



IS THE SUN SETTING FOR SMALL FRANCHISEES?

By **Kevin Burke** | Managing Director, Trinity Capital

The restaurant industry has staged a remarkable comeback from the start of the COVID-19 lockdowns that forced many companies to lay off workers and shut their doors. Fortunately, according to the National Restaurant Association, it's estimated that sales in 2022 will exceed 2019—the year before the pandemic. Franchisees have been at the forefront of this turnaround as customers, often flush with stimulus money and wanting to return to some normalcy, started dining out again. But as COVID-19 moves from pandemic to endemic, restaurants are now facing an array of headwinds including inflation, labor shortages and disruption from third-party delivery companies.

Industry consolidation was already underway before the pandemic, in response to an operating environment that favored greater scale and investment. The pandemic accelerated the trend evidenced by a notable rise in the number of multi-unit franchise operators and the number of units operated by them. Franchisees with one or just a handful of franchise restaurants face the decision of whether to aggressively invest and grow their businesses to compete in today's market at scale and become acquirers themselves, or to exit the industry. With private equity steadily increasing its funding of the industry, along with still strong demand from strategic buyers, many franchise owners might find the current environment an ideal time to sell or generate some liquidity, if they are not well positioned to grow.

Headwinds Are Picking Up

Overall, the industry has learned to live with the pandemic admirably well. At many restaurants, outdoor dining and takeout bridged the gap until vaccines and boosters spurred a return to indoor dining. Although the benefits of takeout varied by restaurant since some foods travel better than others — pizza vs. seafood for example. From 2019 to 2020, industry sales fell 27% from \$937 billion to \$681 billion, but are expected to climb to \$950 billion in 2022. During this snap back, restaurants embraced various technologies to reach customers better and improve efficiency, including apps for online ordering and reservations and voice recognition in drive-thrus.

But new storm clouds are gathering. The government injected over \$10 trillion into the economy to keep it buoyant, and many consumers spent that money

at restaurants. It is well-established that eating out is one of the first “optional” activities that people will spend their money on after covering essential expenses. So, as the stimulus money runs out, restaurant franchise owners could see a noticeable decline in traffic.

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Wages and Inflation on the Rise

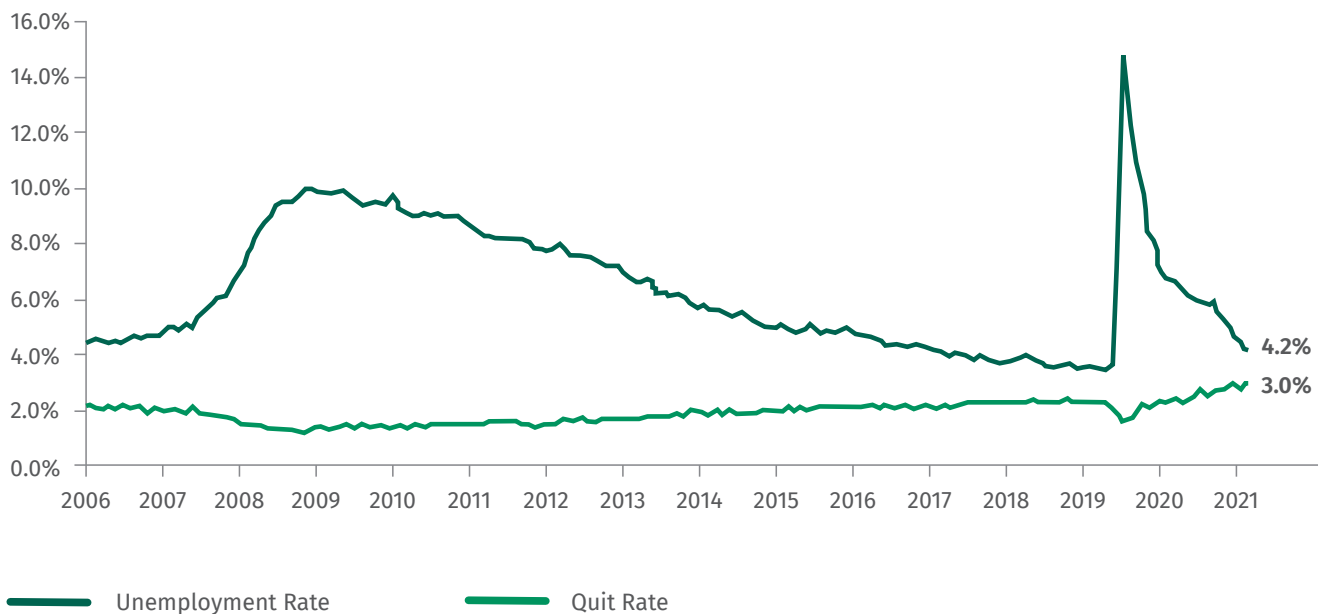
Meanwhile, costs are going up, driven by two powerful forces: wages and inflation. Both of these are rising more rapidly than they have in decades. First, consider the labor market. After the unemployment rate hit about 15% in 2020, it quickly recovered to pre-pandemic levels, according to Nation's Restaurant News. At first this seemed to paint a rosy picture for the industry.

