

APRIL 11, 2005

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

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**THE WALL STREET TRANSCRIPT**

## COMPANY INTERVIEW

**ROBERT E. SCHERMER JR.**  
Meritage Hospitality Group Inc.

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# Meritage Hospitality Group Inc. (MHG)



**ROBERT E. SCHERMER JR.** is President and Chief Executive Officer of Meritage Hospitality Group Inc. Mr. Schermer serves on the Pepsi Advisory Board as well as the Board of Directors of Interstate Communications Inc. Mr. Schermer is active in community affairs, through philanthropic activities focused on the community's needy children. He attended Hope College, majoring in Economics and Finance.

## SECTOR – RESTAURANTS

**(ABL605) TWST: Would you begin with an overview of Meritage?**

**Mr. Schermer** First, I am pleased to have the opportunity to speak with you today about our company. I would like to preface our interview subject to our forward-looking statement disclosures which can be found in our SEC Form 10-K.

Meritage Hospitality Group in the nation's premier publicly traded franchise operator engaged in the development and operations of franchised restaurants. All of our restaurants are operated pursuant to franchise agreements, in proven concepts with broad customer appeal. Meritage is the nation's only publicly traded Wendy's restaurant franchisee and the nation's only publicly traded O'Charley's franchisee. We currently employ approximately 1,800 people and expect to add 300 new positions this year.

**TWST: Could you give us an overview of the strategy that you will follow over the next several years**

**Mr. Schermer** Over the next five years, we are focused on a multi-segment "best of class" restaurant brands growth strategy aimed at internal unit growth, which will expand sales from \$53 million to \$130 million. The goal is profitable

growth and outperforming the industry in operating metrics while achieving segment diversification. We have made a significant investment in training and infrastructure over the past 18 months preparing for our O'Charley's restaurant growth initiative. Casual dining segment diversification helps guard against concentrated commodity exposure such as the QSR segment is experiencing with beef costs.

Our strategy is to grow the business to \$130 million over the next 60 months, using a multi-brand, multi-segment strategy. In our next 12 – 24 months, we forecast that the company will be approaching the \$90 million sales benchmark. The real goal is growing profitability, outperforming the industry in operating metrics and achieving segment diversification.

**TWST: Could you give us your take on current and future industry trends?**

**Mr. Schermer** The food service industry is a \$475 billion industry. I'll grant you that for the typical investor, the business of selling food is not terribly exciting. However, one should not underestimate the value proposition in selling a basic need such as food. The two largest segments of the industry are the \$134 billion quick service restaurants ("QSR") and the \$165 billion casual dining

# Corporate Profile

## Meritage Hospitality Group Inc.

Ticker (exchange)

MHG (NYSE)

Price close 4/06/05

5.03

12 Months Price Range

4.75 - 5.31

### Corporate Headquarters

1971 East Beltline Avenue,  
N.E., Suite 200  
Grand Rapids, Michigan 49525

**Phone:** (616) 776-2600

**Fax:** (616) 776-2776

**Web:** meritagehospitality.com

### Corporate Officers

**Robert E. Schermer, Jr**  
Chief Executive Officer

**James R. Saalfeld**  
Vice President, General Counsel,  
Secretary

**Robert H. Potts**  
Vice President of Real Estate

**Gary A. Rose**  
Vice President, CFO & Treasurer

### Corporate Business Description

Meritage Hospitality Group is the nation's premier public franchise operator engaged in the development and operation of franchised restaurants. All of our restaurants are operated pursuant to franchise agreements, in proven concepts with broad customer appeal. Meritage is the nation's only publicly traded Wendy's restaurant franchisee and the nation's only publicly traded O'Charley's franchisee.

### Company Highlights

- 1,800 Employees
- 50 Restaurant units in operations
- Franchisee for two "Best of Class" brands with broad consumer appeal
- Approximately 50% Restaurant real estate owned
- Goal oriented – operations focused management culture

### Investment Fundamentals

**Value:** Current equity valuations do not reflect embedded equity associated with the Company's real estate ownership and franchise business model.

