

THE FOOD & BEVERAGE INDUSTRY IN LOS ANGELES: A Roundtable Discussion



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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 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 – from the financial, legal and business perspectives — 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

'The increase in minimum wage has been a repeated concern of our restaurant clients. Rising insurance costs, employment claims, and accessibility and other lawsuits have also made it increasingly difficult to maintain profit margins.'

DAVID SUDECK



◆ **What are some of the factors for success that uniquely apply to the food and beverage industry?**

SUDECK: It is important for the chef/manager to understand food and labor costs and deliver a consistent experience to the customer. I have seen many of our restaurant clients drive big revenue numbers but the restaurants have not succeeded because there were not adequate cost controls. A successful restaurant must maintain a balance of style, value and service while controlling these costs.

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

SURUKI-CARMANY: Compared to many other states, California is heavy on regulation. But a more pressing challenge right now is the drought. As a result, water usage and rights will continue to be a high-priority issue for agribusiness, even if we do get heavy rains in the near future. To put the drought in perspective, the state's supply is so depleted that NASA's satellite data shows California needs more than 11 trillion gallons of water to recover. This has the most direct impact on growers, but it reaches everyone. Water-intensive crops and ingredients are going to become more costly to source, which is going to impact nearly every food and beverage subindustry—and ultimately the consumer. That being said, despite water issues, California is still regarded as one of the premier growing states in the country. Napa wine and California-grown produce enjoys brand recognition (and premium pricing) around the world.

◆ **Are there any licensing issues specific to California that out-of-state restaurant owner/operators need to be aware of?**

COSTALES: While not completely different from other states, California has a unique set of laws, rules and regulations when it comes to the sale and service of alcoholic beverages. Out-of-state owners/operators need to learn more about California's licensing system, regulated by the Department of Alcoholic Beverage Control (ABC). Those owners/operators also need to become familiar with the regulatory framework (for, among other things, zoning) of the local jurisdiction(s) in which they want to do business in this State. For alcoholic beverages, this is critical because the ABC will largely defer to the local jurisdiction when it comes to certain activities (e.g., hours of service, live entertainment, security, etc.). My advice to anyone starting a business in California is to seek counsel familiar with the State and local systems as early in the planning process as possible.

SUDECK: It is important to understand the significance of a conditional use permit (CUP) and compliance with its stated conditions. Before signing a lease or acquiring a business or property, the restaurant owner must have a thorough understanding of the CUP requirements, if any. These

conditions can have a significant impact on the property's operations and often result in a delay in opening. Also, when remodeling a restaurant, the owner must understand what will and will not trigger health department plan check and new ADA/local accessibility law compliance issues.

◆ **What are some of the newest consumer trends affecting the industry today?**

KOTTON: Food and beverage companies are beginning to leverage the power of social causes. We're seeing many industry leaders backing certain social initiatives, and as a result, gaining brand recognition and consumer loyalty. For example, Chipotle's cause-related marketing around sustainable and non-GMO ingredients is helping to build their brand and increase the loyalty of their customers.

SUDECK: My clients are using social media effectively and carefully monitoring review sites (like Yelp) to build loyalty and a sense of community.

COSTALES: As has been the case for the last few years, craft beer continues its amazing growth in California. Consumers like the wide variety of products offered by these brewers, and this in turn has affected distribution and retail chains in terms of portfolio mix, product placement and competition for limited shelf space. I believe the next trend will be increased demand for craft distilled spirits. We're already seeing an uptick in craft distillers which, if it continues similarly to craft beer, will also affect distributors and retailers. Another trend we're seeing is consumer use of smartphone apps – many which are used to order food and beverages from both off-sale retailers (grocery stores, markets and liquor stores) and on-sale retailers (restaurants, bars and nightclubs). The use of apps can be problematic under alcohol laws, and there undoubtedly will be fallout as a result of enforcement activities in this area.

◆ **What do you project will be the major issues facing the food and beverage industry in the next 3-5 years?**

SUDECK: The increase in minimum wage has been a repeated concern of our restaurant clients. Rising insurance costs, employment claims, and accessibility and other lawsuits have also made it increasingly difficult to maintain profit margins.

SURUKI-CARMANY: Consumers' continued search for healthier options provides ample opportunities for innovation, so companies that can interpret and appeal to the complex, changing appetites of a broad range of consumers can expect to grow and succeed. Second, consumers have come to expect transparency from the brands they buy, especially when it involves their food—think pesticides, animal welfare, sustainability, fair trade, product quality, and GMOs. We expect regulation will continue to escalate surrounding this information, and manufacturers and producers will be pressured to provide simpler labels, better communication, and a proactive approach. Finally, new food safety regulations by the FDA are only the beginning of regulatory change we expect. The globalization of food trade and production, ris-

ing world population, climate change, diminished land availability, urbanization, global economy, and instant communication will likely also play a role.

