U.S. franchise restaurant sector outlook

Restaurant Industry Facts at a Glance

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restaurant locations in the U.S.</td>
<td>1 million +</td>
</tr>
<tr>
<td>Restaurant industry's sales in 2018</td>
<td>$833B</td>
</tr>
<tr>
<td>Restaurant industry employees</td>
<td>15.1 million</td>
</tr>
<tr>
<td>Restaurant industry's sales projected in 2019, up 3.6%</td>
<td>$863B</td>
</tr>
<tr>
<td>New restaurant jobs created by 2028</td>
<td>1.6 million</td>
</tr>
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2018 Review

Last year’s restaurant performance was muted across the larger franchised brands when measuring same-store sales. There was a sense that clouds were looming on the horizon with respect to sales pressures, labor shortages, increased competition, dampened M&A activity and the beginning of a credit down cycle. In an environment of rising interest rates in the fourth quarter of 2018, the outlook grew more pessimistic and retail sales in December were much weaker than expected. Casual dining made a comeback in 2018 with growing same-store sales, but there was a question of how much was driven by discounting and promotions that generated little flow through to the bottom line. A recurring problem of declining traffic remained the industry’s biggest problem, masked by price increases that many operators used as an offset.

2019 Outlook

For this year, we simply expect more of the same pressures experienced in 2018, as well as an increasing risk of a recession as indicated by the inverted yield curve—a historically reliable predictor of future economic performance. In the first quarter of 2019, more signs of weakness emerged, with headlines of falling retail sales and a four-year low in U.S. auto sales. Labor shortages still abound despite growing retail bankruptcies and store closures, while more states are increasing minimum wage rates annually. Franchise finance lenders’ appetite for credit risk has been dampened and may worsen if a growing group of overlevered borrowers continues to experience stress. It remains an environment where the best credits have their pick of terms, while weaker credits cannot be refinanced without equity injections or improving their cash flow margins. Here are some key data points we’re watching.
The Traffic Jam

Restaurant operators are in a traffic jam. Not the congested highway type, but an overcrowded competitive marketplace and too many restaurants in certain hot markets. In other words, too many seats and not enough seated. According to Technomic, restaurant industry traffic was down 4.2 percent in 2017 and 2.4 percent in 2018; the outlook for 2019 was too cloudy for a prediction. The few brands driving traffic are able to attract new diners through exceptional execution and exciting product offerings, but many more are relying on discounting to bring diners through the door. In the burger segment, it remains a zero-sum game where leaders like McDonald’s can increase their same-store sales, like they did by 2.3 percent in the fourth quarter of 2018, and they grabbed almost $250 million in sales from competitors in the U.S. For franchisees focused on the bottom line, the reliance on discounting is going to have a real cost while “renting” those discount-seeking customers.

Can Delivery Bring Home the Profits?

When Russell Bendel, CEO of Habit Burger, said delivery “is not as incremental as the third-party aggregators tell you they are,” it may have been the first time delivery profits were being called out explicitly on the risk of cannibalization. With a typical cost of 20 to 30 percent of the ticket collected by the delivery provider, operators are increasingly questioning the profitability of this new source of revenue and its ability to actually lift sales.

Cannibalization of existing profitable customers is a reality, but many operators are resigned to the fact that they must play or suffer the sales loss to competitors. Some operators like Darden Restaurants, Texas Roadhouse and Raising Cane’s have resisted the delivery relationship, instead focusing on the strength of their hospitality experience and higher quality food delivered on-site, and they have not suffered same-store sales losses as others feared. Nonetheless, more and more operators are signing up to play with the larger providers while those delivery companies burn through their venture capital offsetting their own losses. All are hoping that scale will lead to “profit delivery” one day.

Delivery leaders based on Q4 2018 revenue (in millions)

<table>
<thead>
<tr>
<th>Company</th>
<th>Revenue (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grubhub</td>
<td>$1,143.9</td>
</tr>
<tr>
<td>DoorDash</td>
<td>$645</td>
</tr>
<tr>
<td>Uber Eats</td>
<td>$640.3</td>
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<tr>
<td>Postmates</td>
<td>$271.3</td>
</tr>
<tr>
<td>Caviar</td>
<td>$100.2</td>
</tr>
</tbody>
</table>

Source: Technomic

Concepts We’re Watching (or Eating!)

**Torchy’s Tacos • www.torchystacos.com**
Very hip segment leader is now venturing out of Texas.

**Velvet Taco • www.velvettaco.com**
A leader in the creative taco movement, they capture the imagination of tortilla lovers.

**Tacodeli • www.tacodeli.com**
A solid Interior Mexican taco chain from Texas featuring braised meats and big flavors.

**Taco Ranch • www.tacoranch.com**
Sister company of Austin, Texas, favorite P. Terry’s Burger Stand, this made-from-scratch new hometown darling is likely to keep growing across the city and perhaps beyond.

**Taco Bell • www.tacobell.com**
Yes! Taco Bell is on the list with new fryers in every restaurant and a robust pipeline of new products coming soon. Unit volumes keep growing with a strong mix of value messaging and now delivery.

**Biscuit Love • www.biscuitlove.com**
The Nashville, Tennessee-based scratch biscuit maker is generating long lines and wait times. They’ve won accolades from Bon Appétit and Food & Wine.

**Maple Street Biscuit Company • www.maplestreetbiscuits.com**
Jacksonville-based with over 30 units, this operator ties themselves to the local neighborhoods, dropping the “general manager” title and going with Community Leader titles instead.

