

RED ROBIN GOURMET BURGERS INC
Form 10-Q
November 05, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended October 3, 2010

or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number: 0-49916

RED ROBIN GOURMET BURGERS, INC.

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(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

84-1573084

(I.R.S. Employer Identification No.)

6312 S. Fiddler s Green Circle, Suite 200N

Greenwood Village, CO

(Address of principal executive offices)

80111

(Zip Code)

(303) 846-6000

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class
Common Stock, \$0.001 par value per share

Outstanding at November 3, 2010
17,088,079 shares

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****RED ROBIN GOURMET BURGERS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)****(Unaudited)**

| | October 3, 2010 | December 27, 2009 |
|---|----------------------------|------------------------------|
| Assets: | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 11,240 | \$ 20,268 |
| Accounts receivable, net | 5,903 | 4,703 |
| Inventories | 14,901 | 14,526 |
| Prepaid expenses and other current assets | 9,895 | 6,203 |
| Income tax receivable | 2,887 | 4,713 |
| Deferred tax asset | 1,968 | 4,127 |
| Restricted current assets - marketing funds | 6,489 | 665 |
| Total current assets | \$ 53,283 | \$ 55,205 |
| Property and equipment, net | 418,021 | 431,536 |
| Goodwill | 61,769 | 61,769 |
| Intangible assets, net | 44,609 | 47,426 |
| Other assets, net | 4,023 | 4,159 |
| Total assets | \$ 581,705 | \$ 600,095 |
| Liabilities and Stockholders' Equity: | | |
| Current Liabilities: | | |
| Trade accounts payable | \$ 14,379 | \$ 10,891 |
| Construction related payables | 4,447 | 3,181 |
| Accrued payroll and payroll related liabilities | 28,513 | 26,912 |
| Unearned revenue | 5,752 | 15,437 |
| Accrued liabilities | 22,138 | 18,818 |
| Accrued liabilities - marketing funds | 6,489 | 665 |
| Current portion of term loan notes payable | 18,739 | 18,739 |
| Current portion of long-term debt and capital lease obligations | 868 | 779 |
| Total current liabilities | \$ 101,325 | \$ 95,422 |
| Deferred rent | 33,410 | 30,996 |
| Long-term portion of term loan notes payable | 85,214 | 103,954 |
| Other long-term debt and capital lease obligations | 55,949 | 67,862 |
| Other non-current liabilities | 8,152 | 13,239 |
| Total liabilities | \$ 284,050 | \$ 311,473 |

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Stockholders' Equity:

| | | |
|--|------------|------------|
| Common stock; \$0.001 par value: 30,000,000 shares authorized; 17,079,573 and 17,079,267 shares issued; 15,587,293 and 15,586,948 shares outstanding | 17 | 17 |
| Preferred stock, \$0.001 par value: 3,000,000 shares authorized; no shares issued and outstanding | | |
| Treasury stock, 1,492,280 shares, at cost | (50,125) | (50,125) |
| Paid-in capital | 170,710 | 167,637 |
| Accumulated other comprehensive loss, net of tax | (324) | (1,212) |
| Retained earnings | 177,377 | 172,305 |
| Total stockholders' equity | 297,655 | 288,622 |
| Total liabilities and stockholders' equity | \$ 581,705 | \$ 600,095 |

See notes to condensed consolidated financial statements.

Table of Contents**RED ROBIN GOURMET BURGERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(Unaudited)**

| | Twelve Weeks Ended | | Forty Weeks Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Revenues: | | | | |
| Restaurant revenue | \$ 191,612 | \$ 183,878 | \$ 657,094 | \$ 648,436 |
| Franchise royalties and fees | 3,001 | 3,035 | 10,292 | 10,265 |
| Other revenue | 230 | 34 | 4,310 | 147 |
| Total revenues | 194,843 | 186,947 | 671,696 | 658,848 |
| Costs and expenses: | | | | |
| Restaurant operating costs (exclusive of depreciation and amortization shown separately below): | | | | |
| Cost of sales | 46,723 | 42,961 | 160,432 | 156,472 |
| Labor (includes \$211, \$126, \$631, and \$1,249 of stock-based compensation, respectively) | 68,231 | 64,113 | 233,080 | 224,063 |
| Operating | 29,080 | 27,963 | 96,695 | 94,968 |
| Occupancy | 14,074 | 14,434 | 48,361 | 47,836 |
| Depreciation and amortization | 13,341 | 13,112 | 43,777 | 43,815 |
| Selling, general, and administrative (includes \$1,349, \$600, \$3,100, and \$4,942 of stock-based compensation, respectively) | 22,612 | 16,096 | 73,455 | 63,088 |
| Pre-opening costs | 740 | 125 | 1,992 | 3,263 |
| Asset impairment charge | 6,116 | | 6,116 | |
| Total costs and expenses | 200,917 | 178,804 | 663,908 | 633,505 |
| Income (Loss) from operations | (6,074) | 8,143 | 7,788 | 25,343 |
| Other expense (income): | | | | |
| Interest expense, net | 1,099 | 1,321 | 4,241 | 4,994 |
| Other | 7 | 10 | (13) | 29 |
| Total other expenses | 1,106 | 1,331 | 4,228 | 5,023 |
| Income (Loss) before income taxes | (7,180) | 6,812 | 3,560 | 20,320 |
| Income tax (benefit) expense | (2,967) | 1,110 | (1,512) | 4,352 |
| Net income (loss) | \$ (4,213) | \$ 5,702 | \$ 5,072 | \$ 15,968 |
| Earnings (loss) per share: | | | | |
| Basic | \$ (0.27) | \$ 0.37 | \$ 0.33 | \$ 1.04 |
| Diluted | \$ (0.27) | \$ 0.37 | \$ 0.32 | \$ 1.03 |
| Weighted average shares outstanding: | | | | |
| Basic | 15,519 | 15,408 | 15,494 | 15,379 |
| Diluted | 15,519 | 15,535 | 15,668 | 15,488 |

See notes to condensed consolidated financial statements.

