THE GOOD EGG

What was to be done with the acquisition of a 20-unit restaurant company: The Good Egg?

“Now what?” Ken pondered as he stared out the window on his flight back from Phoenix having just closed on the acquisition of a 20-unit restaurant company: The Good Egg. Ken Pendery, the CEO of the First Watch restaurant chain for the last 30 years, had just recently grown the company by 20% in one fell swoop. But what was he to do with these Arizona restaurants located more than 1,000 miles from the nearest company-owned First Watch...convert them to First Watch, leave them be, institute the First Watch menu but leave The Good Egg flag...?

Ken understood that the decision regarding what to do with The Good Egg brand would have far-reaching consequences. The purchase and conversion to First Watch of two J. Christopher’s restaurants in Atlanta 18 months earlier had not gone as planned. Part of the predecessor’s loyal customer base defected, sales fell by nearly 20%, and the company struggled for the next year to restore sales and profits to pre-conversion levels. If The Good Egg were to have the same fate upon conversion, the results would be devastating for the company and the management team. Recognizing that The Good Egg was the most highly-penetrated breakfast, brunch, and lunch brand with 15 locations in Phoenix and 5 in Tucson as well as a 30-year operating history made the decision even more precarious.

The reasons for conversion were clear in Ken’s mind. First Watch had 10% higher average unit sales volumes than The Good Egg. Additionally, having 20 newly-converted First Watch restaurants would provide a foothold in the West, further expanding the brand’s presence. Finally, upon the inevitable sale of First Watch by its private equity group, the valuation of First Watch would be enhanced if those 20 restaurants were converted to First Watch as opposed to selling two disparate brands.

Allowing The Good Egg to simply continue to operate independently would provide a predictable, stable revenue and profit stream, and remove the possibility of conversion loss as was realized in Atlanta. Straying from this strategy posed the possibility of considerable upside potential, but also significant downside risk.

This would be one of the most pivotal decisions Ken would have to make as CEO and the decision consumed him for the remainder of his 5-hour flight back to Sarasota.

1 Copyright © 2016, Chris Olson. This case was prepared for the purpose of class discussion, and not to illustrate the effective or ineffective handling of an administrative situation. Names and some information have been disguised. This case is published under a Creative Commons BY-NC license. Permission is granted to copy and distribute this case for non-commercial purposes, in both printed and electronic formats.
U.S. Restaurant Industry

Today’s food service industry is a result of the industrial revolution (see Exhibit 1). Technological advances made possible the mass production of food products, speedier distribution of goods, climate controlled storage facilities, and more efficient cooking appliances. New and emerging methods of transportation (trains, automobiles, and trucks) created a significant demand for public dining establishments (www.foodtimeline.org/restaurants).

Beginning in the early 1970s, women began working outside the home at an increasingly higher rate which had a direct effect on food spending away from the home (see Exhibit 2). Young families with dual incomes but little time used restaurants as a replacement to cooking at home. This changing demographic created strong demand for the restaurant industry fueling increases in both sales and restaurant outlets through the 1980s and 1990s. In the early to mid-2000s, the percentage of women in the workforce peaked and then started to decline. Decreasing along with this was the rate of change in restaurant same-store-traffic as restaurant supply began to exceed restaurant demand. Same-store-traffic was a key metric in the restaurant industry defined as the percentage change in visitation for all restaurants open in the current and prior year.

By 2014, the restaurant industry was the 2nd largest private sector employer with 14 million employees and industry sales topping $700 billion. There were over 1 million restaurant locations in the United States where spending accounted for over 50% of every food dollar spent (National Restaurant Association).

While it was sometimes difficult to distinctly categorize a restaurant brand and its food and service offerings, the restaurant industry could be subdivided into two classes, limited service and full service, and a number of different segments within each class.

Limited Service Restaurants

Limited service restaurants comprised 55% of industry sales and included the quick service segment and the recently emerged fast casual segment.

