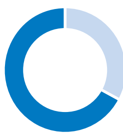
# U.S. Franchise Restaurant Sector Outlook


**$799B**[1]
Restaurant industry size in 2017



**35%**[2]
of restaurants are franchised

**7.3%**[2]
Estimated growth in output for restaurant franchising in 2018

**2017**
Saw total restaurant units shrink by 2%, but fast casual grew by 4% where saturation is becoming evident as a shakeout takes hold.

## IFA Franchise Business Economic Outlook: January 2018 Forecast[2]

| | Number of Establishments | Change Over Previous Year | Employment (in 000's) | Change Over Previous Year | Output ($ Billions) | Change Over Previous Year |
|---|---|---|---|---|---|---|
| Quick Service Restaurants | 194,723 | 2.1% | 3,777 | 4.5% | $256 | 7.3% |
| Table/Full Service Restaurants | 31,976 | 1.8% | 1,060 | 3.8% | $72.7 | 7.2% |
| **Total** | **226,699** | **2.1%** | **4,837** | **4.3%** | **$328** | **7.2%** |

## Labor Outlook

- Wages: up 4–5% per year with shortages
- Employment: 20%+ of all new job creation
- Turnover: increasing pay = job moves

**Questions:**

- Raise prices to offset or wait for the robots?
- Recession brings labor relief, but also sales declines?

## Delivery Outlook

- Ubiquitous availability = jump in users
- Employment: big competition for drivers
- Restaurants committing to grow delivery

**Questions:**

- Is it incrementally profitable or cannibalizing?
- Will you still pay $5–$6 for delivery in a recession?

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# 2018 Outlook

Thanks to growing consumer confidence and strong business investment, the franchise restaurant industry is poised for solid revenue growth in 2018, but unit counts are a worry. While labor challenges remain, operators will also be keeping an eye on trends in third-party delivery services and the rise of microchains as growth opportunities.

### Contractions: Unit Counts, Traffic and Same-Store Sales

**For unit counts, 2017 was another year of contractions** for much of broad restaurant industry, as NPD reported total restaurants declined by 2 percent and independents took a hit of 3 percent, while overall traffic was flat to negative for most.[3] Casual dining extended its decade-long traffic decline, and its unit count dropped by 2 percent with more closings projected to come once landlords stop granting rent relief and lenders have to start taking write-downs on some loans in workout mode. Bankruptcy filings of owners of Bertucci's, Joe's Crab Shack, Romano's Macaroni Grill, and the second largest Applebee's franchisee may be indicative of what's to come in that segment as unit closures are realized.

Fast casual seemed to be hitting a point of saturation, with unit counts growing by 4 percent, while the segment experienced same store sales declines in 2017. The shakeout in fast casual is happening in real time and more headlines and unit closures will likely emerge in 2018 as the segment now matures.

QSR unit counts were under pressure too, but it remained a bright spot as sales and traffic grew with a renewed focused on discounting and value messaging to attract the trade down from other segments. When looking to specific brands, the QSR leaders—McDonald's, Burger King, Wendy's, Taco Bell and KFC—were the beneficiaries of the trade down from others. A strong push from franchisors is fueling a development boom among some of those leaders as well.

However, all of this contraction in unit count belies a fact that total restaurant sales in dollars were up 2 percent in 2017 according to the NRA, and the outlook remains bright for *franchised* restaurants that look to add over 7 percent sales growth in 2018. The larger QSR franchised chains are expected to remain as the go-to option for consumers on the go as they have proven to be most recession resistant and flexible when it comes to value.

