level adjusted EBITDA decreased 8.5% to $32 million in the fourth quarter of 2022. Restaurant-level adjusted EBITDA margins were 21.2% in the fourth quarter of 2022 versus 25.2% in the fourth quarter of 2021.

The 400-basis-point decrease in restaurant-level margins was primarily driven by the continued impact of increased commodity costs and, to a lesser extent, labor investments. We partially offset higher expenses through menu price increases and operational efficiencies. We raised menu prices 1.5% in the first quarter of 2022, 3.5% during the second quarter of 2022, and 3.4% during the fourth quarter of 2022. These actions resulted in an effective price increase of approximately 7.9% in the fourth quarter of 2022 and 7.5% year-to-date. During mid-January of 2023, we did increase menu pricing to reflect a net 2% price increase as we continue to combat inflationary cost pressures and restore our margins.

Our G&A expenses decreased $33.6 million to 11.7% in Q4 2022 from 37% in Q4 2021. The absence of IPO-related expenses in Q4 2022 contributed to the overall decreases in equity-based compensation of $25.5 million, option holder payments of $6.6 million, and transaction-related fees and expenses of $2.3 million. Variable-based compensation also decreased by $1.7 million in the quarter. These decreases were partially offset by increases in our people and business. We will continue to make investments in G&A in 2023, and estimate that full year spend will be in the range of $72 million to $77 million.

Preopening expenses increased $1.7 million to 2% in the fourth quarter of 2022 from 0.9% in the fourth quarter of 2021. This increase was due to the timing and geographic location of activities related to our planned restaurant openings at the end of fiscal 2022 and early fiscal 2023. We expect preopening expenses to be between $7.5 million to $8 million in 2023, which covers four Class of 2022 restaurants and the nine additional restaurants we expect to open during the second half of the year. All this led to adjusted EBITDA of $18.1 million in the fourth quarter of 2022 versus $23.2 million in the fourth quarter of 2021, a decrease of 22.1%.

Below the EBITDA line, interest expense was $8.4 million in the fourth quarter of 2022, an increase of $0.8 million from the fourth quarter 2021. This increase was primarily driven by $2 million of additional interest expense on our first-lien term loan due to an increased interest rate, partially offset by lower outstanding borrowings under our first-lien term loan and by the payoff of our second-lien term loan. As of the end of the fourth quarter, the effective interest rate on the first-lien term loan was 10.4%.

On February 2nd, we announced that we entered into a new five-year $300 million term loan and $100 million new revolver facility. The proceeds under the term loan and revolver facility, along with cash on hand, were used to repay outstanding debt under our previous first-lien term loan and transaction-related expenses.

At prevailing rates, the all-in interest rate on the term debt has been reduced by approximately 270 basis points. At these rates, we expect that our annual interest expense in 2023 will be approximately $8.5 million lower as compared with our previous debt facilities. This new credit agreement provides additional financial flexibility to pursue our growth strategy and other strategic initiatives.

Income tax benefit was $1.7 million in the fourth quarter of 2022 and an income tax expense of $1.8 million for the year. Our effective tax rate for the year was 9.6% versus 20.9% in 2021. Our future effective tax rate will fluctuate as Class A equity ownership increases and as equity-based awards are exercised in best. We ended the quarter with $44.4 million in cash. Subsequent to the quarter, we deployed approximately $9.7 million of cash on hand in connection with the refinancing to pay off the existing term loan and transaction-related fees, and repaid $5 million of outstanding borrowings under our new revolver facility.

Going forward, we will be using our cash balance plus operating cash flow to support our continued growth. In 2023, we are estimating our capital expenditures to be between $70 million to $75 million. We remain committed to delivering healthy top line and bottom line growth in 2023 and beyond. More importantly, we're confident in our long-term outlook that was provided in our earnings release this morning.

Thank you for your time. And with that, I'll turn it back to Michael.

Michael Osanloo

President, Chief Executive Officer & Director, Portillo's, Inc.

