By James Morden

The Impact of COVID-19 on the Restaurant Industry Outlook

Editor's Note: *To stay up to date on the COVID-19 pandemic, be sure to bookmark ABI's Coronavirus Resources for Bankruptcy Professionals website (abi.org/covid19).*

James Morden
Capstone Headwaters
Birmingham, Mich.

James Morden is a director in the Capstone Headwaters Financial Advisory Services practice in Birmingham, Mich. With more than 19 years of interim management, financial advisory and restructuring experience, he specializes in guiding companies in operational and financial distress, and has advised on complex engagements for companies, secured lenders, unsecured creditors and public-sector entities.

The 2019 novel coronavirus disease (COVID-19) has created unprecedented distress in a number of industries. Arguably, the hardest hit to date may be the restaurant industry. Changes in consumer behavior stemming from concerns about exposure to the virus and governmental orders forcing closures and capacity limitations have ravaged the sector. Going into December 2020, more than 110,000 restaurants had closed their doors permanently or long-term during the pandemic.[1] Major names have filed for bankruptcy in the past year, including Chuck E. Cheese, Sizzler, California Pizza Kitchen and Le Pain Quotidien.

The end may not yet be in sight, as Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, estimated that even with a vaccination rate of 75 to 80 percent, the U.S. might not be able to return to something resembling normal life until the end of 2021.[2] Early indications, however, are that the vaccine adoption rate might be below that range. Given this, there is a real risk of additional fallout due to ongoing governmental dining restrictions, along with uncertain consumer sentiment regarding returning to in-person restaurant dining.

According to Robert Hersch of Mastodon Ventures, an investment banking and advisory firm that specializes in working with lenders, equityholders and buyers in the restaurant space, the hardest hit restaurants are independent sub-10-unit groups. Among this class, fine-dining enterprises are in the worst position; as Mr. Hersch notes, "It's hard to sell a $30 delivery pasta dish."[3]

While all restaurants with a significant dine-in component are impacted, some chain locations have a slight leg up over independents. Name recognition helps them achieve a higher carry-out and delivery market share. In addition, at a time when restaurants are pivoting to delivery service, the scale of chain restaurants allows leveraged negotiations with third-party delivery services, helping to maintain better profit margins.

That still has not saved a large number of franchisee locations from joining a steady stream of troubled restaurants going through one Chicago-based troubled asset manager's portfolio. They advised that since Paycheck Protection Program funds have dried up in the last few months, there has been a boom in restaurant credits moving to workout.

Getting through a workout during COVID-19 has proven quite challenging. The complete lack of visibility into what regulations will be within even a week has made it difficult to create workout plans. Debtors cannot reliably predict how much liquidity they will have or require, thus making it difficult for lenders or sources of new equity to assess their options. As one lender noted, "[T]he authorities' inability to provide a framework, benchmarks, or an explanation of their decision-making process has made it impossible to underwrite, game plan, and put additional money in." Lenders would prefer to see firm medical/social benchmarks provided as part of the basis for restaurant closures or changes in regulations in order for them to do their own modeling and analysis.

Aaron L. Hammer, chair of the Bankruptcy, Reorganization and Creditors' Rights Practice Group at Horwood Marcus & Berk Chtd., also cited uncertainty as a chief concern in the industry. He brings a unique perspective as not only a workout lawyer, but also as managing partner of Red South Beach, a restaurant located in Miami Beach, Fla. "Uncertainty is the biggest challenge," Mr. Hammer said. "In good times, you know how much working capital you're going to have and need. The lack of governmental guidance regarding regulations makes cash planning very difficult."

As the COVID-19 regulations fluctuate, the pandemic's effects beyond those of just lost sales begin to enter the equation. A hurdle for restaurants still operating is the reduction in payment terms from key suppliers. Some major food distributors have shortened payment terms in an effort to minimize collection losses from restaurant shutdowns. The shorter terms produce a permanent reduction in available cash for the restaurants at the same time they are experiencing stress on sales.

1 Joanna Fantozzi, "'Free-Fall': 10,000 Restaurants Have Closed over the Past Three Months, According to the National Restaurant Association," *Restaurant Hospitality* (Dec. 7, 2020), *available at* restaurant-hospitality.com/operations/free-fall-10000-restaurants-have-closed-over-past-three-months-according-national (unless otherwise specified, all links in this article were last visited on Jan. 8, 2021).

2 Alvin Powell, "Fauci Says Herd Immunity Possible by Fall, 'Normality' by End of 2021," *Harvard Gazette* (Dec. 10, 2020), *available at* news.harvard.edu/gazette/story/2020/12/anthony-fauci-offers-a-timeline-for-ending-covid-19-pandemic.

3 Quotes in this article without sources or citations are taken from direct interviews conducted by the author.

Having the right employees might also be a problem going forward. Paul Neitzel of Rock Creek Advisors served as financial advisor to the debtors in the bankruptcy of BarFly Ventures LLC, a chain of brewpubs.[4] He cited employee retention as an ongoing challenge to the industry. In the short-term, former employees might be difficult to lure back to a job that may start or stop at any time. Looking further out, many valued employees have indicated that they would be exiting the hospitality space permanently due to concerns over long-term reductions in jobs from a lasting consumer preference shift away from dining out, as well as the potential for a repeat of the current closures at some point in the future. The problem might be exacerbated for more urban locations that are seeing what could be a permanent exodus of population as a fallout from the pandemic.

