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WAKEFIELD**



THE FOOD HALL MODEL

Independent
F&B's Pathway to
Post-COVID-19
Profitability



**RESTORING
RETAIL**
CONFIDENCE



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Before the COVID-19 crisis, food halls were not only the fastest growing trend in food and beverage, but one of the hottest growth concepts in the greater retail world. These socially-driven, experientially-focused projects weren't just a hit with consumers (overwhelmingly popular not just with millennials and the emerging Gen-Z demographic, but foodies of all ages), but they became a critical part of landlord and developer strategies to backfill empty space in ways the now challenged department store sector once did. Lastly, because of

their low barriers to entry, the potential pool of entrepreneurial restaurant tenants and licensees for food halls was deep. The challenges facing food halls were not those of connecting with consumers. If anything, the very few food hall failures that had occurred came from developers looking to replicate the success of best-in-class projects while ignoring fundamental precepts of the model regarding operational, design, site selection, economic, and tenanting considerations.

At every level, we are witnessing how COVID-19 preys upon vulnerabilities. This is not just true epidemiologically, but also in terms of its impact on business. The “Independent Restaurant” has revealed itself as one of the enterprises most vulnerable to the challenges of this crisis; both because of the obvious impact of shutdowns and social distancing, but less obvious, because the traditional independent restaurant financial model was flawed to begin with (more on this later).

Against this backdrop, it would seem that socially driven food and beverage concepts would be the most vulnerable and that the era of the food hall may be ending abruptly. Yet, as counterintuitive as this may sound, we see a strong case as to why the exact opposite is true—not just in terms of the ability to survive the immediate challenges posed by the pandemic, but to emerge as one of the dominant forces to rebuild the independent restaurant industry in the post-COVID world.

No retail category post-COVID-19 had seen as much growth and relevance with consumers before the pandemic as independent food and beverage.

We estimate that approximately 100,000 new restaurants opened in the U.S. since 2010. By 2016, the USDA was reporting that consumers were spending more money on food expenditures away from home (restaurants) as they were at home (grocery). The multi-decade rise of foodie culture meant that American palates were becoming more experimental (spiking growth opportunities for cuisines once deemed outside of the mainstream), more refined (driving chef-driven concepts), and more organic (leading to an explosion of locally-sourced farm-to-fork players).

Challenges with SBA Aid

All the funds in the first wave of the Small Business Administration’s (SBA) Payroll Protection Program were exhausted within a few days of Congress enacting the \$342B plan. Of that amount, 8.9% (\$30.5B) went to the Accommodations and Food Services industries (i.e., hotels and restaurants).

Loan forgiveness was stipulated on businesses retaining 80% of their staff for at least two months with no more than 25% of funds going towards business expenses.

Banks earned between 1% and 5% per transaction on processing these SBA-guaranteed loans. But while smaller loans would have earned them higher commissions, the reality is that many were understaffed and could serve their larger clients first rather than manage the more labor-intensive smaller lending to independents. Anecdotally, few small operators report they received funding.

A second round of PPP funding added another \$175B by the end of April, but this will still likely be nowhere near levels of need in the marketplace.



The Delivery Conundrum

While pizza chains have factored delivery into their models for decades, most restaurant categories did not until delivery app services opened a powerful new channel for restaurants to market to consumers. However, they come with a hefty price tag.

Fees to operators average between 15% and 30% per order. That's rich for most retailers operating under tight margins. While many of these services have enacted programs to forgive or defer fees to independents, the reality is that the delivery model was only marginally profitable (at best) to begin with. While this move will help many operators, and delivery demand has surged, the reality is that for most restaurant sectors relying on takeout, drive-thru, and delivery alone will simply not offset losses from empty dining rooms.

The market was becoming oversaturated with dated restaurant concepts, so even prior to COVID-19, we entered 2020 anticipating a minor shakeout. This wasn't because of waning consumer popularity, but because of changing preferences, a crowded marketplace with extreme competitive pressures and rising labor costs in what had been a sub-4.0% unemployment economy. That damage was likely to be minimal and focused on the weakest players. Only those struggling with less relevant outdated concepts, subpar food offerings, or the weakest balance sheets were at risk. Most of the sector was forecast to do well this year.

Yet, in terms of individual business failures, there may be no other portion of the U.S. economy that will be more challenged than restaurants in the months ahead. Why is this so? Restaurants are not the only retail category where profitability is highly dependent on people entering the store.

