

## OUTLOOK

**Taking the Risk Out of Growth**

I've talked more people out of going into the restaurant business than going in, which is odd for someone who pens a restaurant finance newsletter and produces a restaurant finance conference.

Years ago, I wrote if you took McDonald's out of the equation, and added up all the operating income made in all types of restaurants since the beginning of time and netted out all of the capital expenditures on failed restaurants and equipment redeemed at 10 cents on the dollar over the same time frame, the restaurant industry's returns were negative.

I once told the late, great hockey coach, Herb Brooks, not to open a sports bar, but instead, keep giving speeches for \$20,000 a pop and be remembered as the architect of the Miracle on Ice team, not a local bar-and-grill owner.

At a franchise convention, I told a fireman who owned three mac-and-cheese restaurants not to franchise, because I thought it would be best for his wife and kids if he didn't risk his pension trying to expand a concept that I had a gut feeling would never travel. He told me I was the only one at the convention who gave him that advice.

I once told a franchisee of a large QSR brand he was frittering away his capital building new restaurants in a state where it cost \$1.5 million to build and he was lucky to generate \$1.0 million in sales. Are you familiar with the sales-to-investment ratio? I asked him.

I was the CFO of a marginal franchise business in the '80s, and in 1989 I launched a newsletter and conference on restaurant finance. Here is what I learned through the years: For every Chipotle or Wingstop, there are hundreds of D'Lites, Boston Chickens, Naugles, G.D. Ritzly's, jock bars, mac-and-cheese concepts and too many poorly executed franchises to name that gobble up capital and are often business killers.

Growth for growth's sake is what gets so many restaurant owners in trouble. The American culture celebrates risk and I get it. Gates, Bezos, Musk, et al. But, restaurants are a different breed.

Building new is ingrained in the psyche of every restaurant owner and CEO, even when it's a bad idea. I coined the phrase "unit envy" many years ago to describe the hubris restaurant owners exhibit when they brag about how many units they own or how many stores they are going to build in the next year.

There's also a belief a buyer will always pay a higher multiple on a company that's growing than one that is stagnant. Possibly, but that doesn't apply to every brand, especially ones with sales and margin problems. Look, everyone wants to be the next Chipotle, they're building 200 stores a year and they trade at 40x earnings. But they have \$1.5 billion in cash in the bank and their store-level margin is 27%. They should be building 300 stores a year with those numbers. The risk to Chipotle of occasionally opening a stinker is minute.

Wall Street and public company CEOs like to throw out TAM (total addressable market) numbers that pump up the number of potential stores, but are unlikely to ever be attained. The "pedal-to-metal" growth philosophy must be tempered with reality. Growth at all costs leads to too many marginal stores. Rents and construction costs are high and the new stores are staffed with employees their restaurant neighbors were glad to get rid of.

Daniel Kahneman, a psychologist and economist who studies behavioral bias in investing, says a "reliable way of making people believe in falsehoods is frequent repetition, because familiarity is not easily distinguished from truth." The industry's obsession with building new stores no matter what is one of those falsehoods.

What I witness every year are too many owners and operators building stores by adding leverage, selling off their real estate and leasing it back, and now within the last two years, paying higher rates of interest. Chasing the dream, especially with today's hurdle rates, is likely to become a bad dream, when a better alternative would be to improve the performance in your existing stores. Once those stores are modernized and are kicking out so much cash the banks want to lend you more, then think about building new ones. Not before.

—John Hamburger

### Phelps Leads East West Bank Franchise Finance Efforts

“One of the unique things about the bank is when we find an opportunity because of the banker, we will look at those industries,” said **Mike Burr**, senior managing director with **East West Bank**. “One of the opportunities we found is with Ken.”

**Ken Phelps** joined East West Bank over a year ago as senior relationship manager/FVP to lead their franchise finance effort there. East West is a large regional bank headquartered in Pasadena, Calif. with assets of \$67 billion. “East West is the 23rd largest bank in the U.S. by asset size,” Burr reported, but are often thought to be owned “by an Asian conglomerate” because of their name. While they have licenses there, they mainly operate in the U.S.

East West approached Phelps to help them open an office in the Southeast, as he is based in Atlanta. “I told them of my interest in restaurants,” Phelps said.

“Once we got to know Ken, we knew we would want to start the process of leaning in (on franchise finance). As Ken becomes even more successful, we will become more important in that vertical,” said Burr.

Phelps has experience in the franchise finance sector, getting his start in the space with Wells Fargo Restaurant Finance. From there, he moved in 2018 to the restaurant group at Regions Bank, which closed down after Covid hit. He stayed there, “managing down some of the relationships, as well as managing the relationships they wanted to stay in,” he explained. He had finally moved to their general corporate and commercial lending group when East West came calling.

For their franchise finance efforts, East West Bank is not as focused on the brands themselves, “we are more focused on the (strength of the) restaurant owner,” said Phelps, “but the brands need to be strong, too. We can also lend to operating companies in the small to mid-range size. A lot of other lenders have gotten out of that space.”

Their deal size ranges from \$10 million to \$40 million, to fund term loans, acquisitions, and development lines of credit, to name a few. They will participate in club deals and syndications, as well.

With syndications recently becoming harder to pull together as the participating banks are in need of some share of borrower deposits, “that hurt a lot of our competitors,” said Burr. “They can try to get more deposits, or stop lending.” East West’s demand for a bigger share of deposits isn’t as great as those of some of the other banks in the space.

“Our activity is up right now,” Phelps said, “and we are seeing opportunity to win some business while other lenders are pencils down.”

Burr said it all comes down to the people. “You hire really talented people with experience in the vertical and empower them to build a business,” he said. “Let them form the box based on their own experiences.”

Phelp’s experience, he said of his own career, “is that there have been great people to work with in the space. At heart, I’m a lifer.”