Thanks, Michelle. Before we open for questions, I want to thank our Portillo's team members for all of their hard work in 2022. We persevered during a challenging year for the restaurant industry, and this is because we kept our focus on what matters: an unrivaled experience for our team members and our guests. And it's working. Our guest satisfaction scores continue to be the highest they've been in three years. Consumers are choosing Portillo's. Our sales and comp trajectory continue to show that.

In 2023, we're focused on balancing the needs of our three core constituents. We're creating value for our guests by delivering delicious food at a great price point. We're creating value for our teams members through great work experiences. And we're creating shareholder value by improving our already healthy restaurant-level margins. We'll keep delivering on those promises. Thank you.

With that, operator, can we open the line for questions?

QUESTION AND ANSWER SECTION

Operator: Yes. [Operator Instructions] Our first question is from Sara Senatore with Bank of America. Please proceed.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Oh, great. Thank you. I actually just wanted to sort of dig into the margin piece and the cost outlook. Specifically, if you can give us any kind of guidance. I know you're looking to improve that. Maybe sort of talk through how much price you expect to have on the menu. Also, more specifically, you talked about continued labor investments.

My sense had been that your wage inflation has been pretty much in line with the industry, in the double-digit range in 2022. So maybe you could talk to that. Is it maybe perhaps you got a later start to raising wages? Is it to stay ahead of the curve? Should we expect to see more broadly maybe another wage cycle in 2023? I'm just trying to understand sort of the complexion of the margin outlook and wages in particular.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah. Good morning, Sara. Let me start and I'll turn it over to Michelle. On pricing, I mean, I don't think – hopefully, it's not lost to anyone that our pricing last year lagged our competition. And when we look at the underlying metrics, when we look at our traffic trends, our sandwich count metrics, when we look at guest satisfaction scores, speed of service scores, we feel really, really good about the value that we're providing guests, and we think that we have untapped pricing power. And so, I'm not going to say specifically how much we're going to price this year, but we feel like we have pricing power and it's right and appropriate to catch up to the pack in terms of overall pricing.

And then I'll let Michelle talk about labor. The one thing I'll tell you that the gift that keeps on giving for us on labor is we have worked very, very hard as an organization to make sure that we are providing a great experience and a great environment for our team members. And we see that our gap in hourly turnover versus the rest of our competitors is actually getting bigger. So, we have anywhere from a 40- to 50-point gap on turnover versus other limited service restaurant companies. And our gap on turnover with our management teams has also increased.

And, like, turnover is hugely important to this industry. There are soft costs and hard costs associated with it. The hard costs is relatively easy to measure. Soft costs is a little bit harder to measure. I think that the investments that we're making more than pay for themselves in terms of team members satisfaction, lower turnover, which in turn generates better guest experiences.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah, Sara. I would just add on to what Michael's saying in terms of the pricing and the margins, with the pricing that we put out there with the 2% we took in Q1, we'll be at around 9-ish-percent in the first quarter of 2023 and then we'll be then lapping a price increase in mid-May. So, if that falls off, you'd be at about 5.5% price if we took no action.

But as Michael said, we're going to remain fluid and flexible on our pricing approach. We're not committing to anything beyond what we've already announced with the January price increase, because we've got to continue to see how the landscape plays out with both commodities as well as the labor environment. I mentioned on my prepared remarks, we do expect to continue to make investments in labor. I think when you look at – you mentioned our labor inflation in 2022, we saw double-digit inflation. That started to come down a bit in the back half of the year. So, we were at about 9% labor rate inflation in the fourth quarter. I expect that to come down as we start to lap some of those numbers. But we do expect to make the continued investments in labor as well in 2023.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. And so just to put a finer point on it, it sounds like you can take price you think to cover – broadly cover inflation. So as we think about margin expansion, should we be thinking about leverage on positive transactions, or is there something else that might go into that?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah, Sara. Absolutely. We've always discussed, as we think about combating inflationary pressures, using price as a mechanism to do that. So, we'll continue to think of it in that regard. And then the other thing is our operational efficiencies that we've talked about over the course of 2022. We're going to be looking at can we do some additional things within our restaurants from that standpoint to help the margin profile.

