FRANCHISED FAST FOOD RETAIL

SECTOR INSIGHTS

LOCAL
KNOWLEDGE,
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Contents

1. Market overview

The growing popularity of online food delivery platforms is driving revenue

Fast food operators have faced challenging operating conditions over recent years, exacerbated by the COVID-19 outbreak and the Russian invasion of the Ukraine.

Pandemic lockdowns split the sector fortunes between those that were already equipped, or could adapt quickly, to the booming food delivery platforms, drive thrus and “click & collect” formats. Brands such as Domino’s benefitted hugely but, overall, the severe trading limitations of the pandemic lockdowns were the main contributor to a 0.3%pa overall decline in fast food operators’ revenue over the five years through 2021-22, to £10.1billion.

The growing popularity of online food delivery platforms such as UberEats, Just Eat and Deliveroo - which service a much wider range of food outlets than franchised fast food retailers - has had an overall positive effect on industry performance over the past five years, although it has increased the visibility of competitive smaller fast-food chains that focus on serving niche markets, such as vegetarians, vegans and healthy eaters.

Although the boom in delivery services seen in the pandemic has eased-off, demand for delivery remains higher than before the pandemic, and is likely to remain so due to the perceived value of convenience and wider choice – to the ongoing benefit of those brands such as Domino’s, KFC and McDonalds that are wholly eat-out or which have mature eat-out sales channels and infrastructure.

The sector has had to adapt to changing consumer preferences, particularly the rise of vegetarianism and veganism and the trend to healthier eating – these factors have weighed on the performance of traditional fast food chains such as McDonald’s and KFC which were relatively slow to adapt, allowing new, smaller franchises that focus on serving these niche markets to establish.

The convenience of online ordering and the low price of fast food has benefited demand, which is likely to rise still more due to falling consumer confidence and the cost-of-living squeeze - which typically strengthens demand from low-income households, the industry’s largest downstream market. This segment of the population sees fast food as the cheapest out-of-home food option, increasingly favouring it over full-service restaurants and increasingly expensive supermarket food.

Over the five years through 2026-27, industry revenue is forecast to grow at a compound annual rate of 2.8% to reach £11.6 billion, albeit there are serious headwinds that will challenge margins.

Food franchise at a glance

£10.1bn revenue (2020 - 2021)

forecast to grow 2.8% pa to £11.6bn by 2026 – 2027)

7.9% margins (2021 - 2022)

the reduction from 9.8% in 2016 – 2017 was driven by stiff competition and increasing operating costs

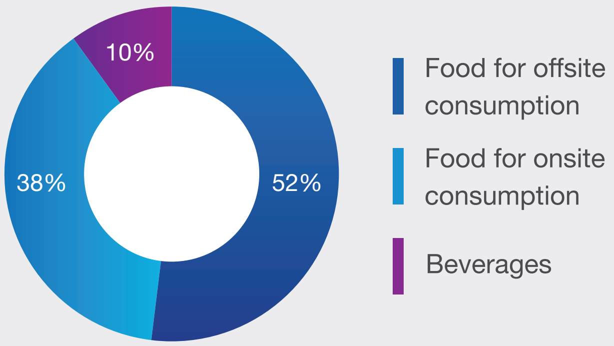
130 distinct brands

forecast to increase 2.2% p.a. between 2022 – 2027

205K sector employees

forecast to grow at 0.5% between 2022 – 2027

Service segmentation 2021/22

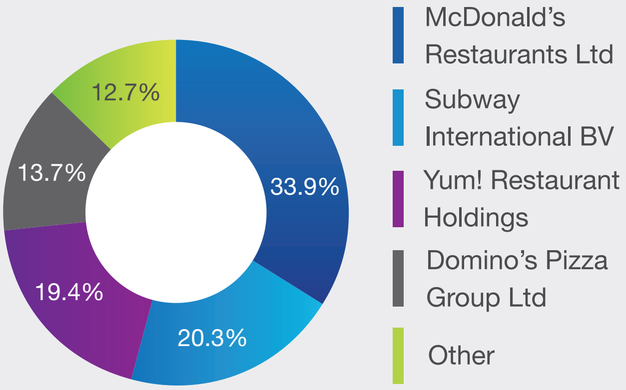


Food for offsite consumption now represents over half of sector revenue.

Beverages represent only 10% of revenue.

