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OUTLOOK

Investing in Early Stage Restaurant Companies
By Dennis L. Monroe

I have seen everything from a salsa and chip kiosk in Iowa to a 20,000-square-foot casual dining jungle. Yet the appetite for new, potentially lucrative restaurant concepts seems inexhaustible. In today's market, with all of the private equity money and lack of quality deals, more buyers are looking at early-stage concepts, even concepts with one or two stores.

Two good examples of an investment in early stage concepts are Pizza Rev (Buffalo Wild Wings' investment) and Hash House A Go Go (Morehead Capital's investment). Years ago, these early-stage concepts probably would not have received the attention of such sophisticated buyers. These days, there are special funds called search funds, where investors hire someone to look for early-stage investments.

At least once a week I get a call from an investor group trying to find early-stage companies. The number of private individuals with large portfolios who are anxious to get involved in alternative investments is also on the rise. Such alternative investments may include early stage restaurant concepts, because investors can make a higher return than they can in the fixed-income market or stock market.

What should an institutional investor, a strategic investor or an individual need to take into account before investing in early-stage concepts?

Here are eight points to consider:

Restaurant Sector. What restaurant sector the concept is in may not be the most important aspect, but if the investor looks at the trends and restaurant sales in 2013, the only sector in the industry that was up was fast casual—the sector's sales grew 6%. Everything else was down. Why would an investor take a risk in anything but fast casual?

Unit Economics. An investor needs to make sure the unit economics work. This means a high level of store operating profit and reasonable labor, food and occupancy costs. I have been approached by a number of concepts that have high sales but unit economics that just don't justify an investment.

Investment Level Per Unit. This is probably one of the most significant points. If the restaurant is fast casual, the investment level per unit should be as low as possible. Also, the number of square feet being used should be conservative (2,000 square feet or less). Capital investments should be less than $500,000. This does not hold true for casual dining or QSR. The old rule of thumb is 2x sales-to-investment, in today's market, I prefer that ratio to be 3x.

Expandability. Another important question is whether the concept can grow from its existing location and geographic area. Expandability does not necessarily mean you have to have 1,000 stores; it means you have to have the ability to grow the concept. Certain concepts may only be looking at a local or regional presence, and they can be successful.

Larger, upscale concepts may be looking at going into only certain types of cities (for example, cities with an NFL franchise). A number of early-stage concepts have a local, regional presence with a cult following, but probably cannot be transferred to other areas. A good example of consumer constraints on expansion is Dunkin' Donuts (which is not an early-stage concept). It has been unable to expand west of the Mississippi. Part of the reason is that the following Dunkin' has on the East Coast can't be replicated elsewhere. The same may be the case with a number of early stage concepts.

Few System Problems. Often, even good concepts with good corporate stores decide to franchise too early. It does not necessarily mean they are not worth investing in, but normally franchising needs to be reconsidered and may be put on hold. A typical problem with a franchise system is that a concept has, let's say, four stores: two are great; one is average; and one is a poor performer. What is effect of that bad store on the whole system? Is it something that can be dealt with, or is it something that will continue to plague the concept and make it difficult to get adequate return?

Management. Management must have a clear understanding of the concept, because they presumably developed its culture. Do they understand the competition? Do they have reasonable financial control even though they are small? Are they more interested in profit than straight sales? Do they have a clear vision for the type of management necessary to grow the concept? Do they understand the limitations? These questions must be answered to determine if a concept has reasonable management one could feel comfortable investing in.

Legal Structure. Often a big hang-up concerning investing in early-stage concepts is the company's legal structure. Many early-stage concepts have done whatever they could to get to where they are. So their legal structure may be problematic. They may have a preferred class of interest, which most investors do not want, so that must be converted to common interest. They may have private debt, which needs to be converted. There may be family loans or agreements with friends and suppliers that need to be changed to arms-length transactions. An investor should look carefully at these structures and the balance sheet to ensure the investment is viable.

Exit Strategy. It is virtually impossible for an investor to invest in an early-stage concept and then grow it speedily to do an IPO. It is important to have an exit strategy that makes sense. In fact, it is wise to have more than one exit strategy. Make sure the existing owners and founders are in agreement as to the potential exit strategies. There is nothing worse than an absence of a commonly agreed upon exit strategy between the owners and investor in an early-stage company.

Despite all of these caveats, there is a huge opportunity to invest in early stage concepts. While we shouldn't disregard the old adage that 70% of the restaurant concepts might fail, I am seeing more early-stage concepts that have legs and are able to attract the right type of investors and management, and grow to become huge successes.

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