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INDEPENDENT RESTAURANTS ON A BUMPY ROAD

For the past several years, independent restaurants have enjoyed considerable and hard-earned success and gained share. Many factors contributed to their growth: creativity, clever marketing, favorable economic conditions, customer engagement, generally stable food costs, available capital, early and effective adoption of third party delivery platforms and social media, and secular declines in selected chain segments (most notably casual dining). As a consequence, independents, especially Local Leverage Operators (LLOs in major metro markets), have become even more desirable targets for suppliers. As we know, their desirability is significantly enhanced by their brand loyalty and profitability.

The dynamism and high profile of the independent restaurant business led to a significant growth surge and extensive media coverage. There were and continue to be a vast number of new openings, many of which were very expensive to build and operate. Consumers are benefiting by a seemingly ever-increasing variety of attractive dining options at all price points.

During 2017 (particularly the latter half of the year), we have witnessed a raft of well-publicized closures of respected, established and seemingly successful restaurants. In Chicago, Grace, Tru and 42 Grams (all have two or more Michelin stars) closed as did a host of famous New York City restaurants like Le Cirque, Schiller's Liquor Bar and Carnegie Deli. Celebrity chefs like Marcus Samuelson, Roy Choi, Gordon Ramsay, David Chang, Richard Sandoval, Daniel Boulod, Guy Fieri and Bobby Flay (among others) announced closures. The pattern appears to be nation-wide. **The independent restaurant market is clearly facing some "tough times"**.

What are the underlying causes?

To varying degrees, independents are facing a confluence of adverse factors, the collective magnitude of which is onerous. While disputes among owners and lack of succession are a "constant," current contributing causes are, in no particular order:

Skyrocketing rents and property taxes

- Anecdotally we are hearing reports of up to 500% increases, which even the most successful operator cannot absorb. Property owners have the "upper hand" in most major markets and, by almost all accounts, attractive deals are much harder to find. The pendulum will swing back at some point but high occupancy costs in desirable locations will continue to be a bane for independents for the next several years.

Rapidly rising labor costs due to labor shortages and legislated wage increases

- The shortages are for both skilled and semi-skilled labor and the construction "boomlet" occasioned by the last summer's hurricanes is reallocating labor away from restaurants. The labor situation will be a major headwind for the industry.

Too many restaurants, especially in light of very modest increases in consumer demand

- A successful restaurant owner told the three of us: "Five years ago I was the only restaurant on the block. Now there are six, and each of them spent $3 – 5 million to open. It makes it really hard to keep my customers coming back."
- Chain closures notwithstanding, for every failed concept-location, two more starry-eyed franchisees of the "next big thing" are ready to move in.

Too many "me too" concepts

- Like other consumer businesses, many restaurant operators tend to follow trends (both menu and décor trends) rather than create them. Think, for example, how many ramen shops or gourmet taco stands or "beer centric" establishments have opened in the past several years. Or how many places use reclaimed materials as a central design feature.

Imbalanced media attention

- Coverage of the restaurant business is extensive and arguably greater than ever. However, the "spotlight" is (perhaps understandably) very heavily skewed toward new openings (and closings). This skew tends to favor the "new kids on the block" (somewhat) at the expense of the "tried and true" operators.

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Inadequate, and, commonly, negative return on investment.

- Operators are making multi-million dollar investments in décor, equipment, and facilities in an effort to appeal to consumers. Given market conditions and the vagaries of the business, the capital costs often prove to be a "back breaker."

Celebrity chefs and restaurant groups spread too thin

- A celebrity chef may lend his/her name to a restaurant concept and provide recipes but is often not a regular part of the ongoing operation. This can lead to heightened expectations of the consumer and poor execution by the operator. Celebrity chefs may also have multiple restaurants or concepts in major markets like New York City, Las Vegas and Miami, but are unable to provide the oversight necessary to deliver the expected dining experience thus leading to consumer disappointment, a predicable decline in sales and an inevitable closure. In a related vein, popular restaurant groups have recently been in an expansion mode, with some putting extensive focus on new openings to the detriment of existing restaurants.

Chain restaurant competition

- While Pentallect sees many chain operators and segments to be stagnant or declining, we do note and commend the improved effectiveness of selected chains (most notably but not exclusively McDonald's). When a Chick-fil-A opens somewhere in America every 2-3 days, who cedes the $80k per week it suddenly achieves? The chain "winners" have enviable strengths and pose a real hurdle to independent restaurants.

Nontraditional channel expansion

- As we have discussed previously, consumer's food choices are proliferating and they are increasingly taking advantage of options such as meal kits, limited assortment stores, food trucks and the like at the expense of traditional restaurants.

The independent restaurant business is still well-positioned to meet the evolving demands of consumers, especially large independents in prime urban locations. However, **we appear to be entering a correction period that will likely last for the foreseeable future**. Paradoxically, new restaurants will continue to open at a breakneck pace but the turnover rate will accelerate, meaning the job of pursuing, selecting, and winning with trading partners becomes more complex than ever. Industry participants are urged to recalibrate expectations when and where appropriate.