RESTAURANTS TRY TO BALANCE PLATES PILED WITH DEBT

The restaurant industry is among the hardest hit by the effects of the pandemic.

While operators have spent the past six months tirelessly shifting business models to develop resilience while accommodating ever-changing protocols and consumer behaviors, for many, the demands of the current environment have proven too challenging to navigate a path forward. In fact, nearly one in six US restaurants has closed on a long-term or permanent basis thus far during the pandemic—an estimated 100,000 units[1]—and closures continue to gain pace across the nation. This closure rate outpaces other adjacent industry sectors of retail and home decor by nearly 50%.[2] Full-service operations, bars and nightlife, and establishments catering to breakfast and snack dayparts have been affected most severely. Segments that are better positioned for off-premise activity, such as pizza and coffee shops, have generally had more success riding out the disruption.

1. National Restaurant Association, September 14, 2020
2. Yelp: Local Economic Impact Report, September 2020

Many operators facing closure are succumbing to direct consequences of the crisis, including increased expenses related to health safety, capacity restrictions, and ongoing weakened consumer sentiment. These challenges have only been exacerbated by the debt load the sector had already taken on prior to the pandemic.

The growing debt, and the deterioration in operating performance required to service it, has forced a heightened level of investor and debt holder concern and oversight in an industry which, prior to COVID-19, was enjoying growth and foot traffic at near-historic levels.

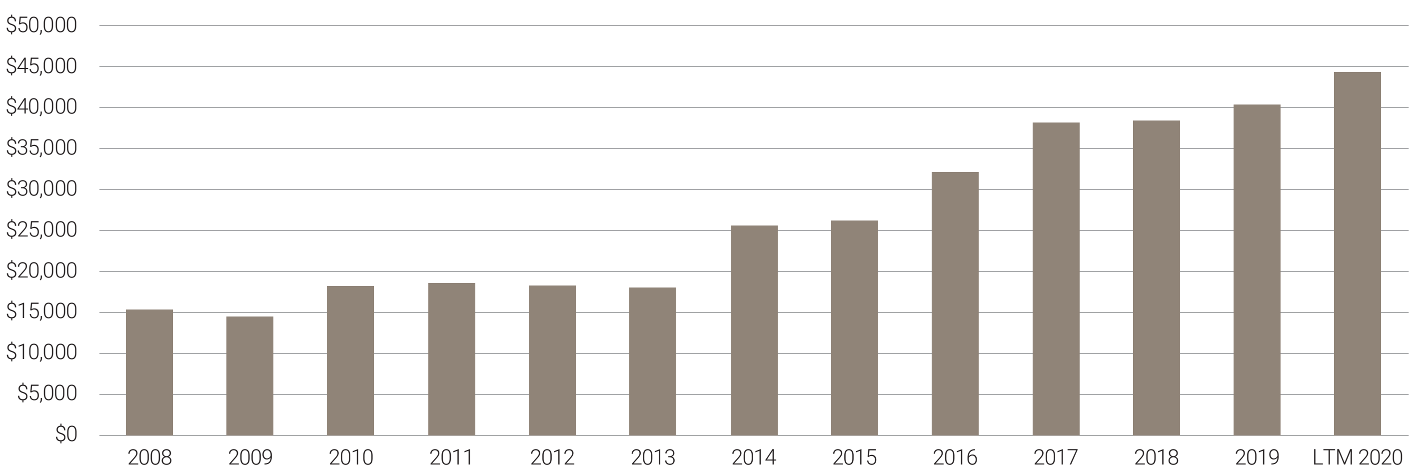
RISING DEBT LEVELS

Restaurant debt has more than doubled since the beginning of the Great Recession, with restaurant companies having taken advantage of continuously low interest rates of the past decade and levering up to fund expansion and drive shareholder returns. This represents a large shift from 10 years ago when the sector's debt levels were low in comparison with other industries. Because much of this increase is driven by McDonalds, it has been omitted from the following debt figures (figure 2).

