RESTAURANT FINANCE MONITOR®

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OUTLOOK

Sales Make Everything Happen

The financial beauty of the restaurant business has always been the ability to rejigger menus and pass rising commodity costs onto customers. Labor costs, typically the second largest expense in a restaurant P&L, has been on a runaway train north and that's vexing many multi-unit operators, especially those with under-performing establishments.

The average hourly wage for all employees in leisure and hospitality topped $20.51 per hour in November, up 31% from the $15.63 average wage five years ago. And, it's headed higher. According to the progressive advocacy group, National Employment Law Project, the minimum wage will increase this year in 86 jurisdictions—27 states and 59 cities and counties.

Despite what operators say about the employment situation easing as of late, finding workers today is much more of a challenge than it was before Covid. According to the St. Louis Federal Reserve's Jolt Study, the number of job openings in accommodation and foodservice was 1,339,000 jobs as of November compared to 822,000 at the end of 2019. Tight markets jack up starting wages.

Higher wage rates and a tough recruiting environment typically leads margin-challenged restaurant operators down two paths. The first is usually to slash labor hours. At the Restaurant Finance & Development Conference in November, Aurify Brands Co-CEO John Rigos told a workshop audience that operators "shortsightedly, always seem to want to squeeze labor to get their margins back in line." The second path of the margin challenged is to throw money at technology to cut even more labor.

The focus on shaving labor to rectify margin problems is counterproductive in an industry that relies so much on its people to deliver the experience. A few years ago, Red Robin eliminated the busser position, a big labor saver, thought the top brass. The hosts, servers and bartenders, however, had no desire to clean tables. When the customers came in they saw a dumpy restaurant, what with dirty glasses and dishes piled up waiting to be bussed. Guess what? Sales went down and

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The Lender's Choice Awards

"Liquidity is what drives markets," says the great investor Stan Druckenmiller, and nowhere is that more evident than in our micro world of franchise finance. A competitive advantage exists for select franchise brands with ready access to capital and credit support. When multiple lenders are willing and able to provide credit to a brand's franchisees, those grand plans of new unit growth and seamless consolidations are much easier.

As a matter of fact, prospective franchisees are much more attracted to the top brands such as Taco Bell or Wendy's, because of the many lending options available.

A school of lenders willing to make loans to the top brands should not be a surprise. Lenders reduce their credit risk by first green-lighting a brand, and then tiptoeing through the credit tulips of the individual franchisees. That dual approach to analyzing default risk is one reason why so many lenders like the space.

The so-called "tier-one" franchise brands signify a class above, businesses with decent unit-level economics, a reasonable cash-on-cash return for new units and remodels, and a franchisor willing to make accommodations in terms of transfers in the event of a default. Franchise systems that fall short of tier-one status run the gamut from untested new concepts to tired brands closing more stores than they open.

A year ago we took some of the guessing out of the franchise-tier calculus by surveying the active restaurant lenders and asking them to provide color about the makeup of their loan portfolios. Who do the lenders consider to be in the top tier of brands, we asked.

This year we contacted approximately 40 franchised restaurant lenders and asked them to identify the brands in their portfolio, their five largest brand exposures and the brands they were intending to fund in the coming year. A point for the brand was assigned each time a lender checked a box on any one of the three questions. The brands with the most points were placed in the top tier. For purposes of this report, we designated the top 20 brands as tier-one brands.

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Simmons Bank Lending to QSR Franchisees

Rick Riecker joined **Simmons Bank** as Managing Director in August 2021, and has been "quietly lending" to restaurant franchisees ever since. "We're very busy right now," he said. "It's a blessing we can choose our customers. One of the benefits of not having a legacy portfolio is that all of our attention is on our new business and new customers."

Simmons Bank, which in a bygone era was known as "the gentleman's bank," Riecker said, was founded in 1903, and today has about $27 billion in assets. Riecker and team were brought in to work on building the franchise efforts because the bank "was looking to diversify. They're in six states, but they had a national platform on the mortgage side." They wanted to keep diversifying geographically, and franchise finance can help with that effort.

Riecker has worked in franchise finance since 2005, and before that, was in investment banking for 20 years. "I have a unique perspective: I saw large deals; I worked in M&A and understood financial analysis. That gave me a good background to look at transactions."

Joining him at Simmons are **Chuck Fletcher**, franchise relationship manager, and **Cabell Finch**, senior credit officer. "Each of us has at least 20 years of experience in this, and we know the business inside and out."

The trio originated the franchise program there, he reported. "The models, the proposals, everything you need to make a franchise loan we built from the ground up here. And the fact that we are small also means we're agile; there's not a lot of hoops or bureaucracy. Doing this from scratch, we can build this in a way to avoid the pitfalls of the past. That makes it a better experience for the customer."

Speaking of customers, they are looking to work with franchisees that have more than five units, and operate under one of Simmons' 20 or so targeted brands, mainly in QSR. Deal size will vary, Riecker said, but total relationship could be anywhere from $5 million to $40 million. "We could have smaller deals built onto larger ones." They will lend for acquisitions, refinancing, real estate or equipment.

Riecker's experience in franchise lending includes tenure with names like First Franchise Capital, Chemical Bank and TCF Bank—all in all, he keeps coming back to restaurant lending.

"I think franchisees are fascinating," he said. "Some come to the U.S. with nothing and build these successful businesses. I can't get enough of their personal stories." For more information, contact Rick Riecker at rick.riecker@simmonsbank.com, or at (201) 258-9202.

BankRI Expands List of Targeted Brands

Tom Fitzgerald, senior vice president for **BankRI**, like a large swath of the population, worked as a restaurant server to help put himself through college. "It was one of the hardest jobs I have ever had," he said. "But, one of the things I loved was the familial feel to the business."

