Research @ Citi Podcast, Episode 11: U.S. Consumer — Dining Out or Dining In?

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Transcript:

Lucy Baldwin (00:02)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

My name is Rob Rowe. I am the U.S. Regional Director of Research at Citi. With us on the podcast is Jon Tower. He's our U.S. restaurant analyst here at Citi. Jon, thanks for being on the podcast with us today.

Jon Tower (00:33)

Yeah, Rob, thanks for having me. I appreciate it and look forward to our conversation.

Rob Rowe (00:37)

Fantastic. And this is, of course, a fun topic. It's restaurants. And I know everybody who listens probably loves to eat or go out to eat. We've seen a lot. You know, when I think about what we've gone through in the pandemic, and how the restaurant industry has transformed itself or changed, we've gone through a lot, and now we're in the post-pandemic phase. But there's so many different options now between delivery of food and going out. You know, I think post-pandemic, there was an enormous surge because everybody just had to get out of their houses and their apartments. But, you know, in the context of all that, what's the state of the U.S. restaurant consumer today? What are the highs versus low-income demand and how's that shifted over the past year? And where do you see pockets of strength and weakness?

Jon Tower (01:28)

Yeah, it's— really the pandemic did shift the landscape pretty dramatically. If you think about it, the industry was right in the bull's eye of the impact of Covid. When you think about many restaurants needing to shut down and shift their operating model in order to address the new world where people needed to stand six feet apart, and they needed to put up barriers within the walls of restaurants to keep people separated. But then they also had to fulfill this new state of demand in that new channel of away from home, specifically delivery to fulfill consumers' appetite, frankly, for not being around others during that period, and it's really then evolved from that point in time to: How can we clean up the operating models for addressing this new world with the menu where consumers want to go with health and wellness, where they want to go indulgent, special occasions, et cetera. So a lot of change since that point. And frankly, the consumer itself from that point in time to now has really undergone quite a bit of shift.

If you think about coming right out of the pandemic, many consumers, particularly in the lower-income cohorts received stimulus benefits from the government, there was a fairly significant uptick in wage rates during that period. And so you saw a really strong window of demand from lower-income consumers that translated into very healthy demand within the restaurant industry. Traffic was up, particularly in the fast food space for some time. And then obviously, higher-income consumers navigated that period relatively well as well because of appreciation and asset prices, whether that was their home price or the stock market doing quite well. And frankly, jobs didn't necessarily disappear there either. So you had a fairly large wall of discretionary spending that frankly trickled into the restaurant industry. And that meant the years coming out of Covid — ’22, ’23 — were quite robust for the industry, and the consumer was feeling pretty darn good.

It wasn't until late 2023, really that August timeframe, when cracks started to form, a bifurcation, I would say, in the marketplace between the high- versus low-income consumer. And specifically, we started seeing limited-service operators speak to slightly softer demand. And that's really carried forward through late ‘23 into much of 2024, and it's been amplified across media outlets where, you know, lower-income consumers have really cut back quite a bit, shifted their spend away from the restaurant channel and towards more food at home, so the grocery locations rather than the restaurant space. In terms of, you know, pockets of strength and weakness, flipside of that, higher-income occasions and consumers have generally been pretty resilient. There's been some signs lately within recent months, particularly within fine dining concepts. There's been a little bit of a pullback. It's almost effectively following the trajectory of the economy, and some of the macro indicators that we're looking at. That cohort itself, the higher-income group, is beginning to peel back a little bit. So If I was to kind of give a grade, let's say, A through F in terms of the health of the U.S. restaurant consumer, I'd put it probably in that C bucket, with lower income more in that D, and the higher income, probably in that B bucket. So we're not in the greatest spot right now. Could be healthier.

Rob Rowe (05:13)

And is that, do you think, very much correlated with— I mean, obviously, the Fed is going to embark upon an easing cycle, the labor market is softened up. Inflation— and I want to ask you about inflation too, because inflation has come down a little bit. I don't know if it has in this particular industry or not, but one, is this correlated with what we're seeing in the economy in general and also how has inflation impacted restaurant demand?