Table of Contents**RED ROBIN GOURMET BURGERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

| | Forty Weeks Ended | |
|---|----------------------------|----------------------------|
| | October 3, 2010 | October 4, 2009 |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 5,072 | \$ 15,968 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 43,777 | 43,815 |
| Gift card breakage | (4,165) | |
| Stock-based compensation expense | 2,954 | 6,191 |
| Asset impairment charge | 6,116 | |
| Restaurant closure costs | 89 | 598 |
| Other, net | (3,144) | (3,557) |
| Changes in operating assets and liabilities | 851 | 3,495 |
| Cash provided by operating activities | 51,550 | 66,510 |
| Cash Flows From Investing Activities: | | |
| Changes in marketing fund restricted cash | 824 | |
| Acquisition of franchise restaurants, net of cash acquired | | (1,248) |
| Purchases of property and equipment | (25,793) | (40,776) |
| Cash used in investing activities | (24,970) | (42,024) |
| Cash Flows From Financing Activities: | | |
| Borrowings of long-term debt | 124,100 | 147,900 |
| Payments of long-term debt | (159,631) | (171,815) |
| Payment for tender offer for stock options | | (3,498) |
| Proceeds from exercise of stock options and employee stock purchase plan | 636 | 937 |
| Excess tax benefit related to exercise of stock options | | 155 |
| Payments of other debt and capital lease obligations | (715) | (463) |
| Cash used in financing activities | (35,609) | (26,784) |
| Net change in cash and cash equivalents | (9,028) | (2,298) |
| Cash and cash equivalents, beginning of period | 20,268 | 11,158 |
| Cash and cash equivalents, end of period | \$ 11,240 | \$ 8,860 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Income taxes paid | \$ 725 | \$ 2,103 |
| Interest paid, net of amounts capitalized | 3,802 | 5,089 |
| Purchases of property and equipment on account | 4,447 | 3,181 |

See notes to condensed consolidated financial statements.

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RED ROBIN GOURMET BURGERS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Recent Accounting Pronouncements

Red Robin Gourmet Burgers, Inc. (Red Robin or the Company), a Delaware corporation, develops and operates casual-dining restaurants. At October 3, 2010, the Company operated 312 company-owned restaurants located in 31 states. The Company operates its business as one operating and one reportable segment. The Company also franchises its restaurants, of which there were 134 restaurants in 21 states and two Canadian provinces as of October 3, 2010.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Red Robin and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The Company's financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates included in the preparation of these financial statements pertain to recoverability of long-lived assets, recoverability of goodwill, estimated useful lives of other intangible assets, bonus accruals, self-insurance liabilities, stock-based compensation expense, estimating breakage on unredeemed gift cards, legal contingencies, and income taxes. Actual results could differ from those estimates. The results of operations for any interim period are not necessarily indicative of results for the full year.

The accompanying condensed consolidated financial statements of Red Robin have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in the Company's annual consolidated financial statements on Form 10-K have been condensed or omitted. The condensed consolidated balance sheet as of December 27, 2009, has been derived from the audited consolidated financial statements as of that date, but does not include all disclosures required by generally accepted accounting principles. For further information, please refer to and read these interim condensed consolidated financial statements in conjunction with the Company's audited consolidated financial statements included in the Company's annual report on Form 10-K for the fiscal year ended December 27, 2009.

The Company's quarter which ended October 3, 2010, is referred to as third quarter 2010, or the twelve weeks ended October 3, 2010; the second quarter ended July 11, 2010, is referred to as second quarter 2010, or the twelve weeks ended July 11, 2010; the first quarter ended April 18, 2010, is referred to as first quarter 2010, or the sixteen weeks ended April 18, 2010; and, together the first, second, and third quarters of 2010 are referred to as the forty weeks ended October 3, 2010. The Company's quarter which ended October 4, 2009, is referred to as third quarter 2009, or the twelve weeks ended October 4, 2009; the second quarter ended July 12, 2009, is referred to as second quarter 2009, or the twelve weeks ended July 12, 2009; the first quarter ended April 19, 2009, is referred to as first quarter 2009, or the sixteen weeks ended April 19, 2009; and,

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together the first, second, and third quarters of 2009 are referred to as the forty weeks ended October 4, 2009.

Reclassifications

The following table provides the effects of the reclassification of certain marketing expenses from restaurant operating expenses to the selling, general, and administrative expense category for the twelve and forty weeks ended October 4, 2009. This reclassification has been previously disclosed in the Company's audited consolidated financial statements included in the Company's annual report on Form 10-K for the fiscal year ended December 27, 2009 and had no effect on previously reported net income.

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| (In thousands) | Twelve Weeks Ended October 4, 2009 | | | |
|---|---------------------------------------|------------------|-----------------|--|
| | As Reported | Reclassification | As Presented | |
| Restaurant operating costs | \$ 31,950 | \$ (3,987) | \$ 27,963 | |
| Selling, general, and administrative costs | \$ 12,109 | \$ 3,987 | \$ 16,096 | |

| (In thousands) | Forty Weeks Ended October 4, 2009 | | | |
|---|--------------------------------------|------------------|-----------------|--|
| | As Reported | Reclassification | As Presented | |
| Restaurant operating costs | \$ 106,976 | \$ (12,008) | \$ 94,968 | |
| Selling, general, and administrative costs | \$ 51,080 | \$ 12,008 | \$ 63,088 | |

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued authoritative guidance on the consolidation of variable interest entities (VIE), which was effective beginning fiscal year 2010. The new guidance requires a qualitative approach to identifying a controlling financial interest in a VIE, and it requires ongoing assessment of whether an entity is a VIE and whether an interest in a VIE makes the holder the primary beneficiary of the VIE. This new guidance did not have a material effect on the Company.

In January 2010, the FASB issued an update regarding guidance over the disclosure requirements of fair value measurements. This update adds new requirements for disclosure about transfers into and out of Levels One and Two and also adds additional disclosure requirements about purchases, sales, issuances, and settlements relating to Level Three measurements. The guidance is effective beginning fiscal year 2010 for the disclosure requirements around Levels One and Two measurements, and is effective beginning fiscal year 2011 for the disclosure requirements around Level Three. This new guidance currently has no impact on the fair value disclosures of the Company, as there have been no transfers out of Levels One or Two.

2. Restaurant Impairment and Closures

During the third quarter of fiscal 2010, we determined that four company-owned restaurants were impaired, and, the Company recognized a non-cash impairment charge of \$6.1 million resulting from the continuing and projected losses of these restaurants. We reviewed each restaurant's past and present operating performance combined with projected future results, primarily through projected undiscounted cash flows, which indicated possible impairment. The Company compared the carrying amount of each restaurant to its fair value as estimated by management. The impairment charge represents the excess of each restaurant's carrying amount over its estimated fair value.

The Company closed one restaurant in the first quarter of 2010. The closed location was an older restaurant that management did not believe would provide acceptable returns in the foreseeable future. There was no associated amount of goodwill to write off in connection with this closure. The Company has incurred \$89,000 in expenses related to the restaurant closure for the forty weeks ended October 3, 2010.

The Company closed four restaurants in the first quarter of 2009. There was no associated amount of goodwill to write off in connection with these closures. The Company recognized charges of \$598,000 for the forty weeks ended October 4, 2009, related to lease terminations and other closing related costs for these four restaurants.

3. Stock-Based Compensation

Stock Options

During the twelve weeks ended October 3, 2010, the Company issued 44,000 options with a weighted average grant date fair value of \$9.05 per share and a weighted average exercise price of \$20.03 per share. Compensation expense for these options is recognized over the remaining weighted average vesting period for all options outstanding, which is approximately 1.44 years. The Company issued 36,000 options with a weighted average grant date fair value of \$8.58 per share and a weighted average exercise price of \$19.97 per share during the twelve weeks ended October 4, 2009.