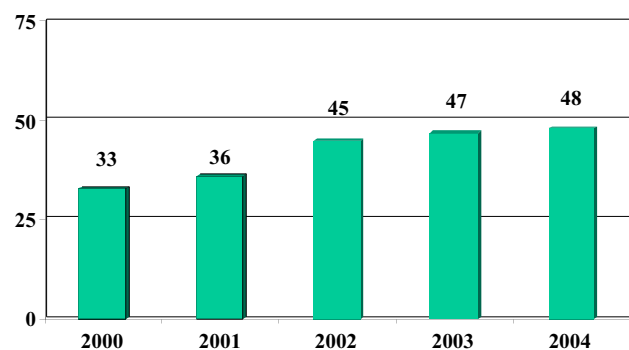
**Growth:** The O'Charley's restaurant development initiative is providing quality, high-growth opportunity.

**Income:** The Company returned cash to shareholders through a special dividend in 2005 and will consider future cash dividends.

Cumulative Total Return to Shareholders has averaged 44% annually over the past six years.

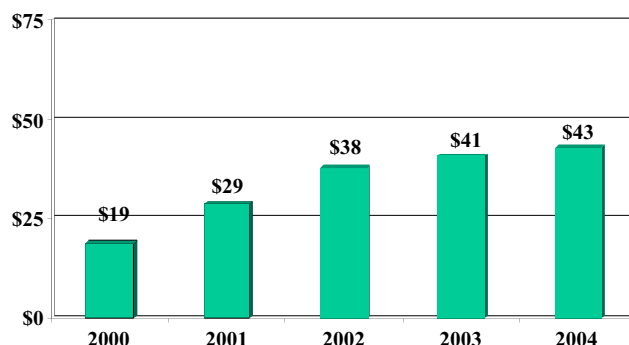
Ownership by management and associates is in excess of 43% of common shares.

## Restaurant Units in Operation



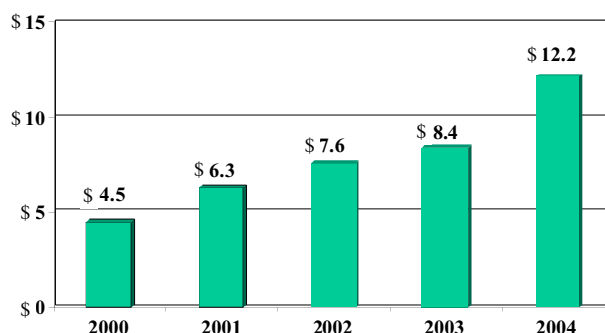
## Total Assets

(\$ in millions)



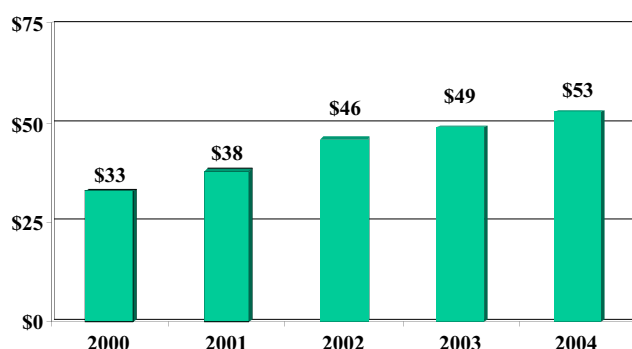
## Stockholders Equity

(\$ in millions)



## Total Consolidated Sales

(\$ in millions)



segment. Within these two segments, the 200 largest multi-unit franchisees generate \$17.9 billion of sales annually, operating 16,600 units.