Fast Food Franchises – Source: IBISWorld

Major players

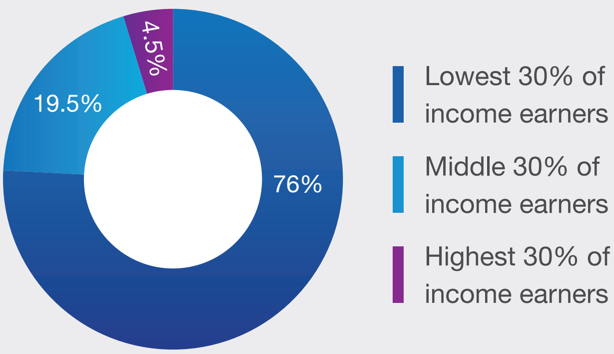


The market is dominated by four international franchise brands which, collectively, account for over 87% of sector revenue.

These four players have over 6,200 UK outlets.

Fast Food Franchises – Source: IBISWorld

Customers – Revenue split



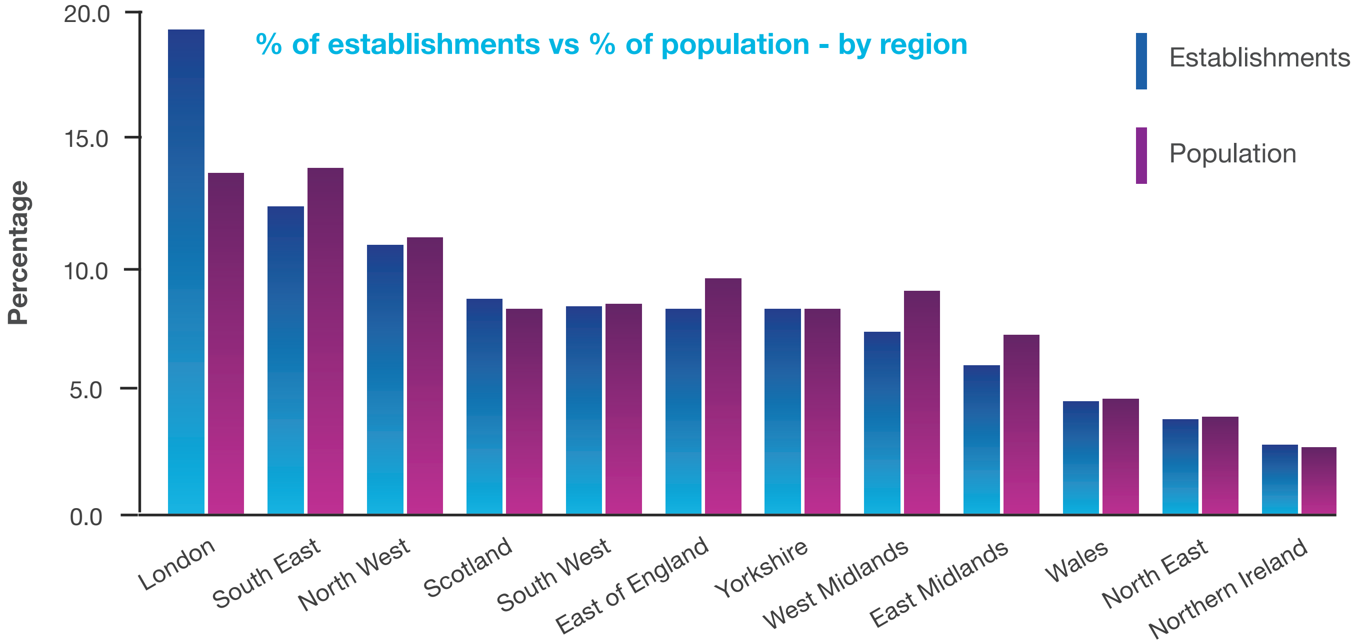
76% of demand is from low-income earners, a demographic which typically favour cheap fast food over full-service restaurants and increasingly expensive supermarket groceries.

The UK's exit from the EU has supported demand from this market.

Discounts and loyalty cards used by larger industry operators have grown demand from this income demographic.

Fast Food Franchises – Source: IBISWorld

Sector geographic concentration



Fast Food Franchises – Source: IBISWorld

Only London and Scotland have a percentage of establishments that are higher than their percentage of population.

