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Casual dining and dessert sector review – UK

The UK restaurant industry has been facing a looming industry crisis of which the ramifications are now being felt. Currently one in three of the top 100 UK restaurants are loss making.

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A decline in the sector

Recently there have been several high-profile casualties of the food and beverage market. Government reports revealed that 984 restaurants went into administration in 2017.

Several factors can be blamed for the difficulties faced in the food and beverage industry. The first being increased operating costs. The increasing rental costs combined with the implementation of the living wage has place an extra financial burden on businesses. Restaurants thrive on cheap labour, however with Brexit looming access to low cost immigrant labour will now be restricted. This in turn will drive restaurants towards paying a living wage to attract and retain workers. Increased business rates have placed further strain on the cost base. The Association for Licensed Multiple Retailers estimated in 2017 that the current business rates would add "£300m-£500m in additional costs in the hospitality sector."

The second major factor is over-expansion which is no longer seen as viable by private equity who have been discouraged by the lack of returns on their investments, and as a result have scaled back on further investment. In the past year restaurant openings in London have slowed down. Capital investment was scaled back by 3.3% in the food and drink industry which amounted to £1.9bn. Closures, cost savings and restructures is the new strategy for private equity.

Another factor is the changing demand in food. There are new food trends which are emerging in popularity, such as breakfast restaurants, and vegan food.

The final factor which has adversely affected the food and beverage market is the changing relationship between customers and restaurants. Customers have different expectations of restaurants. With the value of the pound dropping post Brexit and inflation increasing, customer disposable income has fallen. As a result, they will be more cautious in their spending, and will seek more value for money to compensate for increasing prices. Furthermore, British customers exhibit less loyalty to restaurant brands and are more adventurous. The proliferation of different restaurant options and international cuisines has meant that customers are more likely to try new restaurants.

There is also the introduction of technology in the relationship between the customer and the restaurant. Technology and third parties are now introduced such as review sites like Tripadvisor, and delivery services such as Deliveroo, JustEat and UberEats. The immediate benefits come in the form of free advertisement of your brand on their platforms, and access to delivery revenue from customers. Other issues with this relationship is the disconnect between customers and restaurants. There is no personal experience for the customer, they cannot enjoy the ambience of restaurants or the direct customer service provided by staff. It means that there is extra pressure on restaurants to provide a different kind of service for customers to enjoy due to the lack of personal engagement and compensation for mistakes if they happen.

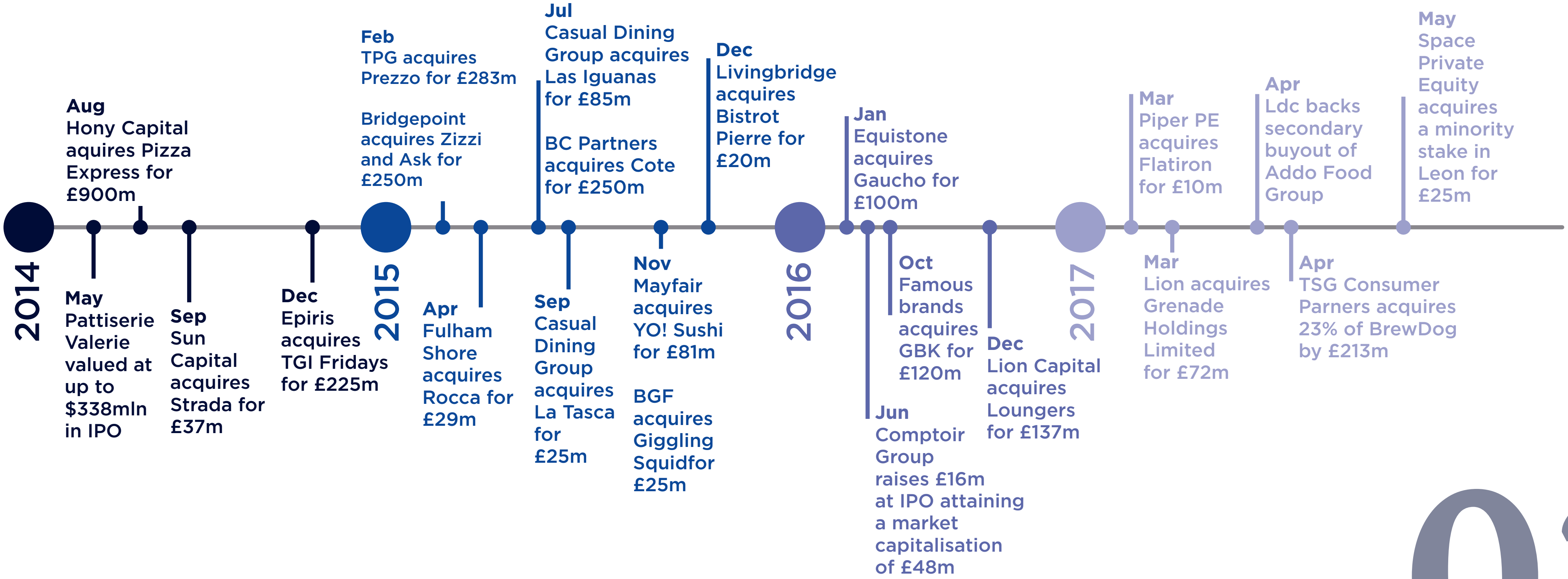
M&A market trends:

M&A in the restaurant sector has been strong over the last few years. The sector saw significant activity between 2014-2016 especially among private equity buyers which included several secondary buyouts. These trends have somewhat dissipated since 2017 however there has still been select activity within the sector.

Opportunities exist among differentiated brands and well managed businesses with the scope for scalable growth.

The challenges within the sector have adversely impacted earnings and have constrained multiples. Consequently this will have an impact on valuations as well as financing available for financial sponsors. Additionally with interest rates expected to increase the cost of borrowing will have a further impact.

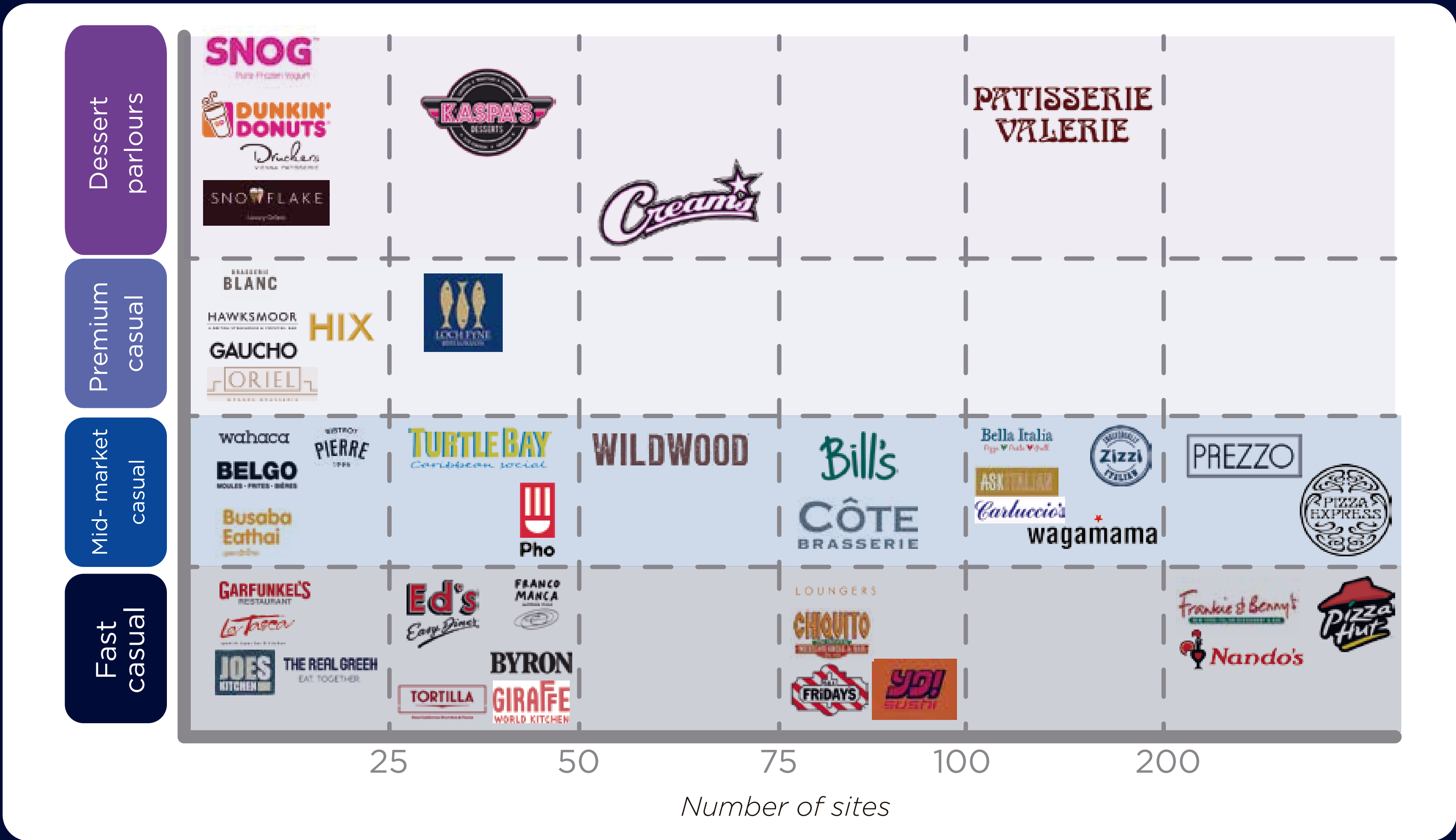
The potential for distressed and restructuring opportunities coming to market is no doubt inducing interest among private equity. Prime targets are companies who have over expanded beyond consumer demand and have an unextraordinary and incrementally dissipating brand proposition.



