NEWS

Strategic buyers heat up M&As with smaller deals

BY SARAH E. LOCKYER

Even as deep-pocketed private-equity players continue to grab headlines with billion-dollar restaurant acquisitions, operators and blank-check companies are increasing their purchasing activity in smaller deals, resulting in a more vibrant merger-and-acquisition market.

With increased access to capital because of favorable debt financing and the recent stabilization of sky-high purchase prices, operators are finding diverse ways to participate in the M&A space, investment bankers say. And because the amount of capital that private-equity firms have to deploy for investment is still robust, those firms are seeking out larger investment opportunities that in turn leave ripe, low-hanging fruit for strategic purchasers.

Investment bankers use the term "strategic buyer," or a buyer interested in an acquisition because of how it would fit into its business plan, to differentiate from a "financial buyer," or one interested in the return garnered through buying another business.

"Many equity sponsors are so focused on larger transactions today that a $15 million to $20 million infusion isn't an option," said David Epstein, a principal at investment bank J.H. Chapman Group LLC. "So the strategics are playing at the lower levels, where there is more inventory with fewer buyers."

A prime example is the battle between Houston-based Landry's Restaurants Inc. and New York-based Patina Restaurant Group LLC as they vie to acquire New York-based Smith & Wollensky Restaurant Group Inc., parent company of 14 upscale restaurants. The latest offer made by Landry's totaled $84 million. Darden Restaurants Inc. of Orlando, Fla., also has noted its ongoing search for an approximately 25-unit, regional growth concept.

Although hyperactive private-equity buyers bullish on the restaurant sector have dominated many restaurant deals during the past two years — think of the billion-dollar transactions concerning Dunkin' Brands Inc. and OSI Restaurant Partners Inc. or the potential buyout of Applebee's International Inc. — most deals occur under the $150 million mark among franchisors, franchisees and other buyers eager to purchase concepts to facilitate corporate growth.

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TIM BOYLE/GETTY

McDonald's experienced a 15-percent increase in its coffee sales after upgrading its standard brew. The chain now is testing iced coffees, espresso drinks, sweet iced tea and bottled soft drinks at thousands of restaurants.

QSR players aim to drink in higher sales with new kinds of beverages

BY CAROLYN WALKUP

The lucrative beverage component of the quick-service restaurant business is taking a big leap forward as McDonald's and other traditional segment players try to siphon off market share from leading coffeehouse chains by offering new varieties of teas, coffees and bottled drinks.

McDonald's, now an espresso source like Starbucks, has ramped up its McCafe specialty coffee test following a 15-percent bump in its coffee sales since upgrading its regular and decaf brews last year.

Answering analysts' questions at a recent conference in Las Vegas, Don Thompson, president of McDonald's USA, said, "We expect to take some share out of the specialty coffee marketplace." He declined to name specific competitors being targeted.

Meanwhile, segment leader Starbucks has downplayed speculation that McDonald's and other traditional quick-service chains will have negative effects on the Seattle-based chain's sales.

"We have not seen any impact from McDonald's efforts to improve their brewed coffee and no impact from Dunkin' Donuts' efforts to introduce espresso beverages," Starbucks chief executive James Donald told analysts at a subsequent conference in Las Vegas. "More educated customers are good for all the participants in the business."

McDonald's, which recently said it was considering the sale of smoothies, is testing several new beverages, including hot and iced coffees, espresso drinks, sweet iced tea and bottled soft drinks, at thousands of restaurants. Its caffè latte and cappuccino varieties, for example, are in test mode in all of the chain's 531 restaurants in the state of Michigan, and in other regions.

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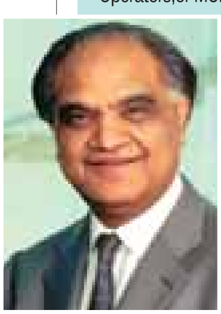
Ram Charan, acclaimed business adviser-motivator, to be MUFSO '07 keynoter

LOS ANGELES — Ram Charan, one of the world's most sought-after business advisers to top executives, will deliver a keynote address at the 48th annual Multi-Unit Foodservice Operators, or MUFSO, conference, to be held Sept. 30-Oct. 3 at the Hyatt Regency Century Plaza Hotel here.



Ram Charan

Known for an energetic and interactive teaching style, Charan has a reputation for offering down-to-earth, relevant advice that focuses on the real-world complexities of business. For the past 35 years, he has shared his insight with major corporations such as GE, Verizon, Dupont, Honeywell, KLM and Bank of America.

In a recent Newsweek magazine interview, Jack Welch, former chief executive of GE, said he was a big admirer of Charan and found him unusually adept at helping companies import best practices from other firms.

Alan Gould, publisher of Nation's Restaurant News, which produces MUFSO, said "As hundreds of leaders from the world's most successful companies can attest, Dr. Charan has an uncanny ability to solve the toughest business problems and also deliver hard-nosed insight into the nature of human potential.

