03-Aug-2023

Portillo's, Inc. (PTLO)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Portillo's Second Quarter 2023 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. Thank you. Please go ahead.

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

Thank you, operator. Good morning, everyone, and welcome to our fiscal second quarter 2023 earnings call. You can read through the results we announced this morning in our earnings press release and supplemental presentation at investors.portillos.com.

With me on the call today is Michael Osanloo, President and Chief Executive Officer; and Michelle Hook, Chief Financial Officer.

Let's begin with a reminder that any commentary made during this call about our future financial results and business conditions constitute forward-looking statements, which are based on management's current business and market expectations and are not guarantees of future performance. We do not undertake to update these forward-looking statements unless required by law.

Our annual report on Form 10-K and our Form 10-Q, both include discussions of risk factors that may cause our actual results to vary materially from these forward-looking statements.

Today's earnings call will make reference to non-GAAP financial measures. Any non-GAAP financial measure should not be considered as an alternative to GAAP measures. We direct you to the materials we released this morning for the reconciliations of these non-GAAP measures to the most comparable GAAP measures. 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're glad to have you with us for our second quarter 2023 earnings call. I'm proud to report that we delivered another quarter of double-digit revenue and restaurant-level EBITDA growth, results that highlight the durability of our brand.

We grew total sales by 12.3% and achieved restaurant-level margins of 25.3%. We generated this level of profitability even under the weight of adding six new restaurants since Q2 of 2022. Michelle will detail our financial performance in a moment. But, first, let me walk through the main drivers of this momentum that we have.

To continue this positive – oh, sorry. First, we feel great about our class of 22 restaurants and their overall contribution to our financial performance. While it's still early, this class of restaurants continues to outperform our underwriting expectations.

And I know we've talked a lot about The Colony, but year-to-date, this restaurant has already done over $8.5 million in sales. That's not an annualized number. That's a year-to-date number. That's feeding a lot of happy Texans. Tucson and Gilbert are already generating average weekly sales comparable to our mature Arizona restaurants and Schererville, Indiana is cruising, generating Chicago-like AUVs.

To continue this positive trajectory, we heavily emphasize quality and execution so that we deliver an outstanding experience for both team members and guests. New restaurants tend to have lower margins early on because we invest additional resources to ensure great performance.

But what's really exciting is that the class of 2022's margin drag has been lighter than expected. That's a testament to both the operating strength of that class and the fact that they're overachieving on the top line, which brings me to my next point. We've earned the right to grow because of the strength in our core.

In the second quarter, same restaurant sales grew 5.9%. Michelle will decompose that comp for you in a minute. But in an economic environment that's been sending mixed signals, we delivered mid-single digit comps against the low-single digit target we have in our long-term growth algorithm.

Our restaurants are fully staffed and we're empowering our team members to prioritize the guest experience by serving delicious, high-quality food in an engaging environment at a great price point. This focus has allowed us to sustain multi-year highs in key guest experience metrics like speed of service, accuracy, overall satisfaction, and importantly, in our value perception.

These metrics carry even greater weight when consumers are feeling pinch because guests are a lot choosier about where to spend money when their wallets feel lighter. We're confident that offering a consistently great experience for our team members and, in turn, for the guests they serve is the right way for us to thrive amidst economic fluctuation.

Finally, in this quarter, we saw continued restaurant-level margin improvement. We've implemented two strategic initiatives to help us maintain this momentum. One, we've been actively managing our commodity exposure, locking in prices when appropriate, and letting the rest ride. We continue to expect some margin benefit from that unlock portion of our commodity basket as the rate of inflation continues to ease.

Second, we continue to hunt down labor efficiencies across the system. One example of this is our Kitchen 23 initiative. We've already completed a third of the Kitchen 23 conversions that we plan for this year. These involve quick and capital-light remodels of legacy Chicagoland restaurants that feature a relocated salad bowl, grab-and-go retail displays, and self-service fountain drinks. These changes are generating real operational efficiencies and helping us meet our 2023 margin improvement goals.

But Kitchen 23 is not just about cost efficiency. We're also seeing incremental beverage and product sales from smarter merchandising. And frankly, the restaurants just look better. This initiative is doing everything we hoped it would, and you'll see more of them come online in ongoing retrofits and as new builds in the Class of 2023.

Now, let me remind you that Q2 is typically our seasonally highest margin quarter, and we have a couple of margin headwinds on the horizon. We recently implemented our annual wage increases for the restaurants and the remainder of the year will be heavy with restaurant openings. Despite that, we remain committed to year-over-year margin improvement for the full year of 2023.

Now, let's talk about the new restaurants opening in the Class of 2023. As a reminder, we've announced that we'll open three new restaurants in the Dallas Fort Worth market, three in Chicagoland, including our second Portillo's pickup in Rosemont, Illinois, one location in Arizona, and one in Central Florida.