And today, that's one of the reasons he has stayed in the industry as long as he has. "Often these are family businesses: They are hard-working and diligent. From what I've seen and watching their success, it is different than other C&I (commercial and industrial) businesses. What I love is watching these families succeed."

Fitzgerald has been financing businesses for more than 20 years, and 17 of those have been focused on franchisees. He joined BankRI 10 years ago to launch their franchise finance group. And that all started with Dunkin'.

"It's the dominant brand that we finance, but we are looking to expand into other concepts, too," he said. "Mainly in QSR, top-tier brands" like Wendy's, Domino's, Taco Bell, Burger King and others.

"We are a traditional bank," he explained. "We would typically look at more well-established concepts and franchisees." They will finance franchisees focused in the Northeast, but will follow customers to other areas of the nation where it makes sense.

BankRI offers senior debt for acquisitions, development, remodels and transfers, with transaction size ranging from $500,000 to over $60 million. Franchisee size doesn't really matter, he said, as they look at each transaction on a case-by-case basis. "I've had banking relationships that started at $500,000 that are now in the $15 million range."

But what is also true, as a smaller bank, "We're big enough to do the $60 million deal, but also have hands-on decisions down to that $500,000 transaction," Fitzgerald said.

And that's their value proposition. "Our money is as a green as everyone else's," he noted, "but we have deep relationships with our customers."

The franchise finance team has been together for years, even before coming to BankRI "and they understand the business like me. When you look at how we helped our clients with PPP, how quickly we worked, you could see how we communicate and how responsive we are. We act quickly, we get things done and keep things simple."

For him, it is about letting franchisees know "we're open for business." For more information, contact him at 401-787-1345, or at tfitzgerald@bankri.com.

Auspex Secures $50 Million in Financing for Border Foods

Border Foods and its affiliates, a New Hope, Minnesota-based Taco Bell franchisee owned and operated by long-time franchisees and brothers **Jeff and Lee Engler**, has obtained a total of $50 million of financing, including $30 million of business development lines of credit and $20 million of real estate development lines of credit.

The business development line of credit includes $20 million for Border Foods, led by **Citizens Bank**, with **BMO Harris Bank** and **M&T Bank** participating; and $10 million for Border Foods of Wyoming, LLC; Border Foods of Wisconsin, LLC and Sioux Falls Bells, LLC led by **Huntington National Bank**, with **City National Bank** participating.

The real estate development lines of credit include $10 million for Marvin Development South Dakota, LLC from Huntington National Bank and $10 million for Marvin Development III, LLC from **Cadence Bank**, with **Bank Midwest** participating.

The development lines of credit will be used for future remodels and development of new restaurants. Border, in conjunction with various affiliates, now owns and operates 232 Taco Bell restaurants including the real estate underlying 113 locations. Border is one of the 10 largest Taco Bell franchisees in the United States. **Auspex Capital** acted as the financial advisory and debt placement agent to Border for the transaction.

For more information, contact **Chris Kelleher**, Auspex managing director, at ckelleher@auspexcapital.com, or at 310-721-3532.

Igram Follows Passion to Franchise Education

Ab Igram, put simply, "wants to help create better franchisees who have an entrepreneurial mindset. And franchisors should want that."

Igram has spent his whole career financing businesses, mainly franchises, with organizations like GE Capital Franchise Finance and Webster Bank. Today, he is the executive director of **The Tariq Farid Franchise Institute** at the Arthur M. Blank School of Entrepreneurial Leadership at **Babson College** in Boston.

As an MBA grad from Babson, it's all come full circle, he said. Years ago, he met Steve Spinelli, who today is president of Babson. They stayed in touch, and Igram recently was advising him on launching the franchise program there. When Webster pulled out of the franchise sector, Igram was looking for the next opportunity. Spinelli tapped him to lead the institute.

The Institute delivers undergrad and graduate curriculum for both franchise brands and future franchisees. They also conduct academic research and look at ways franchise concepts are innovating, or could be innovating. Plus, they want to dispel some of the myths around franchising, and publicize how franchising can be a way to scale businesses.

Igram himself taught his first franchise class this last fall semester, and "our hope is to have a concentration in franchising. Since we have this platform, we want it to be multifaceted. We want to increase the awareness of this opportunity for Babson students."

On the brand side of the equation, he wants to help them educate their franchisees on how to be more successful.

"If we can create better franchisees, and convince brands to move their bottom franchisees up, that will help those brands, too," he said. "We're listening to and learning from franchisors. What's important to them? We're creating the content they want to help their companies and their franchisees."

A collaboration to build franchise leaders

Igram also is working with Cheryl Kiser, the executive director of The Institute of Social Innovation at Babson. That institute's goal is to help develop leaders with both an entrepreneurial and a values-based mindset.

"When I met Ab, I knew nothing about franchising, but we talked about how franchising could help with community investment, when done right. It could be one of the best opportunities for economic development," Kiser said. "We can develop leaders and scale the impact each franchise has."

She referenced McDonalds in England, which is working toward net zero emissions by 2040.

"How do you use innovation for impact?" she said. For each company the social impact could be different, whether that's a focus on the environment, diversity or education, to name a few. "What are the opportunities and what are the risks?"

"It's really a multi-pronged approach," said Igram. "Franchising is the ultimate network. And that's the start."

For more information, contact Ab Igram at 203-583-0241, or at aigram@babson.edu.