The growth of large multi-unit franchisees has evolved over the past two decades as franchisors realized the cost efficiencies of utilizing multiple store development agreements versus single unit deals with individual operators. At the same time, growth capital from banks and finance companies have become available to top tier brands. The emergence of these two forces has created today's large, sophisticated multi-unit franchise operators. Looking ahead, the QSR and casual dining segments have some very compelling dynamics. Americans' desire for convenience and socializing outside of the home has driven the percentage of food eaten away from the home from 25% to almost 50% over the past 50 years. During the same time, the premium restaurant's charge for a meal over the supermarket has declined from a 93% premium to a 26% premium. "Time" has become one of the most valuable commodities in people's lives, and that has transformed restaurants into consumer staples as opposed to a consumer discretionary item. This growth in demand has fueled the evolution of large segment brands. Recent consumer surveys demonstrate that nearly half of American's believe restaurants are an important part of their lifestyle.

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**TWST: What impact is the general economy likely to have on your business?**

**Mr. Schermer** The restaurant industry today is very healthy. For investors, this is an asset class that has been very resilient overtime. In theory, people will eat somewhere regardless of the local economic climate. The restaurant industry competes for real estate locations with many free-standing retail concepts such as drug stores and banks. The industry's traditional capital resources are benchmarked to the 10 year Treasury, so as interest rates move, so does the cost of growth capital for the restaurant industry.

We believe over the next 10 years, the demographics for our two segments are outstanding. There has been a lot written about the Baby Boomer and "Generation Y" population waves in the U.S. over the next few decades. The reality is this is a seismic economic and social shift that is changing the US retail landscape. It is well documented that the "over 50s" crowd controls the vast majority of wealth in the United States. These 77 million Boomers have the highest "food consumed away from home" of any generation in US history. Following behind them is the eco-boom or Generation "Y" — sons and daughters of the Boomers — at 60 million strong. They rival the Boomers in size and, soon, in purchasing clout. The growth in dual-income and single parent households, combined with the Generation "Y" trends, creates compelling opportunity for us in the Wendy's and O'Charley's restaurant brands. We believe the long-term prospects for the servicing of these two segments are excellent. The barriers to entry of a single restaurant unit can be relatively low. However, we believe critical mass for a multi-unit franchisee to obtain optimal operating leverage is between \$75 - \$100 million in sales (\$1 billion in sales for a franchisor). So we find ourselves in a growth industry with relatively high capital barriers of entry to obtain scale.

**TWST: How would you describe the culture you have tried to build at the company?**

**Mr. Schermer** People are our greatest asset. In this business, it matters how employees feel because how they feel ends up on the plate. We operate much differently from the majority of our franchisor and brand competitors with a decentralized management structure. This structure puts much more decision making control in the hands of store management; then we reward them with performance-based compensation. Recruiting and retention are paramount to successful growth.

Our number one goal is customer loyalty, number two — employee loyalty and number three — shareholder loyalty. We believe customer loyalty is earned by loyal employees and we do not deserve shareholder loyalty without customer and employee loyalty.

**TWST: What will the expansion program look like in coming years?**

**Mr. Schermer:** We've grown internally due to our strategy, which is a risk-averse strategy. We would rather grow organically, or internally if you will, as opposed to going outside and acquiring franchise units, other Wendy's franchise units in other markets or O'Charley's units in other markets from O'Charley's corporate. We built and opened a new Wendy's restaurant on average every eight weeks for the past several years, until we built out West Michigan with Wendy's. Then we geographically ran out of trade areas. This led us to start investigating casual dining opportunities and go through the brand selection process .

Today, we have about 18 months of investment behind O'Charley's in terms of building infrastructure and hiring and training employees. There is long lead time, much longer lead time in casual dining than in QSR, for management training. Today, we are positioned to roll out a unit

every 90 days and would hope to accelerate that growth once we get a base of nine or 10 units.

During 2005, we started taking advantage of a historically high real estate market for free-standing, single tenant restaurant properties. The company began selling and leasing back a tranche of our Wendy's real estate, using proceeds to pay down long-term debt and build cash reserves for internally funding O'Charley's growth. We expect sale proceeds to pay down approximately \$13 million in debt and increase cash reserves by \$7 million. As a result, in 2005, we will report a series of one-time debt extinguishment charges associated with the accelerated debt pay down but also record long-term deferred gains on our balance sheet which will be accounted for as a reduction in rent expenses over the lease terms.

