Mark Abell

Promising a new year of innovation and adventure

Dr Mark Abell looks at how corporate activity will continue its resurgence in 2014, while expansion strategies in the UK and abroad will rely on inventive franchising structures

Sticking its neck out: Tesco bought Giraffe for £49m

This year promises to be a challenging but potentially exciting one for the UK's food & beverage (F&B) sector with an increase both in corporate activity at home and expansion abroad.

The UK's domestic economy seems likely to continue its gradual improvement and one would expect to see the sector benefit from that. However, the signs are that there will be more than this at play. An increase in corporate activity will be fuelled both by the desire of investors to exit businesses and realise a profit now that the liquidity of the market is improving and by the growth strategies of large retailers looking to extend their interests beyond their traditional range. At the same time, a belief that the British public will never be able satisfy its desire to eat premium quality hamburgers seems likely to see the establishment of a number of aggressive and well-financed US brands in the UK. The continuing reluctance of the banks to lend to smaller businesses is likely to drive operators to adopt non-traditional, innovative structures to support their growth strategies.

Beyond the UK there will still be continuing opportunities for British F&B brands and while the Middle East and Asia will continue to attract many brands, the emergence of other developing economies hungry for aspirational restaurant brands is likely to also become a key factor in international growth. All of this promises that 2014 will be a year of excitement and innovation in the UK F&B sector.

Corporate activity

Last year saw the start of a resurgence in corporate activity in the restaurant sector with, for example, Giraffe being bought by Tesco for £49m, Drake & Morgan being bought out by its management for £50m backed by Bowmark Capital, and Gondola selling its Byron chain for £100m to Huttons Collins. With valuations being more realistic than during the heady days of 2007 and 2008, this increase in activity on the domestic market seems likely to continue.

A number of established brands seem likely to be placed on the market. For example, Las Iguanas has already announced the appointment of BDO to advise on its proposed sale, while a number of other brands are rumoured to be on the verge of announcing similar arrangements. If 2014 becomes the year that sees many brands change hands, perhaps a number of them will follow the lead of Carluccio's and Coffee Republic and find themselves sold to one of their wealthy foreign master franchisees looking to spread its investment risk into Europe. Their existing knowledge of the brands, which they operate under licence, and their financial muscle make serial developers such as Alshaya (which holds the Middle East franchise for both Gaucho and PizzaExpress) obvious contenders for the UK F&B brands that they already have relationships with. Such vertical integration will make the buyer's due diligence far easier and, because of the existing relationships, they may well be able to make the acquisitions without publicity or the support and advice of corporate finance advisors.

Perhaps Tesco will also continue on the acquisition trail and look to add other brands to Giraffe and Harris + Hoole. And if it works for them, who knows what Sainsbury's and other large retailers might do? Such investments not only lead to the establishment of the acquired brands in large retail outlets but also to the 'ghosting' of brands in the high street – that is the growth of small brands through the financial backing of larger known brands. Harris + Hoole is a good example of this with outlets appearing not only in Tesco Extra sites but also on town high streets across the UK. Brands such as Starbucks are also rumoured to be adopting this 'ghosting' or multichannel approach to the market, as a way of avoiding being portrayed as a large multinational and going back to their 'neighbourhood hero' roots.

The initial public offering (IPO) market is also likely to see increased activity in the sector. For example, Gondola, the Cinven-backed owner of PizzaExpress, Zizzi and Ask, has appointed Goldman Sachs and Rothschild as advisors for an IPO or sale. Although there seems to have been no decision as to whether the group will go for a sale, break up or float, the rumour mill seems to be suggesting that some kind of deal is likely in the second quarter of the year.

Burger wars: Five Guys is one of several US chains targeting the UK

Newcomers on the scene

The establishment of the Five Guys burger business in London seems to have started an avalanche of interest in the London market, from US burger chains. At least four of them are currently in discussions with UK partners and landlords to open in the capital during 2014. Presumably some, if not all, will be successful in the coming year. So, adding to them existing UK brands such as GBK, Byron and Meat Liquor, it seems 2014 is likely to be the year in which the 'burger wars' really do break out. Stout hearts, big bank balances and an ability to localise the US concepts are likely to be key in deciding who will win this conflict.

New domestic growth strategies

Many F&B brands have sought to use franchising as a method of growing their businesses in the UK. Domino's is a good example of the way in which franchising can be the catalyst for aggressive and successful domestic growth. However, with access to bank finance still rather difficult, it is likely that some brands will turn to more innovative structures to enable them to use franchising to grow their networks in the UK.

'Francubation' is one such structure that we may see take off in the coming year. This franchise hybrid addresses the difficulties that many prospective franchisees, who tick all of the boxes as regards their ability to grow a successful restaurant under the franchisor's brand, face. 'Francubation' removes the 'artificial' fiscal barrier of access to funding for capable prospective franchisees, by the brand owner funding part of the set-up cost of the franchisee's new restaurant and allowing the franchisee to buy the rest of the business in a series of tranches out of the profits generated by the new business.

This 'buy-in' structure gives the brand owner much greater access to top-quality operators (and, therefore, higher levels of profitability for its restaurants), while imposing far less fiscal pressure on itself to achieve worthwhile growth. The idea is simple, but the legal structure is a sophisticated one and needs to be carefully crafted.

International expansion

Despite the rather lack-lustre performance of Wagamama in the US, a number of other UK F&B brands, such as Yo! Sushi, have recently committed themselves to joint ventures or subordinated equity arrangements in the US. With several brands already in negotiations about similar projects, the coming year is likely to see still more assaults on the US market by UK brands.

