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Portillo's, Inc. (PTLO)

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CORPORATE PARTICIPANTS

Michelle Hook
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Brian Harbour
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MANAGEMENT DISCUSSION SECTION

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Okay. Great. Good morning, everyone. I'm Brian Harbour. I cover restaurants and food distributors here at Morgan Stanley. Thanks again for joining us. And now we are going to talk Portillo's with Michelle Hook, who's the CFO. MIchelle, thanks for being with us.

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

Thanks, Brian. Great to be here.

QUESTION AND ANSWER SECTION

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

So I think we should probably start with just on the development side because certainly since you guys have gone public a couple years ago, store expansion has really been key to your story and will continue to be. And maybe just start by talking about some of the openings for this year, how you think that went, your takeaways from kind of the recent cohorts of restaurants. Arizona, Texas, Florida have been focus areas. You're, of course, born in Chicago, but those have been newer markets for you.

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

A

Yeah. No, absolutely. As you look at our journey, right, as we IPOed in October of 2021, we've put out there that Portillo's is going to grow at 10% a year, which is, I think, when you think about that, it's not outrageous, right, growth. But where we're focused on is primarily in the Sunbelt markets of Florida, Texas, Arizona, as we look at where we've been growing. And so when you look at how those restaurants are performing and you – I'm sure your follow-up is why are you picking those markets to grow, which we can talk about, but we've been extremely happy with the performance of those restaurants. And so we actually entered the Dallas-Fort Worth market for the first time this year. That was a new market entry. We opened our first restaurant in a town called The Colony, which is near Frisco. And we've been very, I'll say, non-humble about bragging about that restaurant. And initially when it opened, it was projected to do $17 million annually. Now it's come down since then, but it's performing like a Chicagoland restaurant, which those average nearly $11 million in AUVs.

And so we're now at three restaurants in the Dallas-Fort Worth market, having opened two since The Colony and then we continue to build out Arizona and Florida. And when you look at the pipeline, so we started this year with 72 restaurants. We will be at 84 by the end of this year. So we will have opened 12 new restaurants in fiscal 2023, which is the most Portillo's has ever opened. And when you look at the performance of the restaurants, which was your question, one of the things that we provided at our Development Day in September, so anyone can go access these slides on our website, was we looked at the 2022 class of restaurants, which is seven restaurants in that class. And when you look at what we're targeting, by year three, we're targeting 25% cash-on-cash returns. And so we snapshotted that class of 2022 and how they're performing in that first year and they're above expectations for that class of 2022.

So we feel really good about the performance of those restaurants. And then as we go into the class of 2023, we have eight restaurants, we have two left to open this year. Our most recent opening was actually this weekend in Rosemont, which is a city right outside of O'Hare. And so we feel it's super early innings on the class of 2023. But similar to the class of 2022, we like the profile of those restaurants and as a class performing above expectations.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. And what do you think has made them so strong? Is there anything you kind of learned over the last few years, especially opening outside of your home market where there isn't as much brand awareness? What defines the top performing ones?

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

A

Yeah, I think obviously where you build the real estate site selection, we've gotten a lot more refined on that over the course of the last few years. And so when you look at Portillo's as a whole, we could build a restaurant in Chicago really anywhere and it would do well. And so that's not the case in outer markets outside of our core market. And so what we found is we can't be the only draw to an area. So we need to be building our restaurants where people are gathering, where they're congregating. And so we have to have that aspect to the site selection. We need to have good visibility, right? You don't want to be buried in the corner of a mall or in another area.

And then because our restaurants average as a system almost $9 million in AUVs, clearly, these are busy restaurants. You have to have a good access, so good ingress/egress. Those are all characteristics as we've built the class of 2022 and as we're in the class of 2023 now that we've needed. And so I think once you start to do that and you see the benefits of that site selection come to fruition with what we're seeing in the performance of the class of restaurants, and I think that's part of it, Brian.

And then I think the question is, well, why are you building in those markets? That's where people are moving. When you look at population growth here in the US, the fastest growing states are Texas, Florida, Arizona. And so, of course, we're going to build there because that's where the population is growing. We still absolutely have opportunities in our core market of Chicagoland and we are going to continue building there. But the vast majority of our growth for the next couple years is going to be concentrated in the Sunbelt.

