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The growth menu

How the U.S. restaurant industry is negotiating a challenging environment

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Executive summary

The restaurant industry stands at an inflection point. Over the last several years, amid an economic expansion, the US$800 billion U.S. restaurant industry — a magnet for strategic investment and a source of global food industry concepts — outperformed many other sectors and the overall economy. For much of the current economic expansion, rising average product prices and a range of economic, demographic, and market trends fueled consistent growth in all restaurant segments. But growth has stalled in several market segments, and most analysts are predicting flat to downward same restaurant sales (SRS) in the near term for major, established chains as the competition from new, innovative players intensifies.

The result is likely to be turbulent times for established restaurant operators over the next few years. Despite declining SRS growth, however, deals activity remains robust. The sector in 2016 and 2017 witnessed an uptick in M&A activity from 2015 levels as investors came to see restaurants as largely protected from the likes of Amazon. By focusing the offerings on core consumers, building supporting capabilities, driving efficiency, and optimizing portfolios (both organically and through M&A activity), players can achieve future success. New and innovative restaurant concepts are increasingly capturing a larger share of the market and are projected to continue to experience strong growth. We also expect a rise in portfolio rationalization and M&A as companies seek to preserve and increase their advantage.

An industry faces an inflection point

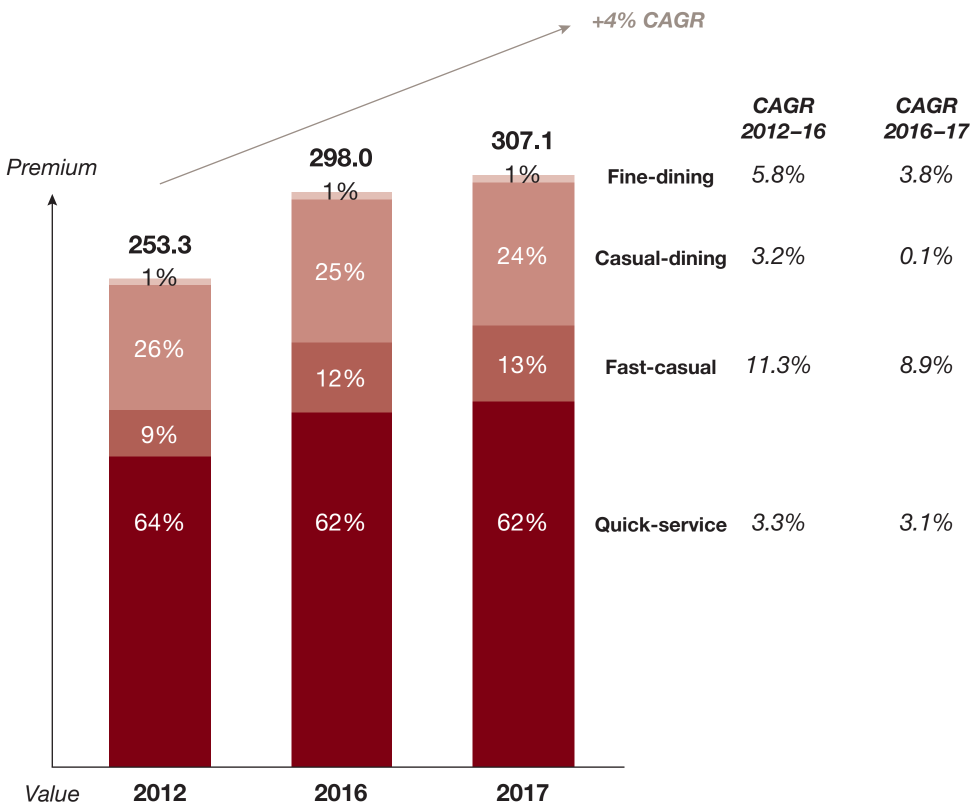
Over the last several years, amid an economic expansion, the US$800 billion U.S. restaurant industry has outperformed many other sectors and the overall economy. Rising average product prices and a range of economic, demographic, and market trends have fueled growth in all restaurant segments, with "fast-casual" chains such as Shake Shack and Panera showing the most impressive results. M&A activity has also been strong, as both industry players and private equity firms have sought to make plays in the buoyant sector.