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During the forty weeks ended October 3, 2010, the Company issued 298,000 options with a weighted average grant date fair value of \$9.14 per share and a weighted average exercise price of \$21.45 per share. Compensation expense for these options is recognized over the remaining weighted average vesting period for all options outstanding, which is approximately 1.44 years. The Company issued 402,000 options with a weighted average grant date fair value of \$6.22 per share and a weighted average exercise price of \$15.69 per share during the forty weeks ended October 4, 2009.

The fair value of options at the grant date was estimated utilizing the Black-Scholes multiple option-pricing model with the following weighted average assumptions for the periods presented:

| | Twelve Weeks Ended | | Forty Weeks Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Risk-free interest rate | 1.1% | 1.7% | 1.6% | 1.5% |
| Expected years until exercise | 3.9 | 3.6 | 3.6 | 3.6 |
| Expected stock volatility | 59.9% | 58.2% | 57.6% | 52.9% |
| Dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Weighted-average Black-Scholes fair value per share at date of grant | \$ 9.05 | \$ 8.58 | \$ 9.14 | \$ 6.22 |

In the first quarter of 2009, the Company completed a cash tender offer for out-of-the-money stock options held by approximately 514 then current employees and officers. As a result of the tender offer, the Company incurred a one-time pre-tax charge of approximately \$4.0 million for all unvested eligible options that were tendered. This was reflected as a charge of \$886,000 to labor expense and a charge of \$3.1 million to selling, general, and administrative expense in the first quarter 2009 financial results. It represented the compensation expense related to the acceleration of vesting on the unvested options tendered in the offer, which would otherwise have been expensed over their vesting period in the future if they had not been tendered. The Company paid \$3.5 million for the approximate 1.6 million options tendered in the offer.

Restricted Stock

The Company did not issue any shares of non-vested common stock during the twelve or forty weeks ended October 3, 2010. During the third quarter 2010, the Company's former CEO retired, resulting in an accelerated vesting of 75,000 shares for approximately \$871,000. Compensation expense for the aggregate 27,000 shares of non-vested common stock outstanding at October 3, 2010 is recognized over the remaining weighted average vesting period, which is approximately 1.19 years. The Company issued 34,500 shares of non-vested common stock during the forty weeks ended October 4, 2009. These awards had a weighted average grant date fair value of \$15.28 for the forty weeks ended October 4, 2009, respectively. These awards vest in installments over four years on the anniversary dates.

Time Based RSUs

During the twelve weeks ended October 3, 2010, the Company granted 23,000 restricted stock units (RSUs) to certain non-employee directors and employees under the Amended and Restated 2007 Performance Incentive Plan (the Stock Plan) with a weighted average grant date fair value of \$19.83. The fair value of each RSU granted is equal to the market price of the Company's stock at date of grant. Compensation expense for the RSUs is recognized over the remaining weighted average vesting period for all RSUs outstanding, which is approximately 1.86 years. The

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RSUs granted to employees vest in equal installments over four years on the anniversary date and upon vesting, the Company issues one share of the Company's common stock for each RSU. The RSUs granted to non-employee directors are scheduled to vest in three equal installments on the first, second, and third anniversaries of the date of grant, and the shares underlying the units will be distributed to the reporting person in three equal installments on or following the third, fourth, and fifth anniversaries of the date of grant, unless earlier per the terms of the award agreement. The Company granted 600 RSUs with a weighted average grant date fair value of \$18.99 during the twelve weeks ended October 4, 2009.

During the forty weeks ended October 3, 2010, the Company granted 114,000 RSUs under the 2007 Stock Plan with a weighted average grant date fair value of \$20.83. The RSUs vest in equal installments over four years on the anniversary date and upon vesting, the Company issues one share of the Company's common stock for each RSU. The fair value of each RSU granted is equal to the market price of the Company's stock at date of grant. Compensation expense for the RSUs is recognized over the remaining weighted average vesting period for all RSUs outstanding, which is approximately 1.86 years. The Company granted 38,000 RSUs with a weighted average grant date fair value of \$15.18 during the forty weeks ended October 4, 2009.

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In March and September 2010, the Company granted performance based restricted stock units (PSUs) to executives and other key employees. These PSUs are subject to company performance metrics based on Total Shareholder Return and measure the overall stock price performance of the Company to the stock price performance of a selected industry peer group, thus resulting in a market condition. The actual number of PSUs subject to the awards will be determined at the end of the performance period based on these performance metrics. The fair value of the PSUs is calculated using the Monte Carlo valuation method. This method utilizes multiple input variables to determine the probability of the Company achieving the market condition and the fair value of the awards. These awards have a three-year performance period and are classified as equity as each unit is convertible into one share of the Company s common stock upon vesting. Compensation expense is recognized on a straight-line basis over the requisite service period (or to an employee s eligible retirement date, if earlier). During the first quarter 2010, the Company issued 40,500 PSUs under its 2007 Stock Plan with a grant date fair value of \$35.90. The Company issued 20,400 additional PSUs during the third quarter 2010 with a grant date fair value of \$33.01.

4. Earnings Per Share

Basic earnings per share amounts are calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share amounts are calculated based upon the weighted-average number of common shares and potentially dilutive shares of common stock outstanding during the period. Potentially dilutive shares are excluded from the computation in periods in which they have an anti-dilutive effect. Diluted earnings per share reflect the potential dilution that could occur if holders of options exercised their options into common stock. During the twelve and forty weeks ended October 3, 2010, 764,000 and 529,000, respectively, weighted stock options outstanding were not included in the computation of diluted earnings (loss) per share because to do so would have been anti-dilutive for the periods presented. During the twelve and forty weeks ended October 4, 2009, 363,000 and 864,000, respectively, weighted stock options outstanding were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented. The Company uses the treasury stock method to calculate the impact of outstanding stock options. The computations for basic and diluted earnings (loss) per share are as follows (in thousands, except per share data):

| | Twelve Weeks Ended | | Forty Weeks Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Net income (loss) | \$ (4,213) | \$ 5,702 | \$ 5,072 | \$ 15,968 |
| Basic weighted-average shares outstanding | 15,519 | 15,408 | 15,494 | 15,379 |
| Dilutive effect of stock options and awards | | 127 | 174 | 109 |
| Diluted weighted-average shares outstanding | 15,519 | 15,535 | 15,668 | 15,488 |
| Earnings (loss) per share: | | | | |
| Basic | \$ (0.27) | \$ 0.37 | \$ 0.33 | \$ 1.04 |
| Diluted | \$ (0.27) | \$ 0.37 | \$ 0.32 | \$ 1.03 |

5. Gift Card Breakage

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The Company sells gift cards which do not have an expiration date, and it does not deduct dormancy fees from outstanding gift card balances. The Company recognizes revenue from gift cards when: (i) the gift card is redeemed by the customer; or (ii) the likelihood of the gift card being redeemed by the customer is remote (gift card breakage), and the Company determines that there is not a legal obligation to remit the unredeemed gift card balance to the relevant jurisdiction. The determination of the gift card breakage rate is based upon the Company's specific historical redemption patterns. The Company recognizes gift card breakage by applying its estimate of the rate of gift card breakage over the period of estimated performance (24 months as of the end of the third quarter 2010). The Company completed its initial analysis of unredeemed gift card liabilities for gift cards that it sold in its restaurants during the first quarter 2010, and recognized \$3.5 million into revenue as a one time adjustment. For the twelve and forty weeks ended October 3, 2010, the Company recognized \$192,000 and \$4.2 million (inclusive of the one time adjustment) respectively, into revenue related to unredeemed gift card breakage. The Company has not recognized breakage on third party gift card sales due to the relatively young age of the third party gift card program. Gift card breakage is included in other revenue in the consolidated statements of operations.