Gould added that Charan's appearance fits appropriately with this year's MUFSO theme of "Fire Up Your Brand."

"Dedicated employees are vital to brand success, and Dr. Charan is a leader in understanding the capacity of people to achieve extraordinary things," he said.

Charan's introduction to business came early while working in a family store in the small Indian town where he was raised. He earned an engineering degree in India and took a job in Australia and then Hawaii. He pursued his talent for business by earning a master's degree in business administration and doctorate from Harvard Business School. He graduated with distinction and was a Baker scholar. He then served on the Harvard Business School faculty.

Over the past decade, Charan has captured his business insights in numerous books, including "Execution: The Discipline of Getting Things Done" and "Confronting Reality," both co-authored with Larry Bossidy, the former chief executive of Honeywell.

His latest book, "Know-How: The 8 Skills That Separate People Who Perform From Those Who Don't," came out in January. He also has written many magazine articles, including two cover stories for Fortune magazine: "Why CEOs Fail" and "Why Companies Fail."

"I am excited that top restaurant executives will have a chance to hear Dr. Charan at MUFSO," said Ellen Koteff, editor of NRN. "He gets to the central issues and speaks the language of a real person rather than the Harvard-trained academic that he is."

Charan's appearance Oct. 1 adds to a MUFSO lineup of keynote speakers that also includes Leon Panetta, former chief of staff to President Bill Clinton. Panetta's address is sponsored by the Elliot Leadership Institute.

Like all MUFSO conferences, the 48th edition will be packed with activity, starting with the "Taste of Los Angeles" reception Sept. 30, which is sponsored by the Coca-Cola Co. Other highlights include the Hot Concepts! Panel; the Presidents' Panel, sponsored by American Express; and the Eat and Ear Awards, sponsored by PepsiCo Foodservice, which honor the best restaurant advertising on radio and television during the past year.

MUFSO culminates with the Annual Awards Banquet Oct. 2. Sponsored by American Express, that gala event honors the Golden Chain winners, the Pioneer and Innovator Award winners and the Operator of the Year.

For MUFSO information, call (212)756-5201 or visit www.mufso.com. ■

Strategic buyers heat up M&A market with smaller deals

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"All of the large private-equity-sponsored, public-company buyouts are basically financial engineering," Epstein said. "But most of the M&A activity is really strategic in nature — deals that make good business sense for diversification, expansion to other markets or the taking out of a weak franchisee, for example."

According to Rosemont, Ill.-based J.H. Chapman, strategic buyers completed 60 percent of the 99 nonpublic-market transactions in the restaurant industry in 2006. In 2005, that number was just 20 percent of all nonpublic-market transactions.

More specifically, in 2005 there were 29 transactions involving equity funds and 15 involving operators, according to J.H. Chapman's research. In 2006, that gap narrowed, as there were 27 transactions involving equity funds and an equal 27 transactions driven by operators. This year, if the lending environment remains positive, the industry should see the same level of activity as it did in 2006, Epstein projected.

Ron Berger, chairman and chief executive of Figaro's Pizza, a 114-unit pizza delivery and take-and-bake restaurant chain, kicked off 2007 with an acquisition. In mid-March, Figaro's, based in Salem, Ore., acquired the 10-unit Sargo's Subs, an Italian-theme sandwich chain. While terms of the deal were not disclosed, Berger said the transaction was financed solely through cash from operations.

Berger said he had been looking since 2001 to make acquisitions, both within the pizza segment and among brands that would complement its flagship Figaro's chain, and only now was able to find the right deal.

"It was the right strategic opportunity," he said. "We're in the pizza business, so about 70 percent or 80 percent of our sales are after 4 p.m. In the sandwich business, almost 80 percent of their sales occur before 4 p.m."

Both brands would be the focus of expansion, Berger said, as his company will offer Sargo's franchises to both prospective and existing Figaro's franchisees. In addition, Figaro's franchisees would be offered the opportunity to sell a selection of Sargo's sandwiches in their Figaro's units.

Berger said he was looking for additional acquisitions, mostly among concepts in the 50-unit range.

Also operating in the under-$100 million market is Christopher R. Thomas, president and chief executive of Restaurant Acquisition Partners Inc., a publicly traded blank-check buyout firm.

Ron Berger, chairman and chief executive of 114-unit Figaro's Pizza, said he had been looking into acquisitions since 2001 before acquiring 10-unit Sargo's Subs last month. "It was the right strategic opportunity," he said.

Thomas said he and his partners — all restaurant industry veterans from various chains like Planet Hollywood, Sizzler, Chart House, Long John Silver's and Wendy's — purposely undertook a small equity-gathering public offering in the $20 million range so that future acquisitions also would be small.