London's figures reflect the large number of workers that commute into London and the high levels of tourism.

Scotland's result probably relates to its high student population.

Public Health England reports that deprived areas have five times more fast-food outlets on average than affluent areas.

2. Seven recent trends

1 Online delivery platforms and digital implementation are driving growth

The rapid growth of delivery platforms such as UberEats, Just Eat and Deliveroo has increased established players' sales but, because it caters for a much wider spectrum of food businesses, it has made smaller brands and operators more visible, thereby increasing competition for fast food operators and blunting the benefit to some extent.

Furthermore, its impact on operators' store-level profitability is a much-debated issue; delivery sales are not always as profitable as in-store sales – it depends on factors such as whether delivery costs are fully recharged to the customer, whether the franchisor charges royalty and commissions on that marginal income, and whether additional store staffing is required to service the delivery sales.

Until Covid-19 struck, hospitality as a whole had been slow to adopt digital, continuing to focus on dine-in business and conveniently outsourcing online/home delivery to the third-party aggregators. But Covid-19 forced many companies to operate as multi-channel businesses – whether they liked it or not – to survive.

"the digital transformation is fully underway, and technology will continue to impact the way the hospitality industry operates. Evidence of this rapid change is the fact McDonald's says it is now providing 11 ways for people to get a meal at its newly designed outlets, on which it is spending £250m. In McDonald's major markets, digital sales now account for around 30% of sales, up 60% on a year ago".

Glynn Davis, leading commentator on retail trends

2 Fewer, but larger, franchisees is the goal

Probably over as long a period as the last decade, franchisors have learned that having large numbers of franchisees is difficult and expensive to manage, risking brand damage. So, to varying degrees and at a strongly accelerating rate now, most franchisors are reducing the number of franchisees and encouraging the better performing ones, which they want to retain, to run larger businesses. The process tends to start with a grading of franchisees' performance using the brand's established KPIs and brand standards. We've seen, or are seeing, this occur in brands such as KFC, Costa, Starbucks and Pizza Hut, amongst others – resulting in some brands now having some very large, dominant franchisees such as EuroGarages in KFC, and MSG in Domino's.

However, going too far potentially brings other concentration and control risks, so care is needed.

3 Re-franchising of larger brand-owners' "equity" stores is accelerating

A number of the larger international franchisees are scaling back the number of stores they operate themselves – so called "equity stores" – by refranchising them out to existing or new-to-brand franchisees.

KFC have been through this process, selling off hundreds of stores in two tranches to leave only around 50 equity stores. Pizza Hut and Starbucks also started this process some years ago. PKF Smith Cooper advised clients in all of these brands at the time.

Costa are just embarking on the process, with two "trial" deals with leading existing franchisees being completed during 2021 and 2022, and significant bundles of stores reputedly on the market currently.

Pret is also refranchising stores to selected franchisee partners that are committed to significant further store openings.

Of course, there are always exceptions to the rule; Domino's and Burger King have both acquired bundles of franchisee-owned stores, albeit Domino's have sometimes made the acquisition in partnership with an existing franchisee. Burger King, which is owned by PE house Bridgepoint, has different motives and has completed its deals solus. Meanwhile, one frozen food delivery group is buying all of its franchisees' businesses and withdrawing from franchising, as did Pandora, the jewellery business.

4 Vegan, vegetarian and healthy options

Consumer demand is driving a rapidly increasing number of meat and dairy-free menu offerings from big players, and spawning new operators specifically focussing in these niches.

Catering for these increasingly numerous and demanding customers is a fast-developing sub-sector that is widening the consumer market for most operators.

Embracing this trend, EG Group invested £100m acquiring LEON, the healthy fast-food business, with the aim of adding LEON outlets in its service stations, and building 20 new outlets pa, including drive-thrus.

Evidencing the strength of demand for vegan products, in 2019 LEON vegan products represented 37% of sales and nearly 50% of its burger sales were the vegan options. The Guardian reported that orders of vegan meals in the UK grew by 388% between 2016 and 2018.

Meanwhile, more established large operators have introduced new products to tap this market – examples include McDonald's Veggie Dippers, KFC's award-winning vegan Chicken Burger and the famous Greggs Vegan Sausage Roll.

