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Portillo's, Inc. (PTLO)

Q3 2023 Earnings Call

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Michael Osanloo
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Michelle Hook
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Andy Barish
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David E. Tarantino
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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Portillo's Third 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. Please go ahead.

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

Thank you, operator. Good morning, everyone, and welcome to our fiscal third quarter 2023 earnings call. Our 10-Q earnings press release and supplemental presentation are posted at investors.portillos.com. With me on the call today is Michael Osanloo, President and Chief Executive Officer; and Michelle Hook, Chief Financial Officer.

Any commentary made here about our future results and business conditions are forward-looking statements, which are based on management's current expectations and are not guarantees of future performance. We do not update these forward-looking statements unless required by law. Our 10-K and our quarterly 10-Qs identify 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, which are not an alternative to GAAP measures. Reconciliations of these non-GAAP measures to their most comparable GAAP counterparts are included in this morning's posted materials. 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. Good morning, everyone. Thank you for joining our third quarter 2023 earnings call. We demonstrated excellent operating leverage this quarter as total sales growth of 10.4% translated into restaurant-level EBITDA growth of 22.9%. These results highlight the benefit of our throughput, operational efficiency, and labor utilization even as we continue to expand our restaurant base. Our ability to sustain profitable growth is a key differentiator for Portillo's. The strength of our brand, the consistency of our operations, and the ongoing execution of a disciplined development strategy all support our fantastic business model.

At our Development Day in September, we talked about how profitable unit growth is the key driver for our valuation. We also shared our plans for accelerating that growth and expanding our markets, which we know fans across the country are excited about. In fact, we've already had a great reaction from fans in our new frontiers of Colorado, Nevada, and Georgia. We can confidently play the long game because of the financial strength of our business. It continues to carry us through the ebbs and flows of the current economic environment.

As a growth company, we expect the contributions of our newly opened restaurants to increase that momentum. And in Q3, we can already see the impact of new restaurant development as a countercyclical factor. Revenue contribution from our newly opened restaurants meaningfully drove year-over-year growth. The bulk of that improvement comes from our class of 2022 restaurants, which continue to outperform our underwriting expectations. We're opening and operating our new restaurants incredibly well, and our early read on the class of 2023 is that it will also continue this strong performance.

In the third quarter, same restaurant sales grew 3.9%, despite an industrywide transaction sluggishness. The good news is that we've already seen improvements going into the fourth quarter. Comps will fluctuate as they've always done in this industry. What's different for us now is the growing strength of our development engine. Keep in mind that we entered this year with 72 restaurants and we'll end the year with 84 restaurants. So, investors can count on our self-funded development to drive revenue growth in the near term not just in some far flung future.

Our third quarter restaurant-level margin of 25.1% increased 250 basis points year-over-year. We're also well on track to deliver year-over-year margin expansion for full-year 2023. We're doing this even as we add more restaurants in a single year than we ever have throughout our 60-year history. Again, this is a testament to our profitable business model. We generate enough operating cash flow to self-fund all of the development plans we shared with you several weeks ago and few growth companies can say that.

Speaking of growth, let's talk about what's left for the class of 2023. In Q3, we successfully opened Queen Creek, Arizona and Allen, Texas, both of which feature our more efficient modern kitchen design. And we've since opened in Cicero, Illinois and will open next week in Arlington, Texas. The other four restaurants in the class of 2023 Fort Worth, Texas; Clermont, Florida; Rosemont and Algonquin, Illinois are on track to open in the fourth quarter. As a reminder, we will have opened 12 restaurants this year. Nine of those are in the Sunbelt, four in Texas, three in Arizona, and two in Florida, and we're still growing the Midwest with three in our home state of Illinois.

As we continue to grow, I'd like to thank our amazing team members for bringing Portillo's to life. They're the reason why Portillo's is an experiential brand with a growing fan base. Guests can rely on Portillo's for a delicious meal at a great price point in a vibrant environment. I'm certain that by taking care of our guests our team members make a meaningful impact on driving long-term shareholder value.

So, with that, let me hand it over to Michelle to discuss the quarter's financial performance.

Michelle Hook

Chief Financial Officer, Portillo's, Inc.

Great. Thank you, Michael. In Q3, we continue to see strong top line revenue growth. Revenues were $166.8 million, reflecting an increase of $15.7 million or 10.4% compared to the third 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. New restaurants contributed approximately $11 million to revenue growth in the quarter. Same restaurant sales increased 3.9% during the third quarter, which was attributable to an increase in average check of 7.4%, partially offset by a 3.5% decrease in transactions. Higher check was driven by an average 9.1% increase in menu prices, partially offset by product mix.