Although these trends are generally applicable to the restaurant industry, the extent of the impact varies between restaurant categories. From 2012 through 2016, fast-casual chains grew at an impressive average compound annual growth rate (CAGR) of 11.3 percent — nearly six times the rate of annual GDP growth. Fine-dining establishments (companies such as Fleming's, Ruth's Chris, and Capital Grille) had the second-fastest growth rate (albeit from a small base), and the two other main segments — "casual-dining" (companies such as Applebee's, IHOP, and Texas Roadhouse) and "quick-service" (McDonald's, Burger King, and Taco Bell) — also outpaced GDP growth (*see Exhibit 1, next page*).

Today, however, the restaurant industry stands at an inflection point. In 2017, growth stalled for the top 500 restaurant chains — in almost all market segments, particularly in casual-dining, where revenues grew only 0.1 percent in 2017. Most analysts are predicting flat to downward same restaurant sales (SRS) in the near term for major, established chains. Growth in the fast-casual category remained robust in 2017, albeit somewhat slower than in the preceding years.

Overall, we expect turbulent times for established restaurant operators over the next few years. But by focusing their offering on core consumers, building supporting capabilities, driving efficiency, and optimizing portfolios (both organically and through M&A activity), players can achieve future success. We also expect portfolio rationalization and M&A to play a key role as companies seek to preserve and increase their advantage.

Exhibit 1
U.S. chain restaurant market by key segment sales (top 500 chains) in US$B, 2012–17



Source: Technomic (based on top 500 chain restaurants); Data World Bank; Strategy& analysis

Economics and consumer expectations

The restaurant industry has been benefiting from favorable market and economic trends over the last several years. Typically, a broadly expanding economy brings higher spending at restaurants. Since the expansion began in 2009, growth in spending on “food away from home” has outpaced both the economy at large and spending on “food at home.” In 2016, for the first time, Americans spent more on restaurants than they did on food at home (*see Exhibit 2, next page*).

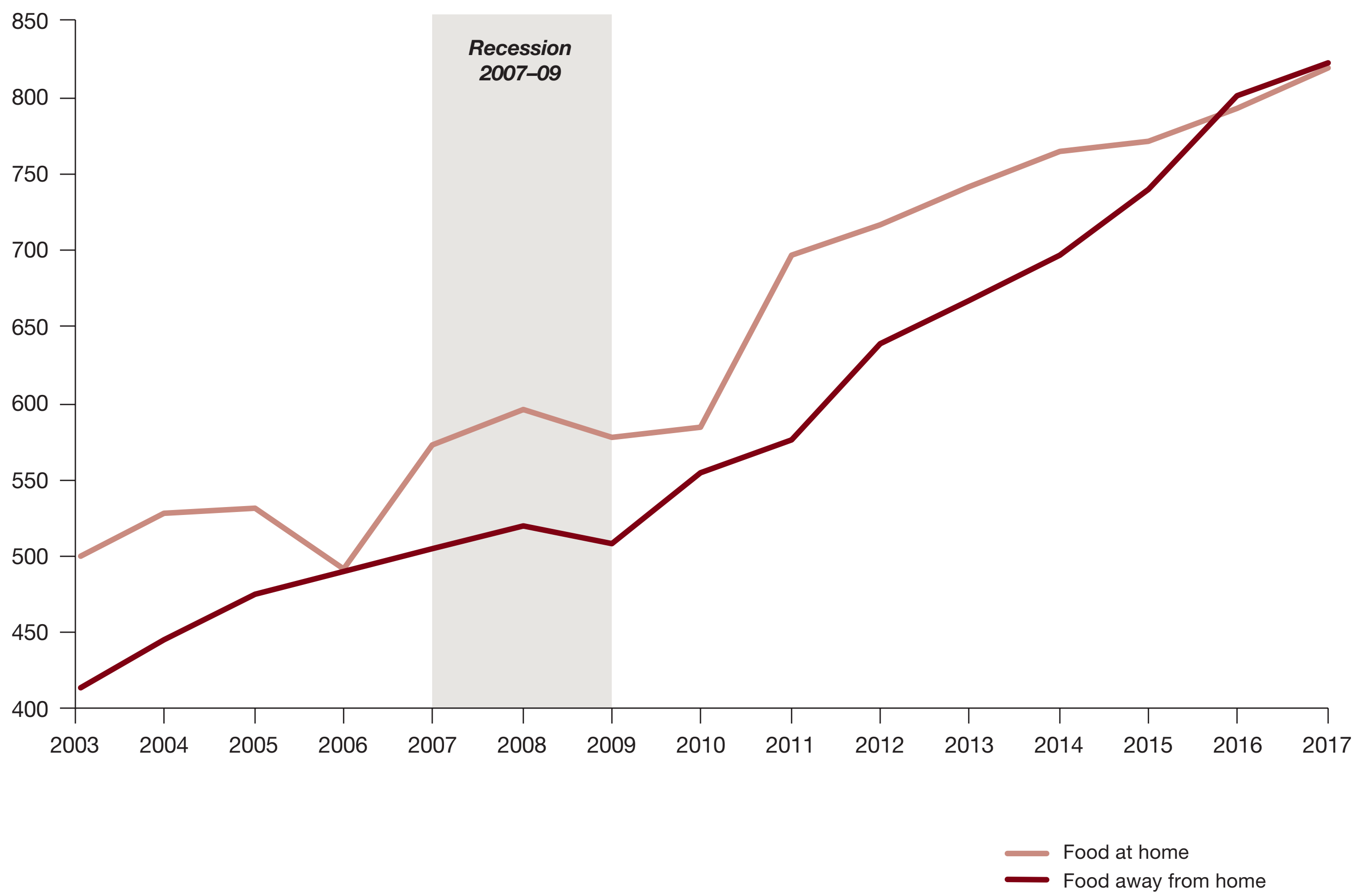
The industry has benefited from changing demographics and consumer expectations. Continuing ethnic diversification, with the corresponding mix in tastes and preferences, supports new restaurant cuisines and more exotic menu offerings. Consumers are also increasingly health-focused and are altering their diets, activity levels, and life styles accordingly, creating demand for healthy food across all restaurant formats.