Quick Service

Quick-service (fast food) restaurants provided foodservice where patrons generally ordered or selected items and paid before eating. Food and drink could be eaten on premises, taken out, or delivered. The average per-person dinner was $3-$6. Examples of traditional quick-service restaurants included: Pizza Hut, Taco Bell, KFC, Hardee’s, Wendy’s and Carl’s Jr. While the quick service segment’s share of limited service sales at 85% dwarfed that of its newer member, they had been consistently losing share to this emerging fast casual segment.

Fast Casual

The burgeoning fast-casual segment of restaurants served freshly prepared, wholesome quality, authentic foods in a reasonably fast service format. The average per-person dinner was $7-$9. Examples of fast-casual restaurants included: Chipotle, Five Guys, Panera, Panda Express, and Pei Wei. While making up only 15% of limited service sales, fast casual restaurants had seen their sales growth consistently outpace that of quick service and continued to steal their market share as consumers clamored for a better limited service experience.
Full Service Restaurants
Full service restaurants made up the balance of industry sales at 44% (save 1% for the bar/tavern category) and included the family dining, casual dining and fine dining segments.

Family Dining
Family dining full-service restaurants provided serving staff and orders were taken while the patron was seated. The average per-person dinner was $10 or less. Members of this group were fairly diverse and included 24-hour operations, diners, daytime-only restaurants, and budget steakhouses. Examples of this segment included: IHOP, Denny’s, The Egg & I, Steak-n-Shake, First Watch, and Ponderosa.

Casual Dining
Casual dining full-service restaurants provided serving staff and the order was taken while the patron was seated. The average per-person dinner was $10- $25. Examples of this segment included: Chili’s, Olive Garden, Red Lobster, TGI Friday’s, Macaroni Grill, and Outback Steakhouse. The casual dining segment was hit hard by the great recession and, coupled with the emergence of the fast casual segment, had seen same-store-traffic declines of 2% per year since 2009. To compete, this segment relied heavily on discount promotions (i.e., buy one get one free/2 for $20) and limited time menu offerings.

In terms of price point, the top end of this segment had been further defined with the tag of “polished” casual dining. Examples of polished-casual restaurants included: Bonefish Grill, Season’s 52, Brio, Kona Grill and Houston’s.

Fine Dining
Fine dining full-service restaurants provided serving staff and the order was taken while the patron was seated. The average per-person dinner was $25 or more. Examples of fine dining restaurants included: Ruth’s Chris Steak House, McCormick & Schmick’s, Morton’s Steakhouse and Ocean Prime. This smallest player in full service restaurants was hit hardest by the great recession with negative traffic in the mid to high teens in consecutive years, but has since rebounded (along with the stock market) to pre-recession traffic levels.

Breakfast, Brunch and Lunch Sub-Segment
Also known as the “daytime-only” sub-segment of the Family Dining segment, the breakfast, brunch and lunch (“BBL”) sub-segment was characterized by restaurants that were open only for the breakfast, brunch and lunch meal periods and elected to forego offering dinner service often closing by late afternoon and operating 7 ½ to 8 hours a day.

First Watch Restaurants, Inc.
The company’s name was based on a nautical term used in dividing the 24-hour work day on a ship into six four-hour “watches:” middle watch, morning watch, forenoon watch, afternoon watch, dog watch, and first watch. Ironically, the first watch begins at 8:00 p.m. and ends at midnight, yet First Watch was a daytime-only café. First Watch operated in the breakfast, brunch and lunch sub-segment operating between the hours of 7:00 a.m. and 2:30 p.m.
Company Overview

*First Watch* was a full-service restaurant chain operating in the family dining segment of the restaurant industry. First Watch specialized in award-winning, made-to-order breakfast, brunch and lunch including traditional favorites, such as omelets, pancakes, sandwiches and salads, and unique specialty items like the Chickichanga, Pesto Chicken Quinoa Power Bowl and Fresh Fruit Crepes (see Exhibit 8). All menu items were freshly prepared to order and the restaurant did not use deep fryers or heat lamps. The entire menu was available seven days a week from 7:00a.m. to 2:30p.m. Guests were offered complimentary newspapers and free Wi-Fi Internet access (http://www.firstwatch.com/).

