

Last Updated: July 13, 2011

Rating Methodology by Sector

Food Service

1. Business base

The industry has a large market size, but the industry itself is mature. An industry characteristic is that the booms and busts of companies can be drastic, and the risks of earnings fluctuations are also high. For these reasons, the rating assessment focuses on the sustainability of differentiation that is the basis for competitiveness, including the appeal of the core menu and restaurant management capability. It also focuses on the ability to maintain a certain level of earnings in the medium-to-long term by taking advantage of cost structures and other factors.

(1) Characteristics of the industry

(i) Market overview

The market size of the industry peaked at approximately 29 trillion yen in 1997, and it has been declining since then. Nonetheless, the industry remains a market giant, with a size in excess of 20 trillion yen. The industry includes restaurants, cafeterias, coffee shops, pubs, and other dining businesses, as well as the food services in the hotel business, and mass food supply services in staff canteens, hospitals, and other facilities. Moreover, when the retailers of prepared foods (ready-made meals), such as take-away packed lunches, are included, the figure reaches almost 30 trillion yen.

Apart from a certain number of companies who operate overseas, most operators run their businesses in Japan. For these reasons, the overall industry is in a mature phase, with the domestic market contracting in step with the nation's population decline and the impact of the falling birthrate and aging population as well as changes in customer preference. Despite the contraction in the overall industry, the market scale of businesses that have adopted more industrialized business models, such as fast-food and family restaurants, is not necessarily shrinking.

With the transient preferences of consumers, temporary booms in the industry often result in a rapid expansion of the market, but when the booms end the market shrinks noticeably. These drastic fluctuations in earnings are one of the hallmarks of the industry. The results of the pub business are often affected by regulations, and its sales dropped after the introduction of stricter regulations against impaired driving associated with revisions to the Road Traffic Act in 2007.

Meanwhile, due to the handling of food, the industry is naturally governed by hygiene regulations. Moreover, with the introduction of stricter laws and rising consumer interest in the traceability, reliability, and safety of foods, it has become very important for the industry to take steps to respond to the associated risks.

(ii) Competitive situation

As entering the restaurant business is relatively easy, given the low barriers to entry, the market is very competitive, with roughly 700,000 restaurants competing with each other. There have been cases in which hamburger chains and beef bowl operators have waged a war of attrition, in the wake of a series of price-cutting competitions. Meanwhile, the narrowly defined restaurant industry is competing with the ready-made meals industry, which offers packed lunches in convenience stores and other take-away meals.

Small, privately managed restaurants account for most of the industry, and the share of more industrialized chain restaurants is relatively small. However, given the rise of the companies that operate chain restaurants and the shakeout of small to midsize restaurants, the share of the leading chain restaurants has been steadily growing. Specific business sectors, such as fast-food restaurants and family restaurants, have been discovering that they become increasingly oligopolistic by leading chain operators.

(iii) Cost structure

The cost structure of the industry comprises the so-called FLR costs, the three major costs of foodstuffs, labor, and rent. Of these three, procuring foodstuffs often accounts for the largest part of total costs, and it involves the risk of price fluctuations due to adverse weather conditions, outbreaks of disease, and other temporary factors. Prices of some foodstuffs, including meat, seafood products, and soy beans, are expected to rise over the long term, reflecting changes to the structure of global demand. As a result, it is important for the industry to procure foodstuffs consistently at lower prices. In fact, the beef bowl restaurant operators had been significantly affected by the ban on beef imports from the United States in the wake of the BSE outbreak. To lower procurement costs, the industry needs to maintain reliable suppliers and diversify procurement routes. Meanwhile, it is important to reduce food waste by adopting a central kitchen system and other measures.

Labor costs are the second-largest cost category, after foodstuffs. The industry is a labor-intensive industry, and the weight of labor costs is relatively high. To deal with this, the industry needs to try to reduce fixed labor costs by making use of part-time and temporary workers to an extent that does not lower the quality of service. It also needs to manage restaurant operations through effective worker deployment. Because working conditions in restaurants are somewhat tougher than they are in other industries, the industry needs to take measures to boost staff retention.

The third cost category after foodstuff costs and labor costs is rent. In the industry, operators often manage a number of restaurants using rented properties. As a result, the weight of rents related to opening new restaurants accounts for a relatively high share of the companies' costs. In addition, rents usually are fixed, and the cost burden becomes more severe when sales are declining. Consequently, it is important for the companies to contain the ratio of rents to sales. Companies also need to avoid agreeing to overvalued rents as a result of their excessive drive to open new restaurants.

(2) Market position and competitiveness

(i) Market position

It is relatively easy for new players to enter the industry. As a result, operators are constantly entering and leaving, and rankings of market share or sales today are not always good indicators of competitiveness tomorrow.

Meanwhile, restaurant operators can use economies of scale to exert purchasing power when procuring foodstuffs and other materials. In addition, the high-profile companies that operate nationwide restaurant chains have an advantage in accessing information about properties when developing new restaurants. Moreover, financing the development of a traceability system to ensure the reliability and the safety of foods could be difficult without a certain level of scale.

