

Darden Restaurants, Inc. Is the Turnaround Happening?

Case Summary

Darden Restaurants, Inc. (NYSE:DRI) has been in financial and operational transition for the past couple of years. After a long period of undesired financial outcomes, poor management, slow growth, and a failure of the company's products to meet customer needs and tastes, Darden has recently embarked on turnaround efforts of its two flagships brands led by activist hedge fund investor Starboard Value, LP. The primary reasons Darden needed an extensive turnaround was; declining earnings and poor performance in its two prominent brands. The decline in financial performance stemmed from suboptimal menu offerings, shrinking same-store-sales causing negative earnings, low profit margins, and poor stock returns. This decreased company value in the markets, caused stock prices to fall, and increased the spending capital expenditures. Starboard's recovery strategies are focused on four areas. First, Darden has aimed to increase same-store-sales and EBITDA by improving the popularity of menu items and by lowering food costs and waste. Second, the company has been re-designing the real estate ownership structure by separating the domestic real estates and selling off the specialty restaurant group (SRG). Third, the management has enforced a strict policy on capital expenditures through a well-planned spending program and international franchising strategy. Lastly, Darden's objective is to create substantial value for the shareholders by improving per share prices, and hence, stock returns. This case study discusses the recent turnaround strategies of the largest casual U.S. restaurant corporation, Darden Restaurants. The discussions generated in this case study should provide an in-depth understanding of the financial and operational challenges that Darden has been experiencing.

Target Audience

The content of this case study, including the additional readings, is intended for undergraduate students enrolled in managerial accounting, financial management, and strategic management courses. While the analysis of this case study and teaching note is more suited for the undergraduate level of study, instructors of graduate students could also implement the content of this case study in their classrooms by replacing the additionally assigned materials with some of their own textbook chapter readings. The discussions presented here aim to enhance students' critical reasoning, quantitative judgement, and analytical thinking skills.

Analysis of Teaching Objectives and Learning

Outcomes

Instructors will be able to engage their students in an active learning environment to discuss the strategic organizational process and financial consequences of Darden's recent turnaround plan implementation. Instructors might also assign this case study to students so that they can discuss the ramifications of these revival strategies from the financial perspective. The discussion topics regarding the recent revival plan and its effects on Darden's financial and operational performance will challenge students' critical thinking and enhance their reasoning skills with the integration of various business disciplines, such as financial management, strategic management, and organizational management.

Upon completion of this case study, students should be able to:

- Identify the main reasons and issues for why Darden required a turnaround strategy.
- Discuss the various strategic measures taken by Starboard Value LP to turnaround a financially distressed Darden.
- Analyze how the turnaround strategies can affect Darden's key financial metrics of business performance (i.e., same-store sales, profitability, liquidity etc.).
- Assess Darden's managerial change, board restructuring and new corporate culture as a part of its turnaround strategies.
- Evaluate the pros and cons of the strategic actions under Starboard's comprehensive improvement plan and strategies from four different focus areas.

Discussion Topics and Questions

Earnings and Equity Returns:

1. What are the financial impacts of Starboard's strategic cost-cutting measures on plunging earnings and stock returns?

Credit Profile and Debt-Restructuring:

1. How has the sale of Red Lobster affected Darden's long-term debt, net earnings, per-share earnings, and stock returns? In other words, how has Darden's solvency and profitability conditions changed after the sale of Red Lobster? Discuss.
2. Explain what are the consequences and/or financial benefits of Darden's debt-restructuring plan after Red Lobster sale?

Creation of REITs and Capital Allocation:

1. How will a conversion of Darden's real estate into REITs help the company in regard to its operating performance (i.e., cash flows from operations and capital expenditures)?
2. How do increasing cash flows and declining capital expenditures maximize shareholders' wealth?

Class Instruction and Teaching Methods

The content of this case study can be taught in a variety of ways and it allows educators to implement several different teaching techniques. For instance, time permitting, two separate class periods could be utilized to address financial outlook and operational strategies before and after Darden's turnaround plan. Alternatively, one class period could address both and each topic could be divided among small groups. Regardless, each area of discussion requires about an hour and fifteen minutes of instruction and teaching time to introduce, understand, explore, discuss, and check for understanding. Although this class plan is designed based on the minimal time allowance of 75 minutes, instructors can expand and/or allocate more time according to time available for the instructional phases mentioned in detail below.

Prior to Lesson:

Students will be asked to read the case study along with the additional reading materials for financial and operational turnaround strategies and strategic turnaround management. After reading the documents provided, students will be asked to have a good understanding of the content areas:

- The main ideas of the case study.
- The general financial position and organizational condition of Darden.
- Broad view of Darden's turnaround situation.

Furthermore, students should be able to discuss the following topics:

- Darden's need for financial and strategic organizational revival plan.
- Darden's turnaround strategy policies and objectives.
- The financial and operational implementation of the Darden's recent turnaround plan.
- Potential future business practices for Darden's financial and operational stability.

Phase I (Introduction and Open Class Discussion of the Case Study – approximately 30 minutes):

Start the class with the introduction and the purpose of the case study and then deliver the learning outcomes of the case study (5 minutes).

Deliver a brief lecture on the following discipline-specific subjects: (15-30 minutes).

- Organizational turnaround strategies.
- Financial performance analysis (i.e., ratio and/or benchmark analysis).
- Turnaround management process.
- Organizational restructuring and revitalization.
- Managerial decision-making process.

Ask students about their own perceptions and understanding of the case study and encourage them to share their personal opinions

about financial, operational, and strategic organizational outcomes of Darden's recent turnaround plan. Also, stimulate brief student discussion on future financial and operational plans to maintain targeted profit margins, and hence, market value of Darden (i.e., earnings per share – EPS) (10 minutes).