The first restaurant opened in 1983 in Pacific Grove, California. At that time, there was no breakfast restaurant-focused category. The company was founded by John Sullivan, a restaurant veteran and co-founder of *Le Peep Cafe*, also a breakfast, brunch and lunch concept founded in Denver, CO in 1981. One of those co-founders, Ken Pendery, joined John Sullivan in opening the second First Watch and remained as *First Watch’s* CEO for over 30 years.

In 2014, *First Watch* was the largest and fastest-growing daytime-only restaurant concept in the U.S. with more than 130 restaurants in 17 states (see Exhibit 7). It also operated 20 restaurants under *The Good Egg* name in Arizona and one *Bread & Company* restaurant in Nashville with another under development.

*First Watch* has received more than 200 “Best Breakfast” and “Best Brunch” awards. The company was named a 2013 “Next 20” Emerging Brand by *Nation’s Restaurant News*, a 2014 Top Franchise Value by *FSR Magazine*, the recipient of the 2014 MenuMasters Award for Best Healthful Innovation for its Quinoa Power Bowl and was the 2015 Consumer Picks award winner in the family dining segment from a Nation’s Restaurant News survey (see Exhibit 3 and Exhibit 6).

Strategic Plan

In December 2011, a majority interest in *First Watch Restaurants, Inc. and Subsidiary* was purchased by *Freeman Spogli*, a private equity firm (see Exhibit 4). At that time there were 79 company-owned restaurants and 12 franchise-owned restaurants in 13 states.

The company’s five-year plan developed shortly thereafter called for growing company-owned restaurants to 200 locations and growing franchised-owned restaurants to 100 locations. Company-owned development goals would be achieved through a mix of acquisitions and organic growth--sourcing real estate, negotiating leases and making investments in furniture, fixtures, and equipment as well as improving the leased space. Acquisitions could involve acquiring a lone operating restaurant, an operating restaurant company with multiple locations which may or may not be a direct competitor, or simply acquiring a lease from a tenant with suitable space to build-out a restaurant. Franchise development goals would be achieved through existing franchisees fulfilling the development commitments outlined in their franchise agreement, and selling additional franchise territories and development rights to prospective franchisees.

Demonstrating the ability to grow the number of restaurant outlets, particularly in new states, was pivotal to enhancing the company’s ultimate value. In addition, being able to grow a stable and comparatively less risky stream of royalty payments would inordinately enhance the company’s valuation multiple.

The Good Egg Acquisition

In mid-2013, the company was presented with an opportunity to purchase a 20-location, breakfast, brunch, and lunch restaurant chain located in Arizona called *The Good Egg*. *The Good Eggs* were full-service restaurants operating in the family dining segment of the restaurant industry and were open...
between the hours of 6:30a.m. and 2:30p.m. Founded in 1983, the company grew to 15 restaurants in metro Phoenix and five others in southern Arizona over a 30-year period. The principal of the closely-held company was interested in monetizing his long-held investment and pursuing new investment opportunities.

The acquisition opportunity fit well with the company’s strategic plan of growth through acquisition and the company felt that the underlying real estate for The Good Egg restaurants was superior to that of First Watch. However, the company also believed that having “egg” in the brand name served to stymie lunch sales and that their lunch offerings could be more compelling (see Exhibit 9). In addition, The Good Egg catered to an older demographic while First Watch was seeking to attract younger diners with a more contemporary menu and fresh look with its “urban farm” remodel program.

Following exhaustive due diligence, the company closed on the acquisition in February 2014.

Post-Acquisition Options

Convert to First Watch in Every Way but Trade Name
One option for First Watch was to capitalize on the equity in The Good Egg name, but make it like a First Watch in all tangible respects. It could serve First-Watch food (with The Good Egg name on the menu) in a First-Watch-looking dining room (with a The Good Egg sign on the building) and also keep The Good Egg operating hours. This approach would avoid the potential of alienating its loyal customer base and impinging on the brand pride felt by its employees. Additionally, this would allow First Watch to further leverage its purchasing power (see Exhibit 5).

