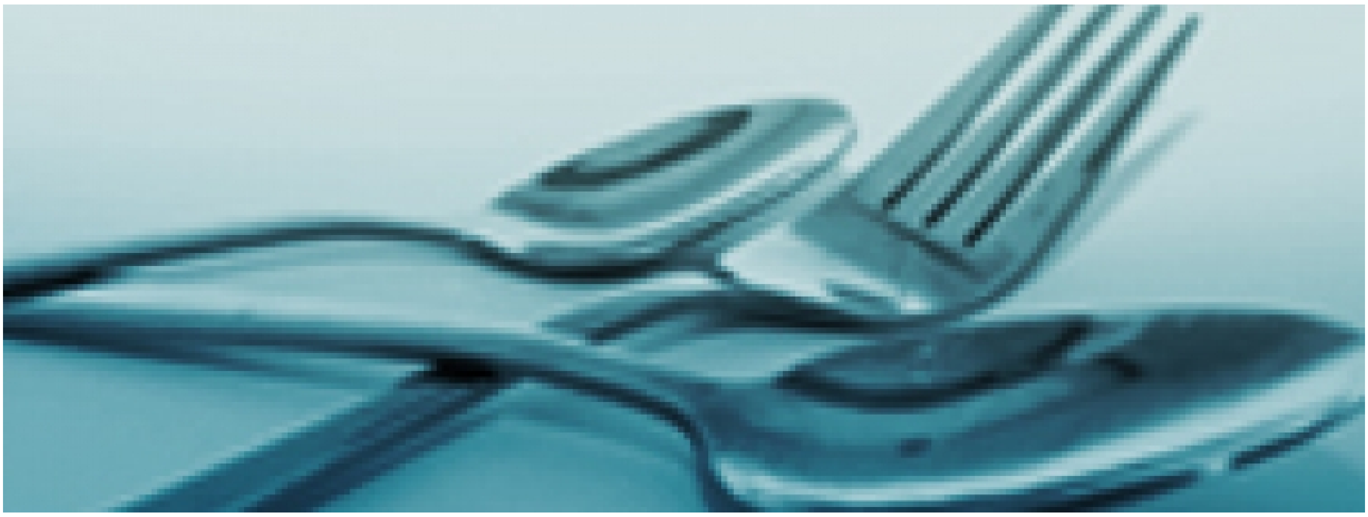


Digesting Restaurant Acquisitions

RESTAURANT TRANSACTION TRENDS

Private equity investors and strategic acquirers slowed the pace of restaurant acquisitions in the 3rd quarter of 2014. Investment activity decreased from 35 announced restaurant transactions during the 2nd quarter of 2014 to 22 during the 3rd quarter of 2014, according to S&P Capital IQ.

In this article, Alvarez & Marsal explores the accounting considerations associated with gift card liabilities, which are particularly relevant as the holidays approach. We also continue last quarter's discussion on evaluating and improving underperforming units. New owners, prospective investors and other stakeholders should understand these unique accounting and operational considerations associated with restaurants.

Understanding Gift Card Liabilities

Gift cards and gift certificates have become an increasingly popular offering of restaurants, especially during the holidays. Understanding the gift cards issued by a restaurant target is critical to assessing its working capital, associated obligations and cash considerations.

Seasonality can impact the level of issued and outstanding gift cards and, therefore, a restaurant's working capital. For example, restaurants typically issue an increased amount of gift cards during the holiday season. A seasonally high level of issued, but unredeemed gift cards will increase the associated liability recorded on a restaurant's balance sheet. Investors should consider this when assessing working capital, particularly if a transaction closes during or immediately following the holidays.

Restaurants often record gift card breakage income for an assumed number of gift cards that will never be redeemed. Prospective investors should consider the level of breakage income when assessing a restaurant's profitability, as well as understand compliance with local escheat laws regarding unredeemed gift cards.

Finally, restaurant investors should consider the extent to which the seller has collected cash from the sale of gift cards. In cash-free, debt-free transactions, the buyer will often not enjoy the benefit of previously collected cash from the sale of gift cards until new gift cards are sold. This is particularly relevant to transactions that close during or immediately following the holidays, when a seasonally large amount of gift cards are sold.

A careful examination of gift cards during due diligence will prevent surprises following the completion of a restaurant transaction.

