Restaurants

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1. Restaurant industry overview: history, players and trends

Although recent headlines might suggest the opposite, the global restaurant market is undergoing a remarkable and exhilarating renaissance that will better serve customers for generations to come. Never before have so many diverse and dynamic restaurant concepts been poised for growth; and the realities of the financial crisis have spurred tremendous innovation across all dining segments from quick service restaurants to fine dining. While economic conditions have and will continue to take their toll on the global restaurant industry for the foreseeable future, many brands will emerge from the crisis sounder in terms of operations, financial controls and brand integrity. In addition, lack of sensible development opportunities in home markets, or potential opportunities in foreign markets, has motivated many brands to develop internationally or seriously contemplate such a strategy. The next decade should provide the most dramatic facelift in the history of the global restaurant industry, with customers being the primary beneficiaries.

Franchising has served as the most critical growth vehicle for restaurant brands over the course of time. Through franchising, brands such as McDonalds, Subway and countless others have grown to tens of thousands of stores in most every country on the planet. In the United States, restaurant franchising dates back to the 1920s, when A&W root beer started a franchising operation that had opened 170 units by 1933. Many others followed, realising that franchising could serve as ideal growth structure for a restaurant concept. Some of the earlier franchised restaurant systems, like A&W and Dairy Queen, focused primarily on the sale of treat products with food as an add on. The franchised systems were simple, the barriers and cost of entry low and the offerings often seasonal. Franchisees often had considerable discretion as to what they could put on the menu in connection with the core treat product. Direct franchising and sub-franchising were common system structures with the vast majority of franchisees owning single units.

The 1950s witnessed the transformation of the franchised restaurant business from treat-centric to a more food-centric model thanks to McDonald's. Ray Kroc, who became acquainted with the McDonald brothers as the seller of their milkshake equipment, observed the potential for high profits on the food side. By 1961, he had acquired the business from the two founders and proceeded with an aggressive expansion programme, which resulted in McDonald's first international location in British Columbia in 1967. Other international locations soon followed, as McDonald's blossomed in key markets around the globe in the 1970s. Today, McDonald's is the largest restaurant company in the world, with more than 31,000 locations in 119 countries. Subway recently passed McDonald's in terms of the actual number of restaurants, with more than 32,000 locations in operation in over 90 countries.

2. The evolution of restaurant concepts

While the world of chain restaurants has long been dominated by fast food restaurants (referred to hereafter as QSRs), a number of other restaurant industry brand segments have evolved over time. International QSR growth is expected to remain strong into the future, but restaurants in other segments will see more opportunities than ever before, as consumer demand propels development in underserved markets.

Next to QSR, the casual dining segment is the most established segment of restaurant industry chains. Casual dining traces its roots to the 1960s with the debut of concepts like T.G.I. Friday's. This segment of restaurants typically feature table service, a full bar and a price point above QSR, but they are much more affordable than fine dining. The 1980s and 1990s witnessed the rapid growth of several casual dining chains in the United States, many of which operate internationally. These include Chili's, the Olive Garden, Red Lobster, Applebee's, Ruby Tuesday, Hooters and Red Robin. Within the last decade in particular, a number of restaurant concepts at the higher end of the casual dining segment have experienced rapid growth. PF Chang's China Bistro, California Pizza Kitchen, McCormick and Schmick's, Legal Seafoods, Houston's, Earl's (Canada), Ruth's Chris, Morton's and a variety of other brands added a substantial number of units, giving customers many casual dining options.

Recently, the emergence of the fast casual restaurant segment has captured headlines and customers. This segment, which is marked by a higher food quality than QSR, but a price point more reasonable than casual dining, has exploded in the United States in the past few years. The restaurants are typically around the same size or smaller than QSRs, but are in-line or end-cap spaces without drive through. Design elements are more sophisticated than QSRs. The smaller real estate footprint keeps the cost of occupancy reasonable. In addition, most feature counter service, which lowers labour costs. Beer and wine sometimes make up a small percentage of sales, but few offer spirits. Take out and catering often make up a healthy portion of a fast casual dining restaurant's business. Starbucks should be credited with providing early inspiration for this segment, whose marquee brands include Chipotle Mexican Grill and Panera Bread Company, with many up and comers such as Qdoba, Zoe's Kitchen, Daphne's Greek Café, Moe's Southwest Grill, Wingstop, Raising Cane's, The Veggie Grill, Pei Wei Asian Diner, The Counter, Chop't Creative Salad Company, Wagamama, Corner Bakery, Vapiano, Five Guys Burgers and Fries and Smashburger.

