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THE NEWSLETTER OF THE BDO RESTAURANT PRACTICE

SELECTIONS

IPO OR NO?

Top Considerations for Restaurants Thinking of Going Public

By Gary Shamis and Dustin Minton

Last year saw a marked increase in restaurants exploring going public, with around half a dozen concepts taking the plunge with an IPO. Consumers have more dollars to spend with help from a strong dollar and low oil prices, and more diners are eager to spend those extra dollars on healthy, innovative foods when eating out. The current IPO landscape is attractive for restaurants in those niches, especially for concepts that can build grassroots buzz and differentiate themselves in a loaded market. Furthermore, the critical mass required to go public has dropped significantly in recent years, paving the way for smaller companies to pursue IPOs.

Exploring an IPO can be an exciting venture, but knowing whether the time is right can be difficult and riddled with a variety of complex considerations.

Heightened Regulatory and Internal Control Requirements up the Ante

Public companies are subject to more bureaucratic business environments than privately held companies, and therefore must implement a more sophisticated corporate structure to allow for proper governance. Necessary compliance measures such as establishing audit committees and structuring an independent Board can be costly and time-consuming, while also adding a layer of oversight that executive teams may not have anticipated ahead of the IPO.

Restaurant CEOs and CFOs are no strangers to risk, but going public brings up a new crop of business considerations and risks that are unique and personal for these individuals.

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CONTENTS

Read more

CONTINUED FROM PAGE 1

IPO OR NO?

Specifically, the Sarbanes-Oxley Act, or SOX, requires that senior management assume personal responsibility for the accuracy of reported financial statements, including quarterly and annual reports to the SEC. Another key provision of SOX requires management to establish extensive internal controls, as well as reporting methods on their adequacy.

For growth chains focused on finding an influx in funding to sustain needed changes and expansions, it's important not to forget the elevated regulatory requirements associated with an IPO, or underestimate their ramifications on business functions.

New Stakeholders Intensify Earnings Pressure and Financial Scrutiny

When going public, restaurants open themselves up to scrutiny from a variety of stakeholders that might not have impacted them previously, including investors, analysts, regulatory bodies, the public and the media.

One driving force behind the recent uptick in restaurant IPOs is a trend toward major spikes in valuation. Many restaurants choosing to pursue an IPO have extensive growth plans that benefit from the influx in capital that comes with an IPO offering.

But high valuations result in a pressure to maintain earnings per share and trade at a high level, placing public restaurants under a microscope. Quarterly reporting to the SEC can also add a level of required financial oversight that many smaller companies might not have practiced prior to considering an IPO.

Broad Market Conditions Shape the Funding Landscape

The influx of private equity funding since the 2008 recession has stimulated the IPO market for restaurants as those investments mature. Private equity investments are made with the ultimate goal of turning the investment into a liquidity event within approximately five to seven years, either by selling to another company or by taking the concept public. This timeline has held true as many concepts that received post-recession private investments have evolved into potential IPOs today.

Restaurants looking for funding can also consider holding onto their concept, or pursuing further investment from private equity. Some well-established legacy concepts benefit from choosing to remain private, though in the current business landscape, the trend favors public offerings among emerging brands.

Gut Check: How do Internal Factors Affect your Growth Potential?

Restaurants should weigh timing and their concept's overall outlook by considering various factors that might impact growth potential, including location, branding, competition and potential for market differentiation.

From a logistical perspective, concentration in a particular region plays a role in a concept's growth potential. For example, Bojangles', which recently went public, is located primarily in a few Southeastern states and has amassed a loyal following there. Stepping up to the national IPO stage could open up the possibility of expansion nationwide.

Restaurants thinking about an IPO should also consider whether the concept will be able to differentiate itself in the market. For instance, Chipotle Mexican Grill pioneered meal customization in the fast casual segment, but the company's investment in cause marketing differentiates them further as personalization becomes more commonplace.

Looking Ahead

As private equity investment in specialty and niche restaurant concepts builds momentum, the end goal of a liquidity event will remain consistent and could continue to stimulate unprecedented numbers of restaurant IPO offerings. We expect that as innovative concepts emerge within the marketplace, IPO activity will continue its upward trajectory, providing fruitful opportunities for restaurateurs and investors alike.

