

# Why Do Restaurants Fail? Part III: An Analysis of Macro and Micro Factors

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# WHY DO RESTAURANTS FAIL? PART III: AN ANALYSIS OF MACRO AND MICRO FACTORS

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## **Why Do Restaurants Fail? Part III: An Analysis of Macro and Micro Factors**

Restaurants are a significant part of American life. According to the National Restaurant Association (2009), total revenues for the restaurant industry exceed \$580 billion with nearly 1,000,000 operating restaurants in the US; providing jobs for over 13 million people. The sizeable economic impact of the restaurant industry can be measured by the 4% contribution it makes to the Gross Domestic Product in the United States. In addition, the restaurant industry has been expanding at a steady rate of 2 to 4 % over the past three decades. In 2009, despite the economic downturn, the restaurant industry grew by 2.5% (NRA, 2009). The restaurant and foodservice industry continues to be one of the largest private sector employers in the United States with a projected increase of 1 million jobs by the year 2020 ([www.restaurant.org](http://www.restaurant.org) ). In 2010, the restaurant industry added 24,000 new jobs and nearly 84,000 jobs in first three quarters of the 2010 ([www.restaurant.org](http://www.restaurant.org) ). With one in three Americans having worked in this industry at least once in their life time and two in five agreeing that ordering food from restaurants make them more productive in their daily life, restaurants are an integral part of American society.

In spite of its sustained growth over the past three decades, the restaurant industry has experienced one of the highest business failure rates. According to the Dunn and Bradstreet report (2001), the restaurant industry has one of the highest business failure rates among the retail and service industries. Erroneously, American Express has estimated that 90% of restaurants fail in the first year. A study by Parsa, Self, King and Njite (2005) showed that the restaurant failures are in fact under 30% during the first year of operation, and although individual failure rates may rise by the third year of operation, they do not achieve the levels

reported by American Express. Other studies by Self (2004) using data from California have shown that restaurant failures are also less than 30%. The National Restaurant Association of US recognizes a 30% failure rate as the norm in the restaurant industry.

Even the well established and commonly accepted 30% failure rate during the first year of operations is still unacceptable as it has significant economic impact. According to the National Restaurant Association (2010), there are nearly 1,000,000 restaurants in America and the average growth rate for the industry is 2 to 4% per year. That means, by taking the average of 3% growth rate per year, 30,000 new restaurants are added every year in this industry. If the restaurant failure is 30% during the first year of operation, then 9,000 restaurants fail every year in America. According to the National Restaurant Association, average revenues per year per restaurant are about \$580,000. Then there is a potential loss of \$5.20 billion in the form of lost restaurant revenues to the national economy. In addition, restaurant failures also lead to the loss of nearly 40,000 jobs per year as estimated from the National Restaurant Association statistics. The annual restaurant failure rate of 9,000 units per year would also precipitate the loss of invested capital of \$3.2 billion per year in failed restaurant units at a rate of 60% of estimated annual sales considered as the initial investment. Thus, many restaurant entrepreneurs and their investors are also expected to experience extensive economic hardships as a result of restaurant failures. These facts clearly indicate that restaurant failures are a significant factor to consider for their economic impact and its impact on lives of American entrepreneurs.

Restaurant failures have been an enigmatic topic for many decades. In our earlier reports titled *Why Restaurants Fail? Part I and Part II*, we presented empirical data in order to accurately establish restaurant failure rates. In the current paper, we would like to identify the various factors that contribute to restaurant failures. An extensive review of factors that contribute to

restaurant failures would help future researchers to empirically test the role of the different factors that contribute to restaurant failure. This study is designed to meet that objective.

Factors that contribute to restaurant failures can be divided into two major types: 1) Macro factors and 2) Micro factors. This next section first identifies the macro factors that contribute to restaurant failures followed by a description of micro factors that have been identified. A word of caution is warranted here. These macro and micro factors are specifically drawn from the American context, thus, they may or may not be appropriate for other parts of the world.

