The Food and Beverage Industry in Los Angeles

A Roundtable Discussion

JEAN HAGAN
Principal
KROST CPAs & Consultants

ISSY KOTTON
Assurance Partner
BDO USA, LLP

DON SNYDER
Partner and Food and Beverage Practice Leader
Green Hasson Janks

JOEL WEINSTEIN
Partner, Practice Leader – Restaurant, Food & Beverage Group
Greenberg Glusker LLP

THE food and beverage industry as a whole is unique in many ways – and here in Los Angeles, where we have some of the best dining and food-for-purchase options in the nation, there's perhaps an even more finely tuned set of rules for success. Stir in an unpredictable economy and unique regulatory conditions and you've got a sector of Southern California business that continues to evolve as swiftly as any other.

To make some sense of this exciting and unpredictable realm, the Los Angeles Business Journal has once again turned to some of the leading experts in the region to get their diverse insights and assessments regarding the current state of the industry that Angelenos most certainly couldn't live without!

FOOD & BEVERAGE ROUNDTABLE

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> ISSY KOTTON

◆ What opportunities and challenges do the food and beverage industry face as business tax reform takes shape?

KOTTON: Should tax reform pass as proposed, food and beverage companies may have the opportunity to enjoy tax cuts. Given the uncertainty surrounding tax reform, now is the time for businesses to proactively lower their tax rates by meeting with their tax and legal counsels. When companies design a lean tax strategy, they will be better prepared for any regulatory changes that may occur. According to BDO's 2017 Tax Outlook Survey, a reduced corporate tax rate is the primary tax issue for tax executives across industries. However, our data also suggests that many tax professionals expect the rate to fall somewhere between 20 and 24 percent. On the flip side, changes to the federal tax code could complicate state and local taxes for businesses that operate across multiple states. Above all, food and beverage companies can most effectively prepare for tax reform by staying informed of new developments.

WEINSTEIN: All industries face the uncertainty about whether federal tax reform will occur. Nevertheless, tax planning continues to remain critical for a food and beverage company throughout the company's life cycle. Tax planning begins at the formation stage with the basics such as entity selection (i.e., formation as a limited liability company, limited partnership or S-corporation) and structuring issues such as forming an intellectual property holding company to hold trademarks for royalty license agreements. During its operating phase, a company should consider maximizing tax credits (i.e., with respect to research and development or enterprise zone hiring), as well as depreciation deductions. There are important tax considerations for liquidity events such as a sale of assets as compared to a sale of equity, as well as the rollover of equity into the purchaser.

◆ How might proposed base-broadening measures like the border-adjustment tax impact the food and beverage industry?

SNYDER: The border-adjustment tax currently being discussed in Congress could result in more than $80 billion in new taxes on California businesses that import goods. This would then threaten thousands of jobs due to the cost-cutting measures that would inevitably follow. The proposed border-adjustment tax would impose a 20-percent tax on U.S. companies on all goods they import, whether final products, component parts or raw materials. The bill would disproportionately impact small businesses and reduces the money available for hiring or retaining employees. We will have to wait and see what happens if the tax is passed, but I see it having a big impact on smaller food and beverage companies unless specific exemptions are created for ingredients used primarily in food and beverages.

KOTTON: Although many tax professionals remain skeptical of whether the border-adjustment tax (BAT) will come to fruition, it's important for the food and beverage industry to be prepared. Companies of all sizes source a variety of their ingredients from outside of the U.S. If passed, sales of imported goods would be fully taxable while the sales of exported products would be exempt from tax. Food and beverage companies would likely need to offset increased costs to continue sourcing foreign ingredients, potentially by raising prices for customers. How will consumers react to higher coffee or cereal prices? The objective of the BAT is ultimately geared to reverse the perceived U.S. trade imbalance. The impact it will have on individual businesses, however, will vary. Food and beverage businesses should evaluate whether their reliance on imported goods outweigh international sales revenue, or if the opposite is true.

