FOOD & BEVERAGE ROUNDTABLE

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THE food and beverage industry as a whole is unique in many ways – and here in Los Angeles, where we have some of the finest dining options in the nation, there's perhaps an even finer tuned set of rules for success. Stir in an unpredictable economy and you've got a sector of Southern California business that continues to evolve as swiftly as any other. To make some sense of this exciting and unpredictable realm, the Los Angeles Business Journal turned to some of the leading experts in the region – from the financial, legal and food & beverage service perspectives – to get their diverse viewpoints and assessments regarding the current state of the industry that Angelenos most certainly couldn't live without!

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◆ New restaurants always seem to be opening – and closing. What advice would you offer to an early-stage restaurant company seeking growth capital?

GRAVES: There are many financing options available to early-stage companies. Generally, a founder should try to fund the first locations with "friends and family." This will be the cheapest money and allow the founder to retain the greatest control. For operators with a few successful locations, an excellent choice, if you have the bargaining position to obtain it, are high net worth individuals who are willing to invest in individual future locations (rather than the entire company). Frequent customers are excellent candidates for this. This arrangement is greatly advantageous since the founder will retain both control over the concept and the greatest amount of upside potential for him/herself and the earliest-stage investors. Sophisticated money is going to want greater control and higher return and will only invest in the top tier entity. Equipment loans, early franchising, joint ventures, SBA loans, and strategic partnerships are also worthy alternatives to consider.

◆ Brand extension is an important marketing tool for a variety of companies. What types of brand extensions are available to restaurant companies?

O'SHEA: Catering is typically the most common brand extension for restaurant brands. What began as a few intimate dinners in the homes of our most loyal patrons of Patina Restaurant has grown into Patina Catering. We also have Patina Weddings, which we cross promote with all of our restaurants and catering operation.

GRAVES: Restaurant companies have a wide range of potential extensions, which can be quite profitable and can greatly increase the company's public profile and popularity. Some extensions can be seen on street corners everywhere (food trucks!), which, if used properly, can substantially raise brand awareness. Smaller footprint stores and fast casual and "grab-and-go" brands can complement casual dining concepts. License agreements with food manufacturers to produce and sell a restaurant's signature items in grocery stores can drop significant revenues directly to the bottom line. Higher-end restaurants, especially those with celebrity chefs, can license their name for a variety of consumer goods such as cookware, knives and lifestyle products. It is imperative to negotiate the license agreement properly; otherwise operators can severely limit their opportunities, lose value in their brands, or receive significantly lower royalties than they should.

◆ Gift cards provide a significant source of revenue to restaurants. What are the most important issues associated with launching a gift card program (legal, accounting, etc.)?

COSTALES: From a legal perspective, restaurants need to ensure that gift cards are not given away (or sold at a discount) when customers purchase an alcoholic beverage. Otherwise, the California Department of Alcoholic Beverage Control (ABC) could take disciplinary action, including the imposition of fines and/or a suspension (or even revocation) of the restaurants' liquor license. In addition, restaurants must make sure that gift cards are not used by minors or obviously intoxicated persons toward the purchase of alcohol.

GRAVES: Laws applicable to gift cards are complex. Prior to launch, restaurants should determine whether their gift card programs comply with federal and state restrictions on expiration dates and fees, as well as cash redemption and disclosure requirements, or whether they qualify for various exemptions. Restaurants should also understand and account for any "unclaimed property" associated with unused gift cards, as they may, depending on several factors, need to escheat certain amounts to various states. The terms and conditions of their gift card programs should be "clear and conspicuous." Restaurant companies should also analyze whether their gift card programs trigger any federal or state money services license requirements or anti-money laundering or customer identification program obligations. Many of these issues may also apply to rewards, loyalty, and promotional programs, and restaurants should evaluate their programs accordingly.

◆ Restaurant companies seem to be the target of a multitude of class action suits. What advice can you offer restaurant executives to reduce their risk?

