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Restaurants make tasty targets for private equity firms

Local restaurateurs lure capital despite reputation of dining sector as treacherous

GUEST COLUMN

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Burned by dotcom portfolios that whetted investors' appetites but often left them without anything to chew on, venture capital and private equity funds are increasingly drawn to opportunities in the hospitality industry. During the past two years, private equity firms have taken a fresh look at many restaurant chains in particular.

The business case for sophisticated investors' play in a stereotypically risky business is simple. Consider what good restaurant companies can offer: proven brand concepts; steady cash flow; predictable growth opportunities through geographic expansion; and uncommonly stable, up-through-the ranks experienced management teams.

Locally, some of the Portland area's most successful restaurant companies have similar private equity themes.

Vancouver's Waterloo Restaurant Ventures Inc., the first domestic franchisee of the Romano's Macaroni Grill concept owned and developed by Brinker International, has used infusions of capital from Saugatuck Capital Partners of Stamford, Conn., and Crates Thompson Capital of Fort Worth, Texas, to open and acquire 11 restaurants and additional development rights in the Pacific Northwest and Northern California during the past four years.

Shari's Management Corp. of Beaverton (offering a brand concept founded nearly 30 years ago in Hermiston) was sold last year to an investor group led by the New York-based private equity firm Circle Peak Capital for just under $80 million.

NW Hayden Enterprises, an experienced restaurant outfit operating out of Tualatin, recently secured $1.2 million in funding from Aequitas Capital Management Inc., based in Portland and Bellevue, Wash. The restaurant company used the capital to fuel its opening of a handful of new outlets, including Mark Lindsay's Rock n' Roll Café in Northeast Portland.

As these examples indicate, private equity firms are closing on investments in restaurant business models ranging from national brand franchise operators to in-house chains to independent concept projects.

Restaurateurs seeking private equity as a source of expansion capital should be prepared to set themselves apart from the myriad opportunities for private placement. Strong brand equity, solid operations experience and a compelling and reliable financial story are required. Sound employment practices and legal compliance are a must.

As one might expect, deal structures and valuations vary. Smaller private equity deals are often paired with additional debt vehicles from traditional lenders.

Analysts for Nation's Restaurant News have pegged restaurant deal valuations at roughly seven or eight times EBITDA (earnings before interest, taxes depreciation, and amortization). Last year's highly-visible sale of Dunkin' Brands to a consortium of global private equity firms for $2.4 billion was at nearly 12 times EBITDA.

Restaurant businesses with private equity in the door generally aren't pressured by the same quarterly earnings and Sarbanes-Oxley demands faced by publicly held companies. And most aren't involved in the high-risk, high-stakes games that are commonly associated with venture capital in early-stage technology companies.

But management must be attentive to their capital partners' expectations, not only with regard to their mutually agreed strategy when the investment was made, but also with respect to the return on investment required to maintain the interest of astute investors.

With the recent surge in restaurant investment activity, we've observed that many private equity funds have not previously invested in such heavily regulated businesses, where the rules vary so widely from state to state. This is particularly the case when multistate liquor licenses are involved, where new owners must be approved as licensees.

Private equity providers, on the other hand, must be prepared to meet licensing obligations that require them to provide — sometimes for the first time — sensitive and confidential information to state agencies. For example, the alcohol regulatory authorities in Washington, Oregon and California are among the most aggressive in the country in terms of requiring corporate information, as well personal information and financial disclosures from the directors and officers and all material parties in interest (including the ultimate owners) of the business.

Deal counsel and other professional advisers who are experienced with sophisticated investment transactions and the unique demands of hospitality businesses can assist with structuring deals and managing regulatory processes in order to avoid unrealistic expectations, while minimizing the impact on operations and the time needed to conclude required approvals as a pre-condition to closing the investment.

Investments in the restaurant and hospitality industry do bring new challenges, for private equity funds and their on-the-ground operators. Negotiations and deal closings can be lengthy, and distract restaurateurs from the needs of their day-to-day operations. For those who persist and find the right fit, the rewards can be great. Expansion proceeds and profits are plated. This most commonly occurs when the restaurateur not only works with a private equity firm that understands the business, but when the restaurateur also works to understand their investment partner's business as well.

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