Industry Spotlight: Q2 2020 Restaurants

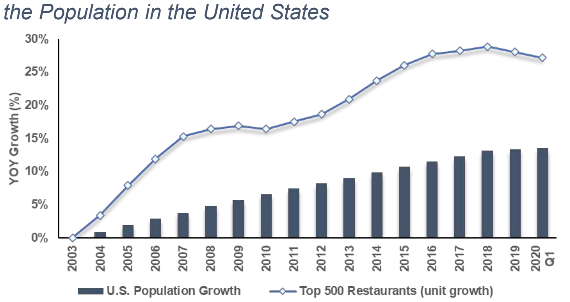
Leaving Money on the "Virtual" Table

COVID-19 has been a clear catalyst for food delivery. Widespread government-mandated restaurant closures and consumer quarantining has been driving unprecedented demand for grocery and food delivery services. As the adoption of online ordering and delivery by restaurants accelerates, this phenomenon is giving rise to new business models to meet demand.

What Goes Up, Must Come Down

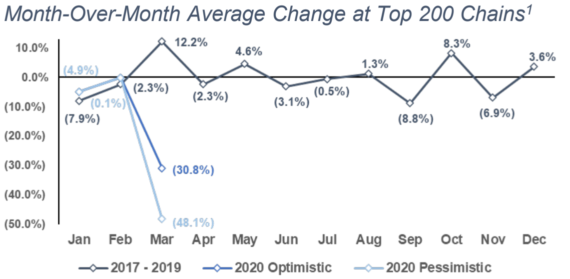
The restaurant industry has spent much of the past decade adding capacity with some of the biggest fast-food companies opening locations on what seemed like every corner. Growth for the top 500 dining chains has outpaced U.S. population growth since 2003, leading to a situation of oversupply. There are significantly more seats than diners nationwide.

The Unit Growth for the Top 500 Restaurants Rivals that of the Population in the United States



Much of the early expansion was financed with cheap debt as companies took advantage of low interest rates; however, lending was already slowing down in the restaurant space prior to COVID-19. Shifting consumer tastes, delivery, e-commerce, rising wages and increased competition all hammered restaurants in 2019. The nationwide "social distancing" mandate to contain the spread of COVID-19 will be the final blow for some, with many independent restaurants forced to close their doors for good. Traditional restaurant traffic nearly disappeared overnight, down between 40% and 80% across the industry.

Month-Over-Month Average Change at Top 200 Chains[1]

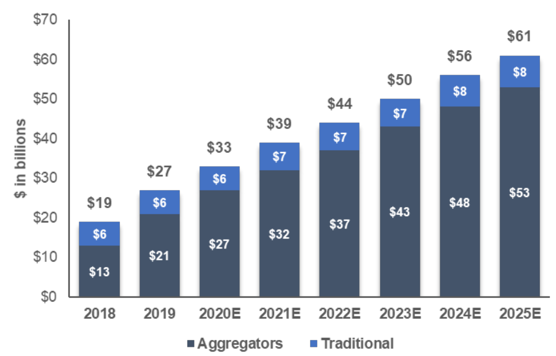


Smaller chains that managed to hang on because of cheap debt are the most at risk. Lower interest rates will bring down the cost of debt, but too much market volatility could dry up sources of capital. The looming bankruptcies are a major problem for landlords that have relied on restaurants as stable tenants as other parts of the retail landscape are decimated by e-commerce.

Convenience is Key

Consumers have grown accustomed to having meals brought to their workplace or home with a simple phone call or a few mobile swipes. Even before the outbreak, the online food-delivery market was on the rise, projected to reach $61 billion by 2025, growing at a CAGR of 14.6%. The online food-delivery market consists of two different delivery service models: restaurant-to-consumer delivery (traditional) and platform-to-consumer delivery (aggregators).

Online Food-Delivery Market Expected to Grow through 2025 at a CAGR of 14.6%



The traditional delivery segment includes the delivery of meals carried out directly by the restaurants. The order may be made via platforms (e.g. Delivery Hero, Just Eat) or directly through a restaurant website (e.g. Domino's). Major brands including Chipotle, Panera and Roti have added second lines to accommodate the influx of carryout orders.