KOTTON: One of the hot topics impacting the food and beverage industry today is the minimum wage hike. Ultimately, restaurants are going to have to get creative with inventory management to control costs without making substantial increases to their menu prices. We recently hosted a Restaurant CFO Bootcamp in Las Vegas, which brought together finance and accounting professionals across the restaurant industry, minimum wage regulations were consistently discussed as a major issue facing the industry. These CFOs recognized that, as wages increase, they're going to have to evaluate new ways to manage labor and other organizational costs.

◆ **What are some of the best ways for a food and beverage company to build its brand and elevate itself from the competition?**

KOTTON: One of the hardest demographics to attract is millennials, because they want more organic and healthy choices at reasonable prices. It is important that food and beverage companies are aware of their target consumers' preferences, and in the case of millennials, establish themselves as trendy establishments that offer a wide variety of options. Superior customer service is also, as always, crucial.

SUDECK: Some of my most successful clients are effectively using merchandising and packaged food products as additional ways to generate revenue and build brand recognition.

SURUKI-CARMANY: If you're just starting, establish your identity by articulating the attributes and values that define you, then build your business around them. Indicate who your target audience is, whom you're competing with, and what your unique value proposition is. Be sure to talk about your brand with your employees consistently so they embrace it and understand its importance. Your brand-building priorities will change throughout the business life cycle, and your approach should constantly evolve. Don't take for granted that consumers know your brand, and once your brand has matured, resist the temptation to stray from your core identity and values. If nurtured properly, they'll continue to serve you well into the future.

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

COSTALES: The rise and unprecedented growth of social media present unique challenges to state and federal regulators. Owners/operators use social media sites to attract new customers, monitor satisfaction, improve brand awareness and seek non-traditional sources of funding. Consumers use these sites to post online reviews, and to document and share their experiences (via blogs, pictures and videos). Regulators remain extremely concerned about advertising and solicitations to minors, as well as illegal "tied house" situations that may arise (when brewers, distillers, winegrowers or other alcohol beverage suppliers appear to exert undue influence over retailers). Recently, organizers of a hugely

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CAROL SURUKI-CARMANY

popular food and beverage event in Sacramento cancelled the event (held for the last 13 years) due to regulatory challenges brought by the ABC after last year's event. The ABC sent letters to various wineries and breweries alleging that their "re-tweeting" information about the event (which was sponsored by a retailer) violated California law.

KOTTON: Companies are increasingly relying on social media to attract and engage new and existing customers. People want to eat at the places that are quickly and creatively using new technology and platforms. For example, Domino's now allows customers to use Twitter to order pizza. This is an effective and unique way to appeal to their targeted, digitally-focused audience.

SURUKI-CARMANY: Social media is a great way to launch new products, gain ideas from your brand's followers, express and manage your brand, offer special promotions to your loyal supporters, and address complaints or comments. It offers infinite ways to promote your brand and products, and getting involved generally has a positive effect. In today's media environment, it's possible to focus your advertising on your target segments to make your spend more efficient, so select your communication channels carefully. A few of your options are lifestyle print media, social networks, and geo-targeted mobile campaigns.

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

KOTTON: Location, location, location. Make sure you do your research, pick a heavy-traffic area that is growing and has long-term popularity potential. It is also important to develop an atmosphere that appeals to a large demographic, so that you're not limiting your potential customer base, and a brand that is able to evolve with the restaurant industry.

SUDECK: Most early stage restaurant companies are funded through "friends and family." However, we are handling an increasing number of raises involving, at least in part, EB-5 financing (immigration-based investment – typically with the inbound investment dollars coming from China to fund a loan or preferred equity). EB-5 financing may be a particularly attractive, and low-cost, source of capital when the restaurant is part of a hotel or a larger mixed-use project, as it tends to be easier to find investors for larger projects. It is helpful if the sponsorship includes at least one partner with a successful track record, or a well-known chef or celebrity backing. EB-5 investors typically have little or no voting rights, which allows the sponsor to maintain greater control over the restaurant's operations. Note, however, that the typical investment period for EB-5 financing is 5 years, so the sponsor will need to show how the international investor/lender will be repaid as of the end of that period. For more detailed information on EB-5 financing, you can visit: <http://hotellaw.jmbm.com/category/eb-5-financing>. We are also hearing from our restaurant clients that they have an interest in raising funds through "crowdfunding." Recent changes in securities regula-

tions allow for the general solicitation of accredited investors under certain circumstances. I expect that we will see at least a few new restaurants funded this way. Many of the same qualities that attract international EB-5 investment will likely be important in attracting investors in a crowdfunding context.