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6. Advertising Costs

Costs incurred in connection with the advertising and marketing of the Company are included in selling, general, and administrative expenses and expensed as incurred or when the advertisement first runs. Such costs amounted to \$6.4 million and \$23.3 million for the twelve and forty weeks ended October 3, 2010, respectively, and \$3.9 million and \$11.8 million for the twelve and forty weeks ended October 4, 2009, respectively.

Under the Company's franchise agreements, both the Company and the franchisees must contribute a minimum percentage of revenues to two marketing and national media advertising funds (the Marketing Funds). These Marketing Funds are used to develop and distribute Red Robin® branded marketing materials, for media purchases and for administrative costs. The Company's portion of costs incurred by the Marketing Funds is recorded as selling, general, and administrative expenses in the Company's financial statements. Restricted assets represent contributed funds held for future use.

7. Derivative and Other Comprehensive Income

The Company enters into derivative instruments for risk management purposes only, including derivatives designated as a cash flow hedge under guidance for derivative instruments and hedging activities. The Company uses interest rate-related derivative instruments to manage its exposure to fluctuations in interest rates. By using these instruments, the Company exposes itself, from time to time, to credit risk and market risk. Credit risk is the failure of either party to the contract to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Company, which creates credit risk for the Company. The Company minimizes the credit risk by entering into transactions with high-quality counterparties whose credit rating is evaluated on a quarterly basis. The Company's counterparty in the interest rate swap is SunTrust Bank, National Association (SunTrust). Market risk, as it relates to the Company's interest-rate derivative, is the adverse effect on the value of a financial instrument that results from changes in interest rates. The Company minimizes market risk by establishing and monitoring parameters that limit the types and degree of market risk that the Company takes.

In March 2008, the Company entered into the variable-to-fixed interest rate swap agreement with SunTrust to hedge the Company's floating interest rate on an aggregate of up to \$120 million of debt that is currently outstanding under the Company's amended and restated credit facility. The interest rate swap has an effective date of March 19, 2008, and \$50 million of the initial \$120 million expired on March 19, 2010, in accordance with its original term, and the remaining \$70 million will expire on March 19, 2011. The Company is required to make payments based on a fixed interest rate of 2.7925% calculated on the remaining notional amount of \$70 million. In exchange, the Company will receive interest on \$70 million of the notional amount at a variable rate that is based on the 3-month LIBOR rate. The Company entered into the above interest rate swap with the objective of offsetting the variability of its interest expense that arises because of changes in the variable interest rate for the designated interest payments and designated the swap as a cash flow hedge since its inception. Accordingly, changes in fair value of the interest rate swap contract were recorded, net of taxes, as a component of accumulated other comprehensive loss (AOCL) in the accompanying condensed consolidated balance sheets. The Company reclassifies the effective gain or loss from AOCL, net of tax, on the Company's consolidated balance sheet to interest expense on the Company's consolidated statements of income as the interest expense is recognized on the related debt.

The following table summarizes the fair value and presentation in the condensed consolidated balance sheets of the interest rate swap as hedging instruments as of October 3, 2010 and December 27, 2009 (in thousands):

| Balance Sheet Location | Derivative Liability | |
|-------------------------------|-------------------------------------|---------------------------------------|
| | Fair value at October 3, 2010 | Fair value at December 27, 2009 |
| Accrued liabilities | \$ 806 | \$ 1,833 |
| Other non-current liabilities | | 222 |
| Total derivatives | \$ 806 | \$ 2,055 |

The following table summarizes the effect of the interest rate swap on the condensed consolidated statements of operations for the twelve and forty weeks ended October 3, 2010 and October 4, 2009 (in thousands):

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| | Twelve Weeks Ended | | Forty Weeks Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Unrealized gain (loss) on swap in AOCL (pretax) | \$ (70) | \$ (353) | \$ (378) | \$ (1,496) |
| Realized loss (pretax effective portion) recognized in interest expense | \$ (375) | \$ (626) | \$ (1,614) | \$ (1,582) |

As a result of this activity, AOCL decreased by \$305,000 and \$1.2 million on a pretax basis or \$114,000 and \$888,000 on an after tax basis for the twelve and forty weeks ended October 3, 2010, respectively, and increased by \$273,000 and \$86,000 on a pretax basis or \$167,000 and \$53,000 on an after tax basis for the twelve and forty weeks ended October 4, 2009, respectively. The interest rate swap has no hedge ineffectiveness, and as a result, no unrealized gains or losses were reclassified into net earnings as a result of hedge ineffectiveness. The Company expects no ineffectiveness in the next twelve months. Additionally, the Company had no obligations at October 3, 2010, to post collateral under the terms of the Interest Rate Swap Agreement.

Comprehensive income consists of net income and other gains and losses affecting stockholders' equity that are excluded from net income. Comprehensive income (loss) consisted of (in thousands):

| | Twelve Weeks Ended | | Forty Weeks Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Net income (loss) | \$ (4,213) | \$ 5,702 | \$ 5,072 | \$ 15,968 |
| Unrealized gain on cash flow swap, net of tax | 114 | 167 | 888 | 53 |
| Total comprehensive income (loss) | \$ (4,099) | \$ 5,869 | \$ 5,960 | \$ 16,021 |

8. Fair Value Measurement

Fair value measurements are made under a three-tier fair value hierarchy, which prioritizes the inputs used in the measuring of fair value:

Level One: Observable inputs that reflect unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level Two: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level Three: Inputs that are generally unobservable. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

Assets and Liabilities Measured at Fair Value

The derivative liability associated with the interest rate swap is considered to be a Level Two instrument. The interest rate swap is a standard cash flow hedge whose fair value is estimated using industry-standard valuation models. Such models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves. See Note 7, *Derivative and Other Comprehensive Income*, for the discussion of the derivative liability. The Company's deferred compensation plan is a nonqualified deferred compensation plan which allows highly compensated employees to defer a portion of their base salary, bonuses, and commissions each plan year.

