Restaurant Reflections: What Will Happen in 2017?
by: John A. Gordon, Principal

The 2017 ICR Exchange Conference in Orlando on January 9-11 2017 will be an important early peek of what will happen with restaurants in 2017. Over forty publicly traded restaurants will present, with some dozen additional up and coming companies looking for funding. It is the first opportunity in 2017 to identify catalysts. Be sure to watch for notes.

Restaurants had a so so year in 2016. US Food consumer expenditures away from home continued its upward path as has been seen for decades, but restaurants counts continue to grow. That makes it harder for existing restaurants to grow organically, as a market share game is not good for operators or investors. Stock value indices fell and then rose in November and December. The 2016 as reported chain sales and traffic indicators were either soft, or not what would be hoped. The space remains extremely competitive from every angle; even world-wide, restaurant counts are growing. With declining food commodity costs affecting grocery store prices, it is very challenging to take restaurant price increases. Expenses, especially labor and rent are long term problems, and more need for CAPEX to be deployed has become essential to compete. Fortunately, debt financing is still relatively easy. Yet there are some standout stars; the restaurant space remains investable, it just takes more work, and patience to find the stars.

Was there really a restaurant recession in 2016? No. There was a same store sales slowdown in many chain brands but overall restaurant consumer spending continued to grow. That "restaurant recession" perception affects those who monitor and judge this industry by the same store sales metric. Looking over the years, macros forces that affect restaurant demand—population, disposable income and GDP were positive all year. For example, the Bureau of Labor Statistics food and drinking place sales grew every month year over year in 2016. But some chains didn't keep up. There were a record number of Chapter-11s and more are coming, but these chains had been weakening for years.

The reporting and obsessive focus on same store sales has to be made more sophisticated and robust. While an important measure, it is hardly the single measure of success. Many other true brand health measures don't get the attention they deserve. In November 2016, Howard Schultz executed the classic takedown of an analyst who insisted on asking whether mid single digit guidance meant plus 4 or plus 5. Here is Howard's response:

> **…to just try to take a step back every now and then and recognize that comp store sales, while we all recognize is important, is not the driving force behind a company [Starbucks] that did $20 billion in revenue and $4 billion in operating profit…yes, it is important and strategic, but it is not everything.[1]**

End of Chipotle fever: Chipotle's pathway from 2006 until late 2015 showed the value of the fast casual model, driven by company store expansion, premised on a then unique quality proposition. It created incredible stock valuation and investor interest that spilled over to future IPOs (Can this company be the next Chipotle?). But Chipotle will take years to recover from the food safety hit it took in late 2015; from its unfocused recovery; it is not now nor will be a $15 EPS stock (current 2017 EPS consensus) for some time going forward.

Any $750 dollar restaurant stocks likely in 2017? Not likely. And hopefully not; that kind of investor pressure causes suboptimal pressures on the space to build and grow brands properly. The Chipotle run up in 2006-2010

[1] Starbucks earnings Call, November 4 2016.

represented the right growing brand for the times. But Chipotle of 2017 is not the same company as 2006. The restaurant space was a vibrant marketplace where brands were created and died for decades before Chipotle existed and it will be so afterwards.

Will there be a single standout star stock? Not likely just one, but a cluster. There are now several standouts in this very dynamic space. Several of these standout stars will be presenting at ICR 2017. Since 80% of the guest transactions in the US are at or under $10 per customer, that places an informal price guide. I'm watching Shake Shack (SHAK), Habit (HABT) and Zoe's (ZOES) as new age star candidates. They have the quality positioning (how does the food taste and is it contemporary), presence of multi sales platforms, strong store economics and expansion potential, including international development. Other standouts—Starbucks (SBUX), Texas Roadhouse (TXRH) and Panera (PNRA) have either reinforced their positions (TXRH) or are expanding their national and international positions. (SBUX, CAKE, RUTH). By no surprise, Starbucks and Panera were early leaders in digital, service and multi sales platform development.

The availability of labor and need for improved people practices to keep employees is a fundamental challenge this industry has to overcome. Not all but many companies routinely run hourly employee turnover greater than 120% per year and management turnover of 40% at the store level. That is costly and unsustainable, and requires complete changes in brand culture in some places. Such turnover affects service, cost and revenue flow; new employees do not upsell for example. This is especially true of the franchise space where franchisees are always more challenged because of royalty payments and higher cost of capital.

If hourly and management turnover can be reduced, that practically is the offset to rising wage per hour rates to avoid even larger price increases that might be required otherwise.

The necessity for new CEO talent: Five publicly traded restaurants[2] have no or only an interim CEO in place currently. That is an all time high, and difficult for the brands involved. Who do you recruit in to fix Noodles? The industry must find fresh talent.

One essential investor question is does the restaurant brand have the ability to expand in the US and to literally close down competitors? Competition in the US for brand attention, customers, employees, sites and intellectual greatness is extreme. The investment stories heard in the past—white space, asset light must be tempered to the US realities. Restaurant supply has been building ahead of population growth for years. While this has always been a very creative business, with businesses coming and going, today's and future brands have to literally take out competitors in this overstored environment.

The accessibility of the right real estate and working patient market development strategies is critical. In 2016, fast casual brands like Noodles (NDLS) and Fiesta Restaurant Group's Pollo Tropicale brand (FRGI) pulled back expansion and closed new stores in major expansion markets (Washington DC, Dallas), showing evidence of the trickiness of new unit expansion. Both of these were 2012 IPOs. These store closures were unfortunate due to the loss of capital and employees and the lack of investor patience that forced them.

[2] Ignite (IRG), Noodles (NDLS), Fiesta (FRGI), Ruby Tuesdays (RT) and Rave Restaurant Group (RAVE).

Attention to franchisee margins needed: Franchisors cranking up their unit development models to plaster restaurants everywhere is a dated 1960-1980s era approach not right now for the US. It is sub optimal strategy for the brand, the franchisees and the industry as a whole. Look at Subway for example; new store builds have less than 70% of annual sales (AUV) of existing stores. Resulting swaths of less than 11% franchisee store level EBITDA store margins (which is common in the US restaurant space) does not provide a return for franchisees and results in stores that can't be maintained or remodeled.

Really differentiated brands needed: systemic, decade long weakness in the casual dining grill/bar brands of Ruby Tuesdays (RT) and Applebee's (DINE) are very clear. The best anecdote is highly differentiated and experience brands, such as Dave and Buster's (DAVE) and Fogo de Chao (FOGO) both of which have a measured expansion pathway.

And finally, credible international store execution is key. With the US overstored, brands with great store economics that develop international markets and sales platforms will be the premium going forward. This can be accomplished via low capital or no capital methods (JVs, master area franchising or developmental licensee models) or via company operations. QSR best in class: think Starbucks (SBUX), it is miles ahead of potential small box coffee peers. Best in class casual diner: Cheesecake Factory (CAKE) who can command the very best in JV partners.

About the author:

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, attorneys, management consulting firms, a sell side firm, 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.