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Restaurant Bankruptcies and Restructurings: The Next Big Wave in Retail Insolvencies?

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results matter



Restaurant Industry Overview and Trends

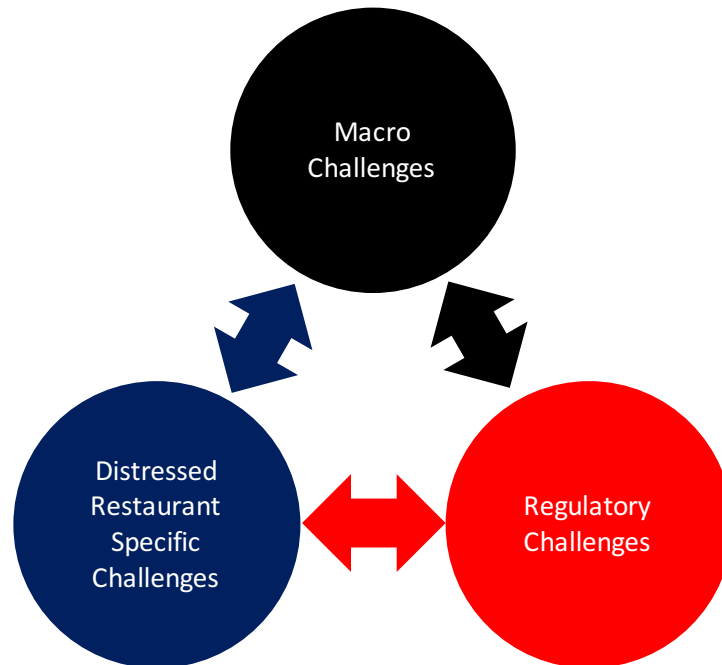
Brief Industry Overview

- Highly fragmented from white table cloth restaurants (\$100 avg check) to quick-serve (“QSR”) restaurants (\$5-\$7 checks).
- Industry is segmented into various segments and not everyone uses the same terminology (ex. QSR, coffee/snacks, fast casual, casual dining, family, fine dining). Additionally, these major segments may have their own subsets (QSR – chicken, subs, sandwiches, pizza, etc.)
- Low barriers to entry
- Threat of substitution (grocery stores, meal kits, meal delivery services)
- Typical Cost Structure:
 - COGS averages: 25% - 35% of sales
 - Labor: 25% - 30% of sales
 - Operating Expenses: 10% - 15% of sales
 - Occupancy: 8% to 12% of sales

Brief Industry Overview – Recent Trends

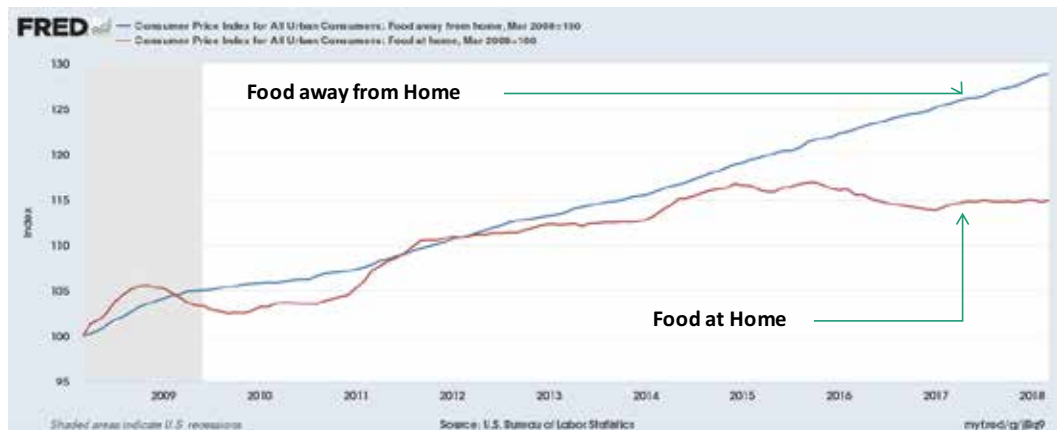
- Macro trends have been great the last few years
 - Unemployment trending down for 5+ years
 - Steady economic growth
 - Low gas prices & interest rates = more consumer discretionary spending
 - Low interest rates & commodities = lower costs
- But Challenges Abound:
 - Food-at-Home and Food-away-from-home
 - Supplier Consolidation driving cost increases
 - Overcapacity: Low interest rates = too much real estate = too many real estate deals
 - Trend towards convenience OR experience – the middle gets left out

