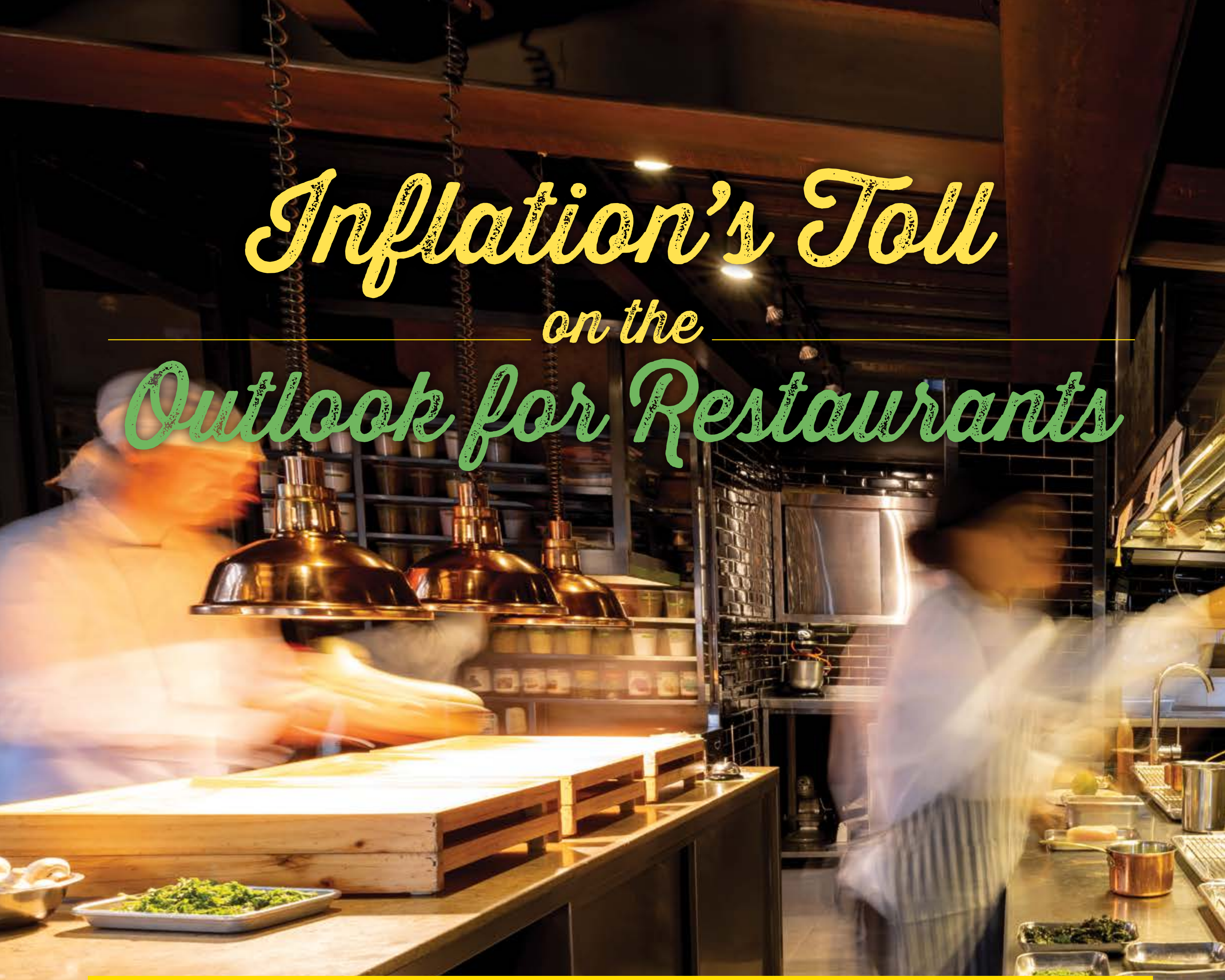

Inflation's Toll on the Outlook for Restaurants

BY GARY LEMBO, PARTNER, PALADIN

"I think we now understand better how little we understand about inflation."
- Federal Reserve Chair Jerome Powell, July 29, 2022

Even the chair of the Federal Reserve had to admit that inflation is a ferocious animal. He was on a rate hike mission for all of 2022 and is only now getting a sense if inflation is slowing down.

Many factors affect the economy, but most people would likely agree that inflation and its profound impact on consumer demand and the actions of the Federal Reserve could lead to a recession with unintended consequences, especially for restaurants and the hospitality industry.

During the pandemic the Fed was concerned that credit would tighten, and as a result, the U.S. government injected an unprecedented amount of stimulus into the economy, providing much needed liquidity to the market. Since March 2020, the Fed has printed more money than at any time in history and increased the U.S. money supply by more than 40% (20% annual growth over three years). For context, over the past 130 years, the money supply has grown

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What level of unemployment is the Fed looking to achieve, and what will that do to the restaurant and hospitality industries?

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by less than 7% per year on average.

This stimulus, however, created the inflation the U.S. has experienced for the past 18 months and which continues today, albeit at a somewhat slower pace. What is unfortunate at this point in the economic cycle is that in the event of another pandemic it is unlikely the Fed can step in again, as prices of goods and services would likely soar even higher. In the end, the inflation consumers and restaurants are dealing with continues to make consumers increasingly poorer as their money gets devalued and price increases are instituted.

Inflation's effect on prices is not only a problem for consumers but for investors, owners, and managers of restaurant and hotel companies as well. The costs of everyday goods and services continue to increase, affecting consumers, but wages, energy and food costs, and rising interest rates are taking a toll on middle market companies as well.