As the millennial generation has come of age, and its spending power has grown, these influential younger consumers are searching out experiences rather than products. This shift is mirrored across the population more widely — a recent survey by the National Restaurant Association reports that 56 percent of adults would rather spend money on an experience, such as dining out, than on purchasing an item from a store. Thus, fast-casual players have recently been developing experiential restaurant concepts around themes like craft beer and ethnic cuisines.

In an additional wrinkle, the rise of income inequality and the polarization of incomes have created opportunities for restaurant companies at both the low end and the high end of the market to appeal to two distinct groups of customers: survivalists and selectionists. Survivalists (value-oriented consumers) are well served by quick-service restaurants, but are also attracted to “masstige” (mass prestige, or mass-produced and marketed as prestigious) experiences at chains such as Panera Bread and Starbucks. Selectionists (less price-sensitive consumers) are fueling the trend to premiumization in both limited-service and full-service dining.

Exhibit 2
U.S. food sales at home vs. away from home

Annual sales (US$ in billions, 2003–17)



Note: Excludes alcoholic beverages as well as home production, donations, and supplied or donated foods.

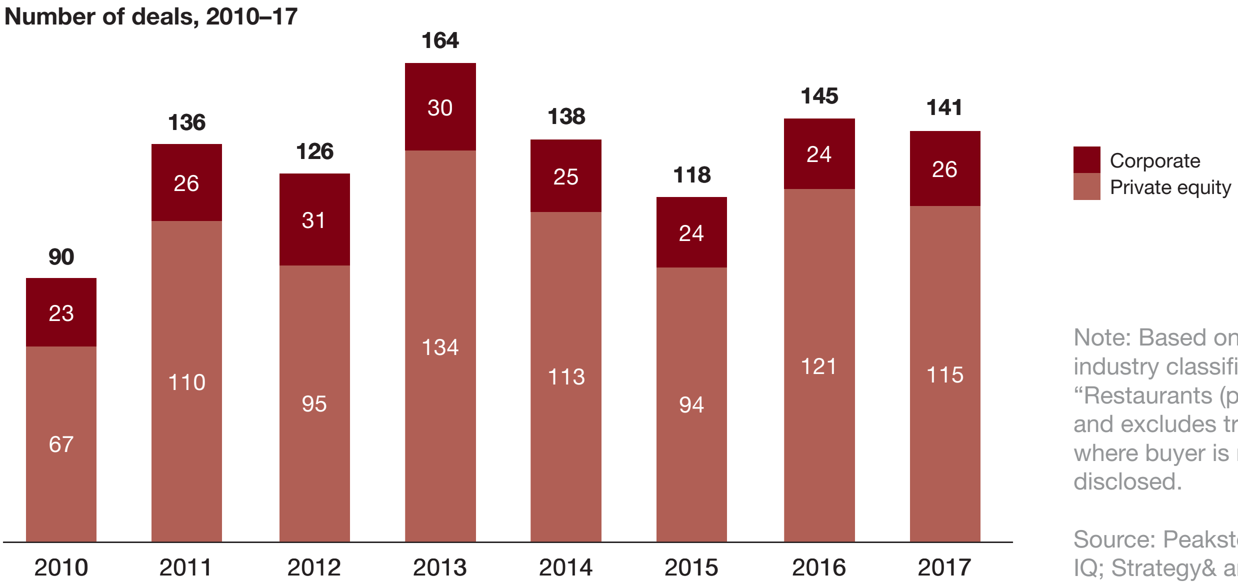
Source: Census Retail Trade

Stabilizing deal activity

Historically, the revenue growth supported by these positive macro trends and large chains looking to consolidate their respective segments drove deal activity in the restaurant space. More recently, however, the deal market corrected, given a very high price expectation by sellers and a general slowdown in the classic opportunities for value creation for established players — i.e., store rollouts and operations improvement (*see Exhibit 3, next page*). The focus of deals shifted toward new and innovative restaurant concepts that offer the prospect of rapid growth.

Looking ahead, as many traditional retail investors view restaurants as a sector resilient to Internet competitors, we expect M&A to continue to play an important role in the industry. On one hand, deals will focus on novel, innovative restaurant concepts that can drive growth on a regional or national basis. On the other hand, large chains will divest underperforming brands to focus on a core few, and private equity firms will look to turn around struggling brands.

Exhibit 3
U.S. restaurant transactions by buyer type



Note: Based on industry classification of "Restaurants (primary)" and excludes transactions where buyer is not disclosed.

Source: Peakstone; Capital IQ; Strategy& analysis

Differing growth trajectories

Historically, SRS growth at large, established restaurant chains varied significantly for good and poor performers. To show overall revenue growth amid sluggish SRS growth, several restaurant chains aggressively opened new stores. Recently, because many of them have saturated the market, large chains have reduced the levels of new store openings. At the same time, innovative fast-casual chains and concepts have continued to expand their footprint, albeit from a much smaller base.