O'SHEA: Consistent internal communication is the most important way to create and maintain a corporate culture of openness and engagement. Follow the basics of active listening, training, recognition, and fairness. Developing managers to be active listeners and leaders who embrace their teams while providing fair and consistent discipline is also important. This culture of open communication helps to reduce the risk of class action lawsuits.

GRAVES: Class actions are the bane of many restaurant companies because restaurant operations inherently involve many factors that are frequent subjects of lawsuits. Large numbers of hourly employees create a heightened risk of employment class actions. Advertising exposes restaurants to class claims attacking the ads. Restaurants handle private consumer data such as credit card information daily, with a volume that attracts class action lawyers. Restaurant operators need to engage specialists who understand compliance requirements to limit exposure.

◆ Restaurant companies frequently complain about the complexity of liquor licensing procedures at the California Department of Alcoholic Beverage Control, the time it takes to issue licenses, and the amount of disclosure required by private equity funds, which take small interests in the proposed licensees. Can anything be done to expedite licensing procedures?

COSTALES: This is a standard complaint, but you have to remember the State's budget crisis and its impact on the ABC (which is both understaffed and overworked). However, there may be some relief — the Legislature has a bill pending that, if passed, would require the ABC to not only evaluate its license review process for restaurants (in order to implement a more expedited process), but also prepare and submit a report to the Legislature, on or before December 31, 2015, relating to the review. As for private equity funds and ABC disclosure requirements, the ABC's General Counsel recently indicated that the ABC may issue a new form of affidavit that might allow private equity firms to make certain certifications about their passive investors. We'll have to wait and see on both of these issues.

GRAVES: There are a number of approaches that can streamline the licensing process. We have a former ABC Director and a former Deputy Director for Southern California on staff that provides licensees with valuable advice on mechanisms that can often accelerate the process and overcome any special problems, such as protests against the proposed license. As to disclosure requirements, the California Restaurant Association and many licensing professionals, including our experts, have convinced the ABC to amend their requirements so that private equity funds will be able to simply certify that no investor holds an interest in other alcoholic beverage licenses prohibited by the "tied-house" laws (which restrict cross-ownership between suppliers and retailers) and that no investor will own more than 10% of the proposed licensee. This change is important because previously many funds preferred to forego their investment in a California licensee than to disclose their investors.

◆ What will be the major issues facing the food and beverage industry in the next 3 to 5 years?

O'SHEA: Some of the major issues facing the industry are rising insurance costs, liability issues, employee retention, and human resource issues such as new laws and lawsuits.

SNYDER: In our 2012 Food and Beverage Industry Survey, 80% of respondents listed increasing competition and fuel costs as among their top challenges for the coming year. I believe that fuel costs and higher ingredients costs add competitive pricing pressures which can be particularly challenging to small or start-up companies. Also, more than 70% of survey respondents cited financing and cash flow as an additional challenge. While lending has been on the rise, it seems that banks and other lenders may still be limiting the amount of financing available to small businesses,

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which many companies depend on to stay competitive and to meet growth objectives.

SMITH: Food industry executives will continue to face uncertainty from the cost of commodities, ingredients and energy. They also must navigate increasing government regulation in the form of food safety, taxes and healthcare. At the same time, food executives have to develop a new strategy for identifying and interacting with their customers. Technology and social media have forever changed the way food companies attract and retain customers. Food and beverage companies recognize the shift in how consumers prefer to get information and are responding by implementing strategies to take advantage of new opportunities to track purchases, drive sales and communicate to—and with—customers and target audiences, while guarding against the security and reputational risks that are inherent in social media channels. Companies that will be most successful in managing these impacts are those that are the most proactive, implementing strategies to minimize or avoid passing along price increases to consumers.

GRAVES: One of the biggest issues looming ahead is implementation of the shared responsibility provisions of the Affordable Care Act. Currently, many food and beverage employers do not offer health insurance to their service workers. Beginning in 2015, however, businesses that have at least 50 full-time equivalent employees must provide a minimum level of coverage to at least 95% of their full-time employees or pay a penalty of up to $2,000 per employee. Even if the employer does offer health coverage, it may owe a penalty if the employee premium is more than 9.5% of his/her household income. Hourly wages may serve as a proxy for household income, but because food and beverage employees often earn a substantial portion of their income in tips, they can have relatively low hourly wages, making it difficult for employers to structure their healthcare programs to keep premiums below the affordability cap.