**Holler & Dash Biscuit House • www.holleranddash.com**
May be spun off from Cracker Barrel due to activist pressure, is a relative newcomer focused on the indulgent southern biscuit and is spreading across the Southeast. Winner of an NRN Hot Concept Award in 2018.

**Rise • www.risebiscuitdonuts.com**
Is over 17 units and is all about Southern biscuits and Righteous Chicken with donuts and fritters for the sweet tooth.

**CoreLife Eatery • www.eatatcore.com**
From Syracuse, New York, this healthful fast-casual thought leader has won the heart of athletes like Tim Tebow. Growing through franchising is their plan for the U.S.

**Lazy Dog • www.lazydogrestaurants.com**
Originating out of Huntington Beach, CA in 2003 but with a feel like Jackson Hole, WY, this once regional chain is expanding across the country, building a novel beer membership loyalty program.
**Labor Shortages and Commodity Abundance**

The “Now Hiring” signs are flying at most restaurants as the unemployment rate remains near all-time lows. Minimum wage increases will continue for the foreseeable future, either by mandate or by demand accelerating the implementation of cost-saving technology as an offset. There is no easy fix for the labor shortage, and the only meaningful offset in the profit and loss statement has been the abundance of commodities due to overproduction and decreased demand from overseas due to trade wars.

Farmers are suffering their third year of beaten down prices, which, in turn, benefit restaurant operators on their cost of goods sold. If the trade wars end, we worry that a reversion to the mean on food costs will mean another hit to the bottom line without price increases to offset.

Furthermore, the most important commodity equally tied to restaurant success is gasoline. Prices at the pump have remained benign and likely will do so in the year ahead with the U.S. becoming a net exporter of oil in the future. As long as gas prices stay below $3 per gallon, we expect that cost to benefit disposable income and restaurant sales.

**M&A Activity To Remain Dampered**

Most in the industry fear another year of dampened deal flow as the labor pressures and rising operating costs eat into EBITDA. Enterprise valuations generally have held up despite this pressure, if only due to the fact that there are too many buyers seeking too few attractive targets. Failed auctions for struggling situations are becoming more commonplace as those sellers seek a way out before a recession hits again one day. Unrealistic expectations abound with any transaction that has a great story to tell, and buyers are questioning their ability to generate favorable returns on equity.

**The Fed’s New New Normal**

The yield curve inverted in early 2019, with the 30-day Treasury note slightly higher than the 7-year note—the day after the Federal Reserve indicated there would not be a need for further interest rate increases in 2019, and perhaps one in 2020. We’re holding the applause because an inverted yield curve is almost always an indicator of a recession. Shrinking tax stimulus, tariff wars, slowing retail sales and profit margin compression due to rising labor costs all seem to be taking a toll on the economy. More worrisome is the fact that if the Fed considers its position to be the new normal, it will not have the arsenal of remedies available as it did before the Great Recession. There is little room to lower the federal funds rate to zero, and the Fed’s balance sheet remains bloated from the last rounds of stimulus.

The Fed’s position remains quite stimulative despite its announcement of a pause in tightening. According to the *Wall Street Journal*, the federal funds rate “is just 0.25 percent when adjusted for long-term expected inflation. By comparison, the real rate was 2.75 percent at the end of the Fed’s last tightening cycle in 2006, and 4 percent at the end of the prior cycle in 2000. And the Fed will still hold more than $3.5 trillion in bonds in September, equal to 17 percent of GDP compared with 6 percent in 2006.”

If we drift into a global recession and the U.S. is impacted, more expansive monetary manipulation will be required at a time when the government appears to be geared toward trillion-dollar deficits in a time of recovery. How deep will the deficits go with a recession and any needed government spending stimulus? Will the Fed run out of headroom to stimulate effectively if it’s already using some of its capacity during this recovery? There is just too much uncertainty in the outlook for the economy to give a confident view for 2019.

**A Century to Remember**

The National Restaurant Association turns 100 in 2019, and it’s amusing to look back on how dining out has changed. On the eve of the Great Depression, the association ran advertising campaigns that read: “Enjoy Life — Eat Out More Often” and “Take Her Out to Dinner at Least Once a Week.” Consumers were spending about 6 percent of their income on food prepared outside of their homes during the Roaring ’20s, which seems incredibly tight when compared to today’s measures of about 51 percent of food dollars being spent in restaurants (including delivery).

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Prohibition took a big bite out of profits, but it did force restaurant operators to up their game on the food and the restaurant experience, laying the groundwork for the hospitality model that exists today.6

During the Depression, restaurants were often the only businesses doing any hiring of the unemployed masses.7

Despite multiple economic ups and downs in the past 100 years, the restaurant remains one of the country’s most special retailers.

The Wrap

Customer traffic woes appear to be the industry’s canary in the coalmine. Years of traffic declines for many brands, hidden by price increases, are hollowing out the dining room, while only a few operators manage to grab more than their fair share. We remain cautious on the overall restaurant space and expect the QSR segment to remain the most recession-resistant due to its long-term ability to speak to value messaging, pick up the “trade down” from more expensive dining out options, provide drive-thru processing of more than 60 percent of its transactions, and lower relative labor costs.

With lots of options available, including QSR, we think delivery impacts will moderate as an upside once everyone is on a level playing field. Commodities remain favorable with diminished demand from exports. But if the trade wars abate, there will be increased demand for these items and food inflation will return, taking away one of the last levers operators have to offset ever-rising labor costs.

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