## **Macro Factors and Restaurant Failures:**

### **Economy:**

Economic factors have a significant role to play in the survival and success of restaurants. Restaurant expenditures are partly dependent on the availability of disposable income of families or individuals. However, this is more accurate in the case of families than single individuals. During recessionary times, consumers experience reductions in disposable income which leads to decreased spending at restaurants resulting in the loss of revenues and eventual failures for restaurants. The opposite becomes true during economically prosperous times where increased disposable incomes lead to greater spending at restaurants, and thus higher levels of success of restaurants as a whole. This is evident by the fact that most national chain restaurants in the US have their beginnings in the prosperous, post-war times of the 1950s, followed by the 1960s, and again in the 1990s. Similarly, high unemployment and recessionary times experienced in the 1940s and early 1980s have resulted in high failure rates in the restaurant industry as did the recessionary times of early the 2000's spurred on after 9/11, the infamous 2001 terrorist attack on the United States.

**Legislation:**

Federal and local legislation could also impact the course of the restaurant industry. Obviously, federal government legislation tends to affect the industry more severely than local legislation. Numerous examples are available to support this proposition. The Prohibition Act of 1919 led to the boom of the restaurant industry. In order to avoid being shut down, most alcohol serving taverns became food offering restaurants quickly. Thus, the 1920's is called the 'Golden Age' of the restaurant industry in the US. At the same time, numerous full service restaurants and hotels experienced significant loss of revenues as a result of the loss of alcohol sales which at the time contributed approximately 25% of the total restaurant sales.

In similar fashion, when the federal government changed the deduction for business meals from 100% to 25%, it significantly and negatively affected the restaurant industry especially for those establishments that depended on business lunches and corporate accounts. Likewise, legislation such as anti-smoking legislation, minimum wage legislation, the American Disability Act, nutrition labeling legislation, trans-fat legislation, the Accelerated Depreciation Act, etc. had profound effects on this industry in terms of increased costs and/or decreased revenues.

Just as federal legislation does, local ordinances and legislation also contribute to restaurant failures. When several city councils adapted the use of parking meters in downtown areas as a source of new revenues, downtown restaurants experienced a steady loss of customers for lack of free parking, or an increase in costs for paying for or providing for customers' parking, and some of them eventually closed their downtown units. Similarly, local zoning ordinances restricting the use of downtown areas by tenant /activity type or hours were found to have significant negative effects on restaurant profits.

**Climate and Natural Events:**

Climatic changes also have significant impacts on the restaurant industry. For example, many seafood restaurants are facing the challenge of finding economically viable sources of quality sea food for their restaurants because of loss of seafood breeding grounds. Weather factors are known to influence the prices of commodities thus resulting in significant economic losses to the restaurant industry. This has been seen in periods when a freeze in Florida has affected the price of orange juice, or loss of a coffee crop in Brazil affects coffee prices, etc. In global markets, events like Mad Cow disease in England, Avian Flu in China etc were found to affect the restaurant industry significantly. Recently, the 2010 oil spill tied to the BP Oil Company in the Gulf Coast of Florida has resulted in significant losses of revenues for the restaurant industry. Local businesses were impacted by reduced sales within their local markets as well as regional and national accounts due to the fear of contamination for seafood harvested from the oil impacted area. As a result of the presumed impact to the quality of local seafood, as well as the impact to the area as an attractive beach destination, numerous restaurants were closed because of the BP oil disaster.

**Regional and Urban Planning:**

Regional and urban planning activities have unintended significant impacts on the restaurant industry. Because the restaurant industry depends highly on the convenience factor as a criterion in consumer selection, changes in traffic patterns can significantly impact the restaurant industry unintentionally. As regional and urban planning strategies are designed and implemented, the traffic patterns are expected to change. When that happens, the restaurant industry is at the mercy of the changing traffic patterns. For example, when a new highway was built in Louisville, Kentucky (USA), Colonel Sanders, founder of Kentucky Fried Chicken, lost



his restaurant and motel business at the original site. Similarly the city of San Francisco has placed numerous restrictions on quick service restaurants in selected locations as a part of their urban planning affecting several independent and chain restaurants.