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***"We are a hybrid with characteristics of a real estate REIT and operating characteristics of a de-centralized restaurant company that has a high likelihood of replicating our historical returns through price appreciation and yield. This recipe should provide an interesting dessert for an investor's appetite in the food service industry."***

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**TWST: What are the goals that you have set for the company?**

**Mr. Schermer** From a cumulative return to shareholders perspective over the past six years, we have averaged 44% annual return or 24% compounded return for our shareholders, which compares favorably in the industry. We accomplished this through a rollout of Wendy's restaurants, opening a unit every eight weeks. Today, we have positioned the company to replicate this growth effort over the next five years with the O'Charley's restaurants. We expect to maintain and accelerate our sales growth from 15.8% over the last six years to 15% - 20% over

the next five years. We anticipate the flow-through of sales to cash earnings to accelerate as O'Charley's is a higher margin business. Therefore, sales and margins should be increasing as we approach the \$90 - \$100 million sales benchmark.

Over the next few years, we will be fully expensing new store openings under the current GAAP rule, which previously allowed pre-opening costs to be amortized over five to seven years. Investors looking at us need to "normalize" the cash earnings to get a fair picture of a "go forward" cash earnings model. Future cash earnings could also get a measurable boost from the newly proposed restaurant depreciation schedules changing from 39.5 years to 15 years. Two bills lingering before legislators are looking to apply permanent 15-year depreciation schedules for new restaurant construction, trimming nearly 25 years from the allowable term, thus reducing taxes payable. If passed, this will have a very positive cash flow benefit for Meritage as a high new unit growth franchisee. Another important pending legislation is a proposal to modify the single business tax (SBT) in the State of Michigan — which is a unique tax to Michigan that penalizes labor intense businesses and new capital investment. The Governor has presented a proposal that dramatically shifts the SBT burden from an employee tax to an income tax on corporate profit. We estimate this would be a tremendous benefit, which would have immediate flow-through to our bottom line. The proposal also includes incentives to encourage new development with a personal property tax credit. I hope both of these proposals will pass this year. What a refreshing, positive change in the business climate that would be for us after Sarbanes-Oxley.

**TWST: What is your view on the franchisor versus franchisee business model?**

**Mr. Schermer** We have not had the opportunity to speak much with the investment community

short of SEC filings and press releases. We do not have any analysts who follow our stock. Many investors pass over our company simply because of our lack of liquidity. I think our stock trades 1,900 shares per day on the American Stock Exchange. That said, I hear often two distinct misperceptions about our business. First, the franchisor versus franchisee business model misconception, and second, not understanding the imbedded equity value inherent in real estate development and franchise ownership.

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First, assuming we are talking about a quality brand, the average new restaurant unit will earn, inside of the four walls, between 2 times to 4 times greater cash earnings (depending on QSR or casual segment) than a franchise fee, which is typically 4% of sales. Therefore, a franchisor will always earn more money and create more value for its shareholders owning and operating a good restaurant than franchising one. The general issues that drive many companies into franchising typically revolves around limited human resources, limited financial resources and the desire to achieve brand scale and a national footprint. Scale creates operating leverage and benefits all units in a brand, particularly compared to independent restaurant operators. Second, our multi-segment, multi-concept strategy decreases commodity and economic risk while increasing growth opportunities. We selected the best of class brands in two of the

strongest industry segments, which both have innovative and distinctive menus focused on high quality food. There is inherent leverage in Meritage by virtue of the size of our shareholder base compared to our franchisor's shareholder base. Wendy's International will have to build 19 new Wendy's restaurants to equal the value we create in building one new Wendy's restaurants. In this case, the law of small number rewards the multi-unit franchisees.