For more information, contact him at (470) 898-7984, or at [ken.phelps@eastwestbank.com](mailto:ken.phelps@eastwestbank.com).

### Unbridled Provides Sell-Side Advisory to BK Franchisee

Boutique investment banking firm **Unbridled Capital** recently provided sell-side advisory to **New King**, led by **John Muirhead**, on the sale of seven Burger King restaurants in the Northeast to **Burger Barn**, an existing franchisee led by **Bonnie Hemrajani**.

With new Burger King management at the franchisor level, led by CEO Patrick Doyle, it seems “they are trying to right the ship,” said **Rick Ormsby**, managing director with Unbridled. “There are a lot of distressed locations out there.”

Even so, this wasn’t the case with these units, he said. “This in particular was a killer business. The units averaged \$2 million in sales per year, which is well above the industry average.”

Ormsby reported they had a number of offers for the locations, “at decent prices. There is still a fairly strong market for well-run Burger King businesses. It was great to see the buyer, a smaller and newer franchisee, acquire the market.”

It’s been his contention that there’s an emerging trend of strategic buyers tapping into the market; a market that previously might have been unavailable to them when private equity, family offices and other institutional buyers were strongly competing for franchised restaurant locations.

“These franchisees want to be in the markets and see the stores,” he explained. “They want to know their employees, visit them. They want to be hands on in these locations.”

Another component to this, he said, is that “the Burger King M&A market can be fluid if the right opportunity with the right AUVs exist. Burger King, the new management and initiatives, seems to be having a better year, and things seem to be on the rebound. A healthy BK business is an attractive asset.”

For more information, contact him at 502-338-0162, or at [rick@unbridledcapital.com](mailto:rick@unbridledcapital.com).

### Amegy Bank Leads Syndication for Popeye's Franchisee

**Amegy Bank** recently led a bank syndication on a recapitalization for **Lakhany Holdings, LLC**, the propco for the regional Popeyes and Tim Horton's franchisee **CSM Group**, which owns several restaurants in Texas, Kansas and Missouri. **Hancock Whitney Bank** participated in the syndication. The amount was not disclosed.

"CSM is a well-known Popeye's operator in the Texas market," said **Terry Morales**, executive VP for Amegy Bank. "The Lakhany brothers are top operators—strong operationally—and they are also known in the finance community."

It helps that Popeye's is a strong brand, "and they have a proven track record, with strong support in the state," she added. "In fact, they are a favorite brand all over the South."

She also tipped her hat to Hancock Whitney regarding the transaction. "It was a good partnership with both them and CSM. Everybody worked together to get it done quickly and efficiently."

Morales said Amegy, based in Texas with approximately \$13 billion in assets, is actively financing in the restaurant space "with top operators and concepts, even though it is definitely challenging times right now." For more information, contact Terry Morales at (713) 705-6190, or at [teresa.morales@amegybank.com](mailto:teresa.morales@amegybank.com).

### Auspex Capital Closes Large Wendy's Transaction

Financial advisory firm **Auspex Capital** recently provided sell-side M&A and debt placement advisory to **CKA Management**, owned by **Joe Cugine** and **Keith Kas**. Quick-service industry veterans with significant experience in the Wendy's system, they have completed a buyout of their long-time partner, **John Antonaccio**.

The transaction involved seven separate entities holding 63 high-volume Wendy's restaurants in New York, New Jersey, Connecticut and Pennsylvania. The deal was structured as a membership interest purchase to assist both buyer and seller in maximizing the tax benefit from the proposed transaction.

Antonaccio continues to be a Wendy's franchisee with an ownership interest in six Wendy's restaurants in New York (three in partnership with Cugine and Kas). Cugine and Kas now own 73 Wendy's restaurants in the Northeast. Affiliate company, CKA Management, provides management and operational services for 76 Wendy's stores. The assignment also involved securing acquisition financing, including a \$50 million senior

secured term loan and a \$2 million development line of credit loan from **Huntington National Bank**.

Auspex Capital is a boutique investment banking and financial advisory firm specializing in the restaurant industry. For more information, contact Managing Director **Chris Kelleher** at 562-424-2455 or by email [ckelleher@auspexcapital.com](mailto:ckelleher@auspexcapital.com).

### National Franchise Sales Closes Denny's, Little Caesars Deals and More

Franchise business brokerage **National Franchise Sales** (NFS) recently closed on the following deals for clients:

- NFS added to the numerous franchises they have sold in Alaska, with the sale of northernmost Denny's in the brand. The sale, to **Anchorage, LLC**, an existing Denny's franchisee, included the real estate allowing the seller to exit the brand for retirement.
- National Franchise Sales assisted several Little Caesars franchisees with the sale and purchase of seven units throughout Kentucky, Maine and Indiana.
- NFS worked with challenging landlord negotiations in the sale of Sizzler franchise holdings in Southern California, avoiding termination and allowing a successful transfer of ownership from **Paramin Corp** to **Downey SZL LP**.
- Multi-unit Wingstop franchisee **VWS Restaurants**, expanded their Wingstop holdings with the purchase of multiple Wingstop restaurants in New Mexico from Randal Clovis and Hobbs Wings, LLC. NFS advised on the sale of the units.
- National Franchise Sales fielded multiple offers for the purchase of **GCL Ventures Inc.'s** Dairy Queen holdings in New York. **Musabbir Rifa LLC** ultimately had its offer accepted, allowing GCL to exit the brand.
- Black Bear Diner franchisee **OSS Partners, LLC** divested their franchise holdings, selling their units to **GVS Hospitality**. NFS completed the transaction in just over 80 days, from purchase contract to changeover.
- NFS conducted the sale and purchase of multiple **Togo's Sandwich** franchise restaurants in Northern California in separate confidential transactions.
- **Gadra Pizza**, a multi-unit gas station franchisee, purchased franchisee **Three Dot One Four's** Marco's Pizza assets. NFS facilitated the sale.