But then something unexpected happened. People did not return to work in the numbers predicted, and the quit rate among American workers began to rise. As the second largest employer in the U.S., the so-called "Great Resignation" has hit the restaurant industry particularly hard. The wealth effect from the government stimulus and other assistance has

emboldened employees to quit, and higher wages from employers such as Amazon and Walmart have enticed them. Both Amazon and Walmart raised their minimum wages 17% in late 2021, according to the Brookings Institution. With a quit rate of more than 6%—more than double the overall average—the industry has struggled to replace its pre-pandemic workforce.

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Unemployment Rate and Quit Rate Trends



Source: St. Louis Federal Reserve

Many restaurant chains have had to cut back operating hours while also raising wages — especially as states across the country raise minimum wages — often in the high single digits. The bottom line is that restaurant wages are now historically high.

As if labor pressure wasn't enough to contend with, inflation is at its highest level in 40 years, accelerating to an annual rate of 7.9% in February of 2022, according to The Wall Street Journal. The roots of the surge are still debated, but supply chain disruptions caused by the pandemic are a principal factor, as well the stimulus itself by pumping so much money into the system.

While early in 2021 some pundits argued that inflationary pressure would be brief as the economy returned to normal, those voices have faded as inflation spreads across the economy. Meanwhile, the threat of global conflicts is a reminder that disruptive, inflationary events lurk around every corner.

Regardless of the cause, virtually all restaurant owners have seen an increase in operating costs due to the dramatic increase across the board in commodity prices. For example, in 2021 corn increased 63%, chicken wings 57% and pork 79%.

