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Why Sophisticated Investors Invest In The Restaurant Space

I'm often asked why sophisticated investors invest in the restaurant space, so I queried three individuals who all have extensive experience in restaurant investing—Jeff Brock, a long-time veteran financier, now managing partner of Hargett Hunter Capital Partners; Navin Nagrani, executive VP of Hilco Real Estate who does personal investing in restaurants; and Jim Coady, senior managing director at Sentinel Capital Partners. I have been a long-time investor in the restaurant space, too, but not as sophisticated as these folks.

The Whys

Navin Nagrani: He says no matter how we look at the restaurant space, no matter which side we are playing on—franchisor/franchisee/multi-unit operator or emerging concept—it is still a niche investment, not a mainstream one, and that makes it a valuable investment option.

Jeff Brock: He has a unique way of thinking about why he invests in the restaurant sector: (1) He enjoys the people in all areas of the restaurant industry; (2) There is a huge diversity in the types of investments. You can make an investment in everything from pure equity to preferred stock to mezzanine to senior debt to sale/leaseback; (3) Part of his enjoyment of the industry comes from the excitement of understanding and mastering it.

Jim Coady: He sees two macro trends that encourage restaurant investing: (1) For the first time, Americans spend more money on food outside the home than inside the home; (2)The Internet can be disruptive to businesses by changing consumer buying habits. But for the restaurant business, the Internet can actually be a boon, such as in Internet ordering and the use of iPads.

Understanding the Elements of the Investment

All three spoke of the importance of understanding the appropriate matrix for a good restaurant concept. They emphasized sales to investment should be at least 3-to-1; unit-level operating profits, 15% to 20%; and a return-on-invested capital of 20% plus.

Return on Investment

Any time you have an alternative or niche investment, you are expecting higher returns because of greater risk. Sophisticated investors believe restaurants will have a greater return than many other options, and they are interested in this upside.

Brock divided the return sector into three areas, explaining there is not much in between: (1) emerging, where it is either bust or home run; (2) real businesses, businesses that are getting close to the point where they can have hyper growth; and (3) mature companies. The early stage obviously brings the higher expected return. None of my interviewees would commit to a return threshold but my guess is: early stage—50%; second stage—25% to 35%; and third stage—18% to 25%.

Management

All three investors believe good management is key to a successful investment. In fact, it was really the No. 1 criteria. Brock believes earlier-stage companies may need to augment their management teams so they can continue to grow.

Leverage

One attraction of a restaurant investment is the ability to use debt for acquisitions and development. At present there is sufficient senior debt, mezzanine debt, leasing and other types of financing sources that can help spike the return-on-invested capital. Brock stated unit development, because of the availability of sale/leasebacks and effective senior debt, can show a high return on cash investment. This is unique to the restaurant industry.

Supply

There are always a number of restaurant deals; but lately, there has been more money than deals, and that's the reason for increased prices. Each of the three investors echoed that sentiment. One fear they have is that pricing has gone up and a lot of sophisticated investors in this space are sitting on the sidelines.

Cash Flow

My investor friends want proven cash flow, and avoid speculative, start-up type companies with no cash flow. Along the same line—cash flow—I asked the investors, "Why would sophisticated investors invest in large multi-unit franchisees?" The universal response was acquisition and development of additional units can lower overall unit allocated G&A, thus improving cash flow (EBITDA). Also, the return is still reasonable, and there are many investors who have an excess supply of funding and need a good cash flow investment.

Scalability

Good concepts have scalability, i.e., ability to grow from an emerging-concept stage to many units and thereby achieve higher value and more EBITDA. Also, the availability of franchising enhances this scalability attribute.

Exit Strategy

The investors generally were not concerned about having a defined exit strategy as much as having good properties that have good cash flow—which if worse came to worse, they could hold onto. Each one likes to think of exiting in five to seven years; Coady said that in looking over all Sentinel's investments, the average had been five years. They are all realistic in understanding the cyclical nature of the restaurant industry, and consequently find that a well-defined exit strategy is not easily arrived at. They all mentioned that for investors in a very large concept to be able to grow the concept, IPOs can be an appealing way to create liquidity.

The thing that struck me the most is that these sophisticated investors do not seem to carry the baggage banks and other groups do when it comes to investing in restaurants. They see the upside, and their knowledge of the space seems to limit the downside. The old adage, "If you want to end up with $1M, start with $2M and invest in restaurants," doesn't necessarily apply to my friends.

—Dennis Monroe, Chair
Monroe Moxness Berg, P.A.