HOULIHAN LOKEY

July 2016

What's Cooking?

UPDATES IN THE RESTAURANT SPACE FROM A DUE DILIGENCE PERSPECTIVE, PLUS GOOD NEWS FROM THE IRS

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Recent changes in the operating, financial accounting, and tax landscape for restaurant owners have created new issues for buyers to consider when approaching transaction targets and performing due diligence. Below we discuss issues we believe could have valuation implications, including how sellers present earnings, as well as tax opportunities for current and future portfolio companies.

New Overtime Rules

Changes to wage regulations, such as minimum wage rates and overtime pay requirements, impact many labor-intensive industries. Restaurants are often among the first to feel the impact of changes.

Historically, all "non-exempt" employees were automatically eligible for overtime. Employees with annual pay in excess of the non-exempt limits but below a threshold referred to as the "minimum highly compensated" level were eligible for overtime pay unless they performed executive, administrative, or professional duties as defined in Department of Labor (DOL) guidance.

In May 2016, the DOL issued regulations aimed at making more employees eligible for overtime pay, estimating that as many as 4.2 million individuals would become overtime-eligible. The regulations more than doubled the minimum salary level for exempt employees to $47,476, and increased the minimum highly compensated level to $134,404 for employees not subject to overtime regardless of work hours. Neither the minimum salary level nor the minimum threshold for highly compensated employees had been increased since 2004. As these changes increase the pool of employees eligible for overtime pay, employers face increased costs in the absence of more efficient scheduling practices.

Effective December 2016, salaried employees paid less than the $47,476 minimum threshold (a level which will automatically increase every three years under a DOL formula) will likely now be eligible for overtime pay at 150% of their base hourly equivalent rate. Additionally, employees paid between the minimum and the highly

compensated threshold must be accurately classified as exempt (i.e., they must actually perform executive, administrative, or professional duties as defined under the DOL guidance), or those individuals will also be eligible for overtime pay.

While some industries may employ temporary labor and/or scheduling efficiencies to avoid overtime hours, restaurant operators may see a greater impact in the ranks of management and kitchen staff due to unique skill sets and industry dynamics. When considering acquisitions in the restaurant space, it is imperative that buyers understand a seller's analysis of the financial and operational impact of the new regulations, including any management actions to mitigate potential cost increases. Diligence of wage costs on a pro forma basis should be data-driven, and should include obtaining detailed job descriptions and duties for employees that now may qualify for overtime pay under these new regulations.

Lease Accounting

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-02, "Leases," in February 2016, effective for fiscal years beginning after 2018 for public companies and the following year for private companies, with early application permitted. The new standard will have a significant impact on the balance sheets of lessees, as entities will be required to recognize right of use (ROU) assets and rental obligation liabilities for all leases with terms longer than 12 months. This new standard is expected to have a large impact on the restaurant industry, where operating leases not previously recorded on the balance sheet are a significant component of operations. Ground leases and building leases, which are usually the largest non-food and non-employee costs of a restaurant, typically are classified as operating leases.

Under the present standard, only capital leases (aka financing leases) were recorded on the balance sheet. Under the new standard, lessees will report a liability for all lease payment obligations, whether classified as capital or operating. The liability will be calculated as the present value of lease payments using the rate implicit in the lease if available, or the lessee's incremental borrowing rate (the risk-free rate may be used by private entities). Lessees will also record a corresponding ROU asset based on the liability, which may be adjusted for certain initial lease costs. These new assets and liabilities, which could be significant, will impact traditional financial statement metrics and ratios, which in turn may require entities and lenders to adjust debt covenants either by changing the calculation methodology to revert to equivalency with the pre-standard basis of accounting, or negotiating to formally modify covenants, in order to avoid unintended noncompliance.

The impact of the new leasing standard on net income should be minimal, as operating lease expense will continue to be recorded on a straight-line basis over the life of the lease. The lease liability will shrink based on the effective interest rate, and differences between cash rent and the change in the liability will be recorded directly to the ROU asset rather than to the income statement. The impact to net income on capital lease accounting is minimal as well, with no substantial change other than a modification from capital asset depreciation to amortization of the ROU asset.

In terms of deal implications, there should be no significant impact; however, we have seen commentary from large advisory firms indicating that EBITDA may be affected by the new standard, a position with which we disagree. The amortization of an ROU asset represents cash outflow for operating lease payments and therefore should not be added to net income in arriving at EBITDA. And while capital lease accounting is not fundamentally changing, the change in terminology to amortize an ROU asset for a capital lease means that

the balance sheet accounts used for capital and operating leases may be intermingled, bringing to light the possibility that companies may report the amortization of the entire ROU asset as an add-back for EBITDA, rather than bifurcate the portion that is operating lease expense which should remain in EBITDA. Accordingly, buyers should perform detailed diligence to understand the components of ROU assets and of D&A in acquisition transactions in which EBITDA is a factor in enterprise valuation.

