

case study

Darden Restaurants, Inc. Is the Turnaround Happening?¹

By Murat Kizildag, Fevzi Okumus and Kevin Murphy

Introduction

Due to increased competition, changing consumer preferences, tougher market conditions, more knowledgeable shareholders, and rising raw product costs, US restaurant companies are experiencing more economic distress and higher risk of bankruptcy. In the aftermath of the great recession in 2008, bankruptcies across US corporations climbed to the record number of bankruptcy filings. Business bankruptcy filings at different levels (bankruptcy chapters 7, 11, 12, and 13) totaled 58,721 and 58,322 in 2009 and 2010 respectively (United States Court Reports, 2012). Although bankruptcy filings have fallen to 26,130 in 2015 (United States Court Reports, 2015), high probability of bankruptcy is still seen in most of the capital-intensive industries, such as the restaurant industry since most of the restaurant corporations use long-term debt to expand and generate cash flows. However, this creates greater financial risk for them (Kizildag, 2015). These companies are far more inclined to engage in strategic corporate turnarounds by selling assets, creating real estate investment trusts (REITs), streamlining or closing divisions, and/or laying people off to cut costs and generate earnings (i.e., Quiznos LLC.). In the past 10 years, some of America's biggest restaurant chains have lost more than 50.0% of their sales as they closed hundreds of locations nationwide (Hess and Sauter, 2012).

The preponderance of bankruptcies, store closures, and negative macro and micro-economic facts have caused companies to take a multitude of strategic actions in order to avoid business failure, to cope with severe financial distress, and to maintain their financial solvency. The turnaround of Darden Restaurant, Inc. is considered to be one of the most remarkable turnarounds of an underperforming restaurant company in recent years for the industry. In October 2015, activist hedge fund Starboard Value LP won a protracted proxy battle to take over Darden's executive board by winning the vast majority of the shareholder votes by publishing a rescue plan manifesto to reverse the fortunes of the struggling restaurant group. Starboard's suggested revival plan was to create positive operational and financial momentum and restore the economic value of Darden's two flagship brands – Olive Garden Restaurants and Red Lobster Restaurants, from which most of Darden's revenue was generated. Since then, Starboard has introduced specific

operational and financial strategies to turnaround Darden.

Therefore, the primary objectives of this case study are to: (a) examine the revival strategies implemented by Darden to boost the stagnant earnings, profit margins, and market value, (b) analyze the critical operational and financial measures executed by Darden to reverse its losses, and (c) scrutinize the future prospects of Darden after the implementation of the turnaround plan. Additionally, this case study seeks answers to several critical questions below:

- What caused Darden to require a major corporate turnaround attempt?
- What were the roles of Starboard Value LP in Darden's revival plan?
- What are Darden's key strategic turnaround actions to prevent further losses?
- What are the fundamental operational and financial outcomes that signify turnaround?
- How does transformed Darden's performance look for the near future?

Corporate Turnarounds

The decline of a firm from a superior performance position to a poor position on any appropriate performance criterion normally points to fundamental operational problems with its management and financial strategies. Corporate business failure, after the onset of performance decline, is highly correlated to leadership inaction and poor timing of strategic actions. In such circumstances, firms need to reverse the overall performance decline and bring performance back to the operational norms by implementing a wide range of turnaround strategies and restructuring (Filatotchev and Toms, 2006; Pearce II and Robbins, 2008; Sudarsanam and Lai, 2001).

Corporate turnaround is defined as: "the implementation of a set of actions required to save an organization from business failure and return it to operational normality and financial solvency. Turnaround management usually requires strong leadership and can include corporate restructuring and redundancies, an investigation of the root causes of failure, and long term programs to revitalize the organization" (CIMA, 2009). Diversification, business mergers and acquisitions, management

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¹ This case study was written for the purposes of classroom discussions. It was not intended to show effective or ineffective handling of executive decisions or a managerial situation. Published materials and academic sources were used in preparing this case study.

reorganization, financial reorganization, or a combination of these, are the financial and managerial strategies for the executives who confront turnaround situations (Pretorius, 2008; Sudarsanam and Lai, 2001). Whatever the reasons for the business failure are, adopted turnaround strategies must reverse the causes of poor performance, resolve the operational problems, achieve a rapid and steady improvement in financial performance (profitability, solvency, and liquidity), regain stakeholder support, and overcome internal problems.