Jon Tower (05:43)

Yeah, very much tracking with the broader economy, where you know, certainly the higher-level jobs data seems to be slowing. GDP seems to be slowing modestly, and we seem to be following suit. We keep track of, on a regular basis, we look at inflation's impact on consumer budgets, specifically discretionary spend. So we weigh aggregate inflation against wage and jobs growth by income bracket. And one can see really things peaked in January of ‘23, particularly for the higher-income consumer, if you're kind of netting the two against each other, inflation against the wage and jobs growth, and it's come down since. And we had pockets in there where lower-income consumers did better. But now we're at the point here where consumers under, say, $50,000 in household income are really beginning to see that impact of inflation weigh on their overall discretionary spend. And, broadly speaking, inflation has been a bit of a pain for the restaurant industry.

Rob Rowe (06:55)

How do they manage that?

Jon Tower (06:57)

Yeah, twofold, right? And it comes in different— two primary buckets, right? When you think specifically about the major cost centers for restaurants, there's food costs, there's labor, and then there's that “all other” bucket, including utilities and credit card fees. Really, there'd been inflation across all those major buckets, but the big pain points had been a spike around food right after the Ukraine and Russia conflict kicked off for a fairly long duration, about 12 months. And then subsequent— or during that period, and even beyond that period, labor rates really took off, wage inflation took off. And, you know, when you think about the different buckets that restaurants can control, the food inflation is going to be what it is. They can't go out and necessarily change the supply chain or grow more cows or chickens, *per se*. But what they can do at the restaurant level is try and manage wage rates or labor hours specifically. Most of them will have to, or all of them will ultimately need to adhere to any sort of local government legislation. So, for example, you know, this past year, actually, April of 2024, California passed AB 1228, which specifically targeted the fast food industry in California and wage rates there. They kicked the average starting wage rate to $20 an hour in that market. So that, you know, and that was roughly $15.50 per hour previously in California. But that's an example of wage rates explicitly moving much higher for the industry.

And, you know, what operators need to do in that circumstance, or often do, is take more pricing and pass it along to the consumer. Not always the greatest way of managing the business, but frankly, when the whole industry is doing it, and they have the excuse of wage rate inflation in particular driving that — so something structural rather than something temporary like commodity prices — they will take prices higher. Now, if you're a consumer, how do you manage this, right? They look at grocery prices, and they look at restaurant prices. And when you compare the two, there was a window really in 2022, 2023 when grocery inflation was really outpacing restaurant inflation. And that gave the industry a nice opportunity to take some pricing. They did. Unfortunately, it seems like they might have gotten a bit over their skis. So now at this moment in time, many of these operators are effectively dialing back a lot of that pricing in the form of greater promotional activity in the marketplace to drive traffic, as they've been losing a lot of that traffic to other mostly food-at-home occasions.

Rob Rowe (09:54)

And on the margin, are they successful at doing that?

Jon Tower (09:58)

Depends on who you talk to. Yeah, it really depends — it's really the bigger the brand with a bigger marketing budget, and frankly, the wherewithal in the relationships that these franchisors in particular have with the franchisees in terms of the longer duration that these brands have been around, and frankly, the relationship that the franchise or has with the franchisee. If they're starting off in a good spot in the first place, so think about box economics, if these franchisees are making some healthy returns already and have a fairly strong cash cushion and aren't necessarily levered, they'll be much more willing to absorb some sort of reinvestment in price in the form of discounting. However, if you're on the margin weaker, you know, you haven't seen the same type of demand that some of the other brands have seen across the landscape, your balance sheets, offsides, then there's a very good chance that you're not going to be able to survive and discount the way that the consumer would like you to at that moment. So it's a tale of two cities. And then, you know, there are other brands that are growing within categories that either have very limited competition today or hit on things that consumers can't replicate at home and have low— you know, there's no switchability between what's available in the marketplace and what they can get at this restaurant or concept. And those brands seem to be running relatively well and winning share. The others who seem to be doing quite well in this backdrop are the ones that really didn't take much pricing. They avoided taking a significant amount of price or have underpriced inflation by 600 to 800 basis points over the past three years, and that's translated into market share wins.

Rob Rowe (11:54)

Let's take it one step further. If we were to actually go into a recession, you know, how would the restaurant sector perform? And what other mechanisms would you see for them to battle that?

Jon Tower (12:06)

Yeah. The industry historically has done quite well during a slowdown in the U.S. You know, we wrote a note back in June of 2022 when there was fairly large concerns about the U.S. economy. It was never short the American appetite. Restaurants are far more durable than durables in a downturn. And historically, what's happened during times of recession in the U.S. is that consumers will effectively walk away from big ticket items, right? So if you were worried about your job, or frankly, a neighbor might have lost his or her job, there's a very good chance that you might defer going out there and purchasing, say, a new sofa, television or some large ticket item. However, if you still have a job, there's a very good chance that you're going to have some discretionary income, and that's going to allow you to still go out and spend some money at, you know, these small indulgences like going to a restaurant. So historically, we've seen the space effectively gain 200 basis points of wallet share during downturns. So effectively, based on where the normalized spend is, you could see roughly a 10% decline in discretionary income before the industry really got a significant hit to overall demand.