The bulk of the Class of 2023 will be in the Sunbelt where we continue to build out markets to achieve efficient scale. For example, Queen Creek in Arizona marks our sixth in the Phoenix metropolitan area. We also recently announced Claremont, which further develops the Central Florida market, and expanding our footprint in the DFW market is a clear priority.

We're actively building in Allen and Arlington, which we plan to feature site visits during Development Day on September 19, and will round out the Class of 2023 with one more location in Fort Worth. These eight Class of 2023 restaurants are actively underway, and we're very happy with that progress.

We'll open two restaurants in Q3 and the rest in the fourth quarter. We do have a ninth restaurant in the 2023 pipeline, but we will deliberately pace that out into the first quarter of 2024. Operationally, it's not ideal to open restaurants during our seasonally busiest period, and this tactic was very successful for us with The Colony earlier this year.

All told, we're navigating an uncertain economic environment and delivering profitable growth while building successful new restaurants. Performance in our core is solid. It allows us to reinvest our cash flow to fund more growth. And remember, all of our growth is self-funded.

With that, let me hand it over to Michelle.

Michelle Hook

Chief Financial Officer, Portillo's, Inc.

Great. Thank you, Michael. In Q2, we saw strong top line revenue growth. Revenues were $169.2 million, reflecting an increase of $18.6 million or 12.3% compared to the second quarter of 2022. This increase in revenues was primarily due to the opening of new restaurants in 2022 and 2023 and an increase in our same restaurant sales.

Same restaurant sales increased 5.9% during the second quarter, which was attributable to an increase in average check of 7.1% and a 1.2% decrease in transactions. The higher average check was driven by an approximate 9.9% increase in menu prices, partially offset by a change in mix.

We are experiencing expected cannibalization from some of our recently opened restaurants. We estimate the impact this quarter to be approximately 60 basis points to 80 basis points. As we build more locally in Illinois this year, we do expect some additional cannibalization to occur.

The incrementality of the new restaurant revenue and margin is very attractive and well worth the short-term cannibalization. Total revenues are in line with our expectations and we remain committed to delivering on our long-term growth algorithm of high-single to low-double digit revenue growth.

Food, beverage and packaging costs, as a percentage of revenues, decreased to 33.2% in the second quarter of 2023 from 34.4% in the second quarter of 2022. This was primarily due to an increase in our revenue and lower third-party delivery commissions, partially offset by a 5.5% increase in commodity prices.

We continue to expect that overall commodity inflation will ease in the back half of the year and estimate mid-single-digit commodity inflation for the full year. We have locked in pricing on 64% of our commodity basket for the remainder of fiscal 2023.

Labor, as a percentage of revenues, increased to 25.5% in the second quarter of 2023 from 25.2% in the second quarter of 2022. This increase was primarily driven by incremental investments in our team members, including hourly rate increases and variable-based compensation, and higher labor utilization quarter-over-quarter, partially offset by the increase in our revenue.

Hourly labor rates were up 4.7% in the second quarter of 2023 and up 6.5% year-to-date versus the prior-year periods. In the third quarter, we did make additional wage investments in our team members and remain committed to providing a compelling compensation and benefits package. We currently estimate mid-single-digit labor inflation for the full fiscal year. Other operating expenses increased $3.7 million or 24.1% in the second quarter of 2023.

This was primarily due to higher credit card fees as our transition to cashless drive-thrus drove an increase in credit card transactions year-over-year, as well as an increase in repair and maintenance expenses, higher insurance and utilities expenses, and the opening of new restaurants.

Occupancy expenses increased $0.9 million or 11.6%, primarily driven by the opening of new restaurants in 2022 and 2023. As a percentage of revenues, net occupancy expenses were flat for the second quarter of 2022.

Restaurant level adjusted EBITDA increased 11.3% to $42.7 million in the second quarter of 2023 from $38.4 million in the second quarter of 2022. Restaurant level adjusted EBITDA margins were 25.3% in the second quarter of 2023, compared to 25.5% in the second quarter of 2022.

Restaurant level adjusted EBITDA margin continued to improve since the fourth quarter of 2022. This improvement is on top of opening four new restaurants in the first two quarters of 2023, which all have a lower margin profile to start.

Our strategic pricing actions have been a very large factor in this margin improvement, combined with our continued focus on the guest experience and operational efficiencies. We do anticipate restaurant level adjusted EBITDA margins to be pressured by the aforementioned wage investments and our planned new restaurant openings in the back half of 2023.

On pricing, as a reminder, we have taken two pricing actions this year. In January, we increased menu prices by approximately 2%. At the beginning of May, we increased menu prices by approximately 3%. These increases continue to combat inflationary cost pressures and progress towards our goal to improve restaurant level adjusted EBITDA margins for fiscal 2023.

We still believe we have pricing power we can use if necessary. We will continue to monitor the current environment and remain flexible and strategic in our pricing approach moving forward. Our focus remains providing a great value for our guests.