For more information, contact NFS President **Jerry Thissen** at [jt@nationalfranchisesales.com](mailto:jt@nationalfranchisesales.com) or at 949-428-0481.

### C Squared Advises on Hardee's Deal

Restaurant financial advisory firm **C Squared Advisors** recently advised **GBL Restaurants**, owned by **George Long**, on the sale of their five Hardee's restaurants to **CKE Restaurant Holdings**, the franchisor. The locations were in the Birmingham, Ala. area.

CKE's interest in those locations was to continue to build out their corporate-owned restaurants in the Birmingham area, according to **Bracken Gardner**, vice president of business development and real assets, as part of CKE's "Market Transformation Program."

According to Gardner, CKE will be investing \$500 million in the restaurants across the country, including "extensively" remodeling exteriors and interiors, adding new digital menu boards and investing in digital platforms, among other efforts. Franchisees will be required to take part in some aspects of the program, as well.

"We had offers from other, smaller franchisees, but the price from CKE was in line with the others. So, it just made sense for CKE to own the market if they were going to complete their Market Transformation there," said **Dan Connelly**, partner with C Squared Advisors.

After Covid, the franchisee worked to get his P&Ls back to where they were in 2019, he added. "QSR is a business of pennies, and he worked to keep his costs in line, too. Our client owns the real estate on some of the locations, and he signed a lease with CKE. Now he has the flexibility of an annual annuity. To have CKE on the lease was a valuable part of the deal for our client."

For more information, contact Dan Connelly at [dan@c2advisorygroup.com](mailto:dan@c2advisorygroup.com), or at 617-784-7866.

### Baldwin Joins United Community Bank's Franchise Lending Group

When a lot of banks are tightening up franchise lending, **Mike Orlov**, SVP of franchise lending with **United Community Bank** (UCB) said, "We're full speed ahead. We are looking to grow our book of business and bring on new customers."

To that end, the bank recently hired franchise finance veteran **Lindy Baldwin** as vice president, middle market franchise relationship manager, to help with that goal. Baldwin joined UCB a couple of months ago from Northern Bank, where she was vice president of franchise lending.

"Lindy is great," said Orlov. "I have known her for years and she has a fantastic reputation in the industry. We both operate the same way: We care that our customers

get the best deal they can—we're very focused on people."

Baldwin's journey to franchise finance is not a usual one—her career was in the medical industry. But, she switched gears in 2010 by joining First Franchise Capital and the franchise finance space. She started as an account manager, but as she moved to other banks, she kept her eye on learning the ropes as a BDO.

"I knew I wanted to be more of a transaction person," she told the Monitor. "I like building relationships." When GE Capital Franchise Finance exited the space and sold one of their portfolios to Sterling Bank, she reached out to the team there and joined as a BDO.

She spent six years there, when Sterling, she explained, was bought by Webster Bank. Northern Bank came calling soon after and she decided to advance her career there.

But, "Mike and I have known each other for quite a while," said Baldwin, "and we had conversations about UCB." When Baldwin's husband took a job in Florida earlier this year, in the middle of the UCB footprint, "it sparked even more conversations." Baldwin made the move.

Even though United Community Bank is a \$30 billion bank in assets, they take a community bank approach, said Orlov, which is one of the reasons Baldwin found herself enthused about joining the team.

"We are transparent and helpful from the beginning," she said. "We are straightforward from the get go."

UCB's deal size is \$2 million to \$30 million, and targets franchisees in the bank's footprint: Florida, Alabama, Georgia, the Carolinas, Tennessee, Kentucky and Virginia. Orlov said they hope to expand that footprint for franchise lending in 2024.

The bank will also focus on all types of restaurants—they are tier agnostic, said Orlov, and they will also finance non restaurants.

"We care more about how strong the operator is. We get presented with deals all the time; things I haven't heard of before." They will also participate in or lead syndications, especially as their customers grow.

With the contacts she has built over the years, Baldwin will continue to find the fun in helping entrepreneurs. "Just being able to be part of a franchisee's growth and have that relationship with them," she explained, "that's significant to me."

For more information, contact her at [lindy\\_baldwin@ucbi.com](mailto:lindy_baldwin@ucbi.com), or at 402-312-2542.



### Crowdfunding Firm FranShares Brings Investment Dollars to Franchisees

Like many entrepreneurs, **Kenny Rose** needed outside capital to get started, and he drew on angel investors for an initial \$600,000 for his business, **FranShares**, a crowdfunding site that focuses on investing in franchisees. Some “400 VCs didn’t respond or passed on us initially because we had ‘the F word’ in our pitch and that didn’t usually relate to a tech investment,” he explained.

Once he had some traction, he went back to those same venture capital firms, but they didn’t know anything about franchising.

“So, they would give me an intro to another VC hoping that if they went in our early round that I’d always remember them for future fundraising,” he said.

Those introductions finally led him to Stuart Larkins, co-founder and partner with Chicago Ventures, a seed stage venture capital firm that focuses on investing in undercapitalized tech firms.

“It was just me and a landing page at the time,” said Rose.

It turns out, Larkins had his own experience with franchising as a past investor in KBP Brands, a large YUM! Brands franchisee. “They had rolled up about 500 KFCs while he was an investor, so he understood the big opportunities in the franchise world that were inaccessible to the average investor and that franchisees lacked proper funding to start or expand,” he explained.

So, when Larkins learned more about FranShare’s mission, it “was a no brainer for him,” Rose said. Chicago Ventures provided \$750,000 of seed capital initially. The firm has since added another \$750,000.

In June 2021, Rose launched the company with the mission of allowing individuals—mostly accredited investors—to invest in franchisee businesses with investments starting at \$500. FranShares raised \$18 million from those investors at the time.

Rose’s crowdfunding site will invest \$1 million on up to \$25 million in existing franchisees to help them expand. The company’s investment in husband-and-wife franchisees Marlin and Brandi McClure is a good example of a typical investment: The McClures owned one Teriyaki Madness restaurant in Charlotte, NC, and were due to open their second.

