

OUTLOOK

Restaurant

Blurred Lines: Redefining the Competitive Landscape

2014 North America Restaurant and Foodservice Review



At a Glance

Industry Snapshot

2013 was mixed: consumer confidence and unemployment rates improved—both of them to levels not seen in the past five years. Nevertheless, the percentage of Americans who feel “good” or “great” about the economy hasn’t changed much, and middle- and lower-income consumers feel much worse about the economy than members of higher-income groups do. All of this translated into some increases in consumer spending, though the lion’s share has gone to durable goods rather than services. Perhaps not surprisingly, per-person spending on restaurants remained relatively flat during 2013, which contributed to sluggish overall growth in the industry.

Consumer Survey

According to our analysis, however, the three most important criteria in Americans’ choices of restaurants to visit are quality, price, and value—in that order. But even though quality tops the list, few people say they’re willing to pay more for it. In addition, consumer expectations regarding what they’ll spend per meal in the next 12 months suggest that average spend per meal will decline by more than 9% in 2014. This is the highest reported decline in intended spending over the past few years; most years’ averages were close to 5%. Consumers are targeting their dining-out budgets for the most-severe belt-tightening, compared with other spending categories.

Options for Operators

The fight for market share is leading operators to spend more on advertising, leverage technology, and to blur the lines between segments within the industry when it comes to menus, service models, and day parts. In this environment, and as shareholder activism gains momentum, we suggest operators follow a few steps on an ongoing basis: (1) Become and remain lean, (2) Regularly evaluate capital structure and support investments, (3) Consider divestiture (multibrand or vertically integrated), and (4) Review investor relations and governance.

An uptick in consumer confidence. Lower unemployment rates. An easing of the threat of financial distress. Those and other developments that unfolded in 2013 painted a promising picture for the North American restaurant and foodservice industry, according to AlixPartners' 2014 Outlook.¹ But other developments—such as spotty operational performance across the industry, relentless price volatility in some commodities, and a drop in traffic late in the year—suggest that industry players might still want to proceed with financial caution.

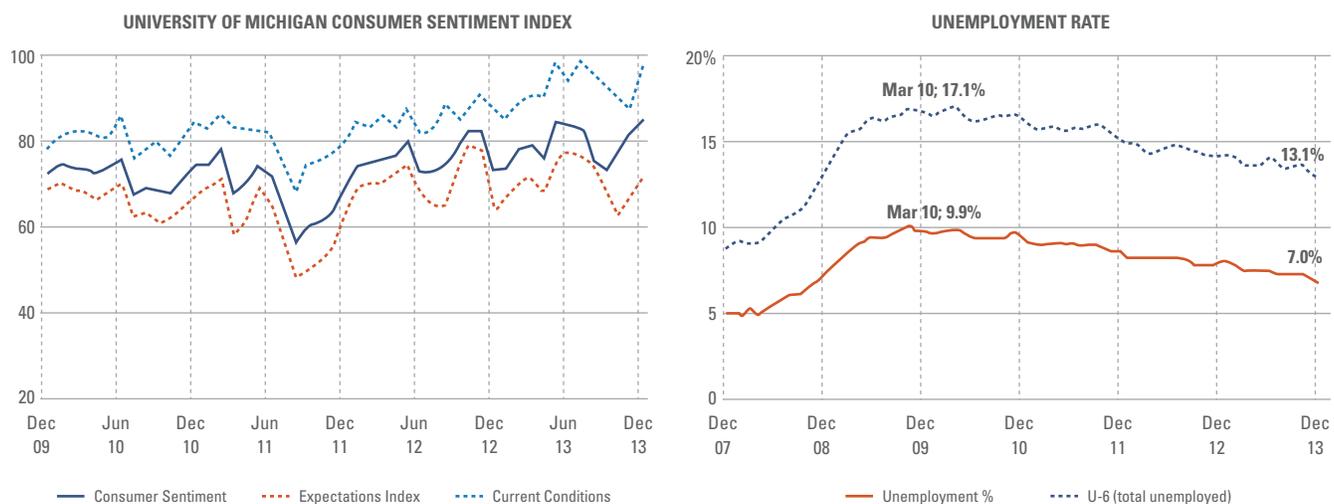
At the same time, competition for market share continues to heat up, and aspiring winners are cooking on multiple burners. Some are experimenting with new business models that blur the boundaries between segments. Others are using technology in new ways to improve the guest experience. Still others are forging new, nontraditional partnerships to drive growth. But winning operators are keeping their eyes on how to maintain share in this market. It's an innovator's game, and the strategies companies choose to put into action now will determine which ones will succeed in satisfying consumers' hunger for quality offerings, reasonable prices, and value.

