INSIGHTS FROM THE BDO RESTAURANT PRACTICE

PREP BEFORE THE RUSH: RESTAURANT M&A HEATS UP

By Ross Vozar and Adam Berebitsky

The French Revolution played a pivotal role in the invention of the modern restaurant. Shaking chefs out of the kitchens of the nobility—who were fleeing Paris for their lives—and into their own establishments, the Revolution gave birth to a Parisian phenomenon that became a global cultural institution. Today, sparked in part by the marriage of technology to nearly every aspect of our lives, the restaurant is undergoing a new kind of revolution, expected to give rise to more M&A.

But technology is just one piece of the changing landscape. More consumers are ordering delivery than ever before. A 2018 UBS report titled "Is the Kitchen Dead?" predicts the food delivery sales market will grow 20% per year until 2030, to $365 billion from $35 billion today. As this market grows, foot traffic shrinks, a major pain point for the industry.

Financial pressures abound. Labor costs as a percentage of sales rose steadily throughout 2018, a trend that is expected to continue through 2019—restaurant CEOs on 4Q18 earnings calls said they expect wages to rise about 5% this year. A $15 hourly minimum wage is now mandatory in many states, but some restaurants have already been paying employees above that to retain talent. The industry is also seeing competition from new entrants like grocery stores that are eating into long-held market share. And restaurant industry tax rates can be as high as 30%.

These factors have driven restaurants to try to retain, regain, and capture market share. But as restaurants strive to grow, the infrastructure that supports them needs to grow, too—from the back office through the supply chain. And as they traditionally operate on relatively thin margins, financing such initiatives has spurred a fair amount of M&A to unlock capital and uncover synergies.

In the United States, more than 70 restaurant chains exchanged hands in 2017 and 2018, according to Restaurant Business; in 2018 alone, there were 40 deals across the restaurant industry, according to Nation's Restaurant News. According to an S&P Global Intelligence report, last year marked a departure from precedent as private equity firms comprised a larger share of buyers.

For those seeking acquisitions, businesses that have a broad asset base like franchises, for example, or that are casual or fast casual restaurants (these segments' same-store sales are outperforming the rest of the industry, according to BDO's ***The Counter: Restaurant Industry Scorecard – 1Q 2019***) have been attractive candidates, as have businesses with restaurants in desirable locations or that have already invested in value-driving initiatives.

For example, restaurants that have adopted digital technologies, rolled out delivery services and advertising campaigns, and adapted their brick-and-mortar footprints to quick-service formats are high on the list of attractive candidates. Such investments have helped boost financial and operational results and can be a natural complement to the operations of either a traditional restaurant that may be struggling to turn itself around, or a private equity fund whose existing restaurant portfolio would benefit from their inclusion.

In last year's largest restaurant deal, Inspire Brands acquired Sonic Corp., the drive-in restaurant chain, for $2.3 billion. Inspire Brands, which is majority-owned by Roark Capital, cited Sonic's "significant focus on innovation, especially in guest-facing digital technologies" and "largely differentiated" brand as part of the rationale for the deal. Inspire Brands itself was formed by private equity-owned Arby's Restaurant Group after the latter closed on its $2.9 billion acquisition of Buffalo Wild Wings in February 2018—the fourth largest U.S. restaurant deal ever, according to S&P Global Market Intelligence data. Buffalo Wild Wings already owned Rusty Taco, the rebranded name of R Taco, which it acquired in 2014.

Having a well-established brand is also key for some players. Private equity fund High Bluff Capital last year acquired QSR Quizno's and, later, fast casual chain Taco Del Mar, in both cases citing the brands' well-established names as well as their tenured relationship with customers as part of their strategy.

With no expectation that pressures on the industry are set to release, there will be a healthy amount of M&A in 2019: strategic buyers will continue to need to scale up and partner with or acquire businesses that have complementary operations, and private equity's coffers are overflowing and seeking lucrative opportunities.

As restaurants evaluate their industry positioning, balance sheets, and the question of whether there's a strategic rationale for a deal, there are some important tasks to check off of their due diligence lists, both financially and operationally. This insight guides you through some critical considerations ahead of a deal.

FINANCIAL DUE DILIGENCE 101

M&A deals can be time-consuming and complex, especially if one of the parties hasn't vetted the many financial components that factor into such a transaction. For a deal to progress as smoothly as possible, both buyers and sellers must have a clear understanding of the financial operating results of the company being sold. Typically, this understanding is confirmed through the financial due diligence process, which takes into account both pre- and post-close financial considerations.

