



Returning to Profitability: Successful Restaurant Restructurings in a Sluggish Economy

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Despite the current economic climate and the fact that most Americans have less discretionary income to spend on eating out, recent news in the restaurant industry has generally been good. Fast food giant McDonald's recently reported Q3 2010 same-store sales grew 2.9 percent for its US locations.¹ Quick service concepts such as Panera Bread also continue to show strength with a 3.3 percent sales increase and year-over-year earnings up 35 percent.² Even much-maligned high-end concepts seem to have turned a corner during 2010, for example Ruth's Chris Steakhouse reported an 8 percent increase in year-over-year sales and a return to profitability for the year.³

Good news for the industry has also come in the form of moderate food costs and a continued weak job market. At certain points during 2007 and 2008, franchises needed to roll out new menus twice a year to keep up with rising food costs. Now, food pricing has moderated along with a general decline in economic activity. Additionally, the unemployment rate remains high at 8.8 percent,⁴ resulting in moderate labor costs compared to recent years.

However, it should be noted that these results are being compared against prior earnings periods that were not exactly stellar. Many companies accumulated huge losses during the past three years, it will take time for the industry to regain solid financial footing, and a great number of companies are still finding themselves in financially distressed situations.

While food and labor expenditures comprise a substantial portion of the cost structure of restaurants, the remaining structural costs related to facilities and ongoing capital requirements represent significant hurdles when attempting to assist restaurant franchises that find themselves in financial distress.

Two notable issues have factored as prominent catalysts for recent financial distress engagements:

- consequences of brisk expansion during the years from 2004 to 2008; and
- impact of deferred capital expenditures on the volume of sales.

Consequences of Brisk Expansion

A recent client of MorrisAnderson is a franchisee of a national brand that operates more than 90 locations throughout the southeastern United States. The author was part of a team hired to help the client work through a restructuring process. As shown in Figure 1, the franchise's main issue was a multiyear expansion into Florida which had increased its footprint by 35 percent. Initially, those units performed well, as Florida went through a prolonged economic expansion. However, starting in 2007, sales began to trend down more than 10 percent each year.

(\$ in 000s)

	Total debt	Cash Flow Available for Debt Service	Debt to Cash Flow Ratio	Annual debt service	Cash Flow to Debt Service Ratio
Florida units (24)	\$28,000	\$500	56.0	\$3,500	0.1
Non-Florida units (68)	42,000	8,500	4.9	6,500	1.3
Total	\$70,000	\$9,000	7.8	\$10,000	0.9

Due to the softness in sales, most of the Florida units were not making money before debt service, even before taking into account general and administration (G&A) expenses. During the company's expansion into Florida, property development costs went from \$1 million per unit for land and building costs to more than \$2 million per unit. Adding to the overall financial distress, the franchise development strategy was partially based on market penetration to support local and national advertising, so units needed to be opened following a prescriptive development schedule.

In the simplest terms, the cost of a franchise facility must usually be less than 85-90 percent of the location's annual revenues. Normally, a restaurant should have rent (or fee-simple building debt payments) at 7 percent or less of its sales. If the property is valued at a normalized 8-9 percent capitalization rate, the facility, and subsequently the building value, should represent around 85-90 percent of sales. With sales stagnating at approximately \$630,000 per unit and building costs near \$2 million per unit, structurally the economics of the situation could not work.

Fortunately the owners got the help they needed early on and the entire organization was successfully restructured through a combination of:

- Spinning off 14 units to one of the partners
- Re-amortizing short term leasehold improvement
- Remodeling notes from less than 3-5 years
- Closing 15 locations
- Conveying real properties to the senior lenders based on liquidation value of the real property; and
- Refinancing a \$15 million portion of the debt with a new lender

The main key to this successful restructuring was a strong base of established units, a good management team that was proactive in seeking early intervention and committed to the positive changes, and some creative solutions plus a little luck in finding a local bank willing to lend into a potentially tenuous situation. Many other companies in similar situations often face steep financial losses and more limited choices in bankruptcy because they did not seek good financial advice when the problems first became apparent.

1 McDonald's Q1 2011 press release, April 21, 2011.
 2 Panera Bread Q1 2011 press release, April 26, 2011.
 3 Ruth's Chris Steakhouse press release, February 18, 2011.
 4 Bureau of Labor Statistics, March 2011 Seasonal Unemployment Rate.

Generally, any franchise concept with more than 30 percent new units or units that were acquired during the years from 2006 to 2009 is very likely to be in serious trouble due to the cost of their real property investments. These companies are at significant financial risk and need to work with a financial advisor that is well-versed in troubled business situations to consider possible restructuring to maximize the chances of a return to profitability along with the country's economy.