The answer is simple; the traditional operational model of the independent restaurant is fundamentally challenged. First, profit margins were razor thin entering the crisis. For almost all restaurant models, food and labor costs typically account for just over 60% of operating expense ratios, but levels of service and quality of food offerings play heavily into vast differences between the Quick Service (QSR)/Fast Food model vs. Casual or Fine Dining. Outside of QSRs, independent restaurateurs achieving a 10% profit margin were rare superstars. This is the case across the board, from mom-and-pop pizza places to kitchens and dining rooms of the most elite world-famous chefs. Further complicating this is the fact that roughly 90% of restaurants are small businesses¹—even most of our seemingly monolithic

¹ National Restaurant Association

corporate QSRs are, in fact, franchise-driven. This means that many operators who were thriving just a couple of months ago simply do not have the financial reserves necessary to survive two months of lockdown.

Unfortunately, the mere act of reopening does not snap everything back to normalcy. Until the coronavirus situation resolves, most economists agree that consumer behavior and spending habits will be fundamentally different, and more risk averse. Mass job losses totaled 20.5 million in April, which has already driven consumer retrenchment. In combination with mandated occupancy limitations and the need to redesign space to accommodate social distancing required within restaurants to prevent additional outbreaks, this means that independent restaurateurs are facing an extended timeline of higher operational costs and significantly reduced

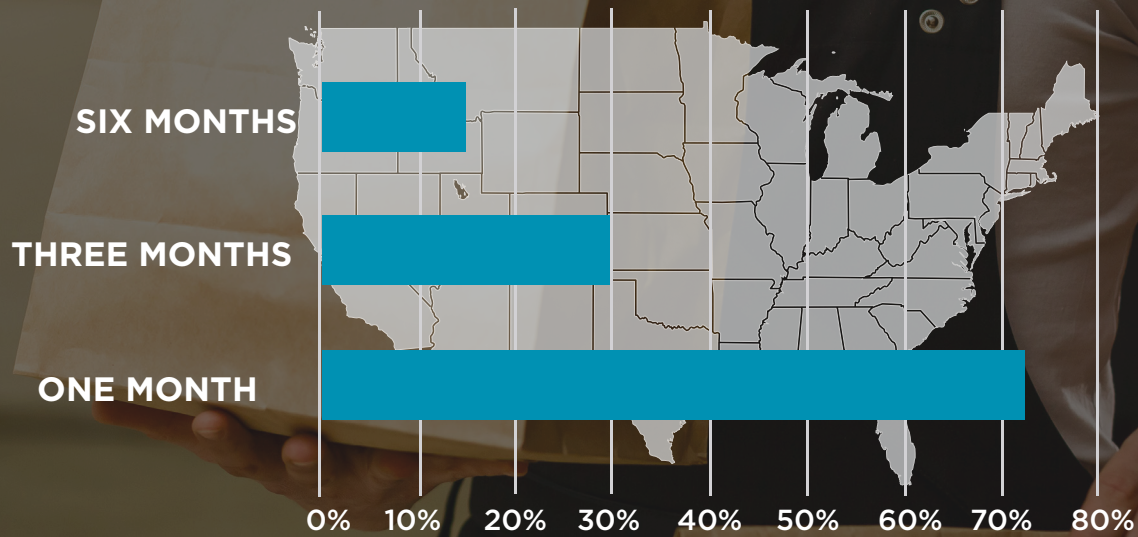
revenues. Safety and enhanced sanitation measures will skyrocket at a time in which businesses are already challenged.

The way things are currently trending, even those restaurant groups that entered the crisis with strong financials and deeper pockets will face significant headwinds. So far, we have seen amazing examples of ingenuity and, indeed, heroism from F&B operators that have pivoted to creating alternative revenue streams. We have also seen many landlords respond with both empathy and creativity in offering blend-and-extends and rent abatement and forgiveness. But the reality is that many restaurant operators—most notably the independents—have struggled to pivot their models and for those that have, alternate revenue streams are simply not enough. Government aid to the sector, so far, has been difficult to secure and uneven in its distribution. And though we have seen



Restaurants: The Lockdown Challenge

CAN THEY SURVIVE ON DELIVERY AND TAKE-OUT ALONE?



