Changing tastes
The UK casual dining market
September 2017
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Outlook for the UK casual dining market

We expect challenging times ahead for casual dining operators impacted by cost pressures at the same time as consumers face a squeeze on disposable incomes. However, changes in consumer tastes and the way diners engage with restaurants, alongside increasing use of technology, provide opportunities for growth if properly harnessed.

The UK casual dining sector is going through a challenging period with margin pressures mounting as a result of higher labour costs, higher business rates and increased food costs. At the same time, consumer confidence is falling, with inflation and sluggish wage growth beginning to squeeze disposable incomes.

Notwithstanding the challenges facing the sector, we see some key consumer trends emerging that casual dining operators can capitalise on in order to prosper in the current environment. These include a desire for more healthy eating, informal and experiential dining experiences, as well as increased consumer focus on food provenance and sustainability.

The use of digital technology is also increasingly impacting across the whole of a restaurant's operations. We believe the “restaurant of the future” will use technology throughout the customer journey, whether it be to provide delivery and pre-ordering services, or to connect to consumers in-store to offer customisable menus and dynamic pricing.

We look forward to discussing our views on the sector and how we are best placed to assist you.

Sarah Humphreys
Lead Partner, Casual Dining
Casual Dining
September 2017
“Consumers want to dine on their terms. In light of the current pressures facing the casual dining sector, it's essential that operators optimise location, occasion and channel in a connected and authentic way.”

Nielsen Harrap, Senior Manager, Customer & Channel Analytics Casual Dining Lead
Consumer confidence outlook

Our analysis shows a fall in consumer confidence in 2017 impacting negatively on consumers’ appetite for discretionary spend. This will directly impact the casual dining sector, which is experiencing a fall in like-for-like sales growth rates.

**Consumer confidence about level of disposable income**

Net % of UK consumers who said their confidence about their level of disposable income has improved in the past three months

- The latest Deloitte Consumer Tracker shows a further fall in consumer confidence in 2017, a sign of rising cost pressures emerging in the consumer economy.
- Since the EU referendum spending has been holding up well, but with inflation rising and nominal wage growth starting to slow, consumers are beginning to feel a squeeze on their disposable income.

**Monthly like-for-like restaurant sales**

- Like for like sales growth in restaurants has been declining over the past c.18 months and is running below the rate of cost inflation (currently around c.5% p.a.)
Key trends impacting the sector

Margin pressures are mounting on casual dining operators largely as a result of rising labour costs, higher business rates and increasing food costs (exacerbated by a weaker pound following the EU referendum)

**Weakening £ to increase cost of food sourced abroad**

<table>
<thead>
<tr>
<th>Effective Exchange Rate Index, Pound</th>
<th>Origin of food consumed in UK (2015)</th>
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<tbody>
<tr>
<td>May 2015</td>
<td>May 2016</td>
</tr>
<tr>
<td>100</td>
<td>90</td>
</tr>
<tr>
<td>70</td>
<td>60</td>
</tr>
<tr>
<td>40</td>
<td>30</td>
</tr>
<tr>
<td>10</td>
<td>0</td>
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</table>

- 19% UK
- 29% EU
- 52% Other countries

**Business rates revaluation in England and Wales will increase property costs in major cities and London in particular**

- Property rates likely to increase significantly in London as well as other major cities including Manchester and Newcastle.

<table>
<thead>
<tr>
<th>Combined business rates¹ payable by restaurants in London (£m)</th>
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<tr>
<td>2016 (Pre-rate revaluation)</td>
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<td>202.0</td>
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+33% increase

**Reliance on offers adds to margin squeeze**

- Diners expect some kind of ‘deal’ from restaurants, particularly during weekday lunch service and other quieter periods of day.

<table>
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<th>% of visits involving deals &amp; offers in UK by sector (2016)³</th>
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<tbody>
<tr>
<td>Casual dining</td>
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<tr>
<td>38%</td>
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**Possible Labour supply challenges from Brexit**

- UK restaurant operators are heavily reliant on migrant workers (especially from the EU). Tighter immigration rules will make it harder for operators to hire staff.

<table>
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<th>UK food and beverage service activities workforce by nationality (2015)²</th>
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<tr>
<td>Foreign-born</td>
</tr>
<tr>
<td>28%</td>
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**Increase in labour costs**

- National Living Wage: Currently £7.50/hour but projected to rise to at least £9/hour by 2020.
- Apprenticeship Levy: 0.5% tax introduced in April 2017 on companies with a wage bill of over £3m.

