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Out of the kitchen

President-elect Donald Trump is a former restaurateur. His Secretary of Labor-to-be, a critic of the $15-per-hour federal minimum wage, is the CEO of a fast-food chain. Beleaguered by eight years of weaponized regulation, the dining-out industry sees a new day dawning. It's too bad about the legacy of the old day. The supply of bars and restaurants is greater than the evident demand for them.

Now under way is a case study in overexpansion. Ultra-low interest rates, digital technology and changing consumer tastes have spurred a wave of hospitality-themed investment. The Federal Reserve itself did not make the loans (or bid up the share prices) that led to the ubiquity of eating and drinking places. Nor did Janet Yellen Ph.D. or her predecessor, Ben S. Bernanke Ph.D., cause millennials to forsake the likes of Applebee's and Ruby Tuesday for upscale takeout at Whole Foods or for the home-cooking "meal kit" services of Blue Apron and HelloFresh. Still and all, EZ money is a kind of boomerang. You wing it at the marketplace in hopes of effecting a fillip in capital investment. Lo and behold, you succeed too well.

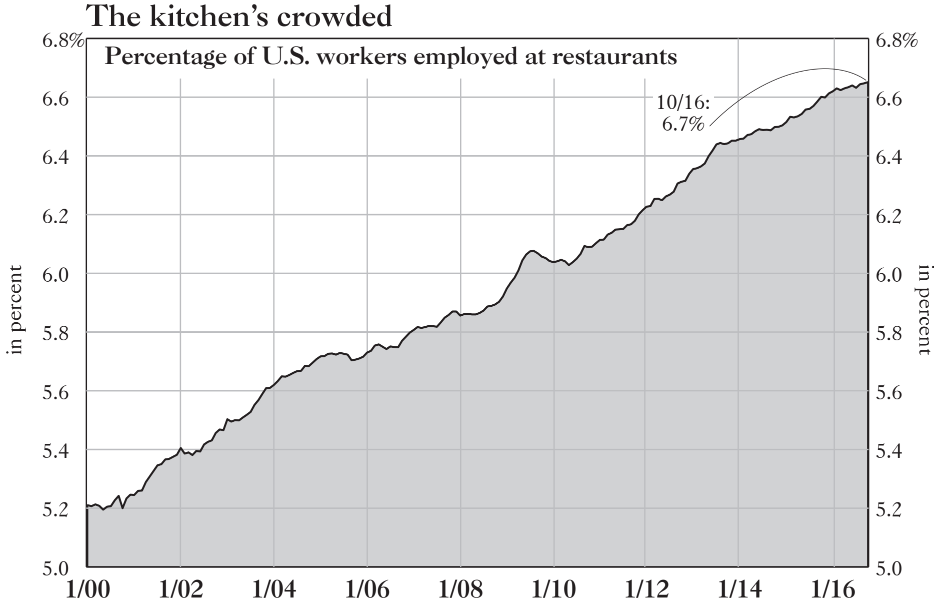
Since Election Day, the Russell 3000 Restaurants Index has jumped by 7.3%. Shares of Middleby Corp. (MIDD on the Nasdaq; *Grant's*, June 17), maker of appliances for restaurant kitchens, have zoomed by 12.3%. Concerning Middleby—to anticipate one conclusion of this unfolding analysis—we believe that its customers are going to want less of the wares it sells.

"The mood of restaurant owners post-election is upbeat after eight years of unrelenting attack from Obama and his anti-business minions," John Hamburger, president of Franchise Times Corp. and publisher of *Franchise Times* magazine and *Restaurant Finance Monitor*, tells colleague Evan Lorenz. Morale soared with the appointment of Andrew Puzder, head of the parent of Carl's Jr. and Hardee's. Just maybe, the restaurateurs dare to imagine, President Trump will rescind the edict that employees earning as much as $47,476 a year are entitled to overtime pay and that franchisors must stand in court with their franchisees when labor disputes entangle the latter.

It's a welcome new broom. Just how clean it may sweep is not so easy to say. The margin-eviscerating redundancy of tables, ovens, chairs and bar stools is a legacy of over-eager lenders, ardent private-equity funds and zero-percent interest rates.