FIGURE 1: NUMBER OF BUSINESSES CLOSED PER 1,000 BUSINESSES SINCE MARCH 1, 2020

Source: Yelp – Local Economic Impact Report, September 2020

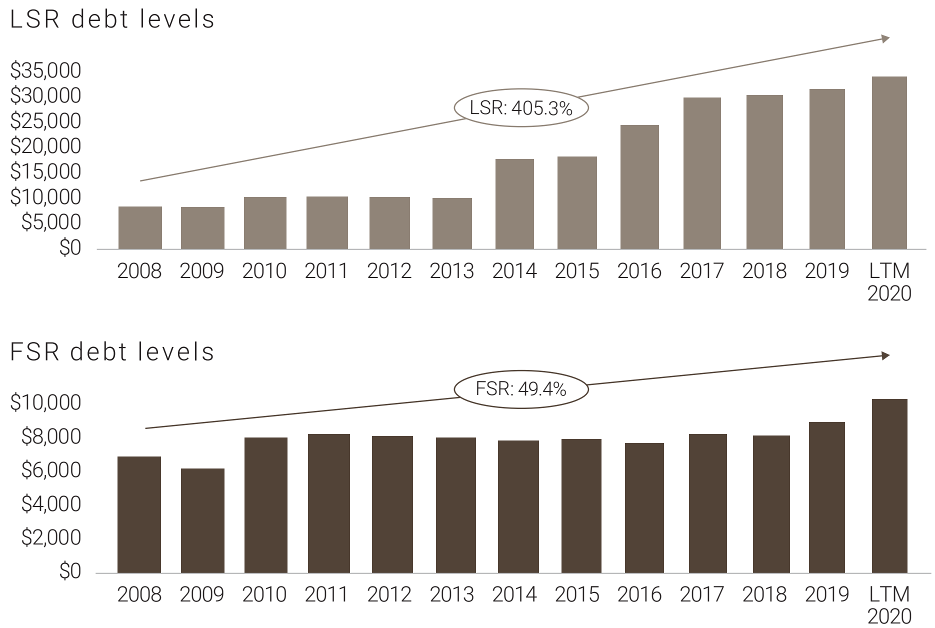
FIGURE 2: RESTAURANT INDUSTRY DEBT LEVELS (TOTAL INDUSTRY DEBT)



Note: in $ million
Source: CapitalIQ

The Limited Service Restaurant (LSR) segment nearly quadrupled its debt between 2008 and the end of 2019, while the Full Service Restaurant (FSR) group segment saw a less aggressive increase in its debt of nearly 30% (figure 3). As difficulty became imminent during the early days of the crisis in 2020 and belt-tightening measures began, many restaurants, LSR and FSR alike, proactively engaged in negotiations with lenders. The goal was to draw down on revolvers to maximize liquidity runways and avoid covenant violations, increasing debt between 2019 and last twelve months (LTM) 2020 by 8.1% and 15.7% for LSRs and FSRs, respectively (figure 3). The LSR segment now sits at more than four times as much debt, while the FSR segment is at nearly 50% more debt than at the start of the Great Recession.

FIGURE 3: FSR AND LSR DEBT LEVELS (TOTAL SEGMENT DEBT)

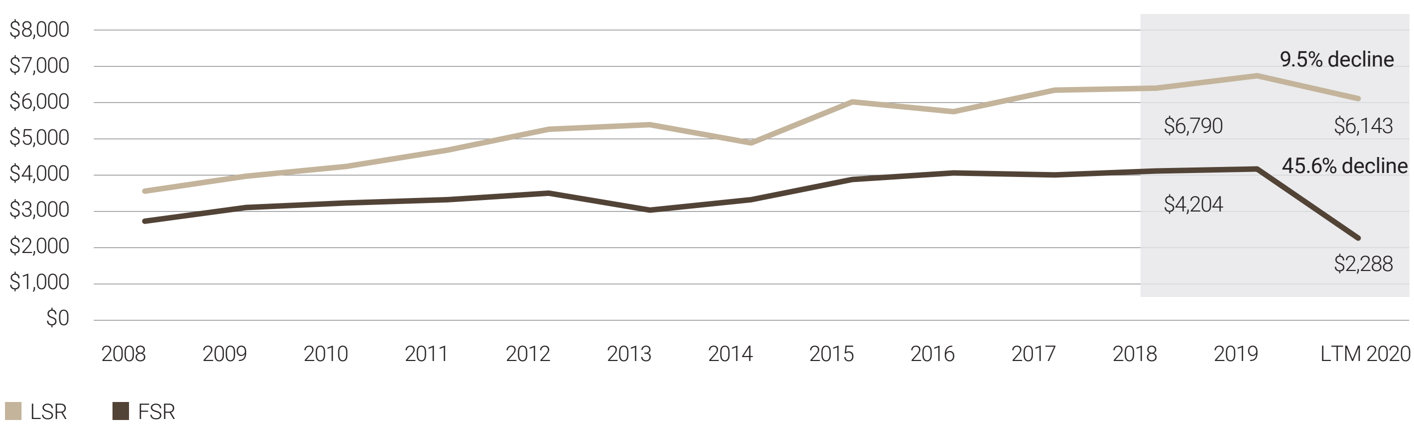


Note: in $ million
Source: CapitalIQ

DECLINING EBITDA LEVELS

While the sharp increase in debt in the LSR segment is noteworthy, the LSR model has proven more adaptable to pandemic conditions, with EBITDA down only 9.5% from 2019 to LTM June 30, 2020. The FSR segment, however, has seen a massive 45.6% decline in the same time period (figure 4). During Q2 2020 alone, the first full quarter of the COVID-19 pandemic, 41% of all restaurants reported negative EBITDA and 45% reported negative levered free cashflow.

