



1998 ANNUAL REPORT

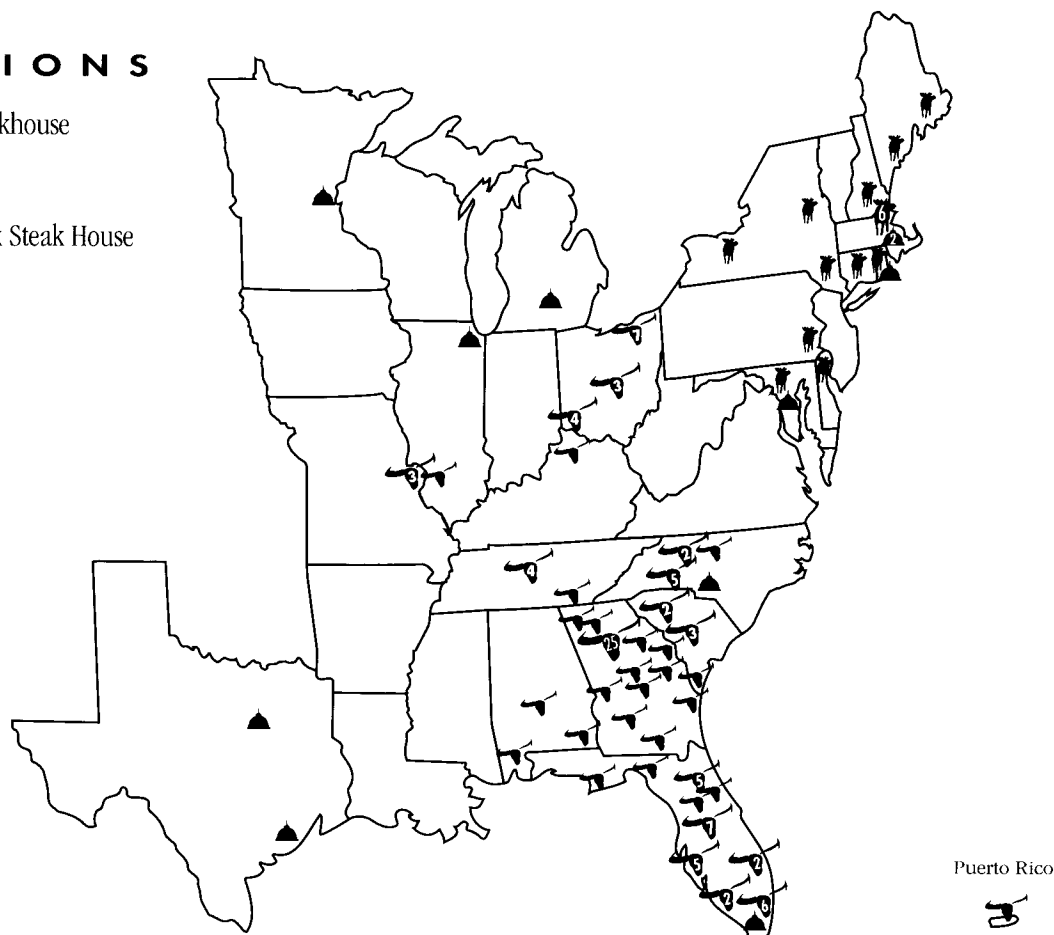


A B O U T T H E C O M P A N Y

RARE Hospitality International, Inc. owns, operates and franchises 138 restaurants, including 109 LongHorn Steakhouse restaurants located in the southeastern and midwestern United States, 17 Bugaboo Creek Steak House restaurants located in the northeastern and mid-Atlantic regions of the United States, and 11 The Capital Grille restaurants located in major metropolitan areas across the country.

LOCATIONS

- 🐄 LongHorn Steakhouse
- ▲ Capital Grille
- 🍷 Bugaboo Creek Steak House



F I N A N C I A L H I G H L I G H T S

(In thousands, except per share data)

For the Fiscal Year

	1998	1997
Revenues	\$ 319,084	\$ 264,754
Operating income, before nonrecurring items*	\$ 19,646	\$ 13,907
Net earnings, before nonrecurring items*	\$ 10,453	\$ 8,127
Diluted earnings per share, before nonrecurring items*	\$ 0.86	\$ 0.69
Weighted average common shares outstanding (diluted)	12,099	11,751

*Excludes nonrecurring expenses for fiscal 1998 of \$2,500 (\$1,700, or \$0.14 per diluted share, after tax) and for fiscal 1997 of \$28,675 (\$20,359, or \$1.73 per diluted share, after tax).

At Year End

Working capital	\$ 1,136	\$ 1,359
Total assets	220,352	195,486
Long-term debt	48,000	43,000
Obligations under capital leases, net of current installments	9,732	5,051
Minority interest	2,610	4,890
Total shareholders' equity	120,618	111,980

LETTER TO SHAREHOLDERS

Fellow Shareholders:

What a difference a year makes! When we wrote you last year in this letter, RARE Hospitality had just completed a difficult 1997 and was undergoing a major transition that would bring an almost entirely new senior management team to the Company. In contrast, now we are writing you about 1998, a year in which we produced a record financial performance, re-established a clear direction for the Company and strategically positioned it for growth in the years ahead.

The Company achieved these results through a renewed commitment to providing superior guest experiences. We refocused our efforts on the simple proposition that to grow this Company consistently and profitably, we must win the "table-top" battle: that nine square foot area that determines the quality of the guest experience and the strength of their intent to return to our restaurants in the future. Winning this battle requires constant, outstanding execution of the RARE standards throughout our restaurants. Perhaps the greatest improvement in RARE Hospitality over the past year is our dedication to training. Superior execution requires focused leadership along with in-depth and comprehensive training throughout the organization.

Our commitment to delivering superior execution was such that we intentionally slowed the Company's new restaurant development schedule for 1998 to be able to devote more managerial focus to the strengthening of the performance of each of our concepts. We also closed five underperforming restaurants during the year, producing net unit growth of 7.1% for 1998 compared with 22.3% for 1997. Due to the strong operational and financial performance of the Company in 1998, we are implementing a more aggressive restaurant development schedule for 1999.

The success of this strategy is reflected in the Company's record financial results for the past year. Total revenues increased 20.5% for 1998 to \$319,084,000 from \$264,754,000 for 1997. Net earnings, excluding nonrecurring expenses, rose 28.6% to \$10,453,000 from \$8,127,000. Diluted earnings per share, excluding nonrecurring expenses, increased 24.6% for the year to \$0.86 from \$0.69, for the prior year, exceeding analysts' consensus expectations throughout the year.

The Company's growth for the year was generated primarily by the opening of 13 new restaurants during 1998, as well as by having full-year results from the 25 restaurants opened in 1997. The LongHorn Steakhouse division showed outstanding improvement with an increase in same-store sales of 5.0%, compared with an increase of 0.2% for 1997. The Capital Grille continued to produce superior top-line results, with same store-sales expanding 6.1%, on top of an 8.7% increase for 1997. The performance of these two concepts more than compensated for the 2.5% decline in same-store sales for the Bugaboo Creek Steak House division, which, nonetheless, produced an improvement over the division's 5.3% same-store sales decline for 1997.

The performance of the LongHorn Steakhouse division exceeded our expectations in 1998. By almost any measure, LongHorn had a great year. In addition to significant same-store sales growth, average weekly sales increased 6.7% due in large part to the strong sales performance of our newest LongHorn restaurants. Other key operating measurements, such as restaurant operating margin, management retention, and "intent to return" (as measured by independent guest surveys), improved throughout the LongHorn system in 1998. As a management team, we believe that the LongHorn division has compelling potential that will continue to be realized as we focus on the strategic initiatives laid out during the past year. LongHorn will be the primary driver of the growth of RARE Hospitality as we head into the new millennium.

The strong performance at LongHorn Steakhouse was a direct result of our commitment to delivering superior execution. At LongHorn Steakhouse, we define superior execution as "the consistent delivery of great tasting food by friendly, knowledgeable servers in a clean and comfortable environment." The increased focus on execution was put into practice through the upgrading of training at both the hourly and management levels.

Complementing the Company's renewed commitment to execution, we continued our efforts to build an outstanding management team during 1998. Among other changes, Phil Hickey was promoted to Chief Executive Officer of the Company, with George McKerrow, Jr. remaining as Chairman of the Board. Doug Benn was named Executive Vice President and Chief Financial Officer and Tom Gathers was appointed Executive Vice President of Human Resources. In addition, we welcomed Lewis Jordan to our Board of Directors, and subsequent to the end of 1998, Gene Lee was promoted to Chief Operating Officer of the Company.

Rounding out the leadership changes during 1998, Bob McGurk and Dave George, both former joint venture partners, were promoted to Vice President of Operations, LongHorn Steakhouse. Rick Kaskel was hired as Vice President of Operations for Bugaboo Creek Steak House, Bill Robertson was appointed the Vice President of Research & Development and Rob Crews was promoted to Vice President of Marketing, LongHorn Steakhouse.

OUTLOOK

A principal goal of the Company's management and Board of Directors is to increase the Company's credibility with its key constituencies: its guests, shareholders, team members, and suppliers, as well as with the investment community. We believe we achieved this goal during 1998 through the Company's strong operating and financial performance. We also believe that the key to maintaining and building our credibility in the future is to produce reliable and consistent earnings growth.

As a result, for 1999 we are implementing a strategy of controlled new unit development combined with an ongoing focus on the quality of the Company's existing restaurant operations. We will concentrate on building the same-store sales performance of each of our three concepts, even as we continue to strengthen restaurant-level management. Our goal is to maintain an attractive rate of earnings growth through a combination of new restaurant openings, increased same-store sales, and margin improvements from economies of scale.

LongHorn Steakhouse – LongHorn Steakhouse is positioned as a “cool Texas saloon where our guests can enjoy a great steak with an iced cold beer.” With 104 LongHorn Steakhouses in operation at the end of 1998, we expect this division to continue to be the Company's primary growth vehicle for the foreseeable future. Having opened nine new LongHorn Steakhouses during the past year - one more than originally planned - we intend to open 12 to 14 new locations during 1999. In addition to back-filling existing markets, we will initiate LongHorn development in the Northeast.

The Capital Grille – The Capital Grille is an award winning, fine dining restaurant that competes in the “top scale” steakhouse segment. Following The Capital Grille's strong financial performance in 1998, we plan to continue improving the concept in the Company's 11 restaurants in operation, while scheduling the opening of one new The Capital Grille for 1999. We expect the division's results will benefit from the maturation of the two restaurants opened during 1998, as well as the closing during the fourth quarter of 1998 of The Capital Grille in San Francisco.

Bugaboo Creek Steak House – Bugaboo Creek Steak House is a Canadian Rockies mountain lodge themed restaurant with a family oriented appeal. We achieved significant improvement in the 1998 operational results of Bugaboo Creek Steak House, including the first positive quarterly same-store sales comparison since we acquired the concept in 1996. However, we believe the concept needs further refinement during 1999. The primary goal of these efforts will be to bring the consistency of the division's financial results in line with the increased consistency of its operations. We intend to accelerate the opening schedule only after we are satisfied with our ability to consistently deliver strong concept performance. After opening two Bugaboo Creek Steak Houses in 1998, and closing one unit, we expect to open two or three new restaurants during 1999.