As Michael mentioned earlier, we have seen improvements going into the fourth quarter on our combined transactions and mix. We are committed to delivering on our long-term revenue growth targets primarily through new restaurant growth, while continuing to deliver positive comp growth. Food, beverage, and packaging costs as a percentage of revenues decreased to 33.3% in the third quarter of 2023 from 35.3% in the third quarter of 2022. This was primarily due to an increase in our revenue and lower third-party delivery commissions, partially offset by a 3.5% increase in commodity prices. We continue to estimate mid-single digit inflation for the full year.

Labor as a percentage of revenues decreased to 25.5% in the third quarter of 2023 from 25.9% in the third quarter of 2022. This decrease was primarily driven by an increase in our revenue, partially offset by higher labor utilization, incremental investments in our team members, including hourly rate increases and variable based compensation. Hourly labor rates were up 1.9% in the third quarter of 2023 and up 4.8% year-to-date versus the prior-year periods. In the third quarter, we made additional wage investments in our team members and remain committed to providing a compelling compensation and benefits package. We continue to estimate mid-single digit labor inflation for the full year.

Other operating expenses increased $1.7 million or 10% in the third quarter of 2023. This was primarily due to the opening of new restaurants, higher credit card fees as our transition to cashless drive-thrus drove an increase in credit card transactions, as well as an increase in utilities and insurance expenses. Occupancy expenses increased $0.6 million or 7.4%, primarily driven by the opening of new restaurants in 2022 and 2023. As a percentage of revenues, occupancy expenses decreased 0.2% compared to prior year, driven by an increase in our revenue.

Restaurant-level adjusted EBITDA increased 22.9% to $41.9 million in the third quarter of 2023 from $34.1 million in the third quarter of 2022. Restaurant-level adjusted EBITDA margins were 25.1% in the third quarter of 2023 compared to 22.6% in the third quarter of 2022. The improvement of restaurant-level adjusted EBITDA is on top of opening six new restaurants in the first three quarters of 2023, which all have a lower margin profile to start. We believe this improvement was a result of our ongoing efforts to deploy strategic pricing actions, elevate guest experiences, and implement operational efficiencies. The strength of our brand, the consistency of our operations, and the ongoing execution of a disciplined development strategy all drive long-term shareholder value creation. Near term, we do anticipate pressure on restaurant-level adjusted EBITDA margins from the planned openings of six new restaurants in the fourth quarter and the ongoing roll-off of pricing.

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 contribute towards our goal of restaurant-level adjusted EBITDA margin expansion for fiscal 2023. We did have 3.4% of pricing that rolled off in October, which puts us at an effective 5.5% price increase the last few months of this year. We will continue to monitor our cost pressures, the competitive landscape, as well as consumer sentiment to inform our pricing decisions in the coming quarters.

Our G&A expenses increased $0.8 million to 11.3% in the third quarter of 2023 from 12% in the third quarter of 2022. This increase was primarily driven by higher variable-based compensation and an increase in wages and related costs, partially offset by decrease in professional fees and insurance expenses. We are currently estimating G&A to be in the range of $78 million to $80 million for the full fiscal year.

Pre-opening expenses increased $1.6 million to 1.4% in the third quarter of 2023 from 0.5% in the third quarter of 2022. The increase 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 $27.3 million in the third quarter of 2023 versus $21.6 million in the third quarter of 2022, an increase of 26.2%. Below the EBITDA line, interest expense was $6.6 million in the third quarter of 2023, a decrease of $0.5 million from the third quarter of 2022. This decrease was primarily driven by improved lending terms associated with our 2023 term loan and revolver facility. As of the end of Q3, the effective interest rate on the term loan and revolver was 8.5%.

Income tax expense was $2.6 million in the third quarter of 2023, an increase of $1.6 million from the third quarter of 2022. Our effective tax rate for the quarter was 28.6% versus 23.9% in the third quarter of 2022. Our effective tax rate increased versus the third quarter of 2022, primarily driven by an increase in Class A equity ownership, which increases our share of taxable income or loss. We expect the full-year tax rate to be approximately 21% to 23%.

