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OUTLOOK

In Case Anyone is Listening

As an observer of the restaurant finance marketplace over the past 28 years, I can summarize the current market in this simple fashion:

"There are periods of intense investor interest in the restaurant business followed by disinterest, and then, often total disdain. It is during the disdain period, though, that smart operators plant the seeds for their ultimate success."

To say there was intense investor interest in the restaurant business from 2002 to 2007 could well be the understatement of my career. The restaurant finance markets were exuberant, irrationally so, especially with deals involving the larger public companies and those acquisitions backed by private equity. But now the credit crunch has companies scrambling and many restaurant chains and their franchisees find themselves shunned at the credit window by disinterested lenders. We take solace in the fact that all borrowers, with the exception of Uncle Sam, are now held in equal disdain by their creditors. This credit crunch is an equal opportunity one and isn't centered solely on restaurants.

Many of the restaurant deals during 2002-2007 involved massive amounts of borrowed money provided by aggressive lenders who willingly accepted low rates of return for the risks involved. This easy debt game attracted the hot money crowd—hedge funds, private equity sponsors and activist investors with little or no experience in the space. The euphoria eventually made its way to some go-go restaurateurs, who got caught up in the excitement of making deals, no matter how expensive or how much leverage was required. As we explained to our faithful readers in countless articles, the easy money drove restaurant valuations to historically high, and unsustainable valuations.

Even restaurant companies who were conservative in their approach to debt and new unit expansion have been impacted by this credit crunch. Fine and casual dining restaurant companies have seen their cash flows impacted by soft traffic. Companies that thought they were in compliance with their debt agreements have received acceleration notices, often as a complete surprise. How bad has the capital destruction been in the restaurant business this year? On the public company side, only three restaurant companies have share prices that trade higher than a year ago: Panera Bread, Buffalo Wild Wings and McDonald's. The others are off 50-60 percent in 2008.

The capital markets react

As we move from this "intense investor interest" phase of the restaurant boom toward that of disdain, we find ourselves in more than just a restaurant finance credit crunch. Every financial institution that relied on the capital markets to make loans or buy real estate is caught in this downdraft of panic and now must scramble to find a new balance sheet. So far the only balance sheet that means anything is the one managed by the Federal Reserve.

From Wall Street to Main Street, the credit meltdown hits even mundane financing transactions for new unit development, remodels, SBA loans and franchisee-to-franchisee business sales. At our recent **Restaurant Finance & Development Conference** at Caesars Palace, the standard line from the assembled lenders was that "capital was still available" and that most of the lenders, including GE, were still in the market. But, with terms more stringent than a year ago, it had the same affect as if they had placed a sign in front of their booths that read "We have no bananas today." A more delicate way to describe this apparent disconnect in the financing markets would be to say this: The restaurant borrower's desire for and ability to repay the capital, and the restaurant lender's price and demands for the repayment of that capital, is nowhere near equilibrium.

The modern financier's playbook of originating loans, restaurant or otherwise, selling them to investors and making money on the spread is now on permanent review by the game officials. The method of borrowing money by issuing bonds or selling off loans and making a new loan to a restaurant company is a non-starter in this capital-starved climate. In prior years, GE Capital and other finance companies could utilize their credit rating to borrow short and lend long at higher spreads, especially in the restaurant business. It was a beautiful arbitrage while it lasted. Unfortunately, as competition for cheap capital grew, lenders competed on price, terms and covenants while margins and credit quality suffered. Nationally, borrowers became less able to service their debts in a declining economy and the collective performance of the creditors and borrowers forced the capital markets to stop cold. Recourse is back on the table now and any loans under consideration are being underwritten at high rates that must actually be repaid, not flipped to another go-go lender.

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Despite this change in lender modus operandi, we expect many of the specialty restaurant lenders, including GE, will stay in the market in 2009, albeit some will stick around merely to massage their existing portfolios. Our wish is the lenders who stay in the restaurant finance world will lend forward in 2009 at least as much as they expect to collect in principal and interest during the coming year. That may be the case with GE Capital Solutions, Franchise Finance. There was discussion at the conference that GE's restaurant funding appetite might be in the $2 billion range for 2009, which would be positive for those restaurant operators who've maintained a modicum of financial integrity. Wells Fargo also told conference goers they were able to lend more restaurant money in 2008 than they did in 2007, and that they are looking to add to that number in 2009.