And then we've recently said we're going to start scouting sites in Atlanta, Denver and Vegas. Those are the next three markets that we'll look to enter. But as we build, we don't believe in just flag planting in new markets. Our goal is to get to scale as quickly as possible because of the scale advantages. And so we believe minimum scale in a market is at least six restaurants. And so when you look at the proof points there, the one I'd point to is what we just talked about, Dallas. So we opened our first restaurant there in January of this year. We'll be at five restaurants in the Dallas-Fort Worth market by Q1 of 2024. So the goal is within, call it, 24 to 36 months of going into a market, you get to scale.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Are there other markets in 2024 that will be hitting that point where you kind of see that improved scale?

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

A

Dallas is the one I'd call out. So we'll be up five in Q1. We just announced Mansfield. So we're continuing to build out Dallas-Fort Worth. We're going to enter Houston. And by the end of 2025, we'll be at scale in Houston. Arizona, for the Phoenix-Scottsdale area is one that we recently opened our sixth restaurant. We have a restaurant under construction in a town called Surprise, Arizona. So we'll be at seven in that market. And so those are the couple markets I call out, Brian, where we'll be at – we'll get to scale.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Is it fair to say those other entries you just mentioned would be 2025 if you're scouting real estate now?

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

Yes. At the earliest, when you talk about Atlanta, Denver and Vegas, 2025 at the earliest, more into 2026.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. That makes sense. At that investor event, you did also talk about flattening the honeymoon curve. Have you seen that yet or what are you doing to try to do that?

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

Yeah. We're actually seeing – so those that don't know Portillo's, we have big bang openings. And so that first year, you have higher AUVs that dip in year two. We put the restaurants in the comp base after 24 months for that reason. And so we're seeing the "flattening of that curve" because we're trying purposefully to do that. And we gave examples of that for our restaurant in Orlando. And then as you look at the class of 2022, some of the early reads on that class and what we're seeing there.

But what we're trying to do is basically when we look at our NRO capabilities, our new restaurant opening capabilities, as we go into these markets, we are making sure that we do, I'll call it, a soft opening for these restaurants, so it relieves some of that demand pressure. We don't tell people that the restaurants open, but we basically open the doors and people figure out that we're open. But it's not the "ribbon-cutting grand opening ceremony" that we announce. And so that lessens some of the demand.

The other things that we're doing that I will say is benefiting the restaurant is we won't open a Portillo's without an experienced general manager. So we need to make sure that we're de-risking these openings and putting seasoned general managers into the restaurant to make sure we're giving the guest a good experience. And so as you do that and as we look at the guest satisfaction scores, again, we gave these slides during our Development Day, you see improvement in the 30-, 60-, 90-day scores, which says, okay, because we're giving the guest a better experience, they're more likely to continue to come back and have frequency versus if you have all these people at your restaurant on the opening and you're trying to get them through and they don't have a good experience, they're less obviously likely to come back. And so some of that is helping to flatten the curve by just performing better operationally and taking care of the guests.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Makes sense. Conscious that the Sunbelt is sort of the focus, you've opened sort of recently outside of Illinois, in the Midwest. Maybe how are those doing? And also, you've opened some alternative format ones in Chicago. How are those going?

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

Yeah. So, yeah, if we throw Chicago out, when you look at the other Midwest restaurants, they're just under $6 million AUV and probably 18% margin. When you look at those outside the Midwest, $7 million AUVs and closer to 20%, just under 20% margins. So that goes back to, right, what we talked about just a few minutes ago about why are you targeting the Sunbelt because a lot of times, people say, well, I would think that naturally you would do better in the Midwest because you're spilling outside of your core and you would have better brand awareness. But what we're actually seeing is better performance in those Sunbelt markets, excluding Chicago.

You want to talk about the alternative formats...

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Sure.

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

A

...because you mentioned that, right? Okay. So we just opened on Saturday, our second pickup-only location, which has all the channels except dine-in. Our first was opened in Joliet in 2022 and we're using that format as an infill strategy in markets we have scale, which the only market we have scale in today is Chicagoland, as we've talked about. And so it does roughly two-thirds the AUVs of a Chicagoland restaurant with a lower build cost. So it clearly bolsters the return profile. It's a format, well, that's doing very well. Again, our second just opened. We'll use it today as just an infill strategy in that market. But as we get scale in other markets, it's definitely an opportunity that we're going to continue to look at.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, makes sense. You've also talked about this push to standardize design. There's been a lot of build cost inflation everywhere. But you've tried to standardize the design and there's also been some operational changes that you've made. Could you explain to the group how that's worked, how much you've kind of been able to realize so far?

