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Annual Review and Outlook

In the fall of 2021, the effects of COVID were finally fading and fiscal stimulus was fueling consumer spending in a return to normal. Then Omicron, a new COVID strain, tested all restaurant operators, including even the nearly "apocalypse-resistant" QSR segment. By January, restaurants were closing for multiple days while their teams were taken down with a virus that seemingly jumped any prior protections. With lost hours or even days of sales, the restaurant P&L cracked; Domino's Pizza alone estimated a full six days of lost sales in the first quarter due to early closings, late openings, or outright closures resulting from staffing shortages.

Prime costs of labor and cost of goods sold jumped 15% to 18% in early 2022, fueled by overtime, supply shortages, and generally higher inflationary pressures across all fixed expenses. Restaurant operators who'd been historically shy about taking more than a 2% price increase now saw their corporate EBITDA margins shrink by 500 or 600 basis points almost overnight, eroding cash flow by as much as 35% to 45% in some cases. For those operators who reacted quickly by taking prices up by as much as 10%, the impact on cash flow was mitigated, but traffic counts began to suffer more severely. With price increases at grocery stores averaging over 13% in the year prior, restaurants were able to average 7% to 9% increases and offer a relative value.

As we made our way through the summer, food commodities started to follow industrial commodities that had rolled over their peaks as supply chain troubles were easing. Beef slaughter due to severe drought conditions led to a 15% oversupply by September 2022, and chicken costs were coming down as increased egg sets were leading to falling prices. Fresh vegetables and eggs remained elevated, however, as wholesale food inflation had not yet retreated. Operators were reporting that their job applications were rising and they had the flexibility to fire underperformers and no-shows once again. By July, average hourly wages in the restaurant space finally declined for the first time since May 2020.

A deep labor shortage in the U.S. had emerged during COVID and appeared to have a longer-lasting impact on restaurants and hotels, which cut 2 million jobs at the height of the pandemic. Workers started to shift to better alternatives like delivery gigs, which paid more due to increased demand and were more flexible. By fall 2022, the overall workforce in the U.S. had returned to pre-pandemic levels and a 3.5% unemployment rate, but the restaurant industry was still short about 600,000 workers. Had we reached a point of "peak employees" when it comes to the size of our overall workforce in the U.S.?

The CEO of ZipRecruiter recently stated that the U.S. is at "peak employment" in the face of an ongoing labor shortage where there had been almost two jobs open for every one person seeking work and unemployment rates have remained at historic lows[1]. This paradigm shift in thinking about labor comes with multiple challenges:

- According to ZipRecruiter, 62% of workers want to work from home or have a hybrid arrangement, while a Stanford economist[2] estimates that 50% of jobs still need to be performed on-site and in-person.
- The worst labor shortages with no option to work from home include healthcare, airline, and restaurant/hotel industries, where the frontline workers will be able to demand higher wages for the foreseeable future and will gain leverage over employers with the help of unions or even state legislatures passing new wage laws for these workers.
- If immigration continues growing on trend from 2019, an estimated 1.1 million non-college-educated workers will be missing in the workforce, with little political will to ease this problem[3].
- Some 80 million baby boomers are retiring in higher-than-e xpected numbers (many in their early 60s), creating promotion gaps for younger workers all the way down the line.
- More women are choosing to stay at home, due to continued challenges arranging child care, but their workforce participation rate has declined from peak levels 20 years ago.

So what happens next and what are restaurant operators to do? If you start to think about second- and third-order impacts, such as reduced demand from workers who no longer commute downtown everyday to central business districts that now have higher office vacancies, the breakfast and lunch dayparts along with office catering will be under pressure for the city-based operators. New restaurant development will have to focus on the suburbs around cities where workers live and more are working from home.