◆ What are the main challenges and opportunities facing food and beverage companies doing business in California compared to other states?

HAGAN: The main challenges of restaurants doing business in California are labor cost because of minimum wage increases and over saturation/competition in the market place. The opportunity is that millennials are spending more money on experiences than consumer goods (Harris Group study 2016) and innovative operators that focus on creating a great overall dining experience will flow into a large market of people willing to spend their money. According to the Food Institute's study (2016), millennials will spend 44% of their food dollars on eating out. Chain restaurants will have to reposition themselves to compete with the unique solo establishments or trendy food truck that offer these types of experiences and attract these diners. In order the cover all assessable guests, restaurant operators must position themselves through service concept models that offer guests different options within one operation - quick casual, full service, take out, and delivery.

◆ How can food and beverage companies keep up and remain current with regulatory changes?

HAGAN: Two great resources are the California Restaurant Association and the California Chamber of Commerce - both offer great information and support services to the industry at a reasonable membership cost. Sites like the SBA.gov provide up to date information on the very dynamic state of food & beverage regulations.

◆ How is food safety impacting the food and beverage industry?

SNYDER: Higher quality standards are an important part of any sustainability policy for food and beverage companies. The industry must work to continuously improve food safety and quality systems to address changing legislation, customer requirements and new product development. Organic foods are grown in a way that promotes food safety, for example, and consumers are making a major shift to these safer foods. That drives revenue, so I'd say safer foods can lead to higher profits.

◆ What is the best way to manage the new LA County health department scoring system?

HAGAN: The best way to manage the new LA County health department scoring system is to tighten current controls, maintain an internal validated system of line checks and reviews. Restaurants could benefit from hiring an external company to perform health inspections on a regular basis. Ongoing food safety training and regular testing and retraining is almost a necessity to prevent a negative and potentially devastating inspection score. Hold your management team accountable for the same standards set in the LA Health Department Inspection Report. Assign different members of your staff sections for responsibility/monitoring. Tie all bonus payments to maintaining an "A" in the restaurant space.

◆ In 2017, what effect do consumer demands have on food and beverage companies' social responsibility practices?

WEINSTEIN: Consumers demand that companies recognize the importance of balancing profit-making activities with action that benefits society. Company founders backing certain social initiatives often result in brand recognition and desired consumer loyalty, and consumers want companies to contribute funds and engage their employees in giving back to the community. Companies focus on several categories of social responsibility such as becoming more energy efficient, reducing waste and creating a healthier environment. Savvy consumers expect companies to search for products and ingredients that are grown and produced in a manner that is environmentally friendly, qualify as organic, or use materials in site design that minimize energy usage. Sustainability efforts can become a differentiator in the marketplace for companies when coupled with use of social media to monitor sites to build loyalty and a sense of community.

SNYDER: Social responsibility practices are an important differentiator for market leaders and are becoming more prominent in marketing messages from brands. The truly innovative market leaders are not just talking about practices such as sustainability and eco-friendliness but backing them up with actions by redesigning packaging, pursuing sustainable manufacturing practices and innovating with new product offerings. The growth of consumers' personal values has, in many cases, pushed food and beverage companies to define and embrace their own values. This heightened awareness around social responsibility now drives the industry, and those companies that can't point to a heartfelt social responsibility policy run the risk of being left behind in the marketplace. Customer demands also push companies to develop new products, packaging and waste-reduction practices. These practices can make a difference in the bottom line – for example, reduced waste translates to higher profits because those resources can be used more productively. For me, that means social responsibility is both smart and profitable.