Evaluating and Improving Underperforming Units

In our September 2014 article, we discussed methodologies and considerations that assist in identifying underperforming units and allow for an objective determination of where the most cost effective and substantial improvement opportunities reside. A&M continues this discussion with some best practice approaches and techniques commonly used to achieve and optimize success in your individual unit turnaround efforts.

Remediation Approach

While varying approaches are often used, those with the highest success rates usually incorporate an experienced and proven, multi-disciplinary team in the effort. This team is assembled by pulling those operators from strong performing stores who have proven capabilities in marketing, culinary, service and overall management. Ideally, the persons selected for the team would be pulled from stores having strong management backfill in place at their home stores, and who will at some point be considered as candidates for promotion within the systems' managerial ranks.

The use of peer-level counterparts has been shown to be more effective in the communication and adoption of initiatives identified during the assessment and evaluation process, as compared to using higher-level management personnel who are more removed from the daily restaurant operations, and whose efforts to date have likely been ineffective. Depending on the size of the endeavor, we would typically advise having at least one project manager in place, independent from internal politics or bias, to manage any conflict and ensure that the various initiatives are cohesive and implemented on a timely basis.

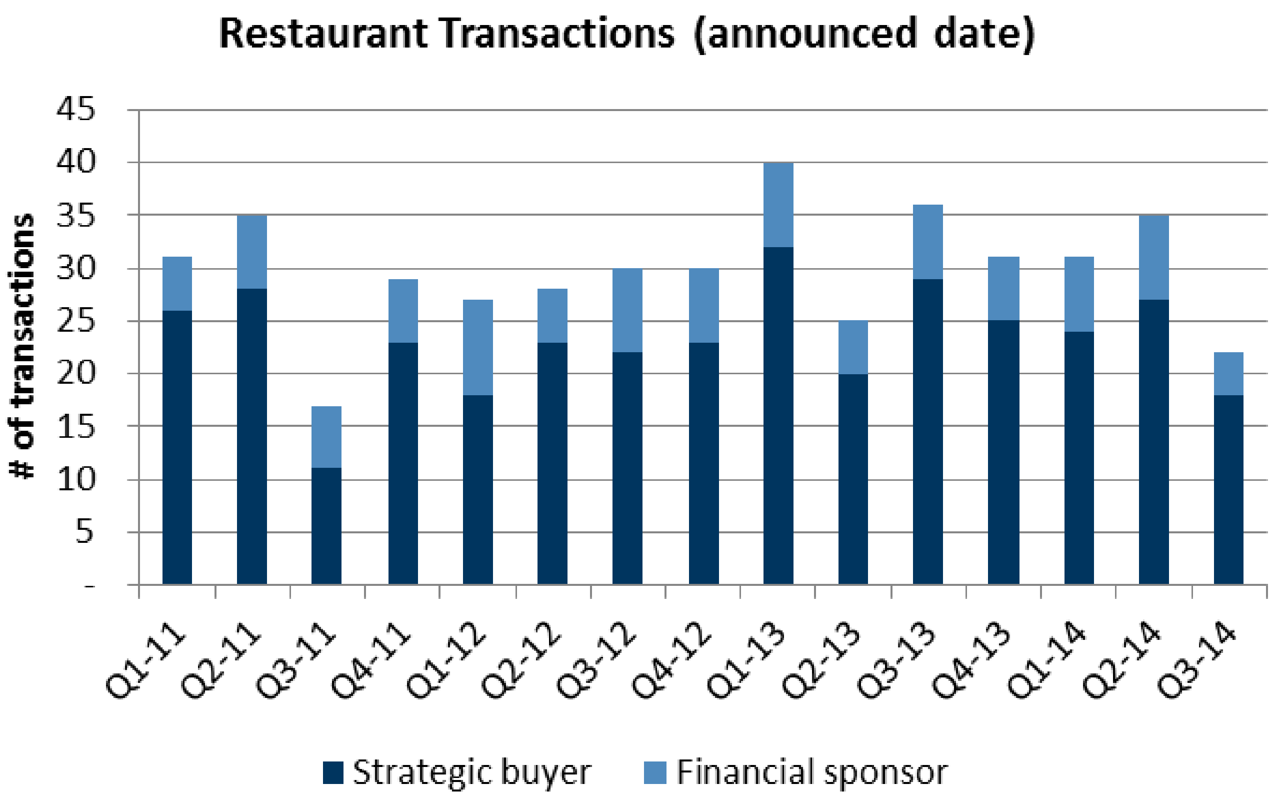
Techniques

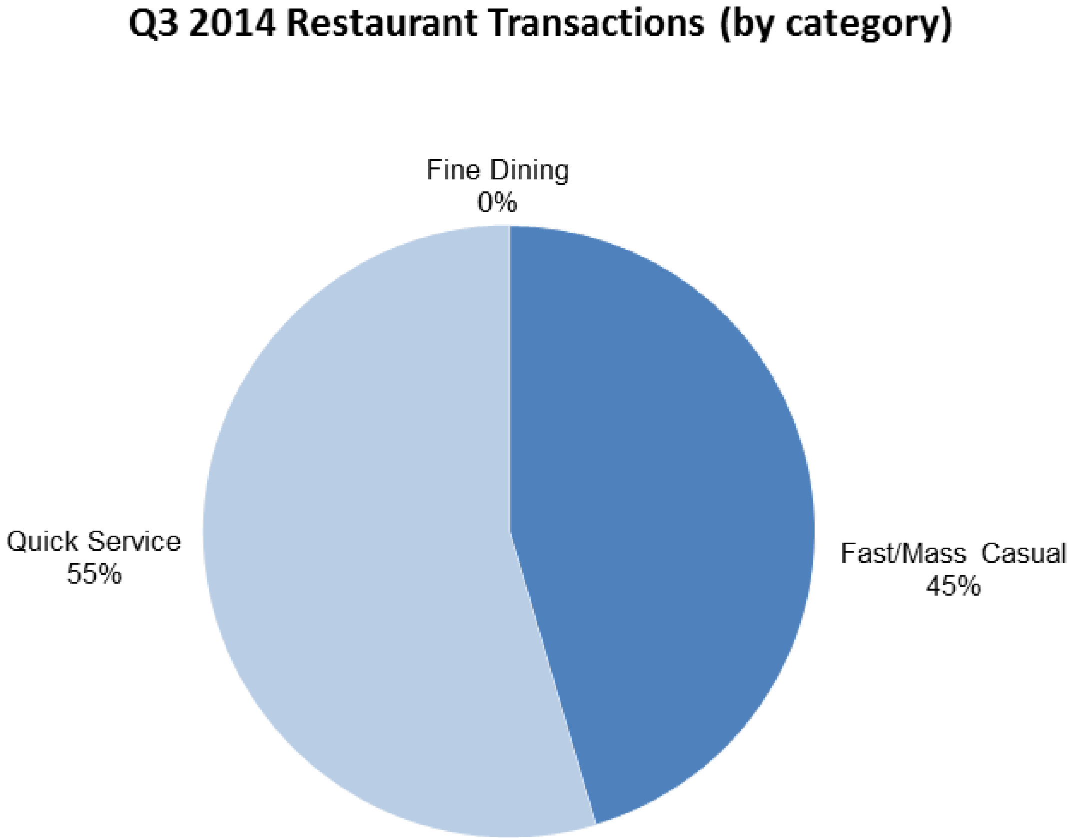
The activities performed by the improvement team will depend largely on the improvement opportunity hypothesis for each unit. However, the following unilateral concepts typically apply:

- A pre-deployment site package should be prepared and circulated to include all key financial data, metrics, trends and other relevant information regarding the store and its management team.
- A focused, one-week site visit with an itinerary that minimizes operational disruption, and includes a comprehensive tour, interviews of management and staff, and reviews of on-site records and tools used to manage the business.
- A collaborative and joint effort while on-site to identify and prioritize issues, opportunities and solutions, including an understanding of the reasons for any failed efforts in the past.
- Assignment of responsibilities and timelines for implementation of the initiatives.
- Development of tools, along with any required training, to facilitate in the implementation and ongoing effectiveness of initiatives.
- Follow-on performance review updates with the team and on-site management, assignment of a peer mentor for each general manager to work with throughout the post-implementation period, and reporting of progress and results to the executive sponsorship.

Using these proven methodologies to turnaround underperforming unit operations will substantially increase the likelihood of successful and sustained improvement over time.

Restaurant M&A Activity Summary





Source: CapitalIQ. / Note: the data above excludes transactions characterized as the transfer of land, transfer of assets between individuals, and other similar transactions.

Summary

Strategic acquirers continued to drive momentum in restaurant transactions, but in a declining pace against the prior quarter. During the 3rd quarter of 2014, there were 18 announced restaurant transactions involving strategic acquirers compared to four transactions involving financial sponsors. Quick Service restaurants continue to be the target of choice.

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