### **Changing Cultural Factors:**

Changing cultural and demographic factors were also noted as significant factors in the rise and fall of restaurants. As Americans continue to become increasingly health conscious, restaurant menus are also expected to change accordingly. As result, some segments of the restaurant industry were expected to experience high failure rates. This can be observed by the steady decline in hot dog restaurants, donut shops, budget steak houses, etc. as a direct result of changes in American demographics and cultural changes. At the turn of the century, hot dogs were the most popular menu items in America. The popular hot dog was replaced by the hamburger as the top choice by the 1950s, and eventually giving way to pizza in the 1980s and 1990s. As these cultural changes took root, restaurants have experienced significant losses and eventual failures. Many hamburger restaurants were forced to diversify by adding non-beef products. Many donut shops were closed as the demand for donuts steadily declined. And Hot Dog restaurants that once were ubiquitous in America are a rarity now; contributing to the loss of several well known Hot Dog restaurants.

### **New Competition**

During the past twenty years, fast food and casual fast food operators have fallen prey to non-traditional competitors including grocery stores/supermarkets and C-stores (convenience). The grocery store/supermarkets now feature their ready-to-eat bonanza of everything from rotisserie chicken at Publix, Kroger and Wal-Mart to upscale seafood, hors d'oeuvres, sushi and fine culinary delights from Whole Foods and Wegman's. The local C-store/gasoline station

offers hot and cold subs, fried chicken, pizza et al.

A new report from Packaged Facts titled “Prepared Foods and Ready-to-Eat Foods at Retail: The New Competition to Foodservice.” The report surveyed 1,881 U.S. adult consumers and found that half of respondents were more likely to eat dinner at home than they were three months ago, while 64 percent reported purchasing ready-to-eat or heat-and-eat food from a grocery store within the last month. The study predicts that supermarket prepared foods will grow to \$14 billion by 2011, largely motivated by consumers migrating away from restaurants during the recession in search of value and one-stop-shop convenience.

## **Micro Factors and Restaurant Failures**

### **Capital:**

One of the most commonly cited factors that contribute to restaurant failures is the lack of capital. The restaurant industry is known to have low entry and exit barriers. Thus, most restaurant entrepreneurs try to enter this industry with low capital because the entry barriers are low. As a result, most entrepreneurs enter this industry with enough capital to open the restaurant doors but not enough to sustain the first few lean months of a restaurant’s life span. Consequently, the entrepreneurs may not even have the resources to market their business as they should when revenues fall short. According to various studies and the Small Business Administration, lack of capital is one of the primary reasons why restaurants fail.

### **Location:**

The choice of location is expected to have significant impact on the success or failure of a restaurant. Success of a location depends not only on its physical site, but also its surrounding demographics. In other words, location is a complex construct that encompasses geographic, as

well as demographic and psychographic variables. Any changes in geographic or demographic/psychographic variables of a specific location could have significant impact on the attractiveness of a location. For example, Kahiki Restaurant located in Columbus, Ohio was ranked as one of the Top 100 restaurants in the US. It was visited by several Hollywood and national celebrities as a destination restaurant. Over next three decades, this particular location continued to become less attractive as the affluent of the neighborhood moved, leaving empty spaces, vacant houses, and 'brown fields'. Eventually Kahiki was closed for good as the location became impossible to operate profitably. In this case, the geographic factors of the location did not change much, but the demographics changed; resulting restaurant failure.

In another situation, a restaurant in Ohio was forced to close its operations after operating nearly 20 years in the same location. In this case, the demographics actually improved over the 20 years making the location very attractive. However, as this small town grew, the city government decided to build embankments on both sides of the road to improve public safety. These embankments totally obscured the restaurant from customers' view. As a result, customers were forced to go to the next traffic light and take a turn to visit this restaurant; compromising the convenience factor which is so important for the industry. This restaurant was closed eventually due to reduced patronage as a result of the lack of visibility.

### **Quality of Life**

The quality of life in the restaurant business is a real challenge. Most restaurateurs are known to work 60 hour work weeks compromising their quality of life and sacrificing their family lives. As documented by Parsa et al (2005), quality of life is one of the primary factors in the closings of most restaurants. Most restaurants are busy when other businesses are closed –

evenings and weekends. This situation forces restaurateurs to sacrifice their family time; placing a strain on their familial bonds. This strain eventually compromises the quality of life of restaurant owners leading to the closure and loss of restaurant business.

### **Entrepreneurial Incompetence:**

Most restaurateurs enter the restaurant business as entrepreneurs chasing the dream of owning their own business. Some of the motivating factors to enter the restaurant business are the attractiveness of low entry barriers; passion for the product; unique product attributes they have developed (secret recipes); experience in the field; an opportunity to purchase a business at an attractive price; (over) confidence in one's ability to perform better than the previous owners of the business; a good match between individual skills and business opportunity etc.