Surveying the Bill of Fare: Industry Snapshot

The year 2013 saw a blend of both encouraging news and difficult news for players in the North American restaurant and foodservice industry. On the positive side, consumer confidence and unemployment rates improved—both of them to levels not seen in the past five years (figure 1). And while 47% of consumers taking part in AlixPartners' latest survey reported feeling "not good" or even "bad" about the US economy in 2013, it represented a marked improvement over the 56% who reported such feelings in our 2012 survey. Still, despite the easing up of pessimism regarding the economy, the percentage

Figure 1: Consumer Confidence and Unemployment

Consumer Confidence and Unemployment Improved in 2013: Both at Best Levels in Past Five Years

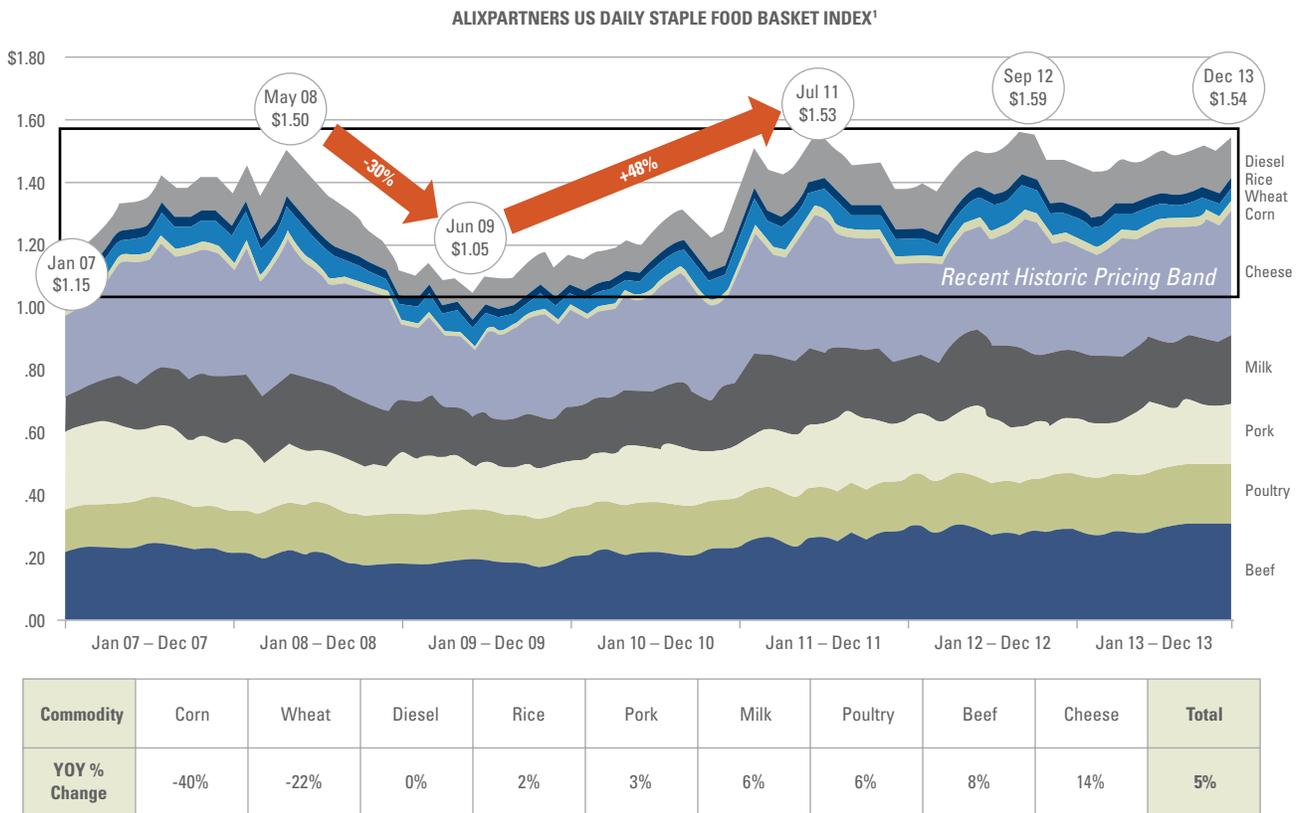


Sources: US Bureau of Economic Analysis, University of Michigan

¹ 2014 AlixPartners North America Restaurant and Foodservice Review. The review is a semiannual update on the state of the industry, a proprietary consumer research update, and the latest thinking on trends that may shape 2014. All references, facts, and opinions contained in this article can be found in the Outlook.