Understanding the Key Financial Metrics

- Pro forma store-level EBITDA
- Pro forma store openings & closings
- Pre-opening costs
- Temporarily closed stores
- Temporary agreements to reduce franchise fee for remodels
- Post-close lease costs – opco/propco
- Above store-level costs
- Capitalization policy
- GAAP vs cash rent

It is common for a seller to underestimate the usefulness of presenting a thorough picture of the historical operating results. Performing sell-side financial due diligence can bridge a great divide when it comes to valuation expectations, ultimately enabling a smoother and quicker deal process.

A seller should represent a recurring earnings stream that offers transparency into its financials—what, for example, may be affecting profit margins, such as store openings and closings, above store-level expenses, and GAAP versus cash rent. For a buyer, understanding what is driving the seller's earnings will lead to a more confident (read as higher) initial valuation that isn't discounted for the unknown.

Most growing restaurants are opening new locations and closing less profitable ones on a regular basis. A buyer will want to eliminate such noise from the financials to understand the fundamentals and determine whether the earnings stream is not only profitable, but sustainable. A prospective buyer should look at the seller's operations as if all of the stores were open: for example, if a store opens in June, a buyer will likely consider a pro forma adjustment to give credit to the seller for annualized earnings.

On the other side of the table, a seller should consider the impact of pre-opening costs and temporarily closed stores and get a credit from the buyer for the non-recurring nature of these expenses.

Another financial component to examine is the company's capitalization policy. In a tax-driven approach, a company is often motivated to expense amounts less than $5,000 in an effort to decrease taxable income, while the seller may have a policy to capitalize amounts greater than $2,500. This difference could result in a significant difference in earnings.

The Metrics behind the Move

In 2018, restaurant M&A multiples ranged from 8–12x EBITDA, according to Citizens Financial Group. In a high-valuation environment, a seller will want to have a clear idea of the growth and value drivers of the pro forma entity. The rationale behind a deal can range from portfolio diversification—a brick-and-mortar-based business acquiring a company that specializes in food delivery services, for example—to portfolio reinforcement (buying more of the same business), economies of scale, or a talented executive team.

When entertaining a franchise deal, for example, most buyers begin with four-wall EBITDA to calculate store-level operating profit. If a buyer owns 100 stores and wants to acquire 20 more, the buyer will likely compare the prospective 20 stores to the current 100 to determine the incremental value the buyer's operating model will provide, which is above and beyond what a seller can provide and expect to get paid for.

Lease costs can also be a value driver. If a seller is only three years into a contracted five- or ten-year below-market lease, a buyer may find this to be an attractive short-term cost savings. Conversely, if a seller's lease is ending, a buyer should weigh the potential impact of signing a new lease on the pro forma earnings stream.

A buyer should also consider how complementary the composition of a seller may be: Is there some kind of infrastructure already in place to absorb the new business? If a buyer is making a foray into the restaurant industry, it will also have to look at the kind of human infrastructure needed to support that purchase—the corporate office, for example: accounting, finance, and the leaders who continue to keep operations flowing through and beyond the transaction.

Don't Overlook Tax Liability

When evaluating a deal, it's common for both parties to be thinking about the big questions, like whether the various puzzle pieces of their businesses will fit together. An often overlooked, but essential, component to a restaurant deal is understanding potential state and local tax liabilities. These alone can determine a transaction's success. How a deal is structured, whether it's an equity- or asset-level transaction, and how the buyer will finance the purchase, may subject the buyer to different kinds of tax exposure, such as sales tax or payroll tax. As a buyer, not knowing the tax liability of the pro forma business can be detrimental to its ongoing operations.

Furthermore, in the post-tax reform era, how to structure a deal is becoming increasingly important on both the buy- and sell-side. On the buy-side, there are new depreciation rules to consider, and on the sell-side, the net gains from a sale may be affected by the change in the tax rate, which fell from 35% to 21%.

Tax liability is an especially timely consideration in light of the 2018 Supreme Court decision in ***South Dakota v. Wayfair***. The ruling, which overturned decades of precedent, allows states to require a business to collect and remit sales and use taxes, even if the business has no in-state physical presence. Though much of the media coverage and tax analysis in response to the ruling has focused on the effects on the retail industry, interstate restaurant transactions **may also succumb to taxation**. Among other requirements, restaurants will need to determine whether the volume of sales they complete across state lines will meet each state's **economic nexus threshold**.