The carrying value of both the liability for the deferred compensation plan and associated life insurance policy are equal to their fair value. These agreements are required to be measured at fair value on a recurring basis and are valued using Level Two inputs. At October 3, 2010, and December 27, 2009, a liability for participant contributions and investment income thereon of \$2.3 million and \$2.4 million, respectively, is included in other non-current liabilities. To offset its obligation, the Company's plan administrator purchases corporate-owned whole-life insurance contracts on certain team members. The cash surrender value of these policies at both October 3, 2010, and December 27, 2009, was \$2.3 million and is included in other assets, net.

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As of October 3, 2010, the Company had no financial assets or liabilities that were measured using Level One or Level Three inputs. The Company also had no non-financial assets or liabilities that were required to be measured at fair value on a recurring basis.

The following table presents our assets and liabilities that are fair valued on a recurring basis for the quarter ended October 3, 2010, and for the fiscal year ended December 27, 2009 (in thousands):

| | October 3, 2010 | Level One | Level Two | Level Three |
|-------------------------------------|--------------------|--------------|--------------|----------------|
| Assets: | | | | |
| Life insurance policy | \$ 2,262 | \$ | \$ 2,262 | \$ |
| Total assets measured at fair value | \$ 2,262 | \$ | \$ 2,262 | \$ |

| | | | | |
|--|----------|----|----------|----|
| Liabilities: | | | | |
| Derivative - interest rate swap | \$ 806 | | 806 | |
| Deferred compensation plan | 2,286 | | 2,286 | |
| Total liabilities measured at fair value | \$ 3,092 | \$ | \$ 3,092 | \$ |

| | December 27, 2009 | Level One | Level Two | Level Three |
|--|----------------------|--------------|--------------|----------------|
| Assets: | | | | |
| Life insurance policy | \$ 2,317 | \$ | \$ 2,317 | \$ |
| Total assets measured at fair value | \$ 2,317 | \$ | \$ 2,317 | \$ |
| Liabilities: | | | | |
| Derivative - interest rate swap | \$ 2,055 | | 2,055 | |
| Deferred compensation plan | 2,358 | | 2,358 | |
| Total liabilities measured at fair value | \$ 4,413 | \$ | \$ 4,413 | \$ |

Disclosures of Fair Value of Other Assets and Liabilities

The Company's liabilities under its credit facility and capital leases are carried at historical cost in the accompanying consolidated balance sheet. For disclosure purposes, we estimate the fair value of the credit facility and capital lease obligations using discounted cash flow analysis based on market rates obtained from independent third parties for similar types of debt. Both the credit facility and the Company's capital lease obligations are considered to be Level 2 instruments. The fair value of the Company's credit facility as of October 3, 2010, and December 27, 2009, was approximately \$148 million and \$179.5 million, respectively. There are \$11.6 million of outstanding borrowings recorded for the Company's capital leases as of October 3, 2010, which have an estimated fair value of \$11.4 million. At December 27, 2009, the carrying amount of the Company's capital lease obligations was \$6.6 million, and the fair value was \$7.7 million.

Asset Impairment

The Company took an impairment charge for four of its restaurants in the third quarter 2010 of \$6.1 million. These are considered to be assets that are measured at fair value on a nonrecurring basis. The inputs used for the fair value measurement of the restaurants are considered Level Three. For further information refer to Note 2.

9. Related Party Transactions

In 2009, the Company appointed a member and former franchisee to its board of directors who qualifies as a related party. This board member is a principal of, and holds, directly or indirectly, interests of between 45% and 100% in each of three privately-held entities that hold the leases for three Company-owned restaurants. Under those leases, the Company recognized rent and other related payments in the amounts of \$214,000 and \$854,000 for the twelve and forty weeks ended October 3, 2010, respectively, and \$229,000 and \$807,000 for the twelve and forty weeks ended October 4, 2009, respectively. Future minimum lease commitments under these leases are \$4.4 million as of October 3, 2010.

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10. Commitments and Contingencies

In the normal course of business, there are various legal claims in process, matters in litigation, and other contingencies. These include claims resulting from employment related claims and claims from guests or team members alleging illness, injury or other food quality, health, or operational concerns. To date, no claims of this nature, certain of which are covered by insurance policies, have had a material adverse effect on us. While it is not possible to predict the outcome of these suits, legal proceedings, and claims with certainty, management is of the opinion that adequate provision for potential losses associated with these matters has been made in the financial statements and that the ultimate resolution of these matters will not have a material adverse effect on our financial position and results of operations.

11. Share Repurchase and Rights Agreement

On August 12, 2010, the Company announced that it extended its previously announced share repurchase plan to December 31, 2011. The Company is authorized to repurchase shares of common stock up to \$50 million. Such repurchases may be made from time to time in open market transactions and through privately negotiated transactions. There have been no purchases of Company stock to date.

On August 11, 2010, the Board of Directors (Board) of the Company adopted a shareholder rights plan. The rights plan sets forth the terms under which the Company would issue preferred share purchase rights (the Rights). Immediately after the adoption of the rights plan, the Board declared a dividend of one Right for each outstanding share of common stock, par value \$0.001 per share, payable on August 23, 2010 to holders of record on that date.

The Board has authorized the adoption of the rights plan to protect stockholders from coercive or otherwise unfair takeover tactics. In general terms, the Rights will impose a significant penalty upon any person or group which acquires beneficial ownership of 15% or more of the Company s outstanding common stock without the prior approval of the Board. The rights plan provides an exemption for any person who was as of August 11, 2010, the date the rights plan was adopted, the beneficial owner of 15% or more of the Company s outstanding common stock, so long as such person does not, subject to certain exceptions, acquire additional common stock of the Company. The rights plan will not interfere with any merger or other business combination approved by the Board.

12. Executive Transition

Stephen E. Carley was appointed as Chief Executive Officer of the Company and as a member of the Board, effective as of September 13, 2010. In connection with the appointment of Mr. Carley as the Company s new Chief Executive Officer, the Company also announced the termination of Dennis B. Mullen s, the former Chief Executive Officer, employment with the Company. The charges of \$2.3 million related to executive transition were recorded to selling, general and administrative expense.

13. Subsequent Events

The Company has evaluated subsequent events and found there to be no events requiring recognition or disclosure through the date of issuance of this report.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations provides a narrative of our financial performance and condition that should be read in conjunction with the accompanying condensed consolidated financial statements. All comparisons under this heading between 2010 and 2009 refer to the twelve and forty week periods ending October 3, 2010, and October 4, 2009, respectively, unless otherwise indicated.

Overview

The following summarizes the operational and financial highlights during the twelve and forty weeks of fiscal 2010:

- *New Restaurant Openings.* We opened three and seven company-owned restaurants during the twelve and forty weeks ended October 3, 2010, respectively. We opened no restaurants in the third quarter 2009 and had opened 13 company-

owned restaurants through the third quarter 2009. We plan to open up to four additional company-owned restaurants in the fourth quarter 2010, two of which opened early in the fourth quarter. We believe all remaining 2010 restaurant openings will be funded from our operating cash flows.