The BRIC countries (Brazil, Russia, India and China) have not all been popular with UK F&B brands over the past few years. Russia has seen hard times in its restaurant sector and Brazil has been focused mostly on US brands, perhaps due to its relative geographical proximity. However, India and China have seen considerable activity by UK F&B brands and these, together with the Middle East and south-east Asia, will most probably remain the preferred overseas destinations for UK brands in 2014, with a number of deals about to be announced. However, we can also expect to see an increasing amount of activity in the MINT countries – Mexico, Indonesia, Nigeria and Turkey. These are dynamic economies with an increasing appetite for aspirational F&B brands. Indonesia and Turkey are perhaps going to be of most interest to UK brands. Indonesia due its membership of ASEAN – the Association of Southeast Asian Nations – and proximity, and resulting trading links, with countries such as Singapore, Malaysia and Thailand; Turkey due to its proximity to the EU.

> This year will be an interesting one for the UK F&B sector with the promise of a substantial increase in corporate activity

This international growth is most likely not going to be via 'vanilla' franchising, as has generally been the case in the past. UK brands are nowadays looking for greater income streams and an interest in the longer term growth of the brand in the overseas markets. This suggests that subordinated equity arrangements and 'manchise' (management/franchise) arrangements will become increasingly common over the next year.

Subordinated equity arrangements are different to joint ventures. They are more nuanced and sophisticated. Although, like joint ventures, they involve the brand owner being given a share in the foreign partner's operating business, they abdicate issues regarding control and decision making to the development agreement and focus on the brand owner's exit rights, the imposition of transparency on the jointly owned business and the limitation of the brand owner's liabilities. The result is a less burdensome and usually more remunerative commercial arrangement for the brand owner.

'Manchise' arrangements are an add-on to 'vanilla' franchise arrangements, which give the brand owner a further income stream, in addition to the service fees/royalties from the franchise agreement. This type of arrangement is appropriate where the local partner is primarily an investor rather than an operator. It enables the brand owner to establish what are in many respects corporate outlets in foreign markets funded by the local partner, with the benefit of extra 'kickers' to reflect exceptional performance by the brand owner's team in managing the foreign outlets.

Conclusion

This year is set to be an interesting one for the UK F&B sector with the promise of a substantial increase in corporate activity and a drive to find new structures and markets for international and domestic expansion. It seems that innovation and adventure will be the key words over the next 12 months.

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Room for manoeuvre?

Inside Track
by Mark Wingett

The need to provide room service has always been one of the main stumbling blocks barring a successful partnership between hotel and restaurant operators. However, a proposal by Hilton Worldwide to replace room service at its full service properties with cafeteria-style eateries as the company moves toward a more limited-service offer could finally open up new partnerships and avenues to expansion.

Traditionally the hotel sector has been the frontrunner for the hospitality industry in terms of the strength of the wider sector and indications are that it will be the first to pull clear of the recession in terms of performance and M&A activity.

Jeremy Hill, director and head of hotels for Christie + Co, says: "As we move into 2014, there remains a substantial amount of equity looking for opportunity. The sums now add up for going concern transactions. New hotel development is still largely predicated on lease structures with still further yield compression for prime located investments achieving 4.5% net initial yield (NIY). Finance is cautiously returning for development with hotel management agreements (HMAs)."

Hill says that London's 'safe-haven' status was reaffirmed during 2013 as it remained at the forefront of major deals and highest prices, but even in the UK regions values were maintained. Indeed the regions saw improved trading performance for the first time in years, attracting buyers into provincial markets, enticed by prospects of capital appreciation.

In October, VQ, the 24-hour restaurant and bar concept, opened its second site in London, after securing a space under the c700-room St Giles Hotel off Tottenham Court Road. Following success with this site – average weekly sales are understood to be c£22k and growing – the company is in talks with a couple more hotel groups regarding ground floor space at their properties. A key part of the deal with the St Giles, involves VQ providing the hotel's executive breakfasts. This encapsulates both the opportunity and the challenge faced when considering taking space in a hotel.

After Hilton Worldwide's successful \$2.35bn (£1.43bn) stock market flotation last month, chief executive Christopher Nassetta said he expects to introduce a new hotel brand in 2014 aimed at affluent, young travellers and emphasising style and design. He also suggested that the ending of traditional room service at its full-service hotels was under consideration. It caused a stir in the summer when it said that it was stopping 24-hour room service at its 2,000-room New York Hilton Midtown site, the largest hotel in the city.

The group immediately responded by launching its own restaurant concept, Herb N' Kitchen, which it plans to roll out internationally. The company says the concept emphasises "the quick-service segment that is moving to the forefront of the hotel experience". It has brought back room deliveries but only during breakfast and dinner hours and presented in paper bags to cut down on labour costs.

Back in 2000 Sir Terence Conran and Des Gunewardena saw hotels as a perfect vehicle to drive traffic into their restaurants, entering a joint venture with Wyndham Hotels. They succeeded in turning a dilapidated building above Liverpool Street Station into the Great Eastern Hotel and achieved a hugely successful exit to Blackstone a few years later. From that D&D London, Hard Rock and Nobu have joined the list of hoteliers, with Corbin & King set to follow this year.

As David Roberts, corporate partner at leisure firm Olswang LLP, says: "More and more, investors should realise that the skillset required to operate one kind of successful leisure vertical is more transportable than might otherwise be currently acknowledged."

Certainly Hilton's move toward a limited-service hotel model opens the possibility of more mainstream operators linking with a hotelier, especially in the squeezed mid-market hotel segment, say an All Bar One or Loungers linking with a brand such as Jurys Inn.

With operators increasingly looking at new opportunities to reach expansion targets, taking up room at the inn may increasingly come into play.