Our G&A expenses increased $4.2 million to 11.6% in the second quarter of 2023 from 10.3% in the second quarter of 2022. This increase was primarily driven by higher variable-based compensation, an increase in wages and related costs, and higher professional and licensing fees. We are currently estimating to be at the high end of our targeted $72 million to $77 million range for the full fiscal year.

Pre-opening expenses decreased $0.1 million to 0.2% in the second quarter of 2023 from 0.3% in the second quarter of 2022. The decrease was due to the timing and geographic location of activities related to our planned new restaurant openings. All of this led to adjusted EBITDA of $29.2 million in the second quarter of 2023 versus $27.6 million in the second quarter of 2022, an increase of 5.8%.

Below the EBITDA line, interest expense was $6.5 million in the second quarter of 2023, an increase of $0.4 million from the second quarter of 2022. This increase was primarily driven by the year-over-year rising interest rate environment, partially offset by the improved lending terms associated with our 2023 term loan and revolver facility.

As of the end of Q2, the effective interest rate on the term loan was 8.2%. In the third quarter, we paid down $5 million on our revolver and currently have $5 million of outstanding borrowings against our $100 million revolver facility.

Income tax expense was $1.5 million in the second quarter of 2023, a decrease of $0.8 million from the second quarter of 2022. Our effective tax rate for the quarter was 13.5% versus 17.9% in the second quarter of 2022. Our effective tax rate decreased versus the second quarter of 2022, primarily driven by the recording of net operating loss carry forwards, partially offset by an increase in Class A equity ownership, which increases our share of taxable income or loss.

We ended the quarter with $22.5 million in cash. Our growth will continue to be self-funded by our operating cash flows and our available cash. We remain committed to delivering healthy top line and bottom line growth in 2023 and beyond.

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 just like to reiterate how excited I am about our future. Portillo's may be a 60-year-old brand, but we're a growth company with a lot of whitespace. Still, we know we have to continuously earn the right to grow by delivering to each of our core constituents, our team members, our guests and our shareholders.

Looking through the lens of development, our team members gain valuable career growth as they open new restaurants for Portillo's fans across the country. It's incredibly important to open these restaurants well, so that our guests find value in the amazing taste and quality of our food, the vibrant and fun experience at our restaurants, and our great prices.

New restaurants that open well, ultimately strengthen our earnings power, which drives shareholder value. And then we get to do it all again over and over, compounding growth. We can't wait to share more on that with you at our Development Day in Dallas on September 19.

Thank you. And with that, let's turn to Q&A. Operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] And the first question comes from the line of Sharon Zackfia with William Blair. Please proceed with your question.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Hi. Good morning. I wanted to come back to development, and I know that there is a team working on ways to kind of bring down the cost of the box. Is there anything you can share kind of the progress about or do we have to wait until September?

And then on cannibalization, is that something, Michelle, where we would expect that to ramp as the year goes on considering the comments you made about Chicagoland or is this 60 basis points to 80 basis points kind of a good level to stick out?

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

A

Yeah. No. Good question, Sharon. So I'll start with the question on the new restaurant prototype. So Michael mentioned Kitchen 23, so that's part of the evolution as we move towards what we're calling restaurant of the future. And so I think in the short-term, what Michael said is true, which is we're retrofitting some Chicagoland restaurants. And then the new builds that you'll see as part of the Class of 2023 will have elements of restaurant of the future in those.

And so, as we've mentioned before, we do expect some efficiencies in those kitchens, both in the short-term and as we move forward. And then in terms of restaurant of the future, which again is that smaller prototype, we will share more with you at Development Day. So hold tight for that and we'll share more with you then.

And then from a cannibalization standpoint, I think for this year, that's a pretty good number, Sharon, because as the Chicago restaurants, the three come online as part of the Class of 2023, you'll see more of that impact I think come later on. And so for right now, the 60 basis points to 80 basis points is a fairly decent number to use in the near-term.

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

A

And Sharon, on the cannibalization point, let me just reiterate something that I think Michelle mentioned, but it only happens really in the markets where we have some scale and density. So like think Chicagoland and a little bit in Arizona, but it's really smart cannibalization, right? The incrementality of the revenue, the incrementality of that margin is so attractive that it's well worth doing for the short-term little bump on cannibalization.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Thank you.

Operator: And the next question comes from the line of Andy Barish with Jefferies. Please proceed with your question.

Andy Barish
Analyst, Jefferies LLC

Q

Hey, guys. Good morning. Just wanted to level set on the commentary around second half margins. If you can give us more color I know we're expecting a move down from the highest seasonal 2Q levels, but can you contextualize that a little bit more maybe sequentially or year-over-year, Michelle?

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

A

Yeah, Andy. We're – I don't want to get in and you know this, so I don't want to get in the habit of giving margin guidance. But I will tell you there is that the comments that we made on both COGS and labor, I think can help you contextualize, where we see margins going.