5 Consumers love choice and convenience

The pandemic lock-downs brought home-delivered food to the fore and, although demand has subsequently eased back, consumer demand for home-eating has notched-up from pre-pandemic levels. It seems consumers have become accustomed to the very wide choice of food options available through delivery platforms, and the convenience which suits a busy lifestyle. Consumers' average weekly hours of work have risen in 2021-2022, meaning they have less time to cook at home, and are more likely to demand fast food.

6 Tightening household income

This is driven by price inflation running ahead of pay increases - a feature of the so-called cost-of-living crisis – and is expected to strengthen demand in low-income households. Historic trends suggest tightening incomes also tend to push more moderate earners away from dining out towards lower-cost options for eating.

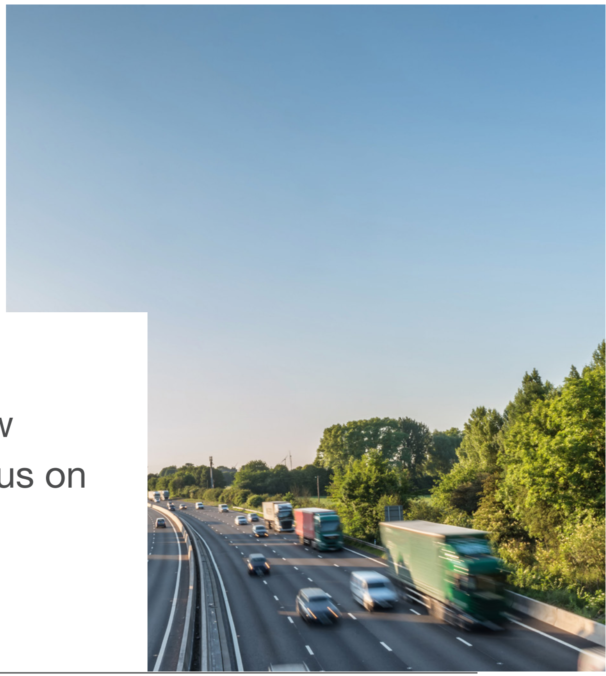
This, however, runs contrary to the findings of a survey by HGEM on the impact of the crisis which found 72% would reduce visit frequency to their favourite hospitality venues rather than find a cheaper alternative. Furthermore, asked what they would cut back on first, the top answer of those surveyed was delivery and takeaway, followed by holidays abroad and then eating and drinking out.

7 Stores serving the "grab and go" market on arterial routes is trending

An increasing number of franchisees focus on travel routes, where customers want to "grab-and-go". Early adopters include the likes of Moto, Welcome Break and SSP but others such as Euro Garages which operates multiple brands from its motorway forecourts, Blakemore Group which operates Spar stores, and others have joined - often opening Drive-thru and Drive-to store formats.

Greggs recently said "As Greggs continues to roll out new shops across the country, there is an increased focus on targeting on-the-go-locations accessible by car."

citing motorway services and petrol stations as examples.



3. Three current challenges

1 Rising costs running ahead of sales price rises are reducing margin

A very significant current difficulty is the timing lag of sales price increases against the rampant supply cost inflation that franchisees are currently enduring, resulting in franchisees' profit margins being squeezed.

Franchisors are naturally concerned not to damage transaction volumes by too big a price rise; and that decision also involves considering what price rises key competitors are implementing. Some of the franchisees we work with contend that franchisors in some brands are being far too cautious - at their expense. It is certainly a difficult balance at present.

It is beyond question that cost inflation and the discontinuation of government pandemic support measures have had a very significant impact on margins, and it remains to be seen whether subsequent sales price increases are sufficient to restore profitability, when they will occur, and whether that correction will sustain or be eroded by more cost inflation.

In our experience, in the last few months EBITDA percentage cuts of 3 - 5% are commonplace in the fast food segment, with many brands, on average, now trading at single-digit EBITDA percentages. In extreme cases strong EBITDA performance has been whittled down by over half by removing the impact of the government VAT reduction, implementing wage increases and, most shockingly, suffering rocketing energy prices.

In mid-June, industry newsletter Propel announced that only a quarter of 589 UK pub, restaurant, café and hotel operators in its database have profit margin of more than 5% - indicating even harder conditions outside of fast food retailing segment.

