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OUTLOOK

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'24 Franchise Lending Survey: No Guaranty For Franchisees Who Take On Too Much Debt

"Credit is so valuable in business it should be closely watched and wisely administered," advised the Wall Street financier J. Pierpoint Morgan.

In the gilded age of Morgan, Carnegie and Vanderbilt, there was no such animal as franchise lending, a quirky bilateral arrangement by which a commercial lender assesses the Four C's—character, capital, capacity and collateral—of an individual franchisee, and then places odds on the performance of the entire brand, all the while knowing a franchisor may not be concerned about the credit profile of their franchisee as the bank is. Caveat emptor!

Consider the franchisee bankruptcies that made news this past year in five big brands: Burger King, Popeyes, Denny's, Hardee's and Wendy's. Three of the five are Tier-One brands according to our recent lender survey (see the rankings on the back page). Blame it on Covid, as most of the companies did in their Chapter 11 filings.

However, what really happened is the typical modus operandi of franchise deals gone bad—too much debt. Restaurant Brands International Chair Patrick Doyle put the finger on excess debt as the main culprit for franchisee failure, when he told an Restaurant Finance & Development Conference crowd last November that leverage of five-to-six times cash flow was "probably too much."

"Probably too much debt" doesn't manifest itself overnight. It isn't as simple as saying the franchisee was too aggressive a borrower, or the lender was careless and advanced too much. Credit deterioration sets in over time. Same store sales gains become aspirational. A borrower overpays for an acquisition, or signs too many expensive leases. Brand performance plays a major role, too. Taco Bell franchisees look like geniuses these days while their counterparts at Burger King or Denny's aren't as prescient.

Sensitivity to same store sales declines is greater for a franchisee with 5x lease-adjusted leverage than one at 3x.

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Uber Founder Travis Kalanick To Keynote Food on Demand Conference Bellagio Hotel May 8-10, 2024

Join us live at the **Bellagio Hotel**, May 8-10, 2024, as leading restaurant and foodservice players gather for three days of great education and targeted networking at the **Food On Demand Conference**. The restaurant industry's only delivery and off-premises focused conference, Food On Demand was co-founded by the Monitor and Food On Demand News in 2018 to help restaurant operators acquire the necessary tools to boost delivery, takeout and catering sales.

Food On Demand welcomes restaurant owners and operators, foodservice management, technology suppliers, packaging innovators, delivery and catering providers, virtual kitchen, grocery and C-store operators, investors, legal experts and meal-kit brands—anyone focused on the future of foodservice off-premises sales.

Over three days of programming, you'll hear from both leading restaurant operators and industry thought leaders that are laser focused on improving off-premises operations. With daily networking breaks, cocktail receptions and a full exhibit hall, you will also be able to connect directly with key players in delivery, catering, data and insights, digital ordering, marketing, pricing, packaging, loyalty, autonomous innovation, AI, and much more.

The Food on Demand conference kicks off on May 8 with a keynote conversation with **Travis Kalanick**, founder of Uber and City Storage Systems, the parent company of CloudKitchens and Otter. Also, at this year's conference, 20 outstanding off-premises professionals from innovative restaurant brands, both large and small, will be recognized for taking creative paths to success with all things off-premises.

Visit www.foodondemand.com to view the full agenda, check out speakers and sponsors and to register.

Raymond James Advises on Premier Kings 363 Sale

Most of us know that a 363-bankruptcy process is complicated, but when it involves franchisees, it's even more so, said **Geoff Richards**, senior managing director, head of capital structure advisory for investment banking firm **Raymond James**.

Richards, along with Raymond James' **Mike Huttner**, who heads up the firm's restaurant advisory practice, and **Enrique Acevedo**, vice president of capital structure advisory, shepherded Burger King franchisee Premier Kings through the channels of a 363 last month. The group advised on the sale of 166 restaurants to four different buyers for $56 million. The buyers were Burger King Corp., the franchisor, and franchisees Mosaic Crown Group, Bulldog Restaurants and Royal Restaurant Group.

"The process had some twists and turns," said Richards, "driven in part by the limitations the franchisor imposed on the buyers." Burger King now limits franchisees to owning 50 locations each, which affected the auction process.

"I have advised about 150 companies in 363 sales throughout my career," he said. "Oftentimes we would try to procure bids for smaller pieces of a system, then bids for larger pieces, then bids for the whole system." Richards said they can play those bids off each other in order to get a higher price overall. In this case, because of the size limitation, they had to split up the units. Plus, the franchisor required that buyers have units contiguous to the ones on which they were bidding.

That also limited private equity coming into the process to bid, as well. "They might be interested in buying a portfolio beneath that 50-unit cap," he said, "but then they have to wonder, who are they going to sell it to later on, if the franchisor won't allow them to have a bigger footprint?"

Burger King may be becoming "more stringent in who they bring into the system, too," said Huttner. "Burger King participated and ended up buying one of the packages. We are seeing this more and more—franchisors buying back franchisee locations. It's a great way for them to gain more control of the franchisee base. And the franchisor is highly qualified to run them."

At one time, Premier Kings was the second largest Burger King franchisee at over 200 locations, and they were the largest in the southeast. The owner, Patrick Sidhu also owned Popeyes restaurants. But, problems plagued the franchisee company as economic headwinds began to blow through the restaurant industry.

"There wasn't an infrastructure built that was adequate for so many restaurants," Acevedo explained, "and there was a lack of a leadership team around him" to maintain control after Sidhu died in 2022.

And, according to Richards, "there was too much debt for the relative performance of the units," as rising interest rates, commodities, labor costs and more began to rise.

"We see this a lot in the franchisee world," said Huttner. "When interest rates were low, it was easy to leverage the business and take on more debt. If you have the tailwinds of lower labor costs and higher margins, you can pay down the debt." But, as commodities rise, capex needs to be addressed, royalties are due, and margins are thinner, it puts the squeeze on franchisees.

"This isn't unique to Premier Kings," he reported.

Turnaround and restructuring firm Aurora Management Partners was brought in at least a year before the auction process "to reposition and revitalize the units," said Richards. "Dave Baker (CEO) and his team did a stellar job, which enabled us to achieve our results."

