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U.S. Restaurant Industry Update

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Q: How important is the restaurant industry to the U.S. economy?

A: The restaurant industry plays a very significant role in the U.S. economy with sales equal to approximately 4% of gross domestic product (GDP) -- this year, industry wide sales are projected to be \$580 billion¹. On any given day, more than 130 million people are served by the foodservice industry in America. Restaurant industry jobs are critical entry level positions and provided a first job for more than 25% of adults in America. According to the National Restaurant Association, the industry employs approximately 12.7 million people or 9% of the U.S. workforce.

Q: What types of concepts (fast-food, casual dining, fast-casual) have been able to raise capital these days? Which ones are finding it the hardest and why?

A: For equity capital, growth potential is most important. For debt capital, predictability of cash flow is critical. And equity investors get excited when they see something unique, a brand that's able to differentiate itself from the pack.

Fast-casual brands have not had a problem raising capital, as long as the type of capital (debt or equity) is appropriate for the company's stage of development. There are many chains in the fast-casual space that have tremendous growth potential and several larger ones with enough stores to provide assurance to lenders of getting repaid.

On the other extreme, casual chains are having difficulties attracting capital because the growth story is unclear given overbuilding in the sector and operating trends remain challenged. Although it feels like sales will come back in 2010, results will likely be mixed depending on the brand. The profit drivers of 2009, primarily commodity costs and rethinking store level operations, will not drive increases in profits in 2010 but rather increasing sales will be necessary to increase profits. As long as there is uncertainty on the sales front, casual dining will remain capital challenged.

In the middle is QSR (quick service restaurants), where generally you have a predictable cash flow stream and probably good growth prospects. Debt is generally available for QSR companies because of their reasonably good performance through the economic cycle.

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“In the current environment, if your business performed well in 2009 and has continued to perform well this year, this may be the ideal time to sell.”

Q: Do you see financing opportunities improving in the future?

A: For larger chains and franchisees of top brands, financing is already improving, and credit terms are getting more favorable towards borrowers. For smaller chains and small franchisees, financing is still difficult. For businesses that are not performing well, capital remains very hard to come by.

The difficulty in providing debt financing to a business with falling sales is a lender is not sure how much cash flow will be available to pay interest and repay the loan. Restaurants have a significant amount of fixed costs (rent, utilities, minimum staffing levels), and as sales fall, profits fall faster. If there isn't much cushion between cash flow and debt repayment obligations, a relatively small drop in sales can lead to financial stress.

I believe you'll see a direct correlation between improving sales and increased financing opportunities. As sales improve, lenders will have more confidence in the sufficiency of future cash flows to pay them back.

Q: What advice would you give an individual looking to sell a franchised restaurant business?

A: The current performance of a business and its growth potential are two of the primary factors that determine a business' attractiveness to a potential buyer. Another important element is the purchase price and what the return on the equity investment will be. The state of the lending market for restaurants determines how much of the purchase price can be borrowed and how much must be contributed by the buyer as equity.

So, ideally, if you're looking to sell your franchise, you should wait for your business' performance to return to historical norms with trends that support growth in cash flow through improved sales and profits and potentially new store development. Also, to achieve a strong result, you need a lending environment that'll be accommodating to the buyer so they can get a reasonable loan to finance a portion of the purchase price. Generally, when debt is not readily available, purchase price multiples suffer.

In the current environment, if your business performed well in 2009 and has continued to perform well this year, this may be the ideal time to sell. There is a tremendous backlog of larger restaurant deals that will be coming to market when business fundamentals improve across the economy. Well-performing franchise businesses (especially Tier 1 franchises) are again able to attract financing and growth prospects are strong given the economic fundamentals. If you wait too long, the market may become more crowded with sellers as the performance of others catches up with your performance.

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Q: What advice would you give someone considering purchasing a franchise?

A: First, understand the business opportunity. If financial information is provided, focus on averages and what’s realistic. Don’t focus on what’s possible, but what’s probable when it comes to sales and profits. Second, make sure the franchisor will provide you with the support you need. The age old adage “location is everything” still holds true today. Picking a location is the most important decision you have to make, and it’s difficult to correct a mistake. After opening, you need marketing programs and support to help you drive sales. You should fully understand the quality of what you get from the franchisor in exchange for your monthly royalty payments.

Q: What is the state of financing for equipment purchases/upgrades?

A: Your best source for financing equipment purchases or upgrades is your existing lender. Financing is also currently available on a one-off basis for purchases of new point-of-sale systems, kitchen equipment and furniture, but this type of financing tends to be more expensive than conventional bank loans. However, it can be a source of funding for smaller operators with limited access to capital.

Q: What’s the upside in the current environment for the restaurant industry?

A: In general, now is a good time to be investing in the restaurant industry. The recent economic data support a recovery in consumer discretionary spending, and restaurants are a relatively inexpensive extravagance for the average consumer.

While store unit growth may remain subdued for some period of time, individual unit productivity should increase with improved sales and profits. And while you have to be careful looking for the “next big thing,” I think that consumers are looking for higher quality product and more convenience in their lives; thus the rise of fast-casual concepts. Brands that can deliver high quality and high convenience will outperform their peers -- think Panera and Chipotle, both concepts which deliver in well-established segments of the restaurant business (bakery/deli and Mexican) but have an established brand image (and execution to back it up) of higher quality than their competitors.



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