This article originally appeared on FastCasual.com: http://www.fastcasual.com/articles/ipo-or-no-top-considerations-for-restaurants-thinking-of-going-public/

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TAX CONSIDERATIONS RELATED TO TIPS VS. SERVICE CHARGES

By Phil Hofmann

The recent IRS rules that redefined tips and service charges are still generating a great deal of questions from restaurants. Understanding how to implement these new rules when it comes to catering and delivery can be challenging.

As we've discussed in a prior blog post, the ruling helps determine the classification differences between tips and service charges. Becoming familiar with the IRS definitions of both tips and service charges are important as these classifications impact whether or not a restaurant is subject to withholding and reporting requirements.

As you may recall, the IRS cites the following four conditions that must exist in order for a payment to be considered a tip:

1. The payment must be made voluntarily, free from compulsion
2. The customer must be free to determine the amount of the payment
3. The payment is not negotiable, nor can the employer dictate the amount
4. The customer should generally have the right to decide who receives the payment

Prearranged service charges such as large party automatic gratuities, banquet event fees, or bottle service charges are not considered by the IRS to be tips.

What is the proper classification of gratuities on catering contracts?

The answer depends on the facts and circumstances of each arrangement. For example, if a prearranged fixed amount tip on a banquet contract is dictated by the restaurant and is not voluntary, it would not be considered a tip. If, however, the contract language allowed the customer to meet the four conditions mentioned above, it is possible to have a tip classification for a banquet or catering event. If no tip is required, but sample computations are provided for the convenience of the customer, the IRS may consider it to be a tip, since the situation is similar to an example outlined in an IRS publication.

What are the considerations around tip versus service charge classifications for delivery?

Some restaurants don't charge a delivery fee, but rather leave it up to the customer to tip the driver or person that delivers the food. A required delivery fee will not meet the four conditions above and will be treated as a service charge rather than a tip. However, when the customer voluntarily gives the delivery person a payment, this may be classified as a tip. Many customers pay for delivered food by charge card and often add a tip to the bill. Generally, this means the employer can take advantage of the FICA tip credit, which has the potential to add up quickly. Fast food restaurants, in particular, may not have previously considered this credit. It may be worthwhile for you to review your delivery policies to ensure you are realizing potential tax savings.

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BLOG

Introducing the Re-Launched **BDO Selections Blog** and the New **@BDORestaurant** Twitter Feed

The BDO Restaurant practice is thrilled to launch our fully refreshed "concept": the new and improved **BDO Selections blog**. At its new home, the blog serves up a fresh perspective on business challenges and opportunities for restaurant industry professionals across segments. Posts come straight from leading professionals with extensive tax, audit and assurance experience and deep industry knowledge.

Drawing on experience serving clients throughout the industry, including franchisors, public companies and independents across segments, posts cover key issues affecting the industry, ranging from regulatory changes to trends in the fast casual segment. They will also provide timely commentary and insights on pertinent issues and developments that shape the restaurant industry's evolving business landscape.

And to keep up with our industry leaders in real time, check out the brand-new **@BDORestaurant** Twitter feed. The feed curates relevant and timely restaurant industry news and trends, and shares a first look at new **BDO Selections blog** posts and other thoughts from the practice.

We hope you'll join us and keep up with our team's business, tax and industry insights on the BDO Selections blog at https://www.bdo.com/blogs/restaurants, and we encourage you to follow and engage with us on Twitter at @BDORestaurant.

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IMPROVING FINANCIAL PRACTICES FOR LONG-TERM SUSTAINABILITY

By Alexis Becker

A well-managed restaurant doesn't always guarantee a sound business strategy, but approaching restaurant management with a focus on facts, figures and the future can help in achieving long-term success.

When it comes to running your business, financial modeling and long-term planning often get lost in the shuffle of day-to-day troubleshooting and management responsibilities. But for those looking to improve their financial practices and better communicate the restaurant's potential success and value to lenders and investors, understanding the numbers and using them to effectively plan for long-term sustainability should be a top priority.