Convert to First Watch in All Respects
The Arizona market was not without First Watch restaurants. As many as four licensed First Watch restaurants had been in operation in the Phoenix/Scottsdale area over the last 30 years with three in operation as of 2014. The licensee was a former partner of Mr. Pendery in the original First Watch restaurant and secured rights to license the brand in the greater Phoenix area while Mr. Pendery headed east to plant the First Watch flag in Sarasota, FL in 1986. While not under the stricter supervision of a franchised First Watch restaurant, the brand was, at least, already established in the “Valley of the Sun” and enjoyed comparable average unit sales volumes as The Good Egg.

With 20 additional First Watch restaurants in Arizona, the company would further establish its presence in Arizona and the western United States, and could leverage its scale related to purchasing, advertising, human resources and accounting costs. In addition, upon the ultimate sale of the company to private investors or a public offering, the company would likely garner a higher valuation with a homogenous company of First Watches versus a portfolio of disparate “BBL” concepts. Finally, the typical First Watch restaurant enjoyed 10% higher sales than its The Good Egg counterpart. And those higher sales carried with them a 40% marginal profit rate.

Hybrid Approach
Given the total number of restaurants being acquired and in two distinct markets, the company could engineer a test to ascertain the effect of changing any or all components of one or more of The Good Egg restaurant locations. It could convert three restaurants in all respects, and convert three others in all but trade name and then monitor traffic and consumer perceptions versus the remaining unchanged
restaurants (control group). This approach would serve to reduce the exposure to an unfortunate reaction by loyalists, while also lowering the amount of capital being put at risk.

**Do Nothing**

There was no impending reason to convert *The Good Egg* to *First Watch*. *The Good Egg* was highly-penetrated in Phoenix and Tucson with a recognizable brand name, was well-trafficked, and had significant sales and cash flow. Being in the BBL segment, *The Good Egg*’s offerings and service style were similar enough to that of the company such that it could still bring operational expertise and purchasing synergies to *The Good Egg* under its current moniker. Under this alternative, the company would also avoid the capital expense of converting trade dress and signage to that of *First Watch*.

**Summary**

The acquisition of *The Good Egg* was not the company’s first acquisition. In the fall of 2012, the company acquired two *J. Christopher’s* restaurants in suburban Atlanta, GA—the company’s first restaurants in the Atlanta market. A significant part of the predecessor’s loyal customer base immediately defected and migrated to remaining *J. Christopher’s* in the market. Some customers did not even bother entering the building once they saw the new sign. Certain employees’ morale also soured as they donned a new polo emblazoned with *First Watch*, a brand previously foreign to them. As a result, sales fell nearly 20% and the company struggled over the next year to restore sales and profits to pre-conversion levels.

The question of what to do with *The Good Egg* was profound. *The Good Egg* represented 20% of the overall company and *First Watch* now owned an Arizona institution having served two generations of families in Phoenix. The geographic challenge of being a thousand miles away from the nearest company-operated *First Watch* was also a consideration and converting 20 restaurants to *First Watch* would pose a human resource challenge.

The upside, though, was clear. Without “egg” in the name, *First Watch* restaurants garnered 10% higher average unit sales predominately from lunch. In addition, having a homogenous portfolio of restaurants would certainly help with the exit valuation.

**Biography**

**Chris Olson** is the Senior Vice President of Finance at First Watch Restaurants, Inc. and a life-long student of the restaurant industry. He is currently enrolled in the Doctorate of Business Administration program at the University of South Florida. He received his M.B.A. from the University of Texas at Dallas and his undergraduate degree in Finance from Oklahoma State University. Olson is also a Certified Public Accountant licensed in the State of Florida.
Exhibit 1: History of the Restaurant

Origin
Derived from the French word *restaurer*, to restore, the origin of restaurants is credited to 18\textsuperscript{th} century France. The first French restaurants were unassuming, highly-regulated establishments that sold *restaurants*; meat-based consommés intended to “restore” a person’s strength if feeling ill. After the French Revolution, the monopolistic rights of the restaurant guild, which had been under license by the king since the Middle Ages, were abolished forcing the former chefs of the aristocrats to find new work serving the working masses. This development stirred the demand of French citizens who embraced the principal of egalitarianism knowing anyone could purchase a given meal if willing to pay the price. Enterprising French chefs capitalized on this swell by offering portioned dishes, prepared and priced to order, and merchandised on menus. The modern restaurant was born.