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

COSTALES: While others can directly answer this question, I have a different take – i.e., what do *venture capital or private equity funding sources* need to know before they invest in a restaurant company? Quite a lot. Investment by even "passive investors" can trigger several liquor license issues. For example, if the transaction results in a change of control of the licensee, the ABC will require a transfer application and may investigate the funding sources. As a general rule, if a new entity acquires a 10% or greater interest in the licensee, that entity may be required to disclose its ownership structure and the individuals with management authority/control over its operations. Fingerprinting and background checks may be required for certain individuals. Funding sources need to understand the highly regulatory nature of this industry and be prepared to relinquish some confidentiality as a result of their investments.

◆ **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, and what items can wait a while until additional funds have been secured?**

COSTALES: If the start-up plans to sell alcohol, then securing its licenses and permits is a top (if not *the* top) priority. Unlicensed alcohol sales in California are not only illegal, but also could result in the ABC later finding that an owner/operator is "unfit" to hold a license — even if properly applied for. (Of course, there are restaurants and off-sale establishments that operate without selling alcohol, but in today's environment, they struggle against the competition.) Also, once the start-up obtains its liquor license, training employees on alcohol laws and regulations should be a major priority. Otherwise, the license could be at risk due to the behavior of untrained individuals. California essentially has a "three strikes" rule when it comes to violations of the Alcoholic Beverage Control Act — three violations within a 36-month period could result in automatic license revocation.

How important is the organic factor today in the food and beverage industry?

SURUKI-CARMANY: Millennials and the generation after them care about what they eat, and the organic factor is important to influencers. These products can be found in most grocers and retailers now, and their growth is evident in the increased shelf space given to organic products. Many heritage consumer brands that Gen X and baby

boomers grew up eating—such as Kraft, Nestle, and Hershey—are starting to advertise that they're going to stop using artificial dyes and chemicals in their products. Companies that are trying to convey the health of their offerings are obtaining certifications and using callouts such as certified gluten-free, non-GMO verified, and vegan.

KOTTON: Consumers are demanding more organic and healthier dining options. One of the challenges that comes with the desire for organics is the ability to balance this demand with the need to offer reasonable, competitive prices.

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

SURUKI-CARMANY: Food safety is an issue that keeps business owners up at night, especially with regards to fresh produce. From a consumer perspective, food safety is considered a must, but it increases prices on the products we buy. From a producer perspective, managing the workforce and tracing products and ingredients can be difficult, time consuming, and costly. Food safety recalls often come after the damage is done, and sometimes it turns out the identified product wasn't the cause after all. The best approach is to be proactive. In the event something you use is recalled, a thorough knowledge of your supply chain will position you to understand whether your products could be affected.

◆ **How important is it to train restaurant managers on workplace legal matters before they become lawsuits?**

SUDECK: The best way to avoid liability is through proper training. Among other things, the restaurant's manager/management team should have a thorough understanding of, and specific compliance training with respect to, discrimination and accessibility laws (including the ADA). Also every front-of-the house employee should understand the rules associated with service animals, communicating with individuals with disabilities, and how to provide accommodations to those individuals. The restaurant's website should also be reviewed for accessibility. While the ADA does not yet include specific technical requirements associated with website compliance, we recommend that our clients conform to current WCAG requirements because we have handled suits generally alleging "inaccessibility" of a website under the ADA. It is equally important to have an updated employment handbook and to make sure that the managers have read the handbook. Wage and hour claims are rampant and expensive to deal with (as they are typically not covered by insurance), so proper compliance training in this area is also critical.

COSTALES: Training is *critically* important, not only with respect to matters that fall under the traditional "labor and employment" category, but also with respect to beverage alcohol. A poorly trained manager can place his or her establishment's liquor license at risk. While the areas of primary concern are sales to minors and/or obviously intoxicated patrons, there are many other areas — including failing to observe service hours or other restrictions

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MARCO COSTALES



imposed by the ABC or local authorities. The ABC actually requires that certain managers submit to background checks as if they are going to be the liquor licensee themselves. There are a variety of “Responsible Beverage Training” certification courses available, and the ABC offers free training at most of its district offices. We encourage all of our clients to require managers and other staff handling alcohol to participate in one or more of these programs.