Brief Industry Overview – Challenges on Several Fronts



Macro Challenges – Food at Home vs. Food Away From Home

- The Spread between Food-at-Home and Food-away-from-Home is wider than it's been in years, and growing

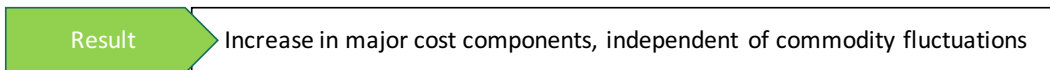


Result

Same Store Sales eroding, and Traffic trends often worse than SSS

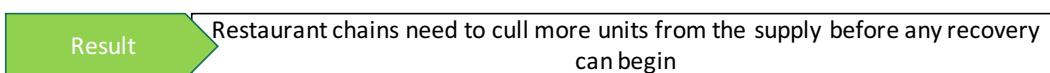
Macro Challenges – Supplier Consolidation

- Consolidation trends in distributors = higher case fees and push towards private-label and house-brand product
 - Regional consolidation
 - Amazon entering food distribution space?
- Consolidation trends in food producers leading to higher prices (recent respite from increasing commodity prices beginning to fade)
 - Heinz/Kraft/Mondelez
 - Anheiser Busch/SAB Miller
 - Four companies control almost all pork, cattle, chicken, and milk production
- Supplier pressures likely to be passed on:
 - Tariffs on aluminum and steel will drive up equipment and beer costs
 - Mounting shortage of long-haul truck drivers will increase distribution costs



Macro Challenges – Over-Capacity

- There are now more than 620,000 eating and drinking places in the United States (Bureau of Labor Statistics)
- The number of restaurants has been growing at about twice the rate of the population; Between 2007 and 2016, the number of casual-dining locations grew by **19.2%**.
- In 2017 - for the first time EVER - the number of casual-dining locations in the US shrunk in 2017, by 1.5% (Technomic Top 500)
- **7,000** retail stores closed in 2017; 300-400 malls expected to go out of business in the next five years
- Heavy Tenant Improvement investment is a operations time bomb



Macro Challenges – Other

Turnover Up	<ul style="list-style-type: none"> National unemployment rate the lowest since 1999/2000 “Battlefield promotions” erodes investment in training “Normal” is 100% for staff, 50% for managers
Chronic heavy discounting	<ul style="list-style-type: none"> Gross-to-net sales erosion Endless appetizers, “2-can-dine”, kids eat free
Activist Investors re-energized	<ul style="list-style-type: none"> Took a breather in 2016/2017, but back in the mix Darden, Bob Evans, Buffalo Wild Wings, Fiesta, Bravo Brio, Chipotle
CEO Turnover & Vacancies	<ul style="list-style-type: none"> Popeye’s, Quiznos, DineEquity (Applebee’s & IHOP), Ruby Tuesday’s, Papa Murphey’s, Fiesta Restaurant Group, Noodles & Co.
Daily news of store closures	<ul style="list-style-type: none"> Famous Dave’s, Noodles, Logan’s, Ruby Tuesdays, outback, Cosi, Garden Fresh, Buffets

Regulatory Challenges – Constantly Moving Targets

- Tip Income Protection Act of 2018
- Federal and local minimum wage increases
- State and Local regulations re: scheduling, time off, personal leave (ever evolving)
- Affordable Care Act (in flux)
- PCI Compliance (ongoing)
- Chip-and-PIN/Cybersecurity costs/data breach risks and costs (ever evolving)
- NLRB ruling that franchisors are “joint employers” (rolled back, but still out there)

Result	Ever increasing cost of compliance, management distraction, and potential for “the bullet you don’t see”
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Distressed Restaurant Specific Challenges