During 1998, we also strengthened our ability to finance our new restaurant development strategy by securing an increase in the Company's bank line of credit to \$100 million from \$60 million. Combined with operating cash flow, we believe this expanded credit facility will be sufficient to fund growth through the year 2000.


SUMMARY

We view 1998 as a year of successful recovery. During the year, we developed the infrastructure for growing the Company at a consistent and profitable rate and secured a quality senior management team. We made training, concept execution, the guest's intent to return and same-store sales performance paramount in the minds of employees at every level of the Company. We also made significant strides in our mission to regain the credibility needed to increase shareholder value. We enter 1999 confident of the Company's ability to achieve its operating and financial targets and enthusiastic about its opportunities for further growth beyond the current year.

The Board of Directors expressed its confidence in the Company's prospects by its authorization in October 1998 of the repurchase of up to \$5 million of shares of the Company's common stock. This action is entirely consistent with our ongoing efforts to increase shareholder value and reflects our belief in the Company's future.

That we have accomplished so much in so short a period is largely attributable to the talent and dedication of **our people**. RARE Hospitality is truly blessed to have over 8,000 employees working diligently to move us forward. We deeply appreciate your investment in the Company and your confidence in its future. Please be assured that, as your fellow shareholders, we are entirely committed to enhancing the quality of our Company while increasing the value of your investment.

Sincerely,



George W. McKerrow, Jr.
Chairman of the Board



Philip J. Hickey, Jr.
President and Chief Executive Officer

S E L E C T E D F I N A N C I A L D A T A

At or for Fiscal Years Ended	December 27, 1998	December 28, 1997	December 29, 1996	December 31, 1995	December 31, 1994
	(in thousands, except per share data)				
STATEMENT OF OPERATIONS DATA:					
Revenues:					
Restaurant sales	\$ 319,084	\$ 264,727	\$ 212,894	\$ 149,279	\$ 111,025
Wholesale meat sales	—	—	2,547	6,495	3,389
Franchise revenues	—	27	308	606	615
Total revenues	319,084	264,754	215,749	156,380	115,029
Costs and expenses:					
Cost of restaurant sales	116,602	97,568	78,637	54,074	39,956
Cost of wholesale meat sales	—	—	2,491	6,159	3,137
Operating expenses — restaurants	142,730	119,480	94,587	67,629	50,924
Operating expenses — meat division	—	—	234	766	702
Provision for asset impairments, restaurant closings, and other charges	2,500	23,666	1,436	155	1,120
Merger and conversion expenses	—	—	2,900	—	—
Depreciation and amortization — restaurants	17,636	15,218	12,191	7,171	5,025
General and administrative expenses	22,470	23,590	13,732	11,082	10,131
Total costs and expenses	301,938	279,522	206,208	147,036	110,995
Operating income (loss)	17,146	(14,768)	9,541	9,344	4,034
Interest expense (income), net	2,939	1,245	(79)	(291)	(794)
Provision for litigation settlement	—	—	605	—	—
Minority interest	1,334	1,219	602	5	—
Earnings (loss) before income taxes	12,873	(17,232)	8,413	9,630	4,828
Income tax expense (benefit)	4,120	(5,000)	3,170	3,047	1,286
Net earnings (loss)	\$ 8,753	\$ (12,232)	\$ 5,243	\$ 6,583	\$ 3,542
Basic earnings (loss) per common share	\$ 0.73	\$ (1.04)	\$ 0.46	\$ 0.67	\$ 0.37
Weighted average common shares outstanding (basic)	12,004	11,751	11,302	9,753	9,517
Diluted earnings (loss) per common share	\$ 0.72	\$ (1.04)	\$ 0.45	\$ 0.66	\$ 0.37
Weighted average common shares outstanding (diluted)	12,099	11,751	11,631	9,955	9,526
BALANCE SHEET DATA:					
Working capital	\$ 1,136	\$ 1,359	\$ 2,065	\$ 561	\$ 22,488
Total assets	220,352	195,486	151,594	107,735	81,951
Debt, net of current installments	48,000	43,000	7,100	13,858	1,808
Obligations under capital leases, net of current installments	9,732	5,051	—	—	—
Minority interest	2,610	4,890	3,301	615	—
Total shareholders' equity	120,618	111,980	121,384	78,133	70,289

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

On September 13, 1996, the Company completed the acquisition of Bugaboo Creek Steak House, Inc., along with related restaurant and real estate properties. The acquisition provided for the issuance of 2,939,062 shares of the Company's common stock to the stockholders of Bugaboo Creek Steak House, Inc. and 240,410 shares of the Company's common stock for the purchase of three other related restaurants and certain related real estate. The exchange of shares was accounted for as a pooling of interests, and accordingly, the accompanying consolidated financial statements have been restated to include the accounts and operations of Bugaboo Creek Steak House, Inc. and the related restaurant and real estate properties that were acquired for all periods presented.

Effective July 1, 1996, the Company changed its fiscal year-end from December 31 to a 52- or 53-week year ending on the last Sunday in December. Interim reporting periods within 1996 contained three months for the first two quarters. The third and fourth quarters of 1996 each contained 13 weeks. Fiscal 1998, which ended on December 27, 1998, and fiscal 1997, which ended on December 28, 1997, each contained 52 weeks. All general references to years relate to fiscal years, unless otherwise noted.

The Company's revenues are derived primarily from restaurant sales from Company-owned and joint venture restaurants. The Company also derives a small percentage of its total revenue from franchise revenues from unaffiliated franchised restaurants. Cost of restaurant sales consists of food and beverage costs for Company-owned and joint venture restaurants. Restaurant operating expenses consist of all other restaurant-level costs. These expenses include the cost of labor, advertising, operating supplies, rent, and utilities. Depreciation and amortization includes only the depreciation attributable to restaurant-level capital expenditures and amortization primarily associated with pre-opening expenditures.

General and administrative expenses include finance, accounting, management information systems, and other administrative overhead related to support functions for Company-owned, joint venture, and franchise restaurant operations. Minority interest consists of the partners' share of earnings in joint venture restaurants.

In April 1996, the Company discontinued the meat cutting and distribution operations of its meat division, but retained the purchasing function. As a result, the Company no longer generates wholesale meat sales to franchises or unaffiliated businesses. Prior to April 1996, the LongHorn Steakhouse restaurants were not charged distribution costs, which were absorbed by the Company's meat division. Subsequent to April 1996 the LongHorn Steakhouse restaurants absorb the full cost of purchased beef.

Beginning with 1998, the Company defines the comparable restaurant base for 1998 to include those restaurants open for a full 18 months prior to the beginning of each fiscal quarter. The Company defines the comparable restaurant base for 1997 to include those restaurants open for a full 15 months prior to the beginning of the fiscal year. Average weekly sales are defined as total restaurant sales divided by restaurant weeks. A "restaurant week" is one week during which a single restaurant is open, so that two restaurants open during the same week constitutes two restaurant weeks.

The Company's revenues and expenses can be significantly affected by the number and timing of the opening of additional restaurants. The timing of restaurant openings also can affect the average sales and other period-to-period comparisons.

The following table sets forth the percentage relationship to total revenues of the listed items included in the Company's consolidated statements of operations, except as indicated:

Fiscal Years Ended	December 27, 1998	December 28, 1997	December 29, 1996
Revenues:			
Restaurant Sales:			
LongHorn Steakhouse	66.3%	64.3%	63.3%
The Capital Grille	16.0	14.9	9.4
Bugaboo Creek Steak House	15.7	16.9	20.4
Other restaurants	2.0	3.9	5.6
Total restaurant sales	100.0	100.0	98.7
Wholesale meat sales	—	—	1.2
Franchise revenues	—	—	0.1
Total revenues	100.0	100.0	100.0
Costs and expenses:			
Cost of restaurant sales ⁽¹⁾	36.5	36.9	36.9
Cost of wholesale meat sales ⁽¹⁾	—	—	97.8
Operating expenses—restaurants ⁽¹⁾	44.7	45.1	44.4
Operating expenses— meat division	—	—	0.1
Provision for asset impairments, restaurant closings, and other charges	0.8	8.9	0.7
Merger and conversion expenses	—	—	1.3
Depreciation and amortization—restaurants ⁽¹⁾	5.5	5.7	5.7
General and administrative expenses	7.0	8.9	6.4
Total costs and expenses	94.6	105.5	95.6
Operating income (loss)	5.4	(5.5)	4.4
Interest expense (income), net	0.9	0.5	(0.1)
Provision for settlement of shareholder suit	—	—	0.3
Minority interest	0.4	0.5	0.3
Earnings (loss) before income taxes	4.0	(6.5)	3.9
Income tax expense (benefit)	1.3	(1.9)	1.5
Net earnings (loss)	2.7%	(4.6)%	2.4%

⁽¹⁾ Cost of restaurant sales, restaurant operating expenses, and depreciation and amortization are expressed as a percentage of restaurant sales, and cost of wholesale meat sales is expressed as a percentage of wholesale meat sales.

RESULTS OF OPERATIONS

Year Ended December 27, 1998 Compared to Year Ended December 28, 1997

Revenues

Total revenues increased 20.5% to \$319.1 million for 1998 compared to \$264.7 million for 1997.

LongHorn Steakhouse:

Sales in the LongHorn Steakhouse restaurants increased 24.1% to \$211.4 million for 1998 compared to \$170.3 million for 1997. The increase reflects a 16.4% increase in restaurant operating weeks in 1998 as compared to 1997, resulting from an increase in the restaurant base from 96 LongHorn Steakhouse restaurants at the end of 1997 to 104 restaurants at the end of 1998. Average weekly sales for all LongHorn Steakhouse restaurants in 1998 were \$41,638, a 6.7% increase over 1997. Sales for the comparable LongHorn Steakhouse restaurants increased 5.0% in 1998 as compared to 1997. The increase in comparable restaurant sales for 1998 at LongHorn Steakhouse was attributable primarily to an increase to customer counts.

The Capital Grille:

Sales in The Capital Grille restaurants increased 29.3% to \$51.1 million for 1998 compared to \$39.5 million for 1997. The increase reflects a 42.1% increase in restaurant operating weeks in 1998 as compared to 1997, resulting from an increase in the restaurant base from 10 The Capital Grille Restaurants at the end of 1997 to 11 restaurants at the end of 1998. Average weekly sales for all The Capital Grille restaurants in 1998 were \$89,329, a 9.0% decrease from 1997. Sales for the comparable The Capital Grille restaurants increased 6.1% in 1998 as compared to 1997. The increase in comparable restaurant sales at The Capital Grille restaurants is primarily attributable to an increase in customer counts.

Bugaboo Creek Steak House:

Sales in the Bugaboo Creek Steak House restaurants increased 12.2% to \$50.1 million for 1998 compared to \$44.6 million for 1997. The increase reflects a 9.1% increase in restaurant weeks in 1998 as compared to 1997, resulting from an increase in the restaurant base from 16 Bugaboo Creek Steak House restaurants at the end of 1997 to 17 restaurants at the end of 1998. Average weekly sales for all Bugaboo Creek Steak House restaurants in 1998 were \$60,788, a 2.8% increase from 1997. Sales for the comparable Bugaboo Creek Steak House restaurants decreased 2.5% in 1998 as compared to 1997. The decrease in comparable restaurant sales at Bugaboo Creek Steak House restaurants is primarily attributable to a decrease in customer counts.

