Restaurants, Cafes, Bars & Nightclubs

Market Update & Minimum Wage Increase

April 2018

Prepared by ANZ Client Insights

INTRODUCTION

Monthly consumer expenditure across the restaurant, cafes, bars and nightclub sectors has grown by +15% over the past two years. However, with a rising minimum wage business owners will need to create efficiencies to manage through this change.

Purpose of paper

- This paper is designed to provide businesses operating in the restaurants, cafes, bars and nightclubs sectors with considerations to manage business performance going forward.
- The paper is broken into three sections:

  1. Market Update – Macro trends impacting the sector
  2. Minimum Wage Increase – Potential impacts of the minimum wage change
  3. Financial Benchmarking – Key financial metrics

- The information which follows is intended as an overview and should be accompanied by conversations with your advisor, accountant or ANZ Relationship Manager.

EXECUTIVE SUMMARY

Key findings

- ANZ transactional data and Statistics New Zealand data show that consumer expenditure across the restaurant, cafes, bars and nightclub sectors over the past two years grew by +15%.
- While a strong tourist market has helped contribute to this growth the standout performer has been the domestic market with its much larger representation of the total expenditure pool.
- Despite this strong backdrop our benchmark of 43 companies shows revenue growth only marginally up. The median revenue growth rates for FY16 and FY17 were +3.2% and +4.2% respectively.
- We see this as a result of increased competition. Statistics New Zealand figures show the number of food and beverage service providers across New Zealand grew by +7.4% over this two year period.
- The median results for wages & salaries as a proportion of revenue was reasonably consistent through FY14 -FY17 around 35%. However, the New Zealand Government has indicated that the minimum wage will be increasing to $20.0/hr by April 2021. This will mean that businesses will need to be proactive around managing cost structures.
- We believe that the pass through of a minimum wage will likely be executed in the form of price increases, portion/menu adjustments and other changes to existing services.
- With annual output price inflation for the accommodation and food services industry running at only +1.1%, passing on additional staff costs through increased prices will require a step change in market pricing.

MARKET UPDATE

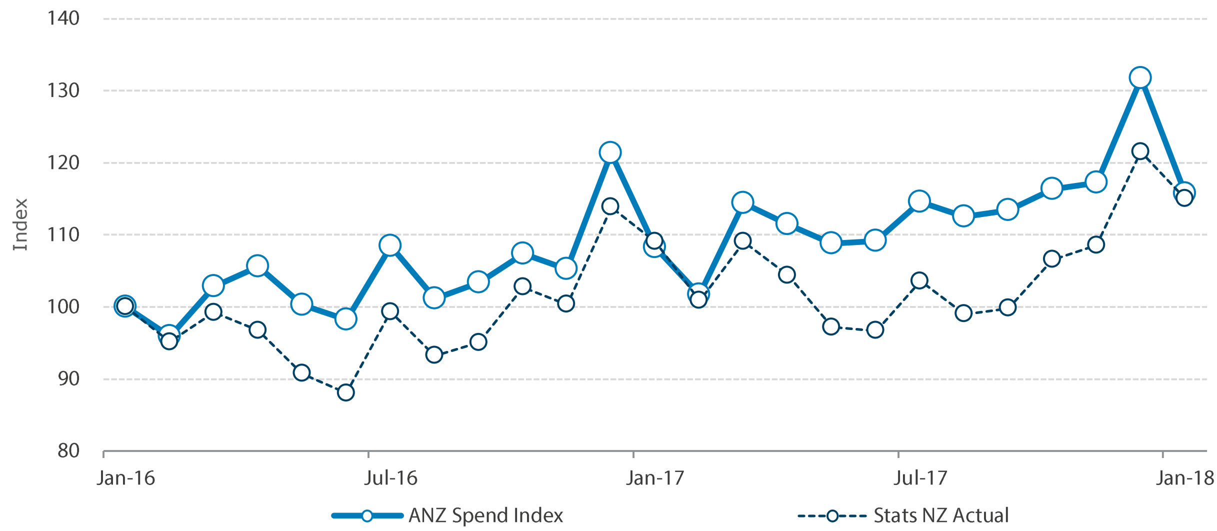
MARKET UPDATE

Macro background

- ANZ transactional data and Statistics New Zealand data show that monthly expenditure in the restaurant, cafes, bars and nightclub sectors grew around +15% from January 2016 to December 2017.
- During this period New Zealand tourism performed strongly, but it has been the strength of the domestic market that has led the way. ANZ credit card data shows that domestic expenditure averaged around 75%-80% of the total expenditure pool over this two year period.
- The seasonal impact of tourism can be seen in the summer months when international spending peaks at around 24% of total credit card expenditure, before dropping to around 9% during winter months.