Operational turnaround and restructuring strategy (i.e., output maximization and input minimization) is composed of cost reduction, revenue generation, asset reduction, and integration of business units' strategies to improve efficiency and margin by reducing direct costs and slimming overhead expenses in line with sales volume (Haron et al., 2013; Slatter et al., 2011). Managerial restructuring and re-organization strategy (i.e., removal of Chairman or Chief Executive Officer) entails changes to the leadership and executive structure to yield improved leadership, management, organizational structure, organizational alignment and culture (Chen and Hambrick, 2011; Koh et al., 2015). Financial turnaround and restructuring strategy is simply the reworking of a firm's capital structure to relieve the strain of interest and debt repayments and to strengthen the balance sheet and/or provide funding. Specifically, cash generation strategies (i.e., dividend cut, etc.) and additional stock issuances are commonly-used strategies to pay down debt, reduce interest cost and improve cash flows (Schoenberg et al., 2013; Slatter et al., 2011).

In recent years, corporate turnarounds have included some of the "giants" in the U.S. economy due to varying reasons. For instance, Best Buy (NYSE:BBY) has turned around its U.S. operations by shedding its assets and trimming expenses to help lift profitability with the new board elected in 2012. Yahoo's (NASDAQ:YHOO) turnaround activities has recently switched to the advertising business as a means of bolstering revenue in 2015. J.C. Penney (NYSE:JCP) has just entered next phase of turnaround by reworking its store services and partnerships to bring the customer visits back towards their goal of increasing \$1.2 billion in earnings before interest, taxes, depreciation, and interest (EBITDA) by 2017 (Kell, 2015; Ashworth, 2014).

As a most salient recent example from the restaurant industry, the fast food giant McDonald's (NYSE:MCD) comparable same-store-sales have fallen globally in four consecutive quarters and are down six straight quarters in the U.S., with no sign of quick rebounds. Hence, the company's new CEO, Steve Easterbrook, unveiled its massive turnaround plan to revive its organization in May, 2015. The plan's major focus is to reorganize its business structure, to sell company-owned stores to franchisees, to increase consumer traffic, and to provide higher returns to its shareholders. McDonald's short-term revival target is to sell some 3,500 company-owned restaurants to franchises by the end of 2018, up from a prior target of refranchising at least 1,500 restaurants by 2016 (up

from a current 81% to about 90%). Additionally, the new plan aims to reorganize its menu (i.e., garlic sauce) to bring customer retention rates back to the previous corporate norms (Wohl, 2015).

Case Synopses: Efforts to Turnaround Darden

Over the past few years, Darden Restaurants, Inc. has underperformed its peer group (i.e., Brinker International, Inc., DineEquity, Inc., OSI Restaurant Partners, LLC, Ruth's Hospitality Group, BJ's Restaurants, Inc.) and the corporation has disappointed its shareholders with its sluggish sales volume, revenue, margins, per share earnings, and stock returns. The declining sales, earnings, and brand reputation have been clear signs for the shareholders to have a logical move to reverse years of declines and to consider perpetual solutions for turnaround, especially for Olive Garden and Red Lobster Restaurants. Concurrently, these two brands were among the worst performers, reporting same-store-sales growth of -2.3% for Olive Garden and -2.8% for Red Lobster (Barington Capital Group Presentation, 2013). This action was much needed and crucial to longer term operational survival, since those two flagship brands made up close to three-quarters of Darden's total revenue.

The story of Darden's financial struggle started with Olive Garden's and Red Lobster's enormous increase in food cost and continuously declining same-store-sales, declining guest counts, and shrinking profit margins. Olive Garden's food costs historically was about 26-27% of sales, but rose to an estimated 29% in 2014 contributing to Darden's overall 30.1% food costs while industry median was around 27.20% (Transforming Darden Restaurants, Starboard Value LP. Investor Presentation, 2014).