(ii) Ability to attract customers

With a mature market and strong supply pressure, the industry is struggling with overcapacity. Consequently, restaurant operators are tending to experience declines in same-store sales and profitability. As sales in the industry fluctuate markedly with boom and bust trends, it is vital for restaurant operators to maintain and increase same-store sales. The key in maintaining same-store sales is to attract repeat customers who visit the restaurants on a weekly, monthly, or other regular basis. To achieve this, restaurant operators can try initiatives such as including the introduction of menus or discount programs that are provided for a limited period as well as the distribution of coupons. Still, the most critical point in securing repeat customers is the extent of menu and price differentiation.

(iii) The appeal of core menus

The starting point for differentiation in the industry is the core menu. A strong core menu, rather than an extensive menu, tends to be a better indicator of success in this industry. Consequently, the focus needs to be on such factors as whether or not a company responds to customer needs by offering a core menu with competitive quality and prices that are hard to beat, whether it provides service that satisfies customers and offers value for money, and whether it takes steps to maintain its edge and prevent customers from wearying of its menu and services.

(iv) Capabilities to open new restaurants and develop business categories

In managing a large number of restaurants, it is important to select and secure desirable locations. So it is critical to examine if a company has established an organizational structure that enables it to do this. However, if the attractiveness of the core menu deteriorates and existing business categories fall out of fashion, there are clearly many cases in which simple changes in menus or prices within existing business categories do not produce a noticeable improvement in operations. More positive

results have been produced when a company has instead changed the structure of its existing categories by developing and adopting new business categories. This shows the importance of having a structure that enables companies in the industry to develop new categories to promptly respond to changes in the business environment. With the development of these new categories, JCR focuses on the ability of a company to maintain a competitive edge through the early stages by taking advantage of its accumulated management expertise and economies of scale.

(v) Management capabilities

JCR pays attention whether or not the business philosophy and policies of senior management are known to all employees in the company, including restaurant staff, and whether comprehensive action is taken to adhere to the principle of quality, service, and cleanliness (QSC). There is also a focus on whether services are consistent across a restaurant chain, and whether individual restaurants can take initiatives tailored to local characteristics. JCR also checks to see if a company is acting to secure and train staff in step with the expansion of its network of restaurants and to lower procurement, production, and logistics costs, while taking other appropriate measures, such as ensuring the reliability and safety of foods and developing price policies.

2. Financial base

(1) Earnings strength

In the industry, there are companies that achieve relatively strong profitability despite their limited sales volumes. Still, a characteristic of the industry is that profitability fluctuates quite significantly, given changes in the external environment and customer preferences. For these reasons, when assessing the ratings of the industry, ratings take into account the risks of profit fluctuations and as such are based on slightly stricter assessments compared with the quantitative criteria.

By opening new restaurants, companies in the industry can easily bolster sales, but existing restaurants are the basis for earnings. As indicators to measure the profitability of existing restaurants, other than net sales, JCR values the year-on-year change of same-store sales.

Key financial indicators

- Year-on-year change of same-store sales
- Operating income margin
- Operating income

(2) Cash flow

One of the characteristics of the financing of the industry is that the burden on working capital is light because most service bills are paid in cash. Some companies, in fact, maintain liquidity on hand that exceeds their borrowings. In addition, because most restaurants are leased properties, companies in the industry basically have fewer financial burdens and relatively small interest-bearing liabilities,

unless they adopt policies of investing in their own restaurants or undertake substantial mergers and acquisitions. It is, however, necessary to determine if the ability to repay debts has deteriorated, as a result of a decline in the ability to generate cash flow associated with a fall in same-store sales.

Key financial indicators

- EBITDA
- Interest-bearing liabilities/ EBITDA ratio

(3) Safety

The industry is exposed to the risk of becoming unable to procure key ingredients, which might occur because of an outbreak of food poisoning, BSE problems, or other factors. For this reason, it is important for companies in the industry to have sufficient financial strength to withstand losses that may arise from unexpected events. In addition, restaurant companies that operate the chain restaurant business need to pay attention to the risks of impairment loss, because the decision to apply asset-impairment accounting is basically made for each restaurant.

Following the introduction of asset retirement obligations as a result of changes to accounting standards, operators are now obliged to record in advance costs for the closure of restaurants in the future as liabilities. Consequently, when assessing ratings, JCR focuses on whether or not the company in question has sufficient shareholders' equity to deal with the risks of accounting losses.

When opening new restaurants based on long-term leasing agreements, the lessee is often required to pay a substantial deposit to the lessor, a reflection of standard business practice in Japan. As a result, items such as guarantee deposits and security deposits, in addition to property, plant and equipment, have a relatively high weight on the balance sheets of restaurant operators. In this case, the companies are exposed to the credit risks of the lessors who hold the security deposits and guarantee money. It is not unusual to conclude leasing agreements for restaurants that extend over 20 years, and the credit situation of lessors can change over that time. In fact, for reasons such as the bankruptcy of counterparties, there have been cases when some or all of the guarantee money has not been returned to the lessee. Consequently, it is important for restaurant operators to have the financial strength to withstand the credit risks of their counterparties, as well as the collection risks that arise in the future.

Key financial indicators

- Shareholders' equity
- Equity ratio
- Debt equity ratio

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