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Lending Opportunities in the Restaurant Industry

Rod Guinn, Investment Banker at FocalPoint, LLC, offers a guarded recipe

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Mondays are a day off for most fine-dining restaurants. In their vernacular, they *go dark.*

On Monday, Dec. 1, 2008, things looked a little darker for restaurants in every sector of the industry. That was when the National Restaurant Association reported that the group's most recent *Restaurant Performance Index* showed across-the-board contraction for the 12th straight month.

If this news weren't bad enough, the nation's leading economic research organization made some unappetizing headlines of its own the same day. As of Monday, the first of December 2008, according to the National Bureau of Economic Research, the United States economy had been in recession for 12 straight months.

It was officially dark.

Still doing business

Despite the gloomy news, some restaurant analysts see a near-term silver lining or two. They believe that lenders can still find opportunities in the restaurant industry, notwithstanding a scarcity of new capital and a down-sized consumer base in virtually every restaurant sector.

Investment banker Rod Guinn is one such optimist. He is an operating partner at FocalPoint LLC, where he is in charge of the bank's M&A advisory and capital raising practice in the restaurant industry. Before that, Guinn was with Wells Fargo Foothill and FleetBoston. He was front-and-center during the cycle of restaurant capital raising that ran from 2004 through the middle of 2007, when the market began to soften and contract.

Guinn sees some promising signs of confidence and stability. "Bank of America and Wells Fargo, for example, are still interested and still looking for opportunities in the restaurant industry," Guinn said. "And, some middle-market lenders and banks are doing selective loans within their parameters."

The legal perspective

There is a threshold issue to resolve when a lender and borrower are considering a debt restructure.

1. Should all growth cease, so that all attention gets focused on debt repayment?
2. Or, should a lender be prepared to support some growth, provided it believes its borrower has a viable concept? In other words, it may make sense for a lender to allow some cash to stay in the business, if it believes in the concept.

Keeping the business going may enhance the likelihood of debt repayment. Here are two key considerations:

- A *quid pro quo* for this concession might be for the lender to require that additional equity be invested in the borrower.
- Even if the lender wants all cash to service debt repayment, it should recognize that its borrower will need enough cash invested in the business to keep the brand fresh (e.g., maintenance, remodeling, etc.).

A lender shouldn't choke a borrower with a viable concept. Instead, look to preserve value, even if it means being more patient. If a lender is too restrictive and scoops all the cash flow to pay down its debt, it may wind up killing the business.

—Phil Herman

Just not business-as-usual business

"Lenders have been getting squeezed at both ends," Guinn explained. "They are having a tougher time finding capital to write new restaurant business on the one hand.

"And, on the other, many lenders have portfolios containing loans written against business plans which are not being achieved."

What to remember

Guinn suggests that lenders can learn a lot from the vaunted good old days of the 2004-2007 cycle, lessons that might not exactly hasten an economic recovery but will at least keep them in the game. "Part of the problem was that the market for debt and equity was more liberal and more aggressive in this period," Guinn said, "and not just for the restaurant industry. Loans were made with far more embedded risk, and lenders inched farther and farther out on the ledge."

Debt was issued on business plans based on continued real growth and favorable economic conditions, Guinn explained. This worked so long as consumers stayed happy.

That formula changed in the summer of 2007, as a worsening national economy increasingly changed consumer behaviors in a more conservative direction. A growing number of restaurant loans consequently began to underperform or default.

"Operators have a capital structure with which they're stuck," Guinn said. "At some point, the capital market will feel that consumer habits have stabilized and that the industry is relatively free of its current volatility." Guinn concedes that reaching this point can probably be measured in many months…if not longer.

In the meantime

So, what might a savvy lender or borrower do until bull replaces bear on the industry's menu? Guinn offers four points to consider:

- ***Be flexible with existing loans.*** Guinn says it's smart to play mediator. "Come to a structure that will work, even if that means re-negotiating covenants or payment terms or converting a portion of the debt to equity." Be willing to ask a borrower to give up part ownership, if that's what it takes.
- ***Know where to look for capital.*** "There are still small pockets of capital around," Guinn said, "and restaurant operators aren't coming after them." These funds were raised ahead of the 2004-2007 cycle. Expect to be charged more for this money, Guinn said, and to be offered more conservative terms. Some of this investment capital might act as a bridge.

The legal perspective

In these challenging economic times, bankruptcy filings are on the rise. Bankruptcy need not, however, be the death knell of a company.

Instead, bankruptcy may be a viable strategic option. This is particularly true for operators who need to close underperforming locations.

That's because the Bankruptcy Code allows a debtor to shed leases by "rejecting" them. This leaves the landlord with a claim in most cases limited to one year's rent.

For any operator considering bankruptcy as an option, pre-bankruptcy planning is of critical importance. This includes…

- Negotiating an appropriate financing arrangement for the bankruptcy case;
- Developing a communications plan for employees, vendors and customers; and
- Formulating an exit strategy.

An exit strategy is particularly important for operators with multiple leased locations. This is because a Chapter 11 debtor has a maximum period of 210 days to assume or reject real estate leases. Any extensions of that period may be given only with the consent of the landlord.

Because of this short period of time to make decisions on leases, lenders willing to finance a Chapter 11 restructuring should consider including in the loan agreement benchmarks aimed at keeping the borrower's Chapter 11 case on track. Of course, this would be in addition to other important bankruptcy-specific protections, such as "super-priority" lien status and a waiver of the debtor's rights under section 506(c) of the Bankruptcy Code (which allows the debtor to recover from the proceeds of collateral the costs of preserving or disposing of such collateral).

—Christine Lynch

- ***Know where to look for qualified borrowers.*** "The quick-serve sector is holding up the best," according to Guinn. "Quick-casuals are close behind." The casual sector is struggling the most, owing to higher labor costs and a crowded field. "The concepts in this sector have blurred," Guinn said, "and the casuals seem to have lost their way with consumers." High-end fine-dining consumers seem to be retrenching, too, including ones whose expense accounts have taken a hit. "The better brands are in crowded sectors," Guinn observed, "and some have started offering discounts and coupons. This helps short-term, but cuts into profit and sets up dangerous expectations with their customers."
- ***Be picky.*** "Lenders are not making many new restaurant loans," according to Guinn, "only occasionally reaching out to a particularly attractive investment." When they do, they are likely to be just as cautious about their risk. "Lenders are agreeing to deals with one-half to one-third of the amount leveraged and priced 200 or more basis points higher than 2007," Guinn said. Borrowers have come to expect more risk on their side, higher rates and more restrictions.

So, while the lights are coming back on, lenders are looking for less sizzle and more steak.

Goulston & Storrs represents both lenders and borrowers, so its lawyers have dealt with debt restructuring from both sides. Phil Herman has worked on dozens of major deals in the restaurant industry. Christine Lynch concentrates her practice on bankruptcy and creditors' rights. They can be reached at:

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