- *Comparable Restaurant Sales.* For the twelve weeks ended October 3, 2010, the 297 restaurants in our current comparable base experienced a 0.9% increase in sales from the same period last year. This increase was driven by a 2.6% increase in guest counts partially offset by a 1.7% decrease in the average guest check. For the forty weeks ended October 3, 2010, the restaurants in our current comparable based experienced a 1.0% decrease in sales from these same restaurants last year. This decrease was driven by a 2.1% decrease in the average guest check partially offset by a 1.1% increase in guest counts. During the forty weeks ended October 3, 2010, our comparable restaurants have experienced a continual return to positive guest counts. Year to date guest counts for the forty weeks ended October 4, 2009 were a decrease of 11.9% over the comparable 2008 period. We believe this return to positive guest counts is due, in part, to our 2010 marketing efforts as discussed below.

- *Marketing Efforts.* For 2010, our marketing strategy is focused on product news with an emphasis on quality, value, and variety to drive guest traffic, retention, and loyalty, which are key components of our YUMMM advertising campaign. During the third quarter 2010, we launched a Limited Time Offer (LTO) promotion featuring two products at a \$6.99 price point. This was the third and final LTO promotion of fiscal year 2010. The LTO campaign included four continuous weeks of media. Two of the weeks of television were in the third quarter and two weeks were in the first weeks of the fourth quarter. One week of the Summer LTO was in the beginning of the third quarter. Our investment in the third quarter 2010 television advertising campaign was \$3.4 million. For the forty week period ended October 3, 2010, our television advertising support of our 2010 LTO promotions increased our marketing spend by \$12.5 million over the comparable period of 2009. We continue to believe our 2010 LTO promotions, supported by national television and digital advertising have contributed to our increased guest counts and restaurant sales. Restaurant sales and guest counts during the promotional campaigns have continued to run higher than pre- and post-promotional periods.

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- *Labor.* Labor costs as a percentage of restaurant revenue increased 0.7% and 0.9% for the twelve and forty weeks ended October 3, 2010. As a percentage of restaurant revenues, we have seen an increase in our managerial compensation, including bonus expense through the forty weeks ended October 3, 2010. These trends from the prior year comparable period have been changing as our restaurant revenues and guest counts have turned positive in recent periods and these primarily fixed costs continue to be leveraged.
- *Food Cost.* As a percentage of restaurant revenue, we have seen an increase in both ground beef pricing and produce costs for the forty weeks ended October 3, 2010. Our ground beef, which is purchased on the spot market, has consistently been higher than 2009 prices, in particular in the third quarter of 2010 when our hamburger costs as a percentage of revenue were 0.4% higher than the third quarter of 2009. We expect ground beef pricing will decline in the fourth quarter but will remain significantly above 2009 prices. The increase in produce costs through the third quarter 2010 were due to higher produce pricing in the first part of the year from inclement weather in produce growing states combined with third quarter 2010 increases due to higher usage of certain produce in our new salad and seasonal produce offerings.
- *Asset Impairment.* During the third quarter of fiscal 2010, we determined that four company-owned restaurants were impaired. The Company recognized a non-cash impairment charge of \$6.1 million related to the impairment of these four restaurants. We reviewed each restaurant's past and present operating performance combined with projected future results, primarily through projected undiscounted cash flows, which indicated possible impairment. The carrying amount of each restaurant was compared to its fair value as determined by management. The impairment charge represents the excess of each restaurant's carrying amount over its fair value.
- *Executive Transition.* Stephen E. Carley was appointed as Chief Executive Officer of the Company and as a member of the Board, effective as of September 13, 2010. In connection with the appointment of Mr. Carley as the Company's new Chief Executive Officer, the Company also announced the termination of Dennis B. Mullen's, the former Chief Executive Officer, employment with the Company. The charges of \$2.3 million related to executive transition were recorded to selling, general and administrative expense.

In view of the foregoing, the Company continues to make every effort to manage controllable costs and streamline operations, while our restaurant teams focus on driving traffic through the quality and value of our guest experience. Our reduced levels of new restaurant openings and lower capital expenditures are expected to result in significant free cash flow, the majority of which will be

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used to reduce outstanding indebtedness and maintain the flexibility to opportunistically repurchase some of our common stock during the remainder of 2010.

Restaurant Data

The following table details restaurant unit data for our company-owned and franchise locations for the periods indicated.

| | Twelve Weeks Ended | | Forty Weeks Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Company-owned: | | | | |
| Beginning of period | 309 | 304 | 306 | 294 |
| Opened during period | 3 | | 7 | 13 |
| Acquired during period | | | | 1 |
| Closed during period | | | (1) | (4) |
| End of period | 312 | 304 | 312 | 304 |
| Franchised: | | | | |
| Beginning of period | 134 | 131 | 133 | 129 |
| Opened during period (a) | | 1 | 3 | 4 |
| Sold or closed during period (b) | (1) | | (3) | (1) |
| End of period | 133 | 132 | 133 | 132 |
| Total number of Red Robin® restaurants | 445 | 436 | 445 | 436 |

(a) Includes one franchised restaurant that was re-opened during the second quarter 2010.

(b) One restaurant was closed during the third quarter 2010 due to a fire and is expected to re-open fourth quarter 2010.

Results of Operations

Operating results for each period presented below are expressed as a percentage of total revenues, except for the components of restaurant operating costs, which are expressed as a percentage of restaurant revenue.

This information has been prepared on a basis consistent with our audited 2009 annual financial statements and, in the opinion of management, includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the periods presented. Our operating results may fluctuate significantly as a result of a variety of factors, and operating results for any period presented are not necessarily indicative of results for a full fiscal year.

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| | Twelve Weeks Ended | | Forty Weeks Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | October 3, 2010 | October 4, 2009 | October 3, 2010 | October 4, 2009 |
| Revenues: | | | | |
| Restaurant | 98.3% | 98.4 | 97.8% | 98.4% |
| Franchise royalties and fees | 1.5 | 1.6 | 1.5 | 1.6 |
| Other revenue | 0.1 | | 0.6 | |
| Total revenues | 100.0 | 100.0 | 100.0 | 100.0 |
| Costs and Expenses: | | | | |
| Restaurant operating costs (exclusive of depreciation and amortization shown separately below): | | | | |
| Cost of sales | 24.4 | 23.4 | 24.4 | 24.1 |
| Labor (includes 0.1%, 0.1%, 0.1%, and 0.2% of stock-based compensation expense, respectively) | 35.6 | 34.9 | 35.5 | 34.6 |
| Operating | 15.2 | 15.2 | 14.7 | 14.6 |
| Occupancy | 7.3 | 7.8 | 7.4 | 7.4 |
| Total restaurant operating costs | 82.5 | 81.3 | 82.0 | 80.7 |
| Depreciation and amortization | 6.8 | 7.0 | 6.5 | 6.7 |
| Selling, general, and administrative (includes 0.7%, 0.3%, 0.5%, and 0.8% of stock-based compensation expense, respectively) | 11.6 | 8.6 | 10.9 | 9.6 |
| Pre-opening costs | 0.4 | 0.1 | 0.3 | 0.5 |
| Asset Impairment | 3.1 | | 0.9 | |
| Income (loss) from operations | (3.1) | 4.4 | 1.2 | 3.8 |
| Interest expense, net | 0.6 | 0.7 | 0.6 | 0.8 |
| Other | | | | |
| Income (loss) before income taxes | (3.7) | 3.7 | 0.5 | 3.0 |
| Income tax (benefit) loss | (1.5) | 0.6 | (0.2) | 0.7 |
| Net income (loss) | (2.2)% | 3.1% | 0.8% | 2.3% |