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

A

Yeah. We've been on a journey to look at what "box" that we're building for our restaurants. So if you go into Chicagoland, you will see a traditional Portillo's is probably anywhere from 10,000 to 11,000 square feet. If you go into the kitchen, you'll see a production line that's very linear, that's about 100 feet of production line. So what we're building today, which is on the journey to what I'll talk about in a minute, is what we're calling Kitchen 23. So Kitchen 23 is about 7,700 square feet that we're building today. The production line is about 65 feet. And obviously with that shrinkage on the line, you get less conveyance, more adjacencies as you're working. And so we've seen the benefit of the labor efficiencies with this new kitchen.

As we move into what we're calling Restaurant of the Future, that prototype today is 5,500 square feet to 6,000 square feet and the production line is about 47 feet. And so we will start to build those late in 2024 at the earliest, but all of the class of 2025 will be in that new prototype. These restaurants have all the channels. They will still be able to do 10-plus million AUVs. The kitchens are still built to handle high AUVs and will still look and feel like a Portillo's.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

What kind of drives that? For those of us that don't spend much time in the back of your restaurants, why can they do the same AUVs despite being considerably different in layout and size?

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

A

Yeah. If you look at the – like, I'll give you a quick example. Like, if you look at the line, now we've moved the line in the middle of the kitchen. And so if you go into a traditional Portillo's, there has generally been two lines. One has been for the drive-thru part of the business, one has been for the Dine in part and, call it, other off-prem channels part of the business. And so you can move the line in the middle and you can work both sides of one line and you and I can stare at each other and still make beef sandwiches, hotdogs, etcetera from one line that doesn't require as much space as two separate lines.

And so when you look at the actual equipment in the restaurant, we're able to reduce some of that footprint and actually work more efficiently because you and I can talk to each other. If drive-thru gets busy, we call it racking in the drive, if you're racking in the drive and the dine-in is a little slower, I can look at you and say, okay, do you got this order and you can switch it over to the kitchen video system to that side. So it's things like that, Brian, that when you look at the actual physical layout, it makes a lot of sense to go and move to where we're moving because it creates those adjacencies and that communication is a lot more efficient.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Makes sense. You also increased kind of the unit potential at that, right? It was 600 at the time of the IPO. Now you're saying 800. Could you talk about where are those kind of additional 200? Did you make – I think you do, but maybe if you could tell us more about it, the same assumption about volumes and store margins as you look that far out?

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

A

Yeah. I think as we looked, we tweaked some of the assumptions, right? And we call it the MAM, the minimal – minimum achievable market for Portillo's. So we really got more surgical with the analysis in terms of looking at where it makes sense to build a Portillo's. And the criteria was I need the restaurant to do at least $7 million and I don't want to build within a certain radius of another Portillo's because I want very minimal – minimum cannibalization of the existing restaurants because we're at the stage right now that within our growth trajectory that we're not building a lot of restaurants that are cannibalizing. But -- so when you put that criteria in and said, okay, where should we be, that's where we get to the 800. And the 800 are full-size Portillo's that have all the channels.

And the other number that we gave was, we believe, there's 120 at least what we're calling the pickup-only or walk-up locations. So we have the two pickup locations that we talked about. And we don't have any walk-up formats yet, but you can think about a scenario where an example that we gave at our Development Day is when you look at Times Square and you see there's a recent Cane's and there's a Chick-fil-A, concepts that traditionally have drive-thru businesses like ours, they have walk-up locations. Yes, we can do that format as well. We don't have those today, but it's absolutely an opportunity.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. How about licensing? I mean, you can put them in airports, you can put them in the Middle East.

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

A

We could do all of that. The criteria for us, particularly when you talk about licensing, is we want to run the restaurants. We don't want someone else running the Portillo's. And so that's the criteria we've set for ourselves. And in some locations, it's fine; in others, it's a little more challenging to get folks to agree to do that. But those are absolutely opportunities. And then we've talked about international franchising at some point is absolutely an opportunity for Portillo's. But that's years down the line. That's we're focused on US development and growth right now.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Makes sense. Maybe just a couple of questions on your sales trends. You did – you're one of several that kind of noted some improvement into early 4Q relative to late 3Q. I mean, what do you think was behind that? I guess maybe if everyone saw the same thing, it was across the industry. But what do you think was behind that in your case?

