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chain restaurant analysis and advisory

Restaurants: Recognizable Realities in 2015
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The restaurant space slogged it out in 2014. Finally, with meaningful wisps of economic recovery seen in Q4 and more disposable income running in the system, hope of discretionary spending is seen. Several attractive IPOs, Habit (HABT), and Zoe's (ZOES) made it through the gauntlet and with more to come in 2015 (SHAK and others). On January 5, Jim Cramer of CNBC said that domestic restaurants are key to the market performance in 2015. That sets a high bar.

Of course a reality gap exists between Wall Street wants and needs and Main Street corporate realities. The prism restaurants operate is not really seen by Mr. Market.   Looking beyond the veil, restaurants are a tough business, talk to the departed CEOs of Darden (DRI) and Bob Evan's (BOBE) about that.

There are several ongoing dynamic restaurant financial realities that underpin restaurant performance. All are realities, all are opportunities. All are addressable.

Need to manage and improve restaurant profit flow through. Also known as the PV ratio, we shouldn't have been surprised to hear that the ten year US McDonald's (MCD) average sales per unit (AUV) grew $770,000 but flow through grew by just $70,000, or 9%. Was it all those beverages that cannibalized food? A national survey just reported the McDonalds average consumer expenditure reported at $3.88 per person, which is shockingly low.

It's a broader restaurant issue however: For a client, I recently examined three QSR brands (McDonald's (MCD), Burger King (QSR), Wendy's (WEN) and three casual dining brands, Denny's (DENN), Bob Evans (BOBE),and Applebee' (DIN) that grew average store sales only $46,000 and unit EBITDAR by only $500 between 2009 and 2014, about a 2% flow through rate. Shockingly low sales gains, even worse flow through.

Both Chili's (EAT) and Outback (BLMN) added a boatload of new at or under $10 items to their menus in 2014, and Chili's added their signature fajitas to its 2 for $20 menu. This exasperates the flow through problem; let's hope additional upsell initiatives kick in to maintain the average check.

This is the result of hyper food inflation, and some labor cost inflation and a lot of discounting. The fix? Multi dimensions required. Start by not listening to the ad agencies to take the fast, cheapo way out and simply discount; get staff to upsell.

M&A is both a value enhancer and a destructor: Both good and bad M&A are in the background and the foreground. Bad M&A can be seen considering Darden (DRI) and Bob Evans (BOBE) this year. Good: future possible spinoff BEF foods for $400M ($413 million value estimate by Miller Tabak). Its current EBITDA baseline is only a few million dollars. Spin it and give the money to shareholders.

Bad M&A: waiting so long to dump both Red Lobster (DRI) and Mimi's (BOBE). Interestingly, financial disclosure and visibility of both brands by their HOLDCOs was awful. Who really knew before Darden spilled the beans in 2014 that weekly customer counts were only 3000/week? That is unacceptable for investors. The fix: the sell side and shareholders should demand better disclosure. Vote with your feet.

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Restaurant IPO valuations need a reality check. First year restaurant IPO valuation ratings need an asterisk. There's nothing fundamentally wrong with Noodles (NDLS) other than their unsustainable claim to get to 2000 US units. It's a nice, differentiated concept. They will grow but not at Chipotle (CMG) rates. Potbelly (PBPB), El Pollo Loco (LOCO) and Papa Murphy's (FRSH) may grow if they can grow profitability beyond their geographical base. The Chipotle of 2015 isn't the Chipotle of 2006. It can't be: The US is proportionately more overloaded with more restaurants during the Noodles 2013 IPO than CMG's 2006 IPO.

First year restaurant IPO price earnings (PE) ratios and Enterprise Value to EBITDA ratios need an asterisk because they may well fall later and resume upward momentum later after the post IPO equilibrium is found and real earnings and free cash flow growth is achieved.

Why does this matter? Growing restaurant brands that are over pressured by high valuations do stupid things. Good brands need to be given a chance to grow solidly.

Franchise overfishing, resulting subpar restaurant cash flows in the US: earlier in 2014, when fears of US restaurant wage increases were at its peak, several industry studies noted how low restaurant franchise EBITDA flow really was: 10 to 11%. The SS&G (now BDO) restaurant data in December just backed that up. For investors, franchisors, franchisees and anyone else: 11% EBITDA on a $1 million AUV base isn't high enough level to service debt, cover overhead and provide funds for maintenance and remodeling capital expenditures in the amounts needed.

The US is overfished, with too many franchise restaurants. 1 million restaurants in the US. Until the supply issue is addressed, franchise restaurants will chase the temporary +1 or +2 same store sales customer flow that migrates from one brand to another.

Franchisors need to take responsibility for their brand's future evolution. That they don't fully can be seen in the minimum wage debate. Franchisors, notably McDonald's, Burger King/Tim Horton's (QSR) and Wendy's (WEN) indicated that it was their franchisees that set the wages. While technically true, it is the franchisor that is the steward of the brand. If the wage goes to $20/hour, it is the responsibility of the franchisor brand to regenerate a store level model that works.

A place to start is to rightsize store physical plants smaller to get the CAPEX lower and to find ways to thin the system of weaker operators who want or need to exit. Closely associated with this is issue poor franchisor earnings disclosure: Sell side analysts covering Dine Equity (DIN) have given up asking for meaningful information about the 100% franchised brands, and we noted one intrepid sell side analyst who was a journalist couldn't pry the Burger King (QSR) international new Russia and China sales levels a pillar of their stated growth strategy and a metric that should be disclosed.

Restaurant free cash flow matters. For a client recently, I composed a 45 year snapshot of how sales components and building size has changed over the years. Guess what: while customer traffic (transactions) has declined, the building size has not.

The perception gap between the signal of the profit/loss statement and the other costs, and outlays that determines free cash flow is a material problem for an industry so CAPEX heavy. This same concern applies to the "asset light" franchisors, whose franchisees are the investors and have to make a return to be viable. This is not so complicated; performance appraisal systems at any level could be rejiggered to include CAPEX. You manage what you measure.

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