Digesting Restaurant Acquisitions - May 2016

RESTAURANT TRANSACTION TRENDS

Following private equity investors' and strategic acquirers' stable appetite for restaurant acquisitions in the U.S. during the 1st quarter of 2016, Alvarez & Marsal highlights several unique accounting and operational considerations associated with restaurants that new owners, prospective investors and other stakeholders should understand.

In this edition of Restaurant Transaction Trends, A&M leaders discuss **advertising funds** used by franchisors and the key considerations in understanding these funds when evaluating a restaurant transaction. In addition, we examine the industry's continuation of driving customer growth through **retention**.

Understanding franchisor advertising funds: what are you buying?

Advertising funds, also known as marketing funds, are funds established by franchisors which pool the required contributions from franchisees to promote a restaurant's brand. Operationally, these funds are intended to ensure coordination and consistency with respect to advertising efforts and also serve as an effective means to achieve purchasing efficiencies on marketing expenditures, given the collective scale.

Funds are normally established via a mandatory contribution from franchisees which is usually defined as a percentage of retail sales. The funds are used for various forms of advertising to promote the restaurant's brand. A franchisor's Franchise Disclosure Document ("FDD") usually sets out terms of permitted spend.

If an advertising fund is used by the target in your restaurant transaction, it is important to understand the following:

- Is this fund included in the transaction perimeter?
- How does the target account for the fund? Advertising funds may be structured in a number of ways.
    - In some cases the target may form a separate legal entity, such as a corporation or LLC, or create a trust or non-profit entity to hold the funds.
    - In other cases, the target may elect to collect the funds and disburse them as part of its own operations. If structured as a separate entity or trust, it's important to consider whether the advertising fund should be included in the target's consolidated financial statements under applicable accounting guidance. From a high level, this will largely depend on who oversees and controls the operation of the fund.
    - In instances where the contributions are collected and disbursed under the control of an independent committee of franchisees and the target has no rights or obligations pertaining to the collective funds, it's likely the advertising fund would not be consolidated with the target for financial reporting purposes. Alternatively, if the target controls the most significant decisions of the advertising fund, it would likely be consolidated with the target.
- Have the fund's expenditures been used in accordance with the terms set forth in the Franchise Disclosure Documents (FDD)?
- Does the fund have to maintain "proof" of advertising to the franchisees? If so, does it?
- Have any of the target's general and administrative costs been allocated to the fund? If so, are the allocations

reasonable? Unreasonable or excessive allocations may distort the financial results of the target.

- Do any of the franchisees contribute to the fund at a reduced rate? For example, some FDDs allow franchisees who spend advertising dollars on local marketing initiatives to contribute at a reduced rate.

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

Driving Same Restaurant Store Sales – The Right Way, Part II

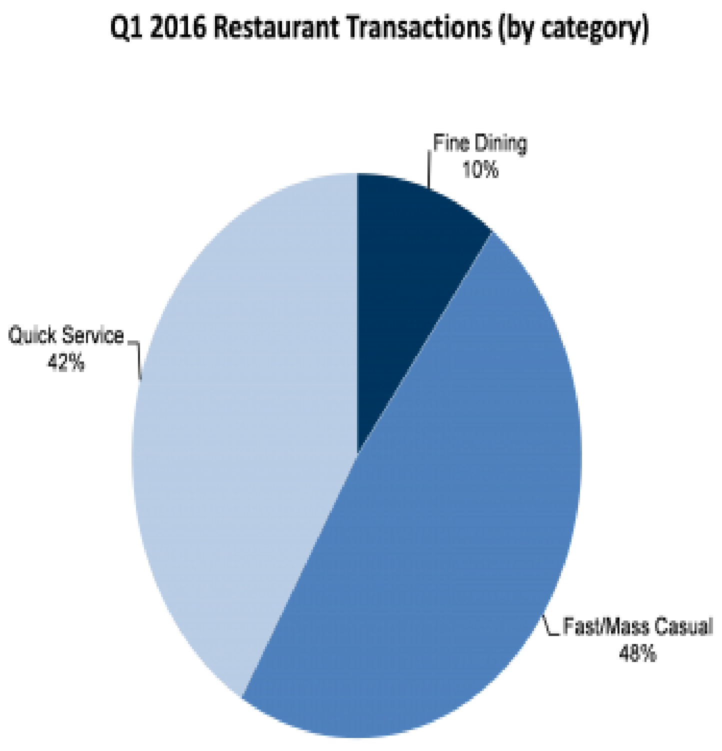
In our last newsletter we talked about one of the best mechanisms for measuring customer growth, the RPA analysis. In the second edition of our customer growth series, we will be focusing on retention. Retention can be defined as the number of last year's customers whom we have again this year. Retention is best measured on a year-over-year basis for the restaurant industry to account for all visit occasions. There is a two phase process for promoting a high retention rate.

The first is to truly understand why customers come back and why they leave. Each are equally important and those reasons *must* align with the elements that drive your business. Eg. High retention customers who visit only when deeply discounted promotions are available may not be your best customers. The best way to understand retention is to regularly measure the customer pulse through mechanisms such as surveys, net promotor scores and social media.

Once those reasons for staying (or going) are understood, the second phase is to create programs and infrastructure that drive both customer retention and profitability. Some questions to consider:

- Do you have a customer data mart to understand customer retention rates?
- Is your loyalty program designed to provide both monetary and intrinsic rewards?
- Are you measuring customer profitability in relation to your retained customer base?

Thinking about retention in these kinds of ways will optimize your retention rates, while driving higher guest counts and profitability. In our next article we will dive into the "P" in RPA, penetration.



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. During the 1st quarter of 2016, there were 26 announced restaurant transactions involving strategic acquirers compared to three transactions involving financial sponsors. Fast/mass casual restaurants continue to be the target of choice, although transactions involving quick service targets have increased in recent quarters.

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