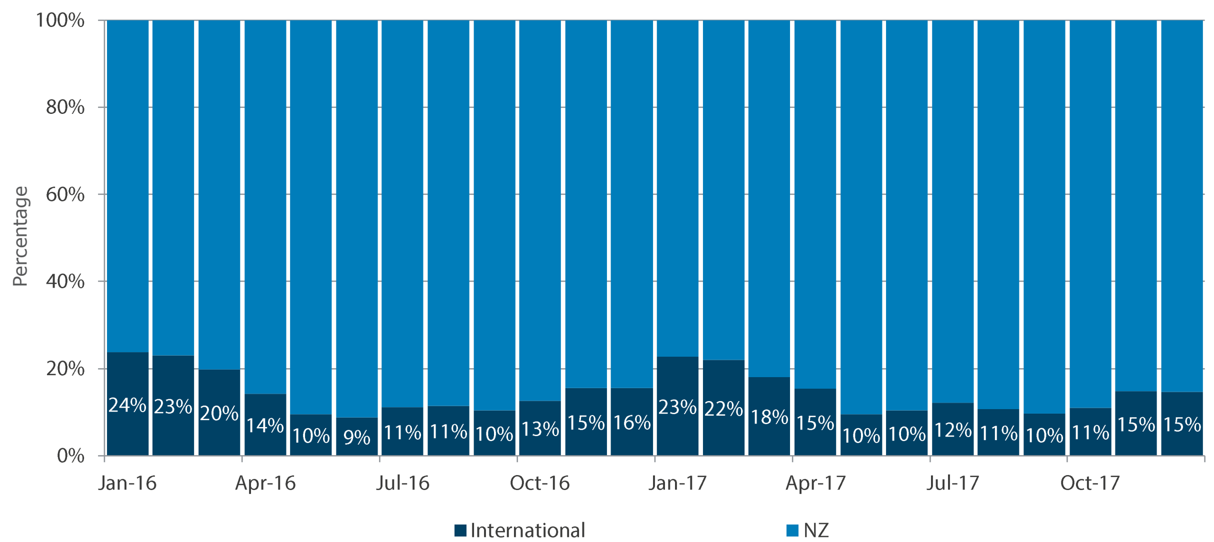
Monthly expenditures (rebased to 100 in Jan 2016)

Source: ANZ Merchant Terminal Data, Statistics New Zealand



Percentage breakdown of international and domestic credit card transactions

Source: ANZ Merchant Terminal Data

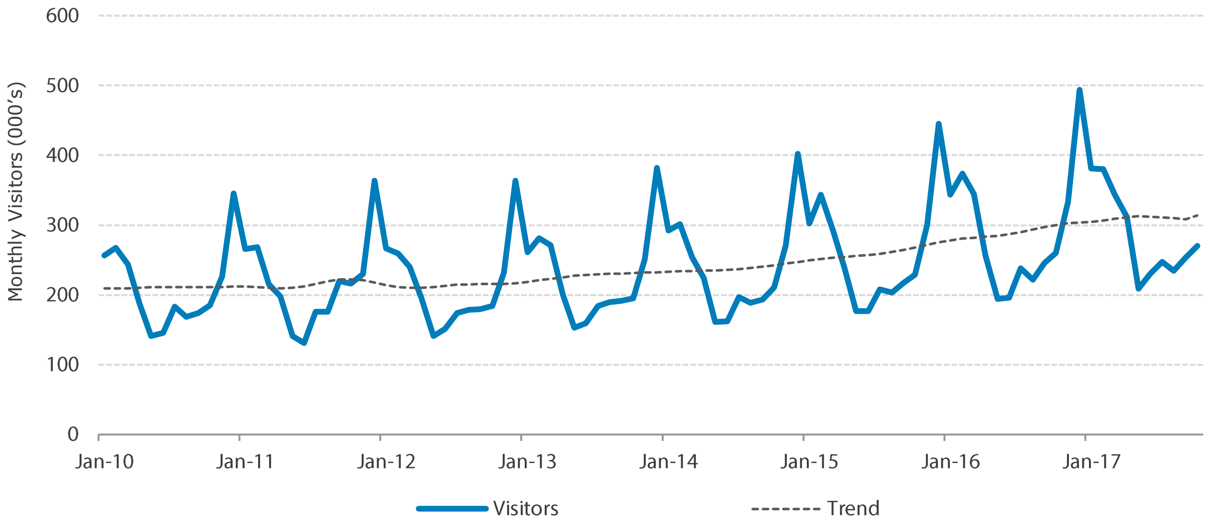


Tourist market

- Monthly visitor numbers to New Zealand reached a record 494k[1] visitors in December 2016, the fifth consecutive summer record. Off peak (winter) figures also show a higher number of tourists arriving in New Zealand over the last few years.
- While we acknowledge that there are favourable tailwinds for New Zealand tourism we also need to consider the length of the global economic cycle since the GFC, which has been unusually long. An economic correction over the next couple of years would impact the continuation of this trend and businesses which are exposed to tourism should be considering current profitability, cost structures and capitalisation to position against this risk.