We ended the quarter with $12.9 million in cash. As a reminder, we invest our operating cash flows and available cash into our future by self-funding our new restaurant growth. We currently estimate the CapEx range to be $75 million to $80 million versus the previous range of $70 million to $75 million. We increased this range based on capital being deployed ahead of the 2024 pipeline. Our average net build cost per restaurant remain in the range we disclosed at Development Day in December. 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. And before we open for questions, I just like to reiterate how proud I am of Portillo's, our teams, and all we have to offer. We're a growth company and we continuously earn the right to grow because we manage our core business profitably. Q3 was another quarter with really great margins. Our investors can count on us to deliver on both the top and bottom line to keep funding that growth. This starts with efficient operations which our engaged team members drive every single day. Their dedication and hard work creates a fantastic experience for our guests and keeps them coming back. This is our flywheel and you'll see that it's really starting to spin. We expect our momentum to last long into the future.

And with that, let's open the line for questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] . Our first question comes from Sharon Zackfia with William Blair. Please go ahead.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Hi, good morning. I know you don't normally talk about recent trends, but you did bring it up on the call and I think a lot of others have had to evolve just given kind of what seemed to be a return to more normal seasonality in the quarter. I guess, do you concur that part of the slowdown that you saw in the third quarter was more normal kind of pre-pandemic seasonality or do you think there's something else happening in the business? And as you think about the rebound here in October, how do you think about pricing power value proposition as you look towards 2024?

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

A

Yeah. Good morning, Sharon. Thanks. Great question and yes, we don't normally like to talk and talk about what's going on, but given the context and how everyone else is opined on it, we felt it was appropriate. We are seeing strong momentum across the board in October and I think you're 100% right. We're back to what I think is more of a normal rhythm in the restaurant industry going back to 2019 kind of mindset. Third quarter's always a little bit of a sluggish quarter for the restaurant industry and typically we come roaring back in the fourth quarter. So, we're seeing a much more consistent pattern with the past. So, we're happy about that and we feel very optimistic for our fourth quarter.

With regards to the second part of your question, look, we feel – we are very, very, I guess, astute on monitoring our pricing versus all of our competitors. We look at our typical basket versus everybody else. We compare ourselves to not just fast casual, but QSR and sort of the best of QSR. And we feel we have a very strong price position, but we're also a little cautious and we're going to play it by year, where we forewent, I guess, any pricing in October. As Michelle indicated, we're going to have a 2% pricing that we're going to lap off of in January and we're still evaluating whether or not we do anything there. We feel we can, that's not the issue. But we really do want to protect our price position and be a really great value for our guests. So, that's the balancing act for us.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Thanks. And I guess, I don't want to [indiscernible] (00:17:58) the point, but I hear all the time from investors like, how does Portillo's stack up as a long-term investment if traffic is slightly negative, which has been for a couple of quarters. So, it would be great if you could help contextualize maybe what's happening in traffic and I know you're burdened by this big Chicago base where you got kind of declining population. But if you could help frame kind of why the optimism on the long term when investors look at the near term and they think, well, what's the consumer saying with that traffic number?

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

A

Yeah. I think you actually said it well and thank you for teeing up the answer. But, look, the Midwest and particularly in Chicago, we're in a negative population state, right? So, as population declines, that makes transaction growth very, very challenging. You effectively have to steal share from other people. As I enumerated, the bulk of our growth is Texas, Florida, Arizona, all states with significant population growth. And so, we are putting ourselves in a position where, just from a transaction standpoint, it's almost transaction arbitrage. We are repurposing capital to states with transaction tailwind and we will be a beneficiary of that along with all the other restaurant companies that are in those markets.

What we like to think is that in Chicagoland and in the Midwest, we can fight the negative macro trends with the strength of our brand and steal share where appropriate. But in these growth markets where we're repotting ourselves and putting all of our capital, we can rise with the rest of the tide there. So, that's the play for us. That play is going to have some quarterly fluctuation. We're not frankly too talked up about that. But over the quarters, the years, we're very confident in Portillo's transaction strength, in Portillo's traffic strength, in Portillo's comp strength, and especially our margin strength.

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

Sharon, I'll just jump in for a minute and reiterate our long-term growth algorithm right of that low-single digit comp growth and the revenue growth that we're going to generate from the new units, as we talked about on the call, that's really going to drive that revenue growth as we go forward. And we're definitely not saying, I know how important comp is. And, as Michael said in his prepared remarks, that will ebb and flow. But that new unit growth and the development that that we see in the pipeline, I think is really going to propel us. And so, I'd say that's definitely the investment thesis for Portillo's.

Sharon Zackfia
Analyst, William Blair & Co. LLC
Q

Yes. Thank you.

Operator: Our next question comes from Andy Barish with Jefferies. Please go ahead.