“The partnership with FranShares allowed us to expand quickly, without waiting for an SBA loan to come through,” said Marlin McClure.

FranShares has \$12 million earmarked for investment in

existing multi-unit Teriyaki Madness franchisees to help them expand. Other brands are on their radar, as well.

“We’ve been talking to about 20 (brands) right now,” said Rose. They are taking into account the strength of the franchisor’s leadership team, whether or not the brand is recession resistant, and finally, they take a look at the operator themselves.

“The operator makes the business work, at the end of the day,” said Rose. “We want those operators who are going to be in there every day. Not just someone who writes a check.”

Their timeline is a five- to 10-year investment, with the intention of selling their stake to another investor group at the end of that period, or “more ideal, selling that equity back to the operator,” he said.

Rose himself is the son of an entrepreneur, so he understands the mindset. “I’m living my dream, too,” he said. “We’re solving issues that I’m passionate about—helping business owners.”

His outlook for his business in five years? “I can’t wait for the day when someone walks into a Jimmy John’s, they love the experience, and then can scan our code sitting on the counter to invest in that location. When that happens, I’ll know we’ve made it.”

For more information, contact Kenny Rose at 619-929-4140, or at [kenny@franshares.com](mailto:kenny@franshares.com).

### Star Hill Financial Hires Turner as VP of Sales

Equipment and franchise finance lender **Star Hill Financial** recently added **Libby Turner** as vice president, sales to the team. Turner will be responsible for increasing Star Hill’s nationwide presence in the equipment finance space, working closely with vendors, manufacturers, and end users, offering programs tailored to clients’ needs.

Turner has more than 10 years of experience in the space with names like Commercial Funding Partners and VFI Corporate Finance.

Founded in 2016 by **Hollis Bufferd**, Star Hill Financial is a certified Women Business Enterprise and independent equipment and franchise finance company based in Fairfield, Conn.

For more information, contact President **Keith Smith** at (201) 465-4477, or at [ksmith@starhillfinancial.com](mailto:ksmith@starhillfinancial.com).

Many restaurant and retail businesses “have had their hat handed to them” after building a flagship location in Manhattan. This past summer, **Raising Cane’s** opened an 8,000-square-foot “statement store” in Times Square on the corner of Broadway and 44th street. That restaurant, Cane’s Co-CEO **AJ Kumaran** told Yahoo Finance, will “become one of the busiest QSR restaurants in the world.” Check back in three years, we say.

**El Pollo Loco** franchisees had no inkling last month when they were at their franchise convention in Carlsbad, Calif., that the company’s board of directors would oust CEO **Larry Roberts** a few weeks later. “A total surprise,” a franchisee told the Monitor. Roberts had been the CFO of the company since 2013 and became CEO just 20 months ago. Could **Sardar Biglari’s** four million share purchase in August (approximately 12% of Loco) nudged the board to make a move on Roberts?

**Evercore ISI** analyst **David Palmer** was ranked as the No. 1 restaurant analyst in Institutional Investor’s All-America Equity Research survey of 4,200 investment professionals from over 1,600 asset management firms and institutions.

**Apollo Global Management** acquired **Qdoba** from **Jack in the Box** in 2017 for roughly \$300 million. **Modern Restaurant Concepts**, an affiliate of **Butterfly Equity**, paid Apollo \$330 million in merger consideration last year for Qdoba, subject to an earnout that could possibly earn Apollo an additional \$70 million. Now, Qdoba just issued \$305 million in securitized notes backed by the franchise and development agreements of the brand’s approximately 531 franchise locations and the “synthetic royalties” on the 196 company stores.

**Chicken Salad Chick** CEO **Scott Deviney** told the Monitor the fast-casual chain just opened its 245th location and is now in 19 states.

**Spirit Realty Capital’s** 317 quick service and 115 casual dining restaurant properties will soon become part of **Realty Income’s** vast property portfolio once the merger is approved by shareholders. Spirit was founded in 2003 by **Mort Fleischer**, who was also the founder of Franchise Finance Corporation of America (FFCA), which was acquired by GE Capital in 2001. Fleischer also co-founded STORE Capital, which was sold earlier this year to a pair of institutional investors. Spirit owned a total of 2,037 commercial properties.

You’d think cap rates would be rising quickly in the sale-leaseback world given the overall rise in interest rates over the past 20 months. However, according to **Northmarq’s Matt Lipson**, the average sold cap rate was only 55 basis points higher in September

2023 than in December 2021. But, here’s the catch: There were 75% fewer deals in September than in December 2021 and Lipson attributes that to stronger deal fundamentals. “As loans continue to mature and tenants continue to feel the effects of elevated expenses, we’ll start to see an adjustment to the comps that match brokers and sellers’ day-to-day reality,” Lipson told the Monitor.

When **Fiesta Restaurant Group (Pollo Tropical and Taco Cabana)** was spun off from **Carrols Restaurant Group** (the largest Burger King franchisee), the sky was the limit for the two brands. Tim Taft, the former COO of Whataburger was hired to run the combined operation and the enthusiasm for the company was so strong that its shares hit \$65 in 2015. Unfortunately for Fiesta, unit growth outside of its core markets proved elusive, so much so that when the company began soliciting potential buyers in 2021, buyers questioned once again its expansion prospects. **Garnett Station**, the restaurant-centric private equity fund run by **Matt Perelman** and **Alex Sloane**, acquired Fiesta (Taco Cabana was sold to Yadav Enterprises in 2021 for \$85 million) on October 30 for \$8.50 per share. Good price? According to an analysis completed by Houlihan Lokey, the last 12 months-adjusted EBITDA multiple was in a range of 7x to 9x.