Visitor arrivals (per month)

Source: Statistics New Zealand

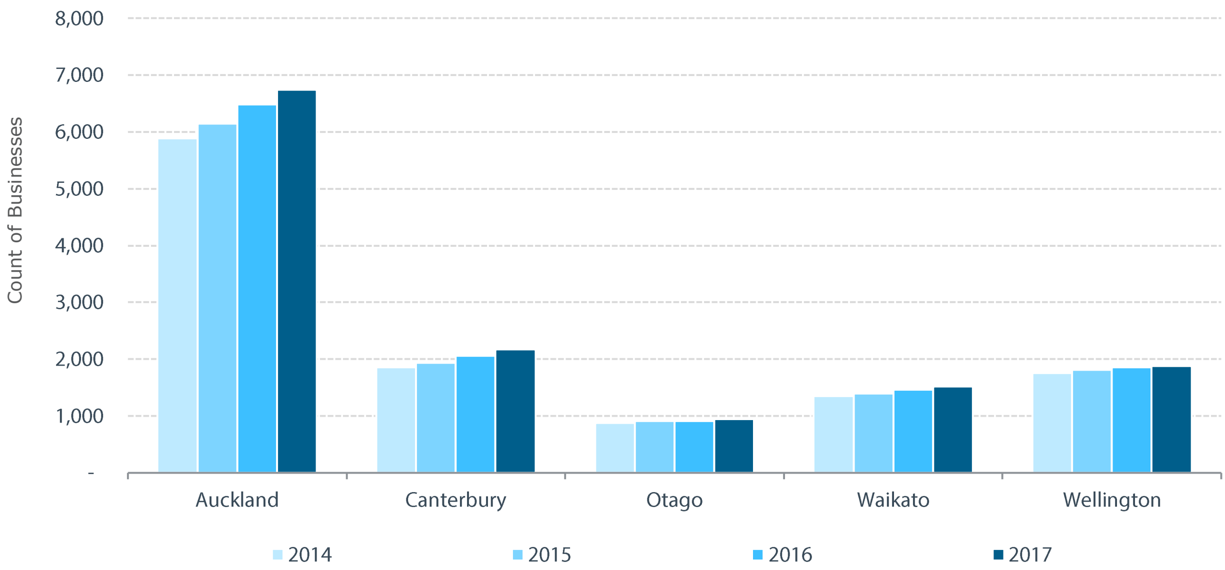


(1) Statistics New Zealand – International Travel and Migration

Food and beverage providers

- While the size of the revenue pool has increased, so too has competition.
- Over 2016-17 the number of food and beverage service providers[2] across New Zealand grew by +7.4%. This will have had a dilutive impact on revenue growth on a per provider basis.
- All New Zealand's main destinations recorded growth in the number of providers, with Christchurch leading the way on +11.6% growth. This is likely due to the progression of the earthquake rebuild.
- Auckland follows closely behind with +10% growth, a significant number given it is the largest market. Otago saw growth of +4.6%, Waikato +8.6% and Wellington +3.3%.