The local bank option
One idea percolating around the conference was that local banks might take up the slack left by the big finance companies. This remains a possibility, although it won't be as easy to accomplish as some say, especially in this climate. Restaurant debt can shift to banks, but it will be underwritten much tougher than before. One banker we spoke to at the conference doesn't expect the banks to be overly aggressive at underwriting new restaurant loans. "The fundamentals of most restaurant chains have to get better," he told me.

Fundamentals aside, local and regional banks have tightened the lending screws too. In a recent Federal Reserve survey of bank loan officers, 85 percent of domestic banks have tightened lending standards on commercial loans and 95 percent report they have tightened the costs of credit lines. If your credit is stellar and you have a positive local presence, go ahead and apply at the bank. But don't expect the local or regional banks to suddenly understand cash flow lending and restaurant collateral. They aren't wired that way.

Attorney Dennis Monroe, a restaurant finance specialist for the past 25 years, suggests presenting yourself to a bank as a small business—a business that has a huge growth potential and is backed by a superior management team. Instead of asking the bank whether or not they do restaurant lending, Monroe suggests that you ask the banker whether they will "look at small business or middle-market lending."

Jerry Thissen, president of National Franchise Sales, a business brokerage firm, thinks deals put together with solid operators who put up equity can get completed at banks." There is still an appetite for creditworthy deals at the local banks," says Thissen.

Surprise! Real estate is in demand
The best opportunity in restaurant finance these days seems to be in the real estate category with sale-leaseback providers still holding capital for investment. The sale-leaseback providers who attended the conference, like Servant Investments, Cardinal Capital and National Retail Properties, were quick to say that they had money to invest and were eager to put it to work in the restaurant business.

And with more vacant real estate hitting the markets, another option for operators is to find vacant strip center locations or closed free-standing buildings and get help from that landlord. Real estate companies that presented at the conference's Sixty Second Deal Forum were eager to show vacant locations at a fraction of their original cost. "We think even more supply will present itself after the first of the year when some marginal operators are expected to close units," said Jerry Herman, an Ohio restaurant real estate specialist.

John Brodersen, a 29-unit Popeyes franchisee in Michigan and Wisconsin told conference attendees that during the past six months he has seen some of the best deals for real estate in his life. Brodersen said he will lease vacant locations with an option to buy and expects when the market picks up and lending resumes, he will have taken advantage of the current downturn. Other restaurant operators also report success in renegotiating leases that have a limited term remaining, as landlords would rather lower the rent to keep a tenant than have more vacant space on their hands.

The franchisor to the rescue?
On the franchise finance side, some franchisors are getting involved in meeting with lenders or organizing capital sources for their franchisees, especially for the ones who might buy their company stores. But most are loathe to lend money directly to franchisees or give up any portion of their royalty stream.

Dominos reports they are working with banks and other lending institutions to sell underperforming franchise stores or secure funding for franchisees who need capital. But, the company stops short of direct lending to them. During a recent conference call, Dominos CEO David Brandon said "It will never be my preference to provide financing to our franchisees and would rather keep our relationship with them focused on being the franchisor rather than their bank." Brandon later acknowledged that he doesn't want to see his franchisees fail, however, and said he would consider some short-term financial support and solutions including a "non-material level of bridge financing." In the Monitor lexicon of financial terms, that's code for "nothing."

Monroe suggests if franchisors are serious about helping franchisees, they would consider credit enhancements that can take other forms besides direct lending. These include limited guaranties, remarketing agreements, seller financing or pledging collateral. This financial support from the franchisor is essential, says Monroe, to keep funds flowing to the franchise system. Other short-term franchisor support generally means royalty relief. Most franchisors defer royalties rather than forgive them, although the impact of deferment is simply to increase the liabilities of the franchisee, making them more vulnerable in a continued downturn. Many franchisors also look the other way when it comes to compliance with development agreements, and allow the franchisees to postpone or defer new unit openings. (See "development agreements" article on page 6.)

My prediction
Many franchisors will choose not to lend their balance sheet to their franchisees because of their own credit issues. That's fine in a normal financing market. In my opinion, though, this market is different from other downturns I've experienced. I can't imagine franchisees buying a significant number of company stores in 2009 or 2010 unless the franchisor provides the franchisee with an incentive in the form of royalty relief, seller financing or credit enhancement from a lender. The risk is too great for the franchisee in this environment, especially in a market where lending is so tight and, in some cases, where there is doubt as to the wherewithal of the franchisor.