Unfortunately, in most cases, an entrepreneur's passion exceeds one's competence. They may possess necessary technical skills that may only be good enough to open the business, but may not have the necessary business acumen to understand the intricacies of marketing, accounting, finance, legal matters, human resources etc. In other words, most restaurateurs may be excellent entrepreneurs but not necessarily have the skills to succeed as business managers. In other words, entrepreneurs may not have the skill sets to transform themselves from entrepreneurs to professional business managers, which also often results in restaurant failures.

### **Experience**

Most restaurant owners may lack the necessary prior business experience to manage their restaurants. Lack of prior experience in a related field makes new restaurateurs more vulnerable to failures. According to a recent study by King (2002) employee theft is one of the primary reasons why some restaurants fail. The owner did not have enough knowledge or experience in the field to control employee theft which eventually led to the closing of the restaurant. In

contrast, most successful restaurateurs tend to have prior industry or related experience as in the cases of Dave Thomas of Wendy's; Howard Shultz of Starbucks (who studied 500 coffee houses located in Italy prior to opening any of his coffee houses); Colonel Sanders of KFC etc.

### **Leadership**

Obsession with Product and Service Quality is a recipe for success in the restaurant industry. This obsession applies to fast food, casual, upscale or fine-dining. The restaurant operator must maintain a pulse on guests' likes and dislikes at all times by constantly asking the guest for "complaints" – how can we be your favorite restaurant and make you a fanatically loyal repeat guest? When the operator demonstrates this approach to the business, the employees will reflect the same attitude. This infectious attitude will make the difference between success and failure.

### **Ability to Create/Build the Brand**

During the past ten years, more and more "corporate refugees" have left the corporate world to become entrepreneurs. They set-up shop for themselves and try to make a go of it - even in this economic environment. More power to them! Because of the proliferation of small business restaurant owners, they often lack the basic branding skills necessary to thrive in the competitive world of restaurants. The competition (especially with the mega chains) is too fierce to not focus on the basic 12 Ps of restaurant branding: Place, Product, Price, People, Promotion, Promise, Principles, Props, Production, Performance, Positioning and Press. The operator frequently does not consider incorporating all five senses into the restaurant brand to create trial use – triggering moments of truth that resonate emotional chords in the brain of the guest. Only by consistently obsessing over the 12 Ps in order to brand (short, mid and long-term marketing)

will the restaurant have a chance to capture repeat and referral disciples. A sampling of these critical branding concerns follows.....name, design and concept.

### **Name of a Restaurant:**

An analysis of 1,800 restaurant names by the authors has revealed that a typical restaurant name has 13 letters comprising of 8 consonants and 5 vowels. The name of a restaurant makes a difference in the success or failure of a restaurant. A restaurant name should be different and at the same time descriptive. Restaurant names should be brief enough to remember and consumers should be able store them in their short term memory. When a restaurant name is too long and not descriptive enough, then that restaurant is less likely to succeed. A restaurant with a name that is brief, descriptive and attractive is more likely to succeed. For example, the well known restaurant company *Kentucky Fried Chicken* has changed its name to *KFC* to avoid emphasis on its frying production method which was perceived as being less healthier. Another independent owner has changed his restaurant name from the too long and overly descriptive name, *Cameron's Contemporary American Cuisine*, to a brief, but memorable name - *Cameron's*; a hamburger chain, *Wendy's Hamburgers*, simply became *Wendy's*, deemphasizing its hamburger business as it added chicken and other non-beef items. From the retail industry, Walton Mart has changed its name to Wal-Mart; General Motors became GM; British Petroleum became BP; International Business Machines became IBM; National Cash Register became NCR, etc. Some companies change their names to hide their national identity or the origin of the product when they enter global markets.