## STATS AND QUOTES

### WHAT THE EXPERTS SAY ABOUT BANKING CONDITIONS

<b>Jamie Dimon,</b> CEO JPMorgan	“This may be the most dangerous time the world has seen in decades. While we hope for the best, we prepare the firm for a broad range of outcomes so we can consistently deliver for clients no matter the environment.”
<b>Nathan Stovall, S&amp;P Global Market Intelligence</b>	“Deposits are still down year-to-date [and banks] are shifting what funds they have into loans. Demand is going down [due to] how long people will actually be willing to borrow at today’s rates.”
<b>Charlie Scharf,</b> CEO Wells Fargo	“While the economy has continued to be resilient, we are seeing the impact of the slowing economy with loan balances declining and charge-offs continuing to deteriorate modestly.”
<b>Elon Musk,</b> CEO Tesla	“I think there’s still quite a few shoes to drop on the bad credit situation. Commercial real estate obviously is in terrible shape. I’m not saying things will be bad. I’m just saying they might be. If the macroeconomic conditions are stormy, even the best ship is still going to have tough times.”
<b>David Fanger,</b> Senior VP Moody’s	Banks currently hold about \$3.3 trillion in cash. This large cash level “is a logical response to a slowing economy and particularly to a scenario, where you’re seeing deposit outflows and you need to conserve cash.”
<b>Austin Goolsbee,</b> President Chicago Federal Reserve	“We’ve been tightening financial conditions to bring inflation down, so if the response to recent banking problems leads to financial tightening, monetary policy has less to do.”
<b>Scott Anderson,</b> BMO Capital Markets	“We don’t have a lot of data to really hang our hat on at this point,” but “we’re pretty confident we’ll see a slow-down” given the impact of tighter credit.

### INTEREST RATES (%)

	11/9/23	Last Month	A Year Ago	Trend
Fed Funds Rate	5.50	5.50	4.00	↑
30-Day BSBY 1M*	5.38	5.37	3.84	↑
90-Day BSBY 3M*	5.60	5.58	4.48	↑
30-Day SOFR**	5.32	5.31	3.80	↑
90-Day SOFR**	5.32	5.31	3.80	↑
1-Year Treasury	5.43	5.36	4.58	↑
5-Year Treasury	4.66	4.62	3.94	↑
10-Year Treasury	4.64	4.66	3.83	↑
30-Year Treasury	4.77	4.83	4.08	↑
Prime Rate	8.50	8.50	7.00	↑

\*Bloomberg Short Term Bank Yield Index \*\*Secured Overnight Financing Rate

**Berkshire Hathaway co-chairman Charlie Munger was asked by a Wall Street Journal reporter if investors make systemic errors when it comes to investing:** “There are lots of cognitive biases that are very significant. One is the constant tendency to overrate your own intelligence and skills in deciding what to do and what not to do.”

**James Grant, founder and editor of Grant’s Interest Rate Observer talking about interest rates to a reporter at the Wall Street Journal:** “Five percent is more or less the average of investment-grade rates since the time of Alexander Hamilton. The problem is the structures that 10 years of ultra-easy money brought about. People blame it on the normalization of rates. The previous bout of abnormal rates is the problem.”

**KPMG Chief Economist Diane Swonk tweeting about the higher cost of borrowing:** “The breather we got from locking mortgage rates in low is fleeting. Higher rates will eventually slow growth. A surge in corporate debt taken on during the pandemic is also critical. Much is poised to reset in 2024.”

**McDonald’s CEO Chris Kempczinski described the change in strategy on the part of labor organizers at last February’s International Franchise Association meeting:** “If you can get the right coalition of leaders at the state level to pass legislation, you can essentially get unionization to happen by fiat.”

**Co-CEO of the 800-unit Raising Cane’s chicken chain, AJ Kumaran, discussing the impact of the \$20 minimum wage deal in California on Yahoo Finance:** “I’m sure it is going to impact all fast food restaurants equally. Everybody will have to take some kind of price increase to cover for that. As you know, the restaurant business operates on razor thin margins. To be able to take on 25-30% wage increase it is not practically feasible. We follow what everyone is doing and then we will appropriately adjust our price to cover for that.”



### The Deal a Day is Back

**The predictable U.S. long-term debt and interest rate crisis has arrived**, interest rates having gone from zero to about 5%. The inevitable “equal and opposite” reaction to more than a decade of interest rate suppression apparently wasn’t clear to Janet Yellen, former Fed Chair and current Treasury Secretary. She opined in October 2022 that \$31 trillion of debt was no problem because interest rates were “so low,” the expectation being this would prevail for the next decade. Thirteen months later, that debt is almost \$34 trillion, rates are close to 5% and “equal and opposite” has arrived.

The fact is \$7.6 trillion of U.S. debt will mature within 12 months, with additional \$2 trillion to \$3 trillion from the current deficit to be financed, as well. Therefore, about \$10 trillion of U.S. debt will cost 450 basis points more than previously. U.S. interest expense, which ran \$659 billion in the fiscal year ending September 2023, will therefore increase by about \$45 billion monthly. At current rates, the interest expense will be annualizing at \$1 trillion and compounding upward.

For perspective, total U.S. spending in the fiscal year ending in September was \$6.1 trillion, with interest expense at 11%. The other largest expenditures were Social Security at 22%, health at 14%, Medicare at 14%, national defense at 13%, income security at 13% and veterans benefits at 5%. Interest expense will soon exceed national defense, health and Medicare, only exceeded by Social Security. This comes at a time when the economy is weakening and the possibility that the Federal Reserve could halt their bond sales and even resume purchasing. I do expect the Fed to eventually reverse course, but rates will be resistant to a decline from current levels, primarily due to the huge and ever-growing supply of debt issuance.