Franchise Revenue:

During 1997, the Company acquired all of the LongHorn Steakhouse restaurants that were then paying franchise revenues. In September 1998, a franchise LongHorn Steakhouse restaurant opened in Puerto Rico; this franchisee began paying franchise fees in January 1999. No franchise revenues were earned during 1998.

Costs and Expenses

Cost of restaurant sales, as a percentage of restaurant sales, decreased to 36.5% in 1998 from 36.9% in 1997. This decrease is due, in part, to purchasing contracts negotiated during the year, which stabilized the cost of restaurant sales as a percentage of restaurant sales.

Restaurant operating expenses decreased as a percentage of restaurant sales in 1998 to 44.7% from 45.1% in 1997. The decrease in operating expenses as a percentage of sales in 1998 was due to an increase in average unit sales providing greater leverage of fixed and semi-fixed expenses, principally rent and management labor.

The provision for asset impairments, restaurant closings, and other charges of \$2.5 million in 1998 was determined under Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of" ("SFAS No. 121") by comparing expected future cash flows to the carrying value of these assets. This charge was primarily the result of a decision by management, in the fourth quarter, to close one The Capital Grille restaurant partially offset by favorable developments in estimated amounts accrued in 1997 for costs associated with closed facilities.

General and administrative expenses decreased to \$22.5 million in 1998 or 7.0% of total revenues, from \$23.6 million in 1997, or 8.9% of total revenues. The decrease as a percentage of total revenues was primarily due to the \$5 million in nonrecurring expenses recognized in 1997 as partially offset by higher general and administrative expenses in 1998, primarily payroll related, associated with building the infrastructure necessary to support the Company's growth.

Interest expense increased to \$2.9 million in 1998 compared to \$1.2 million in 1997. The increase in interest expense is due to higher average borrowings outstanding under the Company's revolving credit agreement as well as additional expenses associated with obtaining the Company's new revolving credit facility. The Company's weighted average interest rate on borrowings was approximately 7.8% in 1998 as compared to 7.2% in 1997.

Minority interest increased to \$1.3 million in 1998 from \$1.2 million in 1997. This reflects an increase in the number of joint venture restaurants for most of 1998, partially offset by the purchase of a joint venture partner's partnership interests in 11 joint venture restaurants during the fourth quarter of 1998.

Income tax expense in 1998 was 32.0% of earnings before income taxes. The Company's effective income tax rate differs from applying the statutory federal income tax rate of 35% to earnings before income taxes primarily due to employee FICA tip tax credits partially offset by state income taxes.

Net income of \$8.8 million in 1998, as compared to a net loss of \$12.2 million in 1997, reflects the net effect of the items discussed above.

Year Ended December 28, 1997 Compared to Year Ended December 29, 1996

Revenues

Total revenues increased 22.7% to \$264.8 million for 1997 compared to \$215.7 million for 1996. Restaurant sales increased 24.3% to \$264.7 million in 1997 compared to \$212.9 million in 1996.

LongHorn Steakhouse:

Sales in the LongHorn Steakhouse restaurants increased 24.8% to \$170.3 million for 1997 compared to \$136.5 million for 1996. The increase reflects a 23.7% increase in restaurant operating weeks in 1997 as compared to 1996, resulting primarily from the opening of 14 new LongHorn Steakhouse restaurants and the acquisition of 3 additional LongHorn Steakhouse restaurants. Average weekly sales for all LongHorn Steakhouse restaurants in 1997 were \$39,035, a 0.5% increase over 1996. Sales for the 54 comparable LongHorn Steakhouse restaurants increased 0.2% in 1997 as compared to 1996.

Bugaboo Creek Steak House:

Sales in the Bugaboo Creek Steak House restaurants increased 1.3% to \$44.6 million for 1997 compared to \$44.1 million for 1996. The increase reflects a 6.9% increase in restaurant operating weeks in 1997 as compared to 1996, resulting from the opening of 3 new Bugaboo Creek Steak House restaurants. Average weekly sales for all Bugaboo Creek Steak House restaurants in 1997 were \$59,114, a 5.2% decrease from 1996. Sales for the 10 comparable Bugaboo Creek Steak House restaurants decreased 5.3% in 1997 as compared to 1996. The decrease in comparable restaurants sales at the Bugaboo Creek Steak House restaurants is primarily attributable to a decrease in customer counts.

The Capital Grille:

Sales in The Capital Grille restaurants increased 94.4% to \$39.5 million for 1997 compared to \$20.3 million for 1996. The increase reflects a 96.4% increase in restaurant operating weeks in 1997 as compared to 1996, resulting primarily from new The Capital Grille restaurants. Average weekly sales for all The Capital Grille restaurants in 1997 were \$98,169, a 1.0% decrease from 1996. Sales for the three comparable The Capital Grille restaurants increased 8.7% in 1997 as compared to 1996. The increase in comparable restaurants sales at The Capital Grille restaurants is primarily attributable to an increase in customer counts.

Company-wide:

A contracted meat distribution system was implemented for the LongHorn Steakhouse restaurants during the first half of 1996, thereby eliminating the need for an internal meat production and distribution facility. Accordingly, the Company's meat cutting and distribution activities ceased during 1996 and wholesale meat sales were eliminated.

Franchise revenues decreased to \$27,000 in 1997 compared to \$308,000 in 1996 due to i) the termination of the franchise agreement for the Hoover, Alabama franchised LongHorn Steakhouse restaurant, ii) the Company's acquisition of two franchised LongHorn Steakhouse restaurants in the first quarter of 1997, iii) the closure of two franchised LongHorn Steakhouse restaurants (one each, in the first and third quarters of 1996), and iv) the formation of a joint venture to operate three previously franchised LongHorn Steakhouse restaurants in the second quarter of 1996.

Costs and Expenses

Cost of restaurant sales, as a percentage of restaurant sales, remained flat in 1997 and 1996 at 36.9%.

Due to the elimination of wholesale meat sales during 1996, there were no wholesale meat costs for 1997, compared to 97.8% of wholesale meat sales in 1996.

Restaurant operating expenses increased as a percentage of restaurant sales in 1997 to 45.1% from 44.4% in 1996. This increase was primarily attributable to i) incremental labor, controllable expenses and start-up expenses associated with the Company's new store opening program, as the Company opened 25 restaurants in 1997; and ii) increased labor and controllable expenses as the Company focused on better execution and higher standards in the LongHorn Steakhouse concept.

General and administrative expenses increased to \$23.6 million in 1997, or 8.9% of total revenues, from \$13.7 million in 1996, or 6.4% of total revenues. The increase was primarily due to \$5.0 million in nonrecurring expenses including charges resulting from i) current asset reconciliation and evaluation processes and ii) severance, hiring and other employment related charges.

In the fourth quarter of 1997, management initiated an in-depth analysis of the Company's growth strategies and assets available for accomplishing future growth plans. This analysis prompted an evaluation of the fair value of certain underperforming assets under SFAS No. 121 by

comparing expected future cash flows to the carrying value of these assets. The resulting impairment, primarily related to restaurant closings and the write-down or write-off of restaurant assets in the LongHorn division, along with the write-off of other specific assets, aggregated \$23.7 million.

Interest expense increased to \$1.2 million in 1997 compared to \$79,000 in net interest income in 1996. The increase in interest expense is due to higher average borrowing outstanding under the Company's revolving credit agreement.

Minority interest increased to \$1.2 million in 1997 from \$602,000 in 1996. This reflects an increase in the number of joint venture restaurants to 43 at December 28, 1997, from 35 at December 29, 1996, partially offset by the purchase of joint venture partners' partnership interests in 10 joint venture restaurants during the fourth quarter of 1997.

Income tax benefit for 1997 was \$5 million due to the pre-tax loss reported by the Company, resulting primarily from the aggregate \$28.7 million in nonrecurring charges recorded during the year. Income tax expense in 1996 was 37.7% of earnings before income taxes, reflecting \$2.5 million of nondeductible merger and conversion expense, offset primarily by the benefits of FICA tip credits.

The net loss of \$12.2 million in 1997, as compared to net earnings of \$5.2 million in 1996, reflects the net effect of the items discussed above.

Liquidity and Capital Resources

The Company requires capital primarily for the development of new restaurants, selected acquisitions and the refurbishment of existing restaurants. Principal financing sources in 1998 consisted of cash flow from operations (\$35.1 million) and additional borrowings under the Company's revolving credit facility (\$5.0 million). The primary uses of funds consisted of costs associated with expansion, principally leasehold improvements, equipment, land and buildings associated with the construction of new restaurants (\$25.0 million) and the acquisition of joint venture partnership and franchise interests (\$6.6 million).

Since substantially all sales in the Company's restaurants are for cash, and accounts payable are generally due in seven to 30 days, the Company operates with little or negative working capital.

The increases in accounts receivable, inventory and accrued expenses are principally due to the new restaurants which were opened during 1998 and the result of higher average unit volumes experienced during 1998. Further increases in current asset and liability accounts are expected as the Company continues its restaurant development program.

On August 26, 1998, the Company amended and restated its revolving credit facility to increase the aggregate commitment from \$60 million to \$100 million with an initial term of three years. The terms of the revolving credit facility, as amended, require the Company to pay interest on outstanding borrowings at LIBOR plus a margin of 1.25% to 2.0% (depending on the Company's leverage ratio) or the administrative agent's prime rate of interest plus a margin of 0% to 0.75% (depending on the Company's leverage ratio), at the Company's option, and pay a commitment fee of 0.3% to 0.5% per year on any unused portion of the facility. As of December 27, 1998, interest on the revolving credit facility accrues at LIBOR plus 1.625% or the prime rate plus 0.375%. As of December 27, 1998, the Company is required to pay a commitment fee of 0.35% per year on any unused portion of the facility. The revolving credit facility contains various covenants and restrictions which, among other things, require the maintenance of stipulated leverage and fixed charge coverage ratios and minimum consolidated net worth, as defined, and also limit additional indebtedness in excess of specified amounts. The Company is currently in compliance with such covenants.

In August 1998, the Company entered into an interest rate swap agreement with a commercial bank, which effectively fixes the interest rate at 7.515% on \$40.0 million of the Company's borrowings through August 1999, decreasing to \$35.0 million through February 2000 and decreasing to \$25.0 million through August 2001. The Company is exposed to credit losses on this interest rate swap in the event of counterparty non-performance, but does not anticipate any such losses.

On December 27, 1998, \$48.0 million was outstanding and \$52.0 million was available under the Company's revolving credit facility at a weighted average interest rate equal to 6.836%. Giving effect to the interest rate swap agreement, the weighted average interest rate on borrowings under the revolving credit facility was 7.421%.

The Company currently plans to open 12 to 14 Company-owned and joint venture LongHorn Steakhouse restaurants, two or three Bugaboo Creek Steak House restaurants and one The Capital Grille restaurant in 1999. The Company estimates that its capital expenditures (without consideration of contributions from joint venture partners) will be approximately \$44 to \$48 million in 1999. The capital expenditure estimate for 1999 includes the estimated cost of developing 15 to 18 new restaurants, ongoing refurbishment in existing restaurants, a planned expansion of the corporate offices in Atlanta, costs associated with obtaining real estate for year 2000 planned openings, and continued investment in improved

management information systems. The Company expects that available borrowings under the Company's revolving credit facility, together with cash on hand and cash provided by operating activities, will provide sufficient funds to finance its expansion plans through the year 2000.