There's more: Unless franchisors are willing to step up to the plate, buy franchise stores and establish a floor for the plummeting value of these franchise transactions, few franchisees will even open new franchise stores in 2009 or 2010. A franchisor that is unwilling to bid on stores, no matter how low the price, tells the rest of system that the remaining franchise stores are of little value. If the stores are of little value on resale, why should a franchisee open more?

Restaurant chains that continue to move away from operating company stores (i.e. the Applebee's model) face the risk that the existing franchisees in the system will stop investing in the brand anyways. I pose this question: What benefit is it to be a big, multi-unit franchisee in a brand with a heavily leveraged franchisor who can't even run their own company stores? None.

The seeds for future restaurant glory take hold in unsettled economic times, just as it happened in the late '80s and early '90s. Companies that have reasonably good operations that didn't want to leverage up, or couldn't afford to expand during the 2002 to 2007 go-go period because of high rents and big buildout costs, are now able to take advantage of the problems in restaurant land.

The leveraged legacy concepts that fail to keep their restaurants fresh during this recession will find themselves left out when consumer spending eventually comes back. When the consumer comes out of this recession, perhaps in 2010 or 2011, they will look for what is new in restaurants. A new investment cycle in restaurants will begin again. Traffic will shift as it has in the past from the leveraged legacy chains towards newer and fresher concepts.

For 2009, the amount of franchise financing provided by GE, Wells Fargo, Irwin, Bank of America, SunTrust, the sale-leaseback providers, local banks and the rest of the franchise lenders will be more than enough to satisfy the needs of the majority of the restaurant industry, given the current fundamentals.

The Debt Extravaganza Era is Over

The poster child of the restaurant debt extravaganza era was probably the leveraged buyout of OSI Restaurants, Inc., a.k.a Outback Steakhouse. In 2007, Bain Capital Partners, Catterton Partners, and the original Outback founders, Chris Sullivan, Robert Basham and Timothy Gannon paid $3.2 billion plus $400 million in closing costs, debt assumption and special reserves to buy the chain at more than 10 times EBITDA (earnings before interest, taxes, depreciation and amortization), an absolutely unheard of multiple for a mature restaurant business. The majority of the financing was of the leveraged variety and included $1.8 billion in secured and unsecured debt and a $1.0 billion sale-leaseback at fair market value of all of the company's real estate. I remember a number of vocal institutional shareholders who suggested the deal was unfair as it undervalued the company. Outback was forced to postpone its shareholders meeting because it was unable to convince enough shareholders to accept the $40.00 per share bid, despite the fact that it was a huge premium over the average stock price during the past year. As it turned out, the shareholders of Outback extracted a revised bid of $41.15 per share in cash from a company that had already begun its casual dining descent.

The Outback buyout promoters estimated that a "worst case" scenario for 2008 would be $4.3 billion in sales and $429 million in EBITDA. Yet, based on the company's first three completed quarters of 2008 and an estimate for the fourth quarter, the chain will record just shy of $4.0 billion in sales and less than $300 million of EBITDA. This performance implies that the real price for the company was actually 12 times EBITDA. As you can imagine, a sales and EBITDA miss of this magnitude doesn't go unnoticed by creditors, especially in a company that is so leveraged. The $550 million unsecured portion of the Outback debt now trades at $.14 on the dollar and is priced to yield almost 77 percent, an ominous sign for the company.

Outback wasn't the only euphoric deal in restaurant land during the go-go years. Other restaurant companies completed bull-market acquisitions or bought stock back at all-time highs in 2006 and 2007. These include DineEquity's big leverage and ego-driven $2.1 billion acquisition of Applebee's; the big stock buybacks of Ruby Tuesday, Brinker, Cracker Barrel, Cheesecake and Starbuck's that were misguided and expensive; and the ill-timed acquisitions by Darden Restaurants (Rare Hospitality) and Ruth's Chris (Mitchell's Seafood) that were unnecessary and costly to shareholders.

It wasn't just the public companies that made dumb deals. Private equity chains wish they had kept their powder dry, too, but instead bought and loaded up little restaurant companies with too much debt. There were also franchisees who bought other franchisees during this go-go period and found it was easier to get financing than actually make the operations work. None of these companies or their lenders ever imagined they would have trouble achieving their worst-case scenarios. Unfortunately, it's now playing out in prime time.

—John Hamburger