After activist hedge fund Starboard's severe criticism about Darden's underperforming brands and contentious proxy battle in 2014, Darden's board was replaced with Starboard's entire slate of board members. Starboard's 294 page revival plan has shifted Darden's managerial and financial strategies to longer-term perspectives to turnaround these aforementioned unsuccessful Darden brands. The main objective of the new owners' revival plan has been clustered around a value enhancing strategies for Darden's real estates, restaurant concepts, and franchising systems under a company-wide, comprehensive operational improvement plan. Starboard's specific initiatives are to: (i) build up Darden's creditworthiness, re-structure its debt, and foster sustainable long-term shareholder value, (ii) improve the sales volume, increase earnings, and boost stock returns, (iii) convert properties into real estate trust funds (REITs) and optimize capital expenditures for future investments. Table 1 outlines Starboard's specific turnaround strategies and initiatives in detail.

Darden's current major shareholders are still in frustration since Starboard injects twelve executives to Darden's current board with 8.8% stake in the company. Starboard is now the second-largest investor and it ousts Olive Garden owner's full board (Transforming Darden Restau-

Table 1

**A Comprehensive Operational Improvement and Revival Plan
Starboard Value LP**

Focus Areas	Strategic Actions
Board Restructuring	<p>Radical replacement in top executives with cohesive group of board members to convey a sense of calm and control to Darden's shareholders.</p> <p>Incentives and corporate governance to represent the best interest of all shareholders (wiping off a long history of abysmal corporate governance).</p>
Operational Reforms	<p>Revenue generation through reducing operating assets, minimizing direct costs, and slimming overheads in line with sales volume.</p> <p>Improving margins (EBITDA, profit margins, etc.) and solidifying investment credit rating and dividend policy.</p> <p>Reinvigoration in international expansion and franchising programs.</p>
Financial Initiatives	<p>Reconfiguration of Darden's real estate assets through REIT conversion and divestment of Red Lobster Restaurants and specialty restaurant groups.</p> <p>Financial reorganization for Darden's optimal productivity through reduced capital expenditures, long-term liabilities, interest expenses, and improved cash flows and returns on capital.</p>
Competitive Re-positioning	<p>Enforcing non-conventional marketing efforts to increase marketing and advertising savings.</p> <p>Re-energizing Olive Garden's product market focus via revitalized menu design and items (bringing back the Italian authenticity).</p> <p>Cuts in portion sizes on existing lines of Olive Garden's menu to stimulate demand (traffic growth) and customer service.</p>
<p><i>Note: The components of Starboard's comprehensive operational improvement and revival plan are taken from Starboard's 294 page long investor presentations.</i> <i>Source: Transforming Darden Restaurants, Starboard Value LP. Investor Presentation [Power Point Slides]. (2014). Retrieved from http://blogs.wsj.com/moneybeat/2014/09/12/starboards-olive-garden-slides-salting-the-water-custom-straws-and-more/</i></p>	

rants, Starboard Value LP. Investor Presentation, 2014). The downside of Darden's new corporate culture is that this board restructuring might restrict the flexibility of Darden's current major shareholders' in critical decision making processes, such as establishing some of the essential corporate governance provisions. Also, existing shareholders will now have less voting power in the board. However, Starboard believes that replacing the majority of incumbent board members is necessary to bring fresh managerial and operational perspectives to the company from revamping the menu items and portions (i.e., salt level added to the pasta) to boosting re-arranging the corporation's real estate structure (i.e., converting Darden properties to REITs).

This multidimensional plan has also been initiated to implement critical reforms to the operations of underperforming brands, such

as Olive Garden and Red Lobster. In this operational reform package, Starboard proposes to improve EBIT margins by \$215 - \$326 million per year for the next five-year period while improving the overhead costs (i.e., food cost) and guest dining experience and customer traffic. Darden's existing shareholders are still skeptical about immediate positive outcomes of these operational reforms on cost efficiency and margin improvement. Their conclusion remarks that these reforms will cause huge fluctuations in earnings and profits and the company will lose its existing customer base. Nevertheless, Starboard thinks reforms will give roughly 20% boost to same-store-sales, especially for Olive Garden (Nef, 2015). This plan is mostly implemented to turnaround Olive Garden's sluggish same-store-sales, lacking service standards, and increasing food waste. Starboard also adds that higher earnings

will positively affect their credit ratings, dividend policies, and international franchising programs in the long-run since Darden will retain higher levels of earnings.

