EVOLVING QUICK SERVICE FOR THE FUTURE

JANUARY 2024 / NO. 311

QSR®

Subway Redefines its Future

WITH A NEW OWNER IN PLACE, THE LEGACY CHAIN IS PREPARED FOR A KEY EVOLUTION.

| P.20 |

AND FEATURING:

7 BREW DISRUPTS THE BEVERAGE SEGMENT

The rising brand is grabbing attention with its swift growth trajectory.

| P.30 |

PLUS:

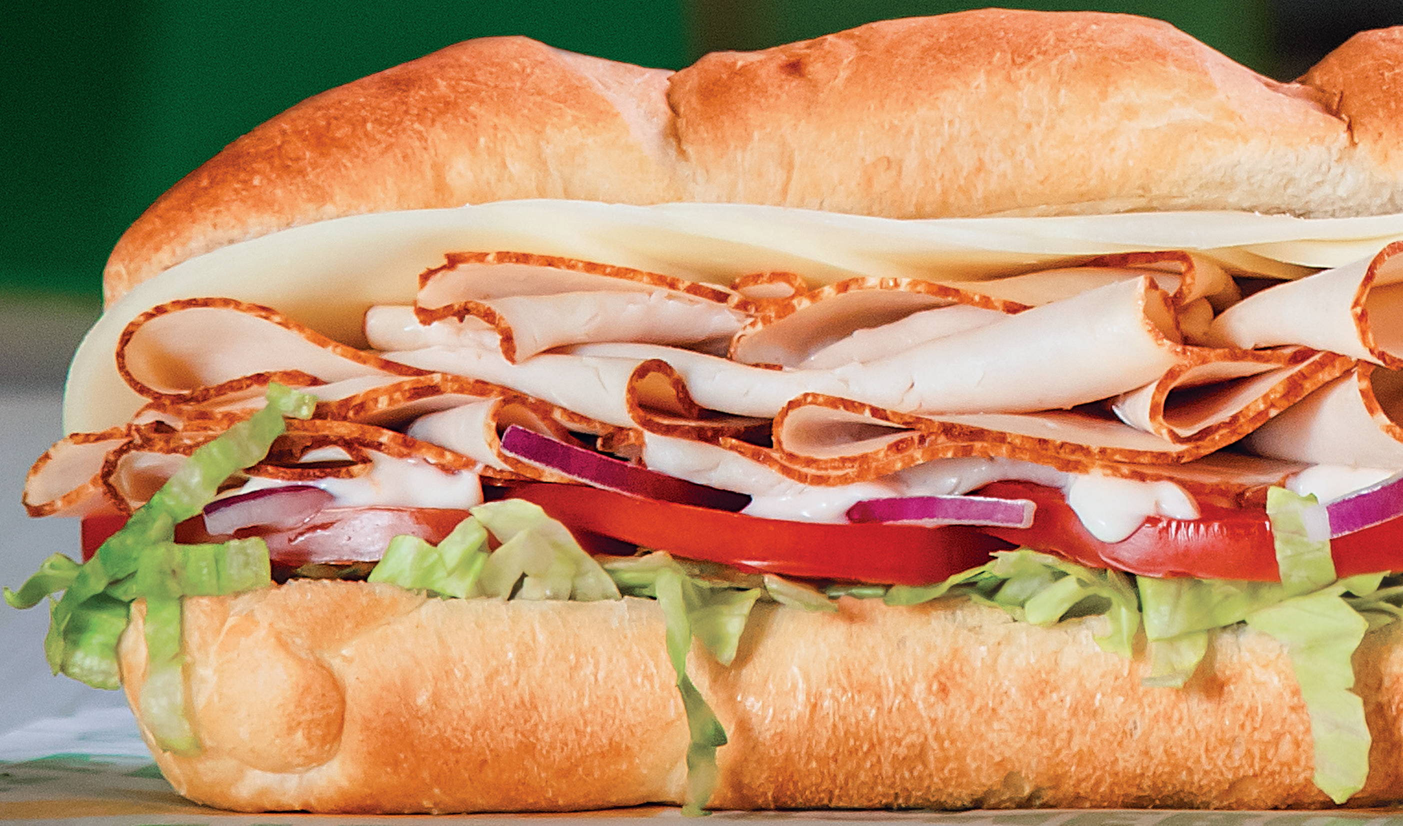


TABLE OF CONTENTS

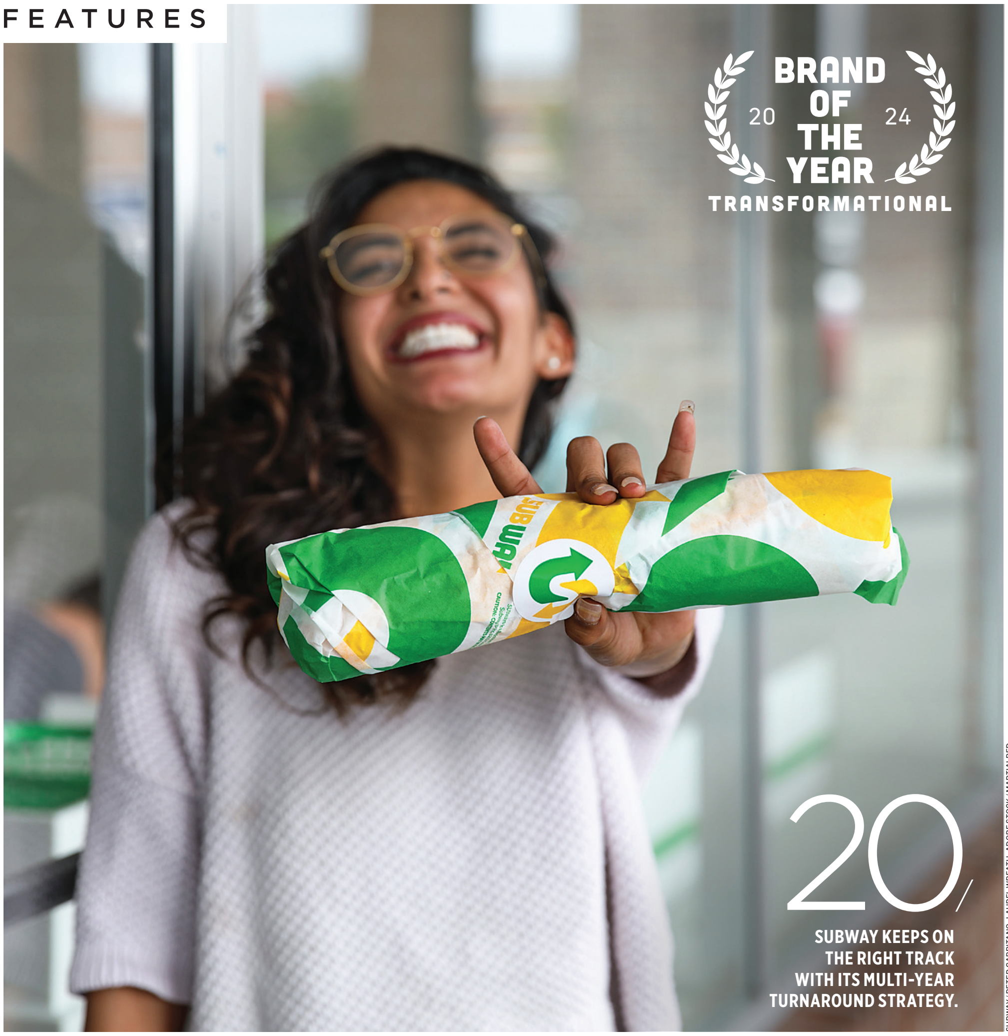
JANUARY 2024

#311

January

QSR / LIMITED-SERVICE, UNLIMITED POSSIBILITIES

FEATURES



SUBWAY / PETER GARRITANO; LAUREL WREATH: ADOBE STOCK / MARTIALRED

DEPARTMENTS

NEWS

INSIGHT

ON THE COVER

Subway is working through a major comeback journey.

PHOTOGRAPHY: SUBWAY
LAUREL WREATH: ADOBE STOCK / MARTIALRED

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HOW SUBWAY BECAME A WINNER AGAIN