### **Design and Layout:**

Success or failure of a restaurant depends partly on the physical layout and architectural design of restaurants. Design failures of restaurants lead to operational inefficiencies and

eventual loss of competitive edge, ultimately leading to financial losses. Architectural limitations were found to be one of the major factors in restaurant failures especially in urban settings, and some of the architectural limitations in restaurants have even resulted in the greater failure of the business. Inadequate production or storage space is one of the most common complaints in hotel foodservices. A major hotel near the convention center in Orlando, Florida was forced to forego some of the restaurant business as its facilities were not designed in proportion to the hotel size. The production area was too small to accommodate the necessary capacity seating. As a result, some of the customers were forced to choose other restaurants nearby. Similarly, a major pizza restaurant in Fayetteville, Arkansas was forced to new build a 'dumb waiter' to bring its supplies from the basement constantly. After several years of continued operations in that location, this location was closed and the restaurant was moved to a better location to meet its storage needs.

### **Taj Mahal Syndrome:**

Most restaurant entrepreneurs often forget the fact that a restaurant is a business that is meant to achieve specific financial objectives. Like all other businesses, restaurants are also expected to result in positive financial outcomes with reasonable returns on investments (ROI). Restaurants that do not deliver these objectives are bound to take the path to a restaurant cemetery. To put things in a historical perspective, the monument Taj Mahal of India was not built as a place to live or a palace to visit. The King Shah Jehan wanted to build a memorial for his wife who died at a young age of 39 after giving birth to several children. The construction of Taj Mahal took so long that even the King Shah Jehan did not live long enough to see the completion of it. Eventually he was also buried in the same place next to his wife.

Similarly, most restaurateurs often get carried away with their own grandiose plans and creative ideas for their restaurants. They tend to invest every last penny they have in building a

monument instead of constructing a realistic, practical and financially feasible place of business. For example, two entrepreneurs in Columbus, Ohio spent over 1.5 million of borrowed money in remodeling an old bank structure with Greek gothic columns and incredibly high ceilings into a destination restaurant. They spent so much money on remodeling the old bank building that they did not have any money left for marketing the 'Taj Mahal' they just built. Within six months this particular restaurant was closed for lack of marketing efforts and eventual lack of consumer awareness. This gorgeous building still remains vacant.

### **Concept:**

Fields (2007), poor concept that is not differentiated is one of the primary reasons for restaurant failures. When a restaurant is not differentiated from the competition, then consumer acceptance of that concept is bound to wane quickly after the excitement of a 'new kind on the block' attraction fades. Simple 'cookie cutter' imitation of another concept does not have the staying power. Most imitations are bound to fail quickly as it happened in case of White Towers restaurants that imitated White Castle; Andy's and Cindy's restaurants that copied Wendy's; Burger Chef and Burger Queen that imitated other major hamburger chains etc.

Undifferentiated concept is symptomatic of bankruptcy in entrepreneurial innovation. Restaurant concepts that focus on imitation and 'me too' concepts do not have the skill sets to face the challenges of continual adaptations that are essential to survive in the restaurant business.

### **Controls**

According to the National Restaurant Association (2009), a typical restaurant in America earns a net profit under 10%. That means 90% of revenues are used to defer the cost of doing business. Thus, managers that do not understand the importance of cost controls are bound to fail



in the restaurant business. Two major costs in the restaurant industry are food cost and labor cost. These two costs together are referred to as prime costs. For a restaurant to succeed, the prime costs are expected to be less than 60% of revenues. It is a 'rule of thumb' and a good rule to follow. Most restaurants that have failed often were found to have prime costs exceeding 60% indicating greater potential to failure.

For example, a popular celebrity restaurant in Buffalo, New York has reported food cost exceeding 56% which is almost twice the industry average. It is needless to say that this particular restaurant has failed within 2 years of opening because of poor cost controls. Similarly the failure of a popular nationwide restaurant chain, Vitoria Station, was attributed to its high food cost resulted from selling prime ribs on its menu.

### **High Fixed Costs:**

Unfortunately some restaurateurs are tempted by the attractiveness of a location so much that they are often willing to pay unrealistically high rent for a location. The attractiveness of a location should always be tempered by the realities of the rent paid. Unrealistic rent, a fixed cost, does not change when revenue change. When revenues decline and do not meet the financial objectives, the fixed costs continue to remain constant and become a major financial liability. This case is true especially in down town locations and tourist attraction places. The rule of thumb for rent/lease/mortgage fixed cost is 7-9% of revenues.