For example, Red Robin saw its commodity basket costs rise by 16% in 3Q 2022 alone. Papa Johns saw its commodity basket costs rise by 18% in 3Q 2022, noting that the costs of cheese (30% of basket) and wheat were the main cause of the increases. Furthermore, both Papa Johns and Red Robin saw guest counts decline slightly in 3Q 2022, suggesting that consumer spending might be running out of steam.

These companies are finding themselves needing to do everything in their power to improve the performance of their operations to offset these inflationary pressures..

Consumer Demand

The headlines are everywhere—the consumer overspent in 2022 and that, coupled with no more stimuli, will crimp demand, restaurant guest counts, and travel.

U.S. household debt is a record $16 trillion today, which amounts to an average of $123,000 for every household. Over the past 20 years, consumer debt has more than doubled, while Americans' real incomes have barely budged, with real wages up only 10% over that span **(Figure 1)**. In addition, the pressure on prices is eroding consumers' savings.

The tech industry and several others have already started the year by cutting thousands of jobs. Is there another wave of layoffs around the corner? Only time will tell, but one thing is certain: the layoffs that have already occurred will only exacerbate the decline in consumer demand.

This slowing consumer demand is starting to show up in the guidance of public restaurant companies. Cracker Barrel recently offered revised guidance lowering its earnings estimates for 2023, and that was followed by Red Robin reducing its 2023 estimates for EBITDA. Even BJ's Restaurants, which historically does well even when its competitors struggle, recently lowered its Q4 2022 estimates for same store sales.

The Federal Reserve

Its 2% inflation target remains key to the Fed's vision for stable prices. However, it's no secret that inflation remains far above that 2% target, and no one knows for certain how high interest rates must go for inflation to return to that 2% level. As of February 16, "…two Federal Reserve officials said the U.S. central bank likely should have lifted interest rates more than it did early this month and warned that additional hikes in borrowing costs are essential to lower inflation back to desired levels." (Reuters.)

In the end, the Federal Reserve is doing its job by raising rates and increasing the unemployment rate, but at what point is enough enough? What level of unemployment is the Fed looking to achieve, and what will that do to the restaurant and hospitality industries?

Until recently, the jobs data hasn't shown that anything the Federal Reserve has done to increase unemployment so far has succeeded. The unemployment rate for January came in at 3.4%, its lowest level since May 1969. The U.S. added another 517,000 jobs to the economy, compared to economists' predictions of only an additional 187,000 jobs.

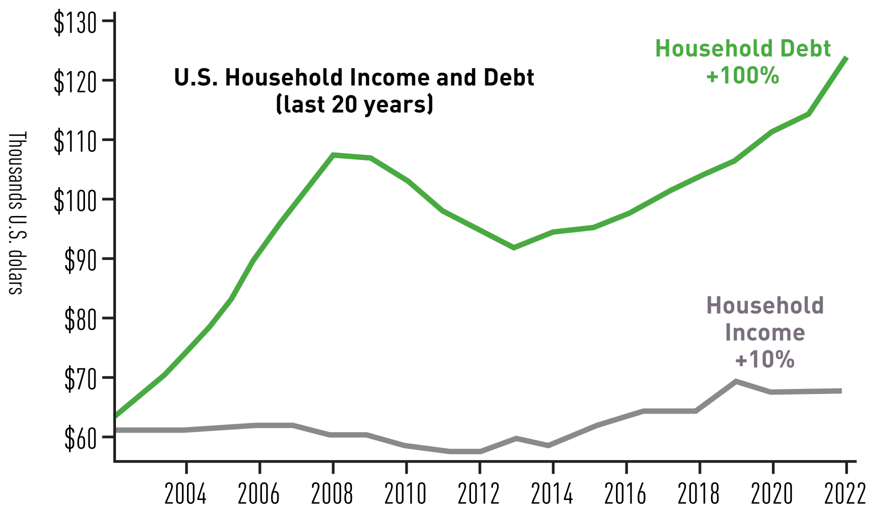
A new economic report could pressure the Federal Reserve to raise interest rates again. For example, the U.S. Census Bureau said retail sales surged 3% in January 2023, outpacing the expected 1.8% increase. That unanticipated increase, coupled with the fact that January retail sales were 6.4% higher than last year, could lead the Fed to raise interest rates higher than everyone expects.

Even some Fed officials are worried:

The Fed "has come an appreciable way in bringing policy from a very accommodative stance to a restrictive one, but I believe we have more work to do," Cleveland Fed President Loretta Mester said in a virtual speech to a Global Interdependence Center conference. "The incoming data have not changed my view that we will need to bring the Fed funds rate above 5% and hold it there for some time" in a bid to get inflation back to the central bank's 2% target. Mester said in her speech there was a good case for increasing rates by 0.5% given the strength of the economy.

Is the U.S. headed for a recession? The author believes so. Questions remain regarding how deep and prolonged a recession would be. At what point does the Fed stop raising rates affecting middle market companies that have not hedged their interest costs and face near term maturities? Will the credit markets turn their back on these borrowers? Will management teams be able to execute their business plans flawlessly to see their way through these tough times? Only time will tell.

U.S. Household Income and Debt



Source: Federal Reserve Bank of Saint Louis

Gary Lembo is a partner with Paladin in New York. He brings a unique skillset and perspective from wide experience as a lender and advisor. Always with a focus on the middle market, he is experienced in using creative and innovative capital solutions as well as operational assessments in challenging distressed situations. Lembo holds bachelor's degrees in criminal justice from the University of Maryland College Park and accounting from Rutgers University and an MBA in finance from Rutgers University.