One sign of the times (and of the consequences of times gone by) was the crowding around of lenders at the *Restaurant Finance Monitor*-sponsored Restaurant Finance and Development Conference in Las Vegas last month. Armando Pedroza, a managing director at Citizens Financial Group and himself a restaurant lender, noted that disquieting fact in remarks from the rostrum: "In 2010, there were 36 lenders in this conference. In 2015, there were 106 lenders. This year, there are 136 lenders. . . . Because capital is avail-

The kitchen's crowded



source: U.S. Bureau of Labor Statistics

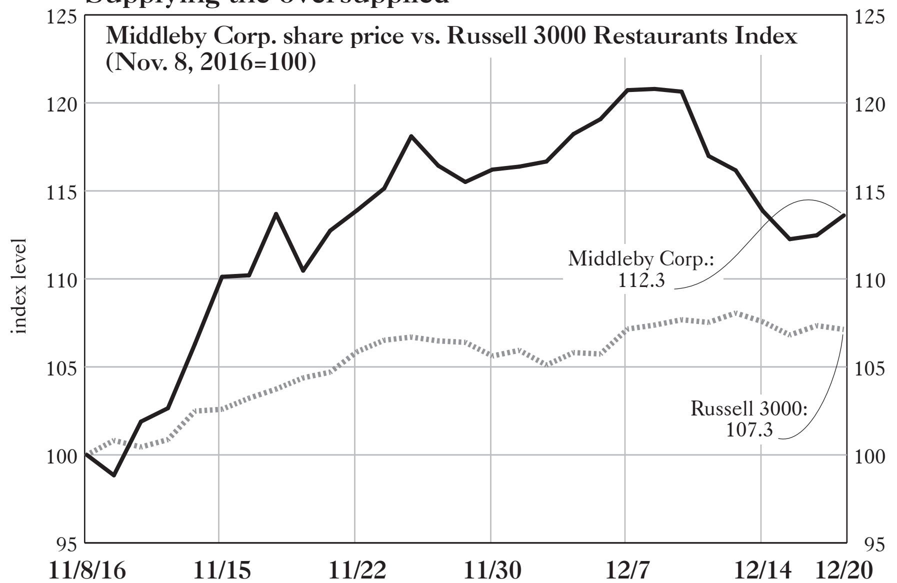
able, of course, restaurants are getting built and demand isn't there for those restaurants. The supply of restaurants gets overbuilt, and eventually demand will catch up. That's the correction that I think we are in."

Over the past five to seven years, credit availability for an aspiring restaurateur has migrated to ultra-ease ("Please, take this money") from utter inaccessibility ("Not one thin dime"). "I sat with a franchisee of a national chain, and he told me how little money he had to put in. It sounded like pre-recession," says Wallace B. Doolin, chairman and founder of TDn2K, the parent company of Black Box Intelligence. "The small amount of money they have to put in to get an operation up and moving is amazing." The franchisee in question needed only 25% in cash; financing was available for the balance. For a long time after the recession, according to Doolin, 50% down was de rigueur.

Thus, the restaurant business has come to resemble a long-seated patron at an all-you-can-eat buffet. Job growth is one telltale sign. "Thus," Lorenz points out, "from December 2007, the start of the Great Recession, to October 2016, the number of servers, chefs, bartenders and maître d's increased by 18.7% compared to 4.7% growth in the total nonfarm labor force. In consequence, restaurant workers now constitute 6.7% of nonfarm labor, up from 5.9% on December 2007. You could say that restaurants are increasingly reliant on their own employees to buy the marginal hamburger."

Restaurant sales would be booming if, as the economists say, other things were the same. They are not the same. "If I were to turn back the clock to six to seven years ago," Nick Cole, executive vice president of restaurant finance at Wells Fargo & Co., told the RFDC conference-goers, "and said, 'Let me paint you a picture from a macro perspective in a year when unemployment has been on the decline for five straight years and is now just under 5%, gas prices are at decade lows, the overall economy has been growing for seven years straight and commodity/food costs have been at historic lows for nearly every brand,' you would say, 'I'll take that all day long. It sounds like we would have a great year.'"

Supplying the oversupplied



source: The Bloomberg

In fact, in November of this ungreat year for eating out, restaurant comparable-store sales fell by 1.3%, measured year over year, the ninth consecutive month of declining revenues, according to Black Box Intelligence. More worrying is the drop in customer visits. Year-over-year soundings in same-store restaurant traffic fell by 3% in November, on top of a 1.7% decline in November 2015, also according to Black Box.