And then the expectation is, and Michael mentioned this in his remarks, that transaction, as well as our entrée count, has been positive year-to-date. I know it's early on, but it's to be determined the remainder of the year; but we're seeing good trends there early on.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Great. Thank you very much.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah.

Operator: Our next question is from Sharon Zackfia with William Blair. Please proceed.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Hi. Good morning. I'm curious if you could talk about commodity inflation. I know you mentioned it's going to drop off as the year goes on, and it would be lower than the fourth quarter sequentially in the first quarter. But there's a lot of room to be lower than 14.5%. So, can you give us kind of how you expect commodities to play out as the year progresses? And I don't know if I missed it, but could you talk about kind of where you are on the percent of your basket that's locked?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah, Sharon. Obviously, the year is – there's a lot of year left to play out, but I don't expect it to be the 14.5% we saw in Q4. As I said, I do expect sequential improvement. But as you can imagine, I don't expect that to fall off a cliff either, and all of a sudden get us into a range that is single digits or even mid-single digits. But based on what we know today, what I would expect is that, again, that improvement quarter-over-quarter.

We have locked in – we do have some hedge positions. We're at about 34%, about a third locked for the full year in 2023. As you know, most of the positions that we take is generally on those beef [indiscernible] (00:26:51) where we do forward buys on that. And so we have that pretty locked in for Q1. We've taken some positions in the remaining quarters on that particular line item. And then we're working through some other items on our basket today.

But I do expect the easing in those chicken and pork proteins, as most have said, over the course of the year. But beef, again, expect that to be more of a pressure in the back half of the year as we continue to see that trend. So, that's what we know today. But, again, a lot of year left to play out, and we'll update you as we continue to get more information.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Thanks for that. And then a quick question on The Colony. I mean those are pretty jaw-dropping volumes. I can't even imagine what it's like to be a team member at that location. I guess, just given those volumes and understanding there's some honeymoon, but still, I mean, does that kind of accelerate any idea of opening a location that might cannibalize some of that? I'm not familiar if you've got something in the pipeline that might take off some of that pressure?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Thank you first, because you're right; they're like eye-popping numbers, and the team has been fantastic. And I think we have – like, we've learned a lot and we probably have overinvested in experienced, talented Portillo's management down there. And our team is doing an amazing job. So, we're very, very proud of that team. We had planned for – and I think we publicly said this – another four to five restaurants in Texas. We want to kind of be in that four to five range by the end of this year, 2023, in Texas. So, we've announced two more. And don't be surprised if we build a few more in Texas this year.

I think The Colony will settle down, and I don't think we need to think about cannibalizing it quite yet. I think that, that's a restaurant that's going to settle down. It is an iconic flagship restaurant for us, in a fantastic location. And so, my expectations is that it performs closer to like a Chicago market restaurant than a typical out-of-core restaurant.

But I'll tell you what it does, Sharon, we have a lot of people asking us questions about, do you think you'll succeed in Texas? Do you think that people will eat Italian beef in Texas? It's only six, eight weeks in, but I feel like the answer to that is a resounding yes. They seem to like our beef sandwiches a lot. No surprise, beef and bread works really well in the great State of Texas.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

All right. Thank you.

Operator: Our next question is from David Tarantino with Baird. Please proceed.

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

Q

Hi. Good morning. Just, first, a question about the fourth quarter. I don't think you mentioned the entrée count growth. If you have the entrée count growth number, that would be helpful.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. David, in the quarter, it was negative for the quarter. But if we excluded the impact of the storm, we would have been flat.

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

Q

Okay. Great. That's...

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

But, all in, it was negative for the quarter. Would have been flat excluding the impact of the storm.