◆ **Can anything be done to expedite liquor licensing procedures?**

SUDECK: The liquor licensing process requires patience and attention to detail. Frankly, most delays that we see relate to the issuance (or renewal) of a required conditional use permit. However, we also see delays in the ordinary processing of liquor license applications as a result of incomplete or improperly signed forms (!). I rarely see the application process take less than two months regardless of how careful our client is, but the process can extend beyond that due to lack of care. Most of our clients in Los Angeles county acquire a Type 47 or 48 license on the open market rather than through a lottery. A temporary license is typically available if the license was issued to the same premises where a new restaurant will be opened, but a temporary license will not be available when transferring a license from one premises to another.

COSTALES: Industry members need to realize that the ABC is understaffed and subject to state budgetary restraints. That being said, based on recent conversations with the ABC’s Chief Deputy Director, the ABC is trying to shorten application processing times (particularly for mail-in applications) and is trying to achieve greater consistency among its 22 district offices. I think the ABC will make some progress in this regard (though probably not enough to appease everyone). Also, when recreational marijuana use becomes legal in California (*and I do believe it will be “when,” not “if”*), the ABC most likely will be charged with enforcement at some level — which could stretch its limited resources even further. Presently, the best approach is for applicants to use trustworthy and knowledgeable attorneys or expeditors to handle their applications to minimize wait times.

◆ **Gift cards provide a significant source of revenue to restaurants. What are the most important issues associated with launching a gift card program (legal, accounting, etc.)?**

KOTTON: Some of the key considerations associated with gift cards are state escheatment laws and accounting for gift card incentives. It is important that restaurants do their research and understand these laws in each state where they have operations, so that they can effectively manage unclaimed property. With gift card incentives, one of the most common issues is expensing these incentives upfront. Instead, gift card incentives should be separately tracked from regular gift card sales and expensed when redeemed.

SUDECK: Gift card and loyalty programs have resulted in a shocking number of lawsuits. There are a number of California state and federal consumer protection laws governing gift cards and gift certificates. The California Department of Consumer Affairs provides good general information in this regard. Some general tips for California law compliance: (1) do not include an expiration date on gift certificates or gift cards that are sold to consumers, and do not charge a fee after a certain “dormancy” period; (2) certificates and cards with a cash value of less than \$10 must be redeemable for its cash value; and (3) none of these rules may be waived. Under certain (limited) circumstances, unredeemed gift certificates also escheat to the state. There are a number of additional rules and exceptions to the rules, so it is best to consult with an experienced attorney in the area to make sure your program complies with applicable law. For your information, the California laws associated with gift certificates may be found at Civil Code Sections 1749.45-1749.6. Happy reading!

COSTALES: From an ABC perspective, owners that sell gift cards at a discount (or give them away for free) when a customer purchases an alcoholic drink are violating the law. A similar result occurs if an owner allowed its gift cards to be used by minors or obviously intoxicated patrons to buy alcoholic beverages. Violations such as these are treated seriously by the ABC, and could result in significant fines, suspension of the owner’s liquor license or even outright loss of the liquor license. As with all matters involving alcoholic beverages, owners must be extremely vigilant with respect to their gift card programs.

◆ **What are the top sources of revenue growth for food and beverage companies this year?**

SUDECK: My clients are focusing on, among other things, catering, special events (including off-site pop-ups) and film shoots to drive additional revenue, attract media coverage, and support brand recognition.

◆ **What tax planning strategies are available to the food and beverage industry?**

SURUKI-CARMANY: There are several, such as looking into your accounting methods, reviewing compliance with the tangible property regulations, and taking advantage of tax credits. Two of the more active strategies for food and beverage companies are entity structure planning and interest-charge domestic international sales corporations (IC-DISCs). Whether your organization is structured as an S corporation, C corporation, or LLC can have a profound impact on your tax liability (as well as a number of other things, like your paperwork and liabilities). Flow through entities (S Corporations and LLCs) are common; however, entity selection is based on a variety of factors that should be evaluated. If you or your distributors export US-produced goods, forming an IC-DISC can generate permanent tax savings by converting a portion of your ordinary income into qualified dividends, which are subject to a lower tax rate (23.8 percent, compared to 39.6 percent at the top bracket).

KOTTON: There are a number of tax planning strategies available to restaurant owners who take steps to capitalize on them. One is research and development credits. Restaurants may be eligible for federal and state R&D tax credits and incentives if they attempt to develop new or improved recipes, formulas, products, manufacturing processes or software. Another strategy is cost segregation studies. Cost segregation studies can help owners of business with real estate assets increase cash flow by accelerating federal tax depreciation of construction-related assets. In addition, tax credits and deductions related to green and alternative energy improvements may be available. Yet another consideration is WOTC and FICA tip credits. The Work Opportunity Tax Credit is a Federal tax credit available to taxpayers that employ individuals from targeted groups, such as qualified, Federal assistance recipients (IV-A), veterans, ex-felons as well as many other types of potential employees.