Figure 2: Staple Food Basket Index

Commodity Pressure Remains As Sustained Global Demand Has Kept Food Prices Relatively High



¹ AP US Daily Staple Food Basket Index tracked since Jan. 2007; shrimp and chicken wings highly volatile. Representative daily portions of selected staple food inputs and avg diesel used to ship basket multiplied by \$/LB prices of raw, unprocessed commodities. Sources: CME, USDA, and CBT

of Americans who feel “good” or “great” about the economy hasn’t changed much. Moreover, middle- and lower-income consumers feel much worse about the economy than members of higher-income groups do.

Looking ahead, consumers may be shifting from a pessimistic stance to a more neutral one—perhaps waiting to see how trends develop. In our latest survey, 59% of respondents said they expect the economy to “stay about the same,” “get somewhat worse,” or “get much worse” over the next year; 41% expect at least some degree of improvement.

All of this translates into some increases in consumer spending, though the lion’s share has gone to durable goods rather than services. Perhaps not surprisingly, per-person spending on restaurants remained relatively flat during 2013, which contributed to sluggish overall growth in the industry.

On the bright side, while sustained global demand kept food prices high overall in 2013, the expectations for food inflation in 2014 appear manageable (figure 2). Uncertainty in the labor market and wage pressure appear to be more-pressing issues.

Global mergers-and-acquisitions (M&A) activity has also slowed, especially that of larger-cap deals. M&A reached record lows in terms of transaction values in 2013. Values totaled roughly \$3.7 billion—a big drop from the \$7.6 billion total in 2012, which itself was a major decrease from the \$13 billion achieved in 2011. In 2013, not a single M&A deal exceeded the \$500-million mark in terms of value. There are a number of reasons for that, including recent initial public offerings (IPOs), the current life cycle for many private-equity funds, and a general decrease in number of opportunities as companies have gone private or sold to other investors.

Still, market factors point to a possible acceleration in future activity. The restaurant and leisure industries continue to outperform the broader S&P 500 in terms of share price—boasting median share-price growth of 47.5% versus 29.6% for the S&P. Moreover, several IPOs have delivered impressive performance in terms of jumps in share price after the IPOs. Availability of capital for new investments, along with improvements in consumer confidence levels, further suggests that M&A activity may pick up.

Deciding Where to Dine: Consumer Choices

Our 2014 Outlook survey findings show that fast food is still a staple for Americans who choose to dine out. Indeed, our study participants tend to prefer fast food along with fast casual for lunch. Fast food also dominates when consumers want to get breakfast on the road or grab a late-night snack. However, respondents reported a drop in the average number of fast-food-restaurant visits from 5.8 in the first quarter of 2013 to just 4.4 one year later. Top reasons for the reduction in frequency included a desire to “eat healthier” (86% of our study participants noted that healthy menu options were at least somewhat important in their decisions about where to dine out) and a need to cut back on discretionary spending.

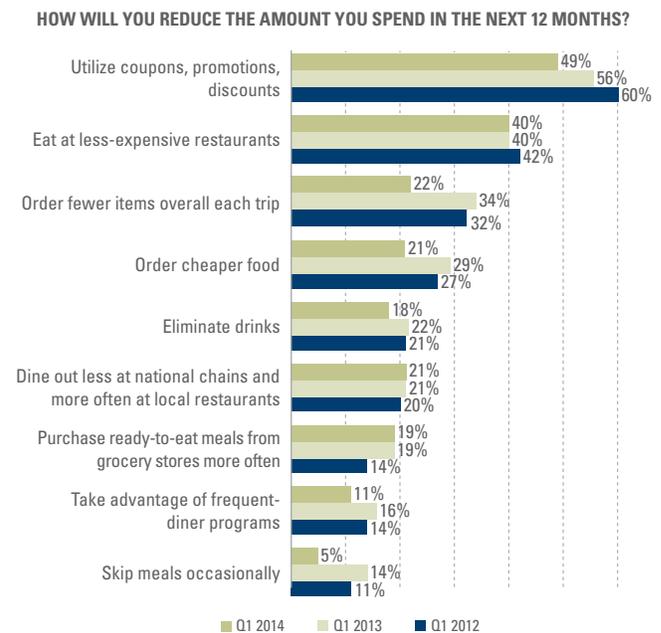
As for food purchases at convenience stores and grocery stores, most of our survey participants said they made such purchases after venturing into such stores to buy other items, which suggests that convenience matters. According to our analysis, however, the three *most important* criteria in Americans’ choices of restaurants to visit are quality, price, and value—in that order. But even though quality tops the list, few people say they’re willing to pay more for it. For example, just 16% of participants in our study said they were willing to pay a premium for certified organic food. In addition, their expectations regarding what they’ll spend per meal in the next 12 months suggest that average spend per meal will decline by more than 9% in 2014. This is the highest reported decline in intended spending over the past few years; most years’ averages were close to 5%. Consumers are targeting their dining-out budgets for the most-severe belt-tightening, compared with other spending categories such as entertainment, home improvement, clothing, vehicles, and travel. To stretch their dining-out dollars, consumers plan to take advantage of coupons, promotions, and discounts as well as eat at less expensive restaurants (figure 3).