In summary, a variety of factors have been identified as contributing to the approximate 30% failure rate of restaurants in their first year. Restaurant failures are contributing over \$1.78 billion in potential revenue loss to the American GDP. A better understanding of this phenomenon is highly desirable. Given the reach of the restaurant industry for consumers'

employment and enjoyment, as well as the positive impacts to the nation's GDP, this topic warrants further research and study.

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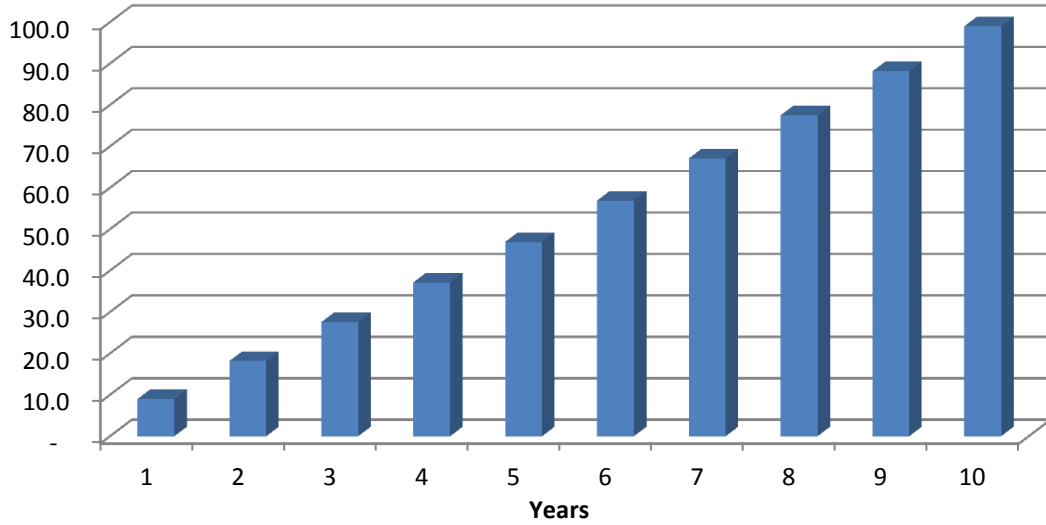
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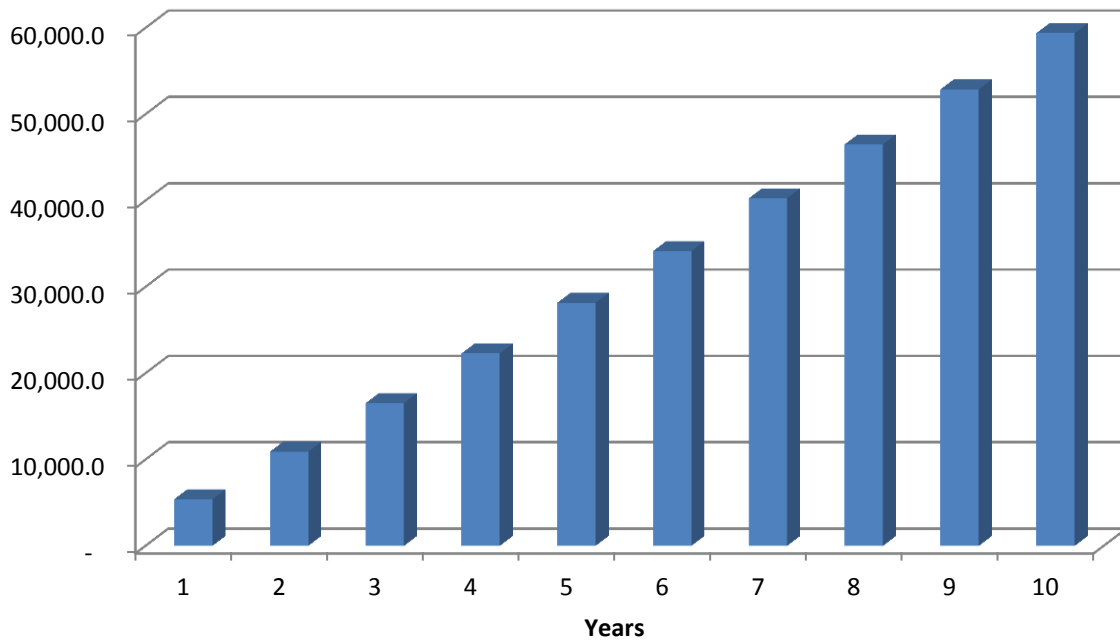
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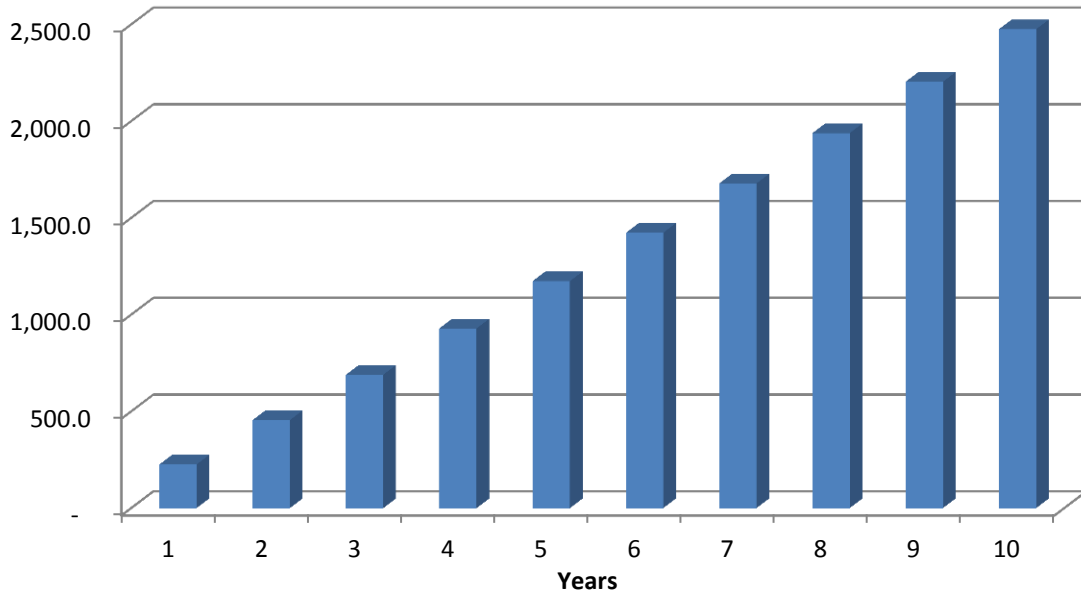
### Cumulative Number of Restaurants Failed in Ten Years (in 000's)