**2018 is shaping up for another year of increased sales,** likely boosted by an increase in disposable income from recently enacted tax cuts, 2 to 3 percent wage growth and increased consumer confidence. Business investment should improve, fueled by the tax reform and accelerated depreciation benefits, thereby stimulating hiring and wage growth. The offset will be how quickly the Federal Reserve raises interest rates to temper inflation risks in the coming 12 months. We expect interest rates to increase in 2018 while remaining at the low end of historical norms. Furthermore, if geopolitical tensions rise and gasoline prices rise quickly as a result, the restaurant business will be under pressure along with disposable income. Heading into summer 2018, gasoline prices were already 20% higher than the prior year, marking a 3½ year high point just as oil prices were surging on the news of the U.S. withdrawing from the Iran nuclear deal.

The outlook for franchise finance lending is mixed. While some lenders are experiencing weakness in their restaurant loans, there's a surplus of newer lenders in the space. But many of these players haven't experienced the cyclicality and other nuances of the industry, which is why picking the right lending partner—one who's comfortable with structuring loans through all market cycles—is especially important in a tightening credit environment. These new players may also be part of the drive behind the current restaurant oversupply—attendance at last November's Restaurant Finance & Development Conference saw a doubling of sources of capital for restaurant investment, lending and leasing.

### Favorite quotes to explain restaurant oversupply:

**"These days if you can buy it on the internet, it's really not a viable strategy for retail development."**

*—Retail real estate developer seeking restaurant tenants for a new project*[4]

**"Saturation is for sponges."**

*—Ray Kroc, McDonald's founder*[5]

**"(Restaurants) are fairly protected against e-commerce penetration. The social aspect and foodie experience that diners want still trumps the convenience of ordering in."**

*—James Cook, Jones Lang LaSalle Director of Retail Research, on "Amazon-proof" retailers*[6]

## Restaurant M&A

**For the same reasons retail developers have shifted focus to restaurants, a crowd of private equity funds, family offices and strategic buyers have shown deepened interest in restaurant investments over other types of retail and consumer investments. A record year of deals at lofty EBITDA multiples brought a wave of first-time restaurant investors while more seasoned investors stood on the sidelines or were sellers. Here is a list of those deals done in 2017:**

**JAB Holding** (parent of Caribou Coffee and Krispy Kreme, among others) purchased Panera Bread for an estimated 20x EBITDA, or $7.5 billion.

**Panera** purchased its long-lost sister chain Au Bon Pain in late 2017.

**Buffalo Wild Wings** went private after Roark Capital acquired the chain for 9 to 10x EBITDA, or $2.8 billion.

**Burger King's RBI** purchased Popeyes for an estimated 18.5x EBITDA, or $1.8 billion.

**Cheddar's,** 160-unit casual dining chain, was sold to Darden Restaurants for 10.5x EBITDA. or $780 million.

**Bob Evans,** 523-unit family dining chain, was sold to Golden Gate Capital for $565 million.

**Checkers,** 840-unit QSR chain, was sold to Oak Hill Partners for $525 million.

**Qdoba** spun out of Jack in the Box to Apollo Global Management for $305 million at what appeared to be a low EBITDA multiple.

**Captain D's,** a leader in fast casual seafood, was sold to Sentinel Capital Partners.

**Culver's** received a significant minority investment from Roark Capital.

**KMAC,** the largest Taco Bell franchisee with 294 units, was sold to Lee Equity Partners, a first-time franchisee investor.

**NPC International,** the largest Wendy's franchisee, grew to 386 units through two large acquisitions, then sold itself.

**MUY Hamburgers,** the largest independently owned Wendy's franchisee, grew to 294 units with another acquisition.

**Meritage Hospitality,** a publicly traded Wendy's franchisee, grew to 250 units through two acquisitions.

**GPS Hospitality,** a family-office backed Burger King and Popeyes franchisee, grew to 395 units through two acquisitions.

**KBP Foods,** the largest KFC franchisee, grew to 450 units through two acquisitions.

**Flynn Restaurant Group,** the second largest Panera franchisee, grew to 130 units with a large acquisition.

**First Watch,** a 300-unit breakfast and lunch concept, was sold to private equity investor Advent International.

**Blaze Pizza,** a fast growing 200-unit fast-casual pizza franchisor, received a significant investment from Brentwood Associates.