Acevedo contended this was one of the more complicated 363 bankruptcies he's been part of. "Just the number of stakeholders involved: Yes, you had the lenders, but you also had an estate with other interests and goals, and then Burger King had unilateral approval of the buyers. Plus, there's landlords and equipment lessors" and other companies owed money.

"Then you add to the fact that we had to sell it in pieces—it was very complex," he said.

As far as the M&A market in general, there will be other opportunities out there for buyers coming up, said Huttner. Even though the M&A market was soft in 2023, "commodities are starting to moderate, and the labor market is opening up a bit," he said. "We feel that company performance will improve into 2024. We think there will be activity out there as it relates to franchisees, both healthy and distressed."

For more information, contact Mike Huttner at 732-284-1325, or at mike.huttner@raymondjames.com.

Hanover Bank Ramps Up National SBA Program

"We are putting a lot of eggs in this basket," said **Craig Goldstein**, SVP of sales for SBA and USDA with **Hanover Bank**. "We're the 44th largest SBA lender in the country, and we hope by year's end to crack the top 30."

Hanover Bank is a commercial community bank based in Mineola, NY, with $2.27 billion in assets. In 2023, Hanover took their existing SBA department, which was making loans locally, and launched it nationally. According to Goldstein, once they got it up and running, "we had a tremendous second half, and our pipeline for 2024 is on track with our goals."

Franchise lending has become about 25% of their portfolio, and they intend to grow those efforts. In fact, in 2023, they closed on $44 million in SBA loans within the franchise sector. And, they've financed franchisees as far away as California, Goldstein reported, which has helped them "prove our national chops." The have worked with restaurant brands like Jersey Mike's and Tim Horton's, to name a couple.

Goldstein has 28 years in commercial banking, and was brought in to help put in the structure for the new national program, plus assist with lead generation, expanding their deal pipeline and helping in the closing process.

They offer SBA-guaranteed financing on up to the SBA limit of $5 million, and they will also do SBA Express Loans, which are transactions under $350,000. "We can do small lines of credit, construction loans, and more," he said. "It's a wide range; whatever the SBA allows."

While they lend on a national basis, as a small community bank they can make credit and approval decisions quickly. "We have a lot of inhouse control and a team of 30 or so people so we can turn things faster. Our turn time is 60 to 90 days, but we're getting closer to 60 more often now," he said. "And, we can do more challenging deals—deals that other SBA lenders may pass on. We've been able to be nimble and move rapidly. We're good at that and I think we are getting even better."

He said early on when they launched the national SBA lending program "it was time for everyone to learn the policies and procedures, but the second half was more than fantastic" as far as deal flow was concerned, Goldstein said.

"We're thinking 2024 is going to be a great year for us," he said. For more information, contact him at 516-548-8570, or at cgoldstein@hanoverbank.com.

Aprio Taps Vozar for Transaction Advisory Group

In January, **Ross Vozar** joined **Aprio**, the 25th largest accounting firm in the U.S., as Partner-Transaction Advisory. He has 25 years in the business, and was most recently with BDO. He focuses on sell- and buy-side quality of earnings, bringing empirical data to bear for their clients.

Vozar joining the firm "is going to give us a depth of resources in our transaction advisory practice," said **Dana Zukofsky**, Advisory Director for Aprio, "tapping into his wealth of knowledge he had from working with restaurants and franchises."

Aprio has a dedicated restaurant practice, Vozar said, and he was impressed by their "bench strength." They have 25 people devoted to the transaction space, and a recent acquisition of accounting firm Antares Group brought them a relationship with McDonald's and the owners of 1,600 locations. "It gives us visibility and an opportunity to bring our services to those owners," he said.

His excitement is palpable as he told the Monitor, "The goal is to be the preeminent quality-of-earnings, M&A transaction advisory practice in the industry."

On both the buy- and sell-side of the equation, he said they really can add value when a company gets to be at least $15 million in revenue, and they've gone as high as working on a Term B transaction worth $400 million. "We are targeting multi-unit or multi-brand transactions," he said.

Vozar said he sees quality of earnings on the sell side increasing. "That's relatively new in the financial due diligence world," he said, with the exception of larger transactions. "No one saw the value of what they were leaving on the table until failed deals started happening. Sellers started to get smart, and wanted help." Because of that, buyers aren't finding problems at the 11th hour and killing the deal, he said.

He's preparing for a "fairly robust year" in 2024. "Now that interest rates are leveling out, that unknown is taken away." Although, he added, labor could continue to give operators "heartburn."

"But there are buyers, like private equity, that have dry powder and they need to spend it," he reported. "Yet to be seen are the strategic buyers and what their role will be in the coming M&A environment. Are they going to focus on operations and technology and being more efficient? They may choose to invest there in 2024."

For more information, contact Ross Vozar at (216) 287-7699, or at rvozar@aprio.com, or contact Dana Zukofsky at (646) 784-4008, or at dana.zukofsky@aprio.com.

Auspex Capital Facilitates Multiple Sell-Side Deals

Boutique investment banking firm **Auspex Capital** provided advisory on the following transactions:

Sell-side advisory: Soma Enterprises, an Orchard Hills, Mich.-based Taco Bell franchisee owned and operated by **Natvar Solanki**, has completed the sale of its three Taco Bell restaurants in the Detroit, Mich. area to **Black River Bells**, a well-established franchisee also based in Michigan. Soma retained the real estate underlying one restaurant and leased it to Black River Bells under a long-term lease.

Sell-side M&A advisory: Northland Investments, a La Palma, Calif.-based commercial real estate investment company that specializes in tier-one, quick-service restaurant properties, has completed the sale of a total of 11 QSR properties in North Dakota, South Dakota, Minnesota and Iowa in eight separate transactions. Following the sales, Northland and various affiliates still own and lease 78 QSR properties in 11 states.

For more information, contact Auspex Managing Director **Chris Kelleher** at 562-424-2455 or email ckelleher@auspexcapital.com.