◆ What are the newest consumer trends in the industry?

SMITH: Attitudes are changing toward ingredient quality, and consumers are looking for more natural occurring colors and flavors from plants. Another new trend: touch sensitive labeling where packaging will become touch sensitive to reveal additional information on demand. Consumers want to know instantly about the product they're purchasing. It's no longer about convenience, it is about "is this brand or product good enough to bring into my home and represent my lifestyle?" Lastly, consumers want to know how "green" a food manufacturer is: was the chocolate sourced ethically? Is the packing made from 100% recycled material? Were the chickens the broth was made from treated ethically? It is no longer just about the product. A purchase decision is now a holistic one.

COSTALES: We're seeing a major uptick in the craft beer industry. I think that this is due, in large part, to the successes of companies like Sierra Nevada, Stone Brewing Co., and Firestone-Walker. Consumers appear to like the variety being offered by these smaller breweries; it's similar to what happened in the wine industry several years ago. This will impact many restaurants because they may need to broaden their beer menus to satisfy this consumer demand for variety.

SNYDER: Far and away, the number one consumer trend that we see is the push for natural and organic food lines. In fact, at our Food and Beverage Conference held in October 2012, Kevin Davis, CEO of Bristol Farms mentioned that any product that is either all natural or organic is a hot product for their store. Baby boomers may be contributing to this trend as they look for foods that contain higher nutritional value and will help them age gracefully, but we are seeing an interest in organic and natural foods from all consumer segments. Other hot consumer trends that we are seeing now include "green" type food products and the use of claims such as "eco-friendly" and "free-range," as well as a push toward locally sourced food and beverage products.

◆ What are the latest licensing and regulatory issues?

COSTALES: The public's desire for a more streamlined ABC licensing process, and private equity firms' concerns about the ABC's disclosure requirements are hot topics right now. In addition, the ABC remains very concerned about the use of social media (or third party marketing firms) to advertise the sale/service of alcoholic beverages.

◆ How is increased interest in natural and organic food products impacting food and beverage manufacturers and retailers?

SNYDER: There is no doubt that our clients see natural and organic food as a growth opportunity. The majority of our clients are either producing natural and organic lines or are investigating this option. They are responding to consumer demand, and fulfilling retail requests. Nearly 3 in every 4 conventional grocery stores are carrying organic products. By some estimates, the organic food industry will grow by 50% over the next five years. We still caution our clients to consider the fact that producing natural and organic lines of products tend to be more expensive than more conventional products. We recommend they closely examine their market opportunities to be sure that sales increases will offset increased expenses.

◆ What is the level of M&A activity in the food and beverage industry now (in 2013)?

GRAVES: Transaction levels are pretty high, and the trend seems to be continuing. There have been a substantial number of restaurant deals in the first half of 2013 (Mimi's Café, Maestro's, Johnny Rockets, and Romano's Macaroni Grill to name a few). Capital is relatively easy to access, and the lending environment remains favorable. Expect more deals in the near future.

SNYDER: In our 2012 Food and Beverage Industry Survey, more than half of respondents indicated that they anticipated a sale or merger of part or all of their company within five years. Companies may find it necessary or desirable to increase market penetration, expand developing lines, transform company identity or diversify invest-

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MARCO CONTALES

ments. While M&A activity in the food and beverage industry has decreased since the fourth quarter 2012, trading multiples in the industry are higher. Our clients are expecting strong M&A activity to continue throughout the year, including high trading multiples which are ranging from 7X to 12X multiples of EBITDA. We believe that food products such as dairy, juice, health snacks and functional foods will continue to be hot prospects for M&A activity in 2013.

◆ How are food and beverage companies using social media in their businesses?

