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TOP 6 TRENDS IN THE BOOMING RESTAURANT INDUSTRY

BY JOSH BENN

At this point, it is clear that 2014 was a banner year for the restaurant industry. Low interest rates, ample amounts of financing and abundant equity capital chasing returns have driven the strongest valuations for the industry in the past ten years. The industry continued to experience significant merger and acquisition activity in 2014, with both financial and strategic buyers showing strong appetites. In addition, 2014 represents the fifth consecutive year of real growth in restaurant sales, with aggregate industry sales, in inflation-adjusted terms, projected to increase 1.2% in 2014, according to the National Restaurant Association. The question becomes will this momentum carry into 2015 and what sub-sectors will be the most exciting to watch?

First, let's review some of the major restaurant deals of 2014, which included several highly publicized leveraged buyout deals such as Burger King's merger with Tim Hortons, Darden's divesture of Red Lobster to Golden Gate Capital and Sentinel Capital's purchase of TGI Fridays. Substantial liquidity and robust public market valuations are facilitating strong transaction volume and premium values. Private equity firms have an appetite for both underperforming established national brands and high growth emerging concepts. Several private equity firms that have not been traditionally active in the restaurant space have recently made investments in the sector. Berkshire Partners purchased a significant minority stake in Portillo's restaurant group, a Chicago inspired casual restaurant chain. Reuters estimates the deal at nearly $1 billion, which represents approximately 14x LTM EBITDA.

Now for the six trends we are watching closely in the restaurant space:

Resurgence of "Eatertainment"

There has been a renewed interest in the "Eat and Entertainment" segment. After receiving a nearly $1.1 billion offer, including debt, from Roark Capital in May 2014, Dave & Buster's, which operates an entertainment chain aimed at adults, instead decided to enter the IPO market in October and successfully raised $94 million in the offering, according to Bloomberg. The stock has traded up 74.0% since debuting, as of January 7, 2015, according to Capital IQ. Apollo Global Management acquired Chuck E. Cheese in January 2014 for $1.3 billion in cash and assumed debt, according to the NY Times Dealbook. On October 16, 2014, CEC expanded its brand platform with the acquisition of Peter Piper Pizza. The target operates 147 units that include family entertainment areas and arcades. Peter Piper has had success attracting Hispanic families in the Southwestern U.S., according to Nation's Restaurant News.

Fast-Moving Quick Service Breakfast Segment

Although the segment remains highly fragmented, CNBC estimates the quick service breakfast market is worth approximately $30 billion in annual sales. There is no national brand leader in the quick service breakfast space, as many providers are regionalized or independently owned. Although breakfast is a secondary offering for McDonald's, the fast food giant is the default breakfast leader because of its large national footprint. Burger King's recent acquisition of Tim Hortons positions the combined entity as the third largest QSR group, according to a Company press release. Tim Hortons is known throughout Canada for its coffee and doughnuts and the merger positions the combined entity to compete with McDonald's and Starbucks for breakfast market share. Taco Bell also entered the breakfast space with a new morning menu rolled out nationally in March 2014 and Chick-fil-A recently partnered with THRIVE Farmers Coffee in August 2014 to offer specialty-grade coffee at its 1,800 plus restaurants nationwide. JAB Holding Co's 10.3x LTM EBITDA acquisition of Einstein Noah, the largest operator, franchisor and licensor of bagel bakery restaurants in the U.S., also highlights the market interest in the breakfast space. JAB already owns Peet's Coffee & Tea, Caribou Coffee and D.E. Master Blenders. With the addition of a leading bagel company, JAB established itself for strong growth in the breakfast and snack segment, which has traditionally enjoyed higher margins than lunch/dinner operations.

Multi-Banner Platform Consolidation

The casual and fine dining segments have experienced sustained strategic consolidation activity over the past five years. According to Capital IQ, Landry's has made eleven acquisitions since 2010, including Mitchell's Restaurants, Mastro's Restaurants, Morton's, McCormick & Schmicks and Bubba Gump Shrimp Co., and has consolidated the corporate infrastructure of these brands into its headquarters in Houston, TX. By combining corporate operations, Landry's has rationalized expenses, including leveraging economies of scale for purchasing and marketing efficiencies. American Blue Ribbon Holdings, owner of O'Charley's, Ninety Nine Restaurant & Pub, Max & Erma's and Bakers Square, have successfully implemented a similar strategy. We expect additional multi-branded, multi-concept restaurant platforms to emerge and pursue synergistic acquisitions to leverage cost efficiencies enabling legacy brands to compete effectively in today's competitive market.