And as Michael mentioned, Q2 we see as the high watermark for the year similar to what you saw last year. So, I don't expect us to hit the highs that we saw in Q2. And the wage investments that we made in Q3 will definitely have a little bit of impact as we get into Q3.

And then you'll see the full impact of those wage increases come into Q4 because we put the increases midway through July. And so it's not a full impact in Q3, so you'll see the full impact come through in Q4. And that's where you'll see the primary pressure points come in is on that labor line in the back half of the year.

Andy Barish
Analyst, Jefferies LLC

Q

Got you. And then just wanted to circle back also on the new restaurant opening inefficiencies, which have been better than expected. Are you doing anything differently in terms of opening the restaurants or is it really purely that the top line is exceeding your expectations, you're able to cover some of those extra costs around opening?

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

A

Yeah. It's a lot – the answer is yes to all of that. So there's certainly – I mean, there's certainly an element. These – in general, the Class of 2022 is exceeding our expectations on the top line and the marginal revenue flows through really well. So that's obvious. But we've done a lot of things differently in how we open restaurants and our new and our old processes, which allow us to get to what I'd describe as steady operations faster.

So we're training smarter, more efficiently and for a shorter period of time. We're pulling out extra resources a little bit more quickly because the teams that are there are much more capable of running the restaurant themselves. We have gone away from doing huge big bang openings to a more steady state opening, which allows the team to get their legs under them.

And we're being very thoughtful about turning on additional channels until those restaurants really are able to handle it. You may recall, like in Orlando, for example, we did not turn on off-premise, any of the off-premise channels for a year because the restaurant was performing well. The restaurant needed to get its legs under it. And so that – all those things contribute to an improved margin profile early.

Andy Barish
Analyst, Jefferies LLC

Q

Thank you very much.

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

A

You bet.

Operator: And the next question comes from the line of Brian Mullan from Piper Sandler. Please proceed with your question.

Brian H. Mullan
Analyst, Piper Sandler & Co.

Q

Thank you. I was just hoping you could speak to that entrée account stat that you've been disclosing, which perhaps I think you said is a better way to think about traffic. And somewhat related to that, it sounds like from the prepared remarks you haven't decided yet on price and in terms of taking any additional pricing actions over the balance of the year. But could you just speak to the primary considerations that are front and center in your minds right now as you do weigh any decision?

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

A

Yeah. So the entrée account is actually getting [ph] eerily (00:25:02) close to the combination of mix and transaction. So they're both around negative 3-plus-percent. So – and I think that as our channel shifting stabilizes, Brian, we're likely to just talk about the transaction mix component. It's probably the cleanest number now that we have more standardized and stable transaction mix.

But so I'm not alarmed by that. And in fact I think Michelle would say that in the last three quarters the aberration of the first quarter aside which we're lapping Omicron we're actually seeing some of the better trends on that combination of transaction and mix. So we feel reasonably good about that.

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

A

Yeah. I think obviously, Brian, the macro environment is what it is. But when I look at the combination of transactions and mix and to Michael's point, when you throw aside Q1 because of we were rolling over Omicron which as you know in the entire industry, we saw improved transactions.

We've actually seen improved combined transactions and mix going back to Q2 of last year and then going into Q2 of this year. So to Michael's point, I think we like where those trends are going and we like the fact that when we look at the underlying metrics of the business which Michael mentioned, guest satisfaction scores, order, accuracy, speed of service, value perception, those all look really good, which for us is a leading indicator. So we feel good about the business.

And then on the pricing front, yes, we have made no decisions on what we're going to do the remainder of the year. We do know that we have about 3.4% pricing that's going to drop off at the beginning of Q4 in October. And so we have made no decisions on what we're going to do there. But as I mentioned, we'll remain flexible in our decisions.

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

A

Yeah. And Michelle alluded to this, Brian, but I think it's worth reiterating. We feel really good about where we are on pricing with the consumer and with vis-a-vis our competition.

We're still getting some of our best guest satisfaction metric scores we've ever gotten in terms of total guest satisfaction, speed of service, accuracy and very importantly, we're getting great scores on value perception. So that's really important.

And we're constantly monitoring how our most popular bundles compare with competitors' most popular bundles in a suite of six, seven different high quality fast casual restaurant chains we're anywhere from $1 to $6, $7 less than their most popular bundles.

So we feel great about where we're priced. And if needs be, we feel like we still have pricing power that we – I prefer not to take, but if we have to take because of commodity or labor increases we're well-positioned to do that.

Brian H. Mullan
Analyst, Piper Sandler & Co.

Q

Thank you very much.

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

A

You bet.

Operator: And the next question comes from the line of Sara Senatore with Bank of America. Please proceed with your question.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Hey. Thank you. A couple of follow-ups, if I may. The first on the wage investments, just trying to understand, were those unexpected or rather just decided on more recently as opposed to maybe at the beginning of the year versus just being consistent with the kind of continuous overtime increases, merit raises, things like that. And if so, what may have prompted the decision to make some of those labor investments? So that's the first question, and I have one more, please.