The preceding discussion of liquidity and capital resources contains certain forward-looking statements. Forward-looking statements involve a number of risks and uncertainties, and among the other factors that could cause actual results to differ materially are the following: failure of facts to conform to necessary management estimates and assumptions; the Company's ability to identify and secure suitable locations on acceptable terms, open new restaurants in a timely manner, hire and train additional restaurant personnel and integrate new restaurants into its operations; the continued implementation of the Company's business discipline over a large restaurant base; risks associated with the Year 2000 issue, including Year 2000 problems that may arise on the part of third parties which may affect the Company's operations; the economic conditions in the new markets into which the Company expands and possible uncertainties in the customer base in these areas; changes in customer dining patterns; competitive pressures from other national and regional restaurant chains; business conditions, such as inflation or a recession, and growth in the restaurant industry and the general economy; and other risks identified from time to time in the Company's SEC reports, including the Company's Annual Report on Form 10-K for 1998, registration statements and public announcements.

Effect of Inflation

Management believes that inflation has not had a material effect on earnings during the past several years. Inflationary increases in the cost of labor, food and other operating costs could adversely affect the Company's restaurant operating margins. In the past, however, the Company generally has been able to modify its operations and increase menu prices to offset increases in its operating costs.

Federal law increased the hourly minimum wage to \$5.15 on September 1, 1997. The legislation, however, froze the wages of tipped employees at \$2.13 per hour if the difference is earned in tip income. Although the Company experienced a slight increase in hourly labor costs during 1997 and 1998, the effect of the increase in minimum wage was significantly diluted due to the fact that the majority of the Company's hourly employees are tipped and the Company's non-tipped employees have historically earned wages greater than the federal minimum. As such, the Company's increases in hourly labor cost were not proportionate to the increases in minimum wage rates.

Impact of the Year 2000 Issue

Most hardware and software designed in the past was not designed to recognize calendar dates beginning in the Year 2000. The failure of such hardware and software to properly recognize the dates beginning in the Year 2000 could result in miscalculations or system failures, which could result in an adverse effect on the Company's operations.

The Company's key information technology systems, including its financial, informational and operational systems ("IT Systems"), which are mainly comprised of third party hardware and software, have been assessed and detailed plans have been developed to address any remediations required before the end of 1999. The Company is in the process of testing its IT Systems to determine Year 2000 compliance. Management anticipates that such testing will be complete by September 30, 1999. In addition, the Company is in the process of assessing its non-IT systems that utilize embedded technology such as microcontrollers and reviewing them for Year 2000 compliance. Assessment of the Company's non-IT Systems is scheduled for completion by September 30, 1999.

To operate its business, the Company relies upon its suppliers, distributors and other third party service providers ("Material Providers"), over which it can assert little control. The Company's ability to conduct its core business is dependent upon the ability of these Material Providers to remediate their Year 2000 issues to the extent they affect the Company. If the Material Providers do not appropriately remediate their Year 2000 issues or develop viable contingency plans, the Company's ability to conduct its core business may be materially impacted, which could result in a material adverse effect on the Company's financial condition.

Where predictable, the Company is assessing and attempting to mitigate its risks with respect to the failure of its Material Providers to be Year 2000 ready as part of its ongoing contingency planning. The Company has requested all of its Material Providers to provide information regarding their state of Year 2000 readiness. The process of following up with Material Providers who have not yet responded and evaluating all responses is expected to be completed by September 30, 1999. Although the communications received by the Company from its Material Providers, to date, have not disclosed any material Year 2000 issues, there is no assurance that these Material Providers will be Year 2000 ready on a timely basis. Unanticipated failures or significant delays in furnishing products or services by Material Providers could cause certain restaurants to temporarily close or remove certain items from their menus, which could have a material adverse effect on the Company's consolidated financial position, results of operations and cash flows. If unanticipated problems arise from systems or equipment, there could be material adverse effects on the Company's consolidated financial position, results of operations and cash flows. As part of the Year 2000 readiness efforts, the Company is developing contingency plans which will need to be implemented in the event of failures in the Company's IT Systems or non-IT systems. The remainder of the contingency plans are expected to be completed by September 30, 1999, but will be modified as additional information regarding possible failures becomes available.

The Company expenses costs associated with its Year 2000 system changes as the costs are incurred except for system change costs that the Company would otherwise capitalize. The program, including testing and remediation of all of the Company's systems and applications, the cost of external consultants, the purchase of software and hardware, the development and implementation of viable contingency plans, including the compensation of internal employees working on Year 2000 projects, is expected to cost approximately \$1,025,000 (except for fringe benefits of internal employees, which are not separately tracked) from inception in calendar year 1998 through completion in calendar year 1999. Of these costs, approximately \$100,000 was incurred (approximately \$80,000 of which was capitalized) during 1998 and approximately \$925,000 is expected to be incurred in 1999 (approximately \$800,000 of which will be capitalized). However, the Company is unable to estimate the additional costs that it may incur subsequent to 1999 as a result of Year 2000 problems suffered by Material Providers, and there can be no assurance that the Company will successfully address the Year 2000 problems present in its own IT Systems and non-IT systems.

Recent Accounting Pronouncements

In June 1998, the FASB issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 133, which is effective for 2000, requires all derivatives to be recorded on the balance sheet at fair value and establishes accounting treatment for certain hedge transactions. The Company is analyzing the implementation requirements and currently does not anticipate there will be a material impact on the results of operations or financial position after the adoption SFAS No. 133.

In June 1997, the FASB issued Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131"). SFAS No. 131, which is effective for 1998, significantly modifies disclosures associated with segments of an entity. Due to the similar economic characteristics as well as a single type of product, production process, distribution system and type of customer, the Company reports the operations of its different concepts on an aggregated basis and does not separately report segment information as provided for by SFAS No. 131.

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 identifies the characteristics of internal-use software and specifies that once the preliminary project stage is complete, certain external direct costs, certain direct internal payroll and payroll-related costs and interest costs incurred during the development of computer software for internal use should be capitalized and amortized. SOP 98-1 is effective for financial statements for fiscal years beginning after December 15, 1998, with earlier application encouraged, and must be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. The Company currently expenses all such costs as incurred. Management has not yet quantified the dollar impact of adopting SOP 98-1; however, when implemented in 1999, it will result in the capitalization of costs which would have been previously expensed.

As is currently the practice of many casual dining and upscale restaurant entities, through the end of 1998, the Company deferred its restaurant pre-opening costs and amortized them over the twelve-month period following the opening of each respective restaurant. The Company also deferred organization costs and amortizes them over a five-year period through the end of 1998.

Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities", was issued in April 1998. SOP 98-5 requires entities to expense as incurred all start-up and pre-opening costs that are not otherwise capitalized as long-lived assets. SOP 98-5 is effective for fiscal years beginning after December 15, 1998, although earlier adoption is encouraged. Restatement of previously issued financial statements is not permitted by SOP 98-5, and entities are not required to report the pro forma effects of the retroactive application of the new accounting standard. The Company's adoption of the expense-as-incurred accounting principle required by SOP 98-5 will involve the recognition of the cumulative effect of the change in accounting principle required by SOP 98-5 as a one-time charge against earnings, net of any related income tax effect, retroactive to the beginning of the fiscal year of adoption. The Company will adopt SOP 98-5 in the first quarter of 1999. The adoption of this change in accounting method is expected to result in a one-time charge of \$2.3 million, less applicable income taxes.

CONSOLIDATED BALANCE SHEETS

	December 27, 1998	December 28, 1997
ASSETS	<i>(in thousands)</i>	
Current assets:		
Cash and cash equivalents	\$ 12,060	\$ 1,752
Marketable debt securities	-	609
Accounts receivable	3,443	2,054
Inventories	9,609	9,152
Prepaid expenses	789	1,373
Pre opening costs, net of accumulated amortization	2,102	3,385
Refundable income taxes	2,700	4,452
Deferred income taxes (note 7)	6,932	6,712
Total current assets	37,635	29,489
Property and equipment, less accumulated depreciation and amortization (notes 4 and 9)	167,810	155,758
Goodwill, less accumulated amortization	10,045	5,304
Deferred income taxes (note 7)	1,490	2,579
Other	3,372	2,356
Total assets	\$ 220,352	\$ 195,486
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 12,423	\$ 12,739
Accrued expenses (note 5)	24,076	14,873
Current installments of obligations under capital leases (note 9)	-	518
Total current liabilities	36,499	28,130
Debt, net of current installments (note 6)	48,000	43,000
Deferred income taxes (note 7)	2,893	2,435
Obligations under capital leases, net of current installments (note 9)	9,732	5,051
Total liabilities	97,124	78,616
Minority interest	2,610	4,890
Shareholders' equity (notes 2, 6, 11, and 12):		
Preferred stock, no par value. Authorized 10,000 shares, none issued	-	-
Common stock, no par value. Authorized 25,000 shares; issued 12,077 shares and 11,979 shares at December 27, 1998 and December 28, 1997, respectively	105,092	103,981
Unearned compensation – restricted stock	(478)	-
Retained earnings	16,752	7,999
Treasury shares at cost; 60 shares at December 27, 1998	(748)	-
Total shareholders' equity	120,618	111,980
Commitments and contingencies (notes 6, 8, 9, and 13)		
Total liabilities and shareholders' equity	\$ 220,352	\$ 195,486

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years ended		
	December 27, 1998	December 28, 1997	December 29, 1996
	<i>(In thousands, except per share data)</i>		
Revenues:			
Restaurant sales:			
LongHorn Steakhouse	\$ 211,440	\$ 170,343	\$ 136,547
The Capital Grille	51,096	39,520	20,329
Bugaboo Creek Steak House	50,090	44,631	44,060
Other restaurants	6,458	10,233	11,958
Total restaurant sales	319,084	264,727	212,894
Wholesale meat sales	—	—	2,547
Franchise revenues	—	27	308
Total revenues	319,084	264,754	215,749
Costs and expenses:			
Cost of restaurant sales	116,602	97,568	78,637
Cost of wholesale meat sales	—	—	2,491
Operating expenses — restaurants	142,730	119,480	94,587
Operating expenses — meat division	—	—	234
Provision for asset impairments, restaurant closings, and other charges (note 3)	2,500	23,666	1,436
Merger and conversion expenses (note 3)	—	—	2,900
Depreciation and amortization — restaurants	17,636	15,218	12,191
General and administrative expenses	22,470	23,590	13,732
Total costs and expenses	301,938	279,522	206,208
Operating income (loss)	17,146	(14,768)	9,541
Interest expense (income), net	2,939	1,245	(79)
Provision for settlement of shareholder suit (note 13)	—	—	605
Minority interest (note 2)	1,334	1,219	602
Earnings (loss) before income taxes	12,873	(17,232)	8,413
Income tax expense (benefit) (note 7)	4,120	(5,000)	3,170
Net earnings (loss)	\$ 8,753	\$ (12,232)	\$ 5,243
Basic earnings (loss) per common share	\$ 0.73	\$ (1.04)	\$ 0.46
Weighted average common shares outstanding (basic)	12,004	11,751	11,302
Diluted earnings (loss) per common share	\$ 0.72	\$ (1.04)	\$ 0.45
Weighted average common shares outstanding (diluted)	12,099	11,751	11,631