Andy Barish
Analyst, Jefferies LLC
Q

Hey, good morning, guys. On the labor line, some nice leverage there, again where seasonality maybe goes against you a little bit. I think you quoted the wage increases were only around 2% for the quarter. So, should we read into that the wage investment that you took kind of picked up steam in the latter part of the 3Q? Just trying to drive those comments with the results.

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

No, I think, Andy, you're right. Q3 labor was up 1.9% and we did make the investments in late June, early July in terms of those wage increases and they were normal increases. So, there was nothing with the increases that was out of the ordinary, I call it. And as we go into Q4, I expect that the Q4 inflation rate will be very similar to what we saw in Q3. So, nothing I would call out, Andy, that indicates that Q4 would look any different than Q3 from an inflationary standpoint.

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

Keep in mind, Andy, year-to-date number on wage inflation is 4.8%. So, that's something to just have in your head.

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

A

Yeah. We started to lap, Andy, some of the wage increases that we had given in prior years that started to roll off. And, again, to Michael's point, we're up just under 5% year-to-date. And when you look it even versus 2021, we're up just under 17% and actually up 30% when you go back versus 2020. So, yes, we've made significant investments and labor over the past three years, but we're starting to see that normalize.

Andy Barish
Analyst, Jefferies LLC

Q

Great. And then just with the number of openings in the fourth quarter, any kind of guardrails or guidance on that restaurant-level margin sequentially or year-over-year, I'm assuming it's going to be down sequentially with all those new openings. But anything there that does kind of help us with those six openings in the quarter?

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

A

Yeah. I would say, Andy, when you look at we already said Cicero opened in October and Michael mentioned Arlington's going to open shortly. And then, when you look at the remaining restaurants, those are going to open later in Q4. And so, yes, you get a little bit of impact to the margins, but also the pricing that rolls off to – the 3.4% pricing that rolls off does impact you when you look at that margin picture in Q4 as well. And so, yes, I do expect sequential margin decline Q3 versus Q4. But I do expect when you look at quarter-over-quarter, Q4 2022 versus Q4 2023 of debt margin improvement.

Andy Barish
Analyst, Jefferies LLC

Q

Got it and then just one final one for me. I'm happy to hear about the start to the fourth quarter kind of in line with what we've been hearing from others and seen an industry data. I think last year your catering business kind of really got hurt with the weather and sort of the holiday week. Anything else that we should be aware of just as the fourth quarter unfolds versus year ago...

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

A

Yeah.

Andy Barish
Analyst, Jefferies LLC

Q

...kind of cadence?

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

A

Yeah. Excellent recollection, Andy. We had Winter Storm Elliott, name that will live in infamy for me. But it ruined the Christmas holiday season. It was the week right after Christmas and that's a really big week for us from a catering standpoint. So, it really pulled the rug out from under our catering business. We're hoping for more mild weather, I guess, in the Midwest. So, knock on wood for that. But that that did pull the rug out from underneath us.

And you will recall that this is a unique year in that we have a 53rd week. So, we obviously will report like-for-like numbers 52 week, but we do have a 53rd week, which will create a little bit of extra kind of momentum for the year.

Andy Barish
Analyst, Jefferies LLC

Q

Thank you.

Operator: Our next question comes from David Tarantino with Baird. Please go ahead.

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

Q

Hi. Good morning, Michael. [indiscernible] (00:25:23) I'm also hoping for more mild weather in the Midwest.

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

A

Amen, David.

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

Q

So, yeah. I had a couple of questions. One is on the October order trend that you referenced, I was hoping maybe you could give us some sense of magnitude of the improvement from what you saw in the third quarter, just so that we're all on the same page here.

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

A

Michelle is giving me a dirty look as is my IR person. Let's just say that we're definitely into the positive territory in terms of transactions, and I think that's all I can say right now. So, we're very optimistic about that. We've also – we're also – in part of that G&A spend, we spent a little bit of money on advertising in Chicagoland. And if you're an unfortunate Bears fan and you've been watching Bears games or Monday Night Football or the World Series, you will have seen some Portillo's advertising. And whenever we do brand-enhancing marketing like that, it tends to have a positive impact for us. And so, we've seen a little bit of that and I wouldn't be surprised if that continues to drive some momentum into the fourth quarter. So, we're optimistic and I think we're pulling some levers to make sure that the traffic trends remain what we have seen.

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

Q

Great. Thank you for that context. The other question I had is on new unit contribution. So, I guess the way we model it, it came in a little light of what we had modeled and it looked...

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

A

Yeah.