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

A

Yeah. I think for us, I can't speak for the rest of the industry, but for us, September, which was the tail end of Q3, is always a slower timeframe. And you see that because people are going back to school, families are getting their lives back in order, getting back to normalcy after the summer season. And so it's traditionally a slower month. And so we saw what I would call a more normal bounce back from that. Outside of that, we were very specific that we have and are making investments in advertising in our home market of Chicagoland in the fourth quarter because of the headwinds that we've been seeing on traffic. And so it's one of the tools we have in our toolkit to use. We don't pull it out often. We only spend about 60 basis points on marketing and advertising at Portillo's. But I think part of that too, Brian, contributed to some of the improvements that we saw coming out of Q3.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, makes sense. Maybe just elaborate on that. It's not usually a big thing for you, but what sort of marketing was that? Does it make sense to do more next year? And it does show up in your G&A. I don't know what kind of the overall impact of that is.

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

A

Yeah. And we've been very transparent. It's about a $1.2 million investment in G&A. That's why we're going to see we said, yeah, we're going to invest a little bit more in G&A in Q4 for these ads. And so I give our marketing team a ton of credit. They developed all the creative. We didn't go out and hire an ad agency to develop the creative. We did all that in-house. They just did a fantastic job. And so you'll see advertisements, commercials on live TV, whether it's Bears games or if you look at live news outlets, we found that that's the best approach on the TV ads in particular. And then you'll see us on billboards on the major freeways in Chicagoland. We've done other partnerships with social media influencers, Barstool Sports. They're fun to follow on Instagram and social media, if you have a chance. They do some fun things with us. And so that's the type of advertising that we're talking about and that'll run through the end of this year. And we've seen good results from that, as we've indicated. And so the question that we get is, well, would you do that again? It's yeah, absolutely. It's a tool in the toolbox, again, that we could use if we think we need to use it. We don't pull it out very often, but it's definitely helping to buffer some of what we saw in Q3.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. [indiscernible] (00:20:45) decision on pricing in the fourth quarter or maybe just how do you think about that into next year?

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

A

Yeah. We've said that we're pausing on pricing in Q4. So as we sit here today, we had some pricing that fell off in October. So we're at about 5.5% pricing today. And when you look at what starts to fall off next year, we have about 2% in January that we took this year that'll come off and then another 3% in May that'll come off. So those are the two pricing actions we took this year. We're going to take price next year. We haven't made that decision on when and how much yet.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. You don't really play with the menu, I don't think. Would you ever do that, or I guess is there anything you might do to shift like mix, for example? I don't – I haven't seen your ads. I don't know if those were focused on a particular product, but curious about that.

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

A

Yeah. So I'll talk about the ads and then we can talk about the menu. So the ads we're just focused on showing Portillo's food. It wasn't specific to price points or look at this value, etcetera, etcetera. It was just reminding people how great our food is and with the tagline Portillo's, it always sounds good. And so, again, just reminding people of the core menu items, when you look at our beef sandwich, our hotdogs, our fries, our onion rings, why people come to Portillo's. So that's the core. When you look at the menu, you're right. We don't – we're not an LTO concept. We do some seasonal shakes and cakes. But outside of that, we don't do LTOs. And our menu is pretty expansive today when you look at it. And so to put something new on the menu, it has to have certain criteria. One, we want to make sure that it has sort of a unique spin on it for Portillo's. But then two, it doesn't add any additional complexity in our kitchens for our operators.

And so we've done some things over the years, like if you look at adding a spicy chicken sandwich that was on trend and we got rid of another sandwich on the menu that wasn't performing as well. When you look at, we introduced a garden hotdog, a vegan option for our guests, which we have been getting a lot of feedback on that. So I think we'll continue to look at, Brian, things that what – how they're mixing on the menu, how they're performing. And if we can make it better, we will. This year, we launched what we called our Rodeo Burger, which was, again, didn't add any additional SKUs into the kitchen, but highlighted an improved bacon that we had in the restaurant and put it just next to other ingredients that we had to create a very good product for us. And so we'll do things like that.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. Okay. The mix component of your same-store sales has been a bit negative. Do you think that will continue into next year or do you think this is just sort of a behavioral shift that takes some time to play out?

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

A

Yeah. I think at some point, it has to turn positive, right? And when you look at the trends, we started seeing negative trends in that in going back to Q2 of 2022. So the question we get a lot of times is, okay, well, you're now starting to lap that this year. And my response is yes and we continue to see a very similar trend, right, in terms of negative mix and so – which is, for us, less items per transaction. Generally, that's what we've been seeing over the course of time. And so at some point, you still get people that are coming to Portillo's that are still buying something. And so I obviously don't have a crystal ball and can't say when I know this is going to stop.