C Squared Advises on Sale of Dunkin' Units

Brothers **Dean and Steve Alepede** recently closed on the sale of three Dunkin' units to **MAP Holdings, Inc.** MAP is owned by husband-and-wife team **Mark and Megan Pesce**. **C Squared Advisory Group**, an investment banking firm focused on multi-unit restaurant businesses, advised the Alepedes on the sale.

"The brothers have been in the system for 35 years," said **Dan Connelly**, principal with C Squared and lead advisor on the transaction. "The second generation is involved, and they are off to a good start. They just wanted to trim their holdings a bit. They have been loyal and high-performing Dunkin' zees for a long time."

The Alepede's business is located in the Northeast, and "they are the typical franchisees who came together, worked hard and grew the brand," he said. "The valuation was strong."

According to Connelly, the Pesces were approved quickly by the brand as the buyer, partly because they were a good fit geographically. "Plus, they are leaders in the brand community." MAP Holdings has more than 30 locations.

"They are up-and-coming in the brand and are putting together a great network," said Connelly.

The market for Dunkin' acquisitions is strong, added **Pete DiFilippo**, principal with C Squared, who recently closed on a separate 10-unit Dunkin' sale for clients in the Mid-Atlantic.

"The attractiveness is the quality of the brand," he said. "Dunkin' is one of the signatures of Inspire Brands. I think they are also attractive because they have one less daypart. It's less complex and intensive as some of the multiple-daypart QSRs. They haven't been as impacted by food and labor costs."

Multiples "are doing very, very well on these," he added.

In general, however, the M&A market has been challenging, Connelly reported. "We have had some pausing of deals" partly because of the interest rates.

A silver lining? "We think inflation is starting to tame somewhat," he said. "Different brands in different regions have seen an improvement in the P&L over the last 90 days." Some of the challenges "have abated, for sure."

For more information, contact Dan Connelly at dan@c2advisorygroup.com, or at 617-784-7866. Or contact Pete DiFilippo at 401-525-6771, or at pete@c2advisorygroup.com.

National Franchise Sales Advises Jimmy John's, Denny's franchisees, and More

Franchise business brokerage **National Franchise Sales** (NFS) recently announced they have closed the following transactions:

• Multi-unit KFC franchisee **Graja, Inc.** added to their cadre of KFC restaurants with the purchase of **Ralph Harman**'s KFC and A&W franchise holdings and real estate. According to NFS, in the midst of Covid, the transaction faced additional challenges based on isolated geography. National Franchise Sales advised on the sale.

• **The Milton Group** grew their portfolio of Popeyes franchises with a purchase from **GMD Foods**. National Franchise Sales identified a buyer from its extensive database of long-time clients and executed the transaction from contract to change over in under 100 days.

• **Lamppost Pizza** corporate office tapped NFS to assist in a transaction between seller **LP Vista** and buyer group **Street Post Pizza** that involved both lease assignment expertise and the transfer of the seller's EIDL loan assumption.

• FAT Brands concept Native Grill & Wings franchisee **MTT Enterprises** divested their franchise holdings in a transaction in which NFS introduced new franchisee **Joy Bangla Enterprise, Inc.** to the opportunity.

• National Franchise Sales guided the sale of a Jimmy John's unit in Indiana for an undisclosed seller who sold to **Culinary Capital**, a neighboring franchisee.

• First-time franchisee **Nhan Pham** of **Radiant Twilight** purchased a Jimmy John's restaurant in Washington state from **Ground Viral**. The buyer was introduced to the Jimmy John's concept by NFS, which guided both buyer and seller throughout the offer, due diligence, franchisor and landlord approvals, the escrow processes and securing financing.

• NFS conducted a transaction for the purchase of their first Denny's by multi-brand owner **BD Foods**. The pandemic-era transaction required no financing, and the NFS Denny's Resale Team negotiated a lease extension for one that was otherwise expiring in seven years. NFS worked to keep parties engaged while awaiting a protracted sale necessitated in order to obtain PPP forgiveness.

For more information, contact National Franchise Sales President **Jerry Thissen** at 949-428-0481, or at jt@nationalfranchisesales.com.

Tier-One Survey *continued from page one*

As you can see from the table to the right, the usual suspects—Taco Bell, Dunkin', Wendy's, Popeyes and Domino's—are the top five ranked brands in our lender survey. Franchisees in these brands performed admirably during Covid and loan defaults historically have been infrequent. That means there are plenty of restaurant lenders willing to lend into these systems.

Of the 27 lenders that responded to our survey, 21 have loans outstanding in the Taco Bell system and for 16 of them, Taco Bell is in the top five of their franchise loan exposure. Dunkin' and Wendy's weren't that far behind. For those two brands, 19 lenders have loans outstanding and 10 of them said they were in the top five in terms of total loan exposure.

Wingstop and Jersey Mike's Subs are two brands finding much more lender interest than a year ago, and are ranked in the top 10. Only four lenders a year ago said they had loan exposure in Wingstop, yet 14 indicated exposure in the brand this year, with 15 lenders saying they intend to loan money to Wingstop franchisees in 2023.

Jersey Mike's Subs also has been a big success story with lenders. Last year, the brand was nowhere to be found in our rankings as just three lenders we surveyed had loan exposure to the sandwich chain, and only four were intending to lend to the brand's franchisees. In this year's survey, 13 lenders had loans out to Jersey Mike's franchisees and six of the lenders said they were in the top five of their total loan exposure.

Operating concerns obviously impacted the rankings of both Pizza Hut and Burger King this year. Pizza Hut, ranked No. 6 a year ago, fell to No. 12 in this year's ranking. Although 15 lenders indicated they had loans outstanding in the Pizza Hut system this year, only seven lenders indicated they would be funding Pizza Hut deals in 2023.