Source: S&P, Deloitte, Bloomberg

Competitive landscape:

Brands have been segmented into 4 categories; dessert parlours, premium, mid-market and fast casual based on the core product offering and value proposition



Note: 1) the price proposition within any of the segments is illustrative only

2) Number of sites for each brand is as of March 2018 and prior to closure announcements

The market response

In response to some of the major issues discussed earlier, we are witnessing a paradigm shift within the casual dining industry. As mentioned before we've seen larger brands which have over-expanded, close stores and also lay off extra staff in response to the meta state of the market. In response to Brexit with a stifled supply of cheap labour, we will possibly see automation replace service workers to save on living wage expenses or less workers employed overall.

Restaurants will also need to be more strategic in their growth strategies to prevent over-expansion. Paying attention to where they expand and evaluating their local brand reach as well as carefully considering costs such as rent. Aggressive private equity growth strategies have proven to be risky in the current market climate, which means that organic growth will become a greater proponent for sustainable and considered growth.

As noted above we can also expect to see updated menus and options to accurately reflect modern food trends such as breakfast options

A surge in dessert parlours

Going beyond menu options, consumer demand has caused the organic rise of retail desert parlours. AIM company and premium desert café Patisserie Valarie had over 100 outlets in 2017 and saw profits rise by 17% in the same year.

While certain restaurants are struggling in the dining industry, it would appear that there are still growth opportunities available as shown by the successful growth of these desert parlours.

The final adaptation we can expect to see from restaurants in the UK is the method in which they seek to address the changing nature of their relationship with the customer. Customer fickleness for instance can be tackled by an enriched customer experience and loyalty schemes which could facilitate stronger brand affinity. Outsourcing delivery services is a consistent form of revenue and advertises the brand on the servicing platforms. But extra steps must be taken to further establish a positive brand image. Finding creative ways to reach and engage customers by for instance committing to CSR will mean that brand identity will be potentially less influenced by user reviews online.

Market diagnosis

Problem	Increased costs	Over-expansion	Changing dynamics between the restaurant and customer	Reduced disposable income	Further market saturation
Cause	- Increased operating costs - Depreciating currency - Wage pressures	- Aggressive and unsustainable roll-out policy	- Rise of third party delivery services	- Inflationary pressures	- Consumer preferences for speciality - Differentiated value propositions
Action	- Cost reduction	- Restructuring and closure of unprofitable sites - Strategic roll-out policy - Reduce fixed cost base	- Enrich customer brand experiences - Realign value proposition	- Stronger brand affinity - Better value for money	- Adapt to cater for changing customer tastes - Seek out international market

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