HAGAN: Whether it's following guidelines for seafood, meat, poultry or produce, restaurants should inform guests of the products they are using to prepare their items. This can also include the choices made for paper products and waste in regards to environmentally friendly practices. If a restaurant is following their philosophy of "Farm to Table"

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The Green Hasson Janks' secret ingredient?
We share our clients' passion for their businesses.
At Green Hasson Janks, we help our people and clients #BeMore: pursue their passions, build thriving businesses, and create a better future.
Celebrating the 40th anniversary of Vegenaise® this year, our client Follow Your Heart® has also been helping customers #BeMore for decades. They believe that all people deserve access to healthy food, that we should have compassion for all living things, and that we have a responsibility to be good stewards of the environment.
Clients like Follow Your Heart inspire us to be relentless about our #BeMore culture.
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JOEL WEINSTEIN

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menu choices - it's important to make the guest aware of your purchasing practices and vendors.

◆ What can food and beverage companies be doing right now to increase their sustainability efforts?

SNYDER: There are a number of things food and beverage companies can do right now:
- Look at reducing waste throughout the supply chain
- Reduce your carbon footprint
- Advocate for sustainability in the industry
- Get a third party to measure greenhouse gases and identify where you can make changes
- Reduce packaging materials as much as possible, especially plastic
- Install solar panels
- Compost and recycle
- Donate food waste to local charities

◆ Considering costs and raw material sourcing, what is the impact on revenue from sustainable practices?

WEINSTEIN: A few years ago, the cost to companies of producing or using products certified as organic was incrementally higher. The cost differential and raw material sourcing for organic products have seen decreases because of the increased availability of those products and the recognition by growers and producers that consumer demand is here to stay for organic and natural products. Data shows that consumer expectation and demand has been increasing at rates that exceed raw material cost increases. We expect and see that education and a focus on social responsibility by consumers plays an important role in incentivizing companies to engage in sustainable practices.

SNYDER: Some companies, such as those that are founded on a sustainability strategy, owe their revenues to being socially conscious. An example is Barnana, a company that takes so-called "ugly fruit" that would be normally thrown away and transforms it into nutritious banana-based snacks. They even use the peels by turning them into fuel pellets. In addition, more and more consumers seek out products that are sustainable and are willing to pay more in many cases. Also many sustainability measures like water reclamation, solar or wind power or a reduced carbon footprint have advantages beyond attracting conscious consumers – these measures will reduce expenses – which translates into higher profits.

◆ How important has "labeling" become today in the food and beverage industry?

SNYDER: Consumers read labels. This has slowly built over time, and many people make their purchases based more on ingredients, growing conditions or manufacturing processes than price (to an extent). For food and beverage companies, it is important to have solid values and produce something you can be proud of. If a consumer has a choice of two products and the label on one says their product is organic or their packaging is zero-waste vs. another product, they will often choose the socially responsible one. The same goes for labeling, such as "organic," that is perceived as healthier along with being socially responsible.

◆ How often should companies in the food and beverage industry assess their business valuation and why?

KOTTON: As with businesses across industries, those in the food and beverage industry should assess their business once per year at the end of the year. However, there are a few exceptions to this approach. When market conditions are volatile, food and beverage companies should ramp up the rate of their valuations to more than once per year. Beyond market volatility, if a company is looking to sell in the forthcoming three to five years, then it should conduct valuations frequently throughout the business year—regardless of the type of sale, from an IPO to a financial or strategic deal. Companies will want to have a consistent, clear picture of the strength of its business to present to potential sellers.

HAGAN: We recommend a Business Intelligence program (like Ctuit or Restaurant 365) for accurate business analytics on a weekly basis. Review financial statements monthly and conduct a yearly comprehensive review of business health.

◆ How are food and beverage companies factoring M&A into their fiscal planning given frequent store closures and the overall industry shift to e-commerce?

KOTTON: Today, food and beverage businesses of all sizes are increasingly considering M&A options. A merger or acquisition requires a considerate amount of financial review and strategy. First, companies should consult their advisors (accountants, investment bankers, M&A lawyers, etc.) as far as 12 months prior to a potential sale. It's important for businesses to have clean financial records as financial and tax due diligence is crucial during the M&A process. Often, buyers expect a pre-acquisition quality of earnings analysis to identify financial matters ahead of going to market. This provides both the buyer's and seller's management teams with sufficient time to correct any significant deficiencies. Additionally, a full understanding of a company's tax structure can minimize tax liabilities and maximize after-tax proceeds. Lastly, the company should build strong technology and operation programs. Having internal finances and operations under control mitigates the sale process and creates mutual understanding between the buyer's and seller's objectives.