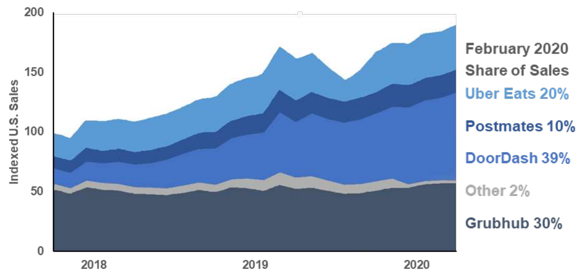
The aggregator segment focuses on online delivery services that provide customers with meals from partner restaurants that do not necessarily have to offer food delivery themselves. In this case, the platform (e.g. Deliveroo) handles the delivery process. Online food-delivery platforms such as DoorDash, Caviar (now part of DoorDash), Uber Eats, Seamless, Postmates and Grubhub (soon to be part of Just Eat) are expanding consumer choice and convenience.

Source(s): Bloomberg, Industry Research, National Restaurants Association, Pitchbook, Second Measure, S&P Capital IQ, Technomic
1 2020 optimistic and pessimistic estimates based on the % reported drop in restaurant visits in the last week of February and March 2020.

BALMORAL® ADVISORS

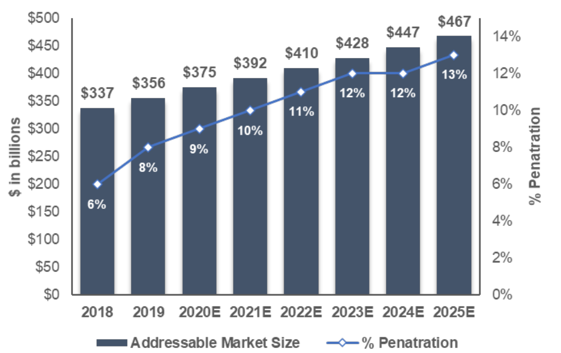
Out with the Old, In with the New

Meal Delivery – U.S. Monthly Consumer Sales[2]



Many online food-delivery companies see COVID-19 as an opportunity to gain market share. Leading food delivery providers such as Uber Eats, DoorDash and Postmates have been offering contactless food delivery. At the same time, many of these platforms have reduced commissions charged to restaurants and begun offering free delivery services in a bid to draw consumers and mitigate the impacts of restaurants ceasing operations. Mobility platforms diversified in delivery are likely to be better insulated from the impact of the coronavirus. Uber CEO Dara Khosrowshahi has indicated he believes the company's Eats segment will see a boost from social distancing as consumers increasingly dine in.

The Online Food-Delivery Addressable Market Size in the U.S. is Attractive

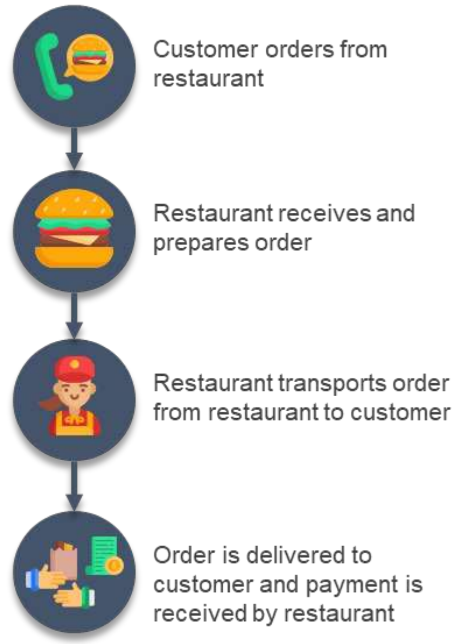


Although the restaurant delivery market is maturing, with only a small number of players dominating the largest markets, smaller cities and rural markets remain underserved. The addressable market share for food delivery in the U.S. alone is estimated to reach $467 billion by 2025. Despite overall industry growth, the battle for customers is getting more intense because fewer of today's diners are loyal to just one service. Grubhub's CEO has cited "promiscuous customers" as hindrance to his company's growth. There is enough demand to go around, with a significant opportunity for investors with capital to deploy.