Trinity Capital Restaurant Industry Report Cites Resilient M&A Market in 2024

When it comes to buy-side opportunities in the restaurant industry, "There really isn't a large supply of superior-performing restaurant companies in the current M&A market that are highly differentiated and check all the boxes such as being both culturally relevant and squarely on point with consumers, as well as demonstrating consistent stratospheric performance," said **David Stiles**, managing director with **Trinity Capital**, a division of Citizens Capital Markets. "Deals in market with those characteristics won't necessarily be hurt on valuation with the higher cost of capital—the scant supply of quality deals drives up demand, so they can uphold premium valuations."

According to Trinity Capital's recently released State of the Restaurant Industry Report, "Restaurant M&A remains resilient," and 2024 deal flow will depend on where the cost of capital lands and if other intruding factors continue to present themselves. For some sellers, if those factors don't ease, it may delay when sellers want to be in market or may even cause deals in market now from getting to the finish line, said Stiles.

"If a typical restaurant transaction can be compared to a golf ball being hit off the tee and your ball lands in the fairway, I believe the multiples you may see in the fairway are still going to generally get you 4.0x to 6.0x, and can even be 7.00x or more if you hit it straight and long. But there is the rough, bunkers, and water hazards that can all still make it harder to get to the pin." he said.

The report also cited that "the top 500 largest restaurant chains added more than 3,500 locations during 2023, a growth rate of 1.7% that was the largest since 2016…New unit growth has surpassed 2019 levels and continues to increase as unit-level margin pressures begin to alleviate, bolstering store-level EBTDAR margins."

According to Stiles, "On the one hand, everyone has their development obligations. But the cost of opening stores has gone through the roof. So, in a lot of cases, it has put an abundance of caution in people's minds on where to deploy their capital. Achieving attractive ROI has been more challenging and the returns are generally not being delivered in the current environment."

For remodel investments, years ago, operators would typically see a 10- to 15% sales bump after a major remodel, he said. From 2000 to 2020 "a lot of brands were renovating an extraordinarily old fleet of restaurants, and franchisees in many cases were upgrading buildings designed or built from the '70s and '80s with very dated architecture elements." That dramatic improvement would elicit a bigger 'wow' factor for the consumer.

Now, many remodel projects are tackling improvement to a fleet of buildings essentially built in the early 2000's and the architecture features implemented today aren't as pronounced or differentiated from one another, he said.

"It seems with all of the crowding and competition, consumers may feel like there is 'nothing to see here' in a new building design. It's just kind of become industry standard to at least have a nice looking store, but it may not be specifically driving traffic to the location. Today, brands are now trying to figure out how investment dollars can be better appropriated for things like more efficient equipment or processes, which customers don't necessarily see with their eyes. Brands now want to implement double drive thrus wherever possible. It's a tough balancing act with limited dollars to invest and deliver on both aesthetics and throughput," Stiles said.

That being said, "If I had to guess, that's why we are seeing a disproportionate amount of new store growth from taking someone else's failure and remodeling it to one of theirs. The cost is simply lower than building from ground up," he stated.

As far as choosing between opening new units or remodeling existing sites, franchisees "are obligated to do both, year after year. Those groups that don't have development agreements are always being asked to refresh a certain percentage of their portfolio. It's the cost of doing business."

Overall, the report noted consumer demand for restaurants is still high, even four years after the pandemic. Food away from home sales "grew 14.1% year over year for the period ended October 2023 to reach $1.3 trillion."

"We certainly feel better about 2024 than we did '23. We have several new engagements already signed up in Q1. For example, in April we will be in market with a meaningfully sized, strong-performing, fast casual franchisee business generating over $200 million in sales and over $20 million EBITDA," said Stiles, when asked about the level of optimism for the industry this year.

"I think what might not be obvious in the report is that, in the wake of the pandemic and all of the related operating challenges it introduced like supply chain disruption, labor staffing and wage issues, and also higher cost of capital, as long as volatility stays away and we are distanced from the uncertainty, it will make for a better dealmaking environment. 2024 should be stronger than '23, but it's not a given."

You can reach David Stiles at david.stiles@citizensbank.com, or at 310-231-3110. For a copy of the industry report, go to www.citizensbank.com/corporate-finance/insights/restaurant-industry.aspx

Restaurant Owners: Is an ESOP in Your Future?

By Dennis Monroe

Brian Bornino, director of GBQ Capital Advisors and an expert on succession issues and employee retention, and I have discussed that ESOPs are an expedient way to provide for succession and employee compensation. They also serve as an incentive, particularly for restaurants that have a lot of employees and problems with turnover.

These two issues are tied together in many ways. I set up an ESOP years ago for a salon business that, like restaurants, had a high turnover. Salon technicians have the option of renting a chair at another salon and taking their clientele with them. Non-competes are pretty much unenforceable, so other options such as ESOPs are needed to incentivize employees to stay. As an example, my client owned five high-end salons with high-earning stylists, and a high turnover rate. The ESOP, set up 20 years ago, and is still going strong today, owning just under 50% of the company's interest. The founder has seen turnover drop to a negligible amount. Some stylists have accumulated sums in the $500,000 range in their ESOP and it has been a huge incentive for key management.

We've seen the same success in the restaurant industry. With input from Bornino, here are some points to consider.

An ESOP can be a valuable tool as an incentive, owner liquidity and succession planning. ESOPs haven't been widely used in the restaurant industry due to issues such as who is included in the ESOP, the accounting for large numbers of employees and determining the qualifications needed to be part of the ESOP. Also, most restaurant companies go with a straight-deferred compensation arrangement that can take many forms. However, these are not qualified plans and don't provide the current tax deductibility. But they are effective and are governed by Section 409A of the Internal Revenue Code. An ESOP is a qualified plan that requires compliance with ERISA, various filings and an annual valuation.