◆ What advice would you offer to an early-stage restaurant company seeking growth capital?

WEINSTEIN: Start by answering four questions: (1) Do you have an advanced business plan with evidence of building your brand and customer base and meeting financial goals? (2) How much money do you need? (3) Do you want to raise debt or equity or a combination? (4) Do you have a plan to make contacts with financing sources? Typically family and friends provide initial capital or loans; founders should understand the difference between giving up majority economic rights versus management control. Although traditional bank loans will not be available, industry "angel investors" may be willing to consider loans (convertible notes) and equity investments. While terms, rates and fees vary, and most require personal guarantees by the founders, equipment financing for new equipment, inventory financing and working capital loans can be accessed (often with online applications) through short-term loans or a line of credit. Owners also should explore SBA loans.

KOTTON: For budding restaurant companies, finding a reliable source of funding outside of private backing is difficult at best. Internally, companies that are just beginning to grow should focus on fortifying a business plan, refining their customers' complete experience, establishing strong internal financial and accounting controls, as well as thoroughly understanding the market. At the same time, entrepreneurs should strategize on how to find a sustainable source of capital. Sometimes, new restaurants can receive loans from the U.S. Small Business Association. For new franchisees, it's also common for a franchisor to help arrange financing if they have a strong relationship with a bank. Most often, new restaurant entrepreneurs turn to family and friends for financial support with the understanding that the ownership mix may ultimately shift. Above all, a thoughtful, developed business plan will help new entrepreneurs find the capital they need.

HAGAN: Early-stage restaurant companies seeking growth capital should consider getting privately funded through investors.

◆ At what stage is a restaurant company ready for venture capital or private equity funding and how does it attract the interest of such investors?

KOTTON: In general, interest from venture capital or private equity is good news for restaurants eager for change, whether that be through growth, scale or new services and concepts. Private equity funds focused on restaurant investment bring capital, more operational infrastructure and a fresh management team to the table. Restaurant groups hoping to franchise their business outside of their home region should turn to venture capital. However, restaurants being courted by private lenders should be sure to "date before they marry." The relationship between a restaurant and their PE or VC financer extends beyond strictly finances; a shared set of values, goals and vision for the exit is also critical to ensuring that the relationship benefits all parties.

WEINSTEIN: The restaurant must have experienced management in all critical functions, and a solid business plan stating its future growth strategy. The key factors driving investor interest are quality food, service and management together with a scalable concept and a differentiating mission statement. Visibility on social media platforms and access to influencers play a role in accessing funding. Also, founders should network with the investment community by attending industry conferences. For venture capital and private equity funding including family offices, the number of stores and EBITDA are key metrics. They typically look for at least 7-10 locations for proof of scalability and profitability, although I have a client with 4 locations with a novel concept in a growing cuisine segment that has attracted PE interest.

◆ What are the most critical legal issues that a new start-up food/beverage company should allocate its limited resources to addressing at the very beginning?

WEINSTEIN: The start-up must (1) make sure that its products and supply sources comply with the Food Safety Modernization Act, which governs preventive controls for human and animal food, produce safety, and foreign supplier verification programs; (2) select the type of business entity and comply with formation and filing requirements; (3) require its employees and consultants to sign a confidentiality and inventions assignment agreement and assure proper classification of employees as exempt or non-exempt; and (4) protect its intellectual property and brand by retaining IP counsel to conduct a trademark search for the primary name and/or logo, followed by trademark registration in at least one class of goods or services. Once the company's website is operational and collecting personal information, California law requires posting a privacy policy, and having a cyber security plan is critical.

◆ Has there been a shift in how food businesses today handle gratuities and service charges?