Number of food and beverage service providers
Source: Statistics New Zealand

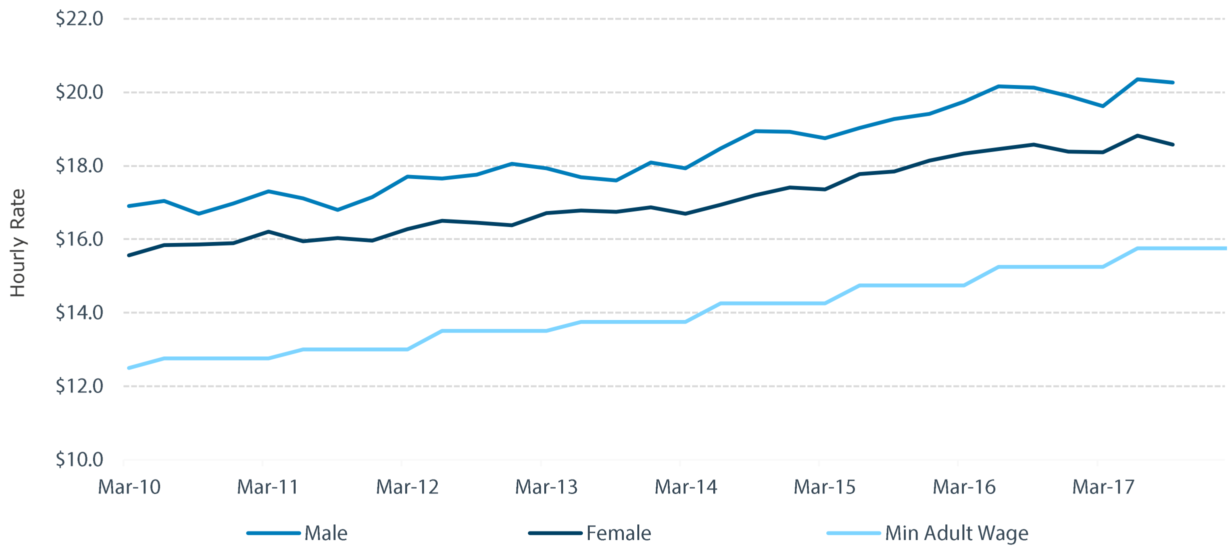


(2) Statistics New Zealand

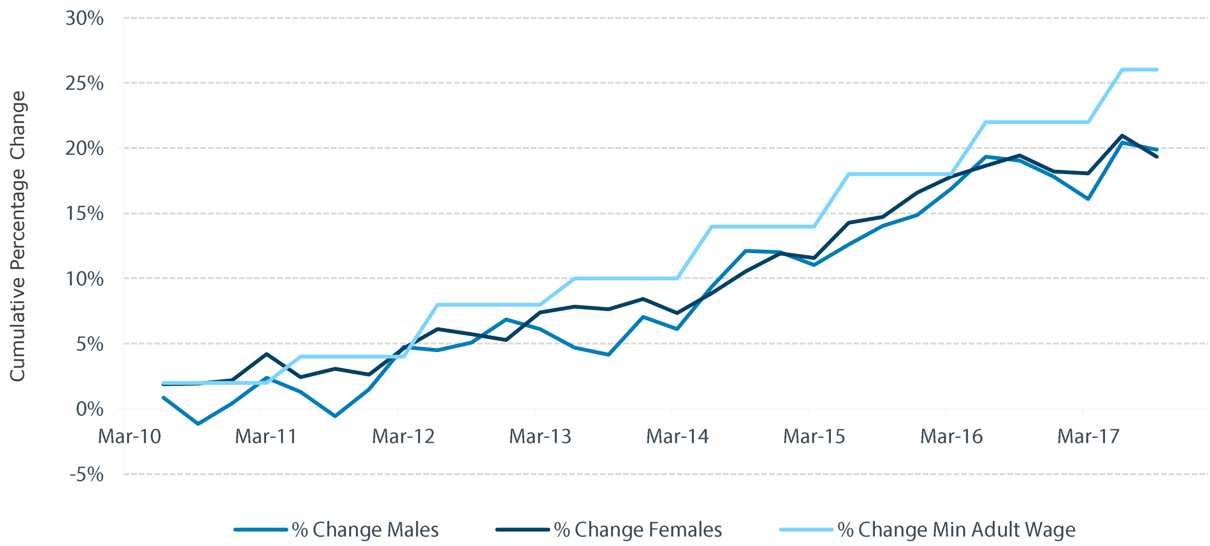
Wages and equality

- The current average hourly wage rates for the accommodation and food services sector provided by Statistics New Zealand are $18.6/hr and $20.3/hr for females and males respectively.
- While both are above the current minimum wage we expect that the upcoming legislated increases will also flow through to workers paid above the minimum wage threshold. The below charts show that there has been a reasonably consistent premium being paid above the minimum wage rate for the accommodation and food services sector since 2010. This resulted in a similar percentage change across male, female and minimum wage categories which indicates a rising minimum wage has had a strong relationship with the direction and magnitude of average wages.

Average hourly wage rates - Accommodation and food services
Source: Statistics New Zealand, Employment New Zealand



Cumulative Percentage change in hourly wage rates since 2010 - Accommodation and food services
Source: Statistics New Zealand, Employment New Zealand



MINIMUM WAGE INCREASE

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Background

- The New Zealand Government has indicated that the minimum wage is set to rise to $20.0/hr by April 2021 (a +27% increase from $15.75 in March 2018)). The first of a series of staged increases occurred on 1 April 2018 to $16.5/hr. This schedule is provisional and may be adjusted by the Government in light of economic conditions.

Forecast wage increases
Source: beehive.govt.nz

Date	Min. Hourly Wage	% Increase from $15.75
March 2018	$15.75	-
April 2018	$16.50	+4.8%
April 2021	$20.00	+27.0%

Impact to profitability

- Technically a +27% minimum wage increase would apply only to those employees on the minimum rate. However, we have assumed that workers on higher wage rates will also negotiate to keep their relativity to the minimum wage, albeit at a diminishing rate the higher the hourly rate paid.
- Forecasting wage growth is challenging. The modelling which follows assumes that a typical business in this sector might experience a +20% increase to the wages & salaries expenses line (versus the +27% increase in the minimum wage). The actual figures which impact individual businesses will vary based on a range of factors.

7.50%
Median EBITDA Margin
Pre Wage Increase (4)

0.50%
Median EBITDA Margin
Post Wage Increase (4)

- Assuming a +20% increase was fully absorbed by each business (i.e. with no adjustment to existing business practices) we see the median EBITDA margin for the sector dropping from 7.50% to 0.50%. This estimate is based on results obtained from the benchmarking of ANZ customers provided in the next section.
- In order to maintain profitability business owners will need to lift revenue, reduce costs and improve efficiency. The following pages outline how this may unfold through two scenarios:

Scenario 1: Revenue Increase through price

Scenario 2: Menu and portion adjustment

(4) ANZ Analysis – refer section 3

Scenario 1: Revenue increase through price

- In order to understand the potential price increase required we have created an example company.
- Key metrics for the example company are taken from the median results of our benchmarking analysis provided in the next section. These include items such as such as revenue, wages & salaries and cost of goods sold (COGS).
- The degree to which each company is impacted by the minimum wage increase (e.g. how much prices need to increase by) will vary depending on the service proposition and other cost structures.
- Our example shows that neutralising a +20% increase to wages & salaries would require prices (i.e. revenue) to be lifted by +7% in order to maintain EBITDA at a constant $225k.
- Note that the +7% price increase modelled assumes that lifting prices will not have any offsetting impact on sales volumes. In practice this may not be the case as consumers will have a degree of sensitivity to price changes.