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

A

Sara, no, those are always contemplated. The timing of it was a little up in the air and it was a little bit more complicated to roll out than maybe some previous years. We – as minimum wages have continued to increase across the country we saw a tightening of wage differences between our veterans and some of the newer team members.

And we wanted to make sure that we were taking good care of our veterans. And so we went through a relatively thoughtful process of allocating the wage dollars, so that veterans who've been with us for 10, 15, 20 years were getting an appropriate raise. And that – they tend to be very productive, great team members, flexible, et cetera. So that's all it was.

And so, it's not a standard, spread like peanut butter x percentage increase across the board. Some people saw double-digit wage percent increase. Some people saw, low-single digit. And it just took a little bit of time to implement and communicate to the field.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Got it. Thank you. And then I just want to clarify what you were saying about the mix plus transactions. So both of those numbers, I think were negative this quarter. To your point, 1Q is maybe exceptional in the sense of Omicron. But in the context of those, I guess entrée declines or however you want to characterize it that 9.9% pricing, you talked about the relative value still being very strong.

But do you see anything that would suggest that, as your pricing is a little bit higher though that negative entrée account also gets more negative? I'm just kind of trying to understand the dynamic between price, and then potentially losing some of those entrées.

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

A

Yeah. I think, Michael mentioned this, Sara. As we continue to look at our value scores, right, we continue to see those, be it multiyear highs and benchmarking the bundles. And so I look at those as, do we see a sign of pushback and guest satisfaction scores, those value perception scores? We're not seeing that pushback and we monitor pricing and what other brands are doing. And there is a lot of brands too, that are carrying over a decent amount of price.

So I don't feel like we're out of line in terms of how we're approaching pricing from that respect. And we've talked about, as we've seen the mix component, which is generally lower items per transaction, lower attachment to some of the orders. You know, we continue to see that in the sites category. I'd say when you look at fries, cheese sauce, things of that nature that's where we continue to see some of the impacts, I would say, of the macro environment, more so than our pricing action.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. Okay.

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

A

And I think underlying your question, Sara, is are we concerned? I mean, I don't want to sound glib, but when we look at the underlying trends of our business, we look at guest satisfaction, we look at the execution and how we're doing it. Everything that we look at from – everything that would be a leading indicator of our business gives us a lot of confidence that we're on a good path.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Got it. Thank you very much.

Operator: And the next question comes from the line of Gregory Francfort with Guggenheim. Please proceed with your question.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Hey. Thanks for the question. I've got a couple. The first one is just – I know that you guys have – it's a little smoother than this in terms of the classes, but you guys are going to open up, I think, 11 or 12 restaurants this year. How much is that dragging margins this year versus last year and maybe versus what might be more steady state like 10%, 11%, 12% unit growth?

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

A

Yeah. I don't think we actually talk about that number, Greg. I mean, it's a great question. It's like we have – and you're right, by the way, the number I think with four hangover from the Class of 2022 and the eight from this class. So we will have opened 12 this year, which is a very high number for us. And obviously, right, when you open a brand new restaurant the first six to nine months, they tend to be lower margin than a steady-state restaurant, especially when you look at our margins, in general.

So there does tend to be a little bit of a margin drag. We're just not seeing it as much as we have historically. A lot of that is because they're overachieving on revenue, but a lot of that is also because we are executing just better in how we open, what we do, how much support we need to provide, and how quickly these restaurants get up to a steady state. So I don't think we've quantified that number.

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

A

No, we have not.

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

A

Michelle shaking her head vigorously, so don't try. But there's an undeniable margin drag with new restaurants in the first, call it, 6 to 12 months of their existence but it's not as bad as we had thought.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Okay. Great. Thanks. And maybe just – can you just update us on where turnover stands, what you're seeing in the labor market or how else you want to frame it? But what's the [ph] fix (00:33:57) look like on that?

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

A

Yeah. Look – if you look at us especially versus black box and the competition, we're continuing to perform exceptionally well. We're probably 20 percentage points, 30 percentage points better versus everybody else from an hourly standpoint. And we're probably another 15 percentage points better on a management standpoint. Obviously, look, you get it, right. There's clear, hard costs associated with elevated turnover. You're spending money to hire new people, et cetera.

But there's probably even more soft costs like lost productivity, just people who aren't quite aligned with how we're doing things. They don't know when to help out each other. So improving turnover continues to be a very important tactic for us. Maintaining a highly engaged, happy workforce is a huge initiative for us. And we'll continue to work very, very hard to make sure we're doing that.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Got it. And maybe the last one for me is just, Michael, I think you're opening up another small box like Joliet. I think it's later this year. Can you talk about....

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

A

Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

...what you might be changing in the format and is a square footage smaller, drive-thru any different, just what changes you're taking from Joliet to the new box? Thanks.