- Assets have been bled to death or near-death
 - Tired décor, aging and mis-matched small wares, patched up kitchen equipment
 - Ongoing cash triage between stores, spend limited to health and safety issues
- Managing for Optionality
 - Need to preserve all forms of *potential* value (e.g. keep a store open b/c it may have real estate value, even if it's an underperformer)
 - Inefficient SG&A, and difficulty making strategic changes
- Planning and Implementation Cycles Becomes Broken
 - Inability to commit to next years' purchases, product introductions, promotional calendars, IT investments, even menu cycles
- Morale, accountability, turnover, "Quitting on the job"
 - Lack of stability and strategy leads to low moral and turnover
 - Difficult to find quality replacements - do without, or turn to consultants and temps
 - Difficult to push improvements through – resistance, limited training, indifference

Typical Management Response

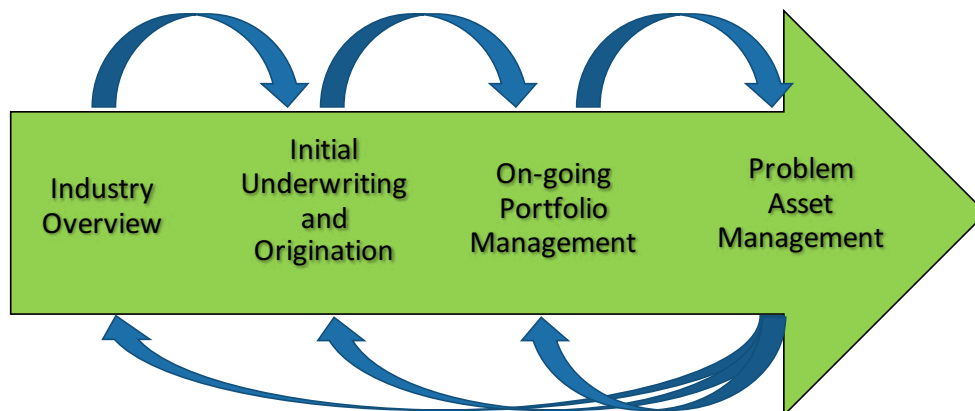
- Near term price/cost fixes
 - Raise prices
 - Trim portions / "Value engineer" the menu (sometimes aka lower quality)
 - Tighten productivity controls - Careful not to sabotage sales (staff for the sales you *should* have)
- Cut SG&A and Marketing – and hope you don't get it wrong!
- Close underperforming stores
 - Almost never the case somehow that poor stores have leases near termination
 - Landlords receptive to negotiations to avoid dark stores – in the right locations
- The "Easy Button" ...
 - Common response to try a "big idea" – no tipping, outlandish promotion, huge IT investment w/ questionable payoff, strategic pivot
 - Doomed to fail w/o buy-in, including investments in store condition, training, and marketing support

What's Ahead

- More declining traffic – no external catalyst for that to change
- Some hope for marginal brands on regulatory and compliance costs, but probably not enough to overcome other macro factors
- Ongoing shakeout in Casual Dining
 - Too many stores, too many brands that have under-invested for years
 - Death spiral already initiated in many places, consolidations will continue
- Fast-Casual is next
 - Crowded field, after years of investors chasing the trend
 - Concepts will get squeezed as QSR moves up and Casual Dining moves down

“Restaurants have historically led the market lower during the three-to-six-month periods prior to the start of the prior three U.S. recessions.” So....

Lender's Perspective of Restaurant Segment



Managing Risk in Initial Underwriting Through Origination (Big Picture)

- Most financial institutions that choose to participate in this segment have clearly defined strategies. These strategies may include:
 - Specialized lending units
 - Identification of segments and sub-segments in which they will participate
 - Concentration limits based on segment, flag, corporate vs franchisee, sponsor vs non-sponsored owned, lead lender vs participant
 - Minimum and maximum transaction size
 - Collateral and loan types
 - Minimum obligor size (revenues, # of locations)
 - Time in business
 - Maximum leverage
 - Minimum fixed charge coverage
- Once it is deemed that an operator strategically is a good fit, focus then turns to the operating entity.