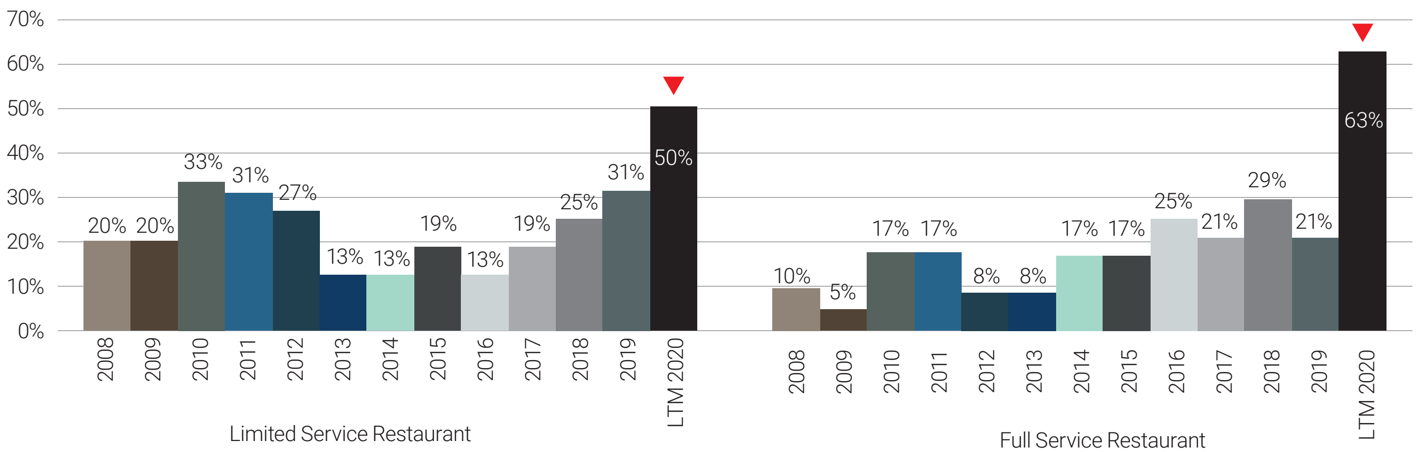
FIGURE 4: SEGMENT-LEVEL EBITDA



Note: in $ million
Source: CapitalIQ

With the fate of indoor dining uncertain across the country as the colder months approach, restaurants will likely find it extremely challenging to service debt obligations in the absence of concessions and amendments. Coupled with increased debt levels, these steep EBITDA declines have resulted in high leverage levels or negative EBITDA at over 60% of the FSRs (figure 5). Should the year progress as it has thus far, that figure could grow to over 80% by 2021. Additionally, the prevailing franchise structure of the industry may prove particularly cumbersome, with many individual franchisees having taken on high debt loads of their own. Given many parent companies may be tied by whole-business securitizations, their ability to provide direct relief to individual franchisees in terms of reduced royalty payments, etc., may be significantly limited.

FIGURE 5: PERCENTAGE OF DISTRESSED BUSINESSES



Source: CapitalIQ; AlixPartners analysis

At such unprecedented stress levels, restaurants have limited options in their paths forward. While rent abatements and Paycheck Protection Program loans provided restaurants with some short-term support, incremental aid has yet to be approved. In order to continue to service their existing debt and to prevent the need for additional financing, restaurants—especially in the FSR segment—are in dire need of a significant turnaround in operating performance, the foundation of which would be a strong consumer return to restaurants. In the absence of this, restaurants may be forced to contemplate a series of debt restructurings in the coming months and years.

And even if restaurants are successfully able to recast their business models to accommodate pandemic-driven shifts in consumer behavior, it is possible that the financial performance of their newfound operating structures may simply not be enough to overcome elevated debt levels. In this difficult scenario, restaurants must preempt long-term challenges in being able to continue servicing their debt obligations. Options include getting creative during negotiations in order to realign debt levels to the new operating structure.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.