Additionally, Darden's new corporate system is free of "corporate-centric-structure", which entitles every decision to board members, and "asset-heavy-structure", which focuses on high levels of property acquisition and investment. In this way, Starboard's financial initiatives target less property buyouts and investments. Therefore, Darden can have reduced capital expenditures, decreased levels of external debts (i.e., long-term commercial loans), and lower interest payments. Also, Darden can succeed lowering lease expenses by converting restaurant properties into REITs and selling off underperformed brands, such as Red Lobster and/or specialty restaurant groups (i.e. Eddie V's). By implementing those financial plans, Starboard suggests that Darden will improve its cash flows and stock returns so they can return more to its shareholders by paying out higher amounts of dividends.

Lastly, Starboard points that current advertising and marketing efforts are outdated and ineffective. Thus, Starboard's comprehensive revival strategies aim to enhance Darden's underperforming Olive Garden's competitive positioning in the restaurant industry and its advertising spending. Starboard thinks that customer traffic and return will be positively affected with the reduced advertising and marketing spending for Olive Garden. This plan specifically targets to stimulate Olive Garden's ineffective price point promotions and couponing, not enough advertising messaging efforts, and lacking social media awareness and digital marketing. However, the existing board still questions the effectiveness of Olive Garden's repositioning attempts since it might be difficult for customers to get accustomed to these drastic changes (i.e., restaurant logo, menu items, menu design). Taken all together, Starboard's comprehensive improvement plan and strategies for Darden are to preserve and create substantial shareholder value by higher levels of earnings, stock price appreciation, more mar-

ket share, and recovering the brand image.

Are Darden's Corporate Turnaround Strategies Effective?

It has been a bumpy road for Darden trying to bounce back from financial distress since early 2012. The company has been under pressure by its shareholders. The profit picture has been ill-defined and the overhead costs (i.e., food cost) and fixed payments (i.e., lease expenses) have reached to undesirable levels. On top of that, customer traffic has weakened due to conservative consumer spending on "out of favor" menu items and there has been an ongoing financial decline in same-store-sales between the first quarter of 2012 and the last quarter of 2015 (Transforming Darden Restaurants, Starboard Value LP. Investor Presentation, 2014).

Prompted by Starboard take-over actions, one of the first actions in Darden's turnaround plans was selling off Red Lobster in an effort to unlock shareholder value. Although Darden still continues to face pressure from its shareholders following the sale of Red Lobster, the company initiated a share repurchase plan totaling \$500 million. Also the management put \$1 billion to refine its debt after receiving \$2.08 billion in cash and \$29.3 million net of transaction-related costs from a \$2.1 billion Red Lobster sale (Gallagher, 2014). The ultimate objective of this asset-reduction effort was to strengthen Darden's credit worthiness by improving its net earnings, earnings per share (EPS), EBITDA, stock returns, and therefore, its shareholder's wealth. Table 2 lays out Darden's quarterly earnings structure with three important earning measures.

Another critical action taken by Starboard was to drive significant improvements in Darden's stock returns since its stock price has underperformed the entire market (NASDAQ Composite). In this vein, Starboard's priority was to increase stock returns by selling Red Lobster, nominating twelve directors for board elections, and bringing rich strategies to capture more investors. Darden's stock has