2 Inflation

Domestic inflation of most costs is running at levels not seen since the 1970s, but in our experience the three key cost issues are:

Food supplies

Cooking oils and wheat prices are spiralling fast, driven by the fact that Ukraine is a major exporter of both. Around 75% of sunflower oil and 36% of exported wheat (which is fed to chicken) comes from the Ukraine and Russia but none is getting through to Western Europe at present. The impact on, say, a KFC operator is easy to imagine.

Energy

Most food outlets use a lot of energy and we are seeing energy costs double or higher than the equivalent time last year, the impact being especially harsh where users are coming off fixed-term supply contracts. Again, the restriction of supplies of Russian oil (especially diesel) and gas, set against only modest increases in supply from OPEC members, is fuelling rocketing prices.

Labour

Operators are not only grappling with the usual annual national Living Wage increases, but also with market inflation and labour shortages exacerbated by the departure of many Eastern Europeans following Brexit, and many leaving the sector after the pandemic lock-downs. Government immigration rules are not helping the situation.

Food and Drink Federation Chief Executive, Karen Betts, commented recently that prices may get worse before they get better, suggesting the cost of supplies such as wheat and sunflower oil “are going to take 12 months, perhaps longer, to make their way into food prices in the UK”.

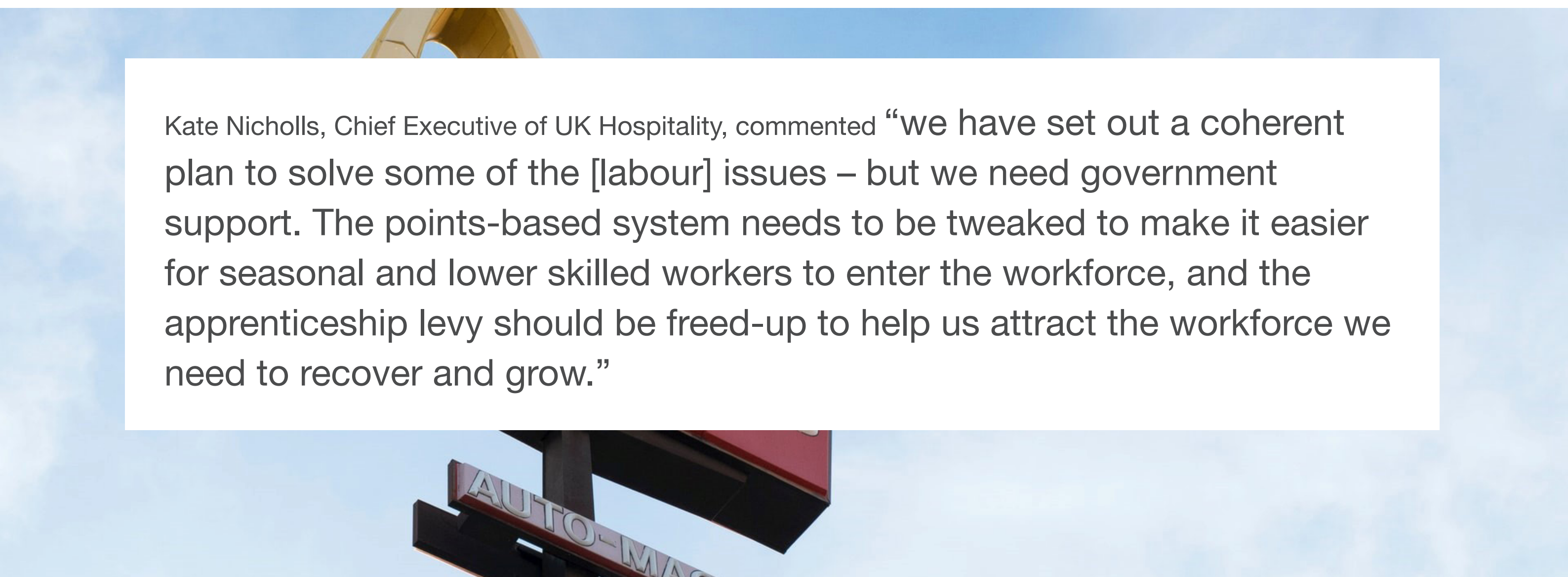
Propel reports that “hospitality staff shortages are at record high despite sector creating almost one in three of all new UK jobs last year”.