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

A

Yeah. Yeah. The new one is at Rosemont, Illinois, which is just outside O'Hare. It's a dining and hotel corridor. It's right near where all the car services park for O'Hare. We're in front of a large hotel. So it's a great location. We're super excited about it. Joliet, as I think I have mentioned before, we would describe as a fantastic success. It's exceeding our expectations but being continuous improvement kind of people, we identified everything that we didn't love about Joliet build, we probably over built it. We probably did not have enough room for people coming in to pick up the food themselves, who wanted to walk inside. So we've tweaked it. It's a smaller kitchen, it's a smaller footprint. We're still going to have a very, very attractive, easy-to-access drive-through. It should cost a little bit less to build and it should still generate plus-sized revenues, so we're super excited about it, Greg. I think it's a version 2.0 of the Portillo's pickup.

I have no doubt that we will make – it will be much better than Joliet in terms of functionality and operational ease, but I have no doubt that version 3.0 will be better still. And then I think we might be at a place where we can mass produce them.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Thank you.

Operator: And the next question comes from the line of Chris O'Cull with Stifel. Please proceed with your question.

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

Q

Hi, guys. And thanks for taking the question. I had a follow-up question related to cannibalization and then a question on development strategy. And I apologize if I missed this, but is the level of cannibalization in line with the company's projections when they selected the site?

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

A

Yes. Yeah, Chris. Those are in line.

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

Q

Okay. Yeah.

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

A

And we knew as we put Schererville, Indiana in place. We knew as we put Gilbert in place, there was going to be a little bit of cannibalization and that's what we're seeing there. And which is why we've kind of introduced this concept and we've talked about this before, but I wanted to make sure as we have three Illinois restaurants coming online later this year that you all understand that, yes, we do expect some level of cannibalization.

However, to Michael's point before, the incrementality of the revenue that we're going to generate clearly is well worth that and we're very comfortable with that and it was absolutely expected.

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

Q

Okay. And then, Michael, I'm wondering if the success of the recent new openings in these high-profile locations that obviously costs more to build but drive higher volumes has caused you to reconsider, rethink the company's development strategy. I'm just wondering if – I mean, it doesn't seem like building brand awareness with backfilling is really necessary, which may allow you to, I guess, pursue more new markets sooner.

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

A

I think that's a great challenge for us. I mean, here's the flip side of that. There is an undeniable benefit to our business when we achieve local scale. So getting to six, seven, eight restaurants in a metropolitan area, you just see the benefit on the bottom line. We've shared that example, particularly with Arizona, where going from two to four restaurants improved by...

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

A

370 basis points.

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

A

Yeah. Just going, Chris, two to four restaurants, we improved margins 370 basis points in Arizona. So for us, there's an undeniable benefit to getting to density and to scale in markets. There's also a challenge when you're opening in a new market, it does – the first in a new market is a particularly challenging operational move to open, to execute, et cetera. And so, we're huge believers in de-risking how we invest money and making sure that those investments work out really well. So our cadence is essentially one new market every year.

You know, this year was Dallas. I love the fact that we built The Colony. It's doing exceptionally well. We have three more coming online in the second half of the year here in DFW. Feel great about that. I think we've openly said that next year we're going into Houston. It's still Texas, but Houston is a very different market geographically, pretty far away, requires different level of resource, et cetera.

And so I think that it's very viable for us to keep building, entering one, maybe two new markets in a given year and achieve density quickly so that both from a revenue and margin profile, those restaurants get to our very high internal expectations as soon as possible.

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

Q

Okay. And just lastly, and I think one of the benefits of having several sales channels would be the opportunity to raise menu prices in different channels. And I'm just curious if you could kind of share with us what the in-restaurant or drive-thru restaurant pricing is. I'm just wondering if you're taking more pricing maybe in catering or other channels that may be less sensitive to price changes?

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

A

Yeah. It's a great question. And so when we do pricing – I think that's a great question, let me explain how we do pricing. First of all, we have number of pricing tiers. We got eight different pricing tiers and those pricing tiers are a reflection of what that local market cost structure is. So if a municipality has, say, minimum wages at $15, $16 an hour, it's going to have a different cost. That's a different cost structure for us than municipalities that might have different minimum wages. So we price differently there.

When we do price, we don't price like peanut butter and spread, the 3% we did in May wasn't 3% across the board. We go and get it and we look very carefully by channel and by item for where we can price effectively. So we might price in one situation. Recently, we just priced catering and third-party delivery.

We said that, look, there's a big gap between where we are from catering standpoint and how we price via third-party delivery. We're going to price those two to get our X percentage of pricing. We're not pricing the in-restaurant experience. So we're very thoughtful and careful about how to get the pricing we need and to look at it both by mix, by channel, by product line to generate that pricing. And what we think is the least transaction impactful way. Did that make sense?

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

Q

It did. Thanks. That helped.

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

A

You bet.