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

Q

...like maybe the average weekly sales for the new units was a little lower than what you saw in prior quarters. So, I just wanted to understand that dynamic and whether it might be related to kind of coming off some of the honeymoons in the early part of...

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

A

Yeah.

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

Q

...the year or if there's something else going on?

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

A

I would encourage you to double check your models and adjust timing because I think that it depending on if you assume the mid-quarter convention for each new unit, we honestly didn't do that. Most of our units are opening up towards the end of each quarter. And like the ones in the fourth quarter, you should be modeling them late in the fourth quarter. Obviously, we're already into the fourth quarter, but it's not a function of they're coming in softer. It's a function of when they're opening and when you model them within a quarter.

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

Q

Perfect. And any comment, Michael, on the second Texas location, how that's opened so far?

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

A

We're very happy with Allen. We're very happy with Allen. We're very happy with Allen. I think Arlington is going to be – I mean, we're super excited about Texas. I'm eager to get Arlington open. It's a beautiful restaurant. The team is chomping at the bit. And then, we've got Fort Worth coming in shortly after that and we already pre-announced Denton early 2024. So, I'm excited to get to five restaurants in the state of Texas in Dallas Metro within 12 months, which is for us – for us, that's an audacious task that we just took on and accomplished.

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

Q

Great. Thank you very much.

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

A

Thank you, David.

Operator: Our next question comes from Chris O'Cull with Stifel. Please go ahead.

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

Q

Thanks. Good morning, guys.

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

A

Good morning, Chris.

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

Q

Good morning. Michael, the industry has started to get more promotional. I think you mentioned incremental advertising here recently, but what other initiatives can the company take to keep traffic flat to positive if it needs to?

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

A

Yeah. So, I want to [indiscernible] (00:29:10) with one thing. So, the industry's gotten promotional, Portillo's does not get promotional. We don't discount. So, you're not going to see a dollar menu, we're not going to do shrinkflation, that's just not who we are. I support when we do brand-enhancing activities, just a reminder of who Portillo's is and our marketing is showing pictures of our food, right? Because it's craveable, it's delicious, it's a reminder of why people love Portillo's. I think our team did an amazingly creative job with the existing advertising, which is the sounds of Portillo's hearing sort of the crunch of the onion rings as they fall onto your plate, things like that. So, it's brilliant – it's brilliant brand-enhancing advertising, and we're seeing the impact of all of the macro trends, Chris. So, our dining rooms are really full and that's because I think that with price points where they are in casual dining we are a refuge from that. We have fantastic food and a beautiful environment and it's working really well for us.

Our drive-thrus did get a little slowdown in Q3 and that's because of exactly what you're describing, some very aggressive discounting activities by QSR, which, again, we don't discount. And so, there's going to be a shopper that chooses to go get a $1 burger or a $2 burger versus our burger. And when economy gets better, they'll come back to us or when they want to sit down with their family, they'll come into our dining rooms. And so, I think we just ride that ebb and flow a little bit. We're happy with where we're positioned. We're not going to promote, we're not going to discount. But we are going to remind people of how delicious our food is and how craveable it is in a brand-enhancing way.

The other lever for us to pull is excellent execution. One of the things that I don't think people talk about, because it's not a short-term fix, it's a medium and long-term fix is when you give great experiences to guests every single day, that's the number one reason why they choose to go back to a restaurant. It's not because of a coupon or a discount or something, but it's because when I went there I had a great experience and I want to go back. And so, that's another way that you can differentiate yourself over the medium and long term and drive consistent traffic by just being operationally sound and that is our mantra internally. We're going to be the most operationally sound restaurant company we can be and that will drive performance.

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

Q

Okay, that's fair. And then, the margin performance was clearly impressive this quarter. And I'm just wondering whether there's – whether you think there may be an opportunity to give back some of that margin improvement to enhance the value proposition, either through changes to some of the menu items or...

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

A

Yeah.

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

Q

...maybe something else that you think can maybe improve value.

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

A

Yeah. I think that's a great – another great question. It's one of the reasons why we decided to forego any pricing for the remainder of this year. And that's essentially where our pricing is coming down to 5.5% and that's one way of giving value back. We did not engage in any shrinkflation lowering quality doing anything like that over the last couple of years. In fact, what we've done is we've added value, right? We spend more money on bacon. We have, I think, the best bacon in the in the restaurant industry that we're selling right now. So, if you try our – bacon burgers are amazing and we've consistently done that. We've added quality and so that's the other thing that we do is, I'd rather in terms of reducing prices, getting to some sort of lower value, lower cost meal, we'd rather just improve the other aspects of value. We'd rather improve the quality of what you're getting, we'd rather improve the quantity of what you're getting, we'd rather improve your experience and then maintain prices as opposed to raising prices.