This combination of severely reduced sales, reduced margins on delivered food, loss of high-margin in-house alcohol sales, a lack of clarity on future liquidity and available funding, and reduced credit terms continue to lead to more distressed restaurants. To combat this, companies are cutting staff to bare minimums and stretching credit where they can, but one of the chief avenues of relief being explored is renegotiation or cancellation of property leases.

Leases represent one of the top three expenses of restaurant operations, alongside those of food costs and payroll. Given that there is little new tenant demand for restaurant spaces, there is a limited market for sale of these properties, and it is expensive to convert the spaces to alternative uses, so businesses are relying on this as a point of leverage for reducing cost. They are doing so with varying success. Less sophisticated lessors, owning just a few mortgaged properties, often are more financially constrained and less flexible in working with the lessee toward an outcome that might have a long-term benefit for both parties.

However, landlords with an extensive portfolio, greater leasing acumen and/or financial reserves may prove more open to percentage-of-sales-based rent, short-term adjustments or deferrals in the hope of avoiding extended vacancy. Given the impact that reduction or deferral of rent can have on a company's bottom line, a landlord's willingness to consider such action can be the difference between continuing operations and folding, or it can be a factor in deciding whether to file for bankruptcy.

For many single-entity and low-unit restaurant groups, it is hard to see the light at the end of the tunnel. Christine Gurtler is design director for Jacobs Doland Beer, a foodservice design consultancy in New York. "Prior to COVID, it was becoming apparent that the days of operators running only one or two restaurants were numbered," she said. "The expenses associated with keeping up operations were becoming unsustainable over that level of revenue. With the hangover effects of COVID, that problem will be exacerbated, and survival will become even more difficult." As sales continue to shrink, small restaurant groups without the necessary base over which to spread fixed costs could also fight a bigger uphill battle in lease negotiations, as they might be reliant on the whims of a single landlord. The likelihood of backstop sources of funding for these entities is also lower.

Finally, like normal fixed costs, the legal and other administrative costs of going through any kind of workout are greater on a dollar-per-dollar-of-sales basis for smaller entities. **John W. Lucas**, a bankruptcy attorney with Pachulski Stang Ziehl & Jones LLP, advises, "We all know what 'too big to fail' means, but when it comes to restructuring a smaller restaurant chain, the problem is 'too small to restructure.' Restructuring fees take their toll on smaller restaurant chains, and success requires a light hand and knowing when and where to push to get the deal across the finish line."

Given these challenges, we are seeing many of these companies simply turn off their lights and shut their doors. As one food service distributor noted, "We are calling customers every day to drive collections. If they're late, we are just hoping they are still there."

For those with entities with enough wherewithal to enter a workout, the process likely depends on the structure of their debt and the approach of ownership. If the lender is an unregulated credit fund, they are usually willing to kick the can down the road on principal payments if they are seeing interest payments being made. If no interest is being paid, they might still be flexible, but if new cash is required to fund the business, they will be looking for equity returns or a debt-for-equity swap. If the lender is a business-development company (BDC), it might be willing to accrue interest at default rates, but again, it will require equity returns if new money is needed.

If a forced sale is necessary in these situations, credit bids are frequently being made. There is currently a significant bid/ask spread in the market for dine-in restaurants. Many buyers appear to be double-discounting the valuation of companies as they develop purchase multiples off COVID-reduced earnings and reduce those multiples because of overall COVID-19 risk. The resulting valuations are often so low that alternative lenders believe that taking over the company and injecting new cash will lead to a greater recovery in the future than taking the level of discount required to execute a sale in the current environment. Credit bids are also increasingly occurring because the number of potential buyers is being limited by the financing markets. In this case, buyers are not entering the market due to the high cost of debt of a leveraged transaction in the restaurant space.

If the lender is a traditional bank, it may be more limited in the leeway it is able to give a troubled creditor. One lender advised that two key variables often factor in to whether or not a workout with their institution would be an option. First, what can ownership bring to the table as far as assets, guarantees and cash; in other words, how are they willing to share in the pain? Second, does the owner have a plan; in other words, have they put in the time to show that they can guide this business forward?

For those restaurants and groups that successfully navigate a workout situation or are able to avoid one entirely, there will be some positives to take out of the experience. Many have been forced into building out a delivery avenue that they might not have otherwise pursued. They may have established a long-term consumer acceptance for delivery or take-out meals they once considered only for dining in. In

continued on page 47

4 Case No. 20-01947 (Bankr. W.D. Mich.).

from page 19

some cases, necessity has also proven to be the mother of invention. In the case of Mr. Hammer's Miami Beach restaurant, the steakhouse is adding a totally new source of revenue: They will begin offering their raw signature cuts and spices for home delivery and in-home preparation.

As we wait for the proliferation of vaccines, and as the country works toward a return to normal, there will be continued fallout. Those restaurant groups that have survived by successfully pivoting to delivery models and identifying other ways to increase revenues, cutting operating costs to a minimum, and negotiating lease adjustments will need to continue to be nimble as regulations shift and consumer demand remains uncertain. The landscape will be altered, with the number of single- and low-unit-count restaurant groups drastically reduced. However, the restaurants still standing in 2021 might be well positioned to capitalize long-term on what they have learned during this challenging time. abi