Normalise EBITDA through price increase
Source: ANZ Analysis

Item	Baseline[5]	Wages +20%	Revenue +7%
Revenue	3,000,000	3,000,000	3,210,000
Wages & Salaries	1,050,000	1,260,000	1,260,000
Wages & Salaries %	35%	42%	39%
COGS (Ex Wages)	1,008,000	1,008,000	1,008,000
COGS (Ex Wages) %	34%	34%	34%
Total COGS	2,058,000	2,268,000	2,268,000
Gross Profit	942,000	732,000	942,000
Gross Profit %	31%	24%	29%
Other Expenses	717,000	717,000	717,000
EBITDA	225,000	15,000	225,000
EBITDA %	7.5%	0.5%	7.0%

(5) ANZ Analysis – refer section 3

Scenario 2: Menu and portion adjustment

- Given the competitive nature of the industry, passing through price increases without any impact on sales volumes will be challenging. Therefore, it is likely that the wage increase will be neutralised by a combination of tactics that optimise the way businesses source, prepare, serve, charge and utilise their space.
- Some of the potential responses are outlined below:

  - There has been a global trend toward sourcing seasonal produce which in theory should flow through to cheaper cost structures. This would require menu flexibility and a sound understanding of how changes may impact upon consumer demand.
  - Businesses could increase revenue generated from a given space by offering more services. For example a lunch and dinner venue could expand into a breakfast service, or alternatively owners could make a commercial kitchen space available to other enterprises when it's unused. There may also be scope to grow capacity by adding tables through optimising layout.
  - Businesses may tender supply contracts to seek more competitive pricing. While a change in supplier may offer a cheaper cost structure this will need to be balanced against quality.
  - Further changes may come in the form of glass and plate sizes. However, changes will need to be subtle and in some cases may require further negotiation with existing suppliers of ingredients (e.g. pre-packaged or pre-cut portions).
  - Automation of ordering systems may assist in creating some efficiencies. However, this will require capital investment and is more likely a strategy suited for higher turnover premises.
  - Additional strategies may include introducing flexibility in menu prices in order to accommodate price spikes in source ingredients (e.g. a shortage of avocados or courgettes).

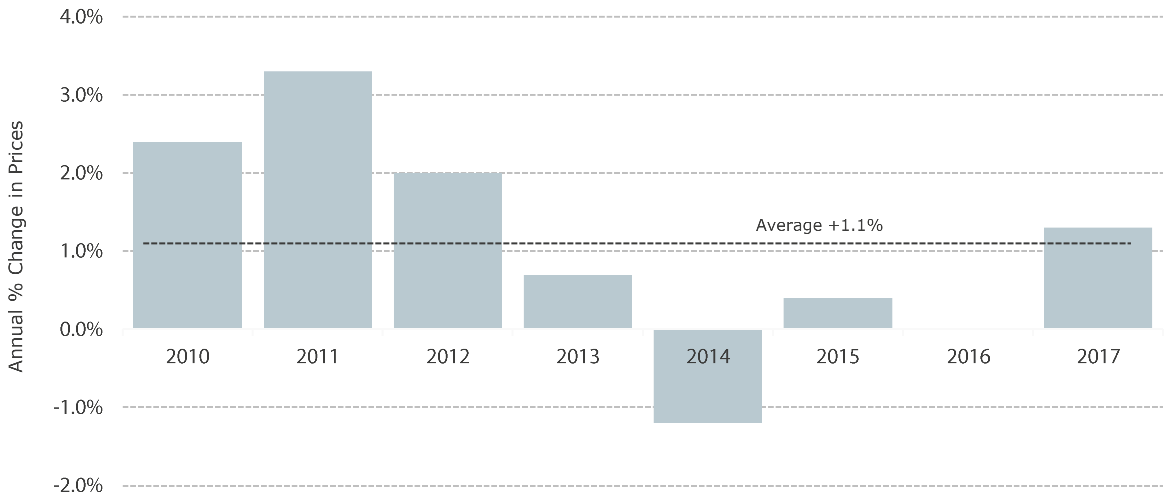
- Overall businesses should challenging themselves to think outside traditional menu structures and strategy in order to create efficiencies.

Inflation

- To put the +7.0% price increase outlined in scenario one into context, we have created a bespoke ANZ price index, designed to show how annual inflation has been tracking for the food services industry[6] since 2010.
- The index includes key products aligned to the sector; coffee, tea and other hot drinks, beer, wine and restaurant meals. These items have then been re-weighted by based upon their composition within New Zealand's Consumer Price Index (CPI).
- Our price index shows inflation for the sector running at an average of +1.1% since 2010, which is well below our scenario increase. Taking into account the rise in wages and sector inflation, then unless there is an economy wide change in price setting behaviour, cost cutting will be one of the considerations to neutralise earnings.
- To smooth that likely transition, business owners who are able to execute price increases are likely to stage this over the next couple of years. In our example this would require an average annual price increase of around +2.5% to +3.0% over the next couple of years. That is materially higher than the average +1.1% inflation rate since 2010.
- Given the length of the current economic cycle price increases may start to appear sooner while underlying demand is stronger. An economic shock over the next few years would make it difficult to justify higher prices in softer market conditions.