Source: http://www.foodtimeline.org/restaurants.html
Exhibit 2: Influence of Women in the Workforce on Restaurant Sales

Source: Developed by case writer.
### Exhibit 3: National & Regional Competitors in the Breakfast, Brunch and Lunch Sub-Segment (“BBL”)

<table>
<thead>
<tr>
<th>Name</th>
<th>Year Founded</th>
<th>No. Restaurants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Le Peep</td>
<td>1970</td>
<td>54</td>
</tr>
<tr>
<td>Jimmy's Egg</td>
<td>1980</td>
<td>42</td>
</tr>
<tr>
<td>First Watch</td>
<td>1983</td>
<td>126</td>
</tr>
<tr>
<td>The Good Egg</td>
<td>1983</td>
<td>20</td>
</tr>
<tr>
<td>Egg Harbor Café</td>
<td>1985</td>
<td>18</td>
</tr>
<tr>
<td>Egg &amp; I</td>
<td>1987</td>
<td>115</td>
</tr>
<tr>
<td>Another Broken Egg</td>
<td>1996</td>
<td>48</td>
</tr>
<tr>
<td>J. Christopher's</td>
<td>1996</td>
<td>22</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1985</strong></td>
<td><strong>445</strong></td>
</tr>
</tbody>
</table>

*Source: Developed by case writer.*
Exhibit 4: Freeman Spogli & Co.

Freeman Spogli is a leading private equity firm dedicated to investing with management in middle market companies in the consumer and distribution sectors.

Our firm was founded by Bradford M. Freeman and Ambassador Ronald P. Spogli in 1983 with the goal of investing capital in partnership with management teams to help build growth-oriented companies. Mr. Freeman and Ambassador Spogli were among the pioneers in the private equity business and raised the firm's first institutional equity fund in 1980. In its three decades in business, our firm has grown to over 25 employees in two offices and has invested $3.4 billion of private equity capital in 51 companies. We currently manage four investment funds totaling $4.0 billion in committed capital and have investments in 14 companies with total sales of $10 billion.

Criteria for Investment

Industry:
- Established companies in the consumer and distribution industries
- Includes retail, restaurants, direct marketing, e-commerce, consumer products, retail services and wholesale and business-to-business distribution

Transaction Types:
- Management buyouts, leveraged recapitalizations, corporate carve-outs and equity investments

Company Characteristics:
- Strong management teams
- Defensible market positions
- Platform for organic and acquisition growth
- Solid margins and free cash flow

Geography:
- North America

Company/Transaction Size:
- Companies with EBITDA of $10 million to $75 million
- Equity investments of $50 million to $150 million
- Transactions of $100 million to $750 million in total size

Source: http://www.freemanspogli.com/
Exhibit 5: Brands with Identical/Similar Offerings and Different Names

Restaurants
The notion of operating identical brands in all material respects but name is not a new phenomenon. After a 1999 merger between Checker’s and Rally’s, Rally’s adopted the Checker’s design and since then both Checker’s and Rally’s continued to offer a limited menu, had a similar restaurant design with a double drive through, and had very similar menu offerings.

In 1997 the parent company of Carl’s Jr. purchased Hardees. Both brands operated in the quick-service segment of the restaurant industry and catered to young males with significant appetites. Eventually, their trade dress and menu offerings became identical although they maintained a separate brand name.

Packaged Goods
In 1932, Best Foods bought its East coast rival, Hellman’s Mayonnaise. Both companies maintained their separate brand identities, as both had large market shares in their respective regions. It was not until 1968 when Best adopted the blue ribbon of Hellman’s, thus, merging the logos in all but name. To this day, both brands use the same commercials and advertisements but with switched names. Both products have the same ingredients, but loyalists swear to a different taste.