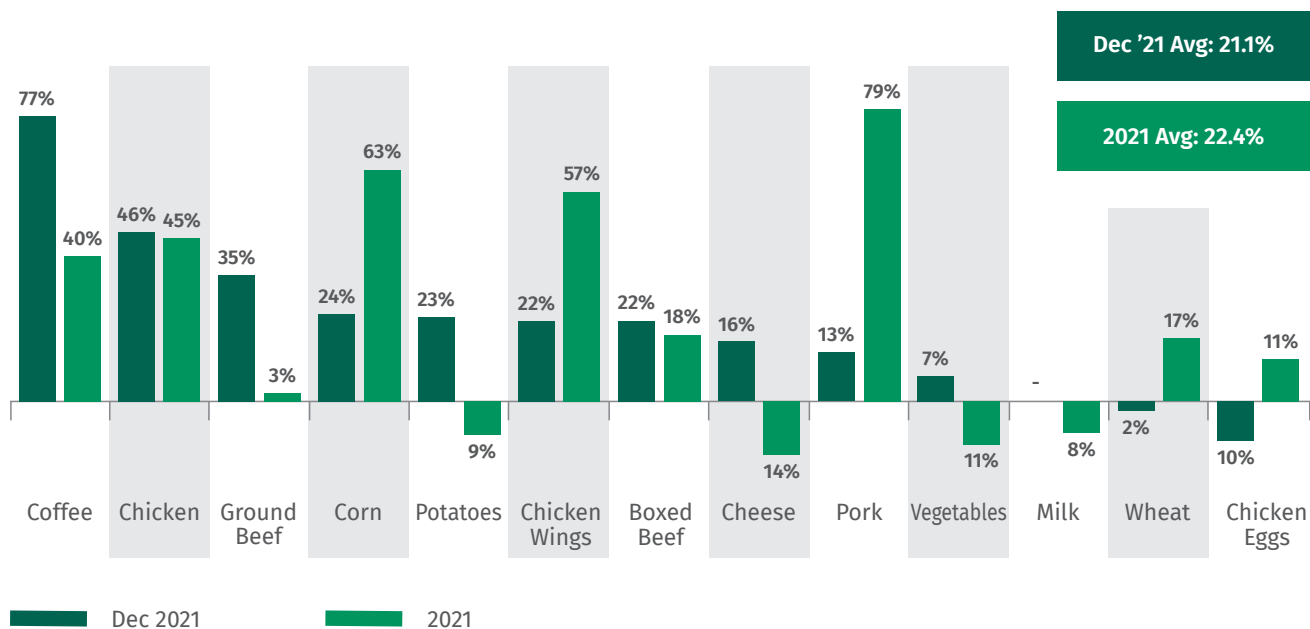
Average Hourly Restaurant Wages (% change YoY)



Source: Restaurant Research

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Select Commodity Costs (% change YoY)



Source: Chicago Board of Trade and S&P Capital IQ

New Technologies and Changing Behavior

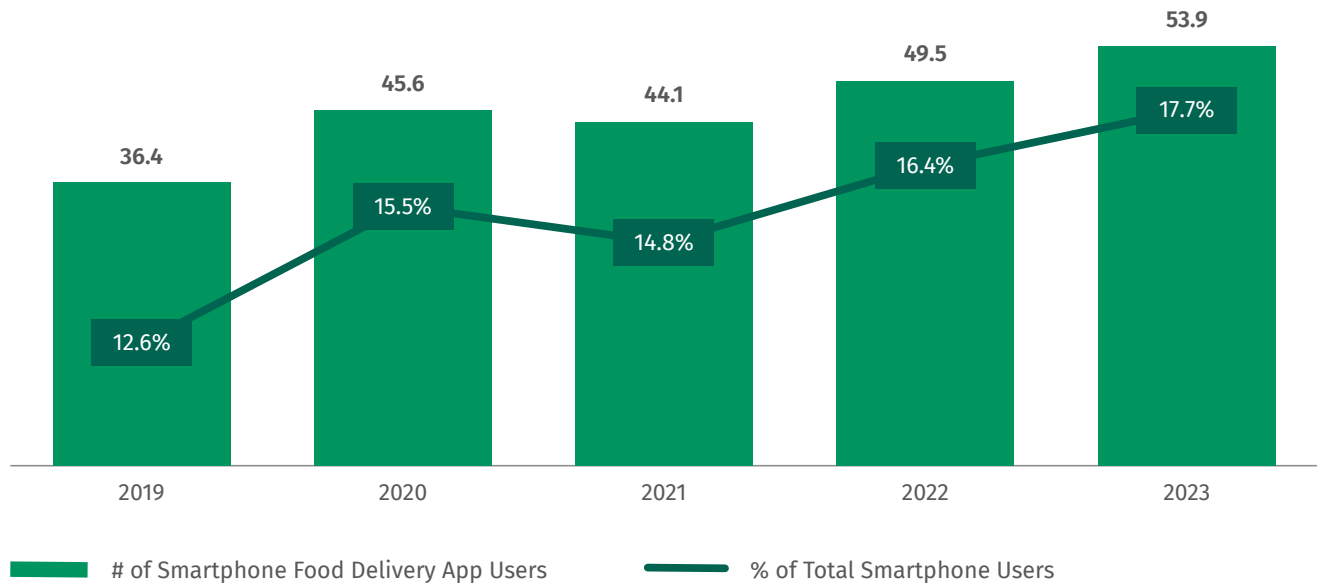
Meanwhile, new technologies are both a blessing and a curse. As noted, technology and automation are coming to the restaurant industry in many forms including software for better accounting and reporting, artificial intelligence to optimize worker efficiencies, voice recognition in drive-thrus, automated ordering, and reservation apps. All these technologies, including the use of social media, promise to bring more efficiencies, reduce costs and appeal to customers once they are properly integrated.