But what I do know is I don't believe 2024 things are going to get drastically better for the consumer. I think there's still going to be pressures. And restaurants are an area where people cut back on discretionary spend. And for us, I think the focus is just continue to give the guests a good experience and that is generally what drives frequency back into restaurants is you had a good experience, whether it's the quality of food, the service, etcetera, right? We don't discount. And so other concepts in this type of environment can prop up a value menu or bundle or do discounting and we don't do that. So we got to focus on the fundamentals.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Right. Maybe also just talk about digital that you have it as does everyone these days. So it's sort of just table stakes. But are you actively incentivizing people to use that more readily? Do they come more often? If you can maybe talk about delivery [indiscernible] (00:25:44).

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

A

Yeah. So our digital mix today is around 22%, which some of you might say, wow, that sounds really low because I know other concepts and restaurants are like 70%, 80% digital. But you have to understand that 40% of our business is through the drive-thru, 40% of our business is dine-in and then 20% are the other channels. Delivery is about 13%, 14% of that and then we have catering and pickup. And so people that have 70%, 80% digital mix generally don't have drive-thrus, right, generally speaking or generally don't want you dining in their restaurants. They want you to pick up your food and go and Portillo's is more of an experiential brand.

And so the digital channel, we continue to see pretty steady at that levels – at those levels. But when you talk about delivery, that channel has been very resilient, it's actually surprised me and we've seen it at that 13%, 14% pretty much hold steady. And you would think that logically in this type of environment, people would migrate towards the other channels. But we're just not seeing that. We're seeing it hold pretty steady. And we offer – we work with all the third parties to offer that. We also do our own delivery on what I would call large catering orders and order over $100 and so we do a little bit of self-delivery as well.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, makes sense. Maybe let's just talk about operations and margins and outside of it. You obviously run very high-volume restaurants with lot of employees. Do you think that there's – and you very much focus on retention pay, etcetera. Do you think there will be above-normal wage investments next year? Anything that we should think about on kind of the staffing side?

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

I think next year, we're going to see mid-single-digit labor inflation. So since 2020, we've seen our hourly rates increase 30%. So we've made significant investments in labor. And part of that is, look, the market moved, right, and we had to do that. And we take pride in taking great care of our team members who take great care of our guests. And so we've had significant investments. And I think as we move into next year, Brian, we'll see what I'll call more normalized investments, but we'll continue to see how markets move. We only – when you look at statutory increases, etcetera, that's not a massive impact for Portillo's. We only have two restaurants in California. And then when you look at wage increases in other markets, we're again already above minimum wage. So we'll continue to move as markets move, but no, I don't expect significant headwinds on labor next year.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. What – you've also done just kind of some process changes and such and you alluded to some of it, but what's working best there? And I guess also, what do you think could be impactful as we look to next year?

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

Yeah, I think we have done a really great job on efficiencies from the labor side within our restaurants. I think part of that goes back to what I mentioned on the Kitchen 23 format that we've been building and some of the other retrofits we're doing in our home market that have created those labor efficiencies. And we're very surgical on how we schedule labor. And when we look at demand within our restaurants and the labor needed to service that demand and how you schedule that labor, for us, again it's a very surgical process by restaurants. I feel really good about operationally and kudos to our ops team for being very focused on that. So I think as we go into next year, there's still opportunities. As we look at the labor that we spend on prep before our restaurants open. We've talked about some opportunities there and we'll continue to look at those. So, yeah, I think we still have opportunities. And as we build the Restaurant of the Future, I think we'll see more of those opportunities.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

And how fast will we see kind of the new kitchen design? You'll put it in new stores, but I think you are going to do some retrofits too.

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

We are and we've done. There's 40 restaurants that had retrofit opportunities. We've done 18 of those, mostly all of them this year. And as we move into next year, we'll do the remaining 20-plus next year. And those will obviously create the labor opportunities for efficiencies that we talked about in those restaurants. So we'll see the benefit of that come through for some of the restaurants, not only next year, but as we move into 2025 when you get a full-year run rate for all those restaurants once they get retrofitted.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Yeah. Can this drive – would you expect to see labor leverage? I mean a lot of restaurants don't or they've seen deleverage over time just given how persistent inflation is. This is true before COVID, too, right?

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

A

Right.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Inflation was so persistent. I mean, do you think that you can avoid that based on some of those initiatives?