With respect to restaurant workers, offering more flexible and predictable scheduling, higher pay and benefits, and more ways to find dignity in their work will lead to higher retention and satisfaction. Unfortunately, taking price will be a balancing act for operators looking for offsets. Implementing the latest developments in artificial intelligence in drive-thrus, mobile app ordering, scheduling and inventory software, and (in very limited situations) robotics will help augment worker productivity, leading to the elimination of some frontline positions over time. Lastly, get politically involved to stay ahead of legislative measures or referendums that could lead to state-specific legislation of higher wages.

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One exception to this outlook is that rising unemployment during a downturn may undermine worker leverage. The massive expansion of delivery of food during COVID attracted over 2.5 million delivery drivers, yet the business has not yielded sustainable profits for drivers, restaurant operators, or third-party delivery companies. If high delivery charges become a non-starter for consumers in a recession, we believe that many of those drivers, after factoring higher gasoline prices into the cost of operating a vehicle, could choose to return to the restaurant business with its relatively higher net wages.

The Fed and interest rates: Are they braking or breaking things? In early 2022, the Fed embarked on a rapid increase in interest rates to reverse the rapidly rising inflation that was averaging 8% or more in the CPI and 5% in wage growth. Their hope was for a soft landing, but its degree of difficulty would be very high. For restaurant borrowers, higher interest rates started impacting proceeds on new real estate loans and tightened cushions on fixed-charge coverage ratios on enterprise loans. Banks started feeling additional strain when first and second quarter compliance certificates were delivered with many surprises in severity and scope. When the resulting tighter lending standards were coupled with EBITDA erosion, M&A activity ground to a halt. In just nine months, more than a dozen larger franchisee deals fell out during due diligence in failed auction processes. Until sellers capitulate and adjust expectations downward, we are likely to see more of the same in the coming months.

On the consumer front, the recession triggered by the pandemic led to record levels of personal savings, with the rate peaking at 33% in 2020, but then shrinking to a 14-year low of 3% by mid-2022[4]. Credit card lines of credit were being drawn down at an annualized rate of 15% to 20% as consumers turned to debt to cover the gap in income vs. expenses during inflationary times. While 60% of Americans were struggling with making payments, the bottom 40% of households who also rent have endured average rent hikes of 15% or more the past year.

These rapid shifts indicate that consumer spending has been under extreme pressure. The Fed efforts to squash inflation will require demand destruction in an economy that is largely driven by consumer spending. While any recession will likely be shorter and less severe than 2008-2009, as the balance sheets of consumers, banks, and corporations are in better shape, the recession may have already begun. Recent signs include the Conference Board's Leading Economic Indicators turning negative for six months straight starting in February 2022[5] (during two quarters of negative GDP in the first half of the year) and the residential real estate market hitting the brakes with spiking mortgage rates.

In an effort to put the brakes on inflation, the chances of a market "break" have escalated in late 2022, where volatility in bond, collateralized loan obligations, and other credit markets has grown and the stock market has pulled back into bear market territory. If markets stop functioning normally, the Fed may be in a difficult position of pivoting to an easing stance and halting or even reversing rate increases. As much as the Fed wants to replicate actions taken in the 1980s to crush inflation, this time it must be engineered against a backdrop of $31 trillion of gross federal debt and a debt/GDP ratio of 120% vs. 30% in the 1980s.

For operators, the reset in valuations will present buying opportunities that make sense if you want to acquire or recap your balance sheet to free up capital. Start building your cash reserves and credit facility capacity today. Most importantly, find bankers who understand your business, have been through multiple down cycles, and can be your trusted advisor to help you get to the other side of challenges.

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See next page for citations incorporated in the material above.

Citations:

1 Employers reaching out to candidates will be ‘the new normal: ZipRecruiter CEO

2 A Stanford Economist Who Studies Remote Work Says Half of All Workers Will Make This Big Change in 2022 | Inc.com

3 US Immigration Rebounds But Remains Far From Plugging Labor Gaps - Bloomberg

4 Consumer Savings Shrink to 2008 Lows

5 The Conference Board LEI for the U.S. Declined in September