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

Q

Okay. Great. And then just kind of circling back on the new unit performance, especially in Texas, I guess, Michael, based on your observations or your data collection for that location, I was wondering if you could just elaborate on why you think it was so strong in the early days. Do you think it's more related to the site you picked, or do you think it's more related to the consumer demand for your type of product? I know you mentioned the beef sandwiches are popular but, I guess, what's your thought on this being a leading indicator for the rest of the market as you go forward?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Great question, David. I'm going to give you a cop-out answer because it's a little bit of everything you just said. It is undeniably a great location and we're thrilled to be partnering with the folks who've developed that area. There's a Nebraska Furniture Mart there. There's a Scheels. Those are world-class retailers. And we have a fantastic location in a very, very well-designed development. So, that's an undeniable truth. It's right next to a business complex in Frisco. It's a mile away from all of the office buildings in Frisco. So, it's great.

Now, that said, we invested time, energy, and money in marketing Texas. We sent The Beef Bus down for two tours to generate excitement, energy, and demand. We overinvested to some extent with a fantastic multi-unit manager down there, a fantastic general manager down there, and 70% of our management team and crew chiefs have Portillo's experience. So, we stacked the deck to make sure that we can handle these volumes, et cetera.

Despite all that, I am a little surprised and overwhelmed by the response that we've gotten. I think that Texas can be either hit or miss for restaurant companies. If you do well, if you really – you approach it with a sense of humility and work your butt off, you can be great. If you try to mail it in and just assume you're going to be great, you might stub your toe. We are approaching our Texas expansion with a great deal of humility. We're looking for A-plus locations. We're going to continue to overinvest in management team and training of our team members. We'll open the restaurant when it's beautiful and ready to go and the folks are ready to go.

And so I think we did just a lot of things right. And as we continue to evolve and develop, we'll continue to get a lot of things right. And so my hope is that it is a precursor of what we can expect for Texas. But, look, Florida is doing really well. Our newest restaurant in Tucson, Arizona is just fantastic. We feel like we've got the flywheel working for us in the sunbelt.

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

Got it. That's helpful. And then one more quick one on Texas. Is Texas – I guess, my impression is it's a lower cost market to operate in, but I guess how would you characterize whether it's construction costs or labor costs relative to your typical financial model? Am I right that that's a lower cost market?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.
A

I mean, there are certain elements that make it easier, I would say, to work in Texas. But our first restaurant there is in a relatively high-priced location. We're paying really well. We're paying for great labor. We expect greatness out of our team. So, I would tell you that, don't think of it as coming out of the gate with Chicago-like margins.

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

Got it. All right. Thank you very much.

Operator: Our next question is from Brian Harbour with Morgan Stanley. Please proceed.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Good morning. Thank you. To that point you just made, Michael, maybe comment on the margin performance of some of the other new locations, not just Texas. But are they coming in better than you expected or perhaps not? And how do we think directionally about the impact of those new units as we think about margins for the first quarter, and then also kind of the second half of the year where you will have quite a few openings as well?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.
A

Yeah. Let me give you sort of the philosophical part of the question, the answer, and then I'll let Michelle give you a little bit more. But keep in mind, when we open a new restaurant, I would really be hesitant to draw any conclusions about margin in the first couple of quarters, because we have a new restaurant opening team helping out. We overinvest in management. When you're running at the volumes that we have right now, you need all hands on deck to help.

And it's very important to provide guests a fantastic experience, right. When you're first in market, you're at a new restaurant, it's really important to provide a great experience or you're going to chase people away for a long time. So we overinvest. And I frankly don't even care about the margin coming out of the gate for the first couple quarters. It will stabilize over the course of the year, and then it will improve. What we think works really well is get the restaurant on the right footing, get it going right away from a guest satisfaction standpoint, from enticing crew members to stick around, and then the margin comes fast.

And, for us, Michelle has talked about this in the past that when we reach six to eight restaurants, there's like an inflection point on our operating margins. And so once we've decided that a market is going to work for us, it is important to us to get to scale relatively quickly to start seeing that material margin improvement.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. I think just to add on to that, Brian, Michael is absolutely right, as we talked about the profile for our class of restaurants, right, and that's sort of how we're bucketing these when you talk about the Class of 2022 or even the Class of 2023, the typical profile for that class is high teens margins in year one, a slight improvement to flattish in year two, and then it starts to grow in year three.

