Restaurant Operators' Optimism Amidst Ongoing Challenges

CONTRIBUTOR

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While data through the first half of 2019 suggests that the restaurant sector continues to feel the lumps of changing consumer tastes (primarily around convenience) and certain economic challenges (like rising labor costs), emerging and fast-growing brands that offer consumers bold and new tastes or differentiated experiences remain of high interest to strategic and financial investors.

First half of 2019 same store sales ("SSS") were choppy across the sector, with most restaurants challenged by the abnormally long, cold and wet winter, rising labor costs, and consumers' continued focus on convenience resulting in a proliferation of delivery services. As a result, SSS fluctuated between positive to negative month-to-month - an indication that operators are seeing mixed results as they continue to try to address these challenges. First half 2019 SSS averaged +0.5% compared to +0.8% in 2018 and -1.1% in 2017.

While sales growth across restaurants has certainly improved since 2017, flat to low single digit positive SSS growth is viewed as a success given the ongoing dynamics within the industry, with most concepts experiencing negative SSS since 2017. Owners and operators of concepts that are not differentiated or that are deemed tired brands will be hard pressed to generate positive SSS given the dynamic shifts occurring around consumer tastes, behaviors and expectations for their meals. Restaurant profitability is further affected by lower margin delivery sales generating an ever-increasing percentage of total sales and the battle to attract customers with extensive discounting. Despite the above challenges, QSR and fast casual concepts broadly demonstrated the ability to drive SSS growth in 1H 2019, fueled by attractive macro trends related to convenience and consumers seeking value.

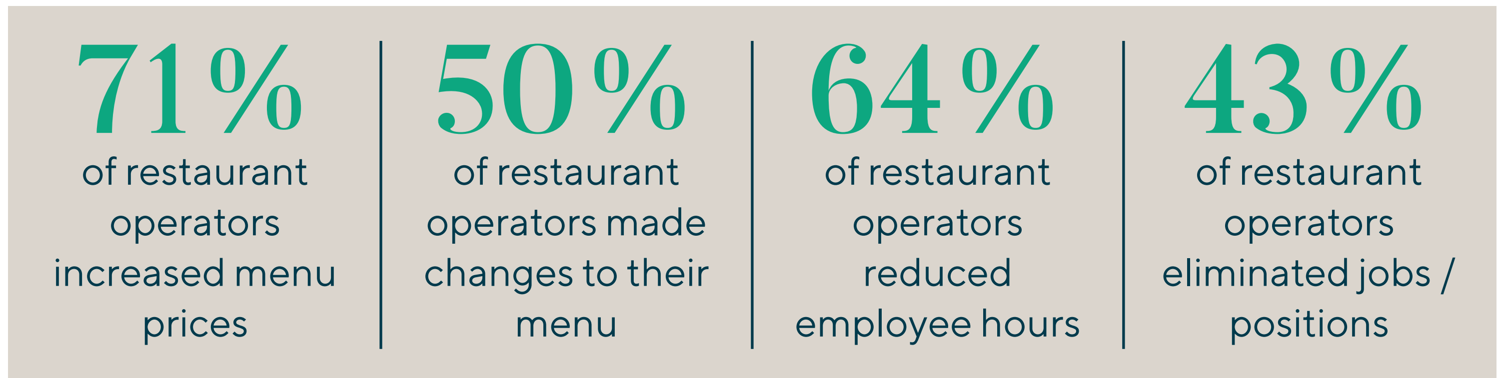
SURPRISINGLY FEW RESERVATIONS ABOUT THE ECONOMY

Two incongruent points from the National Restaurant Association's Restaurant Industry Tracking Survey show that while nearly 80% of restaurant operators expect there to be the same or worse economic conditions in 6 months' time, nearly half of the same operators expect to achieve higher sales in six months' time. According to a recent Lincoln survey of consumer sector investors, close to 60% of investors believe an economic slowdown will occur in the next 2-5 years, 40% expect the slowdown to occur next year.

Given a generally bearish outlook on the economy, restaurant operators are displaying a high degree of confidence in their ability to drive higher sales in the next six months, with fewer means to do so (e.g., consumers will be more sensitive to menu price increases the closer we get to a recession, discounting has been more aggressive across the value chain as it ever has been, consumers have an increasing number of alternatives to dining at restaurants, etc.). Only time will tell but operators may well be overly confident in their outlook for their restaurants and with July SSS coming in at -1.1%, the industry could be in for a rocky second half of the year.

OPERATORS' RESPONSE TO RISING LABOR COSTS

Minimum wage increases and the associated rising wage costs are top of every restaurant operators mind and some interesting data points recently emerged. According to a Harri survey across 4,000 restaurants and 112,000 employees, in response to higher labor costs:



It is clear that restaurant operators are making short term decisions to offset the impact of rising labor costs. Long term, employee turnover will continue to be impacted with employees expected to do more in the same amount of time while on the job. In 2018, turnover in the Restaurants-and-Accommodations sector reached a post Great Recession high of 74.9%, up from 72.5% in 2017 (the Bureau of Labor Statistics does not report data for restaurants alone). While hard to quantify, it is well-known throughout the restaurant industry the hidden cost that high employee turnover causes, including recruiting, training and productivity, not to mention the impact on culture. Restaurant operators are being caught between a rock and a hard place, with the current rising wage environment expected to remain for the foreseeable future.

CONCLUSION

The bar for investing in restaurants is higher in 2019 that it ever has been in the recent past. Deals are taking longer to get done as investors dig into the increasingly available volume of data across more parts of the business (e.g., customer loyalty, discounting, delivery, etc.). Investors will continue to get aggressive for concepts that are unique, have attractive unit level metrics and consistent profitability across their portfolio, demonstrate proven portability and sustainable customer loyalty, and that have significant growth prospects. Strategic and financial buyers will remain active, albeit more selective, with strategic investors likely under pressure to offset mediocre or poor performance within their current concepts by making acquisitions.

ABOUT THE AUTHOR:

Charles Walder is a Director in the mergers and acquisitions advisory business at Lincoln International. He has extensive experience advising companies in the restaurant sector on domestic and cross-border mergers and acquisitions (M&A), capital raising, restructuring and other strategic advisory assignments. Charles has experience working with restaurant companies across a broad range of sub-verticals and business models.

Sources: Nation's Restaurant News, TDn2K's Black Box Intelligence report, RPI 2019, Harri survey of 4,000 restaurants and 112,000 employees, Bureau of Labor Statistics