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

Q

Okay. Thank you.

Operator: Our next question comes from Dennis Geiger with UBS. Please go ahead.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Great. Thanks. Good morning, guys. Wanted to ask if anything additional to highlight on the sort of observed customer behavior changes perhaps, whether it's dayparts, days of the week, off premise versus on, delivery, anything discernible over the last several months there, Michael or Michelle you would call out.

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

A

I think we're largely in some ways our channel mix is very stable. Unsurprisingly, our drive-thrus have a little bit of pressure on them given the promotional activity in QSR, and our dining rooms have a little bit of extra momentum given the pressures that casual dining is facing. And so, it's – for us, it's a really nice dynamic. The other thing that frankly surprises all of us every day we look at is that our third-party delivery partners are still doing a really good job with us. We continue to grow third-party delivery and that is great news. It's also a little bit mystifying given consumer pressures out there. But we feel really confident with where we are right now.

Dennis Geiger
Analyst, UBS Securities LLC

Q

That's great. Thanks, Michael. And then just one maybe two-part question. First, I guess maybe I missed this, but as it relates to cannibalization, anything there that you saw in the quarter, even if modest were some worth calling out? And then, the second sort of unrelated part of the question, I know we're just spent a month – a month and a half ago spent some time on development, of course. But any kind of latest update on timing, permitting, et cetera? I assume it's probably steady as she goes since a month and a half ago. But any update there? A lot of folks have been shifting into next year, you guys obviously are going to get these open. So, just curious if anything has shifted with the open environment on some of that timing stuff?

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

A

Yeah. Dennis, I'll take the cannibalization. There's been no changes since we gave the impact last quarter the 60 basis points to 80 basis points. We're seeing roughly the same impact in Q3. So, continues to be fairly insignificant for us. So, we don't expect that to be a significant headwind for us as we move forward. But it was roughly the same as it was in Q2.

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

A

And then with regard to permitting and those things, I don't want to sound too glib, but it's sort of whatever that military acronym is for SNAFU, Situation Normal: All Messed Up. We continue to face delays in all kinds of like last minute things with getting utilities hooked up, et cetera, et cetera. We're just – I think we have reconciled ourselves to this is a new normal. And so, we continue to pad hours and weeks, actually months into the building cycle for us so that we can still control what we can control, build the restaurants as quickly and as adeptly as we can, and then the stuff that you can't control just it build enough cushion so you're not disappointed from budgeting, timelines, et cetera.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Great. Thanks, guys. Appreciate it.

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

A

You bet.

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

A

Thanks, Dennis.

Operator: Our next question comes from Sara Senatore with Bank of America. Please go ahead.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Thank you. Michelle, I wanted to ask you a little bit about the idea of like sort of what flow-through margins should look like. And I think in specifically, you took sort of a fair amount of price, most of the margin expansion seemed to come from food. So, as I think through like labor and occupancy, particularly or other operating, I should say, in the context of maybe additional drags from new units coming on in fourth quarter, do you have any sort of framework for like what's the right comp number to get margin expansion on some of those six lines? And similarly, in the same vein like G& is creeping up a little bit. So, just trying to kind of calibrate incremental revenues or same-store sales versus flow-through margin on the restaurant line and also G&A. And then I'll have one follow-up question.

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

A

Yeah. Sara, I think when you look quarter-over-quarter, I'll talk Q4 2022 versus 2023, right, you hit the nail on the head. I mean, commodities when you look at that and you look at what we're running on that food line for us, I think that's where you see some of the improvement quarter-over-quarter. I think if you're talking sequentially Q3 versus Q4, we do have the pricing rolling off so that's going to be a headwind. And as these new units come on, we talked about – they're coming on later in the quarter, but that does have a bit of an impact when you think about particularly that labor line.

And so, I see the improvement coming year-over-year and quarter-over-quarter, primarily from that commodities line when you look at that. Because I think labor is generally when you look at Q4 2022 versus 2023 will generally be in line. And so, you get the impact of the commodities. But sequentially, I think we'll be impacted with that pricing rolling off.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. Yeah, I was more thinking year-over-year just...

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

A

Yeah.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

...this idea that 3Q versus 3Q, you had some improvement, but...

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

A

Yeah.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

...mostly it seemed from commodity. So, is that sort of the same...