Fighting for Market Share: Trends Shaping 2014

In a bid to capture fatter slices of this competitive-market pie, restaurants are beefing up their advertising spend, especially on new menu options and limited-time-only promotions. Indeed, advertising spend jumped 6% from 2012 to 2013 (figure 4).

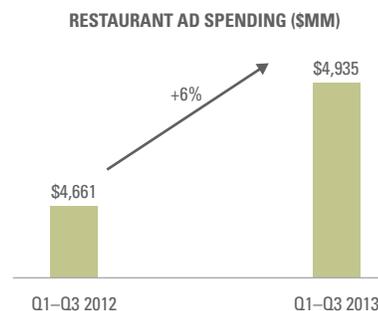
Some companies have continued launching and marketing products aimed at health-conscious consumers, such as gluten-free offerings, sandwiches made with egg whites, and lower-calorie versions of their flagship products. That trend may continue, given consumers’ claims of wanting to eat more healthfully, as well as the fact that organic and health-food products show the highest growth rates of items sold in supermarkets. But despite those efforts, only about 30% of the consumers in our latest survey expressed a willingness to try

Figure 3: Strategies for Stretching Dining-Out Dollars
People Needing to Save Will Look for Promotions and Less-Expensive Restaurants



Source: AlixPartners Consumer Research

Figure 4: Increases in Advertising Spend
Restaurant Advertising Spending Continues to Soar, Outpacing Overall US



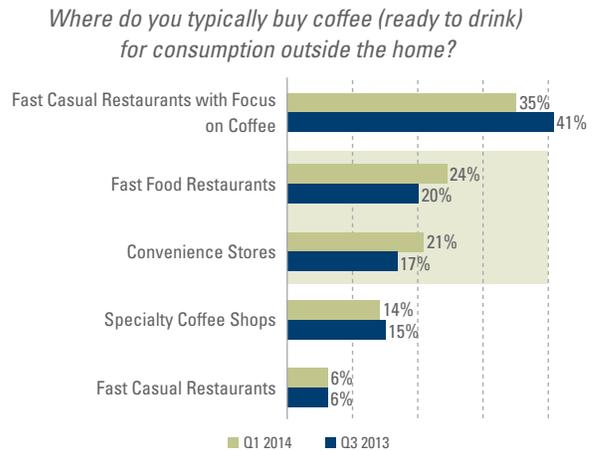
Source: Kantar Media

new menu items—suggesting that consumers tend to stay loyal to the menu items they know and love.²

The fight for market share is also blurring the lines between segments within the industry when it comes to both (1) food items offered and (2) service models and day parts. For instance, some full-service restaurants are developing express formats, a move that’s inching them toward the fast-casual model. And some fast-casual operators are adding table service, making them look a bit like full-service restaurants. That practice gives chains the opportunity to target new consumers in new day parts or in potentially nontraditional venues or formats. Meanwhile, an increasing number of convenience, drug, and retail food stores are putting stronger emphasis on foodservice, with some even offering manned food-station bars, free Wi-Fi, and comfortable seating. Additionally, many are now beginning to embrace traditional restaurant-style marketing tactics by arranging theatrical food displays and offering daily dinner deals. There is evidence that those strategies are starting to gain traction with consumers, as evidenced by the coffee category (figure 5).