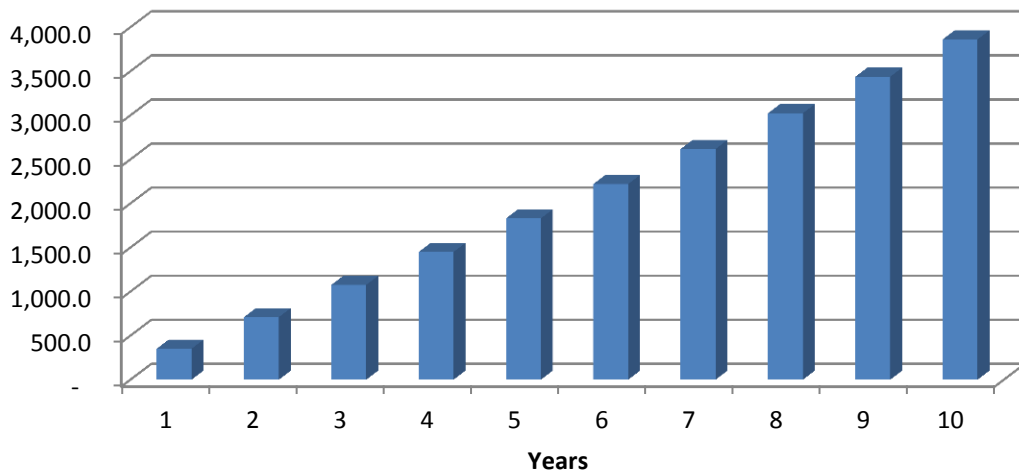
### Cumulative Restaurant Revenues Lost in Ten Years (in \$000's)



### Cumulative Jobs Lost in Ten Years (in 000's)



### Cumulative Tax Revenues Lost in Ten Years (in \$000's)



## Cumulative Investment Lost in Ten Years (in \$000's)