Burger King's ranking also took a hit this year, declining from No. 7 a year ago, to No. 10 this year. Although 15 of 27 lenders indicated they had loans outstanding in the Burger King system, only seven lenders indicated they would be funding Burger King deals in 2023.

Burger King's sales have been lackluster over the past few years and materially underperformed their fellow QSR competitors during Covid and its aftermath. That's led to financial stress among a significant number of franchisees, including Tom's King, a 90-unit franchisee that filed Chapter 11 last week. One lender told the Monitor a few days ago it would be "extremely difficult" for his bank to make a new loan commitment to any Burger King franchisee given the struggles of the brand.

The Monitor's 2023 Franchise Finance Survey

#	Tier-One Rank	Intent to Lend in '23
1.	Taco Bell	Taco Bell
2.	Dunkin'	Dunkin'
3.	Wendy's	Wendy's
4.	Popeyes	Popeyes
5.	Domino's	Wingstop
6.	McDonald's	Domino's
7.	Sonic	Jersey Mike's
8.	Wingstop	Sonic
9.	Jersey Mike's	Arby's
10.	Burger King	McDonald's
11.	KFC	Papa John's
12.	Pizza Hut	KFC
13.	Arby's	Burger King
14.	Papa John's	Pizza Hut
15.	Little Caesar's	Panera Bread
16.	Jack in the Box	Del Taco
17.	Panera Bread	Little Caesar's
18.	Subway	Subway
19.	Five Guys	Applebee's
20.	Buffalo Wild Wings	Jack in the Box

In the second column of the table, we ranked the brands based on the number of lenders that said they would fund them in 2023. For instance, a total of 18 of the 27 lenders we surveyed said they intended to fund Taco Bell, Dunkin' and Wendy's franchisees in 2023, the largest number of lenders in any brand. Those three brands, along with Popeyes, maintained the same "intent-to-lend" rank in the column as their top-tier rank, a sign of strong lender interest.

One could look at the brand rankings in the second column and suggest that a lower rank versus their position in the first column indicates a fall off in lender interest. And alternatively, former tier-one brands such as Applebee's might just be returning to favor as more lenders say they will be lending into their system.

January's annual **ICR Conference** held in Orlando is to the consumer investment world what spring training is to baseball. Optimism abounds with the restaurant chains on hand sporting perfect records. The reliever (restaurant tech) the team picked up in the off-season makes them more efficient. The new designated hitter (increased digital sales) should easily bat over 300. All of the teams are expecting improved fielding metrics this year (same store sales will beat Blackbox and Knapp-Track) and the new products (the rookies) will be superb.

Here are some things we learned at ICR this year:

Red Robin board members **GJ Hart**, **Tom Conforti**, **Dave Pace** and **Steve Lumpkin** acquired almost $500,000 worth of shares of the 500-unit casual dining brand at an average price of $7.10 per share in November. Hart, now CEO, joined the board of Red Robin in 2019 and was the former CEO of Torchy's, CPK and Texas Roadhouse. Conforti was the former CFO for Wyndham and Dinequity. Pace was CEO at Jamba Juice, and held executive roles at Bloomin' Brands, Starbucks, Pepsi and YUM!. Lumpkin, the former DineEquity CEO, joined Red Robin's board in 2016. Hart told the audience he is out to is remake the 500-unit casual dining brand, which he said suffered from "degradation of food quality, labor reductions and underinvestment." Hart said he wants to provide regional and store managers with a piece of the action where they can get bonuses on a monthly basis.

Black Bear Diner CEO **Anita Adams** said the 154-unit family dining chain will open 14 additional restaurants in 2023.

Killer Burger CEO **John Dikos** said the 19-unit better burger concept will open six new units in 2023 at an average cost per unit of around $450,000. AUVs are running at approximately $1.4 million.

Billionaire investor and **Eleven Madison Park** owner **Noam Gottesman's** dalliance with the QSR restaurant business isn't going well. Gottesman's family office, Tom's Capital, was the equity investor behind the 90-unit Burger King franchisee, **Tom's King**, which filed bankruptcy earlier this month. Tom's, with stores in Illinois, Ohio, Pennsylvania and Virginia, closed 35 locations over the past year. According to its Chapter 11 filings, it owes Burger King over $7 million in back rent and royalties while **Bank of America** is owed approximately $35 million under a senior secured credit agreement. Restaurant veteran **RJ Dourney** has been appointed as an independent manager. A sale process is underway and a stalking horse bidder is being sought.

Carrols Restaurant Group's interim CEO **Anthony Hull** said his company has no interest in picking up any of the closed Tom's King **Burger King** restaurants, even those near their operating territory. Hull said he's focused on improving operations in the existing stores, not expanding further in the brand.

Jack in the Box hedged on its original plan to refranchise 184 **Del Taco** restaurants despite plenty of interest received from investors during the recent Restaurant Finance & Development Conference. During meetings at ICR, Jack in the Box's CEO **Darin Harris** implied the company would be more "selective and patient" in the sale of the franchise units, now expected to be approximately 120 locations over the next three years. The initial EBITDA impact is negative, according to numbers the company presented at ICR.

With to-go sales stable in the 20% range, **Chuy's** CEO **Steve Hislop** said that the biggest opportunity for the 98-unit chain is driving dine-in traffic and value remains the key to Chuy's success.

Commissaries are back in style as labor costs rise. **Cafe Rio** CEO **Steve Vaughn** said a move to a centralized "craft" kitchen has shaved 250 basis points off food and labor costs and resulted in reduced kitchen capital expenditures. **Condado Taco** CEO **Chris Artinian** told attendees his 39-unit taco chain has built a commisary that can handle up to 120 restaurants within a 700-mile radius of Columbus, OH.