**The restaurant earnings season has been in high gear:** Almost 50 public companies have reported. Margins are better controlled, but traffic remains challenged, especially for in-store dining. It generally has been a picture of “haves” and “have nots,” with Starbucks, McDonald’s, Texas Roadhouse, Wingstop, Darden and Chipotle remaining the “best-of-breed” operators. Same store sales gains are being generated by price and/or menu mix. Since off-premise is so much higher now than in 2019, dine-in traffic is down materially, and that’s why many QSR companies are not rushing to open their dining rooms.

Another change has been the higher percentage of sales on the weekends than in the past, creating new staffing requirements. We need not remind you consumers are carrying a record trillion dollars of credit card debt,

paying over 20% interest on that debt, and have reduced their savings rate to under 4% (from a peak of over 30% in March 2020) to service that debt. This has been reflected not only in traffic counts, but changes the way diners use the menu, and shifted traffic from mid-week to the weekends, when families are increasingly interested in a dining “experience.” Management teams, in their quarterly discussion, have confirmed that diners have adjusted behavior, especially at the low-priced end of the spectrum, and the following discussion relates to that.

**There is a deal a day in the QSR business.** The fourth calendar quarter is typically a strong time of year in the restaurant industry. Back-to-school spending needs are met in August and September, backyard autumn barbecues are history, winter weather is not yet upon us and the public is starting to anticipate the holiday season. So why am I seeing these types of TV ads everyday?

Burger King is offering two Whopper Juniors for \$5. McDonald’s is offering, until December 3, buy-one get-one Quarter Pounders with Cheese, a Big Mac or 10-piece McNuggets. Wendy’s is offering two-for-\$3 Breakfast Bundles, which includes a biscuit with sausage, egg and cheese, small potatoes and a medium coffee, or a two-for-\$6 meal which includes a single hamburger or chicken sandwich or 10-piece chicken nuggets. Sonic is selling a “2-for-\$7 Menu,” a mix and match between a chicken sandwich, six-piece mozzarella sticks and cheeseburger.

It goes on. Arby’s deal is “2 can dine for \$9.99,” including two sandwiches, two fries and two drinks. Dairy Queen is offering a “2-for-\$5” menu including any two of a cheeseburger, regular fries, small soft drink, pretzel sticks with queso, chili dog or small sundae. Chili’s, whose burger I happen to like, is competing for the business by selling a “3 for Me” at \$10.99, including a beverage, appetizer and full-size entrée, which includes a cheeseburger, three-piece chicken tenders paired with macaroni and cheese.

There are other deals out there, but you get the picture. There is a reason all these companies are getting this aggressive. I suggest that, for the reasons noted above that are stressing the public’s dining budget, this is what it takes to attract attention—at least from Monday through Thursday.

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## MARKET SURVEILLANCE

OVERHEARD ON THIRD QUARTER CONFERENCE CALLS			
Company/Symbol	11/10/23 Price	YTD Change	Commentary
Carrols Restaurant Group (TAST)	\$7.59	+458%	"We continue to expect positive traffic in the fourth quarter. We think that's going to be bolstered by the additional incremental spending that Burger King is planning on doing."
Wingstop (WING)	\$210.94	+53%	"Our boneless mix (is)now at a record level of 44% for the system. This compares to a low 30% boneless mix just a few years ago."
Chipotle (CMG)	\$2,120.58	+52%	"We're not quite at \$3 million (AUV), but we should get there next year, and we're knocking on the door of 27% (margin)."
Shake Shack (SHAK)	\$55.03	+33%	"Our GMs can generally all in make over six figures....many make a lot more than that. We give stock to every GM every year."
Fat Brands (FAT)	\$6.43	+30%	CEO Andy Wiederhorn on the deal climate: "I think you've seen prices come down to levels where deals can get done."
First Watch Restaurant Group (FWRG)	\$16.93	+25%	"Converting franchises to company-owned restaurants is compelling from both a financial and strategic perspective."
Texas Roadhouse (TXRH)	\$104.19	+15%	On the outlook for commodities: "Beef is the driving force of our expected inflation next year."
Bloomin' Brands (BLMN)	\$22.74	+13%	"We are remodeling, relocating and opening new restaurants, especially Outback. We remain on track for 100 remodels this year."
Domino's Pizza (DPZ)	\$378.51	+9%	What used to be called a "buy one, get one, Domino's now calls it an "Emergency Pizza," whenever you want over the next 30 days.
Brinker International (EAT)	\$33.95	+6%	"Chili's reported comp sales growth of 6.1% for the quarter, driven by price of 8.8%, mix of 3.1% partially offset by negative traffic of 5.8%."
Restaurant Brands International (QSR)	\$68.74	-6%	"We are foundationally running these restaurants (BK) better than we were a year ago, and I'm sure better than we were five years ago."
Sweetgreen (SG)	\$8.92	+4%	"We are set to reach our goal of generating positive-adjusted EBITDA on a full-year basis in 2024. This will be a meaningful milestone."
BJ's Restaurants (BJRI)	\$27.01	+2%	"There's no doubt about it that service levels and restaurants that are well-staffed with tenured team members tend to have higher comp sales."
McDonald's (MCD)	\$267.79	+2%	"We're going keep a close eye on that \$45,000-and-under consumer, because of the pressure they're feeling, and make sure we're offering value."
Cava (CAVA)	\$31.07	*	"Restaurant-level profit in the third quarter was 25.1% of revenue versus 21.7% of revenue in the prior year."
YUM Brands (YUM)	\$125.95	-2%	"A Taco Bell loyalty customer already spends 40% more per year than a traditional customer."
Dutch Bros (BROS)	\$27.53	-2%	On California: "We are actively looking at productivity and other options such that pricing becomes the default that we have to make."
Denny's Corporation (DENN)	\$8.75	-5%	"So we do believe that casual probably is trading down into us, but we also believe that we're probably trading-down into QSR a little bit."
The Wendy's Company (WEN)	\$ 18.91	-16%	"We are seeing some trade down from mid-scale casual and sit down into QSR. But we're also seeing some trade out of the lower-income consumer out of QSR and into food at home."
Dine Global Brands (DIN)	\$42.55	-34%	Regarding Applebee's: "Although there's been a decline in guest traffic, our check levels have shown an increase, compared to 2022."