Scale does matter, as Michael pointed out, so that's going to be important as we continue to get to scale. But I think that when you think about the overall margin profile of Portillo's, as Michael mentioned in his prepared remarks, we're committed to improving that despite the restaurant openings in 2023, because we know and we've talked about that we purposefully had margin degradation in 2022 because of our price laggard approach. And so, that is what we're looking to do in 2023 despite the openings.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Separately, maybe just talk about food delivery and what you are still seeing there on a year-over-year basis, maybe on a quarter-over-quarter basis, if you still continue to see that be quite strong. And then also maybe on new units, how do those do just on third-party delivery?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah. Great question. So, like, god bless the people doing third party delivery because it just keeps on growing. And so, it's performing well for us. The channel continues to grow. It's probably continuing to do a little bit of mix shift for us. So, we're seeing continued growth in third-party delivery even through the course of 2022 and into the fourth quarter. So that is definitely happening. The last part of your question about new units is a very good question because we're very thoughtful about metering the channel so that we don't overwhelm a new restaurant. And let me tell you what I mean by that.

Our Orlando restaurant came out of the gate blazing. Had a fantastic first year. And can we tell him this? No. Okay. But it had a fantastic first year. We did not want to overwhelm that team, so we did not have third-party delivery, pick-up, or catering turned on; on purpose. And we've only recently, after a little bit over a year, added a channel, added another channel. So now, it's got the whole the whole mix.

The Colony does not have third-party turned on, does not have digital ordering turned on, does not have catering. Right now, it is exclusively dine-in, pick-up, and drive-thru. And that's on purpose because it's doing such crazy volumes, we don't want to create excess pressure and create more channel stress right now. So, for new restaurants, that is sort of a new normal for us which is expand the channel outreach over time once the restaurant stabilizes and can handle the volumes.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Operator: Our next question is from Dennis Geiger with UBS. Please proceed.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Thank you and good morning, guys, and congrats on The Colony and some of the other strength in the other recent openings. I wanted to ask first sort of on supply chain, permitting, and then any other delays as it relates to targeted openings for this year and how you're thinking about this year. Is there any update there? And I guess maybe, Michael, if you could just kind of touch on build costs, how that's trending, and any kind of expectation for this year relative to what you saw in 2022?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah. On timing, look, I think I'm sure you've heard this from every other restaurant company, but there seems to be a new normal in how long it takes to get through certain administrative processes with governments et cetera. And so we've built in significantly more time for permitting, for all those stuff.

The things that are under our control, we feel pretty good about. We're getting better, we're getting smarter, we're getting faster. Three of the restaurants that we built where we're first-time national-scale general contractors. That's what we've got to do. We've got to become a scale construction company. And so, I feel good that we have learned a lot and that we are more pragmatic and planful in when we think things are going to open.

It is honestly down to this why the 2023 is so back-half loaded. I would never want it to be back-half loaded in a perfect setting. And so my expectation is 2024 is much closer to right, and then 2025 should be perfect. And perfect for us, I think, is 60%, 70% of the restaurants are open in the front half and the remainder open in the third quarter, maybe one in the fourth quarter. That's what great looks like. So, we're not great in 2023; we're back-half loaded, far more than I would prefer. But that is neither here nor there.

And then in terms of construction costs, I would describe it as it has tapered a bit. It hasn't come back to Earth. And I don't know how much of it will, I don't know how much of it won't. We've talked about this before. What that means for us is because we're still very committed to hitting the financial targets that we have set. So, it means Michelle and I are only approving restaurants that we think are going to far exceed some of the numbers that we would have looked at in the past because, the build cost is higher.

We're also being very thoughtful about how much money we're spending to build our restaurants. We've talked about the restaurant of the future. I think in the Class of 2024, we'll start building restaurants that are smaller, more versatile, and have the ability to generate the plus-size volumes that we want. And so I think we've got to skin this cat in those two ways. We've got to be more thoughtful and frugal in how we're building. Still want a great experience for guests, but build a lower cost building. I don't like the word cheaper, so it's got to be lower cost, but still look gorgeous, inviting, engaging building. And we have to be thoughtful that the restaurants that we're signing up for, that the revenue will still greatly achieve all of our aspirations for returns.