In sum, while major QSR and casual dining chains will continue to expand internationally in the next decade, expect fast casual concepts and emerging QSR and casual dining concepts to make a big splash in countries around the world. In addition, expect leading non-US-based chain restaurants to continue to grow in many countries, including the United States as restaurateurs race to meet the needs of diverse audiences and capitalise on affordable expansion opportunities.

3. Restaurant expansion and development structures: past, present and future

Growth-minded restaurant concepts are fortunate to have many expansion options at their disposal, including several different franchising structures. The questions of whether, how, where, when and why to expand have weighed heavily on restaurateurs for generations. Some concepts are specifically designed for growth, some grow organically over time or by happenstance and some never grow .

Serial restaurateurs will explain that restaurants are like children: the most difficult step is going from one to two establishments. By nature, many restaurateurs are perfectionists and controlling and the thought of relinquishing control over an establishment is unfathomable. Danny Meyer, who heads the New York-based Union Square Hospitality Group, took many years to open his second restaurant, despite the great success of his first effort, the Union Square Café. Now, after years of opening only single store concepts, Meyer too has caught the expansion bug, planning strategic growth for his fast casual burger concept Shake Shack.

Meyer's willingness to replicate the Shake Shack concept mirrors the actions of many other better restaurant groups over the past few years. Concepts are not merely expanding for financial reasons, they are expanding because they are becoming more comfortable with their structural options and have faith in franchising as a respectable growth model continuing to rise.

That said, expansion of any kind for a restaurant concept, is a subject worthy of careful consideration, as mistakes can translate into long-term disaster.

With a dizzying array of growth structures at their disposal, it is critical that growth-minded restaurateurs understand the options available to them along with the pros and cons. A prudent expansion plan is derived from considering a variety of factors, including, without limitation:

- the financial condition of the restaurateur and the ability to access capital;
- the sophistication and complexity of operation of the restaurant concept;
- the success (or lack of) of existing corporate and/or other units;
- the perceived public demand for the restaurant concept;
- the status of protection of the restaurant concept's trademarks and other intellectual property;
- competition in the market segment from existing and emerging brand;
- the ability of the restaurateur to manage growth administratively;
- the tolerance for risk; and
- the ability and willingness to relinquish some control if electing to expand through a non-corporate-driven model

4. Corporate growth

Corporate-driven expansion is the preferred growth vehicle for many restaurant concepts, especially those businesses with complex operations, expensive build outs and access to capital.

4.1 Characteristics of corporate driven growth

The characteristics of corporate driven growth are as follows:

- the restaurateur maintains operational control over restaurant chain;
- growth is financed in a number of ways (internally, commercially, private and/or public offerings).

(a) Pros

- Complete control preserves ability of restaurateur to maintain operational integrity.
- Preserves economic upside of maintaining ownership of expansion territory.
- Avoids conflicts and problems that come with franchising, joint ventures and other growth options.
- Changes to the restaurant system can be implemented more efficiently without seeking buy in from outsiders.

(b) Cons

- Typically does not allow for rapid growth due to capital and growth management limitations.
- Sacrifices potential financial rewards of expansion through other growth options.
- Slower expansion may render restaurant concept more vulnerable to competition.
- Franchisees and/or joint venture partners may be a better choice for expansion in foreign markets.
- Restaurateur is unable to protect against market volatility by spreading the risk through partners and/or licensees.

The vast majority of US restaurant concepts associated with higher quality offerings, especially in more complex segments such as casual to upscale casual dining, expand primarily through corporate driven growth, using other growth options strategically, if at all. The corporate-driven growth model is also employed by many QSRs and fast casual chains, especially those in earlier stages of development. The Cheesecake Factory and In and Out Burger are perhaps the best examples of well-known US-based chains that rely exclusively on corporate-driven expansion. The Cheesecake Factory, with its massive menu and tremendous sales volumes, is one of the more operationally complex restaurant chains in the world, which makes other growth options unattractive. In and Out, is well-suited for almost every growth option, but, to date, the closely-held family business has elected not to pursue them.

Other emerging and/or sophisticated restaurant concepts that drive growth primarily through corporate expansion will employ other options, especially in non-traditional growth and international development. For example, PF Chang's, the leading upscale casual Chinese restaurant concept in the United States, signed an agreement last April with M H Alshaya, a leading retailer, to open 34 PF Chang's in the Middle East over the next 10 years. California Pizza Kitchen, the premier upscale pizza brand, operates restaurants in 10 different countries under a variety of different structures and has franchised locations with a major contract concessionaire for more than a decade in US airport locations.

