

## OUTLOOK

### Brutal Truths

At this time last year, we were hoping that the economy would be in the middle of a so-called “V-shaped” recovery by now. The thinking went something like this: If GDP was contracting so much in 2008 and early 2009, then it was only a matter of time before, mathematically, it would come roaring back. However, in my travels around the country talking to small business owners of the restaurant and franchise variety, the economic depiction I hear most frequently isn’t of a recovery underway, but an entirely opposite picture of how things are playing out.

“It’s brutal out there.”

Unfortunately, “brutal” has entered the lexicon of business language in recession-racked America. Restaurant operators tell me that “our sales are brutal” or “last month’s sales were brutal” or “can you believe the brutal year we are having.”

There’s no doubt we are still in the grip of a nasty restaurant recession. Restaurants are experiencing a sales slump across all industry segments and many are engaged in a massive discounting and cost-cutting exercise just to stay in business. The National Restaurant Association’s Restaurant Performance Index (RPI) of restaurant activity remains below 100 for the 24th consecutive month, which signals an industry contraction. Likewise, according to the association, restaurant operators reported negative same-store sales for the 17th consecutive month in October and negative customer traffic for the 26th consecutive month. Real restaurant sales will decline again in 2009, the second year in a row, and the first time a two-year decline has happened in 40 years. Even mighty McDonald’s reported a second straight monthly decline in U.S. same store sales, a sign that the grand slump continues and that QSR is no longer immune from the downturn.

Despite a reported uptick in retail sales for November, restaurant operators aren’t crowing about an upturn. I still see struggling, befuddled, angry and, in many cases, exhausted operators out there. When I hear talk that a down-five-percent market is the new normal, the only word that comes to mind is “brutal.”

Jerry Thissen, CEO of Irvine-based National Franchise Sales,

has been selling restaurant businesses for over 30 years and says he sees a change coming in 2010. Thissen thinks 2010 will be the washout year because of a “fatigue factor” setting in among owners of beleaguered companies who’ve been holding off selling their businesses until the economy turned positive. He sees cases where operators are “burned out” from two straight years of slashing costs to keep pace with sales declines. They want out.

Lately, Thissen has noticed more interest in selling because operators are under “new pressures from franchisors, lenders, purveyors and landlords. Franchisors want remodels, lenders are quicker to default, purveyors want cash on delivery and landlords are more inclined to evict,” said Thissen. He expects more owners to consider selling their operations, some forced, others by choice, as they, their lenders, landlords or purveyors succumb to the fatigue factor.

As I travel around the country, I see first-hand what Jerry Thissen is talking about. One franchisee of a family dining chain I’ve known for years told me he is getting out after 30 years in the business. His desire to sell comes despite the fact he knows he is selling at a low point in the market. He told me he was tired of discounting, tired of his franchisor’s marketing and doesn’t really care the market for business sales is down.

A fast-casual franchisee told me he finally made the decision to close a store and “face the consequences” from his landlord and lender. He’s sick of losing money and lost hope of turning the store around. A sandwich shop franchisee who closed his only store and filed bankruptcy this past November told me his health was suffering from stress and that he was finally “relieved” to shutter the business. Last week, another franchisee told me he is tired of “busting his butt” to make his loan payments and may have to file bankruptcy to get some breathing room.

In sports, the fatigue factor can determine how an individual or team performs in a game. When fatigue sets in, a player can be given the night off or used sparingly in the next game to regain strength. Generally the bodies of younger athletes recover quickly. But in a business context, fatigue and stress associated with ongoing business problems can’t easily be shaken off. Business owners with struggling operations and high debt payments can’t take the night off. They can’t

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afford to go on vacation to recover their mental and physical agility. Typically, they work harder and longer hoping that the economy will turn around and their business will improve. Unfortunately, the adrenaline that kept the struggling restaurant operators going in 2009 is now dissipating.

During this past year, I've talked to many restaurant owners about what it takes to hang in there and not succumb to "burnout." But now I am less optimistic about the turnaround prospects for some companies and concepts. While many restaurant owners and executives are quick to blame the economy for their problems, I wonder how many of them have really examined whether their problems were brought on solely by the "brutal" economy, or, did the good economy mask the fundamental problems they had before the downturn began?

One thing is clear: The "fatigue factor" is stifling innovation and new product ideas for even the most solvent chains. Discounting and menu tricks have replaced new product introductions, and the slashing of labor in the office and stores is killing morale. Where are the new ideas in the restaurant business going to come from? The late management consultant, Peter Drucker, said that real entrepreneurship required innovation and that a business must "free its best performers and devote financial resources for the challenges of innovation." How many good employees are left to innovate?

The restaurant business desperately needs new ideas right now, not more discounting and portion-reducing tricks. In a recent letter to his investment partners, Roger Lipton, a veteran money manager and restaurant investor, pointed out that cutting back on employees and portion sizes is not a "sustainable" business plan. "The savings from layoffs and cheap sourcing don't justify high price earning multiples," said Lipton.

This fatigue factor we are witnessing may be a sign that the economy is starting to bottom out. At least we hope so. In 2010, we may still watch the slow burn of underperforming and in some cases, money-losing restaurants. But if Jerry Thissen is right, and the burn is accelerated, new owners will begin to replace the tired ones in greater numbers, and hopefully will bring fresh ideas to the table. The opportunity still exists for the energetic, innovative and solvent operator. Are there any left out there?

—John Hamburger

