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## OUTLOOK

### Pandemic, Inflation and Now Higher Rates!

If high interest rates are a problem for the restaurant business now, the 20.5% prime rate in July 1981, in retrospect, should have wiped out the entire industry. It didn't. Instead, the high rates forced restaurant operators to raise equity and be more judicious about debt. It should do the same today.

Now that we're presumably on the back side of the lowest interest rates in history, what do higher rates mean for restaurant valuations and new-unit development? Here's a hint: They will come down.

Higher rates have already impacted valuations if you consider the restaurant ETF, EATZ, which began trading on April 21, 2021, when the 10-year treasury was 1.58%. Since then, that rate has risen to approximately 4.25% while the underlying restaurant stocks in EATZ have returned negative 7.04%.

This shouldn't come as a surprise. The relationship between asset values and interest rates is well understood. When interest rates decline, the present value of business cash flows generally moves higher. The vice versa is true. As interest rates go up, the present value of the cash flow declines.

Middle-market and franchisee M&A transactions, especially ones investment banker Susan Miller told me "relied on debt to reach their high valuation" are the ones she says are most likely to be affected by rate increases.

While the M&A world celebrated last summer's Taco Bell deal that found multiple bids in the 10x range and an oversubscribed bank syndicate, sellers are more likely to have to take back paper to make up the shortfall in senior debt. And, they'll have to lower the interest rate on their piece of the capital structure, just so the blended rate is tolerable to the buyer.

Interest expense has become a noticeable line item on restaurant company P&Ls after years of being buried in the footnotes. Refinancing is now a risk factor. Consider the case of franchisee borrowing $50 million at SOFR +275. The rate in April 2021 was roughly 3% (Libor

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**Around the Industry in Sixty Minutes**
**Restaurant Finance & Development Conference**
**November 13-15, 2023 • The Bellagio • Las Vegas**

Attendees to the **Restaurant Finance & Development Conference** receive insight into what's really happening in the restaurant business and the economy, hearing from our keynote speakers and listening to the expert analysis in our specialty workshop sessions.

One of the most popular sessions annually at RFDC is our Tuesday morning general session which we call Around the Industry in 60 Minutes. (Well, it's more like 90 minutes, actually.) It's an opportunity to hear informative "Ted Talk" style presentations from financial experts, covering a wide variety of important restaurant business topics.

This year's Around the Industry session will sport a Wall Street theme and our presenters include an impressive lineup of top Wall Street research analysts including **Joshua Long**, Stephen's Inc.; **Eric Gonzales**, KeyBanc; **Sharon Zackfia**, William Blair; **Gregory Francfort**, Guggenheim Securities; **Thomas Bailey**, Rabobank; and **Lauren Silberman** of Deutsche Bank. In addition, we're looking forward to presentations given by **R.J. Hottovoy**, Placer.ai; **Gregg Nabhan**, Bank of America's consumer investment banker, and the dean of restaurant insight, **Malcolm Knapp**.

Rounding out the Tuesday morning general session we're excited to introduce our attendees to **Jason DeSena Trennert**. Trennert is CEO of Strategas and one of Wall Street's top thought leaders on the markets and economic policy. He's a regular guest on CNBC, Fox Business and Bloomberg TV, among other outlets. Trennert will provide attendees with insight into the U.S. economy and provide an investment outlook for 2024.

The staff at the Restaurant Finance Monitor look forward to hosting you at this year's Restaurant Finance & Development Conference. Make sure you register early. Last year's event sold out. **Register at www.restfinance.com.**

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was the index then), and with SOFR around 5.3%, the rate rises to over 8% today. Interest expense jumps from a rather benign $1.5 million annually to a what-the-heck-is-going-on $4 million a year today.

Bob Bielinski, managing director of AB Private Credit Investors, said the extra cash operators need to pay interest expense has to come from somewhere. "Either it reduces the amount of free cash flow that can be distributed to the owners, or there is less money to be reinvested back in the business in the form of remodels or new locations," he said.

Multi-unit owners are also finding the syndicated debt market not as accommodating as it was pre-Covid. "Syndication deals that would clear market with four banks, now it takes six banks," a prominent senior lender told me last week. That's because the banking crisis last March and the rise in money market interest rates have triggered massive deposit withdrawals, forcing banks to parse out precious capital.

There is also a new banking canon at play here, one with post-Silicon Valley Bank sensitivities. It demands tighter terms and covenants, and an additional 25 or 50 basis points to fund the risk, which by the way, has lower leverage than the credit agreement it is replacing. And, if the borrower agrees to bring in some deposits, that might just swing the loan.

Franchisees are scaling back development and renegotiating their mandated remodels. Mega-franchisee Meritage Hospitality, which operates 375 Wendy's, put on hold its plan to build 55 Taco John restaurants by the end of 2026, with just four units opened.

Tony Hull, CFO of Carrol's Restaurant Group, the largest Burger King franchisee, told shareholders on a recent earnings call that they are more cautious about debt these days.

"We have to balance our investment in the business, which we're keeping pretty modest and generating free cash flow so we can show the credit side of our investor base that we can improve our credit ratings," said Hull.

The entire concept of valuing EBITDA (earnings before interest, taxes, depreciation and amortization) takes on a new meaning with interest expense rising, senior debt options limited and new unit and remodel costs pricing 30% higher than pre-Covid because of inflation. A restaurant transaction can expect a level of lender and investor scrutiny not seen since the 2008-2009 financial crisis.

What will be interesting is what happens to the emerging brand side of the restaurant business, which has never relied extensively on debt. Former Wall Street analyst and now investment banker Janice Meyer told me she sees more capital moving to these promising brands. She and her partner Jessica Kates told me during a recent call they are starting to see private equity funds, previously focused on the middle market, interested in growing restaurant brands.

That scenario might be comparable to the IPO action we saw in the '80s when interest rates skyrocketed.

There were 87 IPOs that decade, and many of them were small emerging brands you've never heard of, and even some franchisees. The big guns—Cracker Barrel, Chili's, Applebee's and TGI Fridays—were the notable public offerings, the up and comers and, as it turned out, the growth brands of that era.

There were a lot of losers, too. Remember, this is the restaurant business. Naugles, D'Lite's and 1Potato2 were notable offerings, too, but in the disaster sense. They cost investors millions when they tanked. (See our "guess what happened to some of the '80s IPOs" on page 9.)

There is a huge difference in borrowing at 3% and borrowing at 8% to 10%. Interest expense is a huge factor after a decade of free money. Finally, there's a hurdle rate. We'll see how many restaurant concepts have the chops to make it over that hurdle.

—John Hamburger

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