Annual % change in ANZ index

Source: ANZ Analysis



(6) Statistics New Zealand

FINANCIAL BENCHMARKING

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Description

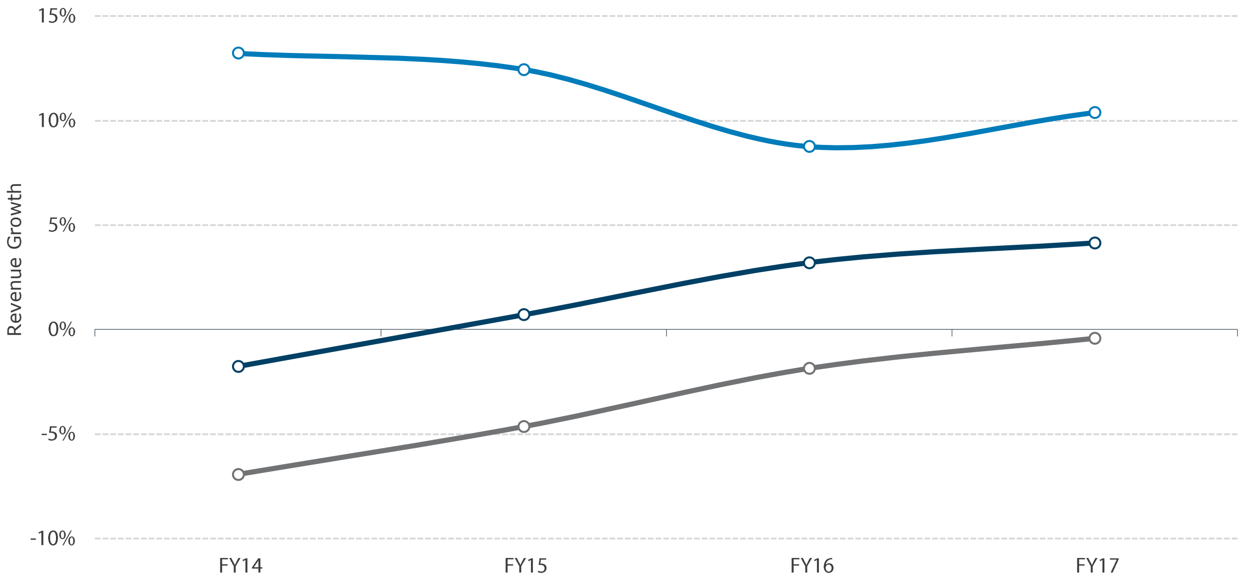
- In the following pages we analyse the performance of 43 providers across the restaurant, cafes, bars and nightclub sectors.
- We have selected businesses across Auckland, Wellington, Christchurch and Queenstown which we believe best reflect the sector and excluded those with revenue less than $1.5m in the sample. We believe that this is an appropriate cut off point to exclude lifestyle-type businesses.
- The median FY17 revenue figure for the companies included in our benchmark was $3.0m.

Revenue

- While ANZ data shows that monthly consumer expenditure has risen by +15% over the past two years, the median result for revenue growth for our sample group was +3.2% and +4.2% for FY16 and FY17 respectively.
- This result suggests that increased competition may have diluted some of the benefit to individual business owners.

Revenue growth

Source: ANZ Analysis

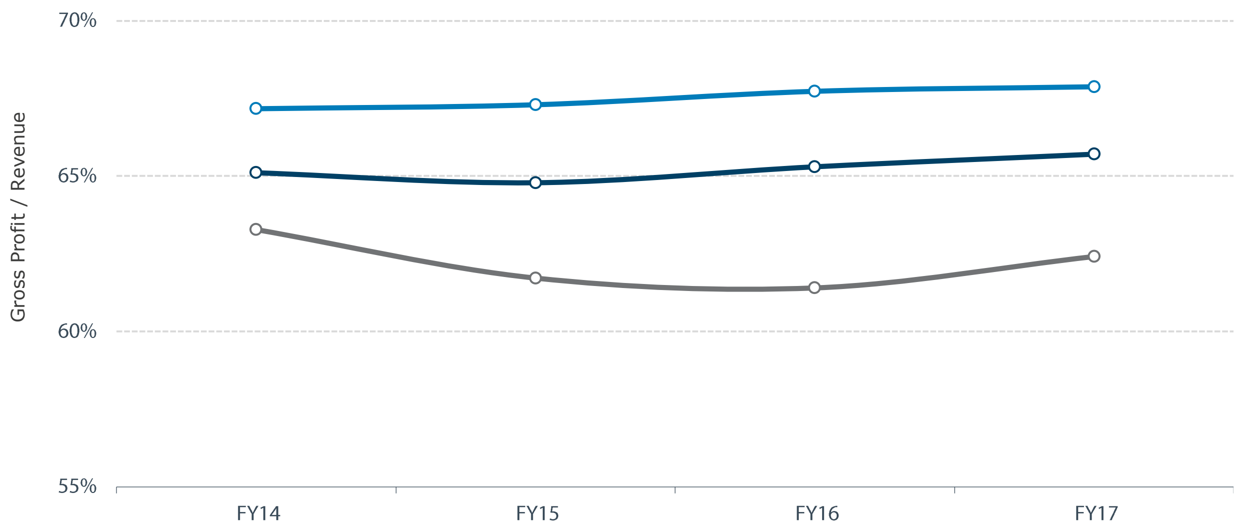


Margins

- Approximately half of our sample group reported gross margins (excluding wages) between 62%-68% of total revenue. There did not appear to be any material trends in this metric across financial years, suggesting that providers have had a reasonably consistent approach to gross margin management.