300,000 new jobs created over the last 12 months

174,000 jobs available

83% more vacancies than the pre-pandemic period of March-May 2019 (ONS)

45% of operators in hospitality are cutting trading hours or capacity to cope with staff shortages, causing the loss of £21bn in trade (UK Hospitality/ British Institute of Housekeeping)



Kate Nicholls, Chief Executive of UK Hospitality, commented “we have set out a coherent plan to solve some of the [labour] issues – but we need government support. The points-based system needs to be tweaked to make it easier for seasonal and lower skilled workers to enter the workforce, and the apprenticeship levy should be freed-up to help us attract the workforce we need to recover and grow.”

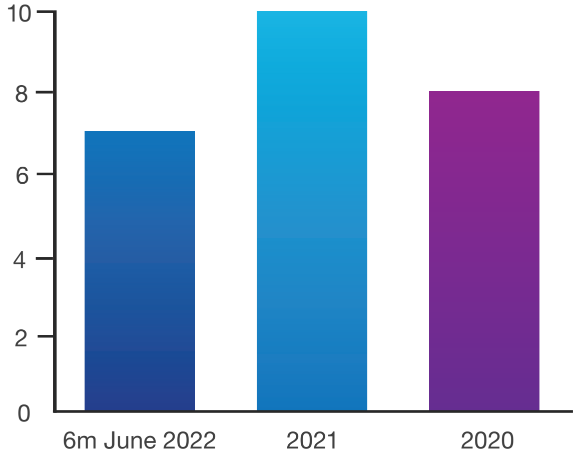
3 Loss of pandemic-inspired government support

The government was generous with its support of businesses in the pandemic, but the rush to get this support flowing to businesses necessarily that meaning some were "over-compensated" whilst others just "got by", or even failed in some sectors of hospitality that could not adapt to lock-downs.

Support included the Retail, Hospitality and Leisure Grant, a business rates holiday, an eviction ban on landlords, VAT deferred payments, and VAT reductions to 5% until September 2021, and 12.5% until March 2022.

The removal of this assistance has been painful, some operators only realising the full extent of the benefit after its withdrawal.

4. Sector M&A activity



Deals by year since January 2020

Sector deals are increasing, despite the difficult conditions.

Refranchising deals by Pret and Costa dominate the first six months of 2022 – five of the seven deals below.

There have been 5 acquisitions by franchisors of franchisee businesses, mainly in the Burger King and McDonald's brands.

The last two and a half years have been a busy time for food and beverage sector

June 2022 – The Chesterford Group, operator of fish and chip restaurants, acquired 4 Pret A Manger stores as a new franchisee

May 2022 – K & Z Holdings took on 4 Pret A Manger stores

May 2022 – Pret A Manger sold 4 stores to Dallas Holdings, a new UK franchise partner

April 2022 – McDonald's acquired its largest UK franchisee, the Appt Corporation, buying out the shares of its founder, Pathak. Founded in 2003, the Appt Corporation grew to 43 sites, stretching from north to west London and into Berkshire

February 2022 – Scoffs Group acquired 9 stores from Costa Coffee, part of a larger deal for around 20 of the brand's equity stores

February 2022 – Sim Trava acquired 8 stores from Costa Coffee, part of a larger deal for 17 of the brand's equity stores

January 2022 – Burger King UK acquired 12 restaurants from its franchise partners, Kaykem Fast Foods and Saxby

December 2021 – A 30-store Irish-based Domino's franchisee sold to existing operator Mike Racz, DPG also taking a stake

October 2021 – Hotel operator Nine Group acquired 31 existing Pizza Hut Delivery and Express Huts in London, becoming a new expansion-focussed franchisee

September 2021 – Euro Garages acquired a portfolio of 52 KFC Restaurants from Amsric Holdings

July 2021 – Existing Starbucks operator Cobra Coffee (part of Southern Co-operative) acquired Amsric Ltd, operator of a chain of 14 Starbucks stores

May 2021 – Burger King UK acquired franchisee Zing Leisure

May 2021 – Lxi REIT acquired a portfolio of Costa Coffee drive-thru sites

April 2021 – Euro Garages acquired healthy fast food chain Leon for £100m

March 2021 – Caskade Caterers acquired Castlebarn and Davton Holdings, operators of 13 KFC franchisee restaurants in the South East London and Kent area

October 2020 – Boparan Restaurant Group acquired Gourmet Burger Kitchen

September 2020 – Foodco UK Franchising acquired Foodco UK, which operates the Muffin Break brand, from the administrators in a pre-pack sale