Now, is this time different? We don't know. The starting point for the industry is much different than say, the financial crisis. It's much more mature. There's also the pricing piece that we spoke about earlier, where the industry on average has taken quite a bit of pricing over the past three years. And unfortunately, when you compare it to food at home, they're much more expensive these days. So there's potential where if we do run into a slowdown, this time might look a little bit different with that wallet share shift. And on top of it, you know, has there been, over the past several years, perhaps some deferment in spend on durables because of the pull-forward of the pandemic, you know, during the Covid window. So many people were buying gym equipment or sofas, you name it, for their new homes or their existing homes. You know, does that pick up back again as interest rates tick lower, and that comes at the expense of restaurant spending? There's so many different variables at play. It's fun to watch. But if history repeats, the category will do quite well. I just don't know if it'll fully repeat. It might rhyme a little bit.

Rob Rowe (14:35)

[laughs] As they say. Jon, maybe we switch over to a little bit on consumer behavior and maybe how that's shifting or what's the longer-term trend for food away from home and the forces at play there? Has this shifted in recent years?

Jon Tower (14:51)

Yeah, it's interesting. You know, it seems as if when you look at restaurant spending, food at home versus food away from home. There was really starting in the 1950s, fairly significant share gains for the category up until really the financial crisis in 2007. Since that point in time, It's improved, so we've gone from 20% of share, or just over 20% of share in ‘59, to over 40% in 2007. Now we're settling out in recent years, topped out at about 45%. And now it's really flatlined. So the question is, are we at this new baseline from here, or will it continue to move higher going forward? You know, I'm of the belief that consumers are going to continue to pay for convenience. And that means, or better said, buy time. And so if that means I will go and order food for delivery at my house such that I get— I might pay a little bit more money for it, but it saves me the time that I would need to cook a meal for my family, I'll probably do it. Many people will. I don't think that trend necessarily goes away. However, the competitive set is also broadened, right? When you think about not only within the industry where you've seen more competitors step in, not only in traditional full service, limited service. Now you've got fast casual that has grown pretty dramatically over the past 20 years.

Rob Rowe (16:27)

And what's fast casual?

Jon Tower (16:28)

So those are restaurants that really kind of premiumize the food a little bit, but it's still counter service. Oftentimes, they don't have drive-throughs, and price points are slightly a little bit higher. Think about, you know, bowls, salads, and such. And that has grown quite dramatically since really the turn of the century. But what's come into play really in the past ten years has been growth within prepared foods at the grocery store. And now you've got delivery from grocery stores growing. And as this continues to improve or grow with the consumer, there's a better chance that you have some add-on from “food service replacement” with these options at the grocery store. And then on top of it, you've also had convenience stores get much better with their fresh food selections. So you've got traditional competitors growing, you've got, you know, nontraditional competitors growing within this kind of overall, you know, feeding of the consumer. Those forces are still there. And I think it could blur the lines on that food-at-home versus food-away-from-home share shifts in the future here. You know, beyond that, there's obviously other bigger, longer-term forces within the space, like going back to the labor conversation earlier. How do you solve that if you're a restaurant operator? Well, the simple answer today—

Rob Rowe (17:55)

You mean, like, wage rate inflation and stuff.

Jon Tower (17:56)

Exactly. You know, that being the primary variable that they can at least control. Automation is going to be here. I mean, I can't tell you when. I think it'll be in the next five to ten years when you and I will go into many of these limited-service restaurants, and rather than having ten to 15 people working in the restaurant, you're going to have machines effectively do the majority of the work, and you'll have three to four people helping kind of finish off the meals and then hand them off to you or guide you to a kiosk where you can order or just frankly provide a little bit of hospitality when you walk in the door.

Rob Rowe (18:34)

So we're going to help the machines.

Jon Tower (18:35)

We're going to help the machines. And that's going to help profitability for these restaurants, right? And hopefully, it means that, you know, this is my optimistic side, that restaurant pricing won't get out of hand going forward, right? If you're allowed to, you know, weave in this automation, pull out a bunch of labor and labor hours, then perhaps restaurant prices won't inflate at the rate that they have been in the past ten years. And then the other, you know, kind of lingering background is what happens with consumer appetites as perhaps GLP-1s become, you know, more prevalent and accessible for the broader U.S. population.