On average, adding a food-delivery option increases revenue 20% for restaurants, however a phenomenon known as the "GrubHub Effect," has allowed small restaurants to see revenue increases up to 50% after signing up on the platform.

The modern food delivery chain is specialized, lean, efficient and data-driven.

Traditional Food Delivery



Modern Food Delivery

Source(s): Industry Research, National Restaurants Association, Second Measure, Statista, Technomic
2 Indexed U.S. Sales indexed to meal delivery sales on January 2018 (=100) with percentages rounded.

Let the Hunger Games Begin!

Some traditional restaurants entering the food-delivery space are partnering with aggregators to offer delivery without the added cost of keeping a delivery team employed. The ease of using aggregators for food-delivery has lowered the barriers to entry, increased competition and has created both an opportunity and a challenge. With demand at an all-time high for food-delivery, many aggregators are struggling to keep up with demand. Ghost kitchens aim to correct the supply and demand imbalance.

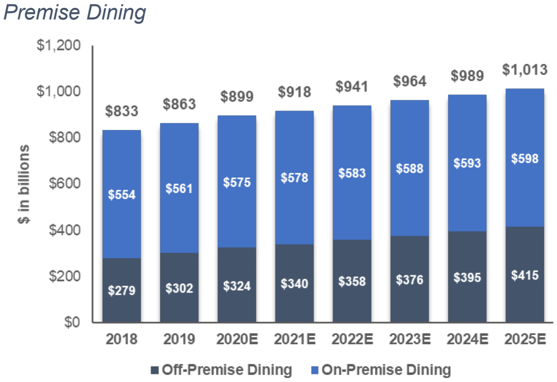
The Ghost Kitchen Space at a Glance

Ghost Kitchens

Ghost kitchens, much like restaurants, come in all shapes and sizes. In general, ghost kitchens (also referred to as commissary kitchens, dark kitchens or cloud kitchens) are brands or menus that are produced without front-of-the-house space or storefront and are sold exclusively online.

The "ghost kitchen" concept is not new, with commercial commissary kitchens routinely used for catering and food truck operators (picture a large warehouse with numerous stations of stainless-steel prep tables, hood vents, stoves, ovens, and sinks, each with its own orders coming in direct from customers). Quicker delivery times drive demand, with the location of a ghost restaurant critical to its success. The closer to the ultimate customer the better. Many are looking at alternative real estate spaces, with unused space in office buildings, shopping centers, multi-family buildings, where office workers, customers and tenants spend their days presents a significant opportunity.

Total Restaurant Sales are Increasing Primarily Due to Off-Premise Dining



With improvements in technology, changes in lifestyle preferences, and upgrades to the value chain, ghost kitchens are set to take off, projected to occupy upwards of 20 million square feet in the U.S. by 2022, and with off-premise dining expected to account for 41% of all restaurant spend by 2025.

Ghost kitchens overlap with restaurants that have a separate brand or menu that is sold exclusively online (virtual restaurant) and commercial kitchen space providers that produce their own virtual brands and menus (hybrids). Ghost kitchens can be independent (single kitchen with a single brand and menu) or multi-brand (single kitchen with multiple brands and menus). Ghost kitchens can be stand-alone businesses, or used as a way to test cuisine, gain followings and generate excitement before turning concepts into brick and mortar restaurants.

Now that a large number of consumers are using Uber Eats and DoorDash, restaurants are implementing a new technique to push as much food out of the door as they can with ghost kitchens. These kitchens, solely used for delivery prep, are helping restaurants increase production and better scale delivery services.

Virtual Restaurants

By comparison, virtual restaurants have their own established brick and mortar locations (or food trucks), and use their existing kitchens to create additional, delivery-exclusive menus. Virtual restaurants allow restaurateurs to serve new on-line customers with the same kitchen, line cooks and inventory with no additional storefront to manage and no additional rent.