Managing Risk in Initial Underwriting Through Origination (Big Picture)

Key risk considerations may include:

- Reliance on commodities
- Rising labor costs (quick-serve vs table service)
- Food safety
- Changing consumer preferences
- Use of and reliance upon information technology
- Dependence upon financial and credit markets
- Risk of over-building
- Laws and Regulations (ACA, min wage, overtime rules, etc.)
- Reliance on Enterprise Value vs Collateral and/or supporting Net Worth
- Leverage levels and EBITDA margins (Rent-Adjusted or Lease-Adjusted Leverage)

Key Risks - Initial Underwriting Through Origination

- Management and Site Visits
- Financial Analysis
 - Heavy emphasis on income statement given it is the source of repayment and critical driver in enterprise valuation
 - Components of EBITDA compared to averages and competitors
 - Fixed Charge Coverage
 - RAL/LAL
 - Same Store Sales (“SSS”) trends
 - Fully Supportable Projections (Base, Stress, Breakeven)
- If syndicated facility, syndication participants should be fully vetted
- Any “non-Bank” participants and any funding provided outside of syndication by “non-Bank” entities? If so, how does this affect initial risk and potential risk in the event the obligor slides down the risk curve?
- Documentation
 - Proper loan covenants with effective triggers.
 - What we think we have is what we have. No surprises.
 - Are we getting paid for risk and do we have triggers that will allow for this to continue if risk increases?

Portfolio Management

- Regular meetings with management, investor/lender calls
- Constant review of updated industry trends and news
- Site visits
- Analysis of quarterly performance relative to historical and projected performance
- Assessment of SSS performance to industry, segment and flags
- Covenant Monitoring
- Confirmation of Risk Rating (Probability of Default)
- As a relationship moves down the risk curve, frequency of all aspects of portfolio monitoring increases. The audience included in these reviews may also grow. It may or may not include workout officers.

Problem Asset Management

- Most financial institutions move management of problem assets to a dedicated workout group upon loan being deemed Sub-standard (“SS”).
- An SS asset is a regulatory term that is used to define a credit that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. These credits have well-defined weaknesses that if not corrected, could jeopardize the weakness of the debt. Loss may or may not occur. In a nutshell, “If things don’t get better, we could possibly incur a loss.”
- Movement of an obligor to a specialized workout unit helps ensure:
 - Objectivity in management of the asset.
 - Ensures risk rating and accrual status are accurate at all times.
 - Specific Reserves are accurate and losses recognized when appropriate.
 - Documentation and management of the asset meets third party expectations.
 - Specialized resources are utilized to benefit the Bank and the obligor. An obligor and a Bank want a batter at the plate who has seen a “slider” before.
 - Loss is limited to the extent possible.

Problem Asset Management

- Different financial institutions handle problem assets differently. This includes deciding: When? How? Who? What? and Where?
- Generally, problem asset management follows the following steps:
 - Gather facts internally. This includes:
 - i. Review and understand history of relationship
 - ii. Full financial analysis
 - iii. Understand issue at hand and root cause
 - iv. Review documentation and ID potential gaps
 - Meet with obligor and reassess management, business model, and capacity and willingness to address issues. Ask for additional information as needed.
 - Set strategy (Rehabilitate/Maintain or Exit. There are subsets to each of these two strategies).
 - Engage legal counsel where appropriate if not already engaged.
 - Execute on strategy and reassess as conditions change.

Problem Asset Management (Issues Specific to Restaurants)

Small Restaurants/Transactions

- Workouts on small restaurants loans where there is hard collateral (RE, Equip, F&F, personal guarantees, etc.) are very similar to larger commercial loans. If unable to rehab or refi, then move to liquidation of assets to repay debt.
- One typically does not see a large % of 11 filings in this space due to lack of access to capital in all forms.
- Collateral going dark does not have a material impact on the value of the underlying asset.

Large Restaurants/Transactions

- Workouts on larger restaurants loans are much more complex because they typically involve having all business assets as security and the loan is based on the enterprise value (“EV”) of the obligor. Remembering that EV is based on EBITDA, when it comes to a workout, there usually is not much EBITDA. How does one determine appropriate reserves?
- In an 11, typically want to keep entity operating to maximize value.
- Restructuring consultants and good debtor’s counsel are a must, regardless of the ultimate outcome. Management often does not view themselves as the root cause of their issues and can be less than objective in their reasoning. Counselors often help them realize this and help drive an outcome that benefits all parties.

Problem Asset Management (Issues Specific to Restaurants)

Large Restaurants/Transactions

- Treatment of leases under 365 can be a large driver of an 11 outcome due to the large # of leases and the potential impact on the income statement.
- Retaining counsel to assist with potential PACA claims and WARN Act issues can be an important component.
- On syndications, creditors often have different objectives. Watch out and hold on to your wallet! I am referring to bankers, not you.