Rob Rowe (19:17)

Yeah, and maybe, I mean, that's actually something I'm very curious about, but also just health in general, like how health-conscious have consumers become as well?

Jon Tower (19:26)

That's a good question. I don't have a firm answer for it. You know, we've seen a handful of brands come out there, gone from really relatively small regional brands to now national brands, but still very early days, and their products are certainly more health and wellness focused. You know, we're talking salads, we're talking bowls, lower calorie, lower fat content.

Rob Rowe (19:47)

I guess gluten free?

Jon Tower (19:49)

Yeah, exactly. A lot of those options on the menu that you couldn't traditionally find at most fast food restaurants. So those are growing. It’s still, I would argue, early days for at least from a chain perspective for those brands, but we're seeing evidence that that is continuing to grow. The health and wellness, so that piece is happening, and then GLP-1 expansion, that could curb appetites, too. It's— we're I think still very early days, we've done some survey work here with the rest of the consumer team to try and see what it could mean for demand. And certainly in the consumers that we've spoken to who have taken the drugs, they have cut back consumption at restaurants and specifically within the food categories, they up their intake of protein and cut back their intakes of carbohydrates. And when you look across the landscape, many of these restaurant concepts skew carb-heavy, protein-light. So menus might need to evolve to address this in the future. And frankly, if it does become a greater force within the industry, I think you're going to see greater consolidation within the space, weaker operators, sub-scale operators are likely going to have to figure out what they're going to do either on their menu or with their asset base because consumers are likely going to continue to move away from that, away from the indulgent meals and towards kind of these healthier options out there that are available.

Rob Rowe (21:15)

So, Jon, when you did your study, I mean, did you see some effect from GLPs? Could you identify it yet? Because I mean, it's been proliferating for a bit now, you know, in terms of use on the GLP-1s, but have you seen some element of that or some evidence?

Jon Tower (21:30)

So the survey work suggested that these users definitely cut back on frequency. So whether it was weekday use, and to actual restaurant visits. You know, the categories that seem to do relatively well were anything within that beverage space. So mostly caffeine, mostly coffee related. And then the limited-service space definitely got a hit based upon what they offer on their menu. Full service, though, not as bad. And if you think about the use case for a full-service occasion, oftentimes it's for a special event, right? It could be date night, it could be, you know, celebrating grads, dads, moms, birthdays, you name it. So those seem to hold in relatively well, at least per the survey. Broadly speaking, zooming out and talking to operators, they're not seeing it yet. At least they're not speaking to it yet. So I think it's still way too early in terms of the penetration, and it looks, you know, based on how we wrote a note today about “Ozempic Town USA,” which is Bowling Green, Kentucky. And that—

Rob Rowe (22:34)

Really?

Jon Tower (22:35)

Yeah. Only about 4% of that— well not *only,* but about 4% of that population can they identified as having prescriptions to one of the GLP-1 drugs. And so we did some work to try and identify how restaurant demand as looking at footfall in that market has trended over the past two years. And, you know, it's hard to tease out direct, you know, causation from this, but you can see that over that time period, restaurant demand in that market, as measured by the 20 brands that we looked at, had fallen by, or lagged the national average by about 120 basis points. So was that the reason, were there other factors at play? Hard to know, but that certainly opens the door to more questions for the operators in terms of what they're going to do in the future to drive demand if this does become a bigger force within the industry.

Rob Rowe (23:33)

And Jon, we're going to close out here, but I thought maybe in summary, how would you say the prognosis for the overall restaurant industry is looking over the next six months to, six to 12 months? I know that, you know, there's a lot of depending on recession versus soft landing. But in general, how do you think it's going to play out?

Jon Tower (23:53)

I think it's going to be very much haves and have nots. Those who cater to the lower-income consumer and aggressively in front of them with deals and value messaging, will continue to win share. Those that are in categories of one will continue to win share. And frankly, I think those that are occasion-based will do relatively fine. Everybody else, it's going to be a fairly tough knife fight.

Rob Rowe (24:20)

Wow. Well, on that note, Jon, thanks for participating on our podcast. I hope everyone enjoyed it, and we'll see you soon. Thank you very much.

Lucy Baldwin (24:29)

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[Disclaimer] (24:55)