HAGAN: Local municipalities are starting to attempt to regulate service charge distributions - this makes it a complicated administrative duty for the restaurant operator with a great deal of risk for mistakes and can create legal issues. Everyone is struggling to find a legal way to balance the inequity between FOH and BOH employees. Every minimum wage increase exponentially benefits the FOH tipped employees – who are already the highest compensated employees in the restaurant.

KOTTON: Media attention of restaurant gratuity and services charges has increased dramatically within the last few years, mostly because of widespread changes to restaurant tipping policies. Many restaurants are winding down their tipping models, instead replacing tips with either mandatory service charges or higher hourly wages that don't necessitate service charges or tips to meet livable wage standards. Restaurants that still utilize a tipping model should retain the traditional methodology of paying their wait-staff relatively low wages, relying on tips to make up the bulk of employee pay. For restaurants that have retained tipping, the IRS provides a federal tax credit for a portion of the payroll tax that the restaurant pays on tip income. This federal tax credit, known as the FICA credit, was designed to encourage accurate tip reporting by employees and to reimburse employers for the payroll taxes that they pay on those reported tips.

WEINSTEIN: Restaurant owners must be vigilant about complying with complicated gratuity and service charge regulations. Fixed or mandatory gratuities impact overtime calculations for the servers. Restaurants located in California cannot require servers to share tips or tip-pooling with back of the house employees. In response, some restaurants have increased menu prices and eliminated tipping, although that practice has not gained widespread support among consumers or restaurant employees. In an effort to reduce pay disparity between servers and cooks, other restaurants have added a "surcharge" line item to distribute to all employees. Although current law does not allow California employers to "credit" an employee's tips toward hourly minimum wage requirements, the recent minimum wage increases may encourage a renewed push for tip credits. I expect gratuities and service charge practices to continue to evolve as restaurants and other retail food businesses grapple with balancing consumer satisfaction and employee incentives.

◆ What are the challenges you see companies facing related to minimum wage changes? What strategies can food and beverage companies use in response to these changes?

SNYDER: California's minimum wage will rise to $15 an hour for companies with 26 or more employees by Jan. 1, 2022 – those with less employees will reach this rate one year later. Interestingly, California cities and municipalities are racing to implement increases that are higher and faster. For food and beverage companies, it will cost more to employ someone because of higher wage and benefit costs. Companies that cannot move operations out of state may turn to technology to solve their increased cost issues, which may lead to more automation in the food and beverage industry.

WEINSTEIN: Effective July 1, 2017, the minimum wage in Los Angeles increased to $12 per hour for companies with 26 or more employees with smaller businesses following in January 2018, although many businesses did not wait for the wage raise. Employees whose hourly rates were slightly more than the prior minimum wage will likely see wage increases. Not surprisingly, many restaurants will look for ways to cut costs. Some already have or will increase menu item prices where the clientele will easily accept the increase, and some will cut hours and jobs for their lowest-paid workers forcing remaining employees to bear more work. Some owners are faced with the challenge of retaining customers who push back on higher prices and loyalty to long-time employees. We see owners and chefs stepping up the personal interaction with their customers to sustain customer loyalty in the face of menu price increases.

HAGAN: With the increase in wage expenses, restaurants need to evaluate their service concept to sustain their revenue. As minimum wage increases, support staff like runners, bussers and expo positions will have to be limited or eliminated. Full-service restaurants will be unable to operate as they have in the past if they have multiple non-revenue generating support on staff.

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◆ How important is it to train restaurant staff on workplace legal matters such as discrimination and harassment issues before they become lawsuits?

WEINSTEIN: This is critical. Optimally, all restaurant staff would receive training about laws protecting against discrimination and harassment. Legal counsel can advise on training sessions and materials, as can human resource consultants. Restaurant managers are the first line of defense because they are on the ground enforcing the restaurant's policies. In smaller operations without a full-time HR staff, and when problems occur outside of traditional business hours, typically managers handle the bulk of the personnel issues and field complaints of discrimination or harassment. If the manager does not know what the law is, or has not been trained on how to handle issues as they arise, complaints can quickly escalate into litigation.