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME

Years ended December 27, 1998, December 28, 1997 and December 29, 1996
(in thousands)

	Common Stock		Restricted	Retained	Treasury	Accumulated	Total
	Shares	Dollars	Stock	Earnings	Stock	Other Comprehensive Income ⁽¹⁾	Shareholders' Equity
BALANCE, DECEMBER 31, 1995	9,711	\$ 62,780	\$ —	\$ 15,349	\$ —	\$ 4	\$ 78,133
Net earnings	—	—	—	5,243	—	—	5,243
Issuance of shares pursuant to public offering	1,875	37,638	—	—	—	—	37,638
Exercise of stock options	67	681	—	—	—	—	681
Distributions made by acquired companies	—	—	—	(361)	—	—	(361)
Unrealized gain on marketable debt securities	—	—	—	—	—	50	50
BALANCE, DECEMBER 29, 1996	11,653	101,099	—	20,231	—	54	121,384
Net loss	—	—	—	(12,232)	—	—	(12,232)
Exercise of stock options	290	2,543	—	—	—	—	2,543
Issuance of stock in connection with purchase of minority interest	36	339	—	—	—	—	339
Unrealized loss on marketable debt securities	—	—	—	—	—	(54)	(54)
BALANCE, DECEMBER 28, 1997	11,979	103,981	—	7,999	—	—	111,980
Net earnings	—	—	—	8,753	—	—	8,753
Exercise of stock options	53	536	—	—	—	—	536
Issuance of shares pursuant to restricted stock award	45	575	(575)	—	—	—	—
Amortization of restricted stock	—	—	97	—	—	—	97
Purchase of common stock	—	—	—	—	(748)	—	(748)
BALANCE, DECEMBER 27, 1998	12,077	\$105,092	\$(478)	\$16,752	\$(748)	\$ —	\$120,618

(1) Comprehensive income (loss) for fiscal years 1998, 1997 and 1996 was \$8,753, (\$12,286) and \$5,293, respectively.

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years ended		
	December 27, 1998	December 28, 1997	December 29, 1996
	<i>(In thousands)</i>		
Cash flows from operating activities:			
Net earnings (loss)	\$ 8,753	\$ (12,232)	\$ 5,243
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation and amortization	18,733	16,418	12,856
Non-cash portion of provision for asset impairments, restaurant closings and other charges	2,500	22,367	1,436
Provision for litigation settlement	-	-	605
Minority interest	1,334	1,219	602
Preopening costs	(3,137)	(5,208)	(4,341)
Deferred tax (benefit) expense	1,327	(3,864)	(743)
Changes in assets and liabilities:			
Accounts receivable	(1,389)	468	(230)
Inventories	(443)	(1,269)	(1,746)
Prepaid expenses	584	92	2
Other assets	(1,207)	(22)	(97)
Refundable income taxes	1,752	(6,900)	-
Accounts payable	(1,176)	(126)	1,020
Accrued expenses	7,482	1,222	752
Net cash provided by operating activities	35,113	12,165	15,359
Cash flows from investing activities:			
Proceeds from sale of marketable debt securities	609	252	6
Purchase of property and equipment	(24,955)	(52,970)	(45,524)
Purchase of joint venture and franchise interests	(6,602)	(3,797)	-
Net cash used in investing activities	(30,948)	(56,515)	(45,518)
Cash flows from financing activities:			
Proceeds from (repayments of) borrowings on lines of credit, net	5,000	35,900	(5,950)
Principal payments on long-term debt	-	(31)	(1,833)
Proceeds from issuance of shares pursuant to public offering	-	-	37,638
Proceeds from minority partner contributions	1,772	2,660	1,796
Distributions to minority partners	(3,283)	(2,928)	(1,634)
Increase in bank overdraft included in accounts payable and accrued liabilities	2,866	1,480	3,873
Distributions made by acquired companies	-	-	(361)
Purchase of common stock for treasury	(748)	-	-
Proceeds from exercise of stock options	536	2,543	681
Net cash provided by financing activities	6,143	39,624	34,210
Net increase (decrease) in cash and cash equivalents	10,308	(4,726)	4,051
Cash and cash equivalents at beginning of year	1,752	6,478	2,427
Cash and cash equivalents at end of year	\$ 12,060	\$ 1,752	\$ 6,478
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	\$ 3,033	\$ 9,624	\$ 2,807
Cash paid for interest, net of interest capitalized	\$ 3,063	\$ 1,039	\$ 109
Supplemental disclosure of non-cash financing and investing activities:			
Assets acquired under capital lease	\$ 4,163	\$ 5,600	\$ -
Issuance of common stock in purchase of minority interest	\$ -	\$ 339	\$ -

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 27, 1998, December 28, 1997 and December 29, 1996

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

OPERATIONS

RARE Hospitality International, Inc., including its wholly owned subsidiaries (the "Company"), is a multi-concept restaurant company operating primarily in the Eastern United States. At December 27, 1998, the Company operated the following restaurants:

<u>CONCEPT</u>	<u>NUMBER IN OPERATION</u>
LongHorn Steakhouse	104
Bugaboo Creek Steak House	17
The Capital Grille	11
Other specialty concepts	2

The Company is a partner in several joint ventures and limited partnerships organized for the purpose of operating LongHorn Steakhouse restaurants. As of December 27, 1998, 36 of the Company's restaurants operate in joint ventures and limited partnerships.

FISCAL YEAR

Effective July 1, 1996, the Company changed its fiscal year-end from December 31 to a 52- or 53-week year ending on the last Sunday in December. Fiscal 1998, which ended on December 27, 1998, and fiscal 1997, which ended on December 28, 1997, each contained 52 weeks. All general references to years relate to fiscal years, unless otherwise noted.

CASH EQUIVALENTS

The Company considers all highly liquid investments which have original maturities of three months or less to be cash equivalents. Cash equivalents, comprised of overnight repurchase agreements, totaled \$8,464,000 at December 27, 1998. The carrying amount of these instruments approximates their fair market values. All book overdraft balances have been reclassified as current liabilities.

MARKETABLE DEBT SECURITIES

Marketable debt securities are classified as available-for-sale and are reported at fair market value, with any unrealized gains or losses, net of deferred income taxes, reflected as a separate component of shareholders' equity.

INVENTORIES

Inventories, consisting principally of food and beverages, are stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Property under capital leases is stated at the present value of minimum lease payments. Leasehold improvements and property held under capital leases are amortized on the straight-line method over the shorter of the term of the lease, which may include renewals, or the estimated useful life of the assets (generally 15 years for non-ground lease sites and 25 years for ground lease sites). Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the related assets, which approximates 25 years for buildings and land improvements, and seven years for equipment.

BASIS OF PRESENTATION

The consolidated financial statements include the financial statements of RARE Hospitality International, Inc., its wholly owned subsidiaries, and joint ventures over which the Company exercises control. All significant intercompany balances and transactions have been eliminated in consolidation.

PRE-OPENING AND ORGANIZATION COSTS

In April of 1998, Statement of Position (SOP) 98-5, "Reporting on the Costs of Start-Up Activities", was issued. SOP 98-5 requires entities to expense as incurred all organization and pre-opening costs that are not otherwise capitalizable as long-lived assets. SOP 98-5 is effective for fiscal years beginning after December 15, 1998. Restatement of previously issued financial statements is not permitted by SOP 98-5, and entities are not

required to report the pro forma effects of the retroactive application of the new accounting standard. The Company's adoption of the expense-as-incurred accounting principle required by SOP 98-5 will involve the recognition of the cumulative effect of the change in accounting principle required by SOP 98-5 as a one time charge against earnings, net of any related income tax effect, retroactive to the beginning year of adoption. The Company will adopt SOP 98-5 in the first quarter of 1999. The adoption of this change in accounting method is expected to result in a one time charge of approximately \$2.3 million, less applicable income taxes.

UNREDEEMED GIFT CERTIFICATES

The Company records a liability for outstanding gift certificates at the time they are issued. Upon redemption, sales are recorded and the liability is reduced by the amount of certificates redeemed.

GOODWILL

Goodwill, net of accumulated amortization of \$755,000 and \$466,000 at December 27, 1998 and December 28, 1997, respectively, represents the excess of purchase price over fair value of net assets acquired. Goodwill is amortized using the straight-line method over the expected period to be benefited (from 13 to 25 years). The Company assesses the recoverability of goodwill by determining whether the amortization of the goodwill balance over its remaining life can be recovered through undiscounted future operating cash flows of the acquired operation. The amount of goodwill impairment, if any, is measured based on projected discounted future operating cash flows using a discount rate reflecting the Company's average cost of funds. The assessment of the recoverability of goodwill will be impacted if estimated future operating cash flows are not achieved. In 1997, the Company's provision for asset impairments, restaurant closings and other charges included a \$4.2 million charge for the write-off of goodwill recorded upon the acquisition of i) the Company's meat company; ii) the assets of Lone Star Steaks, Inc.; and iii) the franchise rights obtained from LongHorn Steaks of Alabama.

OTHER ASSETS

Other assets consist of organization costs, debt issuance costs, trademarks, and liquor licenses. Trademarks and liquor licenses are amortized on a straight-line basis over five years. Debt issuance costs are amortized on a straight-line basis over the term of the debt. The first quarter 1999 adoption of the change in accounting method prescribed by SOP 98-5 will result in a one time charge of approximately \$200,000, less applicable income taxes, related to the write-off of organization costs.

RESTAURANT CLOSING COSTS

Upon the decision to close or relocate a restaurant, estimated unrecoverable costs are charged to expense. Such costs include the write-down of buildings and/or leasehold improvements, equipment, and furniture and fixtures, to the estimated fair market value less costs of disposal, and a provision for future lease obligations, less estimated subrental income. The Company provided for the closure of one restaurant in 1998, seven restaurants in 1997, and two restaurants in 1996.

RECOVERABILITY OF LONG-LIVED ASSETS

The Company accounts for long-lived assets in accordance with Statement of Financial Accounting Standards No. 121 ("SFAS No. 121"), "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", which requires the Company to review its long-lived assets related to each restaurant periodically or whenever events or changes in circumstances indicate that the carrying amount of a restaurant may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Considerable management judgment is required to estimate discounted cash flows and fair value less costs to sell. Accordingly, actual results could vary significantly from such estimates.

INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In connection with the merger of the Company with Bugaboo Creek Steak House, Inc. ("Bugaboo Creek") (see note 2), the Company acquired certain enterprises affiliated with Bugaboo Creek in a transaction accounted for as a pooling of interests. Prior to the merger, these affiliated entities were either S Corporations or partnerships, and as such, their stockholders or partners, and not the enterprises, were responsible for Federal and state income taxes.

STOCK-BASED COMPENSATION

Prior to January 1, 1996, the Company accounted for its stock option plan in accordance with the provisions of Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees", and related interpretations. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. On January 1, 1996, the Company adopted Statement of Financial Accounting Standards No. 123 ("SFAS No. 123"), "Accounting for Stock-Based Compensation", which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant.

Alternatively, SFAS No. 123 also allows entities to continue to apply the provisions of APB 25 and provide pro forma net earnings (loss) and pro forma earnings (loss) per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB 25 and provide the pro forma disclosure provisions of SFAS No. 123.