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

A

I think we've proven that we can do that, right. I think it's easy to sit here and talk about, it's super hard to execute.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Right.

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

A

And I think it comes down to the point of us being surgical on execution and how we schedule that labor and where we see those opportunities. But do I think that those exist in the future? Yes, I think those exist in the future. But we got to, again, grind that out and do the work to get those done. But, yeah, I think we've proven we can do that.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

And typically you've set the expectation, too, new units will be somewhat margin-dilutive. Of course, they're out of the gate, right, as with any concept, but even just relative to your Chicago base. But do you think they may be less dilutive? Can you kind of avoid some of that over time?

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

A

Yeah, that's why we want to get to scale quickly in markets because we see margin improvement sooner rather than later when you have scale because you're leveraging distribution, right, you're leveraging that local marketing across multiple restaurants, that multi-unit manager. So yes, that's the goal is to try and buffer that as much as possible. Our restaurants are cash flow immediately. But when you look at Chicagoland, 11 million AUVs, 30-plus percent margins, obviously, they don't profile like that. We're a 60-year-old brand in Chicago. And so year one of a restaurant is high-teens, right? And then by year three, you get to that low-20% margin. So the quicker we can get to scale, the more that – the sooner I think we can accomplish that, Brian. But absolutely, when you look at the margin profile, so today as we sit here, the portfolio of our restaurants, we're at 24% margin. So that's a healthy margin profile, right, for a restaurant concept. And so as we continue to add these new units, they're naturally margin-dilutive. But the quicker we get to scale again, the more we can buffer that.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. In the near term, you have a lot opening about right now. Will we see that to a significant degree as we look at like 1Q 2024, for example?

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

Yeah. Obviously, when we talk about opening 12 new restaurants, right, in 2023 and having the full effect of that in 2024 on top of new 10% growth in 2024, yes, those are naturally going to be overall margin-dilutive. And when you look at the profile of us next year and you say, okay, if I think commodities and labor are going to be mid-single digits, which is what we believe sitting here today, and we say to ourselves, okay, we have pricing power to largely offset with that, then you say naturally with all the new restaurants, you would have margin degradation for the portfolio. If we had flat margins next year, that would be a win for Portillo's. That's going to be hard to do. But, again, getting to scale quickly is the goal so we can help buffer some of that.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Okay. Makes sense. And on the food side, I mean, you said mid-single digits, largely beef-driven at this point.

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

That's largely beef-driven. The other commodities, I think, will behave. And beef, for those that don't know, for our overall basket is about 35%. When you mix in the other proteins of chicken and pork, it's about 50%, those three proteins of our overall commodity basket. But yeah, we'll see a little bit more pressures on the beef line next year. We're doing our best to mitigate that, taking some positions into Q2 of next year. So I feel good about where we sit in terms of keeping it at that level.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Great. You still have some leverage from being private, right? Do you have any specific targets to reduce that over time?

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

We're at just over three times levered. I feel good about where we sit, Brian. We're able to service the debt we just refinanced in February of this year. So I feel good about where we sit today. We can service the interest and principal payments and still have enough cash to invest back in the business. And so I don't have a specific target in mind. We're naturally going to deleverage with our EBITDA growth as well as the principal payments, the amortization payments we're making. And so I feel good as we sit here today.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Maybe I'll conclude with my standard lightning round question.

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

All right.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Just demand backdrop, we've asked this of everyone, of course. Demand backdrop for the year had, relative to recent trends, accelerate, hold, decelerate, in your view?

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

I would say hold. I think – I don't see it getting – I think, as I mentioned, I think we'll still have headwinds next year. But I think when you look at potentially a little bit of bounce back maybe in the back half of the year, as you pause in and no more interest rate increases and maybe even some decreases there, I think maybe you have a little better outlook in the back half of the year. But I think in our business in particular, we mentioned some of the improvements that we were seeing in Q4. So I think at a minimum hold, but I think potential to be even better next year.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. And how about the margin side, up, down, neutral?

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

I would say neutral, as I mentioned before, is a win. But given the new restaurants coming into our portfolio, I could see some slight degradation.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Makes sense. New capital allocation, you don't do all these things, but CapEx, buybacks, dividends, debt paydown, I mean, presumably for you, it's just investing in the business.

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

It's investing in the business at this point. That's where all the cash is going is right back into the business.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Yeah. Okay. I'll end it there. Thanks, Michelle.

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

Great. Thanks, Brian.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Thank you.

Michelle Hook

Chief Financial Officer, Portillo's, Inc.

All right.