For background, financial models are used to quantify a restaurant's business plan to a given audience, such as new and existing lenders or investors. Its goal is to substantiate the potential value of a restaurant concept, along with the risk threshold for each audience, and can ultimately help determine whether a business is scalable. It's important to note that developing the right financial model is not a one-size-fits-all approach, and although restaurants may have similar store-level operations, long–term goals can vary greatly.

While financial modeling can sometimes take on a life of its own, sticking to basic concepts and utilizing available software can simplify the process of developing a useful forecast. Keep in mind these three tips when developing your financial models:

1. Determine the key value drivers of your business

Key value drivers are the concrete components that have the largest impact on a business's value, and may vary based on where a business is in its lifecycle. Examples include the specific sales and operating efficiencies of existing restaurants, new restaurant openings and G&A leverage. Once you have established the core drivers of your business, devote 80 percent of your focus on them. Directing your focus on the operating efficiencies that have proven successful in existing stores can also be helpful in making decisions about processes in newer restaurants, and can serve as proof points in communicating the potential value of growth initiatives.

2. Utilize the KISS method – keep it simple

Instead of looking in detail at hundreds of line items, categorize them into high-level buckets that encompass multiple costs within a single category, such as cost of goods sold, labor costs and total occupancy. For instance, sales should be included in a single line item, as opposed to being broken down by food sales, beverage sales and retail sales. Using umbrella categories to think about costs helps prevent against being bogged down by the minutia, and allows you to identify and home in on key areas that require attention. Broadly bucketing sets of values can also help planners understand and forecast, at a high level, the potential outcomes that can result under various circumstances.

3. Familiarize yourself with the software

Take the time to learn about and use your software's linking and formula features – it will make the entire process easier. Understanding the software's capabilities from the outset allows for more flexibility in financial models. For instance, automating and linking formulas from the general ledger system to an Excel data model simplifies the process of analyzing data changes and their potential implications as compared to manually updating key data on a routine basis. Spending time upfront to understand the technology will save time and guard against potential for error in the long run.

When it all boils down, your financial model should answer the question, "Will I make money?" Regardless of the outcome, having the knowledge to answer the question is half the battle.

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A SLICE OF THE FAST CASUAL PIZZA REVOLUTION

By Kari Maue

Fast casual pizza restaurants are emerging as a new hot concept and they're making their way into the marketplace – almost as quickly as they can cook the pizzas.

The fast casual pizza concept models offer a Chipotle-like concept by giving patrons personal size crusts, allowing them to pick their sauce and fresh toppings, and cooking the pizza within a matter of minutes, all at an affordable price. The competition in this market is primarily composed of many smaller regional concepts, but they are growing fast. Some concepts, such as Blaze Pizza, have reached over 50 locations, while others, such as Pieology and Mod Pizza, are expected to reach over 100 locations by the end of 2015. Many concepts are led by veterans to the restaurant industry, while others have investors and creators that have already proven successful with other endeavors.

It is no surprise that there is a desire for individuals to open their pockets and invest in or franchise these concepts. The pizza segment has historically enjoyed the lowest prime costs of all restaurant segments with an average of 54.1% for the fiscal year end 2014, according to BDO's Q1 2015 Benchmarking Update. Pizza is closely followed by the fast casual segment, which averaged prime costs of 57.7%. The overlap of these two segments with the emergence of the fast casual pizza trend has been developing quickly over the past few years, and the fast casual pizza players' aggressive growth strategies leave us wondering how the so-called "pizza revolution" could impact other restaurant segments.

As you can see in the BDO benchmarking update, it is clear that the pizza segment as a whole has not yet been affected by fast casual pizza concepts, as it has shown consistent and continued growth quarter after quarter. This is due, in part, to the pizza industry's fierce competition forcing the market to drive down prices by discounting and offering the popular $5 and $10 pizza deals, which makes it an affordable dining option. The traditional pizza industry also offers delivery as well as the ability to order more pizza at a lower cost per person.