<table>
<thead>
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<th>Index of labour costs/hr in UK (hotels and foodservice)</th>
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<tr>
<td>150</td>
</tr>
<tr>
<td>160</td>
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**Key market saturation concerns**

- Operators are struggling to expand in London and other key UK cities due a crowded market and an increase in available delivery options (eg Deliveroo) and are seeking growth from other regional UK locations.

<table>
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<th>% change in visits to casual dining restaurants by area (in the year ended March 2017)</th>
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<tbody>
<tr>
<td>London</td>
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<tr>
<td>0.2%</td>
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Source: ONS; NPD; Mintel; FDF; DEFRA; CVS; Telegraph; The Migration Observatory; ‘UK food industry fears Brexit exodus of EU workers’, FT (February 2017)

Note: 1) Combined business rates payable for 2017 is based on average combined business rate payable by 7,105 restaurants operating in London during 2017; 2) Based on 2015 Labour Force Survey published by ONS; 3) Based on a Mintel survey of 1,840 internet users, aged 16+, who eat at casual restaurants.
Key consumer trends

Casual dining operators are having to react to long-term consumer trends that are being driven by younger age groups who eat out-of-home most frequently.

Key long-term consumer trends:

- **Healthy eating**
  - Low calorie options, vegetarian and vegan diets, allergen-aware dishes (e.g. gluten free)

- **Use of digital technology**
  - Online reviews, pre-ordering, digital menus

- **Value scrutiny**
  - Value for money, set menus, instant rewards

- **“Premium-isation”**
  - Gourmet fast food and indulgence trends

- **Informality**
  - Using restaurants as a place to socialise, on-the-go lifestyles requiring grab-and-go options

- **Experience-driven behaviour**
  - Desire for ‘unique’ and immersive experiences

- **Provenance**
  - Increased consumer focus on provenance and sustainability

- **Home delivery**
  - Home delivery in Britain growing 10x faster than the total eating-out market

- **Consumer promiscuity**
  - Lack of brand loyalty and willingness to experiment with alternative cuisines

... driven by changing demographics:

**UK out-of-home eating frequency by age group (2016)**

Visits per month

The future landscape of the restaurant industry will be shaped by millennials (those born between 1982 and 1996) and Generation Z (those born from 1997 onwards), due to their frequency and spend on eating out-of-home.

**Source:** MCA
The “restaurant of the future”

Increasing use of digital technology is providing challenges and opportunities to casual dining operators, impacting the full "customer journey" as well as business operations.

**Awareness and customer engagement**
- **Channel visibility**
  - Need for visibility in location enabled searches (e.g., Google maps visibility).
- **Digital marketing**
  - Importance of visibility on booking websites and favourable reviews (OpenTable, Square Meal, Tripadvisor etc).
- **Personalised recommendations**
  - Ability to offer tailored communications can drive engagement (e.g., personalised rewards).

**Reservations and delivery**
- **Reservations and ordering**
  - Third party booking platforms influence on reservation volumes.
- **Delivery and collection**
  - New delivery and pre-ordering services providing revenue growth opportunities and pressure on kitchen capacity (e.g., Deliveroo, uberEATS, Mealpal).

**Staffing and operations**
- **Flexible staffing**
  - Opportunities for more flexible staffing models in the ‘gig economy’ (e.g., online shift planning).
- **Mobile on-boarding and training**
  - Opportunity to enhance employee engagement with a variety of training techniques.
- **Supply chain management**
  - Use of enhanced integrated cloud systems can improve operational efficiency (e.g., inventory management, stock replenishment).

**In-restaurant experience**
- **Automation**
  - Potential for self-service ordering and payment.
- **Mobile payments**
  - Ability to split the bill between friends and offer faster payment services (e.g., Apple pay, Splitwise, Venmo).
- **Internet of Things Technology**
  - Providing connected experiences via customer and in-store devices (e.g., touch screens).
“Whilst M&A in the restaurant sector has been strong over the past few years, it appears that multiples have peaked as consumer headwinds and fears of market saturation impact the views of potential investors. However, there remains significant interest for differentiated, well-managed businesses because of their ability to drive value through roll-out.”

Ed Jenkins, Lead Director, Casual Dining M&A Advisor
Branded Casual Dining Landscape

Brands can broadly be segmented into premium, mid-market and fast, based on price proposition and service standards. EBITDA margins have fallen over recent years across all segments, with the premium sector more adversely affected than others.

Source: Mintel; Annual Filings; Company Website; Deloitte Analysis
Note: 1) the price proposition within any of the segments is illustrative only 2) Number of sites for each brand is as of February 2017.
Overview of recent investment activity

There has been significant investment by Private Equity firms into the sector over recent years, although transaction volumes are considerably down in YTD 2017.