BRAND OF THE YEAR 20 24 TRANSFORMATIONAL

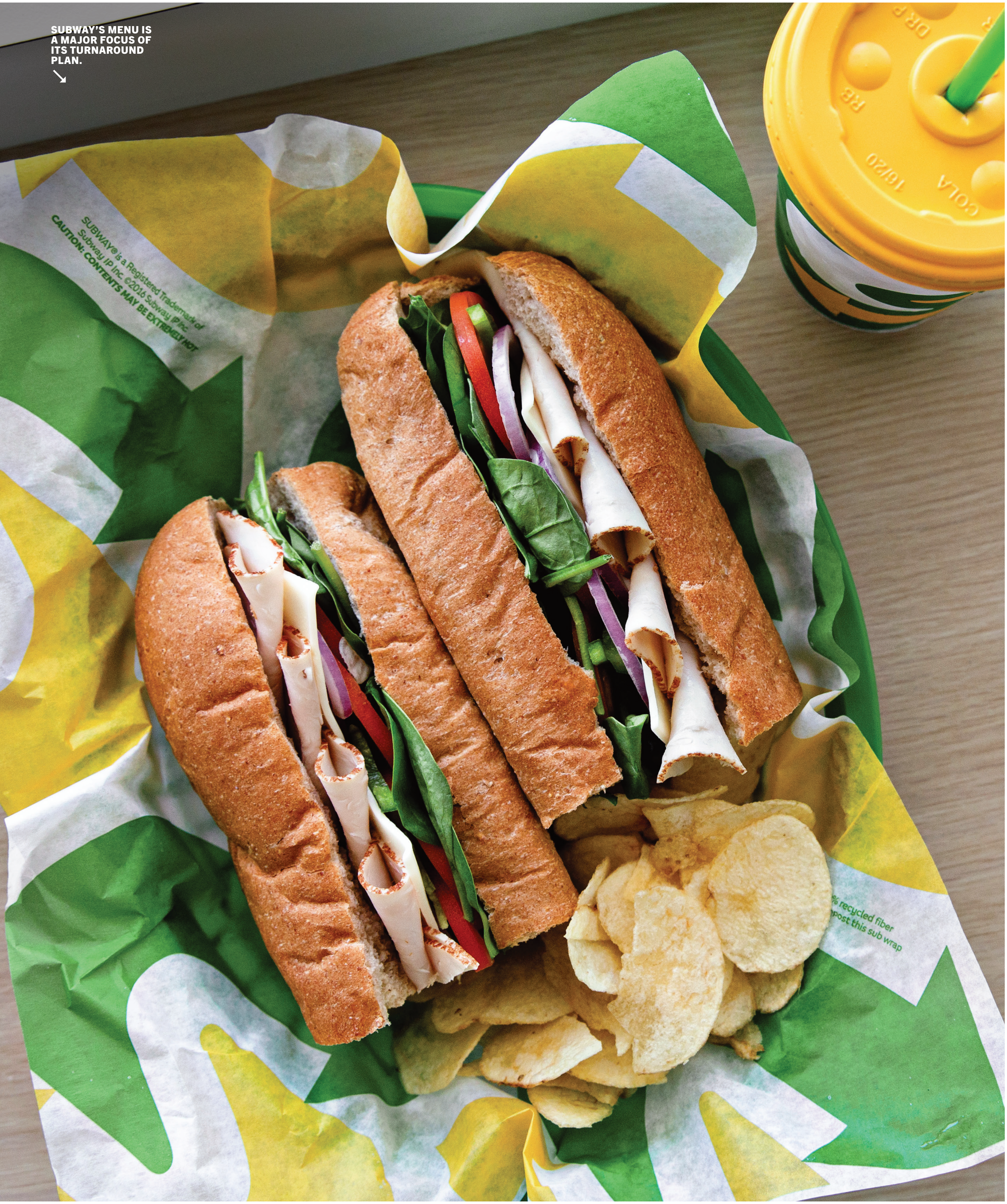
With a new owner and overall growth philosophy, the iconic chain has breathed new life into its future prospects.

/ BY BEN COLEY

CEO JOHN CHIDSEY ARRIVED AT SUBWAY IN NOVEMBER 2019 AND was met with an organization reeling from six straight years of negative sales. The sandwich giant was filled with nearly 60 years of history, but the organization had seemingly never been professionalized.

Over the next few years, Chidsey pulled in experts with experience inside and outside the restaurant industry—McDonald's, Burger King, Outback Steakhouse, Focus Brands, Coffee Bean & Tea Leaf, Pepsi, and Michael's, to name a few—all of whom helped him start "really cleaning things up."

LAUREL WREATH: ADOBE STOCK / MARTIALRED



SUBWAY'S MENU IS A MAJOR FOCUS OF ITS TURNAROUND PLAN. ↘

SUBWAY

Through a variety of marketing, menu, and development initiatives, Subway found itself booming with eight straight quarters of same-store sales growth through the end of 2022. Global comps grew 9.2 percent versus 2021 and 29.1 percent against 2020. In North America specifically, same-store sales lifted 7.8 percent in 2022 year-over-year. Restaurants were repeatedly beating decade-old AUV sales marks. Digital sales quintupled, and international deals were being signed in droves.