Michelle, anything [indiscernible] (00:43:15)...

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. No, You said it all. We're committed to their cash on cash returns we've laid out there. And that's what we look at when we approve new restaurants.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Very helpful color there. Just out one other one, helpful commentary on the delivery strength there. I'm curious, though, if there's anything else to touch on as far as what you're seeing from customers recently, changing behaviors across any metrics, channel utilization, et cetera? Thank you.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

There is a structural shift that is undeniable. Like, if you go back to 2019, 53% of our sales were inside the restaurant. In 2022, 42% was inside. 2019, all the delivery channels were like 6%. Now, they're 14%. Drive-thrus remain roughly the same. And so it's just a question of that inside the restaurant, how much of that keeps coming back and where does it come from?

So, delivery continues to grow, and I think everyone's aware that the price points on a third-party delivery are materially different than if you go through the drive-thru or you pick it up in the restaurant, there's fees, et cetera, and tip and all those things add up. But that consumer sort of defies any price elasticity and continues to be very robust and continues to order from us.

So I think, I would be guessing, Dennis. I'm still surprised that dine-in hasn't picked up more, but it could just be that, that's been a structural change that is here to stay.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Appreciate it, Michael. Thank you.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

You bet.

Operator: Our next question is from Andy Barish with Jefferies. Please proceed.

Andy Barish
Analyst, Jefferies LLC

Q

Hey. Good morning, everyone.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Good morning.

Andy Barish
Analyst, Jefferies LLC

Q

Just wanted to dig into a little bit more on the margin discussion. Just from an operational improvement efficiency perspective, I know you guys have done some good work around that over the last 1.5 years, 2 years. Is this something we should think about as kind of annually an opportunity to drive more productivity in your business? And then secondly, just, I know you're working on a new kitchen 2023 design. How does that roll into the restaurants for this year's builds?

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah. Good morning, Andy. Good to hear from you. So, here's what I'd say. We aspire to be a great company and be a great operator. And that means that you're always trying to get better and improve. While we're a 60-plus-year-old brand with a great legacy, there's a lot of things that we can get better at operationally. And so, I think operational improvement is a thing that's going to be around at Portillo's for quite a while. And we had fantastic efficiencies. We had fantastic efficiencies last year. We, I think, did a really good job of becoming more dynamic and efficient. We're doing things that I think will continue to enable that.

So, one of the investments that Michelle alluded to with labor is what we call the step-up program. So, if Andy is my rock star beef maker, but that's all he's done and he's getting to a certain hourly wage, you can go and cross-train. You can learn how to make hot dogs at the station we call table. You could turn around and work broiler. And every new station that you learn, we pay you more. And every new station that you learn, you're creating flexibility for the company in terms of staffing and utilization. So, that's a gift that's going to give, and that we're figuring all the details of that out. Our goal is to deploy the step-up program in the second half of the year.

You referenced Kitchen 23, which we saw a significant savings where we tested it. It requires a little bit of CapEx and a little bit of a pain to redo the restaurant, but we think we've got a really good idea on how to do that. And we're retrofitting – we're going to target 15 to 20 restaurants in the Chicago area to retrofit towards Kitchen 23 for this year. That will generate savings. And then on an ongoing basis we, we carefully look at our items per labor hour. It's a productivity metric. We look at the spread between the top quartile and the bottom quartile. We look at productivity by day, by day part.

And there is a lot of air there, there's a lot of opportunity for – we have some restaurants that perform at ridiculously high productivity levels and there's some learnings there that we can and should be applying to restaurants that are a little less productive. So, I think that we have a lot of room to improve and it's a multi-year journey. But it's also predicated on taking great care of your team members, right. You want happy, productive team members who are cross-trained, eager to work. And that's when everything works really well.