BALMORAL® ADVISORS

Source(s): Industry Research, Pitchbook, Restaurant Dive, S&P Capital IQ, The Food Corridor

Ghost Kitchens Increase Restaurant Capacity Effectiveness

Just Salad, a NYC-based fast casual concept, partnered exclusively with Grubhub to launch a new virtual restaurant, Health Tribes™. Smokey Bones Bar & Fire Grill, a casual dining concept specializing in wings and burgers has launched two "virtual" delivery-only concepts, Wings Experience and Burger Experience, aiming to broaden its sales network. Foodhaul, a new Chicago venture, instead partners with celebrity chefs to create and license virtual brands and concepts to restaurants, bars and caterers with excess kitchen and labor capacity. Foodhaul is essentially a virtual food hall, offering a variety of culinary concepts with the goal being to give underserved markets access to dishes they couldn't find locally.

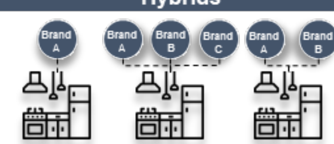
Hybrids

While virtual restaurants use their existing kitchen space to produce virtual brands, ghost kitchens typically lease kitchen space from infrastructure providers that offer kitchen as a service (KaaS). KaaS providers that overlap with ghost kitchens are hybrids, which both provide kitchen space and infrastructure and house their own ghost kitchens and virtual brands. Companies in this space include Kitchen United and CloudKitchens, a Los Angeles based company founded by Uber founder Travis Kalanick. CloudKitchens houses its own virtual brands like Excuse My French Toast and B*tch Don't Grill My Cheese.

Travis refers to CloudKitchens as a "smart kitchen" that comes with software and logistics support to help reach more customers seamlessly. Click Virtual Food Hall offers only delivery and takeout; this concept opened in August 2019 by Houston industry vets Steven Salazar and Gabriel Medina. Click Virtual Food Hall currently has five virtual brands that offer everything from comfort food and cold cuts to Japanese and Filipino cuisine.

The benefits of ghost kitchens stem from the fact that they are quicker and cheaper to launch and operate than traditional restaurants, cutting down on the cost of equipment and front-of-the-house labor. It also enables restaurateurs to start selling almost immediately without having to deal with the risk of opening a new dine-in restaurant. The revenue model for a ghost kitchen works best when fixed and labor expenses are being absorbed by another business. A large brand can create a virtual brand to prepare in-house and partner with ghost kitchens to expand delivery into neighborhoods outside existing delivery zones or free up space at their primary locations. Additionally, they can provide a space that's customized to optimize a restaurant's delivery business, and helps restaurants generate new business and brand awareness. Ghost kitchens allow a brand to focus on a core objective; delivery. When you're trying to cater to BOTH online and in-person orders, things can get complicated.

Overview and Comparison of Alternative Restaurant Models

	Virtual Restaurant	Ghost Kitchen	Hybrids
Model			
Concept	• Uses existing space & equipment • Orders come from online • Single or multiple kitchens • Single or multiple virtual brands • Delivery via in-house or aggregator	• Uses leased space & equipment • Orders come from online • Single kitchen • Single or multiple virtual brands • Delivery only via aggregator	• Acquires space & equipment • Houses owned and acquired brands, partners and other ghost kitchens (tenants) • Orders come from online • Multiple kitchens • Multiple virtual brands and partners • Delivery via in-house or aggregator
Pros	✔ Utilizes existing excess capacity ✔ Moderate operational cost ✔ Moderate set up and introduction cost ✔ Expands brand presence online ✔ Allows for personal touch ✔ Less dependent on delivery aggregators	✔ Low operational cost ✔ Low set up and introduction cost ✔ Highly efficient and standardized ✔ Optimized delivery ✔ Faster expansion ✔ Enables experimentation	✔ Cost savings through economies of scale ✔ Variety of cuisines and price points ✔ Allows for personal touch ✔ Less dependent on delivery aggregators
Cons	× Moderate operational cost × Moderate set up and introduction cost × Highly competitive × Cannibalization of on-premise dining sales × Slow expansion beyond existing capacity	× No personal touch × Customer relationships difficult to build × Limited audience (tech-savvy) × Limited brand presence, no storefront × Highly dependent on delivery aggregators × Highly competitive	× High operational costs × High set up and introduction cost × High operational overhead

