

Buying Underperforming Restaurants: Deal or No Deal?

By Dennis Monroe

When looking for a deal, restaurateurs often evaluate underperforming restaurants. Sometimes a franchisor is encouraging a sale. Lenders may believe an operator can't meet their obligations. And sometimes an owner concludes the business no longer works for them. While these present opportunities for acquisitive franchisees, they also create significant challenges. Success requires a disciplined evaluation process and a clear understanding of what can and cannot be fixed.

To clarify the areas where buyers should focus when evaluating opportunities, I talked to two industry insiders from Capital Insight: Brett Bishov, managing director and founder of the firm, who has worked across multiple facets of the business and brings a unique perspective to distressed situations, and managing director Mike Eagan, who has been in restaurant operations, commercial lending, and now investment banking. Several key themes emerged from our discussion:

1. Why have revenues declined?

When evaluating an asset, buyers must understand why sales have deteriorated and whether the decline can be reversed. Is it the brand? Have demographics around the various sites changed? Has competition increased? Is the problem operational, marketing, or simply poor management? Does the brand have staying power? Does it have a loyal customer base? Has it successfully navigated difficult periods in the past? Is it a strong concept overshadowed by temporary challenges? Understanding the cause is the starting point for any turnaround.

2. Can operational issues be fixed?

Many struggling restaurants suffer from executional rather than structural problems. Staffing issues, inconsistent operations, poor customer service, weak local marketing, and inadequate management can all contribute to poor performance. Buyers should evaluate whether the existing problems are operational and whether they possess the expertise and resources necessary to correct them. Do the problems stem from the operator rather than the concept? If that's the case, a buyer may be able to acquire assets at an attractive valuation and

unlock value through better execution.

3. Evaluate the location and market.

Location is one of the most important factors in restaurant performance. Even strong brands can struggle in poor trade areas, while capable operators can generate meaningful improvements in well-positioned locations. Buyers should carefully evaluate traffic patterns, demographics, competitive pressures, visibility, accessibility and long-term market trends. If the operations were improved, does the site still have the potential to produce attractive sales?

4. Analyze fixed costs and occupancy obligations.

Distressed restaurants face challenges that extend beyond declining sales. Occupancy costs and lease structures, labor obligations and other fixed expenses can pressure cash flow. Can these be renegotiated or restructured? Sometimes the business can be repaired operationally, but the underlying cost structure makes profitability nearly impossible.

5. Identify sources of leverage in the transaction.

Lenders, landlords, franchisors and sellers may have motivations to reach a resolution quickly. If a buyer understands the various stakeholders and their objectives, they may negotiate more favorable terms. Eagan stressed the importance of understanding the capital structure and evaluating whether lenders may be willing to sell their debt at a discount. Bishov said many larger restaurant operators have debt syndicated among multiple lenders that often require consent from various parties, which can complicate negotiations and slow transactions. However, this can create attractive openings for strategic buyers who are patient and well-positioned.

6. Other factors involved in a distressed sale

Eagan and Bishov also mentioned sale-leaseback transactions. In some cases, landlords and real estate owners control portfolios of underperforming restaurants and have incentives to replace operators or reposition their real estate investments.

Both experts expressed caution regarding transactions involving active litigation, which often needs to run its course before value can be determined. Also, attempting to be overly strategic in bankruptcy situations can be challenging because outcomes do not always align with expectations.

Despite the challenges facing portions of the restaurant industry, Bishov and Eagan continue to see opportunities in the market, particularly when strong brands encounter temporary difficulties or when capable buyers can acquire locations from underperforming operators.

As with any investment, success comes down to understanding the issues, evaluating the stakeholders involved, and having a realistic plan to improve performance. Distressed restaurants are not for every buyer, but for those willing to do the work, they can offer compelling opportunities that are often unavailable through traditional acquisition channels.

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