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Rating Methodology by Sector

Food Service

1. Business base

The industry has a large market size, but the industry itself is mature. The 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

Although some companies in Japan's food service industry are operating overseas, most companies' main market is the domestic market. Therefore, the food service industry as a whole is in a mature phase, due to the nation’s population decline and the impact of the falling birthrate and aging population as well as changes in customer preference. However, although the market size of the food service industry has been shrinking since its peak of approximately 29 trillion yen in 1997, it is still a huge market, and the market size of relatively industrialized businesses such as fast food and family restaurants is not necessarily shrinking. As the shakeout of small, medium, and micro businesses continues, there is room for new store openings.

With the transient preferences of consumers, the industry is characterized by large fluctuations in earnings, with the market expanding rapidly during a temporary boom and then declining sharply in a subsequent reactionary decline. In addition, as consumer behavior patterns change, opportunities to eat out outside of restaurants, such as take-out and delivery, are expanding. JCR will check whether a company can smoothly respond to such changes in demand and the external environment and build a business portfolio that is in line with current trends.

Meanwhile, due to the handling of food, the industry is required to take thorough measures in terms of hygiene management. Moreover, with the tightening of regulations on traceability and other aspects of "food security and safety" and rising consumer interest, it is also essential to address these risks.

(ii) Competitive situation

As entering the restaurant business is relatively easy with the low barriers to entry, the market is very competitive. In the past, 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

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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, with the rise of the companies that operate chain restaurants and the shakeout of small, medium, and micro restaurants, the share of the major chain restaurants has been gradually growing. In particular, in the fast food and family restaurant categories, oligopoly by the major chains has been progressing.

(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. In addition, foreign exchange effects should be kept in mind. There is also concern that prices of meat, marine products, soybeans, and other products may rise over the long term due to changes in the global demand structure. For these reasons, JCR confirms whether the company has a procurement base that enables it to procure foodstuffs stably and at low prices. JCR also pays attention to the company’s efforts for reduction of food waste through the use of central kitchens and AI demand forecasting, as well as flexible menu strategies to maintain appropriate cost levels, in addition to the securing stable suppliers and diversifying procurement routes, for the purpose of lowering foodstuff procurement costs.

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. It also needs to manage restaurant operations through effective worker deployment. On the other hand, the industry has more severe working conditions than other industries, making it difficult to secure and retain human resources. In addition, given social structural issues such as the declining birthrate and aging and shrinking population, it is important to standardize work for quickly bringing human resources into the capable workforce and to promote efficiency by reducing the store operations themselves. If store personnel can be allocated to tasks that create more added value by eliminating simple tasks, the value of the store experience and customer satisfaction will increase, and this may lead to differentiation from the competitors.

The third cost category after foodstuff costs and labor costs is rent. In the industry, the companies 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 particular, rent is a cost that is easily fixed, and the cost burden becomes more severe when sales are declining. Therefore, JCR confirms whether the companies contain the ratio of rents to sales to a certain level. In addition, JCR also pays attention to whether the company has concluded lease contracts under relatively

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expensive terms in a hurry 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 rapidly rising and falling, 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 property referrals and other aspects when developing new restaurants. Moreover, it is difficult to bear the cost of ensuring "food security and safety," such as the establishment of a traceability system, without a certain level of business scale. In light of the above, JCR looks at the market position when evaluating the status of the business base established.

(ii) Ability to attract customers

With a mature market and strong supply pressure, the industry is struggling with an overstored condition. Consequently, restaurant operators are prone to 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. JCR confirms whether 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

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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. For the development of 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. JCR also emphasizes the ability to build a portfolio of business categories. For example, if a company operates multiple business categories, such as fast food, family restaurants, and dinner restaurants, with different customer segments and usage patterns, the company can diversify its revenue sources and absorb the negative effects of a deteriorating external environment.

(v) Management capabilities

JCR pays attention to whether or not the business philosophy and policies of top 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 "food security and safety," and developing price policies. In the past, there have been cases where governance systems were inadequate and labor management and quality control problems were found, adversely affecting business performance. In addition to misconduct by part-time and temporary workers, there is also a need for measures to address inappropriate behavior caused by customers. In particular, when misconduct or problems occur at stores or other workplaces, there is a strong possibility that the fundamental ability to attract customers and brand power will be damaged, and it is essential to develop and thoroughly implement internal systems and measures to prevent recurrence.

2. Financial base

(1) Earnings strength

In the industry, there are companies that achieve relatively strong profitability despite their limited sales volumes. Still, the characteristic of the industry is that profitability fluctuates quite significantly due to changes in the external environment and customer preferences. For these reasons, when ratings the industry, JCR takes into account the risks of profit fluctuations and makes 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,

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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

In the restaurant industry, there is a risk of a plunge in sales due to restaurant closures or reduced operating hours in the event of an outbreak of an animal or plant disease that affects foodstuffs or a pandemic of an infectious disease among consumers. For this reason, it is important for companies in the industry to have sufficient financial strength to withstand losses that may arise from these unexpected events. In addition, it is necessary to pay attention to the risk of impairment losses for restaurant companies operating the chain restaurant business, because the decision to apply impairment accounting is basically made for each restaurant. In addition, for companies that have adopted IFRS, there are cases where a large amount of goodwill has been recorded due to corporate acquisitions in the past, so attention should also be paid to the risk of goodwill impairment losses due to a sudden deterioration in business performance. For these reasons, in rating the industry, emphasis is placed on whether the companies have sufficient capital to withstand the risk of such accounting losses.

Key financial indicators

- ■ Shareholders' equity
- ■ Equity capital ratio
- ■ Debt equity ratio

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