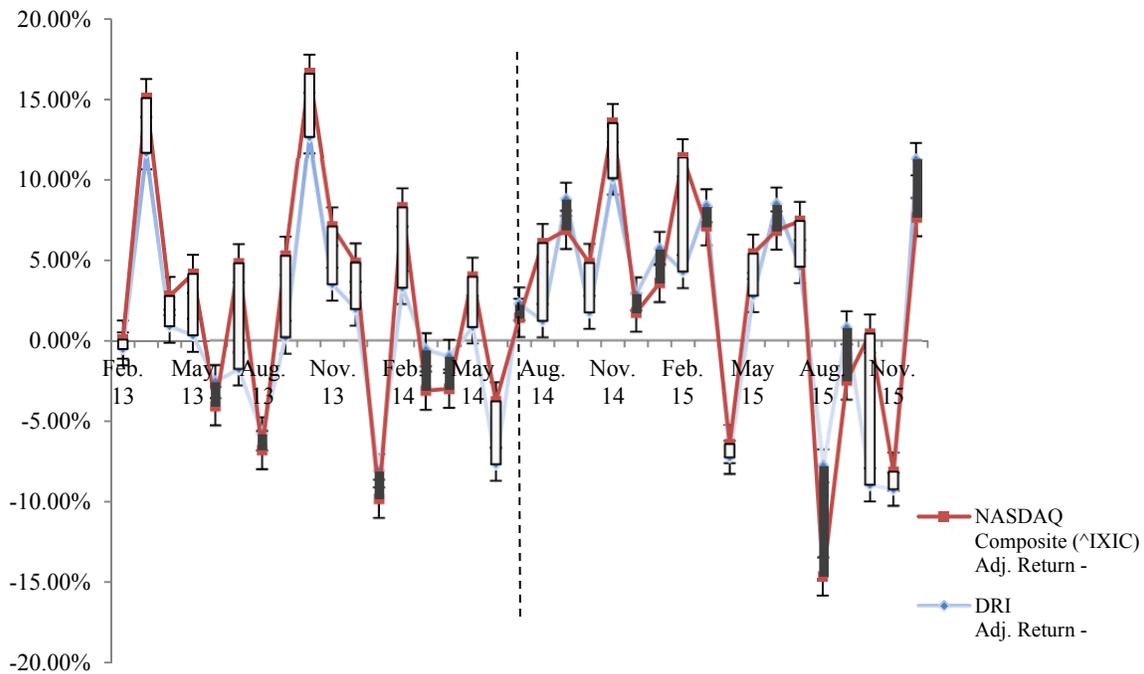
Table 2

Darden's Quarterly EBITDA, Net Earnings (Loss), and EPS Structure (2014-2015)

(Dollars in millions, except for per share data)	Quarters							
	Q1-14	Q2-14	Q3-14	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15
EBITDA	\$200.9	\$161.2	\$153.3	\$98.5	\$250.8	\$246.4	\$213.6	\$164.7
Net Earnings (Loss)	\$109.7	\$86.5	\$503.2	(\$32.8)	\$133.8	\$105.3	\$86.4	\$43.2
EPS (Basic)	\$0.84	\$0.66	\$3.81	(\$0.26)	\$1.07	\$0.83	\$0.68	\$0.34
Source: Quarterly Income Statement Data is gathered from CRSP/COMPUSTAT merged files. Notes: EBITDA: Earnings before Interest, Taxes, Depreciation, and Amortization. Darden's EBITDA calculation is as follows: $[(\text{Operating Income (Loss)}) + (\text{Depreciation and Amortization Expense}) + (\text{Impairments and Disposal of Assets, net})]$ EPS: Earnings per Share including extraordinary items. EPS is derived as follows: $(\text{Net Income} / \text{\#of Shares Outstanding})$.								

Figure 1

Darden’s Monthly Stock Returns vs. NASDAQ Composite (2013-2015)



Source: Closing stock price data for adjusted stock returns is gathered from CRSP/COMPUSTAT merged files.

Notes: Closing prices are adjusted for dividends and stock splits.

Adjusted returns are derived as follows: $[(Initial\ Closing\ Price - Ending\ Closing\ Price) / Initial\ Closing\ Price]$

Dashed line shows the month of Red Lobster sale (July, 2014).

White bars denote Darden’s underperformance over the entire market, black bars indicated the otherwise.