[indiscernible] (00:38:58)

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

A

...Q3 of last year, we were running at about just over 35% versus the 33% this year. And so, I don't expect Q4 of this year to change much sequentially. I think inflation will be very similar to what we saw in Q3 from a commodity standpoint.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. And so, as we think about the complexion of margin, year-over-year 4Q should look similar to 3Q in the sense of most of the tailwind coming from the commodities?

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

A

Correct.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. And then even with perhaps better transaction trends.

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

A

As Michael mentioned in October, we are seeing better trends. And I said in my prepared remarks, when we look at transactions mix combined, yes, we're seeing improved trends versus what we saw in Q3.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Right, but still thinking about the margin construct similarly even though trends, okay...

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

A

Yeah.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

And I'll [indiscernible] (00:39:55).

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

A

Yeah.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. And then just again on G&A sort of thinking through that increase, how should sort of I think about sort of your – the variable comp in terms of when we think about your long-term algorithm? Should we think about your sort of internal goals as consistent with that so that as we're trying to sort of think about where there might be upside in terms of variable comp, it should look sort of similar to what you've articulated at your long-term growth targets?

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

A

Yeah, correct. As you know, long term we're targeting 75% of that revenue growth rate. As we think about and you think about modeling G&A in the future, absolutely. That's how we think about it internally. For the fourth quarter, we increased the range. I think Michael mentioned the incremental dollars we're spending on advertising in the fourth quarter within our just our core market of Chicagoland where we have scale. We think that to definitely I think to Chris' earlier one of the levers that we can pull as we're in this, as Michael mentioned, that sluggish environment in a market that we upscale like our market of Chicago, we can pull that lever, Sara. And that's where we're seeing the increase in the investment that we made in G&A. And that's why you're seeing that range go up in particular in for the full year why we raised that range.

Sara H. Senatore
Analyst, BofA Securities, Inc.

Q

Okay. Got it. Thank you.

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

A

Yeah.

Operator: Our next question comes from Gregory Francfort with Guggenheim. Please go ahead.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Hey, thanks. I just had a couple of quick ones. The first is, I know you guys have not historically wanted to comment a lot about trends regionally, but just given the traffic declines, I'm curious any big differences between either Chicago and non-Chicago or regional things to call out?

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

A

No, I mean – Greg, first, good morning. I wouldn't say so. I think that we obviously look – we look very carefully at our traffic trends and transaction trends and we use black box. We compare ourselves within Chicagoland and not Chicagoland. And I would tell you overall the trends are pretty consistent and the improvements are pretty consistent. So, I don't think there's anything idiosyncratic there with our...

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Got it. And then...

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

A

...performance versus market. Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Okay. Got it. And then just we've seen a few companies start to talk about 2024 labor inflation in the...

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

A

Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

...mid-single digit range. I think it's interesting that you guys are running sort of below that. I don't know if that's something to do with either where you are regionally or I'm just curious if you kind of think that that's – I know it might be a little bit early if that's something that would be consistent with what you guys would expect or...

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

A

Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

...if you guys might be able to run below that next year.

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

A

So, a couple of thoughts. Keep in mind that our labor inflation year-to-date is 4.8%, right? So, that's where we are. And I'll let Michelle talk about what's going to happen going forward. But there's – it's – so there's a whole bunch of noise in this. So, our overall labor is negatively affected by wage inflation. It's kind of a mixed news on our staffing is really good right now, where we are much better staffed than we were last year, which is a good news and a bad news.

The good news is it means our guests are getting great experiences, our restaurants are fully staffed, we can handle volume. The bad news is it puts a little bit of pressure on the labor line because it means you're spending more money. It pays off over time. So, it's a no-brainer to do that. And then, the really positive news and I'm very proud of our ops team is we continue get appropriate labor leverage in operational efficiencies. I made kind of a big deal about we've got a new kitchen design in Queen Creek and Allen, Texas. That new kitchen design is meant to reduce wasted effort. And by wasted effort I mean needless conveyance, people walking 50 feet to go get something when there should be a refrigerator bin right by their feet. And so, our kitchens are more efficiently designed, it reduces conveyance. We've gotten smart about reducing prep work, et cetera.

So, it's those three factors, really, Greg, affect labor. Rising rates, how well staffed you are, and then are you getting efficiency by removing effort that is not value added. And so, the net of those is, how we are going to manage our labor line. And I think we can – we're still targeting to offset most of the wage inflation. Michelle, I mean?