How an ESOP works

An ESOP is a separate trust agreement with a separate owner. It's not owned by the employees, but by the trust. The trust usually has a board of directors. Ownership can't participate in the ESOP, but they can be trustees. To start an ESOP, business owners will sell their stock to the ESOP trust which can be for cash, leveraged with the bank or in installment notes. This will need to be a corporation and usually an S-election is made. The owner then receives the payments in cash or installment notes. In most cases, they are selling less than control; typically 40% seems to be a good number. The ESOP ends up being a shareholder of the entity and the existing owners still have their interest. Because the ESOP is a non-profit, if you make the S-election, the 40% ownership is not subject to tax, so this provides a big advantage. So far this is a fairly easy transaction. The hard part comes when you file with the Department of Labor and IRS, but if you develop a plan it can have various phases, and is not overwhelming. Think of it as similar to your 401(k).

In a white paper for his firm, Bornino stated an ideal company size for a restaurant ESOP is about $5 million to $100 million in value, or $1 million to $20 million in EBIDTA. There are other options for liquidity once you exceed $100 million. Also, if there's an IPO in your future, you would normally buy out the ESOP prior to the IPO. You always have the option to buy out if you go with private equity or do an IPO. One reason why ESOPs are not as popular in the restaurant industry is so many restaurant companies are franchises or large multi-unit operators. The ESOPs we have been involved with have mostly been independent concepts. You need strong leadership and steady growth. If the company goes up and down in value, it can be problematic.

Here are some of the advantages of an ESOP:

1. Succession planning: This is a solution to moving the company ahead, particularly for owners who are not interested in selling, but want to protect their legacy.

2. Several tax treatments: The ESOPs selling shareholder receives capital gains on the sale. There can be some exceptions: You may avoid a part or all of the tax on a sale transaction by doing a 1042 rollover where the capital gains can be deferred and possibly even eliminated. The advantage for doing an S-election is it becomes a tax-free entity. This can be appealing if you are in a high-tax state.

3. Retention and rewarding key management: You can't have a fully leveraged ESOP where there is no value; the debt has to be paid down to have value.

Some key issues: 1) you have to file every year and get a valuation which requires an audit; 2) you will need to find an attorney and accountant who have this expertise, plus an accounting firm for the valuation as well as an audit in the annual filings; and 3) in tackling the franchise side, you need franchisor consent for an ESOP because you have a change in ownership and non-qualified owners. There have been some franchisors who have embraced this, but there isn't much uniformity. This has been hard to trace because it hasn't been public, but we do know of situations where franchisors have approved an ESOP.

ESOPs are certainly worth investigating. You can never have too many tools in your toolbox, and it's certain you'll need them for succession planning in the future.

Dennis Monroe is chair of Monroe Moxness Berg, a law firm which focuses on M&A, taxation, and other business matters for multi-unit restaurant businesses. Reach him at (952) 885-5962, or by email at dmonroe@mmblawfirm.com. To read Brian Bornino's white paper, go to https://bit.ly/436osVE.

Domino's executives told Wall Street analysts last month its average franchisee EBITDA per store in 2023 was roughly $162,000 in 2023, up $23,000 per store over 2022. That's a remarkable feat given that same store sales in U.S. franchisee stores were only up a paltry 1.4% in 2023. The promise of improved profitability is spurring franchise sales activity, though. Some 165 net new franchise stores opened in the U.S. in 2023 and CEO Russell Weiner said 60 new franchisees entered the system and there are "170 new potential franchisees that are either in or have graduated our franchise management school." In the company's most recent FDD item 19 disclosure, a survey of 5,648 operators showed that operators averaging less than $15,000 per week in sales lost money on average while franchise stores generating more than $30,000 per week had an average 13.7% EBITDA margin.

FranData CEO **Edith Wiseman** told an International Franchise Association convention audience last month that 71% of Small Business Administration (SBA) loans issued in 2023 were for less $350,000 per loan compared to 67% in 2022. The smaller loan size, according to Wiseman, is a direct result of SBA outreach to smaller businesses. Higher interest rates could also be a factor. The current pricing for an SBA loan is the prime rate +2.75% (11.25%).

Live Oak Bank ($1.8 billion) and **Huntington National Bank** ($1.37 billion) were the top two SBA lenders in terms of total dollar volume during the SBA's fiscal year, which ended Sept. 30.

One of the risks to **Papa Johns'** share price according to Wall Street analyst **Mark Kalinowski** is "there are likely some customers of Papa Johns that have been so turned off by the words and actions of the founder — (John Schnatter) the namesake of the Papa Johns brand — over Q4 2017-present that they will never return as customers of Papa Johns." Schnatter is active these days on InstaGram as a small business coach.

That was the Florida-based hospitality group, **23 Restaurant Services**, presenting at the recent Las Vegas MoneyShow. The company, which operates 24 restaurants across five different brands (Ford's Garage, Don the Beachcomber, Arnold Palmer's CenterCup, Yeoman's and Tiki Docs) finds equity investors for each new location. It offers a preferred membership unit to multiple investors in each store and combines the outside equity with their own investment, bank debt and tenant improvement allowances. The company has five equity offerings in the market right now, ranging from $1.65 million for a new Ford's Garage in Sanford, Fla., to $4.27 million for an Arnold Palmer's CenterCup in Gainesville, Fl. The company charges each partnership a royalty and management fee and offers partners 80% to 100% of the cash distributions until the partner receives its capital back. The company touts an average annual return of 18.80% on past equity offerings.

Sardar Biglari's Steak n' Shake reported pre-tax operating earnings of $26.2 million that was more than double the $11.5 million recorded in 2022, and marks a turnaround from losses suffered from 2018 to 2020. The brand has fully converted from a full-service operation that peaked in 2018 with 626 units to a self-service format with a slimmed-down 457 units, 309 of which are now franchised. In his recent annual report, Biglari touted the improvements in employee productivity and prime costs, the latter which he said were 69% of net sales in 2019, "but fell to 56% of net sales in 2023."

Jane Grote Abell, **Donato's** executive chairwoman and daughter of the founder Jim Grote, is now on **Texas Roadhouse's** board of directors. Casual diner **Red Robin** is Donato's largest franchisee with the pizza product in over 273 of its locations.