■ How long do restaurateurs believe they can survive a shutdown?

Source: Cushman & Wakefield Research; National Bureau of Economic Research

many landlords (and some of their lenders) trying to work with tenants, using creative temporary occupancy structures, this certainly has not been universal. After the challenges of the lockdowns, one must ask the fundamental question, how many of these property owners (and their lenders) will be prepared to continue to make major concessions (i.e. half rent to restaurants tenants facing 50% occupancy limits) for an extended period of time?

In April, the National Bureau of Economic Research (NBER) polled over 5,800 U.S. small business owners and found that 28% of restaurateurs said they did not have the resources to survive a one-month shutdown. 70% said they could not survive a three-month shutdown. Only 15% believed they could survive a six-month shutdown. The implications are dire for the industry, independents in particular.

If there were ever a time in which tenants, landlords, lenders, suppliers, and local governments (tax revenues) are in the same boat, it is now. By collectively working together, the risk of a widespread collapse could be mitigated. The potential burden to all, could be reduced by every level of the restaurant ecosystem working together collectively.

But still, the question remains as to how long market players can and will remain committed to working together collectively. This will be a major challenge if the pandemic is prolonged.

So where does this leave independent F&B?

As landlords with restaurant tenants question how to best support those businesses, many are forced to envision upcoming or currently vacant space. The same is true for developers now reframing plans for future spaces. While any statement made today on the future of restaurants must be considered a tentative one, it's clear the mechanism for rebuilding food and beverage will require an updated business model, one in which landlord/developer participation in the amenity is key. This model and its greater ability to adapt to economic and operation modification, is why we remain extremely positive on the future of food halls. Food halls were already wildly popular before the pandemic not just for the quality of their food offerings, but for the social experience they offered. Consumers felt as if they received a higher quality product at an approachable price point. Following lockdowns, and what is likely to be an extended period of social distancing, to say that there may be pent-up demand for experiential and social offerings will likely prove to be a major understatement. And while the economic model attached to food halls proved to be a resounding success in the pre-COVID-19 marketplace, we do not believe that this economic model needs to be limited to the food hall genre alone.

The concept of the food hall as an important amenity for landlords and as a risk mitigator for F&B vendors is not a new one. Over the last five years, food halls have grown at a rapid rate. Cushman & Wakefield's research, which has tracked food halls across the United States since 2016, identifies 223 open and operating food hall projects, pre-COVID-19, with over

The Quick-service restaurant (QSR)/Fast Food model is best positioned to get through this crisis. We estimate that there are nearly 300,000 QSRs in the U.S. (including burger, sandwich, pizza, chicken, Mexican, etc.). This model already derived 70% of sales from drive-thru and takeout. But many of these businesses are franchise driven (from mom-and-pops to corporate franchisers with generally deeper pockets).

Fast-Casual had been the hottest F&B sector. There are roughly 75,000 units, but the movement is dominated by independents. It relies on delivery and takeout (few have drive-thrus) for about 50% of revenues pre-COVID.

The Casual Dining/MidScale category includes both major chain operators and mom-and-pops (from family owned diners to full-service brewpubs). It is the largest restaurant sector in terms of sheer numbers, at roughly 392,000 units. Fast casual growth had largely come at the expense of weaker casual dining chains, though most remained relevant to consumers. Pre-COVID-19, this sector generated about 20% of sales from takeout (including curbside) or delivery.

Fine Dining is the smallest sector; less than 5% of its revenues came from alternate channels. It will be further challenged by consumer retrenchment, non-existent travel, and disappearing expense account spending in the months ahead.



All well designed food halls are aligned with operational strategies that focus on economizing vendor sizes and shifting more space to the customer experience side of counters. Food halls that created spacious public areas are now poised to creatively adapt multiple queuing lines, wider aisles, programmable spaces, and flexible seating strategies into a more separated, comfortable - yet still very social - customer experience. These types of adaptations are more difficult to execute in fast casual or quick service restaurants because they're designed with longer, narrower queuing zones and more dense dining configurations.”