ADVERTISING EXPENSES

Advertising costs are expensed over the period covered by the related promotion. Total advertising expense included in other operating expenses was \$8,432,000, \$8,262,000, and \$5,216,000 for the years ended December 27, 1998, December 28, 1997 and December 29, 1996, respectively.

EARNINGS (LOSS) PER SHARE

Effective for the year ending December 28, 1997, the Company adopted the provisions of Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), "Earnings Per Share". SFAS No. 128 requires dual disclosure of earnings (loss) per share-basic and diluted. Basic earnings (loss) per share equals net earnings (loss) divided by the weighted average number of common shares outstanding and does not include the dilutive effects of stock options and restricted stock. Diluted earnings (loss) per share is computed by dividing adjusted net earnings (loss) by the weighted average number of common shares outstanding after giving effect to dilutive stock options and restricted stock. For purposes of computing the diluted loss per share for 1997, the potentially dilutive impact of stock options is excluded since the effect would be antidilutive.

The following table presents a reconciliation of weighted average shares and earnings (loss) per share amounts (amounts in thousands, except per share data):

	1998	1997	1996
Weighted average number of common shares used in basic calculation	12,004	11,751	11,302
Dilutive effect of restricted stock award	1	—	—
Dilutive effect of net shares issuable pursuant to stock option plans	94	—	329
Weighted average number of common shares used in diluted calculation	12,099	11,751	11,631
Net earnings (loss) for computation of basic and diluted earnings per common share	\$ 8,753	\$ (12,232)	\$ 5,243
Basic earnings (loss) per common share	\$ 0.73	\$ (1.04)	\$ 0.46
Diluted earnings (loss) per common share	\$ 0.72	\$ (1.04)	\$ 0.45

Options to purchase 1,171,928 shares of common stock at December 27, 1998, were excluded from the computation of diluted earnings per share because the related exercise prices were greater than the average market price for 1998 and would have been antidilutive.

ACCOUNTS RECEIVABLE

Accounts receivable represent amounts due from restaurant customers and suppliers and interest receivable relating to marketable debt securities.

FINANCIAL INSTRUMENTS

The carrying value of the Company's cash and cash equivalents, marketable debt securities, accounts receivable, accounts payable, accrued expenses, debt, and obligations under capital leases approximates their fair value. The fair value of a financial instrument is the amount for which the instrument could be exchanged in a current transaction between willing parties. The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

For cash and cash equivalents, marketable debt securities, accounts receivable, accounts payable and accrued expenses the carrying amounts approximate fair value because of the short maturity of these financial instruments. The fair value of the Company's debt and obligations under capital leases is estimated by discounting future cash flows for these instruments at rates currently offered to the Company for similar debt or long-term leases, as appropriate. The fair value of the marketable debt security is obtained from publicly available sources.

The Company, from time to time, uses interest rate swaps to reduce interest rate volatility. The interest differential to be paid or received on the swap is recognized in the consolidated statement of operations, as incurred, as a component of interest expense.

USE OF ESTIMATES

Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these financial statements in conformity with generally accepted accounting principles. Actual results could differ from those estimates.

COMPREHENSIVE INCOME

On January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130 ("SFAS No. 130"), "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and presentation of comprehensive income and its components in a full set of financial statements. Comprehensive income consists of net income and net unrealized gains (loses) on securities and is presented in the consolidated statements of shareholders' equity and comprehensive income. The statement requires only additional disclosures in the consolidated financial statements; it does not affect the Company's financial position or results of operations. Prior year financial statements have been reclassified to conform to the requirements of SFAS No. 130.

RECLASSIFICATIONS

Certain reclassifications have been made to the 1997 and 1996 consolidated financial statements to conform with the 1998 presentation.

2 . B U S I N E S S C O M B I N A T I O N S A N D J O I N T V E N T U R E S

In December 1998, the Company purchased the assets of one previously franchised LongHorn Steakhouse location in Tampa, Florida, in a transaction accounted for under the purchase method, for approximately \$1.2 million in cash and a \$50,000 note. The excess of cost over fair value of tangible assets acquired was approximately \$1.2 million and was recorded as an intangible asset to be amortized over 20 years.

In November 1998, the Company acquired the ownership interest of its joint venture partners in 11 LongHorn Steakhouse restaurants located in the Cleveland, Ohio, and St. Louis, Missouri markets for an aggregate purchase price of \$5.3 million in cash and a \$200,000 note in a transaction accounted for under the purchase method. The excess of cost over the minority interest acquired was approximately \$3.8 million and was recorded as an intangible asset to be amortized over 20 years.

In the fourth quarter of 1997, the Company acquired the ownership interests of its joint venture partners in ten LongHorn Steakhouse restaurants located in South Georgia, Southern Alabama, and the Panhandle of Florida for an aggregate purchase price of approximately \$1.1 million in cash, notes payable, and the Company's common stock in a transaction accounted for under the purchase method. The excess of cost over the minority interest acquired was approximately \$1.1 million and was recorded as an intangible asset to be amortized over 20 years.

In January 1997, the Company purchased the assets of two previously franchised locations in Greenville and Spartanburg, South Carolina, in a transaction accounted for under the purchase method, for approximately \$2.0 million in cash. The excess of cost over fair value of tangible assets acquired was approximately \$1.4 million and was recorded as an intangible asset to be amortized over the 13-year period remaining under the acquired franchise agreement.

In September 1996, the Company exchanged 3,179,472 newly issued shares of its common stock for all of the outstanding shares of Bugaboo Creek Steak House, Inc. and certain affiliated entities (2,939,062 shares for Bugaboo Creek Steak House, Inc. and 240,410 shares for other nonpublic affiliated enterprises). Bugaboo Creek Steak House, Inc. operated 14 Bugaboo Creek Steak House restaurants and five The Capital Grille restaurants and the affiliated entities operated three specialty concept restaurants at the time of the merger. The exchange of shares was accounted for as a pooling of interests, and accordingly, the accompanying consolidated financial statements have been restated to include the accounts and operations of Bugaboo Creek Steak House, Inc. for all periods presented.

There were no adjustments required to conform Bugaboo Creek Steak House, Inc.'s accounting policies to those of the Company.

During 1996, the Company entered into a joint venture arrangement whereby the Company contributed two LongHorn Steakhouse restaurants and agreed to contribute funds to construct a third LongHorn Steakhouse restaurant to a joint venture. The other partners in the joint venture contributed three restaurants with a fair market value of approximately \$2,340,000 for a 49% minority interest. The Company recorded goodwill of \$1,050,000 on this joint venture, based on the fair value of assets the Company contributed for its 51% interest versus joint venture partner contributions.

3. PROVISION FOR ASSET IMPAIRMENTS, RESTAURANT CLOSINGS, AND OTHER CHARGES

The provision for asset impairments, restaurant closings, and other charges of \$2.5 million in 1998 was determined under Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of" ("SFAS No. 121") by comparing expected discounted future cash flows to the carrying value of these assets. This charge was primarily the result of a decision by management, in the fourth quarter, to close one The Capital Grille restaurant partially offset by favorable developments in estimated amounts accrued in 1997 for costs associated with closed facilities.

The provision for asset impairments, restaurant closings, and other charges of \$23,666,000 in 1997 was the result of a decision by management, in the fourth quarter, to close seven restaurants and certain administrative facilities, as well as the Company's assessment of the impairment of certain assets based upon the Company's current plans. The Company's current plans resulted from significant changes in key management and a strategic review process employed by new management. The provision for asset impairments, restaurant closings, and other charges consists primarily of adjustments of \$8,300,000 to impaired long-lived assets to be disposed of, adjustments of \$6,000,000 to the carrying values of impaired long-lived assets to be held and used and \$4,200,000 of goodwill write-offs. These adjustments reduced carrying values for long-lived assets to be held and used to estimated fair value and of long-lived assets to be disposed of in connection with the closure of the seven restaurants and the administrative facilities to estimated fair market value less costs to sell. The long-lived assets to be disposed of are primarily included in property and equipment in the accompanying consolidated balance sheet at December 28, 1997, and have an adjusted carrying value of \$1,520,000. Additionally, the provision included \$5,166,000 in accrued costs primarily associated with closed facilities.

The charge in 1996 was comprised principally of the write-off of abandoned leasehold improvements and the accrual of the future lease payments on restaurants closed in those periods.

Merger and conversion expenses in 1996 were nonrecurring costs related to the merger with Bugaboo Creek Steak House, Inc., consisting primarily of investment banking fees, accounting and legal fees, printing costs, and costs to integrate point-of-sale systems.

4. PROPERTY AND EQUIPMENT

Major classes of property and equipment at December 27, 1998 and December 28, 1997 are summarized as follows (in thousands):

	1998	1997
Land and improvements	\$ 18,559	\$ 17,347
Buildings	19,608	23,883
Leasehold improvements	100,396	86,366
Assets under capital lease	9,763	5,569
Restaurant equipment	42,147	36,578
Furniture and fixtures	20,928	19,004
Construction in progress	4,293	1,177
	215,694	189,924
Less accumulated depreciation and amortization	47,884	34,166
	<u>\$167,810</u>	<u>\$155,758</u>

During 1998, 1997 and 1996, the Company capitalized interest during construction of approximately \$270,000, \$663,000, and \$135,000, respectively, as a component of property and equipment.

The Company has, in the normal course of business, entered into agreements with vendors for the purchase of restaurant equipment, furniture, fixtures, buildings, and improvements for restaurants that have not yet opened. At December 27, 1998, such commitments totaled approximately \$11 million.

5. ACCRUED EXPENSES

Accrued expenses consist of the following at December 27, 1998 and December 28, 1997 (in thousands):

	1998	1997
Accrued future lease obligations and other charges	\$ 3,037	\$ 3,867
Accrued rent	1,859	1,620
Payroll and related	5,596	1,263
Other taxes accrued	2,107	649
Gift certificates	4,707	3,766
Other	6,770	3,708
	<u>\$ 24,076</u>	<u>\$ 14,873</u>

6. DEBT

The Company has a variable interest rate revolving credit facility which permits the Company to borrow up to \$100,000,000 through October 2001 and converts to a two year term loan at that time (the "1998 Facility"). The 1998 Facility is the result of amendments and a restatement of the Company's previous \$60,000,000 credit facility. The 1998 Facility bears interest at the Company's option of LIBOR plus a margin of 1.25% to 2.0% (depending on the Company's leverage ratio) or the administrative agent's prime rate of interest, plus a margin of 0% to 0.75% (depending on the Company's leverage ratio) and requires payment of a commitment fee on any unused portion at a rate of 0.3% to 0.5% per year (depending on the Company's leverage ratio). At December 27, 1998 and December 28, 1997, the interest rate on outstanding obligations under the Company's revolving credit facilities was 6.836% and 6.898%, respectively, based on LIBOR plus 1.625% and LIBOR plus 0.75%, respectively. The commitment fee on the unused portion of the 1998 Facility on December 27, 1998, was 0.35% per year. At December 27, 1998 and December 28, 1997, debt outstanding under the revolving credit facilities totaled \$48,000,000 and \$43,000,000, respectively. Amounts available under the Company's revolving credit facilities totaled \$52,000,000 and \$17,000,000 at December 27, 1998 and December 28, 1997, respectively.