The late Manraj "Patrick" Sidhu's sudden death in 2022 and his **Premier King's** subsequent bankruptcy filing put in play some 172 **Burger King** restaurants that Sidhu acquired or built over a period of 12 years. On the date of the filing in October, Sidhu owed a total of $87 million in principal to a syndicate of lenders including Wells Fargo, Bank of America, City National Bank, Truist Bank, MUFG Bank and PNC Bank. Some 166 of Sidhu's stores were eventually carved up and sold in January for $56 million to four bidders. The buyers included the franchisor, **Burger King Corporation** (38 units), Atlanta-based **Mosaic Management** (35 units), West Palm Beach-based **Royal Restaurant Group** (44 units), and Birmingham, AL-based **Bulldog Restaurants** (49 units). **Raymond James** was the investment banker for the sale of the stores. (See our coverage of this transaction on page 2.)

At the recent Focus Brands, now **GoTo Foods,** franchise convention held last month in Las Vegas, **Mike Freeman**, **McAlister's Deli** chief brand officer, announced McAlister's had reached $1 billion in annual systemwide sales in 2023. The Monitor's John Hamburger was a featured speaker at the convention and reminded attendees McAlister's was originally founded in 1989 by Oxford, Miss. dentist **Don Newcomb** and his dental assistant, **Debra Bryson**. Also playing a key role in the early growth of McAlister's were Newcomb's two sons, Chris and Neil. The Newcombs sold a majority interst in the company in 1999 to an investment group led by restaurant veterans **Mike Stack** and **Phil Friedman**. McAlister's was later sold to Roark Capital in 2005. Don and Chris Newcomb went on to found Newk's Eatery in 2004.

The Monitor caught up with multi-unit mega-franchisee **Greg Flynn** at the recent **International Franchise Association** convention in Las Vegas. Flynn had just finished speaking at the general session where he told an audience "just for the record, I'm not selling and we're not going anywhere." Flynn told the Monitor he was miffed by the original article that appeared in Forbes Magazine and the fact that it was picked up by many restaurant publications. Flynn said the title of the article should have been "the sixth recap in 25 years, management team going nowhere." **Roger Matthews** and the Restaurant Investment Banking team at **Bank of America** is representing Flynn in the transaction.

Drive-thru voicebot and pay-at-the-table tablet supplier **Presto Automation** has raised over $200 million in capital since 2008, but earlier this month, it scraped together a $2 million equity offering at $.25 per share, which according to the company's prospectus, provides "sufficient liquidity to sustain the Company until approximately the middle of March 2024 absent additional funding."

If it wasn't for the sale-leaseback of 18 restaurant properties, which generated $58.8 million and a gain, net of expenses of $29.4 million, **Red Robin** would have lost $50 million in 2023.

Restaurant Brands International initially offered **Carrol's Corporation** (1,022 Burger Kings and 60 Popeyes) $8.75 in cash per share on January 11, 2024 and then two days later upped their offer to $9.20 per share. Carrol's countered at $10.00 and eventually the two agreed on a $9.55 per share price. The enterprise valuation for the largest franchisee in the Burger King system is roughly 6.5x 2024 EBITDA. Not a bad price for Carrol's shareholders given that 600 of their Burger King locations will need to be remodeled.

When someone asks you what it is about the restaurant business you really like, tell them that restaurants have the ability to pass on rising food and labor costs to their customers. Look at **Chipotle's** prime costs (food and labor) that as a percentage of sales are the lowest they've ever been in 10 years (54.6% in 2023).

Texas Roadhouse, which has been loathe to raise menu prices, has the highest prime costs of any public restaurant company (68% in 2023).

Next time someone tells you how expensive restaurant dining has become, give them this stat: **Jefferies** food analyst **Rob Dickerson** wrote recently that cost of at-home food is approximately 30% higher than 2019. Still, according to Wall Street analyst **Mark Kalinowski**, "Pricing gains have moved in favor of grocery stores over restaurants." Kalinowski pointed out in a recent report the increase in the consumer price index for food-away-from-home in February 2024 was 4.5%, versus only 1.0% for grocery stores and supermarkets.

Higher interest rates will reduce franchisee cash flow next year as financing agreements roll over and interest rate swaps expire. **Meritage Hospitality,** a 387-unit Wendy's franchisee, reported $3.8 million in higher interest expense for 2023.

The Monitor caught up with **Anish Gandhi**, Managing Director of **Brookwood Associates** to talk about the deal business in restaurants: "Last year as the summer approached, things started to slow down due to uncertainty around the market. Deals started to stretch and many didn't get done. Around November, the phones started ringing a lot again. We are involved with and hearing about a lot of deal activity that is on the cusp of hitting the market, especially toward the end of the first quarter of 2024. As the post-COVID business trends start to normalize, the gap between buyer and seller expectations converges and we see more confidence on what to expect out of the broader economic environment, we anticipate a more robust deal environment in 2024."

Mark your calendars: The **Restaurant Finance & Development Conference** is November 11-13, 2024 at the new **Fontainebleau Hotel** in Las Vegas. Registration opens in June.

It's All About the Returns

The Cheesecake Factory provides an interesting case study on returns: We are all aware of a great number of brands that have come and gone over the decades, from D'Lites to Flakey Jakes to GD Ritzy's. Yet Cheesecake Factory, founded in 1978 by David Overton, is still a highly respected leader in the full-service casual dining sector. Cheesecake went public in September 1993 and had a great 20-year run until 2013. But, over the last 10 years, the brand has succumbed to "the law of large numbers," as well as the battle for market share.

A decade ago Cheesecake was operating 181 locations, 169 of which were the original Cheesecake concept. They generated $1.9 billion in sales and $161 million of operating income and $240 million of EBITDA. They had total assets of $1.1 billion including cash of $61 million and a modest amount of long-term debt, $68 million. Stockholders' equity was $577 million and there were 54 million shares outstanding, trading around $45 per share.

Five years later, in calendar 2018, revenues had grown to $2.3 billion, and total assets to $1.3 billion, but operating income was lower, at $136 million, and EBITDA was slightly lower at $232 million. Shares were reduced to 46 million, but the cash was lower at $27 million and the debt higher at $119 million. The stock was still around $45 per share, reflecting the lack of growth in operating income and EBITDA.