August 2020 – Gerry's Offshore Incorporations acquired Coffee Snobs, and South West Coffee from Kout Food Group, the owner and operator of these 24 Costa Coffee outlets

June 2020 – Cooks Global Foods acquired Triple Two Coffee Holdings, an owner and operator of coffee shops

June 2020 – Sourdough South (trading as Three Joes Sourdough Pizza) acquired The Stable Bar & Restaurants, which owns and operates restaurants

March 2020 – Euro Garages acquired the largest UK's largest KFC franchise from The Herbert Group in a transaction that involved 150 KFC branded restaurants and 1 Pizza Hut restaurant across the UK, Ireland and Jersey

February 2020 – Soul Foods acquired a Warrington KFC restaurant from franchisor, Kentucky Fried Chicken (Great Britain)

January 2020 – Burger King UK acquired 34 outlets from franchisee, Kout Food Group

5. Sector and M&A outlook

Sector outlook

We believe the sector has a good future, and that the trends outlined in section 2 will prevail, with:

- **the sector benefitting from the now-established delivery channels, despite the dust still settling on the future of the delivery market and commission fees following reliance on the channel during the**

Sector analyst Simon Stenning recently said: "Accessing food whenever, wherever, is a habit that younger, urban dwelling consumers are not going to give up on. We will continue to live in densely populated cities, with smaller domestic facilities. Many hospitality operators will continue to grow their multi-channel approach, although some will concentrate on delivering an experiential, premiumised proposition."

- **the cost-of-living squeeze bolstering sales of what is a low-priced option;**

- **more re-franchising by brand owners keen to "off-shore" operational headaches, expansion and the attendant capital requirements to franchisees - which have proved more adept operators in recent**

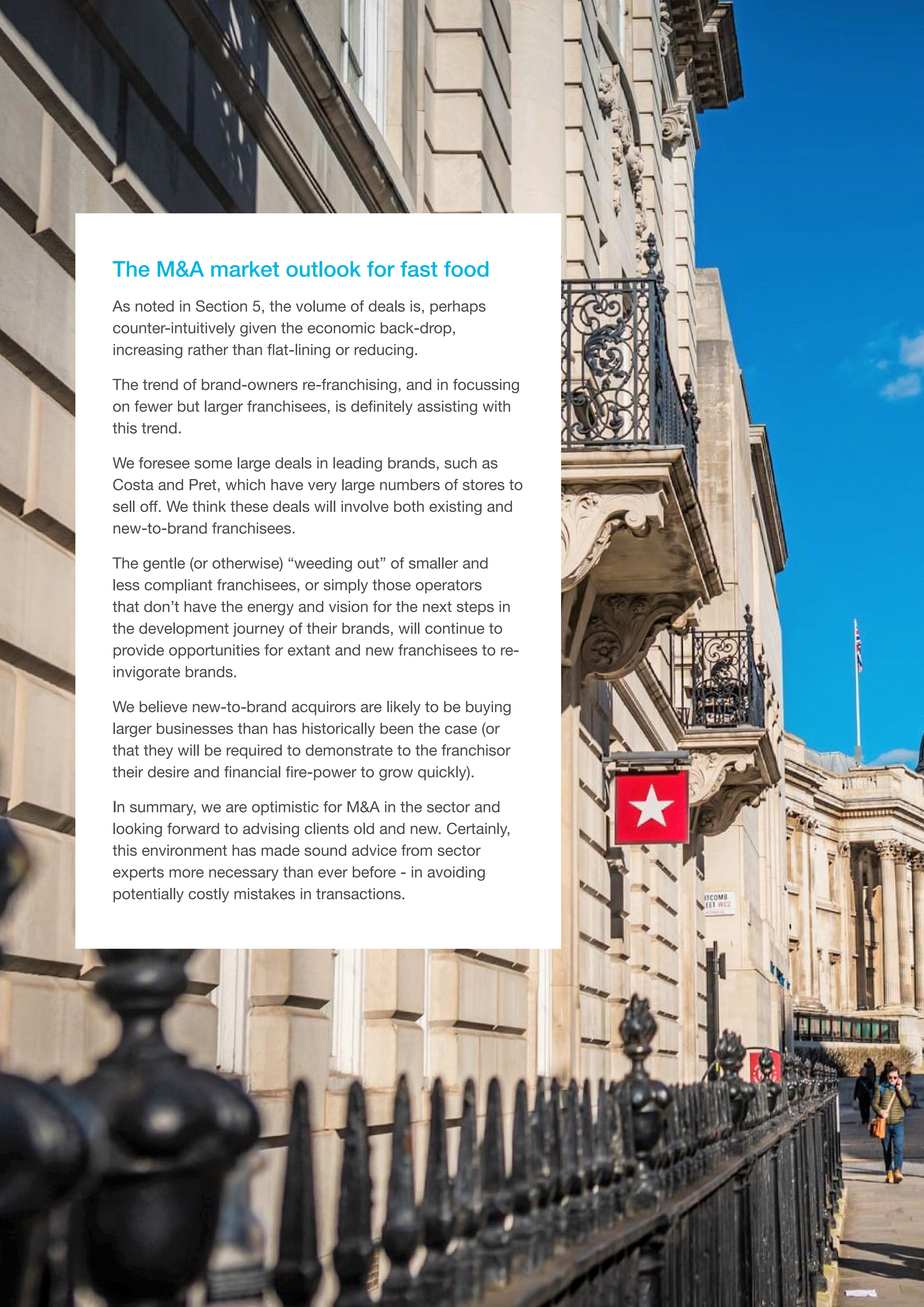
- **more focus on catering to the fast-developing vegetarian, vegan and healthy food**

