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# Financials – February 2017

## Restaurants: Repeating Errors Seen

by John A. Gordon, principal and founder of Pacific Management Consulting Group

Just about everyone reading this newsletter either knows the restaurant business or want to know a lot more about it. Many of us love the space, hence why we are still engaged in it via differing roles over the decades. The industry is stressed right now, for all kinds of reasons. We know there are many factors that affect the business that we can't control, and just must do the best we can to react and see around the problems; but we have to admit there are other factors we can control, we can fix.

Here are four situations, seen so frequently so that they can be labeled as repeating errors. Something can be done about these.

**Situation One: Overreliance on the US.** The US is jammed full of restaurants, and is characterized by some outside observers as a "retail jungle". Yet some brands that have the power and money to develop international beachheads, where competition can be less, when they have the time to do so don't, when they need to do so, where the power of a US brand could be powerful , have not. Consider Chipotle (CMG) and Buffalo Wild Wings ((BWLD). The news recently has been filled with tales of Chipotle's sales recovery problems, operations/HR misfocus (CEO admitted), incremental costs into the model, and associated decline in restaurant operating margin; and continued US store development in spite of low immature unit AUVs. In Chipotle's case, the company funded $1 billion in share buybacks in 2016 that did nothing to move the stock price, but the cash could have been used to find international company operated store CAPEX. Sure, they could have refranchised later if so warranted once the markets were stable and established, similar to the McDonald's (MCD).

https://www.bloomberg.com/gadfly/articles/2016-12-12/chipotle-ceo-changes-welcome-to-the-hot-seat

In Buffalo Wild Wing's case, comps declines, rising wings costs, declining customer service and paying too much for franchisees (defranchising) were seen. In both cases, while it is always easier to develop in home nation, when the home nation stagnates, it would be nice to have other world zones as developed and building markets. Chipotle and Buffalo Wild Wings now have ramp ups, that can't easily be underwritten now by a booming US that are now margin challenged. This problem could have easily been foreseen.

http://www.cnbc.com/2017/01/31/buffalo-wild-wings-shares-fall-4-percent-on-weak-sales-expectations.html?__source=yahoo%7Cfinance%7Cheadline%7Cheadline%7Cstory&par=yahoo&doc=104251991

**Situation Two: Doing the Same Marketing Play Over and Over Again that Doesn't Work:** Most restaurant brands don't like to continuously discount, but rather to mix new product new news, new consumer sales platforms (digital, catering, delivery, etc) and other new things to keep the brand exciting and adding value for consumers. But that is not the situation at Subway, however. Despite years of declining AUVs, Subway continues in its discounting mode, moving from selected daily $3.50 subs to $6.00 "any sandwich" subs in the last two months. Nothing else has happened in the brand and the US sales and franchisee sales/profitability results show it. Thousands of Subway units are said to be for sale.

Based on "approximate polled" US sales and profitability of the February 2017 "$6 Any Event" we found "in a briefcase under a bridge at midnight", here is what happened in February to date for us numbers fans:

| Market: | Change In AUV, % One Year Basis | Change in Store Profit Estimate |
|---|---|---|
| Bulk of US | -.3% | -30.0% |
| Control Market | +1.0% | +1.4%% |

Over the last year, Subway has a new CMO and advertising agency in place, but they haven't been able to break out of the old ways yet. Apparently, Subway has a new interior remodel plan for Subway franchisees, somewhere in the $90,000 to $100,000 range, about half or more the cost of a new store. At this level of depressed sales and profitability, Subway franchisees just can't fund it unless all the discounting is turned off, which expensive additional cash outlay on top of the 5% is marketing fund contribution already paid on top of the 7% royalty.

**Situation Three: Too much CEO Turnover at some PE Firms owned companies:** private equity firms are here to stay in the restaurant space and have served a vital role in providing capital and growth to restaurant brands that went on to be brand powerhouses. Their model is to provide equity and debt financing

and serve as a catalyst for revenue enhancement and cost management, to either 'fix" or grow the brands while not in the withering public spotlight. Their goal is to make money, with the brand value hopefully rising. While turnover from founder or from publicly held management is often understood and expected, CEO level turnover accentuates under some private equity ownership, so much so that waves of new CEOs can't build a team or get anything done. From my own experience on corporate staff, it takes a CEO about 3 years to get their sea legs and get initiatives implemented and perfected in a company operated environment. While every situation is different, I'd note the record of CEO turnover at Real Mix, the collection of casual dining Mexican chains as a meaningful example. While there is no public financial data, the count of open restaurants under the brands declining since 2008 is a good proxy of current conditions. While no one should have a CEO position guaranteed, one year CEO contracts that are used by some PE players seem really dysfunctional.

http://www.nrn.com/latest-headlines/real-mex-ceo-david-goronkin-steps-down

<u>Situation Four: Make it Easier for Customers!</u>

Very recently, I came across a Five Guys that had temporarily closed. All the employees were outside taping signs to then doors, saying that their POS system was down and that they had to close. I asked why and they said that their policy. That was very unfortunate because it was a beautiful Sunday and the store was located on a very busy Target mall pad. Zero sales for all or part of that day, zero rent coverage, etc.

You wondered why a cigar box and paper order tickets for backline and cash settlement couldn't have worked for the down time; paper credit card settlement slips could have been filled out and later entered into the POS system once up and running, same with labor hours. Inventory would self adjust. The entrée and drink prices could have been rounded down to the next dollar to allow for ease of calculation, and calculators could have been on hand. Why did they have to close? One of my twitter friends speculated it was because hourly employees don't know how to make change manually. It certainly could be, but that is a training that could have been handled in operations manuals.

The point is we run across things all the time that discourages sales: no substitutions, no this, no that. We are not in a mode anymore where business can be turned down. Operations procedures and training has to be configured to "how can I get to yes to capture the sale".

https://twitter.com/JohnAGordon/status/830888077690146816

<u>About the author:</u>

John A. Gordon is founder and Principal of Pacific Management Consulting Group, a restaurant analysis consultancy. He focuses on complex restaurant operations, financial, market and management analysis projects for clients, including expert research and litigation support. Typical clients are investors including hedge funds, investors, attorneys, management consulting firms, a sell side restaurant team and restaurant operators, franchisees, franchisors and others. Gordon has four decades in restaurant operations and financial management roles. His website is www.pacificmanagementconsultinggroup.com, email, jgordon@pacificmanagementconsultinggroup.com.

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"If you can't feed a team with two pizzas, it's too large." -Jeff Bezos, Amazon founder and CEO

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