The bigger threat may be to the fast casual segment. The capital market has proven its ability to handle growth in this segment over the last few years with the recent uptick in restaurant IPOs, such as Zoe's Kitchen and Habit Burger. Certain concepts have been hurt by the increasing competition, while others continue to show growth. For example, Chipotle continues to thrive with their burrito concept while they also explore the popular fast casual pizza trend by launching their own concept, Pizzeria Locale. With all of its success, will other segments begin to transform into the fast casual atmosphere?

As fast casual and pizza restaurants continue to show aggressive growth, there is one thing that remains true. In order to compete in today's market, there are two key ingredients: fresh and fast.

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TAX OPPORTUNITIES ON TAP FOR BREWERIES AND BREWPUBS

By Dirk Ahlbeck

Craft brewers have evolved from specialty producers into major players in the food and beverage industry, producing 22.2 million barrels of beer in 2014.

Growth in the craft brewery market has far eclipsed growth in the total beer market, increasing 18% in volume and 22% in retail dollar value last year, compared to a 0.5% increase the total beer market, according to reports from the Brewers Association. These increases are markers of an overall seismic shift in beer appreciation in the U.S. toward a culture that favors innovation and personal local connections.

To effectively respond to shifts in consumer behavior within the industry, it's important for brewers and brewpubs to be familiar with the unique tax landscape in which they operate in order to maximize profitability and minimize tax liabilities.

Here are a few of the tax opportunities offered by federal, state and local governments that can be advantageous to brewers and brewpubs:

Depreciation and Cost Segregation

Depreciation and cost segregation are reporting considerations that come into play when expensing assets and property "on the books," as well as on tax returns. For a brewery or brewpub, depreciation involves expensing the initial investment in capital equipment and build out into three categories: 5-year property, 15-year property, and 39-year property. Bonus depreciation and Section 179 are important opportunities to consider because they allow businesses to accelerate

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CONTINUED FROM PAGE 5

TAX OPPORTUNITIES ON TAP

depreciation by writing off expenses more quickly. Advantages to using one over another or a combination of both varies based on a variety of factors.

Another important opportunity for cost segregation is to conduct a professional engineering study, which is required by the IRS in order to realize the maximum depreciation benefits of a new or existing property. The study examines fixed assets, and can potentially help to translate 39- and 15-year property to 5-year property, which would allow the business to recover the costs of the property over five years, rather than 15 or 39.

FICA Tip Credit

The FICA tip credit is a credit against federal taxes, including social security and Medicare. This credit applies primarily to brewpubs, whose employees typically earn tips, as opposed to breweries. Businesses should note that the tax credit only applies to tips in excess of $5.15 per hour, as tips used to raise the employees wage to $5.15 an hour are considered to be satisfying minimum wage requirements, and thus are not eligible for the credit. The administration's proposed fiscal year budget eliminates this tax credit, and restaurants and brewpubs could face challenges if this credit is removed.

Research and Development Credit

Initiated to incentivize technological advances and stimulate hiring of R&D workers, the Research and Development credit is especially relevant for breweries and brewpubs that, unlike restaurants, develop and manufacture a product. Breweries and brewpubs are best suited to take advantage of this deduction early in the life cycle of their businesses, as it is an incremental credit. Businesses should be sure to document all research in order to satisfy a four-part eligibility test. The tax credit applies to qualifying expenses such as wages, supplies and contractual services connected to product research and development.

Domestic Production Activities Deduction

The Domestic Production Activities Deduction applies to manufacturers, and is unique to brewers, who are manufacturers by nature. To qualify, a business must pay W-2 wages and must be profitable. The deduction amounts to approximately nine percent of sales related to production, meaning that brewpubs must separate sales of beer and related merchandise from food sales.

Structure and Capitalization

A brewery or brewpub's lease can provide tax opportunity in the form of tenant improvement allowances or free rent, usually provided as incentive to lease property. Businesses can also take steps to form a holding structure to enable expensing of the opening costs of new locations. In addition, larger breweries and brewpubs should be aware that Section 263A uniform capitalization is a tax consideration that, as manufacturers, breweries must address when considering purchases and assets.