Andy Barish
Analyst, Jefferies LLC

Q

Yeah. Really good color. Very helpful Michael. And, Michelle, just real quick on the other operating expense, you mentioned NROs in the 4Q. What specifically is that? And was there anything else that moved it up to 12%? I imagine utilities were probably pretty high, and paper and packaging as well with catering and things like that. But just kind of wondering if this is a new run rate at about 12% of sales or so?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. Andy, we have some catch-up on repairs and maintenance that I called out in my remarks. Outside of that obviously year-over-year when you layer in new restaurants, right, you're going to have some of that in there, which is what I called out in the new restaurants. The only other thing that I think I would call out to you that would be an outlier, again, would be some catch-up that we did on the repairs and maintenance expense in Q4. But in terms of a run rate, again, I'm not going to get into future numbers, but that's what I'd call for Q4.

Andy Barish
Analyst, Jefferies LLC

Q

Okay. Thanks.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Thanks, Andy.

Operator: Our next question is from Chris O'Cull with Stifel. Please proceed.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Good morning and congrats on the recent store openings. Very impressive.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Thank you, Chris.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Michelle, given the comp trajectory in the first quarter, how should we be thinking about traffic or entrée count growth as comparisons start to normalize?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

I think, Chris, Michael called out that we've seen positive transaction growth year-to-date. So, that's through the first two periods. The thing that we continue to see is – and I've even talked to you and others about this before – is as we looked throughout 2022, particularly in the back half of the year, we continued to see a negative impact from mix, right, which was that attachment or that items per transaction. My expectation is I don't expect that to immediately turn around as we continue to live through this recessionary-like environment. So we're still seeing that as well as we come into 2023.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And then it sounds like you expect to expand margin this year despite more new store drag, I guess, this year than last year. Other than pricing, what do you think are going to be the primary drivers of that improvement?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah, pricing's definitely a lever, Chris, that we are going to be looking to pull as the primary lever. And, again, I mentioned, we put in a 2% in January. There's nothing else that Michael and I have aligned on moving forward. We're going to again continue to see how the environment looks. But then I would just point to exactly what Michael just said when he was talking to Andy about the improvements that we're looking at in terms of Kitchen 23, our step up program, and then as we look at our items per labor hour, which is our efficiency metric that we measure in our restaurants. So, we're going to be looking can we make some improvements there? So, those are the two things, but pricing would be the primary lever.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Q

And just as a follow-up to that labor question, I think you said there's some labor investments planned for this year. Can you remind us what the magnitude and timing of those investments are expected to be relative to when you start to lap the investments you made in 2022?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. As Michael mentioned, Chris, we haven't determined exactly when we're going to put in place the step up program, for example, and the labor decisions haven't been made fully. We put in place last year in Q3, the beginning of Q3, a round of increases into our restaurants. And so, that's when you'll start to lap some of those increases this year. But TBD on what we're going to do in 2023. We haven't made all those decisions.

Chris O'Cull
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Thanks.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah.

Operator: Our next question is from Gregory Francfort with Guggenheim. Please proceed.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Hey. Thanks for the question. Can you talk just a little bit about the recent sales trends you're seeing to start 1Q? I mean, particularly January number is really strong, and I think the whole industry has had a little bit of a pick-up, but the industry may have easier comparisons. I think you guys have tougher comparisons. So, can you maybe talk about that dynamic? And is there anything regionally that you're seeing, or just thoughts on the consumer strength as a whole? Thanks.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.

A

Yeah. I think – so, Greg, I would just – I think January was honestly a little bit of a bounce back, some pent-up demand from that last week of December that we missed out on. So, there's a chart in the supplemental that kind of, I think, clearly identifies that. Now, even if you neutralize that, we're seeing a little bit more momentum in our business. I would tell you, it's broad based. It's not any individual market. It's broad based momentum in our business. We feel really good about both the traffic trends as well as the sandwich count trends. And by the way, as our channel mix begins to stabilize and I think traffic is the probably more straightforward way to describe it, but, like, we feel really good about that. I know I sound like a broken record, but for the last nine months, we've seen consistently improving guest satisfaction scores, speed of service scores, value perception scores.