COSTALES: Companies are using social media outlets (Facebook, Twitter) to advertise, gauge customer satisfaction, and build/maintain brand awareness. They are also using sites (such as Kickstarter) to help fund initial operations. Because these are novel areas, they are being scrutinized by federal and state regulators. Both the U.S. Alcohol and Tobacco and Trade Bureau (TTB) and the Federal Trade Commission (FTC) are looking closely at social media activities by alcoholic beverage companies. The TTB has issued a statement that all such activities are considered advertising, and steps must be taken to ensure that pages are viewed primarily by persons over 21. The California ABC has become involved in this area as well. We caution our clients to be very careful about user generated content on their social media sites, to limit it wherever possible and to delete any references to underage drinking.

SMITH: Food and beverage manufacturers are using social media in new and creative ways to create a dialogue with their customers. The information gleaned from these customer interactions, in turn, helps manufacturers create and market innovative products that satisfy the ever-changing market. But social media is not without its risks, and companies are becoming more sophisticated about implementing controls and policies for their social media efforts. Amid the uncertainties, one thing is certain. If food and beverage companies plan to continue to thrive in this environment, they must become more flexible and dynamic to adjust to the rising uncertainties in the economy and marketplace. Historically, technology has contributed to the demise of some businesses and the success of others. Today is no different.

O'SHEA: Social media is no longer a trend. It's a mainstay and essential part of the marketing mix. This is partially due to the generational shift in culinary awareness with snap-happy smart phone users. For many diners, a great restaurant meal now includes the obligatory food photo to show their social media following where they've been. Our Chefs and managers review the aggregated reviews and postings from all social media channels on a daily basis and share with their back-of-house and front-of-house teams. This heightened transparency through social media helps improve operations, extend awareness about the restaurant, and proselytize new fans.

SNYDER: Most of our food and beverage clients are actively using social media. Through Facebook, Twitter, YouTube, Pinterest, Instagram and blogging, companies are working to raise brand awareness and to deepen relationships with their customers and followers. Due to the real-time, interactive nature of Social media, many of our food and beverage clients are hiring full time employees to manage social media campaigns that align with other forms of advertising, respond to Facebook and Twitter feeds, blog ideas for using or finding product, and even producing video content. The challenge these companies face is tracking the return on investment from social media. Even without hard numbers, many of our clients are seeing the benefits of investing in social media.

◆ What are the top sources of revenue growth for food and beverage companies this year?

O'SHEA: Healthy dining options continue to dominate the menus at most restaurants. Trends such as raw, paleo, gluten free, and juicing continue to serve as revenue generators for food and beverage companies.

SNYDER: In our 2012 Food and Beverage Industry Survey, respondents indicated that new customers in existing markets are the top source of new revenues. They also indicated that expansion of business with existing customers and new product offerings were critical to growth. Many of our clients are exploring adding natural and organic food lines or targeting the rapidly growing Hispanic market to find new clients where they already have a foothold. Other food sectors that are hot and are growing are "green" or "ecofriendly" products, locally sourced or sustainable food products, alternative types of protein products and premium foods.

SMITH: The most important industry factors influencing sales growth in 2013 are new customers, new products and increased selling prices. New customers and products are increasing sales due to innovation, and increased selling prices are due to the economy slowly improving and consumers valuing quality over affordability.

◆ With over 48% of the Los Angeles County population being Hispanic or Latino (per 2012 US Census data), how is that impacting the food and beverage industry in the greater Los Angeles area? Is there impact beyond Los Angeles?

SNYDER: With the rapid growth of the Los Angeles Hispanic population, many of our food and beverage clients are seeking ways to sell to this market. However, in many cases, it is not easy to break in to this sector with existing products. Some shopping trends are starting to change with second and third generation Hispanic shoppers, and manufacturers may find that their products are more appealing to this younger generation, who are more inclined to shop based on convenience. Language and culture can be barriers to entering in the Hispanic marketplace. Brands must make an authentic appeal to the unique interests and tastes of the

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U.S. Hispanic market through distinct products, channels, messaging and marketing strategies.