Operators are also leveraging technology in new ways in their efforts to win market share. Examples include online ordering, smartphone loyalty programs and apps that communicate daily deals, and gift-giving functionality delivered through social-networking sites. Some companies have begun to hire mobile strategists, which may be a smart move, given that mobility seems to be more powerfully influencing consumers’ dining-related decisions. For example, our survey respondents reported that shopping-related mobile features do exert some influence on their dining-related decisions (figure 6).

Figure 5: For Coffee Drinkers, Restaurants with a Focus on Coffee are Preferred, But Fast Food and Convenience Stores are Catching Up

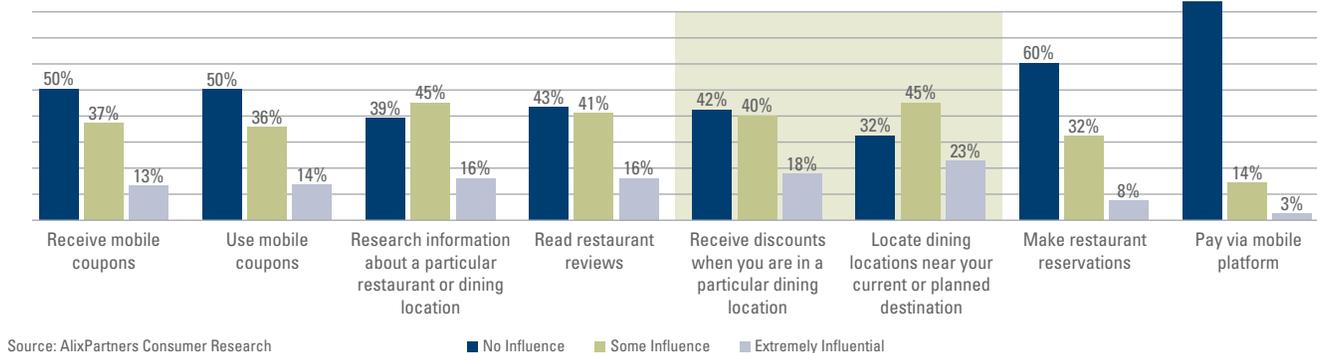


N=597
Source: AlixPartners Consumer Research

Seeking to ride the mobility wave, some operators are forging new alliances to extract greater business value from technology. To illustrate, a game-console maker collaborated with a quick-service restaurant to develop an application for ordering from the restaurant directly through the game console. The alliance generated \$1 million in sales during the first four months after the application was launched. Another quick-service operator announced a partnership with an automobile manufacturer to develop a hands-free ordering platform that would enable this quick-service restaurant’s customers to place orders directly from the manufacturer’s vehicles.

Figure 6: The Impact of Mobile Devices is Significant for Finding Locations and Obtaining Discounts; Company Websites are Gaining Traction

On a scale of 1-3 where 1 = no influence, 2 = some influence, and 3 = extremely influential, how influential are the following shopping-related mobile features on your dining decisions?



Source: AlixPartners Consumer Research

² <http://www.burgerbusiness.com/?p=16527>

Settling Up: Options for Operators

With the changing industry landscape comes an increase in the number of opinions about how best to navigate it. Shareholder activism is definitely a trend with significant momentum. In advance of such activities, we suggest operators follow a few steps on an ongoing basis.

- ▶ **Become and remain lean:** Benchmark costs and honestly gauge efficiency or overspending (profit and loss; leases; capital expenditure; selling, general, and administrative expenses bloat; etc.)
- ▶ **Regularly evaluate capital structure and support investments:**
 - Ruthlessly evaluate uses of cash
 - Examine landownership
- ▶ **Consider divestiture (multibrand or vertically integrated)**
- ▶ **Review investor relations and governance**

The economic trends that unfolded during 2013 suggest that things may begin looking up for the North American restaurant and foodservice industry. Consumer confidence and employment rates picked up, and many consumers say they believe the economy will remain steady at the very least and perhaps even improve during 2014. Equally encouraging, the overall risk of financial distress in the industry is lower than it's been in five years.

At the same time, competition for market share is heating up between traditional and nontraditional rivals, and operators are forging surprising partnerships—in forms including cobranding and licensing—in a bid to cook up new growth. Meanwhile, advertising budgets are ballooning, but the messaging is all over the map—ranging from a push toward limited-time offers to a steadfast commitment to everyday low pricing. And savvy use of technology is helping players in some segments to stand out in a crowded market.