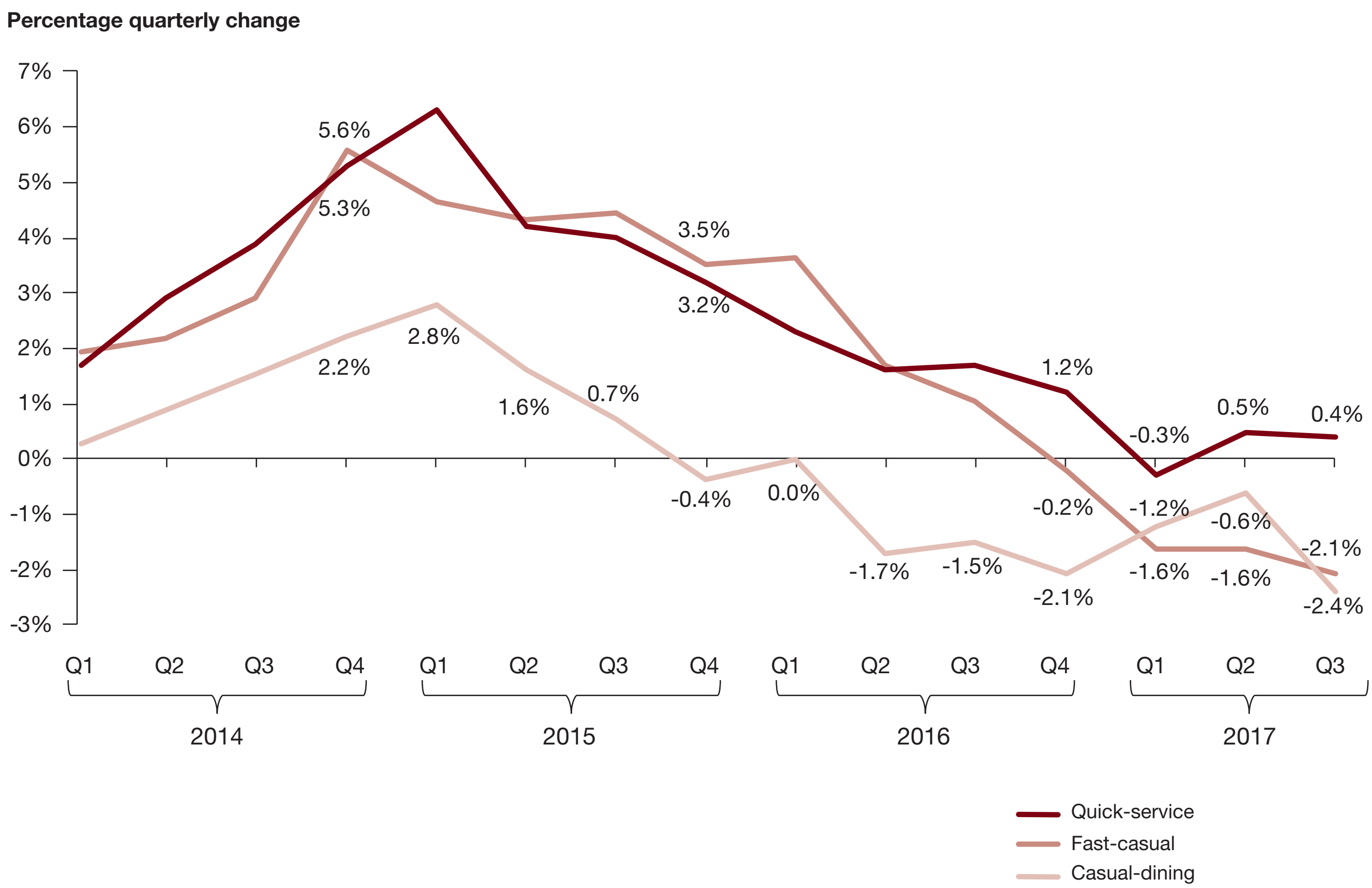
Indeed, a closer look at the data reveals that smaller chains are performing well overall and capturing a wider share of Americans' growing "food away from home" spending. Consumer preferences continue to shift away from the meal consistency of large, established restaurant chains toward the authenticity and experiential dining concepts of small and innovative restaurants. Additionally, diminishing barriers to entry and the ability of social media campaigns and reviews to spur customer engagement are paving the way for small restaurant chains to grow without significant investments in expensive traditional marketing vehicles such as television advertising campaigns.

Echoing a theme that is evident in the broader consumer packaged goods industry, growth in the total restaurant market is likely to be steady in the next few years — with large chains continuing on their sluggish growth trajectory and emerging, innovative players providing a bright spot. Just as rising consumer interest in authenticity is driving growth in craft food, beer, and spirit brands at the expense of large players, it will do the same in the restaurant industry. Players without apparent differentiation will no longer be able to grow new stores at the same rate. Their SRS will rise with inflation, at best. Although some winners and losers are — and will continue to be — apparent, the effect is likely to vary depending on market segment and size.

Over the last several years, the fortunes of different sectors of the industry have diverged (*see Exhibit 4, next page*).

Quick-service restaurants (QSRs): The quick-service segment has seen a slowdown in growth in same restaurant sales since early 2015. Thus, in

Exhibit 4
U.S. restaurant industry SRS growth (top publicly traded players)



Note: Industry growth is defined as the mean SRS growth for top public players in each category; Chipotle and Pie Five were excluded from the fast-casual sample set as outliers due to recent extreme performance fluctuations.