SMITH: Hispanics will also drive industry growth through their demand for traditional Latino foods and their growing population in the United States. The increase in demand for bolder, spicier ethnic foods could lead to increased M&A activity in the near future as companies augment their organic growth plans with acquisitions. U.S. companies have started gradually entering the market by expanding their product lines to include ethnic-flavored foods. Flavor companies have also recognized the potential of ethnic foods and have been working to expand their offerings. For example, Flavorchem Corp., a food and beverage flavor solutions manufacturer, has been sending teams of researchers to Latin America to find new food trends from street vendors and shopping centers. The demand for ethnic foods is expected to remain strong because the millennial generation and the Latino population both drive growth. The millennial generation is well traveled, has developed a diverse cultural palate and demands authentic-tasting ethnic foods. Their strong purchasing power has and will continue to compel food and beverage companies to cater to their needs.

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◆ What tax planning strategies are available to the food and beverage industry?

SNYDER: Food and beverage companies can benefit by exploring tax strategies related to depreciation, R&D credits and deductions for food inventory contributions and domestic manufacturing. The 50% bonus depreciation has been extended through 2013 (2014 for long production property). Of importance to the restaurant industry, the 15-year straight-line cost recovery for qualified leasehold improvements, restaurant buildings and improvements, and retail improvements has been retroactively extended through 2013. Many companies in the food and beverage industry have activities that qualify for the R&D tax credit, which provides taxpayers with a dollar-for-dollar reduction in tax. The American Taxpayer Relief Act of 2012 (ATRA) retroactively extended the enhanced deduction for donation of "apparently wholesome food" (intended for human consumption) for January 1, 2012 through December 31, 2013. Lastly, the Domestic Production Activities Deduction (DPAD), intended to support domestic manufacturing, is an underutilized deduction that is available to food processors.

◆ Culture is very important to a company. Can you talk about what it means and how does a company hold on to their culture as they grow?

COSTALES: Building a company culture is critically important to customer satisfaction and, ultimately, repeat business. Unfortunately, I think we've witnessed quite a loss of culture due to the consolidation in the industry. I'd rather not give examples in this regard, but suffice it to say that the menus and overall "feel" at some of my favorite high-end restaurants (that are now part of large conglomerates) have suffered greatly.

O'SHEA: Patina Restaurant Group started with one restaurant, Patina Restaurant, and Chef and Founder Joachim Splichal. He has successfully shepherded the company into a national restaurant group with over fifty restaurants, cafes, and more. Through this growth period and as we continue to grow, the culture of Patina Restaurant Group has remained very chef driven with an emphasis on its brand and its people. We continue succession planning and career mapping to drive retention. We also have various managers and chefs champion different projects.

◆ How are companies innovating to attract new customers?

SMITH: We have seen food and beverage companies engage in multiple innovating tactics, including producing different packaging and product variations; developing channel and distribution strategies for streamlined efficiencies in delivering their product to the consumer; and advancing technology. Specifically, food and beverage companies have developed technologies for their products that do the customer's job for them. When customers have it easier because of a food company's innovation, they'll either pay more for that product or will choose that brand over the competition.

COSTALES: The use of social media is becoming very prominent in this regard, as part of building brand awareness. The use of fund raising sites also is being used not only to raise funding, but also to make contributors feel that they have a vested interest in the enterprise. Of course, they don't receive an ownership interest per se, but these sites have a strong psychological component associated with them.

◆ More and more in the food industry, we hear companies speak about the "customer experience" and the consumer's relationship with a brand. What does this mean and what are the critical "to dos" for food and beverage companies?

O'SHEA: Creating multiple customer touch points is crucial to strengthening the customer experience. You need to listen and engage with your customers every day. Some of the critical to-dos are developing ways to speak to your guest in your brand voice pre, during, and post dining experience. This includes various messaging and promotions through print, digital, mobile, and in-person.