The 1998 Facility restricts payment of dividends, without prior approval of the lender, and contains certain financial covenants, including debt to capitalization, leverage and interest coverage ratios, as well as minimum net worth and maximum capital expenditure covenants. The 1998 Facility is secured by the common stock of Bugaboo Creek Steak House, Inc. At December 27, 1998, the Company was in compliance with the provisions of the 1998 Facility. Assuming the \$48 million outstanding under the 1998 Facility is outstanding at the end of 2001, the scheduled maturities are as follows: 2002 - \$24 million and 2003 - \$24 million.

In August 1998, the Company entered into an interest rate swap agreement with a commercial bank, which effectively fixes the interest rate at 7.515% on \$40.0 million through August 1999, decreasing to \$35.0 million through February 2000 and decreasing to \$25.0 million through August 2001. The Company is exposed to credit losses on this interest rate swap in the event of counterparty non-performance, but does not anticipate any such losses. After giving affect to the interest rate swap agreement, the weighted average interest rate on borrowings under the revolving credit facility was 7.421% on December 27, 1998.

7. INCOME TAXES

Income tax (benefit) expense consists of (in thousands):

	Current	Deferred	Total
Year ended December 27, 1998:			
U.S. Federal	\$ 2,026	\$ 1,121	\$ 3,147
State and local	767	206	973
	<u>\$ 2,793</u>	<u>\$ 1,327</u>	<u>\$ 4,120</u>
Year ended December 28, 1997:			
U.S. Federal	\$ (923)	\$ (3,215)	\$ (4,138)
State and local	(213)	(649)	(862)
	<u>\$ (1,136)</u>	<u>\$ (3,864)</u>	<u>\$ (5,000)</u>
Year ended December 29, 1996:			
U.S. Federal	\$ 2,884	\$ (534)	\$ 2,350
State and local	1,029	(209)	820
	<u>\$ 3,913</u>	<u>\$ (743)</u>	<u>\$ 3,170</u>

The differences between income taxes at the statutory Federal income tax rate and income taxes expense reported in the consolidated statements of operations are as follows:

	1998	1997	1996
Federal statutory income tax rate	35.0%	(34.0%)	34.0%
State income taxes, net of federal benefit	5.5	(5.0)	5.0
Nondeductible merger and conversion expenses	-	-	11.1
Meals and entertainment	0.4	(1.5)	.6
FICA tip credit	(8.3)	7.3	(11.2)
Other	(0.6)	4.2	(1.8)
Effective tax rates	32.0%	(29.0%)	37.7%

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 27, 1998 and December 28, 1997 are presented below (in thousands):

	1998	1997
Deferred tax assets:		
Provisions for restaurant closings, and other charges	\$ 3,905	\$ 4,558
Deferred rent	717	556
Alternative minimum taxes and general business credit carryforwards	-	2,704
Accrued joint venture contract termination	423	-
Preopening costs	2,054	1,931
Net operating loss carryforwards	-	681
Accrued insurance	499	132
Accrued workers' compensation	297	212
Other	527	217
Total gross deferred tax assets	8,422	10,991
Less valuation allowance	-	(1,700)
Net deferred tax assets	8,422	9,291
Deferred tax liability - Property and equipment	(2,893)	(2,435)
Net deferred tax assets	\$ 5,529	\$ 6,856

The valuation allowance for deferred tax assets as of December 27, 1998 and December 28, 1997 was \$0 and \$1,700,000, respectively. The net change in the valuation allowance for the years ended December 27, 1998, December 28, 1997 and December 29, 1996 was a decrease of \$1,700,000, an increase of \$1,700,000, and a decrease of \$45,000, respectively. The reduction in the valuation allowance for the year ended December 27, 1998, occurred because the Company was able to utilize net operating loss carryforwards as well as general business credits. In assessing the realizability of deferred tax assets, the Company's management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company's management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections of future taxable income over the periods in which the deferred tax assets are deductible, the Company's management believes it is more likely than not the Company will realize the benefits of these deductible differences, at December 27, 1998.

At December 28, 1997, the Company had net operating loss carryforwards for Federal income tax purposes of \$2,350,000 which are available to offset future taxable income, if any, through 2012. In addition, the Company had alternative minimum tax and other general business credit carryforwards of approximately \$2,700,000 which are available to reduce Federal regular income taxes, if any, over an indefinite period.

8 . E M P L O Y E E B E N E F I T P L A N S

The Company provides employees who meet minimum service requirements with retirement benefits under a 401(k) salary reduction and profit sharing plan (the "RARE Plan"). Under the plan, employees may make contributions of between 1% and 20% of their annual compensation. The Company is required to make an annual matching contribution up to a maximum of 2.5% of employee compensation. Additional contributions are made at the discretion of the Board of Directors. The Company's expense under the plan was \$396,000, \$260,000, and \$220,000 for 1998, 1997, and 1996, respectively.

Commencing April 1, 1996, the Company provided a 401(k) salary reduction plan to Bugaboo Creek Steak House employees (the "Bugaboo Creek Plan"). Under the Bugaboo Creek Plan, employees made contributions of between 1% and 15% of their annual compensation. The Company made a matching contribution of 10% of the first 6% contributed by each employee. All employees of Bugaboo Creek Steak House prior to the merger with one year and 1,000 hours of service are eligible for the Bugaboo Creek Plan. The Company's expense under the Bugaboo Creek Plan was \$20,000 for 1996. Effective in 1997, the Company merged the Bugaboo Creek Plan into the RARE Plan.

9. LEASES AND RELATED COMMITMENTS

The Company is obligated under various capital leases for certain restaurant facilities that expire at various dates during the next 25 years. The Company has noncancelable operating leases for restaurant facilities. Rental payments include minimum rentals, plus contingent rentals based on restaurant sales at the individual stores. These leases generally contain renewal options for periods ranging from three to 15 years and require the Company to pay all executory costs such as insurance and maintenance. Under the provisions of certain leases, there are certain rent holidays and/or escalations in payments over the base lease term, as well as renewal periods. The effects of the holidays and escalations have been reflected in rent expense on a straight-line basis over the life of the anticipated lease terms. The Company also leases vehicles and equipment under operating leases.

Future minimum lease payments under capital lease obligations and noncancelable operating leases at December 27, 1998 are as follows (in thousands):

Years ending at or about December 31:	Capital	Operating
1999	\$ 859	\$ 10,219
2000	859	10,007
2001	859	9,542
2002	890	9,207
2003	929	8,119
Thereafter..	21,400	33,452
Total minimum lease payments	\$ 25,796	\$ 80,546
Less imputed interest (at 9%)	16,064	
Present value of minimum lease payments	9,732	
Less current maturities	-	
Obligations under capital leases, excluding current maturities	\$ 9,732	

Rental expense consisted of the following amounts (in thousands):

	1998	1997	1996
Minimum lease payments	\$ 9,611	\$ 8,252	\$ 6,218
Contingent rentals	799	686	640
Total rental expense	\$ 10,410	\$ 8,938	\$ 6,858

Future minimum lease payments to related parties aggregated \$141,000 at December 27, 1998.

Rental expense includes approximately \$110,531, \$106,000, and \$120,000 for 1998, 1997, and 1996, respectively, for rents paid to entities in which certain of the Company's directors have a financial interest.

A standby letter of credit in the amount of \$750,000 has been issued to secure the Company's obligations under a lease of real estate. Drafts may be presented against this letter of credit in the event that the Company is in default of the terms of the lease, all applicable grace periods have expired and the Company has failed to cure all such defaults. The amount of such drafts may be for the amount presently due and owing by the Company to the landlord or the full amount of the letter of credit if the landlord has notified tenant that it has terminated the lease or has exercised its right to repossess the leased premises.

10. RELATED PARTY TRANSACTIONS

During 1998, 1997 and 1996, RDM Design, a company owned by a relative of two Company directors, provided architectural design services to the Company. Fees paid for these services (including payments for subcontracted engineering services) amounted to \$12,000, \$11,000, and \$114,000 for the years 1998, 1997, and 1996, respectively.

11. SHAREHOLDERS' EQUITY

In 1998, the Company's Board of Directors authorized the Company to purchase shares of its common stock, through open market transactions, block purchases or in privately negotiated transactions. As of December 27, 1998, the Company had purchased an aggregate 59,500 shares of its common stock for a total purchase price of approximately \$748,000 (average price of \$12.57 per share).

The Company's Articles of Incorporation authorize 10,000,000 shares of preferred stock, no par value. The Board of Directors of the Company may determine the preferences, limitations, and relative rights of any class of shares of preferred stock prior to the issuance of such class of shares. In November 1997, in connection with the adoption of a Shareholders Rights Plan, the Board of Directors designated 500,000 shares of Series A Junior Participating Preferred Stock (the "Series A Stock") and filed such designation as an amendment to the Company's Articles of Incorporation. Holders of shares of Series A Stock are entitled to receive, when, as and if declared by the Board of Directors, (i) on each date that dividends or other distributions (other than dividends or distributions payable in common stock) are payable on the common stock comprising part of the Reference Package (as defined in the Articles of Incorporation), an amount per whole share of Series A Stock equal to the aggregate amount of dividends or other distributions that would be payable on such date to a holder of the Reference Package and (ii) on the last day of March, June, September and December in each year, an amount per whole share of Series A Stock equal to the excess of \$1.00 over the aggregate dividends paid per whole share of Series A Stock during the three-month period ending on such last day. If any shares of Series A Stock are issued, no dividends (other than dividends payable in common stock) may be declared or paid unless the full cumulative dividends on all outstanding shares of Series A Stock have been or are contemporaneously paid. Upon the liquidation, dissolution or winding up of the affairs of the Company and before any distribution or payment to the holders of common stock, holders of shares of the Series A Stock are entitled to be paid in full an amount per whole share of Series A Stock equal to the greater of (i) \$1.00 or (ii) the aggregate amount distributed or to be distributed prior to the date of such liquidation, dissolution or winding up to a holder of the Reference Package. After payment in full to each holder of shares of Series A Stock, the Series A Stock shall have no right or claim to any of the remaining assets of the Company. Each outstanding share of Series A Stock votes on all matters as a class with any other capital stock comprising part of the Reference Package and shall have the number of votes that a holder of the Reference Package would have.

As of March 8, 1999, there were no shares of Series A Stock issued and outstanding and the Board of Directors had no present intention to issue any shares of Series A Stock.

On April 1, 1996, the Company closed a public offering for 1,875,000 shares of common stock. Net proceeds to the Company from this offering were approximately \$38,000,000, including the underwriters' overallotment.

12. STOCK OPTIONS

The Company's 1997 Long-Term Incentive Plan, as amended (the "1997 Stock Option Plan"), provides for the granting of incentive stock options, nonqualified stock options, stock appreciation rights, performance units, restricted stock, dividend equivalents and other stock based awards to employees, officers, directors, consultants, and advisors. The Company's Amended and Restated 1992 Incentive Plan (the "1992 Stock Option Plan") provides for the granting of incentive stock options, nonqualified stock options, and stock appreciation rights to key employees and directors, based upon selection by the Stock Option Committee. All stock options issued under the 1997 Stock Option Plan and the 1992 Stock Option Plan were granted at prices which equate to or were higher than current market value on the date of the grant and must be exercised within ten years from the date of grant. The 1997 Stock Option Plan and the 1992 Stock Option Plan authorized the granting of options to purchase 750,000 shares of common stock and 1,500,000 shares of common stock, respectively.