Looking at this past year, with a total of 334 restaurants, Cheesecake had total assets of $2.8 billion (after its acquisition of Sam Fox's restaurants), $3.4 billion in revenues, and generated still lower operating income of $108 million and EBITDA of $201 million. Shareholders' equity was lower, at $318 million and there was higher long-term debt of $470 million. There are now 49 million shares fully diluted outstanding, and the stock trades in the mid '30s, about 25% lower than five and 10 years ago. Over 10 years, therefore, Cheesecake's revenues and assets have doubled, but operating income and EBITDA is materially lower. If I had an economics degree, I would describe this as a negative marginal return on invested capital.

The franchisor/franchisee relationship is way out of date. Five years ago in this newsletter, I described the economic inequity between "zors" and "zees." In summary: When Ray Kroc started franchising McDonald's restaurants over 60 years ago, the royalty was 1.9%. It's grown steadily and 5% or so seems to be the standard today, plus 2% or more for advertising and other fees. This higher level of fees and royalties is on top of much higher operating expenses, as well as more intense competition. Even if today's franchisee can produce a pre-royalty store-level EBITDA in the high teens, payments to the franchisor amounting to upwards of seven points is pretty heavy. My answer at the time: Charge lower fees at modest volumes, especially ongoing royalties.

If I were running an early stage franchising company, I would install a sliding scale royalty system, perhaps 2.5% to 3.0% on a modest sales level, more on higher sales. It seems logical a young franchisor adopting this strategy would have a huge competitive edge and the total royalty stream would build more rapidly using this progressive approach. More profitable franchisees, and a more appropriate sharing of store-level cash flow in today's economic reality, would make for a more successful system in the long run.

While no restaurant company I know of has followed my suggestion, I learned recently of a non-restaurant franchise company that I follow—Driven Brands (DRVN)—with their Take 5 Oil Change brand, has brilliantly put in place a "sliding scale" royalty. Over time, the royalty goes from 1% in year one to 5% in year three, and 7% beyond year three after rebates that are dependent upon performance. Most importantly, the unit-level economics are attractive, or none of this would work. The other very appealing aspect of the Take 5 package is average sales build steadily in years one through three, from $872,000 to $1,195,000 to $1,544,000. The franchisees make on average 20%, 30% and 40% in years one, two and three respectively (before rebates). Quoting the FDD, the rebates are contingent upon "material compliance with the development schedule, the standards of operation in the manuals, our training programs, and any and all franchise agreements between us and/or our affiliates and you and/or your affiliates."

The result is the Take 5 franchise network grew a cool 50% in 2023, from 200 to 300 units, and is expecting to grow by at least 33% in 2024, to over 400 locations. It is understandable why the company continues to build on their base of 700 company-operated locations. With DRVN's substantial balance sheet and adjusted EBITDA that is north of $500 million, sale/leaseback transactions can leverage company unit cash-on-cash returns to well over 100% annually. While this discussion applies to only one segment of DRVN, Take 5 represents over 60% of corporate segmented adjusted EBITDA, is the most rapidly growing and apparently the most predictable portion. Check out my website for a more complete analysis of Driven Brands, my recent "stock-of-the-month" recommendation.

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STATS AND QUOTES

THE SCUTTLEBUTT OVERHEARD DURING EARNINGS SEASON	
1.	California's apparatchiks unveil their $20 minimum wage on fast food restaurants on April 1. Only high-volume restaurants will survive this Soviet-style, central planning exercise.
2.	Sweetgreen will barely squeek out positive "adjusted EBITDA" in 2024, yet sports a $2.5 billion market valuation.
3.	Bernstein analyst Danilo Gargiulo says Starbucks is suffering from "decreasing value perception, changing consumer habits, and greater maturity of the brand." China uncertainty isn't helping, either.
4.	Dine Brands top promotions in Q4 were Applebee's' DOLLARITA, All You Can Eat Wings and IHOP's Kids Eat Free and All You Can Eat Pancakes. What does this say about the consumer?
5.	Cava (the next Chipotle) put up strong numbers in Q4—17.9% same-store sales and 10.4% traffic gain; 72 new restaurants opened; adjusted EBITDA of $73.8 million, $61.2 million higher than in 2022.
6.	Remember the old rule of thumb of restaurant chains selling for 1x sales? Cracker Barrel's enterprise value is half their annual sales.
7.	Portillo's, known for hot dogs and hot beef sandwiches, generates $650,000 in salad sales per restaurant, per year.
8.	Dutch Bros will open approximately 160 new restaurants this year at a cost of $280- to $320 million. Whatever happened to asset light?
9.	Barclay's Jeff Bernstein says lower commodities coupled with "still outsized menu pricing" will benefit margins and earnings for those that operate their own restaurants.
10.	Deutsche Bank analyst Lauren Silberman warns of the possibility of value wars as "McDonald's focuses on value, food at home has become increasingly more attractive" and "industry traffic is muted."

INTEREST RATES (%)				
	03/13/24	Last Month	A Year Ago	Trend
Fed Funds Rate	5.50	5.50	4.75	↑
30-Day BSBY 1M*	5.39	5.37	4.74	↑
90-Day BSBY 3M*	5.38	5.38	5.05	↑
30-Day SOFR**	5.31	5.31	4.55	↑
90-Day SOFR**	5.31	5.31	4.55	↑
1-Year Treasury	5.04	5.02	4.30	↑
5-Year Treasury	4.20	4.32	3.67	↔
10-Year Treasury	4.19	4.32	3.52	↔
30-Year Treasury	4.34	4.47	3.67	↔
Prime Rate	8.50	8.50	7.75	↑

*Bloomberg Short Term Bank Yield Index **Secured Overnight Financing Rate

Jim Bianco, President and Macro Strategist at Bianco Research, tweeted a chart that showed economists placed a 65% probability of recession in the U.S. as recently as June 2023. With the economy continuing to surprise to the upside, those odds are now 40%: "Since 1980, the U.S. economy has had expansions of seven to 10 years. So, in any randomly chosen year, the probability of a recession is 10% to 15%. This explains why economists put the odds of a recession around 10% to 20% during normal times. But in the last few years, and even with the decline to 40%, the belief is the U.S. economy is vulnerable to a recession. Why? The Fed hikes until something breaks. The assumption is the Fed had to have broken something by hiking rates so fast. However, risk assets continue to boom, the economy is adding 300,000 jobs per month, unemployment remains below 4%, and consumers continue to spend money. Wall Street forecasts what it wants, different from what they think will happen. What it wants is lower rates. They are so desperate they are willing to forecast a recession (which used to be a verboten forecast) to get lower rates."