Source(s): Industry Research, Medium, Pitchbook, Reforming Retail, Restaurant Dive, The Spoon, Virtual Dining Chicago

Balmoral Advisors | 100 S. Wacker, Suite 850, Chicago, IL 60606 | +1 (312) 766-9890 | www.balmoraladvisors.com

Ghost Kitchen Investment to Accelerate

Investment Trends

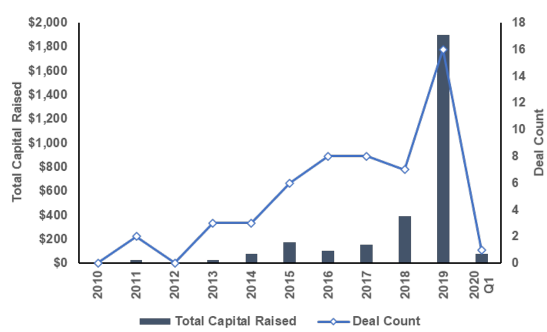
Many investors have traditionally avoided the restaurant industry as a whole. Historically, the traditional restaurant model had limited opportunities to scale their business with expansion driven by cash flows from operations. Over time, this model changed. VC investment activity in ghost kitchen businesses has risen over the past five years, with deal values increasing at least 2.4x each year since 2016. VCs have taken an interest in ghost kitchens with $1.7 billion invested in ghost kitchens in the first quarter of 2019 alone.

Top 10 Ghost Kitchen Deals as of 2020

Company	Close Date	Deal Size ($mm)	Stage	Lead Investor	Location
REEF	Mar-19	$900	Late-Stage VC	SoftBank Investment Advisers	U.S.
CLOUD KITCHENS	Jan-19	$700	Early Stage VC	N/A	U.S.
zume	Nov-18	$375	Early-Stage VC	Grishin Robotics, SoftBank Investment Advisers	U.S.
REBEL FOODS	Aug-19	$125	Series D	Evolvence Capital, Sistema Asia Capital	India
MUNCHERY	May-15	$86	Series C	ACME Capital, Menlo Ventures	U.S.
KITOPI	Feb-20	$60	Series B	Knollwood Investment Advisory, Lumia Capital	UAE
熊猫星厨 Panda Selected	Feb-19	$50	Series C	Tiger Global Management	China
zume	Sep-17	$48	Series B	SGH Capital	U.S.
sprig	Apr-15	$45	Series B	Greylock Partners, Social Capital	U.S.
kitchen united	Sep-19	$40	Series B	GV, RXR Realty	U.S.

Deal activity has declined from its peak in the first quarter of 2019, but investment continues, with $28.6 million invested in the fourth quarter of 2019.

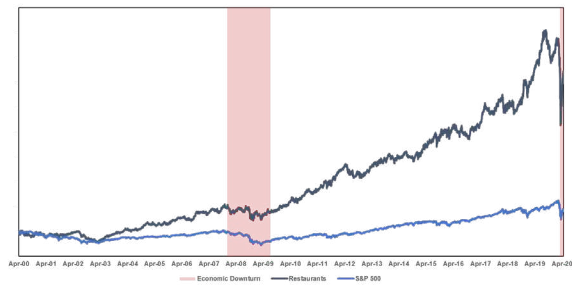
Ghost Kitchen Total Capital Raised ($mm) and Deal Count



Although deal activity has slowed dramatically, with most investors preferring to wait on the sidelines until a model has been proven, COVID-19 has facilitated targeted investments within the space since its onset. Furthermore, COVID-19 will continue to be a catalyst for online food-delivery, with emerging ghost kitchen startups providing an attractive business model as more restaurant sales move to off-premise dining.