Operator: And the next question comes from the line of Dennis Geiger with UBS. Please proceed with your question.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Thank you, and good morning, Michael and Michelle. I want to start off with one question, higher level, and I know you've spent a lot of time sort of addressing this. But, Michael, if you could kind of speak a bit more to some of the learnings from new openings over the last several years and how much better or more efficient those openings have been given sort of the strength of, let's call it, a reasonably new team ramping up on the brand, et cetera.

Just how much better, as you've observed it that the team has gotten and sort of maybe what that means on the go forward, just kind of adding to your confidence in the development story, even adjustments to make the story even better. Just at a high level, if there's anything extra to add as we think about that impact on the development story?

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

A

Yeah. Great question, Dennis. Let me – I mean, I'll tell you a couple of things that will probably sound like motherhood and apple pie, but the first one is we only open new restaurants now with an experienced Portillo's' general manager and that's a big deal, right. So the eight restaurants we're opening this year, all experienced Portillo's' GMs. The ones we're targeting for 2024, all experienced Portillo's' GMs.

Those GMs know how Portillo's is supposed to function. We had the benefit that everyone of the restaurants we're opening this year also has an experienced assistant general manager. And I think 60%, 70% of the other managers, our typical restaurant has a general manager and assistant general manager, and a typical one has about five or six managers. 60% to 70% of them are also experienced Portillo's people.

That is huge because you're not going to – you're not going to be able to move around hourly team members to run new restaurants, but you can have leadership there who knows what a Portillo's is supposed to look like, how it supposed to operate, they understand what our culture is supposed to be, and those are the things that make a smooth running operation.

So I would tell you that the single biggest thing to de-risk an opening is to have experienced leadership in those restaurants. And we now have – we've worked really hard from a people pipeline to have a pipeline of talent that we know, people that we know want to be promoted. We're training them. We have the training programs in place.

So we've done – there's just been a lot of heavy lifting over many – over the last two or three years really to get us in that position. So that's one big thing.

We've learned to train folks on speed when, you know, if you've worked in another fast casual setting or a QSR setting, you know, a very, very busy hour might be $2,000, $3,000 an hour. Well, at a Portillo's, you'll do $6,000, $7,000 lunch hour frequently.

And so we train people on how to handle volume and speed and not buckle under the pressure. That's been a light change difference in how our teams react to business, how they can handle it. They don't – they don't get freaked out. People don't get burned out as quickly and it's a big deal.

And then, we've done a ton of other little things that I would describe. Our NRO, we've invested heavily in new restaurant opening teams. We can theoretically now open three restaurants simultaneously and we have bandwidth with NRO to open, geez, 30-plus restaurants if we needed to. That's a big investment to make sure that we have a world-class team that can parachute in, open a restaurant and then move on to the next one as quickly as possible.

So I think I would give you those are a few of the examples of things that de-risk an opening, make it much more likely to be successful, and then – and make sure that we're doing things in a very sustainable fashion. Those – that first three months that, you get a lot of first-time guests and you get one chance to win them over, so it's really important to execute well those first three months.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Very helpful, Michael. I appreciate that. Then, Michelle, curious, again, sort of at a high level, anything additional you could add sort of on the net effect of some of the margin pressures that you spoke to with respect to wage and some of the new opening dynamics relative to pricing expected, pricing that could potentially come. Just framing up maybe kind of full year, how your expectations on margins have changed? Obviously, we can roughly do the math to some extent, but without putting numbers on it, is there relative to the last quarter anything sort of net that you could speak to high level on change and how you think about margins this year versus the prior quarter?

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

A

Yeah. I think, Dennis, really, when I think about the commodity outlook, it's coming in roughly where we thought it was, right? We're still planning that mid-single digits. I think as we look at labor, I mentioned still for the full year, we're expecting mid-single digits on labor inflation for the full year.

So I wouldn't say there's a change in my outlook in the back half of the year at all. What I would say is we don't know what we don't know in terms of some of the outlooks on the commodities. As I mentioned, we are 64%

locked in the back half of the year, but we're still floating with some items there. So we still got some exposure there.

And Michael said it, too. Look, we don't want to have – we don't want to take price again this year, but we're not going to be a firm, just say we're not going to because we need to have that flexibility to pull that lever as those input costs move.

And so, with the wage environment, I think we have a fairly good outlook on what's going to happen the rest of the year. But, there's still a little bit of unknown if markets start to move. But, no, I would say there's no change to my outlook in the back half of the year versus sitting here during the first quarter discussions.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Very, very helpful. One more, if I may, please. You commented on the strength in the satisfaction scores across a whole bunch of metrics which is encouraging. I think as – and you kind of commented on the number of items per order changing, it is really maybe one of the only observed changes in customer behavior. But any other behavior changes, whether it's daypart, day of the week, off-premise versus on-delivery, anything else there that's changed, that's been an interesting observation? Appreciate the questions.