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

A

Yeah. Greg, I would just add, as we look at 2024, obviously we're putting those plans together. Nothing that I'm seeing today indicates that we're going to be different than what we saw this year, which when you think about that mid-single digit wage inflation, I don't anticipate us being outside of that range as I sit here today.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Got it. And maybe just one last one. I know this is kind of more model focused than I would like for this call. The last week between Christmas and New Year's, I think it shifts between 1Q and 4Q the coming two quarters.

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

A

Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Is that a big sales volume week for you? And just in terms of right sizing both the impact on 4Q, but also potentially the...

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

A

Yeah.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

...impact on 1Q of next year?

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

A

Yeah. That's generally the week after Christmas. And so, as Michael mentioned, we see a lot of catering leading up to that Christmas time, Greg, as he mentioned. And so, I would say what we saw last year, Michael mentioned Elliott and we saw like an immediate pickup in sales last year right after the year ended in 2022. So, that first week in fiscal 2023, we saw big a pickup. So, as we're lapping that week, that 53rd week, let me just say it, could be year-over-year a little bit pressured because you had the pickup from Elliott last year versus this year, if that makes sense to you. So, long story short, I don't say it's like a huge blowout week for us I think the week prior. When you look at that Christmas Eve, Christmas timing, is a lot of the bigger catering volume that we see.

Gregory Francfort
Analyst, Guggenheim Securities LLC

Q

Understood. Thank you.

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

A

No problem.

Operator: Our next question comes from Brian Harbour with Morgan Stanley. Please go ahead.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Yes, thank you. Good morning.

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

Good morning.

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

Good morning, Brian.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Michelle, just to kind of follow-on those comments about 2024, do you have any kind of early thoughts on commodities next year at this point or even on the beef side, do you think there could be a little less inflation in 2023 or maybe something similar?

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

I don't think beef is going to lighten up, Brian, into next year. So, I think that will still be pressured. I mentioned on the last call we're taking positions into 2024. And so, when we look at the beef flats, we're trying to derisk some of that line item. And we have taken some positions into both Q1 and Q2 of next year to derisk that. But, no, I expect that to continue to be pressured. But when we look at the overall basket, I'll say the same thing I said about labor. As I sit here today, I don't expect to be outside of that mid-single digit range. We'll update you all as we get into the New Year at ICR with what we're seeing for the full 2024 fiscal year. But I'm not seeing anything today that would indicate anything beyond that mid-single digit for 2024 as well on the commodity line.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC
Q

Okay. Yeah, sounds good. Just on four wall margins, I mean, they have been quite strong year-to-date, so you're kind of comfortably higher as you've suggested. Do you think that's mainly influenced by just strong new store openings? Maybe they're kind of ramping a bit quicker than you thought or anything else broadly that you'd characterize has really helped store margins.

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

I want to brag about my team because I will tell you that the labor efficiencies that we've gotten by putting people in the right position and reducing conveyance has been a big help. Otherwise, labor would have been out of control. Michelle and her team have done a brilliant job of forward buying beef and doing other creative things to make sure that we're not as – we're not held hostage to the beef prices. So, we track very carefully where our beef flats are versus the market, and we're really happy with what we're paying versus the market and I give a lot of credit to my team for that.

So, it's a lot of – Brian, it's a lot of pick and shovel work behind the scenes to make sure that those margins are as robust as they are. Absolutely, having great new restaurants that open above your target helps. Undeniably, that helps. But there's a lot of like heavy lifting behind the scenes that goes into maintaining those kind of margins, and our team across the board is doing a great job of protecting our shareholders and funding our growth.

Brian Harbour
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

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

A

Thanks, Brian.

Operator: Our next – sorry, our next question comes from Brian Mullan with Piper Sandler. Please go ahead.

Q

Hi, good morning. This is [indiscernible] (00:49:19) on for Brian. I'm just wondering if you could comment on mix. It looks like it was still negative in the quarter, but it's improved sequentially. I know this negative mix dynamic is not unique to Portillo's, but just wondering if there's been any changes as to what's driving this and what it could look like as we progress into 2024. Thanks.

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

A

Yeah, no problem. Yeah, absolutely we did see improvements to your point in the mix going from negative 2.7% in Q2 to about negative 1.8% in Q3. I think answering to Michael's point, in Q4 we're seeing improvements on both transactions and mix. So, we're seeing some improvements of that into Q4. I'd say nothing's change underlying that in terms of we're still seeing the lower attachment, the less items per transaction, that's the main component of that mix change. So, nothing I would call out that's changed from what we previously discussed on that line item.

Q

Great. Thank you.

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

A

Yeah.

Operator: There are no further questions at this time. So, this concludes today's teleconference. You may disconnect your lines at that time. Thank you for your participation.