Restaurant Operational Opportunities 2015
by: John A. Gordon, Principal

In our business, 2014 was a wild year, and 2015 is already looking to be the same. Some operational themes keep showing up time and time again, and restrict restaurant performance. Here are five recurring issues; every issue could be both a problem and an opportunity at the same time.

Holistic View of Brand Promotion Costs Necessary

Restaurant marketing and promotion costs should be viewed holistically. The traditional restaurant P&L does not encourage this view. Three major expenditure and outlay classes—coupons and discounts, traditional TV/ radio/social media spend, and capital spending/new restaurant construction and remodeling all support the brand customer proposition. Think of it this way: these expenses aren't silos; resources should be reprogrammed back and forth as needed. If you don't let restaurants run down from a concept or capital plant standpoint, you won't have to spend more to discount and promote. These expenses should be viewed and managed together. Therefore, it may well make sense to take a time out on television or couponing, to get the remodel CAPEX funded. There is only so much money and economic resources available. See the table below, with typical ranges of expenditures and outlays.

Proforma Restaurant Brand Promotion Costs

Expenditure Stream	Representative Proforma Restaurant % of Sales [1]
Coupons and Discounts	1-7%
Traditional Marketing Spend (TV, print, creative, etc.)	1-6%
Capital Expenditures	2-7%
Total as % of Net Sales	4-20%

From the above, we can see why older brands struggle so greatly: the cost to promote is immense. I'd hate to have a low AUV, low EBITDA brand and one that requires 20% to promote. The accounting firm SS&G just reported restaurant franchisee store EBITDA at 11% in the US. [2]

And once the brand is remodeled it can be seen that couponing and discounting might work against the positive effects of traditional marketing spending and CAPEX. [3]

Global Importance of Supply Chain Operations: McDonald's (MCD) and Yum (YUM) Brands, the world's foremost and expansive international restaurant operators, have been befallen by supply chain problems,

[1] Pacific Management Consulting Group estimates.
[2] SS&G Restaurant Benchmarking Survey, December 2014.
[3] Marketing experts have long confirmed that extreme discounting erodes the brand perception. McDonald's CEO Don Thompson noted the same in their December 2014 Special Investor Update.

particularly in Asia in 2013 and 2014. Horse meat entering the beef supply chain in Europe in 2012 that ensnared Starbucks (SBUX) and Burger King (QSR). China and Japan are focal points. Its not like procuring chicken is a new activity, restaurants have been doing it forever, and McDonald's actually invented restaurant procurement systems via Fred Turner in the late 1950s. These supply chain problems have resulted in billions of dollars of sales and market valuation losses (see YUM China sales and McDonald's Japan sales, profits and stock performance).

What has happened? Are the protein markets now so supercharged that anything goes to make a buck? Or has Quality Assurance been outsourced or cut so that these threats aren't being found? With social media and globalization, there are no secrets, anywhere. In any event, the QSR majors should not be in this position in 2015; as franchising spreads throughout the world, the desire for near 100% international margins have to be tempered by the need to build assurance and redundancy supply chain systems.

Narrowing pricing flexibility and need for store level upsell. A closely watched metric is US food at home price inflation (grocery channel) versus food away from home (restaurants and foodservice) price inflation. In 2014, both metrics were +2.8%. [4] In prior years, food away price increases outpaced food at home. This implies that some (but not all) restaurants don't have a lot of pricing potential.

Our industry needs to maximize revenue more efficiently from the customers it has now. In scores of annual field visits, both QSR segment and fast casual particularly lack seem to lack any spark in upselling. In QSR operations, there is virtually none. In the fast casual segment, there often is not logical add on tiers; chips and salsa gets old. Closely allied to this issue is the secular decline of soda fountain sales and the growth of "water customers", mostly as a zero revenue item; water sales are up a lot. The fix? Train cashiers to say "apple pie" (or whatever) in the QSR space and "side order of X" in the fast casuals, rather than dreaded "is that all"? At least some incremental hit rate will develop than using a meaningless closing. The soda giants or restaurant operators must develop watery, non sugary drinks with bold flavors to get their (and our) lost beverage share back.

Restaurants must progress from the old command and control mentality. Society has advanced from the 1950s, when this industry was born in its modern incarnation. People's expectations everywhere has risen, and is seen in people's requirements for better food (food with integrity), better locations (we all know the need and value to remodeling and reconcepting), better wages and working conditions, and on. This same trend holds in the franchising space where franchisees have higher expectations of business performance and franchisor stewardship. None of these issues are going away.

There were some spectacular corporate flameouts in 2014. A clue as to required leadership traits comes from McKinseys' recent study [5] of global leadership. Of twenty factors studied, just four were said to explain 89% of the variation of the best performers:

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[4] United States Department of Agriculture, Economic Research Service, December 23, 2014 forecast.

[5] McKinsey Quarterly, December 2014

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-Being supportive of one's team members and organization
-Operate with a results expectations mode
-Seek different perspectives
-Solve problems effectively.

Inward "promote from within" cultures were always a part of our business, but clearly now more diversity and fresh blood is valuable now as business itself becomes more diverse. The value of a brand's people is not on the balance sheet, and hard to quantify, but it would be nice.

Restaurant Development, Geography Matters

Geography has always mattered a lot in this business, and provides a clue as to development potential. It seems to be more accentuated in the QSR and fast casuals, a bit less so in the casual dining space. For example, Wendy's is stronger in the Ohio River Valley, Dunkin Brands in the North East, Potbelly in Chicago, Krispy Kreme in the Carolinas, etc. A few brands have become ubiquitous global powerhouse brands such as Starbucks, McDonalds, and Subway for example. Ruth Chris is a powerhouse too but not ubiquitous; of course it works in a much more finite number of locations. Some sites are global gateway sites and store development in a few key areas spreads awareness of the brand. GE Capital weighed on the value of logical, concentric development (and franchisors having skin in the game via company stores) in 2013. [6] Franchisors, franchisees, IPO deal book runners and investors others should keep this in mind. Concentric ring development, along logical travel and information corridors seems smart. Bruxton recently noted Denver, Portland, Austin and San Antonio as attractive 'rising star' markets for retailers and restaurants. [7]

About the author: John A. Gordon is principal and founder of Pacific Management Consulting Group, 100% focused on restaurant analysis topics for clients who need a deep dive perspective. He works complex analysis, investor advisory and litigation support projects. His website is www.pacificmanagementconsultinggroup.com and can be reached at (619) 379-5561.

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[6] GE Capital Franchise Finance, Trey Brown Presentation, 2013.
[7] BRUXTONCO 2015 Real Estate Review, January 2015.