GRAVES: Your brand is everything. It is who you are, what you do, what you stand for and why you matter. Nothing could be more essential! I chair the Restaurant Industry Conference for UCLA Extension, and our theme in 2013 was "Brand Relevance and Evolution." I think the title says it all. Food and beverage companies must remain true to their fundamental values, while also being responsive to a changing market and a variable consumer – and retaining their brand authority and core customers. Legal issues arise in many branding areas, including loyalty programs, advertising campaigns, sweepstakes, other promotions, and menu content and presentation, and operators need to get them all right. It is also crucial to protect the protectable elements of a brand, including the brand name, key tag lines, trade dress, menus, recipes, operational methods, patentable processes, newly developed equipment and predictive software, as well as other unique brand elements.

◆ Expecting the "unexpected" is not good enough anymore. What can food executives do to manage risk and prepare for the unexpected?

SMITH: Crises happen — so it is imperative to control what you can and be prepared. To prepare for a crisis, here are steps to take in advance:
• Line up company spokespeople
• Have external and/or internal PR professionals on hand
• Foster a culture of open employee communication
• Know where your vulnerabilities lie
• Monitor third party vendors
• Monitor online influencers and word clouds. Word clouds are comments about your brand and the white space that ties back to your brand. This is where having a good social media influence is critical. Here are steps you can take in reacting to a crisis:

• Perform an assessment and determine the root of the issue
• Leverage external sources
• Open communication with your board
• Consult industry experts
• Maintain communication lines with your PR agency
It is imperative that your communications convey trust and transparency internally and externally.

GRAVES: Prevention is cheaper than cure, and most professionals with real industry experience can identify "unexpected" risks in advance. It is critical to understand the known risks restaurants and nightclubs face, and to have a compliance plan in place. Professionals can assist companies to purchase the right types of insurance coverage in the right amounts, and to understand what risks are - and are not – covered. When a lawsuit or other claim comes up, operators should immediately speak with policyholder counsel who can best advise how to most effectively shift the expense of litigation. While litigation is a fact of life, operators can effectively plan for the unexpected.

◆ What are investors looking for and what can F&B companies do to attract capital for growth and expansion?

SMITH: Our research shows that private equity houses value innovative businesses offering niche services, which do not depend entirely on the multiple retailers to survive. The corporate acquirers we have spoken with recently value niche offerings, innovation and R&D but they are further looking for businesses with a capacity for overseas expansion or to acquire strong consumer brands to add to their stable.

GRAVES: Investors are, of course, looking for high returns and low risks (even though those two traits are not found together often). The most important factors for restaurant investors are demonstrated performance, significant growth potential, and strong unit level economics. Consistently high comp store sales, experienced management and a strong development pipeline are also important. Food and beverage companies should strive to excel in these areas. Luckily, most of these results will follow directly from sticking with restaurant fundamentals: excellent customer service, a high value proposition, and a strong brand message.

◆ What will be the main drivers of consolidation?

SMITH: The food and beverage sector has been in the process of consolidation for many years and this is showing no signs of slowing in the immediate future. Consolidation comes as a byproduct of vast change in the market, responding to consumer tastes, demand and buying habits. Both private equity and corporate investors agree that consolidation is mainly driven by a need to save costs and a need to revive or offload distressed companies, which are under-performing. For small and medium-sized businesses in the food and beverage sector, growth is often difficult to achieve, so strategic acquisition is one way to move forward. Companies can achieve economies of scale through M&A, which can then be used to reduce costs and shed debt.

◆ Please describe the effect that downtown is having as an emerging market for restaurants in Los Angeles.

O'SHEA: Downtown LA is exploding with new and trendy restaurants. It wasn't always this way, and Chef and Founder Joachim Splichal was one of the first to gamble on downtown Los Angeles. In 1995, he opened Café Pinot, which is located next to the Central Library, and then added Nick + Stef's Steakhouse and Kendall's Brasserie and Bar. The biggest affirmation of downtown as a viable and successful location for restaurants was when the original Patina moved from its original Melrose location to inside Walt Disney Concert Hall in 2003.

COSTALES: With the developments that have occurred over the last several years (for example, Staples Center, L.A. Live, the conversion of historic office buildings into lofts), more people are viewing Downtown Los Angeles as an entertainment destination. As a result, there is increased activity here and additional opportunity for new restaurants, bars, and nightclubs. We're working on several deals in the area as well.