SUDECK: One of the most important decisions for individuals starting a business is choosing the correct entity type. The type of entity chosen can result in significant tax differences. A C-Corporation is subject to double taxation (a tax first on corporate profit and then another tax on dividends to shareholders as income), so it is rarely the entity of choice for a non-public restaurant company. An S-Corporation or a limited liability company (an LLC) are more commonly used. Both S-Corporations and LLCs are required to pay an annual minimum franchise tax of \$800. However, LLC are also subject to a gross receipts tax on gross revenues (which ramps up to over \$11,000 per year at \$5,000,000 or more of revenue). S-Corporations, on the other hand, are taxed at a rate of 1.5% of net income. Therefore, a business with high revenues and low profits may benefit from organizing as an S-Corporation. Nonetheless, we often find our clients prefer to use LLCs as a result of the greater flexibility in terms of entity governance, and allocations and distributions of profits. A tip from one of my clients — be careful when estimating future sales when obtaining your seller’s permit, as the estimated sales will be used to calculate the deposit required by the California State Board of Equalization!

◆ **Should food manufacturing and distribution executives be looking for acquisitions as a core growth strategy in today’s environment?**

SURUKI-CARMANY: Yes. Acquisition continues to be one of the fastest methods to strategically grow a company’s market share or profitability, and it’s likely the marketplace for the balance of the year will continue to be active. Strategic and private equity buyers are continuing to take advantage of aggressive financing markets and the broad set of target food and beverage companies out there. The feasibility of a transaction will vary somewhat based on your subindustry, but in general, if your product lies in a category popular with consumers and is profitable, you’ll likely be a target. Private equity and venture capital investors are showing a marked interest in the ag space right now, so companies open to transactions will find a source of additional financing in these investors (as an alternative to conventional bank debt).

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‘The current trend is finding ways to appeal to busy customers who are looking for a quick and healthy meal. Companies are finding ways to appeal to these consumers by offering to-go orders and making the ordering process quick and easy.’

ISSY KOTTON

◆ **How are companies innovating to attract new customers?**

KOTTON: The current trend is finding ways to appeal to busy customers who are looking for a quick and healthy meal. Companies are finding ways to appeal to these consumers by offering to-go orders and making the ordering process quick and easy.

◆ **Is it important for food and beverage companies to join trade associations? What are the benefits?**

SURUKI-CARMANY: I certainly see an advantage in joining a trade association. Aside from updates on industry-specific issues, such as food recalls and best practices, you could benefit from potential savings on your operating costs, such as those spent for workers' compensation and other insurance services, since trade associations can strike deals with these providers. IC-DISCs, for example, have become popular among almond growers as a direct result of their trade association's recommendation.

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

COSTALES: If your business plan involves the sale of alcoholic beverages, then my advice is “Be prepared to be on the Grid.” This is a highly regulated industry that requires owners/operators to disclose personal and private information, to submit to criminal background checks, be fingerprinted, and to comply with a highly complex set of laws, regulations and rules (many of which date back to the repeal of Prohibition). This is not an industry for anyone that wants to try to remain anonymous or to “fly under the radar” of the regulators. It is an industry that receives a lot of governmental scrutiny – especially at the retail level. The ABC may be understaffed, but it is committed to protecting the health, safety, welfare, and economic well-being of all Californians. You've been warned!

KOTTON: You cannot go into this industry expecting immediate success and profit. Brands take years to develop and the restaurant industry is constantly changing. It is important that you do a lot of research on the location and segment you want to enter, consider emerging trends and potential issues that are coming

down the pipeline in the restaurant industry, and be willing to adapt in order to meet customer demands. It is also important to educate yourself on industry standards and make sure you are benchmarking yourself against others in the industry and specific sub-segment. At BDO, we conduct a quarterly benchmarking study that can help restaurant leaders do just that.

SURUKI-CARMANY: It depends on which sub-industry you're operating in, but my general recommendation is to hire at least a part-time CFO. Most early-stage food and beverage companies focus their spend on sales and marketing rather than upper-level staff positions, but a CFO becomes especially useful when you're looking for financing or a line of credit. With the financial concerns shifted in part to a CFO, owners and entrepreneurs are free to push their product in the market. The insights and guidance of even a part-time or contract, seasoned CFO can add tremendous value to daily financial operations—helping you improve your financial reporting to investors and other stakeholders, managing cash flow, training staff on accounting best practices, and providing management with timely, relevant information. Particularly for startups and companies in transition, this kind of counsel can be the difference between success and failure.