The 1994 Bugaboo Creek Stock Option Plan (the "1994 Stock Option Plan") provides for the granting of options to acquire approximately 306,550 shares of the Company's common stock to directors, officers, and key employees. Through December 27, 1998, approximately 214,050 options have been awarded pursuant to the terms of the 1994 Stock Option Plan. Options awarded under the 1994 Stock Option Plan prior to the merger were adjusted based on the exchange ratio of 1.78 shares of common stock of Bugaboo Creek Steak House, Inc. for each share of the Company's common stock. Options awarded under the 1994 Stock Option Plan are generally granted at prices which equate to current market value on the date of the grant, are generally exercisable after two to three years, and expire ten years subsequent to award.

The Company's Amended and Restated 1996 Stock Plan for Outside Directors (the "1996 Stock Option Plan") provides for the automatic granting of non-qualified stock options to outside directors. The 1996 Stock Option Plan authorizes the granting of options to purchase up to an aggregate of 100,000 shares of common stock. Upon adoption by the Board of Directors of the 1996 Stock Option Plan, each outside director at such time was granted an option to purchase 5,000 shares of common stock. Each person subsequently becoming an outside director is granted an option on the date such person initially becomes an outside director (by election, appointment or termination of employment while continuing to serve as a director). If such date is on or before June 30 of the applicable year, the option is to purchase 2,500 shares of common stock and if the date is after June 30, the option is to purchase 1,250 shares of common stock. In addition, each year on the day immediately prior to the release of the Company's financial results for the preceding fiscal year, each outside director on such date receives an option to purchase 2,500 shares of common stock if the Company's operating earnings per share of common stock has increased at least 20% over the immediately preceding fiscal year. All stock options issued under the 1996 Stock Option Plan are granted at prices which are equal to the current market value on the date of the grant, become exercisable six months and one day after the date of grant, and must be exercised within ten years from the date of grant.

The Company applies APB 25 in accounting for its stock option plans. Accordingly, no compensation expense has been recognized for the Company's stock-based compensation plans. Had compensation cost for the Company's stock option plans been determined based upon the fair value methodology prescribed under SFAS No. 123, the Company's 1998, 1997, and 1996 net earnings (loss) and net earnings (loss) per share would have been reduced (increased in 1997) by approximately \$2,002,000, \$1,002,000, and \$705,000, or approximately \$0.17, \$0.09, and \$0.06 per share, respectively. The effects of disclosing compensation cost under SFAS No. 123 may not be representative of the effects on reported earnings for future years. The fair value of the options granted during 1998, 1997, and 1996 is estimated at \$1,718,000, \$3,384,000, and \$1,593,000, respectively, on the date of grant, using the Black-Scholes option-pricing model with the following assumptions: dividend yield of zero, volatility of 20%, risk-free interest rate of 6%, and an average expected life of eight years.

As of December 27, 1998 and December 28, 1997, options to purchase 592,626 and 367,281 shares, respectively, were exercisable at a weighted average exercise price of \$13.47 and \$16.37 per share, respectively. Option activity under the Company's stock option plans is as follows:

	Shares	Weighted Average Price
Outstanding at December 31, 1995	1,569,977	\$ 15.40
Granted in 1996	162,115	21.56
Exercised in 1996	(67,367)	10.10
Canceled in 1996	<u>(253,959)</u>	21.39
Outstanding at December 29, 1996	1,410,766	15.28
Granted in 1997	995,150	14.47
Exercised in 1997	(289,980)	8.81
Canceled in 1997	<u>(642,843)</u>	17.72
Outstanding at December 28, 1997	1,473,093	14.79
Granted in 1998	567,950	11.62
Exercised in 1998	(52,400)	10.17
Canceled in 1998	<u>(186,795)</u>	16.24
Outstanding at December 27, 1998	<u>1,801,848</u>	13.58

The following table summarizes information concerning options outstanding and exercisable as of December 27, 1998:

Range of exercise prices	Options Outstanding			Options Exercisable	
	Number outstanding	Weighted average remaining life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$8.75 to \$10	449,500	8.4	\$ 9.49	304,430	\$ 9.45
\$10.01 to \$15	915,390	8.8	12.92	82,560	12.46
\$15.01 to \$20	272,700	6.7	17.47	101,060	17.39
\$20.01 to \$25	162,258	6.0	21.87	102,576	22.05
\$25.01 to \$27.25	2,000	0.1	27.25	2,000	27.25

13. COMMITMENTS AND CONTINGENCIES

JOINT VENTURES

Several of the Company's joint venture agreements and employment agreements with joint venture partners and restaurant managers require or provide the Company with the option to purchase the managers' interests upon termination of the joint venture. The purchase prices are based upon certain multiples of the relevant restaurant's cash flow or profits.

SHAREHOLDER SUIT

In February 1994, the Company, several directors, and the two managing underwriters of its previous public offering were named as defendants in a lawsuit filed as a class action in the United States District Court in Atlanta, Georgia. The suit was filed by a shareholder of the Company who claimed to represent a class of all persons who purchased the Company's common stock between July 27, 1992 and June 17, 1993.

The plaintiff alleged that the defendants made material misrepresentations and omissions in connection with the financial condition of the Company and sought compensatory damages and other relief. A total consideration of \$1.4 million was paid in settlement of the case in 1997, the major portion of which was funded by an officers and directors liability insurance policy. The cost to the Company, including related attorneys' fees, was approximately \$605,000.

PURCHASE COMMITMENTS

The Company has entered into certain purchasing agreements with certain meat suppliers requiring the Company to purchase contracted quantities of meat at established prices through their expiration on varying dates in 1999 and 2000. The quantities contracted for are based on usage projections management believes to be conservative estimates of actual requirements during the contract terms. The Company does not anticipate any material adverse effect on its results of operations or financial position from these contracts.

OTHER

Under the Company's insurance programs, coverage is obtained for significant exposures as well as those risks required to be insured by law or contract. It is the Company's preference to retain a significant portion of certain expected losses related primarily to workers' compensation and employee medical costs. Provisions for losses expected under these programs are recorded based upon the Company's estimates of the aggregate liability for claims incurred.

Letters of credit aggregating \$1,100,000 at December 27, 1998 are being maintained as security under the Company's workers' compensation policies.

The Company is engaged in arbitration and litigation with a joint venture partner regarding a dispute related to a joint venture agreement. The Company denies any liability with respect to the counterclaims against the Company and intends to vigorously defend the counterclaims. Management believes that the Company's position has merit and the resolution of these matters will not have a material adverse effect of the Company's financial condition or results of operations.

The Company is involved in various legal actions incidental to the normal conduct of its business. Management does not believe that the ultimate resolution of these incidental actions will have a material adverse effect on the Company's financial position or results of operations.

I N D E P E N D E N T A U D I T O R S ' R E P O R T

The Board of Directors and Shareholders
RARE Hospitality International, Inc.:

We have audited the accompanying consolidated balance sheets of RARE Hospitality International, Inc. and subsidiaries (the "Company") as of December 27, 1998 and December 28, 1997, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 27, 1998. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of RARE Hospitality International, Inc. and subsidiaries as of December 27, 1998 and December 28, 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended December 27, 1998 in conformity with generally accepted accounting principles.

KPMG LLP

Atlanta, Georgia
February 11, 1999

DIRECTORS AND EXECUTIVE OFFICERS CORPORATE INFORMATION

DIRECTORS AND EXECUTIVE OFFICERS

George W. McKerrow, Jr.
Chairman

Philip J. Hickey, Jr.
President, Chief Executive Officer and Director

W. Douglas Benn
*Executive Vice President, Finance,
Chief Financial Officer and Secretary*

Eugene I. Lee
Executive Vice President and Chief Operating Officer

Thomas W. Gathers
Executive Vice President, Human Resources

George W. McKerrow, Sr.
Director

Edward P. Grace, III
*Director
President, Phelps Grace International, Inc. (restaurants)*

Ronald W. San Martin
*Director
President, 490 East Paces Ferry, Inc. (restaurants)
Chief Financial Officer, Fishbone LLC (restaurants)
Chief Financial Officer and Secretary,
We're Cookin' Inc. (restaurants)*

John G. Pawly
Director

Don L. Chapman
*Director
Chief Executive Officer, S & S Tug LLC (manufacturing)*

Lewis H. Jordan
*Director
Founder and Principal Officer,
Wingspread Enterprises LLC (investments and consulting)*

Form 10-K/Investor Contact

A copy of the RARE Hospitality International, Inc. Annual Report on Form 10-K for 1998 (without exhibits) as filed with the Securities and Exchange Commission is available from the Company at no charge. These requests and other investor contacts should be directed to W. Douglas Benn, Executive Vice President, Finance, Chief Financial Officer and Secretary, at the Company's corporate office.

Annual Meeting

The annual meeting of shareholders will be held on Thursday, May 6, 1999, at 2:00 p.m. at the Swissôtel Atlanta, 3391 Peachtree Road NE, Atlanta, Georgia.

Common Stock and Dividend Information

The common stock of RARE Hospitality International, Inc. is traded on the Nasdaq Stock Market (National Market) under the symbol RARE. At March 8, 1999, there were approximately 4,350 holders of the common stock of the Company, including approximately 365 shareholders of record. The market value of the Company's common stock on March 8, 1999, was \$15.25 per share. Since the Company's initial public offering in 1992, the Company has not declared or paid any cash dividends or distributions on its capital stock. (However, due to the accounting for a subsequent acquisition as a pooling of interests, the Company's consolidated financial statements reflect distributions made by certain entities acquired by the Company prior to such acquisition.) The Company does not intend to pay any cash dividends on its Common Stock in the foreseeable future, as the current policy of the Company's Board of Directors is to retain all earnings to support operations and finance expansion. The Company's existing revolving line of credit restricts the payment of cash dividends without prior lender approval. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources." Future declaration and payment of dividends, if any, will be determined in light of then current conditions, including the Company's earnings, operations, capital requirements, financial condition, restrictions in financing agreements and other factors deemed relevant by the Board of Directors.

As of December 27, 1998, there were 12,017,606 shares of common stock outstanding. The following table shows, for the periods indicated, the high and low sales prices per share for the common stock as reported by Nasdaq.

	1998	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High		\$ 12	\$ 13 ⁷ / ₈	\$ 15	\$ 14
Low		\$ 8 ¹ / ₈	\$ 10 ⁷ / ₈	\$ 10 ¹ / ₁₆	\$ 8 ¹ / ₂
		First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1997					
High		\$ 19 ¹ / ₂	\$ 16 ¹ / ₄	\$ 14 ¹ / ₈	\$ 11 ¹ / ₈
Low		\$ 12 ¹ / ₄	\$ 10 ¹ / ₄	\$ 9 ¹ / ₂	\$ 8 ¹ / ₈

CORPORATE INFORMATION

Corporate Office

RARE Hospitality International, Inc.
Building 600
8215 Roswell Road
Atlanta, Georgia 30350
(770) 399-9595

Registrar and Transfer Agent

SunTrust Bank, Atlanta
Stock Transfer Department
58 Edgewood Avenue, Room 225 Annex
Atlanta, Georgia 30303
(404) 588-7817



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