SETTING UP YOUR RESTAURANT FOR SUCCESS IN A RISING INTEREST RATE ENVIRONMENT

A COMMERCIAL BANKING PERSPECTIVE

Citizens Commercial Banking®

Following the economic distress of 2009, many restaurants emerged with more efficient operations because they were forced to examine every aspect of their businesses in order to maintain margins and counteract same-store sales declines. Since then, other stresses have hit their P&Ls – most recently, increases in labor and healthcare costs. Still, restaurant operators have continued to create balance by decreasing costs wherever possible but are now facing the additional challenges of a rising interest rate environment.

In fact, several influencing factors are trending in favor of increased interest rates this year and next. The Federal Reserve increased rates in both December and March and the expectation is that they are planning several rate increases over the next few years. Also, the Trump administration's approach to fiscal policy heavily favors deregulation, which can lead to increased inflationary pressures. In turn, the Fed could begin increasing the frequency of interest rate hikes to combat such inflation. While there will still be interest rate fluctuations and some volatility, there are strategies aside from cost reduction that restaurant owners can proactively employ to protect their businesses.

PURSUE GROWTH AND EXPANSION

One strategy that owners are pursuing is to expedite the development of new stores to realize another type of cost savings: economies of scale. However, this organic growth strategy has also led to the over-supply of restaurants and is driving down same-store sales, particularly in the casual dining and fast-casual segments.

SAME-STORE SALES FROM Q1 2016 to Q1 2017[1]

Casual Dining	Fast Casual
1.18% ▼	1.22% ▼

Still, building economies of scale can have tangible benefits for restaurant operators. As operators grow their businesses, they can spread their fixed costs over a larger number of stores, thereby increasing their EBITDA. For an operator looking to add a couple of additional stores, the number of units the operator already owns plays an important role in determining the benefit of these additions.

There are also other practical advantages to having a greater number of stores. As a cash business, restaurants have the ability to manage their payables more effectively and having a larger number of units affords the added advantage of more cash on hand.

The other method for building economies of scale is via M&A. Through non-organic growth, owners can avoid perpetuating market saturation while still expanding their market share. For operators building a geographical presence – or for those who want diversity from their current concept – the bottom line regarding M&A is purchase price.

As purchase multiples have risen to historic levels in the last several years, driven by the seemingly endless availability of capital, operators have had to be even more diligent about making the right acquisitions. In the past, a traditional financing structure for an M&A transaction included 20% cash equity and 80% senior debt. With purchase multiples for many brands well in excess of 6.0x today, buyers have had to come up with more cash equity via outside investors, second lien financing or other sources of cash. For those acquisitions which necessitate an equity partner, operators must demonstrate proven management and a compelling growth story in order to attract outside investment.

LIMIT COST UNCERTAINTIES

For operators that haven't already done so, limiting variable cost uncertainties is more important than ever. We've already mentioned hedging against interest rate risk, but operators should also review existing leases, food cost contracts and other P&L items that are subject to upward movement.

Even for leases that have several years remaining, working with the landlord or management company to extend them can provide assurances that rent increases will be limited or delayed. Regarding food costs, operators can work with franchisors or co-ops to purchase forward contracts that might limit the volatility in commodity costs. Lastly, operators should consider whether or not there are any other contracts (employment, information technology, etc.) that are worth revisiting to avoid future cost surprises.

INCREASE AND EXTEND LINES OF CREDIT

While many operators already have existing credit lines with their lenders, now is the time to get those credit lines increased and extended; being able to access a revolver or larger development line will be important for managing their businesses.

For those looking to extend existing lines of credit, lenders look for operators to have a well-thought-out remodel or development plan in place to justify the size and timing of an additional line of credit. That said, operators should avoid having credit lines far in excess of their needs, which will ultimately result in fees for capital that won't be utilized.

For those without any existing credit lines in place, it is time to speak to a banker about solutions. Over the next 5 years, nearly every restaurant operator will have some capital improvement requirements, such as expansion or remodeling. Some operators will be able to fund these out of normal operating cash flow, however the majority will need to incur debt to fund such projects. Therefore, now is the time to get a line of credit in place.

LOOKING AHEAD

There are two key questions that could dramatically impact the restaurant industry. First, how difficult will it be to obtain capital in a rising interest rate environment? Second, are we in the correction phase of the 7-to-8-year business cycle and will the oversupply of restaurants need to catch up with demand? Regardless, both scenarios suggest that restaurant owners should proactively prepare by managing these risks sooner rather than later.

Citizens Restaurant Finance

With over $4 billion in loan commitments, the Citizens Restaurant Finance team is a national lender with proven expertise in financing a broad array of brands, sizes and capital needs. Whether you're improving current sites or opening new locations, refinancing existing debt or funding shareholder distributions, our team of industry experts can develop effective customized solutions to help you reach your goals. For more information on our expertise and how we can put it to work for you, please visit citizensrestaurantfinance.com.

[1] 10-Q filings and earnings reports

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