\* Cava went public on June 15, 2023

## Six Year-End Tax Ideas for Restaurant Owners

By Dennis Monroe

Closing out the year there are obvious ideas that carry over every year, like accelerating payment for services or securing extra depreciation for fixed assets placed in service during the year. There's also something new to be borrowed from tax experts. Here are a few things:

**1. Accelerated depreciation** on FF&E and leaseholds are still favorable in 2023, but has been reduced by 80% of the value by the phasing down of this deduction. It still makes sense to get assets placed in service in 2023. In addition, cost segregation and aggressive purchase price allocations are important tools to maximize depreciation.

**2. Credits.** Employee-retention credits are still available if you had a decrease in sales over the appropriate quarters during the pandemic. Make sure you check out Work Opportunity Tax Credits and Empowerment Zone Credits, which are for wages of qualified employees living in certain areas, or on food stamps, or for veterans and ex-felons. These credits will expire in 2025. Don't forget the FICA tip credit for the employer-paid FICA tax on employee tips. This can be a significant amount. If you do take the tax credit, you can't take the deduction for wages used in the calculation, so make sure you aren't double counting. Sometimes it's better to have the deduction.

**3. Big Idea for State Taxes.** A number of states allow flow-through entities to pay the state tax and get a federal deduction. Here's an example of how this works from an article by Kaz Unalan of GBQ Partners, titled Can You Benefit by Making a Pass-Through Entity Tax Election?

"Suppose LLC taxed as a partnership operates a chain of popular fast-causal restaurants located in State A. LLC has two individual members who reside in State A and share the profits of LLC 50/50. State A's income tax rate is 4% but State A also has a SALT Cap Workaround where the entity pays the tax. LLC has a profit of \$2,000,000.

A. If LLC does not make the election then each member will pay \$40,000 of State A income tax (\$1,000,000 x 4%) but are limited on their federal return to a \$10,000 itemized deduction for state and local taxes.

B. Alternatively, if the LLC makes the election, the LLC will pay \$80,000 of State A tax. Those taxes are fully deductible to the LLC on their federal return, and those allocated deductions will flow through to each member as part of the LLC's Schedule K-1 income reported to each member. Each member will effectively get a \$40,000 deduction rather than a \$10,000 maximum itemized deduction. At the top marginal tax rate of 37%, each member will save \$11,100 in federal taxes (\$30,000 x 37%). State A requires each member to reverse the \$40,000 tax deduction but allows a credit for those taxes, resulting in a net neutral tax effect for State A income tax."

**4. Another state tax idea:** An idea we have effectively used for reducing state taxes is for owners in high tax states to establish clear residency in a state with a low tax-rate. A flow-through entity is also formed in the lower tax state. The operating entity in the higher tax state sells or transfers its intellectual property to the newly formed entity. Note, there can be some tax ramifications for this transfer. Then, the entity in the higher tax-rate state pays a royalty to the newly formed entity in the lower tax state, this reducing the amount of income subject to tax in the higher tax state. In addition, you can use the new entity to perform management services to the entity in the higher tax state, thus moving additional income to the lower tax rate state.

**5. Use of management companies:** There are advantages to establishing a corporate management company. Employees who are over store management, such as marketing, accounting, human resources and other key team members, are considered employees of this separate entity. This approach benefits the management team and the newly created entity can qualify for a fiscal year if it is a C-corporation. This creates an opportunity to shift income between tax years of the operating company and the management company, which may be key in light of the pending tax law changes, as well as the ability to create deferred compensation plans and other benefits. Additionally, it may be a way to accumulate income at the lower "C" corporate tax rate. All this being said, there are potentially double tax issues and a need to continue deferred techniques to avoid future accelerated tax.

**6. Use of multiple entities:** Many of these ideas involve shifting income between tax years by delaying income or accelerating deductions, in most cases, through use of multiple entities. The management company is one technique, the licensing of intellectual property is another. All involve the using different kinds of entities, which must fit together for lower taxes, such as LLCs treated as partnerships, or as S-corps and the use of C-corporations. For example, C-corps have a lower tax rate than individuals, avoiding self-employment tax through the use of S-corps and Family Limited Partnerships to having estate tax and transfer of wealth to the next generation. The key is marrying flexibility with creativity to help plan for an uncertain future going into the new tax year.

Thanks to Kaz Unalan and Erik Ordal at Myslajek Kemp & Spencer, Ltd. for their help in this article, and for my partner Scott Husaby for explaining what is important in light of the phase out in Estate Tax Credit.

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### Banks Face Many Current Challenges; Unfortunately, These Obstacles Seem Likely to Persist

Banks are facing a myriad of problems as the economy appears to be slowing and bank cost of capital (including higher required deposit rates offered to customers) rises. Large banks, and especially regional banks, have been affected by these financial conditions. Indeed, the benchmark KBW NASDAQ Bank Index hit a three-year low on October 27, 2023 (though it jumped more than 10% in a broad market rally during the week ended November 3, 2023).

According to Bank of America's CEO Brian Moynihan, the outlook for many businesses "is mitigated by the worries about inflation, the worries about getting teammates to work for them, and also, frankly, the worries [of] the impact of higher rates." Larger companies don't "use our lines of credit. They've dropped the usage back down. That is an indicator [that] the cost of credit has gone up. So, they're much more careful about how they use it."

Not only are Bank of America customers less interested in accessing high-cost credit lines, the bank itself is reluctant to provide credit to customers. On its earnings call, management said Bank of America is "extending less credit into credit-only new relationships on the hope that we're going to get fees versus protecting our wallet where we already have a lot of fees and get cross-sell."