Former **Piper Sandler** restaurant analyst **Nicole Miller Regan**, is the new CFO at **7Brew Drive-Thru Coffee**. Miller told the Monitor she is excited to cross over to the operating side and is really excited about 7Brew's growth prospects. There are currently 38 stores open with about a third of those company operated.

According to SRS National Net Lease Group, a New Jersey investor acquired a new construction, 20-year leased **McDonald's** in The Villages, Florida at a 3.3% cap rate. That's less than the yield on a 10-year treasury.

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STATS AND QUOTES

OUR RESTAURANT INDUSTRY PREDICTIONS FOR 2023	
1.	Margins slowly improve as menu prices generally hold, operating costs stabilize and labor shortages continue to ease.
2.	High menu markups and delivery fees stall third-party delivery orders requiring more operators to subsidize customer fees in 2023.
3.	The M&A market accelerates in the second half as buyers and sellers gain confidence in a stable EBITDA and interest rates peak.
4.	The long-awaited U.S. recession finally arrives this summer. As expected, a weaker economy hammers second- and third-tier brands.
5.	Franchisors experience more royalty workouts as high store-level operating costs impact a franchisee's ability to pay.
6.	Patrick Doyle will take over as CEO of Restaurant Brands International, replacing José Cill.
7.	Chipotle's billion-dollar cash hoard spurs calls for a large special dividend or massive share buyback.
8.	A number of PE-backed restaurant chains file bankruptcy in 2023 after they fail to refinance outstanding debt.
9.	The venture capital drought results in a spate of restaurant tech mergers. Operators need to know if their tech provider will survive.
10.	The 20-25% increased cost of construction will force Wall Street to question the expansion plans of some public brands.

INTEREST RATES (%)				
	01/11/23	Last Month	A Year Ago	Trend
Fed Funds Rate	4.50	4.00	0.25	↑
30-Day BSBY 1M*	4.38	4.14	0.08	↑
90-Day BSBY 3M*	4.71	4.58	0.19	↑
30-Day SOFR**	4.31	3.80	0.02	↑
90-Day SOFR**	4.31	3.80	0.03	↑
1-Year Treasury	4.74	4.64	0.49	↑
5-Year Treasury	3.66	3.65	1.49	↑
10-Year Treasury	3.54	3.50	1.71	↑
30-Year Treasury	3.67	3.53	2.05	↑
Prime Rate	7.50	7.00	3.25	↑

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

In an article he penned for Adweek Magazine, Paul English, managing director at Ogilvy Consulting discussed the importance of value: "Ultimately, when the current financial crisis resolves itself, the brands that invest in providing meaningful value to consumers now will be better set for growth in the future. Those that don't will be remembered, too—but for very different reasons."

James Grant, Grant's Interest Rate Observer: "Ultralow interest rates disguised the costs of years of heavy borrowing, but rising rates are revealing it."

Nick Cole, Head of Restaurant and Hospitality Finance at MUFG: "The number of restaurants per capita is at its lowest point in 25 years against a backdrop of population growth. This supply/demand imbalance bodes well for restaurant chains even in the face of potential softening demand as we head into 2023."

Dana Lancellotti, president and CEO of the New Jersey Restaurant and Hospitality Association told NJ.Com that eateries large and small have been left with conundrums: "Restaurants are having to either take on the extra cost and end up not making much of a profit, or pass it on to the consumer which results in lower numbers. It's a new normal, and I do not see prices coming back down any time soon."

Another Broken Egg CEO Paul Macaluso commenting on alcohol sales at brunch during the recent ICR Conference in Orlando: "Brunch without alcohol is a sad breakfast."

Hope Springs Eternal, Especially at Shake Shack

By Roger Lipton

Twenty-five public restaurant companies presented this past week at the annual ICR Conference for investors in Orlando. Below, we provide our summary of sales and profit margin expectations, as well as some observations regarding long-term expansion in a normalizing interest rate environment, including some observations relative to Shake Shack.

Sales trends in Q422 were firm, both in full service and QSR segments, but the gains were, in almost all cases, price driven, so positive traffic comps were hard to come by. Reference was made to the storm early in December and widespread brutal cold just before Christmas, as well as firm sales a year ago until the Omicron variant hit at the very end of last December. We interpret this not as a setup for disappointing sales in December or Q4, but pointing out a reality relative to December trends which might have softened a bit. Going forward, the comps get easier in Q1'23 against Omicron in 2022, and most companies were cautiously optimistic that comps will remain positive as 2023 unfolds, but traffic gains will still be hard to come by. It is worth noting that dine-in traffic is down materially more than overall traffic, since off-premise is a lot higher than it used to be.

Expectations for prime costs, labor and cost of goods are the following: Wages will be up low- to mid-single digits in 2023, but less of an increase than in 2022. Cost of goods will be volatile but hopefully up less than in 2022. Therefore, there will be margin pressure from those large items. The problem is pricing adjustments continue to be necessary in an effort to recoup pre-Covid profit margins. Nobody wanted to lead the way with price increases, and we might have been hopeful inflation would be transitory (though we warned you), but it's clear now wages are up and going higher, as well as utilities, the cost of repairs and maintenance, insurance, waste disposal, etc. Hardly any management teams are guiding to materially higher store-level or corporate profit margins, being appropriately cautious in an unpredictable economy.

It's worth commenting on the cost of new construction, as well as ongoing difficulty to get timely delivery of materials and equipment. This lowers the return on capital, unless the new locations do proportionately more volume, so virtually every management team is increasingly selective in terms of expansion.