The Public (Markets) Want Better-Burgers

The better-burger space remains strong and continues to take market share from the QSR segment. McDonald's released November U.S. same store sales on Dec 8th. SS sales fell 4.6% vs Analysts estimates of 1.9%. The news sent the stock down 3.8%, making the biggest tumble in two years (since Oct 2012). In response, McDonald's has been testing a new "Build Your Burger" platform at Southern California locations mirrored off of the fast-casual style better-burger competition. Fast-casual better-burger chains are particularly active in the IPO market. Shake Shack is the most highly anticipated upcoming restaurant IPO. The prospectus indicated the company is looking to raise $100 million in the offering. Bloomberg speculates that the valuation could reach $1 billion valuation. Habit Burger Grill, owned by KarpReilly, made its IPO debut on November 20th. It was priced at $18 a share, valuing the company at about $454.5 million, according to Reuters. Since the IPO, the stock has traded up 80.8% as of January 7, 2015, according to Capital IQ. The chain has expanded from 26 units in 2009 to over 100 restaurants in four states. The Company has announced the development of up to 50 new locations in six Middle Eastern countries over the next decade, according to a January 7th press release.

Fast-Casual Continues Sharp-Growth

Fast-casual restaurants continue to attract the lion's share of attention among growth focused investors. Within this category, there have been a number of investments in early stage concepts targeting health conscious consumers. These concepts offer high-quality, fresh and responsibly sourced food delivering compelling value in a rapid dining environment. Sweetgreen is a fast-growing organic salad chain capitalizing on this trend by offering antibiotic and hormone-free protein and organic produce from local farms. The Washington D.C. based concept raised an additional $18.5 million from Steve Case's Revolution Growth Fund and New York restaurateurs Danny Meyer and Daniel Boulud to fund a West Coast expansion after the chain raised $22 million in December 2013 from Revolution, according to eater.com. Upon announcement of the 2013 investment, Case wrote that the success of Chipotle and Starbucks reflects "a shift in America's taste for fast-casual dining." In the wake of Chipotle's pioneering of the fast casual space, a host of new Chipotle-style concepts are emerging. Dig Inn Seasonal Market, a ten unit fast-casual concept taking New York by storm with a service style similar to Chipotle offers seasonal farm-to-table comfort food favorites at affordable prices. The chain aims to get customers in and out the door in 10 minutes with a $10 plate of organic food, for lunch or dinner.

Franchise Transactions

Franchise transactions have also been a feature of the sector, as national franchisors and multi-concept franchisees have been acquiring other franchise operators. Among these franchisors are Krispy Kreme Doughnuts, Noodles & Company, and Red Robin Gourmet Burgers. By adding established and profitable franchises to the company-owned system, large chains can grow annual revenues without the expense and effort of opening new units. Among franchisee transactions, there has been significant consolidation within the Taco Bell system. In December 2013, Altamont Capital backed Tacala acquired Austaco, an operator of 80 Taco Bell restaurants. In a similar transaction, K-MAC Enterprises, a portfolio company of Brentwood Associates, acquired 21 Taco Bell restaurants operated by Ricksim, Inc. In another Yum! Brands transaction, Apex Restaurant Management acquired Morgan's Foods, an operator of 68 Yum! Brands franchises. Current equity and financing markets are providing an ideal foundation for certain restaurateurs to explore a liquidity event. Private equity firms and strategic acquirers are eager to find and acquire growing and differentiated restaurant concepts. As a result, high quality concepts are generating robust market interest and premium valuations in public market trading and private market transactions.

The restaurant M&A market remains active with many new deals being prepared to come to market in Q1 2015. Key themes expected to sustain in the year ahead, include premium valuations for growth companies, consolidation and rationalization of casual dining concepts and acceleration of globalization and foreign investment in differentiated U.S. brands.

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