We own a retail real estate portfolio that more closely resembles a restaurant REIT model than a franchisor model such as Wendy's International that owns 11% of the Wendy's systems' real estate. We have an inherent leverage from the law of small numbers in value creation for the shareholder.

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***"The restaurant industry is healthy. The QSR and casual dining segments are outpacing the economy, supported by very strong future demographics. We have an inherent real estate and business value leverage compared to our brand franchisors by virtue of the multi-unit franchisee business model and our real estate ownership."***

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**TWST: Do you think that investors have a good idea of what you are trying to accomplish?**

**Mr. Schermer** I was hired as the CEO six years ago; the company has been public since the mid-1980s. Today, the management of the company owns 43% of the company, and has steadily increased ownership over the years. We encourage significant ownership by management with a sizable portion of key employees' net worth invested in this company. We believe this keeps management focused on the long-term wealth creation and progressive growth of the business rather than short-term stock volatility. Management has been consistent long-term buyers.

My philosophy is that the business exists ultimately to pay its shareholders dividends. Simply stated, that means earn more cash than we pay out in expenses, then return some money to shareholders and reinvest some back in the business to grow. With the reduced tax burden for holders of dividend paying stock, future investors have greater incentive to buy and hold dividend paying growth stocks than previous generations of investors. The art of the dividend proposition is to have both the ability and the willingness to pay dividends. We have just started paying a cash dividend through the use of special dividends. We hope that will mature into a regular dividend policy as we achieve greater scale in the next several years. The willingness is certainly there as evidenced by management's increasing ownership of the business.

**TWST: Are acquisitions likely to play a role in your future growth?**

**Mr. Schermer** First of all, our Board will always strive to maximize shareholder value. The art of maximizing shareholder value is always up for debate. Over the past six years, we have followed a strategy which you could describe as risk-averse by relying solely on internal new unit growth. We have preferred to build new restaurants rather than acquire existing restaurant portfolios, which tend to have a lot of deferred cap ex and varying management cultures.

In our business model, when we build a new freestanding restaurant, we create value or imbedded shareholder equity, as the industry terms it – measured in two values; first is the real estate value and second is the business value created in each new restaurant unit. In our Wendy's franchise model, we create approximately \$500,000 of real estate value (the difference between wholesale development cost and retail

sales value), and a business value of approximately \$550,000 (5.5 times cash flow after rent). In our O'Charley's model, we multiply these numbers by two, given the proportionately larger size of the investment and sales. These imbedded equity values are not reflected in financial statements and are only realized by selling the real estate or the business value of a restaurant unit. Given our current experience in real estate sale-leasebacks and current market rates for multi-unit franchise transactions, I believe these values are conservative in today's market. A sum of the parts valuation suggests our stock trades at a hefty discount to the underlying intrinsic value of our businesses. As it relates to acquisitions, we would need to see a clear strategic value or major real estate opportunity in order to justify an acquisition.

**TWT: What are the two or three reasons would you give potential long-term investors to take a look at Meritage?**

**Mr. Schermer** Why Meritage Hospitality Group? This is a simple business with relatively few moving parts and long product life cycles. We have a talented and experienced management team that has proven it can execute the development and operations of high new unit expansion. Our six-year cumulative return to shareholders of 44% annually speaks to this. The restaurant industry is healthy. The QSR and casual dining seg-

ments are outpacing the economy, supported by very strong future demographics. We have an inherent real estate and business value leverage compared to our brand franchisors by virtue of the multi-unit franchisee business model and our real estate ownership.

Because of our unique position, being one of the few multi-unit public franchisees, and possessing the "best of class" brands in the two strongest industry segments, the inherent leverage of our multi-unit franchise model will provide improving operated margins. We are a hybrid with characteristics of a real estate REIT and operating characteristics of a de-centralized restaurant company that has a high likelihood of replicating our historical returns through price appreciation and yield. This recipe should provide an interesting dessert for an investor's appetite in the food service industry.

**TWST: Thank you (TJM)**

**ROBERT E. SCHERMER JR.**  
**CEO**

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