Be Mindful of the Chaos Factor

Introducing a potential transaction into the day-to-day responsibilities of employees is usually accompanied by a certain chaos factor. These employees may be asked to support the transaction in various ways—by providing financial and operational documents, for example, and managing extra duties on top of their business-as-usual tasks. From beginning to end, closing a deal can take upwards of six months on the sell side. It is important for both a seller's expectations and the expectations of all employees to be mindful of the lengthy timeline. Preparing the deal team and communicating with them on an ongoing basis to help manage workflow and expectations will also be critical to a harmonious close.

Having an advisory team that understands the current market and how to guide a buyer or seller through the process is essential. The right team of investment bankers, lawyers, and accountants is key to help navigate options, scrutinize financials, and guide toward a satisfactory close.

OPERATIONAL DUE DILIGENCE 101

Sixty percent of transactions fail to achieve the goals they set out to, either because the gears of the integration process jammed or the post-acquisition strategy, if one was in place, petered out in the absence of guidance and reinforcement.

The roadmap to a smooth transaction starts with both parties having a thorough look under the figurative hood in the planning process. Proper operational due diligence truly sets the stage for success because it establishes and sets into motion the processes by which the pro forma company will operate—processes that have been streamlined and optimized for two discrete entities as they sync up to do business as one.

Identify the Risks and Drivers

Operational due diligence focuses primarily on three areas: value drivers, operational risks, and integration risks. In consolidation or scale-type transactions, a deal's value drivers often center around cost synergies—consolidating back office operations, integrating the supply chain, or upgrading IT systems, for example. Cost synergies not only provide the justification for the deal, but a roadmap for its execution. This is different from strategic growth-type transactions in which buyers are generally looking to extract value through revenue synergies like cross-selling or product integration. Operational due diligence is where these value drivers are uncovered and proved out.

On the flip side, there are risks to the value drivers. A due diligence team will assess a restaurant's exposure to vulnerabilities, such as whether a succession plan is in place for a small family-owned-and-operated shop, whether the menu is heavily dependent on a commodity that is forecast to experience significant volatility, or what the makeup of the competition might be if a restaurant is being introduced to a new location. On buy-side carve-outs—when acquiring corporate-owned restaurants from a franchisor, for example—a due diligence team will also analyze the stand-alone recurring costs or the costs of running the restaurants post-close. This will entail assessing the allocated costs, which represent the corporate or shared services provided by the parent to the restaurants, and can range from IT and human resources to finance and accounting services.

Integration risks are just as important to consider. Are there cultural differences between how the restaurants are run—for example, is one management's style command-and-control while the other's is based on consensus building? Culture and brand, especially, can be sensitive issues—a buyer should be wary of bulldozing a beloved brand or forcing its own culture on the acquired company's employees.

A good operational due diligence team will assess these types of risks and will keep them front of mind as they draw up and carry out an integration strategy.

Five Best Practices

Keeping the integration team's focus on risks and drivers of the deal is one of the five best practices for operational due diligence and can save a significant amount of time and money.

1 **Prioritize the value drivers.** The temptation to get sidetracked can be strong. For example, if a large restaurant group accustomed to acquiring smaller businesses has historically focused on consolidating back office operations, but the value driver for this deal is the ability to deploy a new technology, then the team should steer their focus to their top priority, which is the value driver.

2 **Start planning early.** Begin planning integration and value creation pre-close, as this creates the framework around which the entire deal will be structured. The timeframe for operational due diligence should begin early on, and follow-on work will continue beyond deal closure. A good operational due diligence team will define the integration or value creation strategy early on in the deal, determine how that strategy should be executed, and see that execution through to fruition.

3 **Articulate a vision.** Define what the operational model for the combined company will be. Will some aspects of the target's business be fully integrated or will some continue to stand alone? For example, will the sales and marketing teams be reporting to the same person or will they continue to function separately? Share the vision widely with the key leaders and integration team.

4 **Organize the implementation.** Having a plan is, of course, necessary, but adding structure around it will enable the team to execute. Identify milestones, goals, and metrics, and draw up a governance structure to make sure different workstreams are properly executed, coordinated, and headed toward the same end goal.

5 **Day one details.** It's not uncommon for companies to get so absorbed with closing the deal that operations post-close become an afterthought. There are countless considerations, like making sure the buyer has the bank accounts in hand, consolidating reporting within the first 30 days of deal close, and making sure human resources, finance, and accounting policies are aligned. If employee retention is a priority, it behooves you to communicate any aspects of their job that may be affected by the deal, including any managerial or compensation and benefits changes.

Being mindful of a deal's best practices throughout its life may determine its ultimate success. As the industry is expected to see a healthy amount of M&A activity in 2019, both financial and operational due diligence could ultimately be the differentiators between the restaurants that succeed and the restaurants that fail.

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