The post-election burst of animal spirits finds expression in the November jump in the Small Business Optimism Index of the National Federation of Independent Business. Versus expectations of 96.7, the reading came in at 98.4, up from 94.9 in October. Yet just 24% of the surveyed firms said they were planning to undertake a capital investment in the next three to six months, down by 3 percentage points from October. Maybe the entrepreneurs are waiting to see what the new administration actually delivers. Or perhaps they are too aware of the excess capacity that's already in place.

More than interest rates are at work, of course. E-commerce is one such intrusive force. People used to cap a day of shopping with dinner at the mall. They don't do that today if their mall is their phone—or if their supermarket is their restaurant.

Kroger Co., the 133-year-young pioneering Cincinnati grocery giant, serves prepared meals to take home. It competes with not only the likes of Whole Foods but also such casual dining destinations as TGI Friday's and Denny's. Then, too, the customer experience might be better at Kroger. According to Doolin, employee turnover at restaurants is running at an historically high rate, and diners are noticing: "We are seeing decreasing service scores pretty much across the board but not at every company."

Besides, rising wages and rents seem to weigh more heavily on the restaurants than on the grocery stores. In November, compared with the year earlier, the price of food at home fell by 2.2%, while the cost of food away from home rose by 2.3%, according to the Bureau of Labor Statistics. "In the consumer's mind, restaurants are too expensive relative to grocery," says Hamburger.

Which leads us back to Middleby, a *Grant's* pick-not-to-click of six months ago. Capital equipment for the commercial food-service industry is the company's No. 1 business segment. Such products—ovens, refrigerators, dough handlers, charbroilers, warmers, bakery ovens—contributed 64% of companywide third-quarter operating profit before corporate expenses. Overall revenues, measured year over year, registered a rise of less than 1% (excluding the impact of acquisitions and foreign-currency translation). It was foreign sales—up by 21.1%, ex-currency and acquisitions—that saved the division's top line. Domestic food-service revenues dropped by 7.9% (also excluding acquisitions).

Analysts ask why U.S. restaurant sales are falling. "From our perspective," Middleby CEO Selim A. Bassoul said on the Nov. 9 earnings call, "we do not see any indication in our customer base in the restaurant business that they are slowing down their demand for innovation."

"True, perhaps," comments Lorenz. "However, as noted here in June, Middleby spends little on R&D—much less, in fact, than the other appliance makers. You could guess as much from the company's quarterly financial reports; they say nothing about the R&D budget. Anyone seeking enlightenment on this score must search the notes of the 10-K. Middleby has, in the past, bought innovative companies with highly differentiated products—TurboChef, for instance. But, in the absence of continued investment to maintain that technological edge, the competition has, in many cases, caught up."

Domestic sales, which are drooping, contribute 69% of the top line of Middleby's food-service division. Management says little about its international endeavors or whether the growth in overseas sales is sustainable. On this score, it's notable that Manitowoc Foodservice, Inc., a Middleby competitor, reports no bulge in foreign-sourced revenue. In the third quarter, Manitowoc's sales to the Americas declined by 1.2%. This was offset by a 4.9% gain in sales to Europe, the Middle East and Africa and by a 1.8% bump in sales to Asia/Pacific (these are year-over-year increases adjusted for foreign currency, acquisitions and dispositions). On the Nov. 7 Manitowoc earnings call, management blamed delays in orders—in particular by large quick-service restaurants—for the sluggish sales pace.

Neal Sherman, president and founder of TAGeX Brands, has an informed line of sight on the restaurant business. His firm is a restaurant liquidator, a refurbisher of furnishings and equipment and a hospitality-facilities manager. "We have been involved in 100 Ruby Tuesdays, and 50 Logan Roadhouses," Sherman tells Lorenz. "Those are just the higher-visible ones. There are independents that are unrelated that are closing every day or filing for bankruptcy—Chapter 7 or Chapter 11—at a pace that I've never seen before, and this will be our thirtieth year." At the current pace, says Sherman, liquidations will soon eclipse the restaurant-failure rate seen in the depths of the Great Recession.