Source: Company reports; Knapp Track; Strategy& analysis the near term, slow, steady growth seems likely. "Survivalist" consumers, particularly millennials, are increasingly time-pressed and rarely have the time for a long sit-down meal. That creates opportunities in this segment for premium grab-and-go offerings. QSR companies are also increasingly introducing new, healthy menu options that are heavily featured in marketing campaigns playing to the consumer health trend. Several new healthy or vegetarian concepts have gained traction in recent years in well-known QSR formats, such as Subway's "Fresh Fit Choice" offerings. Additionally, many QSR chains are successfully expanding internationally (into Eastern Europe, Brazil, India, Russia, and China) in the quest for continued growth.

Fast-casual: SRS for major fast-casual chains, which has historically been in the mid single digits, turned negative at the end of 2016, and stood at an average of -1.8 percent in the first three quarters of 2017, excluding outliers like Chipotle Mexican Grill and Pie Five. The guest count has been slowing across the major chains, even after stripping out Chipotle's numbers. This slowdown is somewhat alarming given the historical growth rates that large players have enjoyed. On a positive note, SRS slowdowns for large fast-casual chains are paving the way for new and innovative concepts to gain share. In the last few years, several local and regional fast-casual chains that are not yet household names (many with as few as five to 10 stores) have been growing aggressively, and we expect this phenomenon will continue in the near-medium term.

New and innovative fast-casual chains will continue to disrupt the segment and will remain a bright spot in the restaurant sector.

Several broad trends are expected to continue to evolve in this segment. One is more emphasis on new occasions, such as chains that had primarily focused on lunch expanding their breakfast and dinner offerings. Another is a continued focus on ethnic and innovative menus. Other trends include chef-driven concepts, healthy "better for you" options, and locally sourced or artisanal proteins and produce.

Growth in the fast-casual segment, however, will be more selective. Larger chains will likely face constraints on footprint expansion, which will limit growth, and will target time-pressed casual-dining customers and QSR customers seeking to upgrade. New and innovative fast-casual chains, on the other hand, will continue to disrupt the segment and will remain a bright spot in the restaurant sector. The winning companies such as Aurify Brands, which operates Five Guys Burgers & Fries, Field's Good Chicken, and Melt Shop, will manage a portfolio of on-trend assets while leveraging scale for know-how/process sharing and consolidation of back-office and sourcing functions where applicable.

Casual-dining: Casual-dining chains have been particularly challenged since 2015 by declining guest counts as consumers switch to more attractive fast-casual concepts. We expect sales growth in the casual-dining segment to be relatively flat to negative in the near term as guest count, which has fallen in 85 of the last 96 months, continues to decline. The falling number of guests will be somewhat offset by price rises in line with inflation. Outside of some key winners, we expect most casual-dining players to continue to lose guest count to the fast-casual segment. And that should prompt them to tweak their value proposition to diners. They will increasingly offer on-the-go (or delivered to home) and healthy menu items and utilize technology to improve the overall diner experience.

Fine-dining: Fine-dining chains have also been somewhat challenged by higher competition from innovative independent restaurants and a flat average SRS. However, the category is fighting to fully return to prerecession levels and take advantage of the ever-increasing desire of “selectionist” consumers to seek premium dining experiences. We expect that the winners in the fine-dining category will continue to “premiumize” by offering exotic ingredients and unique experiences in upscale settings. In the medium term, full-service restaurants will experience stable SRS growth, nearing pre-recessionary levels.

Given the proliferation of restaurant chains and saturation in the market, the number of restaurant units will inevitably stabilize across the entire restaurant landscape, as less successful concepts exit and more successful concepts continue to expand.

Winning growth strategies

Performing well in this environment is not easy. Even many successful chains are now facing challenges from slowing growth. Unfortunately, there is no silver bullet. Those that succeed will have to build a compelling proposition while running a tight ship. Restaurant companies should focus on a combination of building capabilities and controlling costs to spur organic growth and preserve margins.

Unique consumer experience: Chains should focus on their basic value. Customers return if the food, value, and customer service are good. Texas Roadhouse is an example of a company that focuses on a proposition that works; its SRS grew 3.9 percent in the first three quarters of 2017. It delivers a consistent, simple menu; offers free extras like bread, cinnamon butter, and peanuts; and has a distinctive atmosphere featuring country music and dancing servers. Making the customer experience more efficient and modern can drive performance.