This sentiment is consistent with JPMorgan's recent comment on its own earnings call that industry loan growth will be relatively muted as lending remains constrained both by rates and market conditions. PYMNTS Intelligence, a global data firm, seems to confirm the banking industry's reduced interest in lending in an October 2023 report which said 53% of small and medium-sized businesses (SMBs) had "no access to credit" in the current environment.

Citigroup Inc.'s CEO Jane Fraser is cautious regarding the state of the global economy. She "worries that CEOs are consistently less optimistic than they were just a few months ago."

According to the Federal Reserve's most recent Senior Loan Officer Opinion Survey on Bank Lending Practices (released in late July 2023), a net 51% of banks reported tightening lending standards for larger and medium-sized business, up from 46% in the late April 2023 report. While this stance is certainly not welcome news for the business community, the speed with which banks have tightened their standards has been the fastest and most dramatic during any episode of Fed monetary tightening since at least 1994, per a study by Evercore ISI. Marco Casiraghi, a strategist at Evercore ISI, believes banks' rapid change in lending stance "will eventually bite, to some extent."

The rub in all this is that in prior periods when banks tightened credit standards, the Fed generally intervened and lowered interest rates to boost the economy. Not surprisingly, such actions encouraged banks to loosen their standards and lend more freely. However, even the most optimistic Fed observers don't currently expect the central bank to reduce rates until perhaps mid-2024. Indeed, in his November 1 press conference, Fed Chairman Powell seemed much less hawkish than he sounded in September, but he did not dismiss another possible rate increase during this cycle if progress on reducing inflation were to stall.

Large banks have also become more selective in their loan approval decisions because of proposed stiffer U.S. capital requirements, known as Basel III Endgame, for financial institutions with assets of more than \$100 billion. To account for the changes in regulations, large banks are preparing to increase the amount of loss-absorbing capital they hold against their assets.

Regional banks are likewise feeling the effects of a weakening in credit trends. Indeed, 15 of 18 regional banks with assets between \$50 billion and \$250 billion reported a jump, many of them quite large boosts, in nonperforming loans in 3Q 2023, per Yahoo Finance. Indeed, the average increase in 3Q 2023 was 80% versus 3Q 2022 levels and 8% on a sequential basis (i.e., versus 2Q 2023). Loan charge-offs also increased on a year-over-year basis at 15 of the 18 regional banks that were studied.

Commercial real estate (CRE) weakness is likewise a growing problem for regional banks which have much larger exposure to real estate loans than large banks. Many regionals invested heavily in commercial real estate (CRE) after the 2008 financial crisis. Those bets yielded strong results for years, but recent sharp pandemic-induced declines in property values and occupancy rates may cause borrowers to have difficulty repaying those borrowings as they come due.

Indeed, the U.S. Mortgage Bankers Association says that \$331 billion of commercial and multifamily mortgage debt matures in 2023 alone. An example of a regional bank which is heavily (over?) exposed to CRE is New York Community Bank. Its total non-performing assets were \$404 million at September 30, 2023, up 64% just from June 30, 2023. Given the CRE problems seem likely to become even more difficult over the short run, we would urge restaurant borrowers to focus on banks with limited CRE exposure.

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**Bloomin' Brands**  
**BLMN-NASDAQ**  
**(Overweight)**  
**Recent Price: \$22.74**



Activist Jeffrey Smith shook up Darden 10 years ago. Its CEO resigned and Red Lobster was sold so Darden could better focus on Olive Garden. Now comes Smith chasing another casual diner, **Bloomin' Brands**, where he holds a 9.6% stake at an average cost of \$25.75 per share. The playbook sounds similar. Smith argues BLMN trades at a discount to Darden and Texas Roadhouse because "Outback is no longer fun." His plan: Sell Carrabba's and focus on better execution at Outback. Perhaps Smith could talk Gene Lee out of retirement?

**Barclay's** analyst **Jeffrey Bernstein** called BLMN's third quarter results "below expectations top to bottom." Bernstein is still optimistic about the company precisely for the reasons Smith says he is, a "historical relative valuation discount." BLMN trades at roughly 5x EBITDA, versus 9x for Darden. How do you make Outback as fun as Olive Garden?

**Red Robin**  
**RRGB—NASDAQ**  
**(Hold)**  
**Recent Price: \$8.90**



**Red Robin** has a highly regarded CEO in G.J. Hart and an able board with David Pace, Anthony Ackil, Tom Conforti, Steve Lumpkin and Nicole Miller Regan. However, all this star power brings to mind the Warren Buffet quote: "When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact." Red Robin's third quarter numbers reflect the same troubled casual dining mode as when Hart took over—a meager 11% store-level margin and traffic down 10.4% in the quarter. Hart's management and staffing upgrades, as well as improvements in food quality, will take time.

Meanwhile, **Jefferies** analyst **Alex Slagle** has a Hold rating and a \$9 price target on the stock, yet expresses optimism from improved guest metrics and a new menu that was rolled out in October.

**Papa John's**  
**PZZA-NASDAQ**  
**(Outperform)**  
**Recent Price: \$64.45**



**Papa John's** lower food and labor costs (350 basis points) and slightly higher transactions drove higher store margins in the U.S. despite a lower average ticket, more third party delivery orders and higher levels of competitor discounting. However, the company is cautious about 2024 projecting lower new-unit growth numbers coupled with uncertainty in the Middle East and Asia.

**BMO Capital Markets** analyst **Andrew Strelzik** has an Outperform rating on the stock, yet lowered his price target to \$90 citing "international challenges that likely will continue to limit performance for several more quarters." Strelzik called the company's lower development target "disappointing and pushes our bull case." He does, however, see further margin opportunity in the U.S. based on deflation in wheat and cheese, coupled with "an improved labor backdrop." Strelzik's price target is based on an enterprise value-to-2024 EBITDA multiple of approximately 16x.

## RESTAURANT FINANCE MONITOR

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