Phase II (Discussion on Darden's Ongoing Managerial Strategies and Initiatives for Its Rebound Plan – approximately 30-40 minutes):

Divide students into small groups (maximum 4-5 students per group) and ask them to prepare answers for the following specific topics outlined below. Give each discussion group about 15 minutes to write up the answers for the discussion topics and have a general in-class discussion about 5 minutes so that they can analyze all the primary discussion topics (20 minutes).

- The financial and operational challenges and primary causes that led Darden to need a drastic resurrection.
- Darden's turnaround strategies, business practices, and the new policies after being taken over by the activist hedge fund Starboard Value LP.
- The most significant changes in Darden's financial position and in the entire operation during and after the implementation of the revival plan.
- A comparison of Darden's key financial metrics before and after the turnaround implementation period.
- Specific examples/elements that positively affected Darden's overall turnaround.

Let each discussion group present their answers and perspectives about the key discussion topics and encourage them to provide their recommendations to (10 minutes).

Briefly lecture on the impact of declining restaurant sales to the earnings per share, and the market value of restaurant corporations (5 minutes).

Recap the discussion and check student learning and understanding in regard to the in-class discussions (5 minutes).

Phase III (Check for Understanding – approximately 10 minutes):

Summarize and outline the key points and the main themes of the case study (5 minutes).

Ask student groups whether their initial thoughts and perspectives about the main topics of the case study have changed after hearing the opinions from the other class members during the in-class discussions (5 minutes).

Phase IV (Written Assignment):

Students will be required to write a case analysis report after they complete all of the aforementioned instructional phases. In their report, students will examine and defend their ideas about the turnaround situation and strategies of Darden, evaluate the financial and operational outcome after the implementation of Darden's turnaround

plan, and analytically structure their perspectives of the current issues presented in the case study. Also, students should include four to six related references other than those provided by the instructor. Lastly, if needed by students, additional information assessment might be given along with the related financial data (i.e., financial projections and future strategic practices of Darden).

Assessment on Student Learning

Student's learning assessment will be measured by an extended writing assignment in the form of a case analysis report. The assessment criteria for the students' level of competency about Darden's recent turnaround strategy include the following:

- **Understanding:** Reading and executing the ideas from multiple sources of information.
- **Analysis:** Thinking through reasoning and reflecting the opinions in the report.
- **Effective Communication:** Integrating information and clear coordination of the ideas with expressing insights of the case study.
- **Content Accuracy & Analysis:** The development of a sustained and well-substantiated argument or point of view. Ability to facilitate the related information to cover the discussion topics.
- **Completeness:** Critique all of the issues and topics mentioned in the case study.
- **Evaluation and Synthesis:** Ability to evaluate the options and offer clear recommendations

Analysis of Teaching Objectives

Darden is moving to the right direction. The company has posted encouraging results after the sale of Red Lobster in mid-2014. The company's EBITDA has greatly accelerated in each quarter of 2015 when compared to quarterly results in 2014 (i.e., \$164.7 in Q4-15, \$98.5 in Q4-14) along with the improved overall net earnings results (i.e., \$43.2 million in Q4-15, (\$32.8 million) in Q4-14). Moreover, Darden's stock returns have picked up and enhanced when compared to the entire market after the sale of Red Lobster. Investors are rewarded with higher stock returns and dividend payouts when compared to the stock return performance and dividend payments before the Red Lobster sale.

Olive Garden's declining same-store-sales have responded well to the turnaround efforts. Trailing twelve quarters, there has been a sharp increase in Olive Garden's same-store-sales by 13.84% (from Q1-12 to Q4-15) generating 56.7% (\$3.8 billion in sales) of Darden's entire sales (\$6.8 billion) in 2015. This pattern has also been supported by serious cost-cutting strategies, especially in 2015. Total operating cost and expenses dropped from \$1,579.9 million to \$1,527.1 (Δ% is -3.34%) and food and beverage costs shrunk to \$482.1 thousand from \$530.7 (Δ% is 9.16%) through the end of 2015. This data provided a significant double-digit boost to the company. The company's overall objective is to overhaul the brand's image and customer dining experi-

ence, and thus, increase earnings and profit margins. With the help of revival plan, it appears that Darden's new strategic direction is paying off. Looking ahead, based on the aforementioned cost-cutting efforts and historical same-store-sales pattern, it is highly expected that combined same-store-sales to be up between 1.5% and 3.0% along with the addition of 30 to 50 net new company owned restaurants in the fiscal years of 2015-17 (Darden Restaurant's 10Q reports).

The REIT conversion has already benefited Darden with higher returns on invested capital. This strategy should provide shareholders with the most immediate and tax-efficient path to unlocking the value of the company's substantial real estate assets. Further, in June 2015, Darden raised the dividend payout by 10.0% and announced an annual dividend paid per share of \$2.20. The company continues the steady annual hikes to its dividends with an attractive yield as a result of drastic cut-off in capital expenditures (35.21% since 2012) and sharp increase in cash flows from operations (70.26% since 2012). That is, Darden is returning cash to its stockholders and presenting a stronger opportunity of higher prices of its stocks (Darden Restaurant's 10Q reports).

All told, Darden's operational performance seems to be pulling off an impressive and so far sustained turnaround with major strategic guidance of Starboard. Looking forward, it looks like Darden will be having this positive trend throughout the fiscal years of 2016-18 (approximately around \$7 billion in sales while having a share net of around \$2.80 and paring roughly \$45 million in interest expense and \$90-\$100 million in total cost and expenses) (Darden Restaurant's 10Q reports).

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Additional Reading Materials Assigned

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