Gross margin (excludes wages)

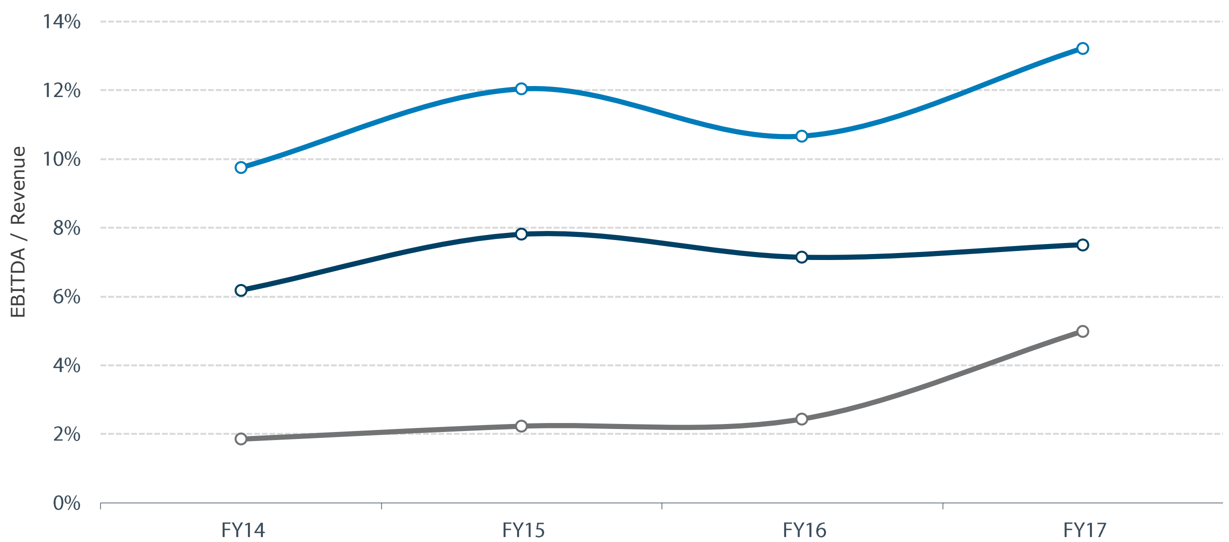
Source: ANZ Analysis



- FY17 showed an improvement in EBITDA margins, suggesting owners have been able to manage their businesses more prudently. However, the bottom quartile of companies still reported an EBITDA margin of less than +5% during this financial year. There is increased pressure on these companies to effectively manage the upcoming minimum wage increase in order to avoid negative earnings outcomes.

EBITDA margin (before significant items)