COVID-19 has hit restaurants hard, specifically those that do not offer take-out, drive-thru or delivery. The historical performance of the restaurant industry indicates a strong comeback is highly probable for those who adapt. Much like the rise of the food trucks following the 2008 recession, ghost kitchens will be at the forefront of the next major industry shift.

Restaurant stocks outperformed the S&P 500 by 541.25% from April 2000 to April 2020



Limits on in-store dining are putting new pressures on restaurants' off-premise capabilities, accelerating an already growing focus on takeout and delivery. The largest companies with the most cash will be the ones that will come out the strongest. Small and midsized concepts will have the toughest time reemerging. Private-equity firms that aren't spending their investment cash shoring up or supporting existing properties or portfolio companies may find an opportunity to consolidate an array of restaurant chains at a discount. Alternatively they could invest in or greenfield KaaS facilities to piggyback off the growth of the online food-delivery trend which is here to stay.

COVID-19 has created both disruption and opportunity in the restaurant industry. Balmoral Advisors continues to closely monitor restaurant industry trends through our ongoing conversations with restaurant owners and management. Whether you're a restaurateur seeking to restructure or raise capital, or a strategic or financial buyer looking to invest in the space, please do not hesitate to contact us.

BALMORAL® ADVISORS

Source(s): Industry Research, Pitchbook, S&P Capital IQ, The Spoon

About Balmoral Advisors

Balmoral is an independent investment bank dedicated to providing mergers & acquisitions, corporate finance, and financial restructuring advisory services involving mid-sized transactions.

We bring a powerful combination of deep experience, industry expertise, and broad market reach to every client engagement. Our senior professionals have decades of experience and collectively have advised on more than $35 billion of transactions. Unlike firms that have a more rigid transaction approach, we focus first and foremost on understanding our clients' goals and developing tailored solutions to achieve exceptional outcomes on their behalf.

Our practice is global, but the culture of our firm reflects our Midwestern roots in terms of values, work ethic, and focus on developing long-term relationships. Our clients value our advice and appreciate our results. Since inception, more than half of our completed transactions were with repeat clients.

Balmoral's Services

Balmoral specializes in helping clients sell their businesses, source and complete acquisitions, and raise or refinance capital. We work with business owners, corporations and financial investors worldwide involving early-stage growth companies, successful mature businesses, corporate divestitures, special situations, and restructurings.

Mergers & Acquisitions
- ♦ Buy- and sell-side advisory

Debt & Equity Placement
- ♦ Growth and acquisition capital, leveraged buyouts, financial restructuring, late-stage venture capital and recapitalizations

Other Services
- ♦ Valuation analysis, consulting, financial modeling and forecasting

Primary Industries Served

Building Products | Business Services | Chemicals & Materials | Food & Beverage | Industrials | Plastics & Packaging

Balmoral's Senior Team

Chris Cerimele
Managing Partner
+1 (312) 371-3527 (m)
+1 (312) 766-9890 x237 (o)
ccerimele@balmoraladvisors.com

Brooks Crankshaw
Managing Director
+1 (312) 399-3627 (m)
+1 (312) 766-9890 x335 (o)
bcrankshaw@balmoraladvisors.com

Bob Dekker
Managing Director
+1 (312) 399-3627 (m)
+1 (312) 766-9890 x335 (o)
bdekker@balmoraladvisors.com

Stan Koss
Managing Director
+1 (312) 953-3666 (m)
+1 (312) 766-9098 x567 (o)
skoss@balmoraladvisors.com

Karen Croyle
Vice President
+1 (217) 621-3431 (m)
+1 (312) 766-9890 x276 (o)
kcroyle@balmoraladvisors.com

Jonathan Goldstein
Associate
+1 (847) 814-4110 (m)
+1 (312) 766-9890 x465 (o)
jgoldstein@balmoraladvisors.com

Michael Palumbo
Analyst
+1 (574) 612-3251 (m)
+1 (312) 766-9890 x725 (o)
mpalumbo@balmoraladvisors.com

Lillie Ross
Analyst
+1 (630) 744-9833 (m)
+1 (312) 766-9890 x767 (o)
lross@balmoraladvisors.com

BALMORAL® ADVISORS