- Ed Eimer
President,
Eimer Design

165 announced as in-development.² The food hall movement was largely a response to demographically focused demand. Millennial and Gen-Z consumers who have led the “experience over goods” charge anointed quality F&B as their experience of choice.³ The economic impacts of this crisis are only likely to reinforce those views. With an experiential focus on authenticity, social interaction, and elevated concepts that still provided value, the food hall experience exploded upon the American consciousness. Its popularity with younger consumers was only part of the attraction. The need for alternative space usage made the product increasingly attractive with developers and landlords—the business model itself not only limited exposure to weak tenants but kept the concept fresh with the public. Most importantly, its low-barrier-to-entry made it never want for potential new tenants and licensees.

When curated and operated with respect for the model (it is NOT an updated food court model), a food hall is a collection of individual micro-economies presenting local, regional, non-chain, chef-driven fare that stands in stark contrast to traditional chain food and beverage. The experiential nature of this type of collaborative dining and the engagement with innovative cuisine provided by independent vendors remains a highlight of the food hall.

Before the pandemic, experiential concepts were among the strongest performers in both the retail and F&B world. The pandemic has put those concepts on hold, and many experiential players that were thriving will simply not make it through the crisis without help. But, we see the food hall model as the vehicle which can lead a resurgence of the experiential F&B economy.

² Cushman & Wakefield Research

³ CNBC, <https://www.cnbc.com/2016/05/05/millennials-are-prioritizing-experiences-over-stuff.html>

It is also encouraging to see food halls adapt quickly to the crisis, perhaps more than most retail categories. Our tracking of the industry indicates that 75% were able to stay open during the lockdowns by pivoting to the ghost kitchen model. In Omaha, Nebraska at *Inner Rail Food Hall*, the venue quickly got creative. Vendors teamed up offering take-out packages billed as a “World Food Tour”, offering tastes of each concept. The creativity possible in a collective is a potential boon, if tapped, for operators struggling to get by primarily on delivery and pickup models for now.

Another inherent advantage for food halls upon their reopening is that their common spaces have been designed to be flexible. The best examples of food hall designs leave room for programming, which purposefully enjoys a broad definition. Pre-COVID-19 food hall success was often closely linked to socially activated space, live entertainment, podcasting, retail pop-ups, art, farmers markets, craft

exchanges, educational classes, “Flower Pot Fridays”, collaborations with community groups, and private events.

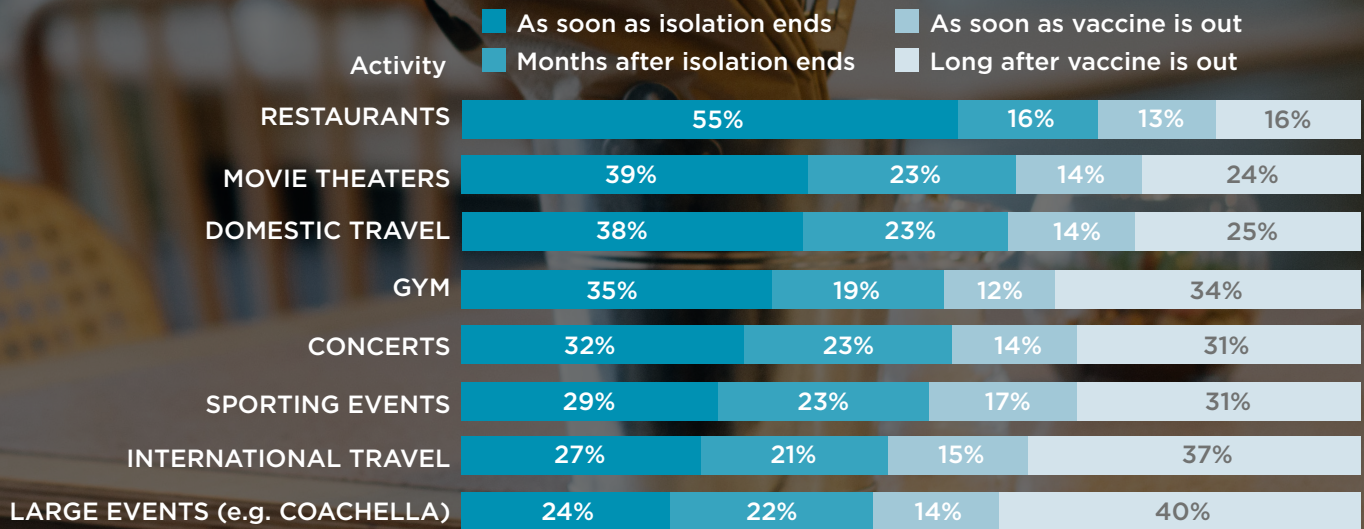
Though food halls were a concept driven by social interaction, they are actually in a significantly more effective position than most traditional restaurants to navigate the challenges of social distancing policies.