Table 3

Olive Garden’s Quarterly Same-Store-Sales Pattern (2012-2015)

Quarters by Fiscal Years	Same-Store-Sales (in millions)	Δ% in Same-Store-Sales	Quarters by Fiscal Years	Same-Store-Sales (in millions)	Δ% in Same-Store-Sales
Q1-12	\$883.9	-2.90	Q1-14	\$918.3	11.62
Q2-12	\$835.7	-5.45	Q2-14	\$869.1	-5.36
Q3-12	\$956.8	14.49	Q3-14	\$929.5	6.95
Q4-12	\$903.6	-5.56	Q4-14	\$913.5	-1.72
Q1-13	\$921.8	2.01	Q1-15	\$881.7	-3.48
Q2-13	\$848.6	-7.94	Q2-15	\$944.6	7.13
Q3-13	\$813.8	-4.10	Q3-15	\$957.1	1.32
Q4-13	\$822.7	1.10	Q4-15	\$1,06b	5.13

Note: “Δ” symbolizes the change. “b” represents billions.

Data is taken from Darden Restaurant’s 10Qs. Available at: <https://investor.darden.com/investors/financial-information/sec-filings/default.aspx>

Table 4**Darden's Four-Year Annual Cash Flows From Operations, Capital Expenditure, and Paid Dividends Summary (2012-2015)**

(Dollars in millions, except for per share data)	Fiscal Year Ended (Audited)			
	2015	2014	2013	2012
Cash Flows from Operations	\$874.3	\$555.4	\$594.4	\$513.5
Capital Expenditures	\$296.5	\$414.8	\$510.1	\$457.6
Dividends Paid	\$278.9	\$288.3	\$258.2	\$223.9
Dividends Paid per Share	\$2.20	\$2.20	\$2.00	\$1.72

Source: The data was taken from Darden's annual reports. Available at: <https://investor.darden.com/investors/financial-information/sec-filings/default.aspx>
Note: Fiscal Year Ended ends at May each year due to non-published and unaudited financial data for 2015.

cumulatively declined ~30% in the days following each of its earnings announcements (Barington Capital Group Presentation, 2013). The new shareholders believe that newly elected officers bring fresh management and investment perspectives. This helps signal positive major changes to the entire market and potential investors that causes to increase in stock prices, and thus, stock returns outperforming the peer group and the entire market. Although the returns might be volatile in short-term, Starboard's plan would benefit to Darden in the long-run, especially after the official board replacement. Figure 1 demonstrates Darden's stock returns against the entire financial market before and after Red Lobster sale in July, 2014 (Q3-14).

Darden's turnaround is further being implemented by revamping Olive Garden's menu items in an attempt to increase operating cost savings (i.e., a more value oriented menu with a smaller plate focus, restricted number of breadsticks served to the guests, etc.), to boost same-store-sales, and to bolster the restaurant earnings as well as marketing and promotions. Table 3 reports Olive Garden's quarterly same-store-sales pattern.

With the fresh perspective of Starboard's new leadership, Darden has made news by converting its real estate assets to real estate trust funds (REITs), as a significant part of its cost-cutting and debt-restructuring program under Starboard's strategic turnaround and restructuring plans. The company announced initial progress on its real estate conversion plan. Prior to the sale of Four Corners Property Trust, the company executed leasing agreements with the trust for 64 of the properties, mainly Olive Garden stores. Then, an additional 424 properties were transferred to the publicly traded real estate trust fund totaling 488 properties and restaurant stores (Nef, 2015). From the cash acquired in this conversion process, Darden paid down \$1 billion in debt that led the company to have no significant debt repayments until 2035. This conversion also helped Darden rein its capital expenditures in order to maintain its sizable payout to shareholders to unlock approximately \$1-\$2 billion in shareholder value. Table 4

reports Darden's four-year cash flows from operations, capital expenditure, and paid dividends summary.

What is the Next Step for Darden?

Darden is currently evaluating its options regarding the best way to monetize its real estate properties in addition to its recent creation of REITs. Starboard's key piece of future turnaround plans includes the potential sale of Darden's most promising specialty restaurant brands, such as Eddie V's. Pursuant to the financial success of the recent REIT conversions, selling off Darden's specialty restaurant group could increase Darden's current market worth by around 10.0% and improve the current capital structure. Alternatively, selling off the other struggling brands, such as Bahama Breeze can help Darden improve the turnaround efforts and strengthen the financial outcomes. Looking ahead, Starboard also has a solid plan to separate the restaurant concepts into the most logical grouping and re-design Darden's both international and domestic franchising program. Such combinations would most likely unlock value by creating a stand-alone company with significant economical foundation and stable growth.