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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Branding, Leasing Woes Tip Dining Chains Toward Ch. 11

By **Natalie Rodriguez**

Law360, New York (March 11, 2014, 7:14 PM ET) -- Sbarro Holdings LLC's return to bankruptcy this week underscores the leasing troubles and brand battles many established restaurant chains are facing in the current economic climate — spotlighting the fact that companies need to make smarter deals to stay ahead of the competition and out of Chapter 11, experts say.

With Sbarro and F&H Acquisition Corp. — the parent to two sports bar chains — having already checked into bankruptcy and others like Quiznos expected to soon follow, experts say a wave of Chapter 11's may just be building up. And the trend puts a new emphasis on the importance of restaurants making smart M&A and branding deals, as well as better lease agreements.

“These are older brands. I think some of them are tired brands. ... You have to spend the money to stay current,” said Bruce Bronster, a partner with Windels Marx Lane & Mittendorf LLP.

He pointed to Starbucks Corp. as a brand willing to update itself. The coffee shop chain spent about $100 million nearly two years ago to purchase Bay Bread LLC, the owner of California-based bakery La Boulange, in order to help revamp its breakfast offerings.

The deal “completely upgraded Starbucks' baked goods, and they're doing a lot better now. ... You have to stay current and have to give modern choices,” Bronster said.

With established restaurant companies facing down nimbler competitors on an expansion streak, experts say that restaurant chains and franchisors need to take careful stock of how their brands might need to be refreshed and strike the right deals — lest they find themselves in bankruptcy court, according to some experts.

“I think there are economic pressures on a lot of businesses in the fast casual space, and Sbarro's certainly wasn't the only one feeling this,” said David Rosendorf, a shareholder with Kozyak Tropin & Throckmorton PA.

Quiznos has recently been marked as the restaurant company most likely to enter Chapter 11 next, but several other established chains like Ruby Tuesday Inc. andApplebee's are also being carefully watched on how they will handle their current financial struggles, experts said

“Sbarro is indicative of a trend,” said Thomas Fawkes, a bankruptcy attorney in the food industry team at Freeborn & Peters LLP, who also noted that out of the limelight there has been a spate of bankruptcy filings for subsets of larger chains and major franchisors for the likes of Burger King.

Some experts, however, are quick to note that the bankruptcy risks are generally confined to older companies dealing with stale brands, overextended portfolios and lease deals made in the heyday of the market.

“I don't think it's an epidemic. I think fast casual is definitely growing. Food sales are very bullish,” Bronster said.

The fast casual dining market has been on an upswing, but it's a much different animal than it was pre-recession. Sales growth hasn't been recovering at a consistent level across the sector.

"Sales growth has been challenged because consumers are just eating out less," said Carla Norfleet Taylor, a director with Fitch Ratings Inc. "That's the bottom line.”

Larger franchisors like Sbarro and Quiznos have been struggling to adapt to the new environment because they are just too large to act nimbly, experts said. And they haven't been able to work with franchisors to refresh their product offerings and branding quickly enough.

“Look at the chains growing quickly right now, like Chipotle [Mexican Grill Inc.] and Jimmy John's [Enterprises Inc.] I think what distinguishes them is an emphasis on quality,” Fawkes said.

In general, consumers are looking for healthier food options made with higher quality ingredients, he and others noted. And companies need to make the right acquisitions and supplier alliances to help bring them up to speed with their competitors.

“The weaker quality players are at risk in this economy. ... I really don't think Sbarro's bankruptcy is a reflection of a weakening in the restaurant industry as much as it is a reflection in Sbarro's business model and product offering,” said Patton Hahn, co-chair of Baker Donelson Bearman Caldwell & Berkowitz PC's financial institutions litigation subgroup.

Additionally, Sbarro has been in particular trouble because pizza is one of the most competitive categories in the sector.

“The competition in the fast casual pizza space is as challenging as it's ever been,” said Anthony Calamunci of Roetzel & Andress, noting that regional trends — with the East and West coasts, for example, preferring different styles — don't help.

“I don't think [Sbarro] ever transferred well to the West Coast,” said Calamunci, adding that it's important for restaurants to take a closer look into their operational structure and be more careful about putting locations where the brand is going to succeed. Similar problems of regional challenges exist in the fried chicken subsector, he added.

Restaurant chains struggling to fix themselves could tap a deal with a private equity player with experience in streamlining similar companies.

“There's going to be mass consolidations and funds buying up brands,” Calamunci said. “As the restaurant industry continues to grow, you're going to see a market adjustment.”

On top of carefully steering their branding, restaurant chains must grow their portfolios responsibly and know when to trim the fat, according to experts.

“Growing nationally is important, but again, there has to be a plan in place to change the model, when consumers are changing their spending and indeed eating habits,” said Greg Wank, a partner with accounting firm Anchin Block & Anchin LLP and chair of its food and beverage companies group.

Pre-recession, just about everyone in the industry was on an expansion streak, and many of the older companies are now weighed down with long-term leases in the less-than-appetizing mall sector, Norfleet Taylor said. And while bankruptcy court is sometimes the only place where those deals can be reworked, experts say shedding some of these lease burdens should be top of mind for any struggling restaurant company heavily exposed to the mall sector.

“There's less people going to malls, and there's less foot traffic in mall food courts,” Fawkes said.

Beyond the leases, restaurant companies are also facing significant headwinds from increasing labor costs and the volatile commodities market.

For example, the prices on flour and cheese have been particularly volatile in recent years, Fawkes said, noting that the recent political troubles in the Ukraine — a major exporter of flour — is likely to exacerbate those issues for U.S. restaurants.

This perfect storm of factors means there will likely be more attempts made by restaurant companies both in and out of bankruptcy court to save themselves by overhauling their operations.

“I think you will see continuing financial restructuring,” Rosendorf said.

--Editing by Jeremy Barker and Philip Shea.