Debtor's Perspective of Restaurant Bankruptcy



Overview of Prepetition Items, First Day Issues, and Items to Consider

- Corporate Structure and Approval to File
- Public Relations discussion with Client
 - "End of the Road" Headlines
 - Restaurant specific hurdles
- Cash Collateral/Funding post-petition
- Lender negotiations/DIP options
- Vendor Comfort
- PACA Issues
- Lease Analysis
- Checklist with client

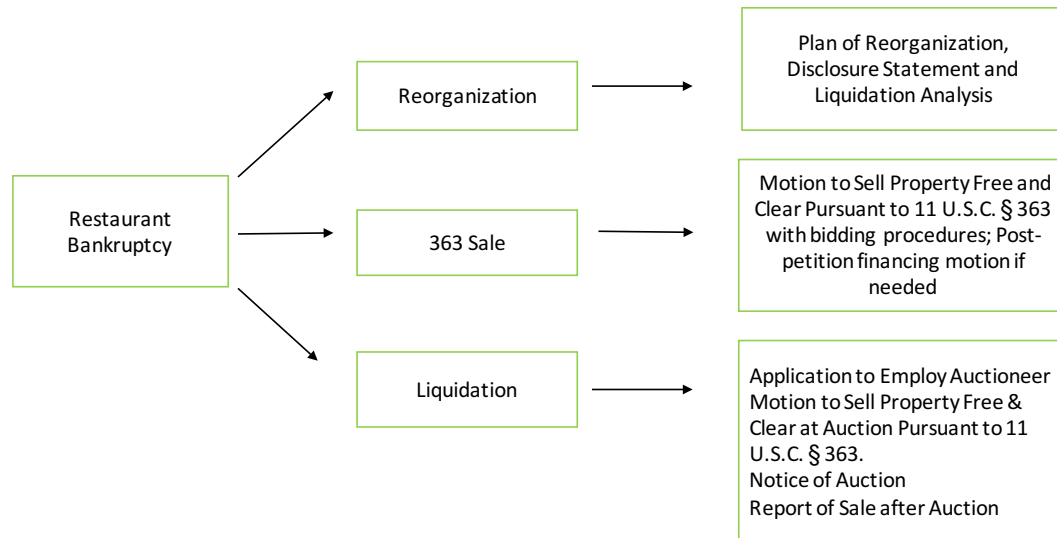
Common Restaurant Case Issues

- **All things 11 U.S.C. § 365**
 - Lease Rejections
 - *In re Buffets Holdings, Inc.*, 87 B.R. 115 (D. Del. 2008)
 - Franchisor/Franchisee
 - *In re Wellington Vision, Inc.* 364 B.R. 129 (S.D. Fla. 2007)
- **Cash Collateral 11 U.S.C. § 363**
 - Lien on food and beverage – proceeds not attributable to sale of goods
 - *In re Cafeteria Operators, L.P.*, 299 B.R. 400 (Bankr. N.D. Tex. 2003)
- **Critical Vendors**
 - Beware 4th Circuit and “Doctrine of Necessity”
 - *In re United American*, 327 BR 776 (E.D. Va. 2005)
- **PACA Claims**
 - *In re Magic Restaurants, Inc.* 205 F.3d 108 (3rd Cir. 2000)
- **WARN Act**
 - *In re AE Liquidation, Inc.* 866 F.3d 515 (3rd Cir. 2017)
- **§503(b)(9) Reclamation Issues**

Potential Options and Goals of Chapter 11

- **Downsize Operation & restructure**
 - What will be the general plan on the restructure and projections? Is the problem “fixable”?
 - Adding new product line? Introducing delivery components?
- **Scale back debt in order to prepare for 363 Sale**
 - DIP Lender and Purchasers – Beware of gap claims!
- **Liquidation**
 - Do you have a broken business model? ATM and Payroll examples
 - Overcoming Mismanagement
 - Impact of 11 U.S.C. § 1104 – Appointment of Trustee or Examiner
- **Hybrid Approach**
 - What negotiations can be done prior to filing?
 - Examples - Turnaround Specialist, Lease negotiations, Potential DIP Lenders

Nutshell Decision Tree



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