- **labour issues being resolved, but maybe not with humans - new research from Vita Mojo indicates many (including 80% of generation Z) prefer less human interaction, and that 64% would spend more and visit more frequently if human interaction was reduced. Furthermore, UK operators, including Bella Italia, are trialling over 80 table service robots;**

- **the sector will recover some or all of the lost EBITDA returns recently lost through sales price-lag, inflation and the curtailment of government support – albeit the timing of such recovery will depend on the uncontrollable macro-economic environment, as well as franchisor and consumer attitudes**

Opinions on this are divided, ranging from the optimistic to the pessimistic. The always forthright Luke Johnson recently said he feared "two years of hell" ahead and continued by saying we are "possibly heading into the worst recession of my adult life".

He was referring to the wider hospitality sector, not the more robust fast food sub-sector, but let's hope he's wrong, or at least over-stating the challenges ahead.



The M&A market outlook for fast food

As noted in Section 5, the volume of deals is, perhaps counter-intuitively given the economic back-drop, increasing rather than flat-lining or reducing.

The trend of brand-owners re-franchising, and in focussing on fewer but larger franchisees, is definitely assisting with this trend.

We foresee some large deals in leading brands, such as Costa and Pret, which have very large numbers of stores to sell off. We think these deals will involve both existing and new-to-brand franchisees.

The gentle (or otherwise) “weeding out” of smaller and less compliant franchisees, or simply those operators that don’t have the energy and vision for the next steps in the development journey of their brands, will continue to provide opportunities for extant and new franchisees to re-invigorate brands.

We believe new-to-brand acquirors are likely to be buying larger businesses than has historically been the case (or that they will be required to demonstrate to the franchisor their desire and financial fire-power to grow quickly).

In summary, we are optimistic for M&A in the sector and looking forward to advising clients old and new. Certainly, this environment has made sound advice from sector experts more necessary than ever before - in avoiding potentially costly mistakes in transactions.

6. PKF Smith Cooper's franchise services

We have advised on projects in the franchise sector since July 2004, working for franchisees, and occasionally franchisors. We first advised on the sale of £9m turnover KFC operator Mercian Fast Foods to KFC, and since then we have worked on over 80 assignments, covering:

- **Project management of:**
  - Sales of businesses to franchisee and franchisor
  - Acquisitions of businesses from franchisee and franchisor
- **Acquisition bid proposals (including presentations) to franchisors**
- **Target assessment and valuation**
- **Business planning, modelling, and fundraising**
- **Deal structuring and strategic advice**
- **Succession planning and pre-sale preparation**
- **Commercial diligence for acquirors and funders**
- **Consultancy/ad-hoc assignments**

Other divisions of PKF Smith Cooper can provide:

Due Diligence	Personal Tax	Corporate Tax
Audit	Accounting	HR
IT Services	Payroll	Wealth Management

Franchise contacts

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