Shake Shack (SHAK) is an interesting long-term case study of rapid expansion, accompanied by decade-long minimal interest rates, which are now beginning to normalize. Founder Danny Meyer, CEO Randy Garutti and their team have created an admirable corporate culture and continue to be the fastest-growing, publicly held, company-operated chain. Even though their AUVs continue to moderate—now in the mid-$3 million range, down from much higher levels when they came public with NYC stores doing $7 million a copy—they now spend an average of $2.4 million on new stores, up about 15% in the last two to three years. Obviously, therefore, the ROI on new stores is a lot less than it used to be. The good news is Shake Shack has had access to very inexpensive capital, both equity and debt. We called their March 2021 convertible bond issue the "Deal of the Year" when, with SHAK trading around $120 per share (now at $50) they raised $250 million, convertible at $170 per share, at ZERO PERCENT interest. They still have that cash in the bank today, with a total of $336 million of cash and marketable securities, so their balance sheet is strong, with adequate long-term flexibility.

Garutti talks about the huge Total Addressable Market for new stores and enthusiastically describes a long list of brand-building initiatives, from drive-thrus to new products, to ordering kiosks, new venues, personalized digital service, etc. At the same time, he and CFO Katie Fogertey know well that the $250 million comes due in 2028. Time flies, and all financings from here will be more expensive than in the past.

Stepping back from the details, opening 40 new company-operated stores in 2023 will be a lot of work but is "only" about 15% against the current company operated base. Unit growth was 41% in 2017, 38% in 2018, 31% in 2019—predictably difficult to closely control. And, 2020 was a fire drill during Covid, with suppressed 12% unit growth; 2021 was a catch up year with 20% unit growth. Last year was more normal, with 16% domestic company unit growth, with 2023 to be about the same.

Putting the last 10 years in context, the inefficiencies inherent in the earlier aggressive growth strategy were affordable because capital was very inexpensive. The good news is the current company-operated unit growth rate should be affordable, sustainable and increasingly efficient over time. At the same time, the asset-light licensing effort has a great deal of potential. The turbulent financial markets promise to provide new challenges, but SHAK management is demonstrably very smart and dedicated, supported by a strong balance sheet, and should be able to productively adjust. (The valuation of SHAK we will discuss another day).

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IS THERE OPPORTUNITY IN THESE BEATEN-DOWN RESTAURANT STOCKS?			
Company/Symbol	**12/30/22 Price**	**2022 Change**	**Commentary**
BurgerFi International (BFI)	$1.26	-77.7%	Here's the story of a SPAC that merged with a mediocre brand, and shareholders found out how lonely it is in micro-cap land.
Sweetgreen (SG)	$8.57	-73.2%	Perhaps one of the biggest hype jobs to come down the pike since Boston Chicken.
Red Robin (RRGB)	$5.58	-66.2%	G.J. Hart must pull a rabbit out of his hat to turn this one around. Mimicking Texas Roadhouse is a good start.
Portillo's (PTLO)	$16.32	-56.3%	The biggest box in QSR has investors wondering how much capital will be required and how expensive it will be.
Carrols Restaurant Group (TAST)	$1.36	-54.0%	Leverage can be punishing when sales and EBITDA are soft. Being the largest franchisee of Burger King doesn't help.
Fat Brands (FAT)	$4.95	-53.3%	In order to make this stock work and service a $1 billion debt load, FAT must sell a lot of new franchises.
Good Times Restaurants (GTIM)	$2.24	-48.4%	Restaurant-level operating profit dropped 600 basis points in 2022 due to higher chicken prices and labor costs.
Krispy Kreme (DNUT)	10.32	-45.4%	Brand awareness is off the charts, but so were higher flour prices and a customer reluctance to pay increased prices.
Dutch Bros (BROS)	28.19	-44.6%	Actually hitting the goal of 4,000 locations nationally (800 today) might justify its current $6 billion market cap.
Shake Shack (SHAK)	$41.53	-42.4%	Shake Shack has many initiatives in the works to improve margins: drive-thru, kiosks, new products, loyalty and expansion.
Kura Sushi USA (KRUS)	$47.68	-41.0%	For a company that has never made money, shareholders must believe in a better future.
Noodles & Co. (NDLS)	$5.49	-39.5%	Chicken prices killed margins in 2022, but this year the 450-unit brand contracted for a year's supply and hopes things settle down.
Domino's Pizza (DPZ)	$346.40	-38.6%	Domino's has been on a roll since 2008 when it reinvented its pizza—that is, until this year with inflation and driver shortages.
Papa John's (PZZA)	$82.31	-38.3%	High costs and lower margins is not a great formula for price appreciation, despite more unit growth in the future.
Denny's (DENN)	$9.21	-37.2%	Is there a segment more disrespected by investors than legacy family dining? Even Denny's went out and acquired an alternative.
Fiesta Restaurant Group (FRGI)	$7.35	-33.2%	167 Pollo Tropical restaurants does not excite Wall Street. In fact, only one analyst was on the recent Q3 conference call.
El Pollo Loco (LOCO)	$9.96	-29.8%	Whether or not the company can regain lost margins in 2023 is the big question. Lots of new initiatives on the drawing board, though.
Cracker Barrel (CBRL)	$94.74	-26.35%	Double digit traffic declines despite relative value versus its competitors. The older customer base must be dwindling.
BJ's Restaurant Group (BJRI)	$26.38	-23.6%	So goes the dining room, so goes BJ's. Comparable sales have gone from negative 1.5% in Q1 to 4.8% in Q2 to 8.2% in Q3.
Ruth's Restaurant Group (RUTH)	$15.48	-22.2%	The 58-year-old brand has cash in the bank, a weekly AUV in excess of $100,000 and is building stores. What's not to like here?
Jack in the Box (JACK)	$68.23	-22.0%	With interest rates going up, investors have doubts the Del Taco transaction was worth the increased debt.