Masters Dreyer and Edy founded Edy’s Grand Ice Cream in 1928. When Mr. Edy left the business in 1947, Mr. Dreyer renamed the company in his likeness. When the company expanded to the East coast in 1981, the company decided to resurrect the trade name Edy’s so as not to confuse the brand with an East coast brand, Dreyer’s. To this day, the company operates under both brands in all respects but brand name.

Orowheat was founded in Hollywood, CA in 1932. Arnold Bakery was founded in Connecticut in 1940. In 1946, Brownberry was founded in Wisconsin. Arnold, Brownberry and Orowheat breads were all purchased by Bimbo Bakeries in the 2000’s. While all have distinct histories, they all now operate as divisions of Bimbo Bakeries, USA.
Source: Developed by case writer.
Exhibit 6: First Watch Accolades

- **Cincinnati**
  - “Best Breakfast”
  - 14th Consecutive Year!
  - “Best Brunch”
  - “Best Healthy Restaurant”

- **Orlando**
  - “Best Breakfast and Brunch”
  - “#1 Best Sunday Brunch”

- **Seminole County, Florida**
  - “Best Breakfast” in Seminole County for the 4th Consecutive Year!
  - “Best Brunch”
  - “Best Healthy Restaurant”

- **St. Louis**
  - “Best Breakfast”
  - “Best Business Breakfast”
  - “Best Brunch”

- **Phoenix**
  - “Best Breakfast Spot”
  - “Best Pancake”

- **Phoenix**
  - “Best Breakfast”
  - “Best Brunch”

- **Columbus**
  - “Best Breakfast”
  - 7th Consecutive Year!

**Source:** Developed by case writer.
Exhibit 7: First Watch Footprint - 2014

Source: Developed by case writer.
Exhibit 8: First Watch Menu
Source: http://www.firstwatch.com/
Exhibit 9: The Good Egg Menu

LOCALLY GROWN

SERVED FRESH

FRESH STARTS

THE TRADITIONAL BREAKFAST
3 eggs served any style with your choice of bacon, sausage, or ham. Garden sides are available for an extra charge.

EGGS SERVED 2 WAYS:* a traditional way or with a choice of side dishes.

BREAKFAST ROLL CUPS
Scrambled eggs served with choice of bacon, ham, sausage, cheese, diced tomatoes, avocado, tomato, or choice of side dish. Served fresh.

EGGS BENEDICT
Poached eggs with grilled country ham, fresh tomatoes, and fresh chives served over English muffins. Served fresh.

BENEDICTS

POached eggs served with grilled ham, fresh tomatoes, and fresh chives served over English muffins. Served fresh.

SKILLET

EGGS benedict served with baked potatoes and fresh tomatoes.

SKILLET

EGGS benedict served with baked potatoes and fresh tomatoes.

OMELETS

Metal with choice of fresh, seasonal vegetables.

SOUTHWEST BREAKFASTS

MINI BURRITOS

A warm flour tortilla filled with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

FIRECRACKER OMELETTES

A spicy omelette with choice of fresh, seasonal vegetables, jalapenos, and cheddar cheese.

FRENCH TOAST

French toast served with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

Lighten Up

EGG WHITE OMELETTES

Egg whites served with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

Omelet with fresh, seasonal vegetables over English muffins.

NOODLES & MORE

Cheddar cheese, fresh tomatoes, and fresh chives served over fresh, seasonal vegetables.

CORN-FRIED EGGS

Crunchy corn-fried eggs served with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

Mexican Nachos

A warm flour tortilla filled with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

ILS PFEIFFER

A warm flour tortilla filled with choice of fresh, seasonal vegetables, black beans, or chicken, and topped with fresh salsa or sour cream.

Lighten Up

Omelette with fresh, seasonal vegetables over English muffins.

Sweet Savory Frittatas

Omelette with fresh, seasonal vegetables over English muffins.