Selected recent transactions (private equity and trade)

- Aug: Hony Capital acquires Pizza Express for £900m
- Oct: Fulham Shore acquires Real Greek for £14m
- Feb: TPG acquires Prezzo for £283m. Bridgepoint acquires Zizzi and Ask for £250m
- Jul: Casual Dining Group acquires Las Iguanas for £85m. BC Partners acquires Cote for £250m
- Dec: Livingbridge acquires Bistrot Pierre for £20m
- Jan: Equistone acquires Gaucho for £100m
- Nov: Alcuin acquires Koh Thai for an undisclosed value
- Sep: Sun Capital acquires Strada for £37m
- Apr: Palatine acquires Gusto Restaurants for £13m
- Sep: Epiris acquires TGI Fridays for £225m
- Dec: Epiris acquires Las Iguanas for £85m
- Apr: Fulham Shore acquires Rocca for £29m
- Sep: Casual Dining Group acquires La Tasca for £25m
- Nov: Mayfair acquires YO! Sushi for £81m. BGF acquires Giggling Squid for £25m
- Oct: Famous brands acquires GBK for £120m
- Dec: Lion Capital acquires Loungers for £137m
- Mar: Spice acquires Flatiron for £10m
- May: Private Equity acquires a minority stake in Leon for £25m

Source: Mergermarket; Deloitte analysis

**Sector transaction summary**

- **Transaction volumes and EBITDA multiples peaked in 2015.**
- **Deal volumes are significantly down in YTD 2017.**

- A surge in investments by Private Equity firms in 2014 and 2015 has helped some small casual dining chains to expand their store count rapidly (e.g., Cote and Giggling Squid).
- Small chains have been attractive to Private Equity firms due to their scalability, potential to professionalise management and relatively liquid market to facilitate an exit.
- Transaction multiples in the sector peaked at around 11x EBITDA in 2015, although have since retreated. Transaction volumes have also dropped off significantly in recent months as concerns regarding the impact of Brexit and consumers' reduced spending power have increased.
- Leverage in the sector is generally around 3.5x – 4.5x EBITDA, although can be higher in business with debt funded expansion plans.

Source: Publically available information
Some recent signs of stress in the sector

There are increasing signs of challenge in the casual dining industry, which has experienced an increase in store closures, management exits and losses in the past 18 months.

Indicators of more challenged dining chains

- **LfL sales**: Like-for-like sales growth running behind rising costs (with costs growing at c.5% p.a.).
- **Management**: Management changes
- **Capex**: Reduction in capex, critical to long-term viability.
- **Capital structure**: Highly leveraged businesses more vulnerable to squeezed margins.
- **Location**: High proportion of out-of-town locations, suffering from lower footfall and increasing retail vacancy rates.

...and recent news in the market

- **2016**: Government report published stating card charges on gratuities should be removed
- **2017**: National Living Wage begins to be phased in (between April 2016 and April 2020)
- **2016**: Ed’s Easy Diner, Red Hot World Buffet and the Yalla Yalla restaurant chain entered into administration in 2016
- **2017**: Eight casual dining chains announce changes to senior management teams in YTD 2017
- **2017**: Handmade Burger Co, Viva Brazil Steakhouse and Millcliffe and CL foods (independent franchisee operators, mainly of Burger King restaurants) have entered into administration in YTD 2017
- **2016**: Three restaurant chains announce changes to senior management teams in 2016
- **2017**: New business rates become effective and the Apprenticeship Levy is introduced (both April 2017)
- **2017**: Three restaurant chains announce store closure programmes in YTD 2017
- **2016**: Three casual dining chains announce changes to senior management teams in 2016
- **2017**: The Deloitte Q2 2017 Consumer Tracker survey results indicated consumers were beginning to rein in leisure spend as their overall spending power is shrinking

Source: Companies House; Mint; The Caterer; Propel News; Deloitte Analysis
“Casual dining operators are currently facing a real squeeze driven by declining consumer discretionary spend and rising cost pressures. In addition, there are some businesses with high levels of debt, generally as a result of recent M&A activity. This is leading some market observers to speculate there could be an increase in restructuring activity over the coming months.”

Rob Harding, Lead Partner, Casual Dining Restructuring Services

“We have invested heavily in developing a suite of market leading analytical tools to help casual dining operators optimise their planning, pricing and trading decisions. These tools, together with our market leading real estate and corporate advisory teams, allows us to implement solutions for our casual dining clients, whatever challenges they face.”