Source: ANZ Analysis



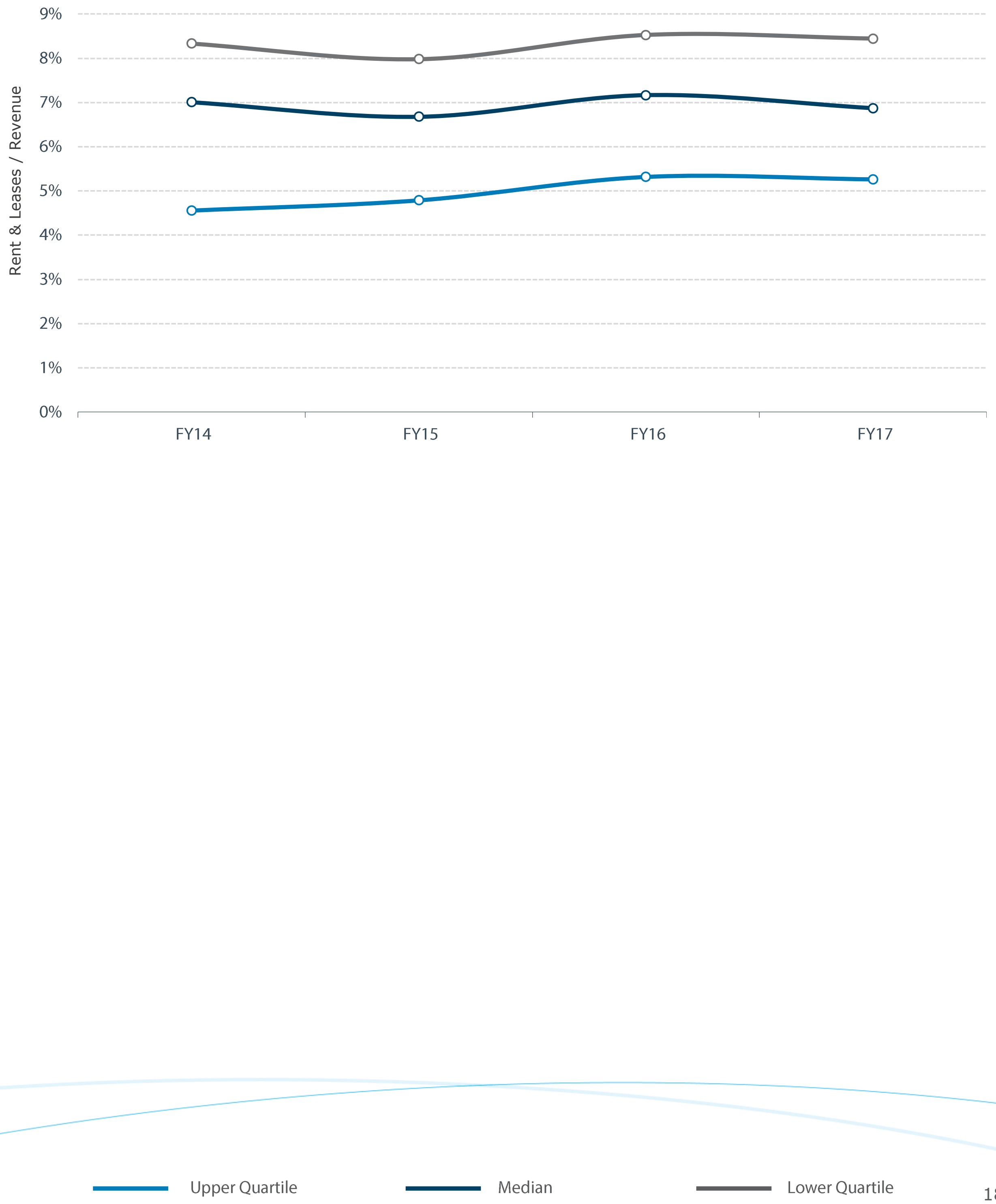
Upper Quartile Median Lower Quartile

Rent & leases

- The below chart shows providers that record a material rental or lease expense. We define this as a rent & lease expenses of greater than 2% of revenue. Most providers in our sample set met this criteria which indicates payment of market rent.
- Our results show that rent & leases, as a proportion of revenue, has bee reasonably consistent at around 7%.

Rent & leases to revenue

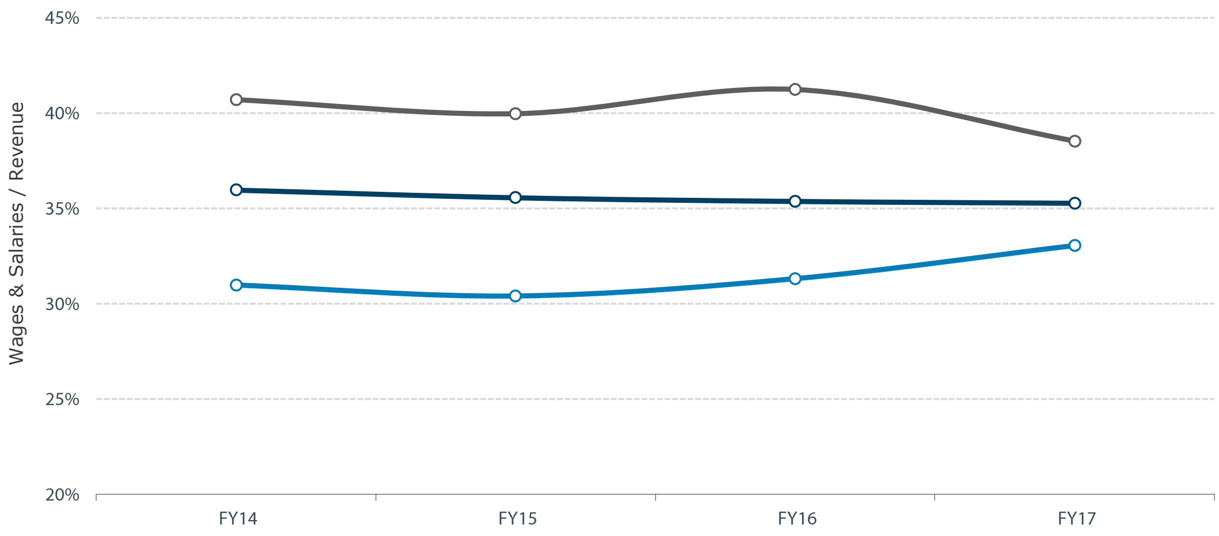
Source: ANZ Analysis



Wages & salaries

- The median wages & salaries result (as a proportion of total revenue) remained around 35% during the period between FY14-FY17.
- As previously discussed, this is a category that will become increasingly important with upcoming increases to the minimum wage.

Wages & salaries to revenue
Source: ANZ Analysis



Conclusion

- Consumer expenditure across restaurants, cafes, bars and nightclubs has grown strongly over the past two years. However, the benefit on a per business basis seems to have been diluted by growth in the number of providers.
- With upcoming increases to the minimum wage businesses will need to manage cost structures on a proactive basis. Businesses who are considering price increases could look to do so sooner to avoid passing on increased costs in softer market conditions (should these arise).
- However, it is also important to highlight that price increases will impact sales volumes. Providers will need to carefully consider what is both practical and achievable in light of their value proposition.
- Additional strategies around menu, portion adjustment and other changes to service offerings should be considered.
- A quarter of companies recorded EBITDA margin of +5.0% or lower in FY17. Those that are able to adjust business settings to improve performance quickly will be more likely to build sustainable long term businesses.

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