Restaurant Growth and the Dangers of Lipstick

It's a familiar story in the restaurant industry: concepts that in only a few years go from "fastest growing" industry darlings to the poster children of the industry's troubles. Some concepts, like Chipotle, have avoided this cycle, but they are the exception to the rule. It's not always even a question of scale: Starbucks, Krispy Kreme, McDonald's and Boston Market each have closed hundreds of restaurants in the past ten years and retrenched or refreshed in other ways, too. While some of these companies have recovered better than others, the financial and brand damage from growing too fast is often immense. Nevertheless, as IAP looks around the industry today, we see many fast-growing concepts and think to ourselves, "This could get ugly."

Successful restaurant businesses are started and run by confident optimists. As a concept gains momentum, there's a natural tendency to push the envelope of growth. However, this isn't only about optimism, it's also about economics. The economics of unit expansion are clear, and it's easy to make the financial models look attractive. All other things being equal, if you have a store or restaurant that makes money at the unit level, you create significant value by replicating it. Better yet, it turns out that the economics of the original business typically improve as scale grows. Unit growth brings more leverage with your suppliers, decreased distribution costs, more reach with advertising along with increased consumer awareness. Even better, once you have all of those locations, it makes it more difficult for competitors to enter as you have first-mover advantage. And fast growth makes you attractive to investors, suppliers, franchisees, employees and customers. That's the theory, and any financial model will confirm it. But how does it work in the real world?

Unfortunately, growing quickly is harder than it looks, and it can be difficult to distinguish solid plans for prudent growth from reckless dreams of unsustainable expansion until substantial damage is already done. And once mistakes are identified, they're not easily fixed, because you're either locked into a bad long-term relationship or you've made a poor first impression with customers in a very competitive marketplace.

Each case differs, but we do see patterns among the wreckage of past failed expansions. Mistakes generally fall into three categories: making bad real estate decisions; opening restaurants with poor store level management (franchisees or

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managers); or outrunning the supply chain. Let's look at these in detail.

Would you like some Negative Synergy with that?

Location, location, location. It seems simple enough… avoid making bad real estate selections. Nevertheless, we see this happen regularly: not enough traffic during the right daypart; poor visibility; bad access; inadequate capacity to ever make money; etc. And once a bad location causes you to miss the sales projections that the unit economics require, it becomes a hole that is virtually impossible to escape, ultimately consuming an unhealthy amount of valuable management time and attention. The pressure to hit a plan, the inverse relationship between quality and cost of real estate, uncertainty around other nearby new development, and lack of understanding how a new concept will perform in new types of locations – all these factors must be juggled to get the real estate right. Once you have the right real estate, you then need to operate the restaurant well and that requires good store level management. But without the right real estate, it's hard for good management talent or even a great concept to overcome.

Store Level Management. Restaurant concepts grow in stages that are primarily defined by span of management control. A founder gets one restaurant to work and then develops systems that enable the oversight of a handful of restaurants and managers; then the pyramid continues to grow. But the process is not purely additive: each quantity can have different qualities. In other words, at each level of the pyramid, a concept faces new challenges as it tries to maintain the key to success in the restaurant business: consistent, high-quality execution. That execution is provided by capable, motivated restaurant managers and/or franchisees. Growth failures come when you either have a restaurant manager (who is typically pulled from an existing store) who "isn't ready" or when the franchisee isn't suited to the restaurant business. Inadequate restaurant management causes poor execution, especially during the challenges of the crucial opening phase of a restaurant. Predictably, the consumer experience suffers, and once that happens it's difficult to win people back. As the old adage says, you only get one chance to make a first impression.

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Supply Chain. You may remember the scene from the movie "Patton" when the tanks run out of gas. Patton's army had outrun its supply chain, and the same thing can happen to restaurants. What do we mean? As concepts grow they need to make sure their suppliers can keep up with that growth in a cost effective way, especially when it's time to expand to new markets. Existing suppliers may have difficulty adequately servicing distant markets, decreased route density might escalate distribution costs, or the chain may need to establish new supplier relationships, which isn't always smooth or easy. The supplier that met the needs of, and was willing to be very helpful to, a small fast-growing chain may not be able to keep pace as growth accelerates. The consumer at the new outlet is usually the first to spot the decrease in quality. New management is often distracted by their increased responsibility, and new employees generally aren't that familiar with the concept's standards.

When we talk with restaurant operators and investors, they're all aware of these potential pitfalls in the abstract. But many seem either a bit fatalistic, consider these issues to be mere "growing pains," or they're overly optimistic and assume a quick tactical fix. We know that these issues are prevented at the outset, as it is costly and difficult or sometimes impossible, to get out of such holes after you've recognized you're in one. We've also watched operators and investors go from "ditch to ditch" with solutions that only create new problems while continuing to bleed cash. And so history seems to repeat itself.

As we noted earlier, there is inevitable pressure to significantly push the growth envelope, and it's exciting to project and measure restaurant openings and sales growth. However, it's not quite so easy to detect growth problems early, before mistakes have done their damage. Once trouble starts, getting to its root cause can be tough, even harder when problems start to interact ("Would you like some Negative Synergy with that?"). For example, are below-target sales due to location or poor restaurant management? Is the new market opening low because it is taking longer than expected to establish the brand or because food from the new suppliers is slightly different? Or is the location great for our customers but horrible for our suppliers? It's best not have to disentangle such wicked problems in the first place, which is why rigor, realism and proper planning about growth at the front end is the key to success.

In sum, ensuring the growth of a restaurant chain is another example where an ounce of prevention is worth more than a pound of cure. Prevention starts with rigorous planning and securing adequate resources, including capital resources. Unrealistic unit growth expectations can probably be met, but they will be met with sub-optimal openings. Then the problems really start to build, and people break out the lipstick for each porker

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of a problem: restaurant margins get artificially inflated by not carrying enough staff; projected returns on equity are hazardously exaggerated by not raising enough capital, etc. But as we all know, the one group who won't be fooled by a pig in lipstick is customers.

Contact IAP to discuss what cosmetics-free growth might look like for your concept.

Insight Advisory Partners advises companies in the food industry across all aspects of corporate and financial strategy including strategic growth initiatives, capital raising strategies, acquisitions and divestitures, retained search, due diligence, pre-and post-merger integration, turnarounds and financial restructurings.

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