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OUTLOOK

The Booming Market For Public Funding

By Dennis L. Monroe

The public finance markets are again open to emerging restaurant concepts. This is due to the supply of capital, the desire of investors to invest in high growth and the liberalization of securities. The Monitor has highlighted some recent IPOs which illustrate the growth in the public markets. This article will discuss public offerings, small offerings and crowdfunding.

An interesting recent public funding example was a follow-on offering ("FO") of Diversified Restaurant Holdings, Inc. ("Diversified") ("BAGR"). This company's business, and thus the offering, is unique in that it involves a substantial base of franchisee-owned stores (Buffalo Wild Wings) and the company's own proprietary concept, Bagger Dave's. Also, it was an uplisting from OTCQB to NASDAQ.

It has been a long time since we have seen an IPO for a franchisee. Franchisee IPOs were popular 15 years ago, but Diversified reflects an updated and new approach. The investment-banking group that helped facilitate the FO was Feltl and Company, a securities brokerage and investment-banking firm in Minneapolis. I recently had the opportunity to speak with the company's CEO, John Feltl, and its senior analyst, Mark Smith. Besides discussing the Diversified FO, I asked for their thoughts on the growing IPO market for emerging restaurant concepts.

What type of emerging restaurant company is a good IPO prospect?

The following the three key elements provide Feltl and Company with a proper matrix for considering a public offering:

1. Great unit economics for the restaurants (performance at the unit level should be 18-20% cash flow)
2. Cash-on-cash return with a minimum of 30%
3. A history of not overspending on sites

While the size of the company's revenues and the size of the IPO are important, they are not key drivers.

What type of management team do you like to see for a potential IPO?

The CEO should be a great operator. The CFO should be "cheap" (which means the CFO will be watching all of the costs and has the ability to talk to the Street and build trust).

What size is needed for the IPO?

Most of the IPOs and FOs that Feltl and Company has been involved in have been in the $30 million-plus category, but smaller sizes are very do-able. For a company to be listed on NASDAQ, in general it has to meet the following guidelines:

1) stockholders' equity in the $5M plus range;

2) market value of publicly held shares of at least $15 million;

3) 1.0 million publicly held shares;

4) minimum of 300 shareholders;

5) at least three market makers for the stock; and

6) a bid closing price of at least $3 per share.

There are different ways to qualify for the NASDAQ, and these are just some of the guidelines.

Many restaurant companies can satisfy these requirements. In addition, new securities rules make it easier to do an IPO. There are reduced disclosures and compliance and a quicker time to market. The IPO market seems ripe for restaurants.

If a stock falls below market capitalization or trading requirements, it is then traded on the "pink sheets." Some people say that is the curse of the public company, but a hedge fund executive recently told me his company regularly looks at pink sheet stocks.

John and Mark also discussed follow-on offerings six months to two years after the initial IPO to raise additional capital. This type of secondary offering is becoming popular, and John sees this as a huge opportunity. I could tell that John and Mark are big believers in the IPO market for restaurants.

Let's turn to two other ways to raise money in the public market:

1) Under Rule 504 of Regulation A, a company can raise up to $1 million in small increments, but all of the investors need to be within one state. This type of funding is common in Wisconsin. This kind of investment is a lot of work, because many small investors are involved, but it is effective in raising that first $1 million. But the number of investors can make future funding tenuous, if the company is successful and wants to bring in private equity or do an IPO.

2) In 2014, the SEC will allow equity crowdfunding, and so we are likely to see a proliferation of this type of investment. The nature of the rules governing crowdfunding is not yet clear. The SEC will regulate crowdfundings, and there will be a pre-sale SEC filing requirement so they can follow these types of offerings.

At this point, the restaurant industry has embraced a form of crowdfunding, which is an Internet sale of services, discounts or benefits at the restaurant. For instance, a person can buy meals or special offers in advance from the restaurant, thus funding their working capital. In many cases, the use of gift cards in crowdfunding is a reliable source of working capital. Unfortunately, the discounts given for buying gift cards, and their immediate use, limits the value of the cash received.

Considering all these potential sources of growth, I believe it is going to be a robust market for the use of public funding in the restaurant industry. Investors seem to be looking for fast-growing, emerging concepts, and the restaurant industry seems ripe for this type of investment profile.

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