HAGAN: In California, it has never been more important to have an updated and mandatory training program for all employees. A complete workplace discrimination and harassment program with assessments, can help create a better environment for all employees as well as providing supporting evidence of good practices in case any issues arise.

◆ How do you see technology (kiosks, mobile, etc.) impacting guest service in the restaurant sector?

HAGAN: Technology will have an immense effect on the Food Service industry. Diners, especially in the quick service space, are moving toward a more frictionless experience. Mobile ordering for pick up is fast becoming the norm as large chains like Starbucks are experiencing rising sales by providing this convenience. 27% of transactions at Starbucks are made with the mobile ordering app. As employee wages continue to rise, kiosks will grow in popularity with quick and fast casual food service operators (example: McDonalds). This enables them to provide quick service to the guest while offsetting high employment costs.

WEINSTEIN: Technology is key for the restaurant sector. Technology drives the omni-channels for delivery of food such as on-site, pick-up, catering, and off-premises delivery. Technology drives consumer personal data security, employee scheduling, back of the house preparation, and handling of food orders, all impacting guest service. This requires that restaurants must adopt comprehensive cyber security policies and procedures to evidence due care for customer data. Technology connects every component of operations to increase speed, improve consistency, provide real-time visibility into business operations, and respond more quickly to customers. Customers use smart phone apps to engage brands and make purchase decisions, and restaurants must embrace apps that allow customers to engage socially on different platforms, improve online customer experience and allow customers to decide the delivery method. Soon apps will allow customers to pre-order and dine at the restaurant, all of which will drive throughput efficiency and table turnover.

◆ How has social media played a role in the food and beverage industry?

HAGAN: The greatest impact in dining has been the shift away from "expert" recommendations to social media review apps and websites. A Boston consulting group survey showed that 53% of millennials use a mobile device to read consumer reviews (yelp, etc.) to help decide how and where to spend their money. It is important that food service operators are monitoring the trends and become part of the conversation.

◆ What is the top cyber-related concern for the food and beverage industry?

KOTTON: Cyber risks for the food and beverage industry are top of mind not only businesses themselves, but also to the public. The federal government considers the food and agriculture sector as one of America's twelve critical infrastructure sectors, meaning its security is critical to national security. The food and beverage supply chain is vulnerable to insecure remote access by hackers, malicious software, outdated security policies, and lack of staff training, among other risks. In addition, consumers are providing troves of personal data when they buy food, beverages or meal kits both online and on their mobile devices, creating new entry points for hackers. New risks can also arise when restaurants or distributors partner, as corporate information can be exposed while moving between different companies' IT platforms. Now, grocery stores and food suppliers alike need to consider how to protect not only corporate data but also their customers' personal information.

◆ What is a good piece of advice you would share with an entrepreneur entering the food and beverage industry for the first time?

SNYDER: Start with defining your values and build them into your business plan. In California, especially, value-based companies attract value-based customers who are willing to pay more for products that reflect their beliefs. This is a rising market segment, and it has a promising future.

KOTTON: Today, the food and beverage industry can often feel saturated as both local entrepreneurs and industry giants compete for market share. Capacity growth and labor constraints indicate a softer market in 2017, which means that entrepreneurs should appear confident, yet move slowly into the space. Entrepreneurs need to identify and amplify their differentiating factor. Look to successful food and beverage companies that fill underserved niche markets or depart from industry norms. The delivery service market is also heating up, and despite labor and cost obstacles, these services provide a new revenue stream, a wider market and digital benefits for new businesses. Finally, organizing a solid tax plan can never hurt. Entrepreneurs should be sure to take advantage of tax benefits such as the FICA Credit, the Work Opportunity Tax Credit, and fixed asset benefits such as those involving favorable tax treatment for repairs and remodels.