As the experience, sophistication and ability of international franchisees and/or joint venture partners continues to grow, one should expect to see more well-known and respected restaurant concepts relying on these parties to assist with their development strategies.

5. Partnerships/joint ventures

Partnerships and/or joint ventures may also be an attractive growth options for restaurants, especially in locations where the restaurateur desires a presence, but the barriers to entry are too significant for corporate-driven expansion.

5.1 Characteristics of joint venture/partnership

The characteristics of a joint venture/partnership are as follows:

- the restaurateur/partner form an entity for the purposes of operating a restaurant concept in one or more locations;
- financing of growth varies depending on the circumstances;
- the restaurateur contributes branding and operating system; the partner operates the restaurant(s);
- profits/losses are shared as agreed upon by the parties.

(a) Pros

- Partnership/joint venture model provides considerable flexibility in business terms.
- With shared profits and losses, both parties typically have strong incentive to develop and operate restaurants successfully.
- Model helps parties avoid regulatory hurdles in certain countries.
- Local partner more experienced and connected in area and can better manage development and operations.

(b) Cons

- Restaurateur maintains some financial risk.
- Management of relationships can be more difficult than other options.
- Exiting partnerships and/or joint ventures sometimes more complicated than other relationships.
- Restaurateur typically relinquishes operational control to partner, leaving brand exposed to risk.

Joint ventures or partnerships provide a restaurateur with the ability to enter a desired market, while often sharing the financial risk and delegating operational responsibility to the other party. It can be particularly attractive to those brands that are not interested in franchised growth and are unable or unwilling to develop independently. Partnerships and joint ventures are common in international relationships, as the experience and abilities of the partner can present a compelling value proposition to the restaurateur, which more than justifies the profit sharing that typically accompanies the structure. However, in such a relationship, the partner is typically on a more equal footing with the restaurateur contractually than in franchise relationships, making it more difficult for the restaurateur to enforce controls and, sometimes, to exit the relationship. The model is popular with concepts that want to test the waters in certain markets or enter markets in which their ability to operate is difficult or not possible (eg, airports, sports arenas, or other non-traditional locations). Restaurateurs and joint venture partners are both advised to conduct extensive due diligence on one another before entering the relationship.

6. Franchising

Franchising continues to serve as the dominant growth vehicle for international restaurant development and this should continue given its proven record as a successful growth vehicle; the maturation of the industry in many markets; and the proliferation of restaurant concepts looking to enter new markets, but without the desire or interest in partnerships or corporate expansion.

The franchise model offers something for brands of every size and sophistication, no matter how modest or ambitious the growth plans. Whether it is a QSR chain looking to open a single sandwich shop in a foreign country, or a sophisticated and successful upscale casual dining chain bent on opening 50 restaurants in the Middle East, there is a structure and, in many cases, suitable franchisees who would be happy to align to accomplish the objective.

7. Area development franchising

The development of the large franchisee has served as one of the most important developments in the restaurant industry over the past 25 years. These businesses, some of which are publicly traded, have the operating experience and capital to open and operate multiple restaurants and, increasingly, to successfully operate multiple restaurant concepts.

The United States is home to hundreds of these sophisticated franchisee groups, many of which operate different concepts in different market segments. *Franchise Times* magazine publishes an annual list of the top 200 restaurant franchisees, which, in 2009, was comprised of groups with gross annual revenues ranging from $28 to $700 million, operating between 15 and 1,100 restaurants each. The majority of the franchisees in the *Franchise Times* operate more than one restaurant concept and more than half of the concepts on the list are in the casual dining sector. Many leading brands will only sell franchise rights to franchisees with proven experience in operating other leading brands and with the financial and management capacity to open and operate restaurants over a strict development schedule.

There are a variety of annual conferences that specifically target these large franchisees, including the Franchise Finance and Development Conference run by *Franchise Times* and the Multi-Unit Franchise Conference run by *Franchise Updates*.

Sophisticated franchisees are also gaining traction in international markets, as these groups, which are often multi-national and multi-concept, are able to provide restaurateurs with the same type of expertise, ability and capital strength that has helped grow the US restaurant market over the past two decades. Groups include Eastern Europe-based Amrest, which operates KFC, Burger King and UAE-based Gulf Gourmet, which operates California Pizza Kitchen, Gourmet Burger Kitchen and Yo! Sushi.