Revenue Recognition on Stored Value Cards

The FASB issued Accounting Standards Update 2016-04, "Recognition of Breakage for Certain Prepaid Stored-Value Products," in March 2016 that modifies liability extinguishment guidance, allowing companies to derecognize financial liabilities of certain stored-value or prepaid cards based on a breakage model. The new guidance becomes effective concurrent with the ASC 606, in 2018 for public companies and the following year for private companies, with early adoption permitted.

Some companies may take this new guidance as an opportunity to adjust an accounting policy that previously required recognition of gift card liabilities into perpetuity, thereby inflating income via one-time noncash adjustments to these liabilities. Acquirers of companies with gift card programs should understand a target company's historical and current accounting policies, as well as analyze the data underlying any breakage analysis that has driven derecognition of gift card liabilities into income.

Other Developments

Viewpoints are developing that the FASB's new revenue recognition standards will have a significant effect on the timing of recognition for franchisor revenues. The new standard will become effective in 2018 for public companies (2019 for private companies), and may change the way franchisors recognize revenue for initial fees and other setup revenues under the concept of separability. The franchise fee and other setup revenues would not be sold separately from the ongoing operations of a franchisee and therefore may be required to be spread over a period of time rather than recognized up front.

Restaurants continue the process of implementing Europay, MasterCard, and Visa (EMV) compliant payment systems. Effective October 1, 2015, liability for card fraud in instances where a merchant is not compliant is generally shifted to merchants, thus potentially increasing credit card chargebacks for fraud, as well as possible fees for non-EMV fees from credit card companies, until such systems are in place. Potential investors should be aware of the implementation status and related impact at acquisition targets.

Finally, in order to stay involved in and continue growing the companies they have created, some sellers are seeking private equity buyers rather than strategic buyers. Equity firms are finding now that they may be competing in part based on skill sets they can bring to the table. The cofounder of Barteca, recently acquired by General Atlantic, was quoted in a recent article by National Restaurant News indicating that buyers with the ability to enhance or reinforce a seller's infrastructure in the areas of IT, PR, regulatory compliance, crisis management, and other areas have a leg up on other buyers, indicating that other buyers may need to start bringing more to the dinner table than just a large check.

Good Tax News!

Tax Deductions for Refresh/Remodels Made Easier

The IRS created a new safe harbor that allows restaurant taxpayers to deduct 75% of refresh/remodel costs. The remaining 25% is capitalized and depreciated.

Historically, restaurant owners had to spend substantial time and money determining what portion of a remodeling project may be deducted as a repair and what must be capitalized as an improvement, which also generated substantial disputes with the IRS. It is anticipated that the new safe harbor rule will substantially reduce the administrative burden of restaurant owners.

Charitable Contributions of Food Inventory

Congress has also made several changes to the tax rules regarding the charitable contribution of food inventory.

Historically, the tax deduction for charitable contributions of food inventory was basis of the inventory plus one-half of the ordinary income that would have been recognized if the property were sold at FMV or twice the basis of the inventory. Recent legislation provides a definition of FMV which removes prior valuation complexities primarily by removing the concepts surplus or inventory nearing the end of their "shelf life" from the FMV equation.

The recent legislation also increased the taxable income limitation from 10% to 15% for C corporations. For non-C corporations, the 15% limit is based upon the trade or business income from the activity from which the contributions were made.

Permanent Section 179 Deduction

Congress has permanently extended the Section 179 deduction, which allows companies to immediately deduct up to $500,000 in purchases of qualifying equipment and property. In prior years, the Section 179 deduction had been scheduled to revert back to $25,000, but Congress extended the $500,000 deduction on a year-to-year basis until 2015, when it became permanent.

Bonus Depreciation

Finally, congress also has provided longer-term clarity regarding bonus tax depreciation, which it had previously extended on a year-by-year basis. The bonus depreciation percentage is 50% for property placed in service during 2015, 2016, and 2017, but then phases down to 40% in 2018 and 30% in 2019. Bonus depreciation may result in substantial present value tax savings for restaurants that have plans to purchase or construct qualified property.

In Summary

The landscape of the restaurant industry continues to evolve with new financial reporting issues as well as operational challenges that impact financial statements. Additionally, changes in tax regulations provide cash flow considerations that buyers should be aware of when modeling future operations. Prudent investors are thinking ahead on these issues and contemplating the current and future impact of such industry changes in their analysis of an acquisition target.

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About Houlihan Lokey

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