**Torchy's Tacos,** leader in the "Nuevo Soft Taco" movement, received a minority investment from General Atlantic.

**Uncle Julio's,** a polished Mexican casual dining chain, was sold to L Catterton.

**Cafe Rio** was sold to Freeman Spogli & Co.

**Jim 'N Nick's BBQ,** a 37-unit full-service chain, was sold to Roark Capital.

**Ruby Tuesday** went private after being acquired by NRD Capital in an effort to turn the struggling chain around.

**Garden Fresh** and **Ignite Restaurant Group** were sold out of bankruptcy to Perpetual Capital Partners and Landry's, respectively.

**J. Alexander's,** a publicly traded upscale casual dining chain, announced the purchase of the Ninety Nine Restaurant & Pub chain.

## Deep Breaths: Labor and Delivery

The big worries on the minds of most operators these days are labor and delivery. Not the stages associated with the sudden trip to the hospital, but the challenges of a full employment economy and a consumer seeking more convenience from a competitive choice of offerings. We believe these two challenges will top the list of issues keeping operators up at night for the foreseeable future, and serve as a "disruption" that the restaurant industry could feel for years.

**Labor**

Labor pains have come in the form of a rising input cost pressuring EBITDA or cash flow of all operators. Labor shortages are now widespread with national unemployment claims hitting 45-year lows,[7] wage inflation at restaurants rising at a rate almost double than that of the national averages, and turnover rising as employees jump ship for the next higher offer. We do not see a relenting of high turnover, higher training costs and staffing shortages until a recession takes hold. Overtime management and scheduling software, and maybe even more automation and robotic processing, will alleviate some pressure on the margins. But higher labor costs will remain a reality for all operators who are still struggling to take price while the competition is discounting.

Other industries like construction or delivery are drafting workers away from restaurants too. The National Homebuilders Association, for example, reported that there are an increasing number of unfilled construction jobs, largely due to a labor shortage. Further pressure on undocumented workers creates vacancies and contributes to shortages across many lower skilled industries. Anecdotal stories of a lack of pizza delivery drivers and new employee no-shows are becoming a much more common complaint among operators. Specifically, one part of the delivery problem is the ubiquitous nature of delivery as it spreads across the industry with increasing appeal and convenience.

**Delivery**

Delivery companies like Grubhub, DoorDash, Postmates and Uber Eats are fueled by venture capital and have successfully created a new appeal to age-old delivery by charging customers an average of $5 to $6 per order for a wide selection of options. Restaurant choices are much easier to consider now, thanks to ordering via mobile apps or online from restaurants that previously never delivered. The jury is still out whether or not these are truly incremental sales or existing customers switching to delivery, but early adopters are reporting up to 80 percent of orders are incremental. In early stages, delivery may rise to 10 percent or more of sales, but over time it's hard to believe those sorts of incremental percentages will hold up as more and more restaurant operators get on board and the playing field levels out. Many are reporting that average tickets are rising, but if you're a seller of alcohol, that sale is lost when delivering.

Third-party delivery companies collect 20 to 30 percent of the total order price as their cut of the sale and bring their own delivery force to the table in this gig economy offshoot. In an industry where restaurant operators earn 5 to 15 percent EBITDA margins after overhead, it's challenging to see how long third-party delivery companies can keep collecting a large percentage of sales (and the data) before operators demand a lower percentage charge or higher prices from customers for the offset. The delivery firms can sustain a long "cash burn" on unprofitable deliveries in the hopes of achieving scale and elusive profits, but we still believe this is an experiment that has not yet produced widespread profitable results. Furthermore, the restaurant business is built on brands and experiences, and if those aspects are weakened by poor delivery service, who will the customer blame?