Breweries and brewpubs face many similar considerations, but it is important to note that brewpubs should maintain separate financial models, reporting and benchmarking for the food service and brewing portions of their businesses.

Is your business familiar with the unique tax break opportunities in the brewery and brewpub industries?

For more information, please contact Dirk at dahlbeck@bdo.com.

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RESTAURANT CFO BOOTCAMP®

EVENT RECAP

By Jeff Tubaugh

What happens in Vegas doesn't have to stay in Vegas!

In June, our team hosted the **BDO Restaurant CFO Bootcamp** in Las Vegas, and spent three days delving into key issues and industry trends for finance accounting professionals in the restaurant industry. What were some of the hot topics discussed?

Responding to shifting labor practices and issues

As unemployment rates decline and external pressures shift workforce dynamics, minimum wage requirements are increasing across the country, most recently with Los Angeles approving an ordinance that would raise the minimum wage to $15 per hour by 2020. Paid sick leave regulations are also beginning to pop up in various localities. With labor being one of the biggest line items on restaurants' budgets, it's important that the industry begins preparing for the impacts of these shifts in labor and employment practices.

Keeping up with the evolution of restaurant technology

Between increased demand for mobile ordering and payment capabilities, and new regulations requiring secure EMV "chip" card processors, restaurants are investing more in technology now than ever before. Restaurants are under pressure to bolster their mobile capabilities to meet customers' growing expectations for convenient and secure ordering and payment systems. Meanwhile, the fast-approaching October 1 deadline for EMV-compliance means that restaurants must have payment systems and terminals in place that are capable of reading and processing EMV card transactions in order to avoid potential liability for credit card fraud. In this highly competitive, evolving industry, restaurants that are not focusing adequate energy and dollars on strengthening and securing their technology systems may find their doors closed.

Strengthening internal controls and mitigating fraud risks

Most companies have a protocol in place for internal controls and fraud prevention, but restaurants should take the time to regularly refresh and update these policies to ensure they're enforced. It's important to take a realistic look at fraud risks: at some point in the life cycle of a restaurant's business, most are at risk for experiencing fraud. If an employee or a third party has motive and is able to rationalize the act, he or she may seize an opportunity to skim funds or commit fraud. While no method is foolproof, the best way to deter fraud is to invest in and properly train employees and maintain a thorough set of internal controls.

Recognizing opportunities to minimize tax burden

While some might cringe at the thought of yet more regulation, certain recently issued repairs and maintenance regulations are considered taxpayer-friendly. Specifically, the new rules help restaurants determine whether certain expenditures should be capitalized and depreciated or immediately expensed. Given that restaurants are typically asset-heavy and require regular repairs and maintenance, the new regulations may offer opportunities for restaurants to alleviate some of their tax liability around those activities. Additionally, strategically structuring entities can help restaurants lessen tax obligations and is especially important to keep in mind when opening multiple locations. When approaching tax structure and opportunities, restaurants should take the time to understand their unique positions so they can minimize tax burden.

Join us for BDO's next Restaurant CFO Bootcamp, September 30 to October 2 in Chicago. For details and to register, go to www.bdo.com/events/restaurant-cfo-bootcamp-chicago.

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BDO is one of very few CPA firms in the U.S. with a robust and dedicated Restaurant Practice. Our professionals serve hundreds of clients across the country, including franchisors, franchisees, public companies, and independents. We also serve all segments – quick service, fast casual, casual dining, pizza, and fine dining. From menu engineering to capital structure, our professionals draw on extensive knowledge of best practices in order to help our clients drive profitability and growth. In addition to a full array of tax and assurance services, we also provide a wide range of advisory services, including internal control reviews, benchmarking studies, and repairs and maintenance studies.

Additionally, BDO organizes roundtables, webinars, and conferences for finance and accounting professionals in the restaurant industry. Our Restaurant CFO Bootcamp® is regularly attended by top restaurant executives including CEOs, CFOs, and controllers, bringing together a variety of speakers and thought leaders to discuss financial management issues unique to the industry. Please visit www.bdo.com for upcoming events and webinars.

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