Creative Use of SBA Loans

By Dennis Monroe

Over the last three years, restaurant businesses have been privy to numerous loan programs and government benefits, several administered in conjunction with the Small Business Administration (SBA). The importance of the SBA as a central part of financing the restaurant community has never been more relevant. In 2021, SBA loans totaled $36.5 billion, up significantly from $22.5 billion in 2020. Most of the SBA loans are made under the 7(a) program, but there are many other interesting options.

For some additional insights into the SBA loan process, I spoke with John Kimball, senior vice president and head of the SBA lending group at Alerus Financial in Minneapolis. Kimball focuses on all aspects of small-business lending, including the restaurant space. As Kimball observed, the economic headwinds and general financing issues have allowed the SBA to provide key lending programs which have greatly benefited the restaurant industry.

The breadth of SBA financing for restaurants surprised me. SBA loans have been used to finance improvements, such as outdoor patio upgrades, dining-room remodels, point-of-sale equipment, as well as other kinds of in-store improvements. Traditionally, these types of uses required cash or equipment leasing, but SBA loans now are able to be used for the restaurant remodel made necessary by the pandemic.

Kimball made it clear the SBA is not a collateral lender, but rather a cash-flow lender, with outside support from personal guarantees. This cash-flow approach recognizes seasonality and is flexible with all types of amortizations. SBA loans can be combined with conventional bank lines of credit. Additionally, SBA loans can provide draws of up to 18 months on the original loan amount, then provide for an amortizing term loan. This is a way to facilitate new restaurant development and provide the necessary flexibility to grow a concept.

Normally the typical restaurant loan would be a five year amortization (if you can get a conventional loan), but the SBA allows for up to a 10-year amortization. The right lender group, Kimball pointed out, is going to look at blending the SBA product with conventional lending. This may entail a first lien for the conventional loan and an SBA product for financing new equipment and new assets.

Another unique option is the use of SBA financing for management buyouts or acquisitions. The seller can be involved with a seller note. There are issues of subordination, but if the seller carries a note back on the transaction, that seller note can count toward the down payment, allowing up to a $10 million loan from the SBA.

A key requirement is the SBA requires a valuation from an independent expert. The business value has to cover the SBA loan. If you have a seller note, all you have to cover with valuation is the SBA loan. Also, when it comes to the issues of EBITDA and proformas, the lender is normally working with historical numbers. While this can be challenging, there is flexibility, such as a weighted average approach to EBITDA which can help to normalize EBITDA for underwriting purposes.

A couple of other points: The SBA has low document loans which have quick SBA approval for loans under $500,000, so this can benefit early startup concepts. It should also be noted in loans up to $1 million, SBA fees are normally waived.

The bottom line is SBA lending, particularly for under $10 million, can be a viable option. At a time when working together isn't always the norm, it's reassuring to see SBA loans and conventional loans pairing together to present a world of options. The key is to find a bank and lender that has that kind of creativity.

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Finance Insider *continued from page 6*

Former Wall Street analyst **Dean Haskell** of **National Retail Concept Partners** has performed labor optimization studies for clients for almost a decade. Haskell told the Monitor that in most engagements they usually identify large variances in scheduling practice and advise an approach to remove excess labor where appropriate, then add back labor in stores that are understaffed. He says this always generates an overall savings of 100 basis points or more in direct labor, while generating same-store sales increases through improved speed of service. For more information, contact Dean Haskell at dhaskell@nrcpartners.com.

What happened to the Wendy's Baconator, the McDonald's all-day breakfast, Taco Bell's $5 breakfast box and Burger King's $5 breakfast mix-n-match? According to **Revenue Management**, QSR breakfast traffic was down 7.3% in the fourth quarter of 2022. Overall QSR traffic was down 4.2% compared to the same quarter in 2021. Perhaps thats because the average menu price was up 16.2% compared to a year ago.

Who Are a Restaurant's Low-Income Customers?

By Jim McFadden

As inflation raged in 2022, which in turn caused virtually all restaurants to raise menu prices to offset rising food costs and boost wages to retain workers, many operators have discussed changes in the attitudes and spending patterns of their low-income customers.

For example, Chipotle CEO Brian Niccol in the company's 3Q 2022 earnings conference call stated customers with incomes below $75,000 are dining at the restaurant chain less frequently. Similarly, Darden Restaurant's management has noted "softness" among guests earning less than $50,000 annually at its Olive Garden and Cheddar's Scratch Kitchen brands.

Low-income customers are simply stretching their food dollars; restaurant visits are being reduced in favor of more at-home eating. To help industry management teams and investors better understand the constraints faced by this customer sector, below we try to define the characteristics of low-income customers.

Families with incomes less than 200% of the federal poverty threshold are generally classified as low income. Specifically, a household of four, with total annual income of about $27,750, earns exactly at the poverty threshold; therefore, a low-income family of four, from a restaurant perspective, has yearly earnings of $55,500 or less. The U.S. Census Bureau reports that just over 37 million Americans, 11.4% of the population, lives below the poverty line, and about 90 million (27.5% of the country) are members of households with incomes equal to a maximum of 200% of the poverty threshold.

