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CAPITAL THINKING: Restaurant Industry Trends in the COVID-19 Pandemic

Q&A: Sarah Gill Campbell

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While COVID-19 has spared few sectors, the restaurant industry – an often low-margin business under the best of circumstances – has been among those hardest hit. Sarah Campbell, head of Stephens Investment Banking's Restaurant Practice, explains what COVID-19 has meant for the industry.

Q: You work with businesses ranging from fast food and quick service to fine dining. What are the unique challenges they have faced?

A: The rules and regulations businesses had to contend with starting in March 2020, particularly with respect to in-person dining capacity restrictions and safety measures, were industry-wide and frequently changing in response to the situation at a given time and in a given place. Many restaurants went from no masks and full-guest capacity, to suddenly closing down, to reopening with mask and social distancing rules, to allowing vaccinated guests without masks. That's challenging to implement, both on an operational and corporate level, especially for chains. It's only been since June 2021 that the last states re-opened to allow in-person dining.

But restaurant operators are resilient and change is something they deal with every day. Even before COVID, they have always had to navigate changing customer preferences along with trends in the larger consumer space, and tremendous competition. Movements in health and wellness that have become so important in many industries over the last decade, such as sustainability and farm-to-table, have been important themes that restaurants had to incorporate into their menus and operations.

Q: How has COVID challenged or changed that inherent resiliency?

A: Facing dramatic uncertainty in March 2020, restaurants closed dining rooms, furloughed employees, took management pay cuts and looked for relief from landlords and suppliers across the board. According to the National Restaurant Association, it was not until May 2021 that the industry saw sales in excess of pre-pandemic levels – 15 months after the start of COVID-related restrictions.

In May, a survey by the National Restaurant Association found that 90,000 eateries in the U.S. would remain closed permanently due to the pandemic. That's approximately 14% of the country's eateries. While that figure is lower than the one-third of permanent closures that some experts were predicting in May 2020, it still accounts for hundreds of thousands of lost jobs. The restaurant industry is the second largest private employer in the country. According to the Bureau of Labor Statistics, as of June 2021, despite six consecutive months of staffing growth, eating and drinking places were still nearly 1.3 million jobs – or 10% – below pre-pandemic employment levels.

Certain concepts have shown resilience in their ability to navigate through the pandemic and back to more normal operations. These include ones that swiftly adjusted operations to accommodate changing regulations and consumer patterns, took advantage of various government initiatives and other opportunities, to keep their businesses afloat during very challenging times. In May of this year, the U.S. Small Business Association began distributing economic relief through the $28.6 billion Restaurant Revitalization Fund. And restaurant operators

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could participate last year in the Paycheck Protection Program (PPP) for loan forgiveness. However both of those initiatives have faced an assortment of hurdles in getting payments to employers.

As in prior recessions, there have always been nimble and adaptable restaurants and restaurateurs, as well as the less nimble and adaptable. Those that succeed are good communicators and have been proactive with their employees and stakeholders. These traits enable them to navigate a lack of clarity.

Q: Has the landscape for capital raising and M&A shifted due to these challenges?

A: After the COVID shutdowns in March, restaurant M&A slowed down dramatically. We saw a number of public companies execute public and private capital raises, and brands drew down on their credit facilities to bolster cash reserves in the face of substantial uncertainty. Several companies that were in market pulled their sale processes in light of declining performance. Dozens of bankruptcies occurred in 2020 for privately held, private-equity backed and public companies, including such well-known brands as Ruby Tuesdays, Chuck E. Cheese and California Pizza Kitchen, many of which sold through the bankruptcy process.

As the sector began to reopen, buyers purchased several scaled quick service restaurant brands that performed very well through the pandemic. Brands such as Tropical Smoothie and Dunkin Brands successfully completed deals with private equity investors in 2020. Fewer deals occurred for brands in the full service and fast casual segments. While private equity is still active in the sector, the bar is quite high for potential acquisitions. It remains uncertain whether strong sales rebounds are due to temporary COVID tailwinds on pent-up customer demand, or due to strong restaurant operations.

While M&A has not recovered completely, additional investors have entered the space, such as SPACs and several new investor funds. For example, Mercato Partners launched The Savory Restaurant Fund, which raised $100 million in May. SPAC deals include BurgerFi International going public through a merger with OPES.

Q: What might be an example of restaurants being nimble?

A: The most successful restaurants quickly evaluated every part of their business – menu, technology, third party delivery, operations, etc. – to determine where to make changes that could continue driving traffic and customers in an environment with closed dining rooms and social distancing required in the back of the house. They faced some unique challenges.

For many concepts, it was much harder – if not impossible – to accomplish that while also requiring social distancing in an environment that usually has people shoulder-to-shoulder working on a kitchen line. They have had to navigate many operational changes that customers rarely see. In part, that's why many restaurants started producing more limited menus.

For others, the rapid roll out of technology solutions and third party delivery options were critical to their survival. Many brands had been focused on implementing digital menu boards, online ordering and third-party delivery over the next several years, but most accelerated those strategies as it became a clear requirement for survival with closed dining rooms.

Q: Are there any other traits or features that have benefited certain kinds of restaurants?

A: Restaurants with a drive-through were in a natural position to accommodate social distancing and customers preferring off-premise consumption. Quick service and limited service concepts, in general, did well during the pandemic because they already had drive-through and off-premise options. They are also at a more value-focused price point that has always been more recession-resistant in an environment where customers need to save more money.

Meanwhile the higher-end players of the industry often had to implement features like delivery, online ordering or third-party delivery – all of which were new features for many of them. Communicating these options to customers, while preserving the high-end experience, was challenging. Ordering delivery for an expensive meal from a fine dining establishment, and sometimes even following at-home preparation instructions for that meal, is a quite different experience than dining inside a high-end restaurant.

Q: To what extent have margins been a factor for restaurants amid the pandemic?

A: Prime costs for restaurants include food ingredients and labor. The cost of beef at a fast-casual restaurant can be much less than the cost of beef at a fine-dining establishment because they buy different qualities and cuts of meat. Higher-end restaurants also tend to have higher labor costs, because they require more workers. In addition to the back of the house, they have hosts, wait staff, and bussers.

Yet margins are relatively slim across the industry, with 15% to 20% store-level margins considered high. That can create challenges if revenues fall by 50% or more, which has occurred for many establishments since March 2020. While we have started to see dramatic improvements in revenue for some brands, many still are not yet back to 2019 sales levels and margins remain depressed.

Q: How have other parts of the restaurant ecosystem been affected?

A: The supplier side initially struggled because many distributors specialized in either restaurants and foodservice, or grocery and mass channels. Early on in the pandemic, significant creativity emerged behind the scenes. Restaurant suppliers started working with grocery suppliers to contract out workers and help offset the labor differential in the two silos, where the restaurant channel had dramatically reduced demand and the grocery channel had dramatically increased demand.

But one of the most important uncertainties remains real estate. Paying rent has been a major challenge for restaurant owners with multiple locations and revenues continuing to be down 30% to 50% in many locations. In some instances, a chain reaction can occur for landlords with various commercial tenants – such as brick-and-mortar retailers of all kinds struggling to pay their rents. The landlord's ability to pay the principal and interest on the property loan then comes into question. In this way, the condition of the restaurant industry connects to other sectors.

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