Certain percentage amounts in the table above do not sum due to rounding as well as the fact that restaurant operating costs are expressed as a percentage of restaurant revenue, as opposed to total revenues.

Total Revenues

| (In thousands, except percentages) | Twelve Weeks Ended | | | Forty Weeks Ended | | |
|------------------------------------|--------------------|--------------------|-------------------|--------------------|--------------------|-------------------|
| | October 3, 2010 | October 4, 2009 | Percent Change | October 3, 2010 | October 4, 2009 | Percent Change |
| Restaurant revenue | \$ 191,612 | \$ 183,878 | 4.2% | \$ 657,094 | \$ 648,436 | 1.3% |
| Franchise royalties and fees | 3,001 | 3,035 | (1.1)% | 10,292 | 10,265 | 0.3% |
| Other revenue | 230 | 34 | NM(1) | 4,310 | 147 | NM(1) |
| Total revenues | \$ 194,843 | \$ 186,947 | 4.2% | 671,696 | 658,848 | 2.0% |
| Average weekly sales volumes: | | | | | | |
| Comparable restaurants | \$ 52,019 | \$ 51,964 | 0.1% | \$ 54,303 | \$ 55,610 | (2.4)% |
| Non-comparable restaurants | 58,240 | 49,385 | 17.9% | 57,553 | 53,893 | 6.8% |
| 2008 Acquired Restaurants (2) | | | | | 51,392 | NM(1) |

(1) Percentage change of more than 100% is considered not meaningful.

(2) 2008 Acquired Restaurants refers to 15 franchised Red Robin® restaurants we acquired during fiscal year 2008. Beginning in the third quarter of fiscal year 2009, these restaurants entered into the comparable restaurant population and their average weekly sales volumes, from that time forward, are included in the comparable restaurant category.

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Restaurant revenue during third quarter 2010, which is comprised almost entirely of food and beverage sales, increased by \$7.7 million compared to third quarter 2009. Sales in our comparable restaurant base experienced a sales increase of approximately \$2.4 million or 0.9% during the third quarter 2010. This increase was primarily the result of a 2.6% increase in guest counts. Offsetting this increase was a 1.7% decrease in average guest check for the third quarter of 2010. This net increase, we believe, was driven by our LTO promotion and the three weeks of television media support. Sales for new restaurants that have opened since third quarter 2009 contributed an increase of \$5.3 million during third quarter 2010.

Restaurant revenue for the forty week period ended October 3, 2010, increased \$8.6 million or 1.3% from the same period in 2009. Sales in our comparable restaurant base experienced a sales decrease of approximately \$9.9 million or 1.5% for the period. This was primarily the result of a 2.1% decrease in the average guest check partially offset by a 1.1% increase in guest counts. Sales for new restaurants that have opened since third quarter 2009 contributed an increase of \$18.5 million during the forty weeks ended October 3, 2010.

Average weekly sales volumes represent the total restaurant revenue, excluding discounts, for a population of restaurants in both a comparable and non-comparable category for each time period presented divided by the number of operating weeks in the period. Comparable restaurant average weekly sales volumes include those restaurants that are in the comparable base at the end of each period presented. At the end of the third quarter 2010, there were 297 comparable restaurants compared to 269 comparable restaurants at the end of the third quarter 2009. Non-comparable restaurants presented include those restaurants that had not yet achieved the five full quarters of operations during the periods presented. At the end of the third quarter 2010, there were 15 non-comparable restaurants versus 35 at the end of the third quarter 2009. Fluctuations in average weekly sales volumes for comparable restaurants reflect the effect of same store sales changes as well as the performance of new restaurants entering the comparable base during the period.

Franchise royalties and fees, which consist primarily of royalty income and initial franchise fees, decreased 1.1% and increased 0.3% for the twelve and forty weeks ended October 3, 2010, respectively. The twelve week decrease is attributable to one franchised restaurant that was closed during third quarter 2010 due to a fire. The year to date increase is primarily attributable to the increase in the number of franchised restaurants. Our franchisees reported that comparable restaurant sales increased 3.5% for U.S. restaurants and decreased 0.6 % for Canadian restaurants for the third quarter of 2010 compared to the third quarter of 2009. For the forty weeks ended October 3, 2010, our franchisees reported that comparable restaurant sales for U.S. restaurants decreased 0.5 % and Canadian restaurants increased 1.9% from the forty week period ended October 4, 2009.

Other revenue consists primarily of gift card breakage. We recognize restaurant revenue when a gift card is redeemed by a guest. Gift card breakage revenue is recognized if the likelihood of gift card redemption is remote and we determine that there is not a legal obligation to remit the unredeemed gift card balance to the relevant jurisdiction. We base the gift card breakage rate upon specific historical redemption patterns. We recognize gift card breakage by applying our estimate of the rate of gift card breakage over the period of estimated performance (24 months as of the end of the third quarter 2010). We recognized \$3.5 million as a one time adjustment during the first quarter 2010. We recognized \$192,000 and \$4.2 million (inclusive of the one time adjustment) respectively, of gift card breakage for the twelve and forty weeks ended October 3, 2010.

Cost and Expenses

Cost of Sales

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| (In thousands, except percentages) | Twelve Weeks Ended | | | Forty Weeks Ended | | |
|------------------------------------|--------------------|--------------------|-------------------|--------------------|--------------------|-------------------|
| | October 3, 2010 | October 4, 2009 | Percent Change | October 3, 2010 | October 4, 2009 | Percent Change |
| Cost of sales | \$ 46,723 | \$ 42,961 | 8.8% | \$ 160,432 | \$ 156,472 | 2.5% |
| As a percent of restaurant revenue | 24.4% | 23.4% | 1.0% | 24.4% | 24.1% | 0.3% |

Cost of sales, comprised of food and beverage expenses, are variable and generally fluctuate with sales volume. For the twelve weeks ended October 3, 2010, cost of sales as a percentage of restaurant revenue increased 1%, or \$3.8 million. This increase was driven by a combined 0.7% percentage of restaurant revenue increase in ground beef, produce, and cheese. The increase in cheese and ground beef costs is due to higher raw materials costs. Produce cost increases are due to a shift in the mix of products ordered including our new salad offerings and our fall 2010 LTO promotion.