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

A

No, nothing that I would call out, Dennis. I think just what I called out before is we're still seeing the lower items per transaction. And when we look at – again, Michael mentioned, when we look at the combined metric of transactions and mix, we feel comfortable with where we're at, especially when we look at the industry and we compare to black box and our performance there versus the industry as a whole. I think we feel very good about that. So no, nothing I would call out.

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

A

I would just reiterate what Michelle said, but be a little bit more specific that it does seem like channels have really stabilized over the last six months for us. So our channel mix of drive-thru, inside, delivery, catering, et cetera, et cetera, has had very, very little movement over the last six months. It seems like we're at some level of new normal.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Great. Thank you, guys.

Operator: And the next question comes from the line of David Tarantino with Baird. Please proceed with your question.

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

Q

Hi. Good morning. A couple of questions here. First, Michelle, as we think about building our models for the second half of the year and really I think we know your pricing contribution would be if you didn't take anymore.

But what I'm really asking about here is on the traffic and mix component, is there anything unusual to think about for the back half of the year relative to maybe the most recent quarter that we should factor in when we're making our assumptions for those metrics?

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

A

Yeah, David. I'd say, you know, from a pricing standpoint, we were – based on the timing of when we took pricing in Q2, we were a little bit higher, so we were at the 9.9x, expect Q3 to be around 9-ish percent price versus the 9.9 we saw in Q2.

And then I'd say when I look at the trends, I will just tell you, you know, again, Q1 aside, but when I look at the combined transaction mix trends, Q4 of 2022, we were at just over 4%, so 4.2% in Q2. The numbers we just released today were at 3.9%. So, call it, 4-ish percent when you combine those two.

I don't really see any changes in the back half of the year to those trends. I don't see the environment all of a sudden getting extremely better. And so to me, I don't expect a material change in those trends that we've been seeing on those two line items combined. So that's how I would think about it, David. And then you already know the pricing component.

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

Q

Yeah. Great. That's very helpful. And then, Michael, just maybe a question on development. It seems like last year was extremely back-loaded and you had some slippage into this year. And this year, again, is very back-loaded in terms of when the openings occur.

I guess, is 2024 going to be similarly back-loaded? Or I know you'd ideally like to have it a little more evenly spread across the year. So any update on the progress to getting it more even-loaded?

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

A

Yeah. It is – it's not fun to be this back-loaded, so I'm not going to lie about that. We have a much better pipeline for 2024 than we did this time last year for 2023 or this time two years ago for 2022. So we're much, much better in terms of the pipeline of deals that we're actively working and finalizing.

We have more signed deals for 2024 right now than – we have – we're way ahead of the game. But 2024 will still not be perfect in terms of timing. It'll still – we'll definitely have more in the front half of 2024 than we did this year or in 2022.

But my hope is that by 2025 is when we will see – you know, ideally, you know, my perspective, I prefer not to open any new restaurants in November and December. I prefer to open all of our new restaurants in the first 10 periods of the year. November, December seasonally for us are very, very busy. It's just extra heavy lifting to open them in November and December. So that's my goal is that by 2025 we're not doing that. Undoubtedly, we'll still have some second half openings in the class of 2024. But my fervent hope is that it's a lot better than what it is this year.

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

Q

Great. Thank you.

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

A

You bet, David.

Operator: And the next question comes from the line of Brian Harbour with Morgan Stanley. Please proceed with your question.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Thanks. Good morning, guys. Could you just comment on the food side, what's primarily locked? And I guess more generally, do you think there'd be similar kind of improvement in food cost in the second half or maybe in fact better?

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

A

Yeah, Brian. So most of what we have locked is going to be on our beef flats and on that beef line item in the back half of the year. We have some locks and some other smaller line items.

But as you know, beef is 30-plus percent of our overall basket. So most of the locks are going to come in, in that form. We've taken some positions on the flats into Q1 of 2024, but for the back half of the year, it's mostly on that line item.

And so, as I mentioned, 64% the rest of the year and so we're feeling good about where we sit there. And when I look at the trend, you can – as you know, Q1, our inflation on commodities was up 8.9%. We saw that tapered down to 5.5% in Q2.

I expect a little bit of tapering down from what we saw in Q2 in the back half of the year. But, to get us to that mid-single digit. So I do expect a little bit of tapering in the back half versus what we saw in Q2 to get us to the mid-single digits for the full year.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Got it. Thanks. Just in terms of the kind of margin impact of new stores, is there less of a drag from Chicago stores versus some of the other markets?

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

A

Yeah. And it's a great point. It's – the Chicago stores just opened up with very high revenues and the margin profile – because they're opening up in a place where we already have scale benefit.

So they open up with higher revenues and they open up with better margins. And that's why that little bit of cannibalization is well worth it, because those are not – Chicago restaurants tend to be much less of a margin drag.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thanks.

Operator: Ladies and gentlemen, there are no further questions in the queue. And that concludes the question-and-answer session. That also concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a great day.