For example, according to data from FastCasual.com, 43% of customers prefer using a mobile app when placing orders, 17% prefer either their cell phone or kiosk, while only 18% prefer speaking with a staff member. Data from other research providers show

similar results. Meanwhile, about half of consumers indicate social media impacts whether they choose to download a restaurant's app.

These preferences point to some fundamental shifts in how customers want to interact with restaurants. Third-party food delivery companies such as Doordash, Grubhub and UberEats have propelled the number of smartphone food delivery app users from 36.4 million in 2019 to an estimated 49.5 million in 2022, according to Statista. And therein is the downside of these technology trends. Increasingly, they aren't really optional—nor are they cheap. According to data from McKinsey and the National Restaurant Association, participating on these third-party platforms can reduce gross margins by 40% or more. As inflation continues, pressure on the third-party delivery business model will exacerbate.

U.S. Smartphone Food Delivery App Users (in millions)



Sources: eMarketer, Statista

As third-party delivery grows, franchisees will face a range of operational challenges, from needing to invest and install technology, to training staff, managing labor inside and outside the restaurant, and ensuring food quality during the delivery process. For example, seafood doesn't travel well, nor do hamburgers and fries. There's also the risk that in competing with third-party delivery, companies will cannibalize their more profitable takeout and dine-in sales.

So, one consideration for franchisees as they mull the choice of whether to grow the business or sell, is how willing and able are they to commit to these technology trends.

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Next Steps for Franchisees

We expect to see Darwinism creep into the franchise restaurant market, with the large category killers maintaining their momentum while smaller franchisees struggle. That's because many franchisees with one or just a handful of restaurants are basically living off stimulus money and the recent sales recovery. As that stimulus winds down and people stop going out as much, profitability will wane for these smaller operators.

Meanwhile, the advantages of size and scale are only going to increase. Larger companies are often better at product innovation, have bigger ad budgets and can hire seasoned operations executives. They can assemble a board of executives with industry expertise to counsel management, invest in the latest technologies, and do a better job of managing supply chains.

As a result of these size advantages, many franchisees may consider whether to grow or sell. One important avenue of growth is through private equity or family office investments. According to PitchBook, PE firms were increasingly active in the franchise space before the pandemic, recognizing the terrific upside potential in what was historically a fairly sleepy corner of the market. Indeed, the intense competition among PE firms has pushed valuations higher and it's been something of a seller's market.

As a rule, PE shops and large family offices are looking to invest in multi-unit franchisees with at least 20 units and then help owners grow the business as quickly as possible to 100 or more. That's when the scale benefits really begin to kick in. Franchisees with fewer units will have a harder time tapping PE capital for growth. PE firms will mostly consider these companies solely as acquisition targets to help grow other portfolio companies.

Smaller firms that want to grow and not sell will generally need to bootstrap their own growth. Given the competitive pressures and operational challenges, the future holds a pretty stark choice for most franchise owners: get big or get out.

Key takeaways

- Higher wages and inflationary pressure will undermine margins while new technologies and competition with third-party delivery will create operational complexity.
- These challenges will make gaining scale more important than ever to remain viable.
- Franchisees with 20 to 40 restaurants may be able to attract private equity investment to grow the business to 100 or more units.
- Franchisees with less than 20 units should consider bootstrapping their own growth to reach the 20-unit threshold or consider selling.
- Private equity's increasing participation in the industry has driven up valuations making it something of a seller's market.



Kevin Burke is the Managing Director of Trinity Capital, a Division of Citizens Capital Markets. Kevin is a member of the consumer team with expertise in restaurants, food and beverage, and multi-unit retail, including franchises.



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