Used-equipment prices, however, are not necessarily crashing, Sherman explained, "because there is an open-mindedness among end users and even people who are part of bigger chains that at one time would only buy new are now very open-minded about the aftermarket because they realize they can save substantially on the capex side. Whereas five to 10 years ago the demand side for the used market would be largely independents, now some people who would buy recognizable brands are buying selective items in the aftermarket instead of only buying new."

Well they might, as colleague Harrison Waddill discovered in an Internet inspection of some recent results at PCI Auctions. If it's a Wells (i.e., Middleby) Commercial Stainless Steel 2-Bay Steam Table with Drain and Storage Shelf that's on your Christmas list, you could have had one for $61.01. Original list price: $2,495.

Waddill identified a half-dozen Middleby-branded items for which the original list price and the auction price were each disclosed. He reports that the auction prices represented an average discount of 93% from brand-new (the steam table just quoted was hammered down at a 98% discount). "Only two of the six auctioned items were tagged as to vintage, but most appeared to be in pretty decent condition," Waddill says. "This also seemed to be the case for non-Middleby-owned brands listed on the same auction."

Middleby's other divisions, which together generate 36% of pre-corporate expense operating income, show uneven results. The residential kitchen division, which makes high-end consumer appliances under such brands as Viking, La Cornue and AGA, accounts for 22% of pre-corporate expense operating profit and continues to struggle. Product recalls have tarnished the Viking brand. In the third quarter 2016, sales declined by 4.8% year over year, on top of a 17% year-over-year decline in the third quarter 2015 (both figures are adjusted for currency fluctuations and acquisitions).

AGA Rangemaster Group plc, a 77-year-old British maker of deluxe ovens, came into the Middleby fold in 2015. Plans to sell AGA ovens to American consumers have so far met with mixed success. For one thing, no dealer network has been secured yet; you can buy the AGA line (for some models, at prices well over $10,000) only online. Bassoul extols the beauty of AGA engineering, yet Middleby says it intends to introduce a redesigned line of AGA products for American consumption in 2018. Integral to this initiative is the elimination of certain winning and characteristic AGA features, including the four-door front piece, which affords separate compartments for baking and roasting. In other words, Bassoul will make AGA's American product line very much like every other premium oven already on offer in America.

Middleby's food-processing division, which makes baking, cooking, grinding and other equipment for the packaged-food industry and contributed 14% of pre-corporate operating profit, is, indeed, zipping along. Foreign-currency-translation effects aside, division sales showed year-over-year growth of 11.2% in the three months to Oct. 1. If only the segment were big enough to compensate for weak performance in residential kitchen and food service; it isn't.

Analysts project a flourishing 2017, with sales and adjusted earnings per share gaining 8% and 14%, respectively. While Middleby's third-quarter 2016 revenue did jump by 28% from the like 2015 period, the elimination of acquisitions and currency-translation effects shrink that growth to 1.4%. AGA was the single biggest driver of acquired growth in the third quarter. However, Middleby lapped that acquisition in September. Then, too, as a company that derives most of its sales in British pounds, AGA will be a drag on the headline numbers in the first half of the new year.

Bassoul, a Wall Street favorite, has given indications that he is, once again, on the prowl for acquisitions; on July 28, the company upsized its credit facility to $2.5 billion from $1 billion. Prior to the 2012 acquisition of Viking Range Corp., Middleby did not compete in the consumer-appliance industry. Its forays in the residential-kitchen arena have not been ringing successes. If there were more high-margin, differentiated professional-appliance buys out there, you would think Bassoul would prioritize those over the cutthroat consumer market. He has not.

"The acquisition pipeline continues to be out there strong," Bassoul said on the company's Aug. 11 second-quarter earnings call. "I think, what is the best thing that I've seen in . . . the past three years to five years, is the number of people who have come to us to say, 'I want to be part of Middleby.' Now, of course, some of them fit, some of them don't, some of them—maybe the valuation, we don't get to a valuation that we agree upon—but there has been a concerted effort by many players wanting to be part of Middleby. . . . So that's why we went on the credit facility. There is a purpose to it. It did not happen that suddenly, and the markets—I'll be honest with you, the interest rate in the markets is very favorable for us to go get a credit facility without diluting our equity base and our shareholders."

Ultra-low interest rates do have that initial uplifting effect. Reconsideration comes later.

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