Menu management and innovation: Creating an optimal menu mix and investing in continuous menu innovation is vital to stay on trend with constantly evolving consumer preferences. Consumers are more knowledgeable and experienced than in the past, and are more willing to try new foods. This has prompted the rise of fast-casual restaurants with cuisine from around the world such as the Middle East–themed Naf Naf Grill, which in 2015 received an investment from Roark Capital that will enable it to expand to 150 restaurants nationwide within five years.

Technology: To capture the trend toward online food ordering, restaurants are investing in online and digital capabilities. Mobile ordering platforms, which enable customers to order food remotely, pay via phone, and pick up their order without waiting in line, are driving higher sales, boosting customer loyalty, and increasing foot traffic, particularly in the QSR segment. Taco Bell reports 30 percent higher average order values on mobile compared with in-store ordering; Starbucks' Mobile Order & Pay offering already represents 10 percent of total transactions at high-volume stores, and Panera Bread has accomplished steady SRS growth since it unveiled Panera 2.0, a tech-focused initiative to speed up orders through in-house tablets and enhanced mobile ordering.

Occasion diversification: Restaurants can increase SRS by expanding their offerings beyond lunch. According to a 2016 survey conducted by the National Restaurant Association, 16 percent of QSR and fast-casual operators plan to focus on expanding breakfast businesses, and 10 percent will look to build traffic during snacking periods. This trend is further enabled by the rise of online ordering, and of food ordering aggregators such as GrubHub, DoorDash, and Uber Eats.

Marketing: Investing in social media and effective marketing capabilities is key. Celebrity endorsements are also important, as can be seen in the success of the Beyoncé effect on Red Lobster: On the weekend after the pop star released a song that referenced Red Lobster, sales rose by 33 percent. For example, Which Wich, a sandwich player in the fast-casual space, has been actively driving customer engagement by consistently polling guests on social media — gaining both product insights and additional customer touch points. Players across restaurant categories have invested in tailoring their marketing and branding to their core customers, and concepts built around ethical, local sourcing and GMO-free ingredients have been gaining traction.

Cost control: To build winning new capabilities, companies need to aggressively manage back-of-house costs both to free up funds for investing in new capabilities, and to enhance margins. There are three key categories for cost management.

- Labor optimization and efficient layouts: tailoring time requirements based on customer levels during the day, making sure staff are trained at different stations, and minimizing time wasted due to suboptimal kitchen layouts.

- Food waste and kitchen equipment: Using the best equipment to ensure the highest quality of food, balanced with the optimal level of preparation time to manage staffing need.

- Technology and logistics: using technology to drive efficiency and save on noncore goods and labor (e.g., using the right kitchen displays and ordering systems and payment technologies).

M&A outlook

Given the challenging market environment, we expect M&A to continue to play an important role in the industry. Struggling restaurant chains can benefit from aggressive operations management, while innovative formats will look for outside capital and professional management to drive regional and national expansion. In addition, large chains deprived of growth will become a target of shareholder activism and will seek out scaled, successful formats to perform a rollup.

For investors, it is important to distinguish between compelling and noncompelling assets and focus on those with the most potential for value creation. Targets with the potential for growth need to show a strong, differentiated brand and market proposition, combined with innovation to serve as a compelling platform for further rollout. On the flip side, assets that present operational turnaround opportunities need a clear plan for cost improvements, be that within the four walls (e.g., back of house or front of house or menu management) or outside the four walls (e.g., portfolio management, location optimization).

Conclusion

There is no question that established players face a challenging environment in 2018 and beyond. Consumer tastes, habits, and purchase behavior continue to evolve rapidly. The cross-currents of higher labor costs, higher interest rates, and continued economic growth make the environment difficult to negotiate. As is the case in every industry, incumbents face a challenge from well-funded and aggressive disrupters.

Industry players will continue to benefit from the trend of more Americans eating more of their meals outside the home and the resiliency of the restaurant against new online alternative models. In order to capture their fair share, however, companies will have to evolve their menus, business models, operations, and technology to thrive in the new environment. Focusing on differentiating capabilities and controlling costs will put companies in a good position to serve up appetizing results.

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