"We were getting encouragement to do a $75 million to $100 million IPO, but we are required to make an acquisition of at least 80 percent of the offering," Thomas said. "If we have to make that large an acquisition, well, because of the heated competition from all the large, flush-with-cash equity firms, we decided that was way too competitive."

The company is seeking to purchase concepts with earnings prior to interest, taxes, depreciation and amortization of between $4 million and $10 million, which would put the transaction value under $100 million, a space that "isn't being addressed by private equity," Thomas said.

Investment bankers Dean Zuccarello and Carty Davis, principals at the Southern Pines, N.C.-based Cypress Group, said there is indeed an "emergence of a subset of strategic buyers" that aren't traditional strategic operators — but are not private-equity buyers, either — looking to add concepts to an existing operating platform.

"The big strategic restaurant companies are still focused on their core businesses," Zuccarello said. "But some of the other groups, they feel they have their houses in order and they need a growth vehicle. … You'll see more of that." ■

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QSRs aim to drink in sales from new beverage offerings

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Dunkin' Donuts, which introduced a line of espresso drinks in 2003, is more aggressively promoting them than in the past. The espresso line now generates more than 5 percent of total sales in 2006, a chain spokesman said. That would amount to approximately $235 million.

Dunkin' Donuts, Starbucks Coffee and McDonald's all have been giving away coffee in special promotions to call more attention to their beverage lineups. McDonald's offers free cups of its regular or decaf coffee every Monday. Starbucks gave away hot coffee for a full day recently, and Dunkin' poured free 16-ounce cups of iced coffee in a one-day promotion.

McDonald's test stores are working on speeding up service as they adapt to the specialty coffee platform, which uses an automated espresso machine that grinds the beans and brews the drink under pressure, steams either 2-percent-fat or skim milk, and adds optional flavor syrups. Thompson said he expects service times to decrease as test unit employees get used to preparing the drinks.

He emphasized that everything McDonald's considers rolling out chainwide must fit customer demands for convenience and speed. Crew members' mandatory offer to add cream or sugar to brewed coffee fits that convenience model, especially in the drive-thru.

Although coffee drinkers order that drink at various times throughout the day and night, coffee sales particularly benefit the breakfast daypart, which, Thompson noted, is McDonald's most-profitable meal period. Two hand-held sandwich products the chain also is testing — a bigger breakfast burrito and a Southern-style chicken biscuit — also are aimed at strengthening breakfast.

Dunkin' Donuts introduced espresso drinks in 2003.

"We think [the chicken biscuit] has the potential to make waves outside the South," Thompson said. He did not further describe the product, and other McDonald's spokesmen could not be reached for comment.

Not only has coffee contributed to McDonald's strong breakfast daypart, but coffee in general has proved to offer especially good profit margins.

"You can't get much better profit than by adding water to beans," Thompson said. "It's a great margin business and one that customers are asking for."

Another product that offers an equal or even better profit margin is tea, which McDonald's may capitalize on if it rolls out a sweet iced tea now being tested in some 4,000 restaurants. Thompson called both tea and coffee "an effective way to gain added customer visits."

One of McDonald's senior executives has registered to attend the World Tea Expo, the world's largest tea trade event, this June in Atlanta, according to George Jage, the event's president. If McDonald's incorporates specialty teas into its permanent menu, it will have a major impact on tea sales in this country, he said.

"McDonald's inclusion of flavored or specialty tea in its restaurant offerings will further move tea into the mainstream of Americans' diet and consumption," Jage predicted.

Variations on iced teas and coffees continue to make inroads in the quick-service segment. Burger King, Dunkin' Donuts and Sonic America's Drive-In recently broadened their iced beverage lines, and Chick-fil-A introduced sweetened iced tea a few years ago. Burger King introduced BK Joe on the Rocks, an iced coffee, in January; Dunkin debuted a specialty iced tea line last summer; and Sonic continues to add new twists to its flavored iced teas.

Frozen blended coffee drinks continue to gain popularity. Most specialty coffee chains are continuing to expand those lines, such as Coffee Beanery's Frappalattes, which have gained 2 points in sales in the past year to account for 7.8 percent of sales.

Although few traditional quick-service chains have so far emulated those fast-casual players that augment their fountain soft drinks with bottled versions, McDonald's is looking at that possibility as a way of offering more choices.

"Customers are looking for convenience. Sometimes that means resealable containers," Thompson said.

The challenge is to ensure that the restaurants maintain their higher profit margin from fountain drinks if bottled ones also become available, he said.

A Sandelman & Associates consumer survey of quick-service restaurant patrons disclosed that soft-drink purchases dropped to 47 percent of visits in 2006 from 52 percent in 2005, said Bob Sandelman, president of the industry research firm. Coffee purchases gained 1.1 percent in the same period, up to 3.5 percent of visits, compared with 2.4 percent a year earlier. Tea and water purchases also increased slightly.

However, Sandelman said he does not see espresso drinks becoming a major part of business at traditional quick-service restaurants. ■

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