Papa John's CEO Rob Lynch on the company's recent conference call: "If franchisees are spending resources running restaurants that are never going to be profitable, that's taking away the resources from the restaurants that they should be focused on growing and building new restaurants that can perform better than the suboptimized restaurants that are already operating."

Convenience Stores Represent a Growing Competitive Threat to Restaurants, Particularly QSRs

Aside from economic uncertainty and rising input costs, QSR restaurants are facing intense competition from convenience stores for customers' food and beverage dollars. Furthermore, the degree of competition from c-stores promises to grow even more heated for the foreseeable future.

In many ways, c-stores are evolving from just a quick-stop shop which sold "cokes, smokes, and gas." However, consistently decreasing fuel margins, as well as more health-conscious customers, have forced c-stores to rethink their business models. They are now more of a food service destination that can satisfy customers' requirements for speed, variety and quality.

According to Convenience Store News, in-store sales at U.S. convenience stores reached an all-time high of $275.3 billion in 2022, up 6.6% from $258.2 billion in 2021. Total in-store gross profit totaled $73.35 billion in 2022, versus $70.26 billion in 2021.

In-store foodservice sales are growing at a much faster pace. These revenues totaled $51.7 billion and $43.2 billion in 2022 and 2021, respectively. Foodservice sales increased 19.7% in 2022 and accounted for 18.8% of all c-store in-store sales during the year. (Merchandise sales account for the balance.) The year-over-year growth rate was 20.3% in 2021, and the 2021 ratio of foodservice sales to total in-store sales was 16.7%.

According to Food Business News, foodservice sales account for about a quarter of all in-store revenues for c-stores, and more than a third of in-store gross margins. In 2022, the average c-store sold nearly $260,000 and $254,000 of prepared food (prepared onsite or offsite) and packaged beverages, respectively, up 20.9% and 7.1% from 2021.

An example of a company with enormous in-store sales is Casey's General Stores, Inc. (NASDAQ: CASY), the fifth-largest convenience store chain in the U.S. and an institution in many areas of the Midwest, especially in rural America. Casey's sells gasoline and diesel fuel at almost all of its 2,600 stores in 17 states, but the attraction for many of its customers is the pizza it makes from scratch in its in-store kitchens. Based on the number of its locations, Casey's would be the fifth largest pizza chain in the country in terms of locations, just behind the 3,180-unit Papa John's Pizza restaurants. Casey's realizes a 40+% gross margin on inside transactions.

Several factors are prompting increasing numbers of consumers to turn to c-stores for food offerings versus fast food restaurants. For example, according to a recent study by a c-store trade publication, about 50% of consumers believe convenience stores are just as capable of providing fresh food and beverages as restaurants. Furthermore, the publication reports consumers generally perceive the value of convenience stores to be higher than quick service restaurants (QSRs).

A September 2023 Convenience Store Shopper Insights Study released by the Acosta Group, a retail and foodservice marketing and data analytics firm, reinforces the growing food and beverage wallet share of c-stores. About 52% of c-store shoppers shop at such locations at least once a week, and 30% acknowledge visiting them more than they did a year ago. Most importantly, Acosta Group's Kathy Risch says for 92% of c-store shoppers, "food and drink purchases are the primary purpose of the trip." Snacks, candy, baked goods and refrigerated beverages represent the most frequently purchased items. (For the study, Acosta surveyed nearly 1,300 U.S. shoppers in July 2023.)

Furthermore, 45% of c-store shoppers purchase hot foods at least once a week, with sandwiches, breakfast foods and pizza being their most common orders. Fifty-one percent of these consumers believe c-store hot food items are at least as good as QSR offerings, and that they are more attractively priced. Interestingly, this demand for hot food is prompting some c-stores to begin carrying gourmet foods like cheeses, coffee and teas and craft beers.

Some c-stores have even taken further steps to appeal to a broader class of customer. Indeed, many stores have added natural lighting and redesigned their layouts to be more spacious and inviting. Even further along the spectrum, c-store chains like Wawa and Sheetz, Inc. (both private companies) have hired chefs, nutritionists, and food scientists to create upscale food experiences, ensuring the quality and taste of the foods they sell.

Blue collar professionals are frequent customers of c-stores. Nearly a quarter of these workers reported visiting a location every day. Even more telling and positive for c-stores, 58% of blue collar workers who frequent these locations buy lunch there, and 48% buy dinner. A whopping 42% eat the meals they purchase in-store.

QSR operators must assume c-stores will continue to offer more food and beverage options, especially as the tobacco side of their business continues to decline. How restaurants respond to this c-store onslaught will be critical to their success in an increasingly competitive market.

Jim McFadden is a CFA and has 25 years of experience as a Wall Street analyst and portfolio manager.

Franchise Lending Survey *continued from Page 1*

A highly leveraged franchisee that has a run of soft sales and low margins runs the risk of having its development line of credit or revolver pulled just when they need it most.

Franchisee bankruptcies in the multi-unit space have two common elements:

1. Too many restaurants that lose money.

I've often joked that in any restaurant franchisee organization, one-third of the locations make good money, another third are generally profitable depending on the time of year, and the bottom third lose money no matter what the season. The trick is to keep the middle ones from heading south. Restaurant owners go through all sorts of machinations to try and turn around losers. Change managers. Renegotiate rents and royalties. Cut costs. Unfortunately, one expense item that gets slashed is labor, and that will drive sales down even faster in a losing store. Why don't you just close them?

Landlords and franchisors all have this in common: They don't like closed stores. Landlords expect to get paid and still have the franchisee maintain the premises even when the store has shut down operations. Restaurant leases are often within a master lease agreement and store closures trigger a default. Often the buyout to get out of lease is so high the operator keeps operating, despite the losses.