The transformable space model designed for food halls allows for easily manipulatable seating at minimal expense to ownership. Space previously used for entertainment programming can now be dining areas. We also believe there are lessons to be learned from the private booth seating found in finer restaurants; while cloth privacy curtains for a table are likely non-starters in this new norm, operators can create safe, private pods with protective materials, disinfected after each use, to further enhance a sense of security for guests. If designed thoughtfully, these pods can create a sense of togetherness, while respecting distance.



Opening Up

AMID CORONAVIRUS, HERE'S HOW SOON GEN Z AND MILLENNIALS SAID THEY WOULD RETURN TO THESE ACTIVITIES:



Source: TruePublic, Margin of error: +/- 2.37%, April 10-16, 2020

Additionally, a significant number of food halls have outdoor patio or rooftop garden space. While these spaces can certainly assist in offsetting the challenges of limited occupancy restrictions, they will also bring an additional layer of security to patrons. Throughout the pandemic we anticipate that consumers will generally feel far more secure in outdoor environments than in enclosed spaces.

Ultimately, how much these measures mitigate the ongoing challenges facing food halls, and the entire F&B sector, remain to be seen. But we do see the inherent design flexibility of the food hall as giving them an advantage in the months to come. And the pandemic will not last forever.

There are already major indicators of pent-up demand. Late April consumer polling of Gen-Z and Millennial consumers indicates that 55% of this demographic (the primary driver of food hall popularity) say they would return to visiting restaurants more quickly than any other activity (movie theaters, travel, gyms, etc.) upon lifting of lockdowns.

The Food Hall Model is the Independent F&B Model for the Future

The economic model of a food hall operates most efficiently on an all-inclusive percentage rent. Revenue generated by the food hall vendors is shared, then distributed by the owner and venue operator of the food hall to resolve operating expenses (including a rent component), with heightened attention on revenue sharing of beverage sales.

Food halls were seen as a “safe amenity” investment by developers prior to the shutdown. The recognition that a food hall contained a number of independent businesses and was significantly less likely to “go dark” than a stand alone restaurant became an attractive attribute. Without a long-term lease and large tenant-specific build-out, a landlord felt secure about a scenario in which a major vacancy will not likely occur. In a food hall with multiple vendors, in the event of an unsuccessful concept closing, the remaining ten vendors

continue operation while the vacated space quickly transforms to accommodate a fresh idea. This model is a winning scenario for the owner and vendor. Owners expend capital, taking the burden off the vendor, but enjoy the upside of their up-front investment. Their space hosts and attracts readily available talent and reaps the benefit for it.

Under a short-term license agreement, owing only a fair percentage of sales, the chef or restaurateur has very few fixed costs. That percentage covers a laundry list of extra bills associated with food and beverage establishments, including utilities, marketing, POS systems, CAM, and real estate taxes. In terms of a start-up cost, compared to a stand-alone restaurant space, where initial investment typically ranges between \$250,000 to \$2,000,000, a single food hall stall investment ranges only between \$25,000 to \$75,000. The low cost to staff 350 SF of space and a condensed menu allows vendors to work economies of scale. This low-cost

alternative also has significantly higher profit margins, typically between 15-20% for the vendor compared to restaurants which often struggle to reach 10% profit.

Moving into the post-pandemic era, we will likely see both significant belt tightening from consumers and pent-up demand for socialization (both of which will favor the traditional fast casual tenant of food halls and the venues themselves). We will also see more landlords and developers in need of backfilling retail space lost to the crisis and absolute need to reconfigure shopping centers towards those concepts that resonate with consumers.

Most importantly, large swaths of the independent restaurant community are going to need a rebuilding mechanism; one with lower inherent risks for all, a better operational model that allows for higher profit margins, and low barrier-to-entry.

Food halls will be where the industry rebuilds first.





CUSHMAN & WAKEFIELD

About Cushman & Wakefield

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 53,000 employees in 400 offices and 60 countries. In 2019, the firm had revenue of \$8.8 billion across core services of property, facilities and project management, leasing, capital markets, valuation and other services. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

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