Since the end of the Great Recession, there has been a resurgence of activity in the restaurant industry. As consumers’ wallets recovered, the need for frugality lessened and food consumption outside the home increased. In fact, more than half of all money being spent on food in the U.S. today is being spent at restaurants.¹ What’s more is that this shift has been accelerating: over the last decade, restaurant spending has grown twice as fast as all other retail spending.²

These conditions have attracted a large number of entrants to the industry, and the number of restaurant concepts and locations has grown dramatically. As a result, industry competition is at an all-time high, and M&A players in the industry—such as large restaurant groups and private equity firms—are seeking the right deals to grow, diversify or otherwise capitalize on the current market opportunities. To be successful in this market, potential buyers and sellers should be aware of three key trends.

VALUATIONS ARE HIGH

Across the industry, M&A valuations have been notably high in 2017. “Average restaurant valuations are in the range of 8 – 12x EBITDA and some recent transactions have been even higher,” says David Dunstan, President of Western Reserve Partners, a division of Citizens Capital Markets. For example, JAB Holding Company—which owns Krispy Kreme and Peet’s Coffee—acquired Panera Bread this year for a multiple of 18.3x trailing 12-month EBITDA.³

As we head into 2018, M&A activity in the restaurant industry is expected to remain high, as are company valuations. Therefore, one of the most important attributes that every buyer or seller must explore is the ability of the restaurant to demonstrate growth potential via a replicable and profitable four-wall economic model. Ultimately, this is the key factor in determining investor interest and valuation multiples.

Furthermore, there are several economic thresholds that, in general, demonstrate a healthy business model and are indicative of an attractive M&A opportunity:

- Cost of Goods Sold: <30% of revenue
- Direct Labor Costs: <30% of revenue
- Total Prime Costs (sum of COGS and Labor): <60% of revenue
- Cash-on-Cash Return (Year 3): 25%+

LARGE BRANDS ARE INCREASING THEIR BREADTH

In this hyper-competitive market, large publicly-traded and sponsor-backed restaurant groups are aggressively looking to acquisitions to drive diversification of their brand portfolios while also demonstrating topline growth and margin expansion to their investors.

For example, Darden Restaurant Group—the parent company of full-service chains such as Olive Garden, Red Lobster and Longhorn Steakhouse—acquired Cheddar’s Scratch Kitchen for $780 million to realize such benefits. In its press release, Darden...
highlighted portfolio diversification and growth opportunities in new and existing markets as top reasons for the deal. These types of acquisitions can also serve to create economies of scale. Common benefits realized include cost reductions in food and beverage, logistics, marketing and real estate. Additionally, reductions in duplicative personnel – particularly back-office and administrative positions – can further enhance profitability and improve margins.

**SMALLER BRANDS ARE ACTIVE PLAYERS**

Like their larger counterparts, smaller restaurant and foodservice concepts are also considering acquisitions to achieve similar business efficiencies and compete with larger industry players or segment powerhouses. As a result, most acquisitions by smaller brands are typically within their own market segments.

For instance, last year, the fast-casual pizza concept Pieology Pizzeria acquired a top competitor – Project Pie. In explaining the rationale for the acquisition, Pieology CEO and founder Michael Nolan stated, “I have long said that consolidation was the future for the fast-casual pizza segment. The Project Pie purchase provides us with an opportunity to strategically accelerate our growth. Now we have both the experience and the strategic and financial support to begin merging the category in a calculated manner.”

For those not pursuing acquisitions, the high level of M&A interest in the restaurant industry presents a unique opportunity for smaller brands to monetize their concepts in the early stages of their lifecycles. However, in order to get noticed and receive a high valuation, they must demonstrate a well-performing unit model, in addition to compelling economics and a strong overall return on investment. In the end, there is a lot of interest in concepts with strong unit economics, but that interest is coupled with cautiousness since potential buyers understand the high level of industry competition and recognize that few of these small concepts will grow to become the next Shake Shack.

Despite the hyper-competitive environment and rising labor and benefits costs, restaurants remain a sector of interest among strategic and private equity investors. However, the high level of competition means investment decisions are founded on strong performance metrics and a concept’s ability to demonstrate a replicable four-wall model with a team that has the capability to grow the business. Ultimately, businesses that can demonstrate those characteristics will attract both strategic and financial investors at premium valuations.