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For the forty weeks ended October 3, 2010, cost of sales as a percentage of restaurant revenue increased by 0.3%, or \$4 million. This increase was driven by a combined 0.5% increase in produce and ground beef, partially offset by a 0.3% decrease in seafood and meats other than ground beef.

Labor

| (In thousands, except percentages) | Twelve Weeks Ended | | | Forty Weeks Ended | | |
|------------------------------------|--------------------|-----------------|----------------|-------------------|-----------------|----------------|
| | October 3, 2010 | October 4, 2009 | Percent Change | October 3, 2010 | October 4, 2009 | Percent Change |
| Labor | \$ 68,231 | \$ 64,113 | 6.4% | \$ 233,080 | \$ 224,063 | 4.0% |
| As a percent of restaurant revenue | 35.6% | 34.9% | 0.7% | 35.5% | 34.6% | 0.9% |

Labor costs include restaurant hourly wages, fixed management salaries, stock-based compensation, bonuses, taxes, and benefits for restaurant team members. For the twelve weeks ended October 3, 2010, labor costs as a percentage of restaurant revenues increased 0.7%, or \$4.1 million. This increase was primarily driven by a 0.5% increase in administrative labor, including manager bonuses, and a 0.5% increase in workers compensation and insurance expenses. These increases were offset by a 0.2% decrease in payroll taxes due to the payroll tax holiday provided by the 2010 Hiring Incentives to Restore Employment (HIRE) Act.

For the forty weeks ended October 3, 2010, labor as a percentage of revenue increased 0.9%, or \$9 million. This increase was driven by a 0.6% increase from sales leverage on fixed administrative labor, including manager bonuses and a 0.2% increase in workers compensation expense.

Operating

| (In thousands, except percentages) | Twelve Weeks Ended | | | Forty Weeks Ended | | |
|------------------------------------|--------------------|-----------------|----------------|-------------------|-----------------|----------------|
| | October 3, 2010 | October 4, 2009 | Percent Change | October 3, 2010 | October 4, 2009 | Percent Change |
| Operating | \$ 29,080 | \$ 27,963 | 4.0% | \$ 96,695 | \$ 94,968 | 1.8% |
| As a percent of restaurant revenue | 15.2% | 15.2% | 0.0% | 14.7% | 14.6% | 0.1% |

Operating costs include variable costs such as restaurant supplies, energy costs, and other fixed costs such as repairs and maintenance. For the twelve and forty weeks ended October 3, 2010, operating costs as a percentage of restaurant revenues remained flat and increased 0.1% respectively, over prior year. This is the result of increased repairs and maintenance costs to maintain our restaurant facilities.

Occupancy

| (In thousands, except percentages) | Twelve Weeks Ended | | | Forty Weeks Ended | | |
|------------------------------------|--------------------|-----------------|----------------|-------------------|-----------------|----------------|
| | October 3, 2010 | October 4, 2009 | Percent Change | October 3, 2010 | October 4, 2009 | Percent Change |

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| | | | | | | | | | | |
|------------------------------------|----|--------|----|--------|-------|----|--------|----|--------|------|
| Occupancy | \$ | 14,074 | \$ | 14,434 | -2.5% | \$ | 48,361 | \$ | 47,836 | 1.1% |
| As a percent of restaurant revenue | | 7.3% | | 7.8% | -0.5% | | 7.4% | | 7.4% | 0.0% |

Occupancy costs include fixed rents, percentage rents, common area maintenance charges, real estate and personal property taxes, general liability insurance, and other property costs. For the twelve weeks ended October 3, 2010, the decrease as a percentage of revenues was driven by a decrease in general insurance costs. For the forty weeks ended October 3, 2010, occupancy expenses as a percentage of revenues remained flat.

Table of Contents*Depreciation and Amortization*

| (In thousands, except percentages) | Twelve Weeks Ended | | | Percent Change | Forty Weeks Ended | | |
|------------------------------------|--------------------|-----------------|--|----------------|-------------------|-----------------|----------------|
| | October 3, 2010 | October 4, 2009 | | | October 3, 2010 | October 4, 2009 | Percent Change |
| Depreciation and amortization | \$ 13,341 | \$ 13,112 | | 1.7% | \$ 43,777 | \$ 43,815 | (0.1)% |
| As a percent of total revenues | 6.8% | 7.0% | | (0.2)% | 6.5% | 6.7% | (0.2)% |

Depreciation and amortization includes depreciation on capital expenditures for restaurants and corporate assets as well as amortization of acquired intangible assets and liquor licenses. Depreciation and amortization expense as a percentage of revenue for the twelve and forty weeks ended October 3, 2010, decreased from sales leverage on these fixed expenses.

Selling, General, and Administrative

| (In thousands, except percentages) | Twelve Weeks Ended | | | Percent Change | Forty Weeks Ended | | |
|--------------------------------------|--------------------|-----------------|--|----------------|-------------------|-----------------|----------------|
| | October 3, 2010 | October 4, 2009 | | | October 3, 2010 | October 4, 2009 | Percent Change |
| Selling, general, and administrative | \$ 22,612 | \$ 16,096 | | 40.5% | \$ 73,455 | \$ 63,088 | 16.4% |
| As a percent of total revenues | 11.6% | 8.6% | | 3.0% | 10.9% | 9.6% | 1.3% |

Selling, general, and administrative costs include all corporate and administrative functions that support our existing restaurant operations, our franchises, and provide infrastructure to facilitate our future growth. Components of this category include corporate management, supervisory and staff salaries, bonuses, marketing costs, stock-based compensation and related employee benefits, travel, information systems, training, office rent, franchise administrative support, Board of Directors expenses, legal, leadership conference, and professional and consulting fees. For the twelve weeks ended October 3, 2010, selling, general, and administrative costs increased 40.5%, or \$6.5 million, due primarily to executive transition costs of \$2.3 million, a \$3.0 million increase over 2009 for our marketing and advertising campaign related to television support for the fall 2010 LTO, higher bonus expense at the corporate level and higher Board of Directors and governance related expenses.

For the forty weeks ended October 3, 2010, selling, general, and administrative costs increased 16.4%, or \$10.4 million, due primarily to an increase of \$10.2 million over 2009 in the marketing and advertising campaign related to television media support for the spring, summer and fall LTO campaigns, executive transition costs of \$2.3 million, and higher Board of Directors and governance related expense of approximately \$0.5 million. This increase was partially offset by \$1.1 million decrease in bonuses at the corporate level and a \$1.0 million net decrease in stock compensation related primarily to the tender offer completed during the first quarter of 2009.

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Pre-opening Costs