

HOW IS RUNNING A RESTAURANT BUSINESS LIKE PLAYING CHESS?

By Alexander Solonin, Auspex Capital

I just came back from the Restaurant Finance and Development Conference in Las Vegas where I had an opportunity to meet with and to talk to many franchisees as well as independent restaurant operators representing various concepts. They came from different parts of the country and had different opinions on where the industry is headed and what it takes to become successful in it. For some it was growing their existing stores' sales; for others it was adding new restaurants and expanding into new markets and new concepts. One thing was common in all of my conversations though, they all had the same final goal – maximizing their returns and making more money. Most of them had a plan on how to realize their vision and how to move their businesses forward. In majority of cases the choice of strategy was based on past success, their own or somebody else's, an imperfect predictor of future success in my opinion.

Nobody has a crystal ball, so being able to predict future events from a set of current or past events with reasonable precision would not seem too bad. Such ability would imply that we live in a *deterministic* system. According to the Encyclopedia of Philosophy, the general thesis of determinism states that for everything that ever happens there are conditions such that, given them, nothing else could happen. That would entail the predictability of the future as well as the past.

However, we got no such luck. All economic systems, including the restaurant industry, are highly indeterministic, i.e. the outcome of any action cannot be predicted with any degree of certainty, i.e., the action has as its consequence a *set of possible specific outcomes*, and not an invariable specific outcome.

There are at least three sources of indeterminism in the restaurant business. The first one stems from the growing importance of innovation and introduction of new products (Angus steak anyone?). The second factor is human resources, which can be viewed as additional constraints on the process of resource allocation. And finally, there are various exogenous disturbances that affect the state of an economic system. Such disturbances originate outside the sector and constitute either political changes (“no eating and driving” laws, for example) or new societal developments like the growing popularity of healthy eating habits and new fashion diets.

The problem with indeterministic economic systems is lack of a complete and consistent linkage between a local solution and the global solution for the system as a whole. Simply put, we cannot replicate a winning restaurant economics across the whole company, let alone the whole sector. What works in a certain set of conditions, does not necessarily work when transplanted elsewhere. Of a huge variety of systems that face this kind of problems we could mention as examples such systems as macroeconomic development, strategic position of a firm, quantum mechanics, and ... the game of chess.

Chess can be used as an example of a relatively simple indeterministic system. Chess is simple because it has fixed boundaries, a fixed goal and fixed starting positions. It also has a fixed set of rules of possible pieces' interactions. Meanwhile chess is an indeterministic system because in spite of the fact that chess is a finite game, it's impossible to search the astronomical number (of the order of 10^{120}) of variations and combinations to create an operationally viable procedure that could consistently predict the outcome, or link the beginning of the game with its end.

As in chess, the desired outcome of the game of business is known in advance. With a few possible variations (market share, long-term growth vs. short-term gain, etc.) it's always about maximizing return and making money. So, we *begin with the final goal in mind* and develop strategies to achieve that goal. As the game progresses, the situation on the "board" changes dramatically and it becomes harder and harder to calculate moves ahead. The best chess players, however, do not calculate moves at all. Instead, they analyze their position on the board relative to the opponent's position and make inferences about their *predisposition* to win. Gross Masters can evaluate their positions well in advance (sometimes up to 20-30 moves) of the final outcome, which is why we never see games end in an actual checkmate at high level chess events. Dr. Aron Katsenelinboigen of the Wharton Business School, who coined the concept of indeterminism and predispositioning, has already successfully applied this theory to various economic systems involving companies' competitive positions and strategy evaluations.

Let's extend the analogy a little bit further and see what "chess pieces" are available to the restaurant chain operator when playing the game. The list below is by no means exhaustive, but hopefully reflects most items that management and, most importantly, investors look at when making a determination on the company's predisposition to win the economic game and whether or not to allocate any additional resources to it.

1. *Exogenous Factors*
 - i. Overall economy
 - ii. Restaurant industry
 - iii. Fast food / casual / fine dining sector
 - iv. Restaurant chain under review
 - a. Nationwide
 - b. Local
 - v. Local market
 - a. Demographics
 - b. Economy
 - c. Competitor trends
2. *Experienced Management Team*
 - i. A deep management team with a proven track record
 - ii. Experience in the industry and the geographical market

3. *Control of the Brand in the Market*
 - i. Control over a prominent QSR brand in a major market
 - ii. Discretion over how advertising dollars are spent in the market
 - iii. Exclusive or nearly exclusive development rights
 - iv. Access to cost effective TV advertising

4. *Positive Unit Economics*
 - i. Positive overall sales trends
 - ii. Average unit volumes in excess of system and industry averages
 - iii. Cost structure in line with the system averages
 - iv. Positive cash flow trends

5. *Capital Expenditures and Deferred Maintenance*
 - i. Relatively new asset base with little to no deferred maintenance issues
 - ii. Low capital expenditure requirements

6. *Moderate Leverage*
 - i. Moderate Debt to EBITDA ratio between 4.0x and 5.0x
 - ii. Projected further decline in the ratio in the near term

Granted, *conventional* values of the above listed pieces vary across markets and individual companies, albeit not dramatically. The differences in *circumstantial* values, however, are much more pronounced since they are purely a function of the ability of the player. For example, some people would argue that a combination of two bishops on the chess board is more powerful than that of a bishop and a knight. Some might disagree. Similarly, a combination of any of the “pieces” listed above might prove more powerful in the hands of one management team (the “player”) and become a liability in the hands of somebody else.

Also, even though not everybody starts the game with a full line-up of pieces, the missing ones can be acquired during the course of the game, very much like having a pawn reach the coveted eighth line. As in chess, pieces from the above list can be sacrificed and/or traded for positional advantage. The most important skill for the player remains that of being able to discern the value of every single piece left on the board as part of the overall position and to determine the company’s predisposition to win the game. It’s time to make your move!