The late Jamie Coulter, a long-time Pizza Hut and KFC franchisee who later was CEO of Lone Star Steakhouse, once told me he wished he'd signed five-year leases with multi-year renewal clauses. That way, he said he could get out of leases on poor-performing stores much easier. Unfortunately, there aren't many landlords that want a five-year lease. Nevertheless, there are some excellent professionals out there that can help you with a "lease extrication" strategy.

Franchisors pressure franchisees to keep stores open, too. Dan Dooley, who served as Tom's King's (Burger King franchisee) restructuring officer last year, told the Monitor "franchisors hate it when franchisees close stores because many of them have securitized their royalty streams and have other restrictions within their financing." That's true, and another big reason is ego. Store closures send a bad message to investors and prospective franchisees.

What all this means is a losing store stays open for much longer than it should and bleeds valuable cash. Unfortunately, if you have too many losing stores, bankruptcy may be your best option.

2. Marginal franchisees dissipate too much cash on capex and M&A.

The second common element of a franchisee bankruptcy is that operating cash flow was diverted to new-unit development, acquisitions, mandated remodeling programs, outside investments or personal expenses that provided no immediate return to the business.

Two recent franchisee bankruptcies are good examples: Andrew Levy's 61-unit Wendy's franchisee filed bankruptcy last year citing a failed joint venture to develop Wendy's locations in Brazil. Levy's Chapter 11 declaration also cited remodeling expenditures "requiring substantial capital expenditures that have modest or no equivalent returns."

Premier Kings, the 172-unit Burger King franchisee owned by the late Patrick Sidhu, filed bankruptcy in October and cited a failed three-store investment in Hummus and Pita Co, a fast-casual concept. They might have survived that but Sidhu had also grown rapidly by making multiple Burger King acquisitions.

When cash is tight after a sustained period of operating underperformance, the last thing a troubled franchisee should do is shovel cash out the door for capex or M&A. Remodeling expenditures need to be managed carefully and planned out in advance with both the lender and the franchisor.

I'm surprised there haven't been more franchisee bankruptcies given the volatility of the past few years. Low interest rates and capital availability enticed many a franchisee to grow their base of stores. As I pointed out last month in the Monitor, From 2012 to 2022, the top 200 restaurant franchisees in our annual Monitor 200 ranking of the largest franchisees went from operating an average of 100 locations to operating 167 locations. Much of that growth came from acquisitions that also came with strings attached to either build more locations or remodel existing ones.

For the most part, franchise lenders have done a pretty good job reining in their franchisee clients, but there is no question the operating environment for most brands is challenged.

The former Drexel Burnham investment banker Michael Milken once said that "liquidity is an illusion. It's always there when you don't need it, and rarely there when you do." And that's why franchise businesses need a rainy day fund or some other form of cash cushion. Just having availability on your credit line is no substitution for cash in the bank.

—John Hamburger

Franchise Lending Survey *continued on the back page*

2024 Lender Survey: Taco Bell is Numero Uno

If there was an Academy Award for the brand most coveted by franchise restaurant lenders, Taco Bell would be the Daniel Day-Lewis of the QSR category. The Monitor's annual survey of the active restaurant franchise lenders, which is presented in the next column, reveals Taco Bell franchisees as the most desirable of borrowers.

When asked what franchise brands are in their loan portfolio, the majority of franchise lenders answer "Taco Bell." Of the five largest brands represented in their portfolio, again the majority names Taco Bell. When asked what brands they intend to make loans to in 2024, who else but Taco Bell?

Why does Taco Bell have franchise lenders salivating? How about franchise same-store sales growth of 6% in 2023, 8% in 2022 and 11% in 2020. Need more? Store-level operating margins north of 20%. Large, successful franchisees. Taco Bell's unit development has been strong, too, with 750 franchise restaurants opened in the past two years.

Wingstop and Jersey Mike's have also caught on with franchise lenders, both are ranked No. 5 and No. 6, respectively, on the lenders' list of brands they intend to finance in 2024. The pair are growing at a double-digit clip and ranked higher than traditional Tier-One brands such as KFC, Burger King, Pizza Hut and Arby's. Culver's and Zaxby's also made it into the Tier One rankings for the first time.

Casual dining is still a tough sell in bank credit as only Buffalo Wild Wings is ranked in Tier One and the lone casual dining brand considered a top concept lenders intend to fund in 2024.

Where are some opportunities for lenders? Surpisingly, Jack-in-the-Box and Freddy's had only a few lenders that reported any significant loan exposure.

How about opportunities for brands not ranked? Have you ever thought about making a concerted effort to get in front of franchise lenders? It might make a difference in your development.

The Monitor's 2024 Franchise Lender Survey

#	Tier-One Ranking	Intent to Lend in '24
1.	Taco Bell	Taco Bell
2.	Wendy's	Dunkin
3.	Dunkin'	Wendy's
4.	Popeyes	Popeyes
5.	McDonald's	Wingstop
6.	Jersey Mike's	Jersey Mike's
7.	Domino's	McDonald's
8.	Wingstop	Domino's
9.	KFC	KFC
10.	Burger King	Zaxby's
11.	Pizza Hut	Buffalo Wild Wings
12.	Arby's	Five Guys
13.	Culver's	Arby's
14.	Buffalo Wild Wings	Panera
15.	Jimmy John's	Burger King
16.	Panera	Culver's
17.	Zaxby's	Jimmy John's
18.	Dairy Queen	Dairy Queen
19.	Papa Johns	Little Caesars
20.	Five Guys	Pizza Hut

The Monitor survey took place in February 2024. Franchise lenders were asked to identify the current brands in their loan portfolio, which brands made up the five largest exposures, and which brands they were most likely to fund in 2024. A point was given to each brand named in each question. The points were totaled up to arrive at an overall ranking. A tie in total points was settled in favor of the brand that received the most points in the "intend-to-lend" question. For instance, Little Caesars and Applebee's were tied for 20th place with Five Guys. However, Five Guys had more lenders intending to lend to them in 2024.

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