We expect many of those trends to maintain or even gain momentum during 2014, which could present operators with valuable new opportunities—as well as obstacles. There will be winners and losers in every segment, and those that thrive will differentiate through innovation, value, and the overall guest experience. To succeed in this complex, challenging, and constantly changing industry landscape, restaurant and foodservice operators would do well to continue

demonstrating fiscal discipline, with a focus on getting and staying lean, ruthlessly evaluating uses of cash, maintaining an ideal capital structure, and divesting underperforming assets. While simple in concept, 2014 will prove challenging for many operators and on a number of fronts.

About Our Research

AlixPartners' 2014 Outlook was conducted in January 2014. It consisted of a survey of 1,000 adults in the United States, aged 18 years or older. The survey focused on (1) consumers' current and planned frequencies of dining occasions across the convenience store, restaurant, and ready-to-eat categories; (2) expected spending on meals outside the home; (3) preferred types of restaurants; and (4) key criteria for restaurant selection. We also asked participants for their opinions on selected topics, including health and wellness, marketing tactics, and innovation in restaurant and foodservice offerings.

Survey Demographics

GENDER	TOTAL
Male	484 49.70%
Female	516 50.30%
Total	1,000

MARITAL STATUS	TOTAL
Married/Widowed	52%
Single	27%
Living with partner	9%
Divorced/separated	13%

EMPLOYMENT STATUS	TOTAL
Work full-time	42%
Work part-time	9%
Self-employed	7%
Student	5%
Homemaker	8%
Retired	19%
Not currently employed	10%

INCOME	TOTAL
Less than \$35,000	30%
\$35,000–\$49,999	17%
\$50,000–\$74,999	23%
\$75,000–\$99,000	13%
\$100,000–\$149,999	12%
\$150,000+	6%
Mean	\$62,900

EDUCATION	TOTAL
HS graduate or less	39%
College incomplete	30%
College graduate+	31%

RACE	TOTAL
White only	79%
Black only	12%
Hispanic origin (not race)	11%

REGION	TOTAL
Northeast	19%
Midwest	21%
South	37%
West	22%

HOUSEHOLD SIZE	TOTAL
1	18%
2	42%
3	18%
4	15%
5+	7%

AGE	TOTAL
18–24	12%
25–34	18%
35–44	17%
45–54	20%
55–64	15%
65+	17%
Mean age	46.1

CHILDREN UNDER 18	TOTAL
Yes	25%
No	75%

FOR MORE INFORMATION, PLEASE CONTACT:

Eric Dzwonczyk

Managing Director
edzwonczyk@alixpartners.com
+1 (212) 845-4017

Adam Werner

Managing Director
awerner@alixpartners.com
+1 (312) 705-3911

Molly Harnishfeger

Director
mharnishfeger@alixpartners.com
+1 (212) 845-4036

ABOUT ALIXPARTNERS

AlixPartners is a leading global business advisory firm of results-oriented professionals who specialize in creating value and restoring performance at every stage of the business life cycle. We thrive on our ability to make a difference in high-impact situations and deliver sustainable, bottom-line results.

The firm's expertise covers a wide range of businesses and industries whether they are healthy, challenged, or distressed. Since 1981, we have taken a unique, small-team, action-oriented approach to helping corporate boards and management, law firms, investment banks, and investors respond to critical business issues. For more information, visit alixpartners.com.

AlixPartners. *When it really matters.*

This publication ("Publication") is the property of AlixPartners, LLP, and neither the publication nor any of its contents may be copied, used or distributed to any third party without the prior written consent of AlixPartners. The opinions expressed are those of the author(s) and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective other professionals or clients.

This Publication was prepared by AlixPartners, LLP ("AlixPartners") for general information and distribution on a strictly confidential and non-reliance basis. No one in possession of this Publication may rely on any portion of this Publication. This Publication may be based, in whole or in part, on projections or forecasts of future events. A forecast, by its nature, is speculative and includes estimates and assumptions which may prove to be wrong. Actual results may, and frequently do, differ from those projected or forecast. The information in this Publication reflects conditions and our views as of this date, all of which are subject to change. We undertake no obligation to update or provide any revisions to the Publication.



North America Boston / Chicago / Dallas / Detroit / Los Angeles / Nashville / New York / San Francisco / Washington, DC

EMEA Dubai / Düsseldorf / London / Milan / Munich / Paris

Asia Hong Kong / Seoul / Shanghai / Tokyo