LACK OF CAPITAL EXPENDITURES: POPEYE'S FRANCHISEE CASE STUDY

Franchise operations in financial distress are all too often hurt by the lack of capital expenditures by financially troubled chains that negatively impact bottom line results, especially in a struggling economy. Once a troubled franchise operation has gotten behind on capital expenditures it is often difficult to make up lost ground.

An example of this effect is a Popeye's franchisee with 26 locations across Alabama and Louisiana. Cash distributions and investments in non-operating real property assets had undermined the financial stability of the company. By the a Chief Restructuring Officer (CRO) was brought in to lead the company through bankruptcy, the franchisee owed the IRS \$2.3 million in withholding taxes, \$1 million in state sales taxes, and \$600,000 in property taxes. In total, the franchisee had \$30 million in debt and outstanding taxes and was only generating \$25 million annually in revenues.

Capital expenditures for the franchisee were also well behind where they should have been, with about \$1.5 million (about \$50,000 per location) in required upgrades to systems, regular maintenance items and property fixes, like painting and parking lot improvements. Sales were lagging, with a downward 8 percent year over year trend.

During the first six months of the bankruptcy process, the franchisee was advised to invest \$500,000 in systems and maintenance capital expenditures. Equipment from closed locations was utilized to improve service levels at the remaining stores. Some of these expenditures were required by the franchisor as part of a workout agreement, but they were also important for their long-term benefit of improving operational efficiency and aesthetics of remaining locations.

The benefits of these changes included improved employee morale and spirits increased managers' motivation because the parent corporation was investing in their locations. Service delivery times dropped dramatically as long-neglected equipment was fixed and returned to working order. Drive-through service times dropped from close to 300 seconds (five minutes) down to 210 seconds (three-and-a-half minutes). Several of the franchisee's locations are now below the brand standard of 180 seconds (three minutes).

One of the metrics Popeye's uses to evaluate locations is the Metric Moving Scorecard (MMS), which contains measures of customer satisfaction, level of employee training, food safety, sales and profitability. Prior to the turnaround engagement, the Popeye's franchisee scored in the bottom 10 percent of all franchisees; during the most recent reporting period they averaged 3.9/4.0 seconds and were among the top performers in the Popeye's system.

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The most current sales metrics show that same store sales for the client are now up over 9 percent year over year. Not all of this growth can be attributed to the capital expenditures, but they are definitely an important part of the equation. In comparison, another Popeye's franchisee that was also behind in capital expenditures and maintenance is currently running at 2 percent year over year – seven percent less than the example franchisee is working with.

It will be interesting to see how the capital expenditures gap plays out in franchise earnings during the next three years or so. For instance, how will struggling chains like Wendy's, Arby's and Burger King keep up with the cash-generating machine of McDonald's? Those concepts that have not kept up with a normalized level of capital expenditures, repair and maintenance will be at a significant sales risk during the next several years. The major problem is the difficulty of escaping a downward spiral, with lack of funds for capital expenditures reinforcing descending sales results, played out against an already-difficult economic backdrop.

PUTTING IT ALL TOGETHER: OPERATIONS REMAIN THE KEY

One significant reason that some troubled franchises have realized successful financial outcomes is that they had strong operations personnel and a committed management team; what they were lacking was better financial leadership and a cohesive, strategic plan to remedy the causes of financial distress. Going far beyond "fixing" the balance sheet, a successful turnaround usually requires fundamental, comprehensive change.

For franchise companies where rapid expansion led to financial distress, evaluating locations, potentially consolidating operations and implementing a solid operating plan for the remaining locations are often called for. Given the complexity of rolling out these initiatives simultaneously, a medium-term workout plan is typically necessary to shepherd the company back to health.

For those companies where deficient capital expenditures may be impacting sales trends, a comprehensive evaluation of the repair and maintenance routines and a unit-by-unit review of capital expenditures are typically required.

The bottom line is that early identification of these and other similar problems, as well as a commitment to making significant changes, can lead to considerable financial improvements for franchise systems that find themselves in financial distress. And that's a win for everyone involved. ■

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David has a specialized expertise in assisting companies in the franchise industry, and has served as a consultant, interim manager and financial advisor for turnarounds and workouts, restructurings and helping financially-distressed and underperforming companies achieve successful outcomes. David is a Certified Turnaround Professional (CTP) and is active in the Turnaround Management Association, Chicago chapter where he is currently a co-chairman of the CTP Committee. He can be reached at dbagley@morrisanderson.com.