Sarah Humphreys, Lead Partner, Casual Dining
How we can help

We have a suite of tools across our multi-disciplinary teams to help casual dining operators find solutions to the challenges and opportunities they face.

Key challenges and opportunities for casual dining operators...

- **Revenue growth**
  Growing the top-line by providing value-for-money dining experiences, offering delivery and collection, developing new site formats and delivering site expansion plans.

- **Improving margin**
  Improving margins through flexible staffing models, supply chain management and cost control.

- **Real estate**
  Finding the right locations for each restaurant format, optimising the number of outlets and the efficiency of home delivery fulfilment.

- **Digitisation**
  Use of technology to generate customer awareness, automate reservations, enable pre-ordering and improve in-restaurant engagement.

- **Transformation**
  Rescaling the business through investment, M&A activity, restructurings or divestment.

...how our expertise can help

**Our consulting and real estate tools**
We have a full suite of analytical tools to provide a complete set of planning and pricing solutions.

We are the only large professional services firm with an in-house Real Estate consultancy.

**Our corporate finance expertise**
Our corporate finance experts secure capital to drive growth and help achieve successful exits / restructurings both with performing assets and in more challenging situations.
Our consulting and real estate tools

Our portfolio of tools address the complete set of planning and pricing decisions for casual dining operators

- **Plan**
  - Segmentation based on customer, location and physical dimension for better planning
  - Restaurant format
  - Simulating optimal table arrangement to enhance table efficiency and performance
  - Layout optimisation
  - Staff rota planning to maximize customer satisfaction
  - Staff planning
  - Portfolio optimisation
  - Portfolio optimisation

- **Develop Pricing**
  - Anticipating emerging consumption patterns to plan store openings more effectively, whilst rationalising under-performing sites
  - Home delivery planning
  - Pricing Strategy Competitor, cuisine and location based pricing
  - Home delivery orders by neighbourhood for better kitchen and logistics planning
  - Pricing strategy
  - Customer and loyalty analytics
  - Supplier analytics
  - Analysing supplier performance to enable more profitable contracts
  - Inventory management
  - Defining timing, frequency and size of order for raw materials; automating processes
  - Bundle offers
  - Bundled offers

- **Trade**
  - Identifying and pricing “attach products” that would lead to incremental revenue if bundled
  - Defining breath of menu by season and meal time
  - Minimizing wastage
  - Understanding performance of past promotions and customer offers
  - Competitive Intelligence
  - Using information on new competition to inform menu and pricing changes

- **Case study** – “Supported Enterprise Inns by developing a comprehensive brand portfolio and network assessment tool, deployed to all 200 regional managers to drive the group’s overall format and food and beverage strategy.”

Our Customer and Channel Analytics team helps analyse market capacity providing commercial due diligence to support the sale, investment and growth of causal dining business through location strategy, market capacity, consumer segmentation and sales forecasting for various Casual Dining businesses.
Our corporate finance expertise

Our corporate finance teams have substantial experience of working in the sector and are well placed to maximise value in casual dining situations

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<th>Examples</th>
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| **Securing capital to drive growth**  
Our M&A and Debt Advisory teams work with both high performing and stressed businesses to assist in planning, identifying and securing additional capital to fund growth plans and major investments.  
Advised Gusto on MBO backed by Palatine PE; and assisted a large listed restaurant group raise a £140m refinancing package. |
| **Due Diligence**  
We provide due diligence services, including financial, tax, commercial and real estate to both private equity investors and casual dining business on potential acquisitions and disposals and securing new financing.  
We provided financial, tax and real estate DD services to Equistone on their acquisition of Gaucho; and financial and tax DD services to TPG on their acquisition of Prezzo. |
| **Achieving successful exits and restructurings in challenging conditions**  
Deloitte’s Managed Exit, Special Situations M&A and Restructuring teams can help clients to review and evaluate the main options, being to “fix and retain”, sell or wind down operations.  
Implemented the Pre-packaged sale of the Chez Gerard restaurant chain.  
Advised Tragus on implementing a CVA for the Bella Italia, Café Rouge and Strada chains. |
| **Ancillary services offerings supporting our corporate finance teams**  
We have a tax team dedicated to casual dining and licensed retail clients, providing practical tax solutions in a number of areas, including M&A, expansion into new markets and restructurings.  
We provide tax advice to a number of the high street’s largest casual dining chains including Pizza Express, Prezzo, ASK/Zizzi, Gaucho and Byron. |
Key contacts

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