## Commodities

Barring any impacts of trade war threats, the U.S. Department of Agriculture predicts that 2018 wholesale food prices will largely be deflationary and certain products will see significant relief. Wholesale beef prices are expected to decrease 2 to 3 percent in 2018, while pork should fall 4 to 5 percent. Farm-level vegetable prices are expected to decrease between 7 and 8 percent in 2018, and wheat flour prices are expected to decline between 2 and 3 percent. Poultry and dairy remain favorable with abundant inventory, but farm-level egg prices are expected to increase an additional 10 to 11 percent.[8,9] While the CPI for supermarkets looks to be flat to deflationary as well in 2018, that fact will make it harder for restaurant operators to take significant price increases versus food-at-home alternatives from the supermarket.

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### Birth of the Microchains

The microchain phenomenon that has developed over the past few years is capturing imagination and spearheading innovation in the restaurant industry today. Defined as three-to-19-unit chains of casual dining, fast casual and QSR, this emerging point of strength in the industry features creative chef-driven or high quality-focused menus with little or no frills; it's all about the food, and they're getting higher prices for it. The appeal for millennials and Generation Z is the sense of discovery and the sharing of that discovery via social media. An even deeper factor is the notion that many people crave adventure and experience in the restaurant visit, as TV personalities such as Anthony Bourdain, Guy Fieri and Andrew Zimmern have shown us. As the definition of anti-establishment, these smaller, growth-oriented chains can be nimble in their strategies and menus and food suppliers have reported they are growing their purchases by over 5 percent last year.

**Some of our favorite microchains to watch in 2018 include:** Tupelo Honey Cafe, Honeygrow, CoreLife Eatery, Tacodeli, Chi'Lantro, Lupe Tortilla, Curry Up Now, Flower Child, Mendocino Farms, Snooze, Postino, Cava Grill,Uchi, Zinburger, Bellagreen, Clean Juice,and Juiceland.

## Conclusion

We remain optimistic that the industry will remain relevant to consumers seeking value, nourishment and an aspirational experience. We expect new delivery options to increase the utilization of restaurants in the coming year, and a generally positive consumer outlook should give way to the celebration that is the restaurant visit. Franchised concepts still have their appeal as consistent stalwarts and growth vehicles, but interest is gaining in microchains as an adventure in dining and discovery. Storm clouds remain in the form of higher gasoline prices and a flattening yield curve—typically the precursor to a recession—and the Fed's goals of raising interest rates that will finally bring the "check" to the table at the same time lenders are seeing credit weakness. Settling the bill will create challenges for overlevered operators, but the smarter operators see this coming challenge as an opportunity to grab market share once again. For investors, cooling EBITDA valuations and tightening credit standards will likely result as a reversion to the mean occurs in this ninth inning of a long term recovery.

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[1] http://www.restaurant.org/News-Research/Research/Facts-at-a-Glance

[2] https://www.franchise.org/sites/default/files/uploaded_documents/Franchise_Business_Outlook_Jan_2018.pdf

[3] http://www.nrn.com/operations/us-restaurant-count-declines-2-percent-npd-reports

[4] https://communityimpact.com/austin/development-construction/2016/05/17/80m-mixed-use-development-slated-william-cannon-drive/

[5] https://books.google.ca/books?id=zrZtCgAAQBAJ&pg=PT206&lpg=PT206&dq=%22saturation+is+for+sponges%22&source=bl&ots=srsIgFd6Tm&sig=lCe-2Km5JrgzNNMUNYDzU6O8i21Q&hl=en&sa=X&ved=0ahUKEwjxlcPwvZLaAhWC44MKHVf8DpwQ6AEIJzAA#v=onepage&q=%22saturation%20is%20for%20sponges%22&f=false

[6] https://www.cnbc.com/2017/08/20/here-is-how-amazon-proof-these-13-types-of-retailers-are.html

[7] https://www.cnbc.com/2018/03/29/us-weekly-jobless-claims-mar-24-2018.html

[8] https://www.ers.usda.gov/data-products/food-price-outlook/summary-findings/#PPI

[9] http://www.supermarketnews.com/news/little-food-inflation-projected-2018