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What is the Future of Restaurant Companies?

By Dennis Monroe

Iconic restaurant companies are unique to the U.S. restaurant industry. Every major U.S. city has restaurant companies that have developed multi-brands and have established a special position in the city, like Union Square Hospitality in New York, Talk of the Town in Orlando, or Parasole Restaurant Holdings and D'Amico's in the Twin Cities. These and other groups are now mature businesses, and in many cases the owners are interested in a succession and/or exit plan.

These private companies may have difficulty finding a reasonable third-party buyer. The company and its individual restaurant properties normally have a long history of strong cash flow and a great brand name, which creates in the owner's mind a high price for the collective holdings or individual restaurant concepts. This limits the field of potential buyers, many of whom conclude they can develop their own brands for the price being asked. These could be other companies that develop and manage multiple brands—precisely the most suitable candidates. Private equity is somewhat reluctant to invest in iconic restaurant companies because many aren't growth-oriented. They may have a concept that could be grown, but in most cases they just generate good, reliable cash flow.

The ownership structure can be an issue when selling a restaurant company. The desire to dispose of the company may vary depending on different ownership types. For instance, an owner who has a majority interest may have a stronger incentive to sell.

Given the above, what can these restaurant companies do to achieve an exit? Here are five possible approaches.

Management buyout: The most logical approach, it assumes the company has developed a talented management group that can run the company with the same proficiency as the original owners. A management buyout is normally done with an installment note with, ideally, some cash down from the buyers/management team. The note has the ability to be serviced from the business, and in most cases from the cash flow of the business. It seems to be an axiom that the note payments should meet or exceed the cash flow taken out by the selling owners prior to the management buyout.

The issue here is the cash the management team can raise. One of the selling owners may want a disproportionate amount of cash. Sometimes management teams may perform their own private placement for raising equity with friends and family or find a private equity group to be their sponsor. If the team decides to use bank financing, then the issue is subordination of the current owner's carried interest (installment note) and possibly inter-creditor issues with the bank.

Annuity Approach: Instead of selling the business, it can be used strictly for its reliable cash flow as an annuity or legacy asset. The key in structuring an annuity approach is the assurance the brands have strong cash flow at present and for the future. If strong management remains in place, the cash flow should continue at its present level or even improve. Sometimes taking the annuity approach means that underperforming assets will be sold in the future.

If the company owns real estate, it should be in a separate entity. In this approach, rent is charged and the cash distributed to the owners.

Sell Off Separate Business Units: Often the sum of the parts is greater than the whole, and some restaurants can be sold off to other restaurant companies. I've seen restaurant companies sell off their well-known steak concepts to a company in another city that focuses on upper-end steak concepts. The advantage is the buyer recognizes the value of being in a certain city, understands the way the restaurant concept is run and possibly can bring efficiencies in management, buying and labor. A potential buyer of an individual restaurant concept may want to locate in that city, and this may be a way for them to gain a foothold there.

There can be a danger in selling certain brands, as the end result may leave the remaining pieces less valuable than all of the pieces as a whole. The key is to get high value for the best concepts and ensure the remaining pieces still generate good cash flows and reasonable value.

Private Equity: If the company's brands can show historically strong, predictable cash flow, it might be desirable for a cash-flow focused private equity group. I know of PE groups who seek long-term investments instead of a grow-and-exit strategy. Again, in order to maintain steady cash flow, the restaurant company must have strong ongoing management outside of the selling owners. Private equity can be good for the management team, because it will rely on them and provide an ownership interest to keep them motivated.

Potential Merger: Look at ways you can put together a potential merger with another similar company to create scale. A merger of two, or a consolidation of three restaurant companies may be a good exit strategy. This creates a larger company with more critical mass, potentially some cost savings and significant synergy. For example, one group has 12 restaurants and six concepts and the other group has 10 restaurants and five concepts. Possibly five of the 11 concepts can be cross-pollinated to produce a bigger company, which will then provide the basis for a private placement. The issue with a potential merger is always the appropriate target, and in many cases it is important to seek the help of investment bankers to facilitate the search and negotiation of a merger.

Often a merger approach is used as an exit strategy for some of the owners. For instance, if there are key owners who want to stay and grow the company, the merger may provide financing and secure appropriate equity for a seller-owner buyout. Thus, be sure the exit strategy for any of the owners is clear.

There are many ways to deal with succession or exit strategies. Whatever approach you choose to take, assess the quality of the restaurants, the company's potential long-term business prospects and the management team's potential for success.

Dennis L. Monroe is a shareholder and chairman of Monroe Moxness Berg PA, a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation. Reach him at (952) 885-5999, or at dmonroe@mmblawfirm.com.