Not surprisingly, disabled Americans represent a high proportion of low-income customers. About 40.8 million U.S. citizens, or 12.5% of the population, are disabled; and about 27.7% of the disabled have incomes below the poverty level, more than twice the overall national average of 11.4%. Data on the number of people with disabilities who have household income of up to twice the poverty threshold—and therefore low-income customers of restaurants—is not available, but it seems safe to say that figure could likewise be around twice the national average of 27.5%. (According to the Center for American Progress, only about 21% of people with a disability participate in the labor force.)

Older adults aged 65 or higher represent a slightly lower proportion of low-income customers than the national average. The Kaiser Family Foundation estimates that 15 million senior citizens have incomes at 200% of poverty level or below. This represents around 26.8% of the U.S. senior citizen population of about 56 million. As an aside, the eating behavior of seniors will have a growing impact on the restaurant industry as the last of the baby boomer generation ages. By 2030, the number of U.S. citizens 65 years of age or older could be around 73 million.

Also according to Kaiser, there are large disparities in the numbers of low-income customers on a regional basis and from state to state. Generally, the Northeast and Mid-Atlantic regions have the lowest per-capita number of low-income citizens, while the Southeast has the highest percentage. In terms of individual states, New Hampshire (17.4%), Massachusetts (21.2%), Maryland (21.6%), and Minnesota (21.8%) are the states where the lowest proportions of citizens have incomes of 200% or less of the poverty threshold. Mississippi (39.8%), New Mexico (39.3%), Louisiana (38.3%), and Arkansas (37.7%) had the highest percentages. While not a state, Puerto Rico has an astonishingly high percentage of its citizens (70.5%) earning at 200% or less of the poverty threshold.

A large segment of low-income restaurant customers are recent immigrants to this country. According to Pew Research, about 40% of U.S. immigrants have household income of less than $50,000. Net immigration into the U.S. peaked at 1.049 million in 2016 but declined in 2020 and 2021 due to Covid and other issues before jumping back to near-record levels in the 12 months ended July 1, 2022. Net immigration was 477,000 in 2020; 247,000 in 2021; and more than a million between July 1, 2021 and July 1, 2022.

Education level is not surprisingly a key factor in whether someone is a low-income customer. Per Statista, a provider of market and consumer data, about 27.2% of individuals without a high school diploma had income at or below the poverty line, which is around twice the overall average for Americans. Conversely, about 13% of individuals with a high school diploma earn at or below 100% of the poverty threshold. That percentage shrinks to just 4% of those with a bachelor's degree or higher.

Low-income customers may be dining less frequently at many restaurants as the economy slows. However, understanding key characteristics of these clients may allow restaurant managements to craft menu items and a pricing structure for these items that permit restaurants to keep these customers.

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

Sales Make Everything Happen *continued from page one*

labor as a percentage of sales went up.

Another labor-saving trick that seldom pans out is to replace a trained manager with an hourly "key keeper." Time and again, restaurant margin do-gooders prescribe the lower-paid, lower-benefit hourly worker as an alternative to the more-expensive manager. Funny how that plan works in theory, but never in practice.

Yet another scheme for reducing labor costs is to replace the full-size restaurant prototype with a much smaller box, that, according to theory, is efficient and can be run with fewer employees. In my experience, these express units hardly ever meet sales projections and labor costs as a percentage of the lousy sales are usually higher.

Higher labor costs and a dearth of workers is also a reason so many operators seek a technological solution to their margin problems. An avalanche of easy money has flowed into technology in recent years and that's intensified the pitch that it can solve all the restaurant industry's labor problems.

Self-order kiosks, robotic kitchens, artificial intelligence and remote call centers are some of the labor-saving alternatives in various stages of testing and implementation. The pitch is seductive: Basic supply and demand of workers and a government committed to raising wages for low-income workers means labor costs will continue to rise. Restaurant workers skew younger and turnover rates exceed 100% per year. With tech you can replace a high-cost, low-experience and high-turnover workforce.

Not so fast.

At its core, the restaurant business always has been centered on the concept of hospitality, that is, the relationship an operator maintains with the guest. Upset that equation and there's trouble. Name one high-performing QSR or casual dining brand that's grown successfully without a bevy of well-trained employees? Quality, service, cleanliness and convenience, and successful expansion, all emanate from people.

Some might argue the surge in off-premise dining, or the growth in takeout and drive-thru accelerated by the pandemic, has changed the people equation. I don't think so.

For instance, has the definition of quality changed so much that the quality of food being trucked great distances by third-party delivery drivers no longer matters? Not really. Cold food is still cold food. A delayed food delivery is no different than a long wait for your food at a table.

Is the definition of service or convenience any different now that you can order food from a kiosk or off a mobile app, or talk to someone from Thailand when you're in the drive-thru lane? God forbid trying to get someone's attention at an inside QSR counter these days, now that they're filled with kiosks. How is that hospitable? Has the concept of cleanliness changed so much that QSR restaurants can permanently close their dining rooms, and even paper up their windows, as some have done, so you can't see what's going on inside?

The restaurant business has always been counterintuitive to a beancounter's propensity to only look at the expense half of the P&L. I should know—I was a master beancounter. To generate higher sales you need better quality, more service, cleaner restaurants, and a seamless experience: One that a customer believes they got their money's worth. Labor hours are a service target, not a margin target. Labor is an investment in higher sales. Restaurants that are continuingly cutting labor eventually will get the sales down to a level they can handle. Usually that number is zero.

My wish is for all restaurant operators to renew their focus to the top line in 2023. Think about building sales first and cutting labor second. You might be surprised. Margins may actually improve.

Back in my beancounting days, I came to my boss one day with a list of cost-cutting ideas. I thought they were excellent. He took one look at them and said, "John, don't forget, sales make everything happen."

—John Hamburger

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