So, I attribute our step up in performance for the first two months that our price laggard strategy is working. We're providing great value to our guests. They're telling us that they find great value. They're satisfied with us. Our guest satisfaction scores are now at three-year highs. And I think that our strategy is working. We've lagged a little bit on pricing, we've said this. We invested in our guests in 2022, and that is generating a little bit of, I guess, beta when it comes to revenue performance at the beginning of 2023.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Thanks for that. And just a follow-up question on the step-up program. I mean, I kind of hadn't heard of any restaurant doing anything like this before of paying you a little bit more as you kind of add different capabilities as a worker. What drove the design of that? I mean, are workers today in your restaurant just less cross-functional than they were in the past? And you're trying to get back to a certain level? Is this going to put you at a kind of a new level of cross-functionality of workers? Just any thoughts on that and kind of where the genesis of the idea came from? Thanks.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.
A

I think, honestly, it's rooted in a concept of pay per performance, pay per play. So the first thing is when we ask our team members what – we want to keep people, you want to keep great people, you want them motivated, you want them happy. And it's undeniable that when people are learning new things that they're actually happier. They actually like being able to do different things. So, the genesis of this truthfully was that we want to keep our team members happy. We want them cross-trained. We want them to be able to work multiple stations, multiple shifts.

It's probably more important to us than some other restaurant companies because we do have so many different stations within our restaurant and it's a great way of rewarding that. So, we can create a win-win dynamic. We can create really happy, engaged, excited team members because they're learning and growing. We actually could make our investors very happy because we can staff more efficiently and get labor productivity. And our guests are happy because they're getting high quality team members who are super excited to be there. So, kind of like, it's a hat trick of wins for us.

Gregory Francfort
Analyst, Guggenheim Securities LLC
Q

Awesome. Thanks. Thanks for the thoughts.

Michael Osanloo
President, Chief Executive Officer & Director, Portillo's, Inc.
A

You bet.

Operator: [Operator Instructions] And our next question is from Brian Mullan with Deutsche Bank. Please proceed.

Brian H. Mullan
Analyst, Deutsche Bank Securities, Inc.
Q

Hey. Thank you. Question on the balance sheet. Congrats to the team on getting the refinancing done. Michelle, with that in the rearview mirror, could you just touch on the priorities after you fund the CapEx requirement needed for the growth of the business? Just philosophically, I'm wondering if you'd be inclined to want to pay down debt and deleverage a bit over time, or whether you'd be more inclined to start to look at capital return over time? And then is there a target net leverage ratio or a range which we should keep in mind that you think is optimal?

Michelle Hook
Chief Financial Officer, Portillo's, Inc.
A

Yeah, Brian. Great questions, and, yeah, we're definitely excited to free up a bit more cash from the refinancing and have that in the rearview mirror. As I think you all saw during our Investor Day, we laid out where the CapEx is going to go. And so the vast majority of our cash is going to be to fund the new restaurants that we're going to build, put investments into existing restaurants, and then continue to make investments in other things like technology, et cetera. We've talked about digital menu boards, those type of things.

Outside of that, to the extent that we have excess cash, I mentioned on the call we've started to already pay down that revolver. So, we had $15 million outstanding on the revolver. I'd like to get that paid down. We paid $5 million off of that a couple of days ago. And so, we're at $10 million outstanding on the revolver. Outside of all that, I am open to whatever makes sense and is in the best interest of our shareholders, whether that's paying down debt or other avenues.

If Michael and I and the rest of the leadership team are comfortable with dialing up growth, then we will do that because obviously that's the best investment. It has a fantastic return. And so, that would be the primary avenues we would deploy our capital.

Brian H. Mullan
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you.

Michelle Hook
Chief Financial Officer, Portillo's, Inc.

A

Yeah. And just, sorry, Brian, I didn't answer your question on do we have a targeted lever leverage ratio. I do not have a target ratio in my head, but I feel very comfortable that we can service the debt, invest in everything I just mentioned, and continue to grow.

Brian H. Mullan
Analyst, Deutsche Bank Securities, Inc.

Q

Thank you.

Operator: We have reached the end of our question-and-answer session. This will conclude today's conference. You may disconnect your lines at this time, and thank you for your participation.