The success put Subway, *QSR*'s 2023 Transformational Brand of the Year, in a position to reconsider its future. Co-founder Fred DeLuca passed away in 2013, and his partner Dr. Peter Buck passed away in November 2021. The children weren't heavily involved in the business. Chidsey, as a steward of the brand, initiated a conversation with both families, letting them know that a transition was necessary.

And when he mentioned "transition," he was referring to selling the largest restaurant footprint in America.

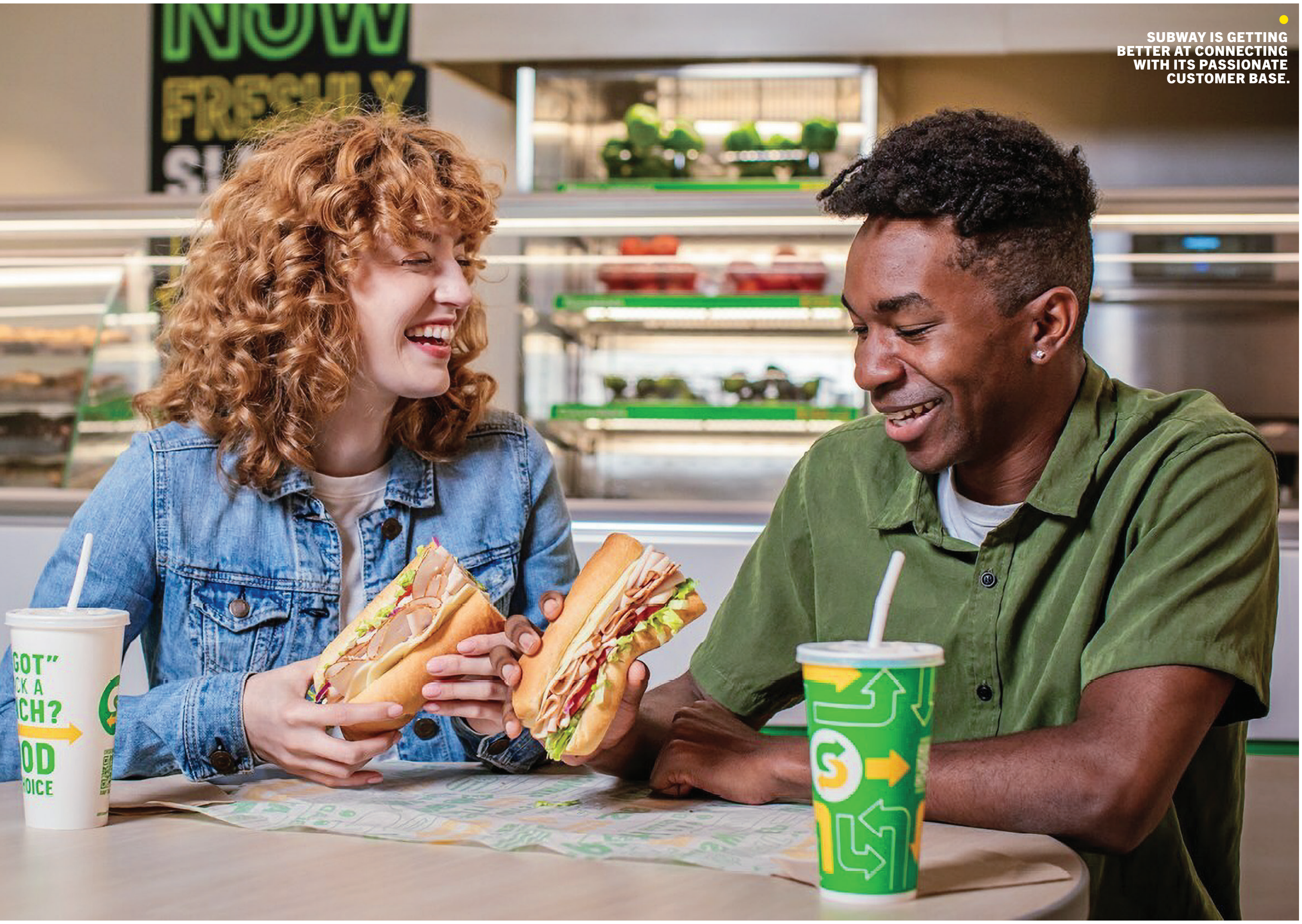
"We were through the turnaround phase, and there was enough growth that we said to them, 'I think we can go out and we can get a big pool of potential buyers,'" Chidsey says. "And clearly want to leave some growth for the next buyer. You don't want to exhaust every avenue. I think the timing was just right from a business standpoint and from where they were in their family situation. The stars aligned, and we took advantage of that window."

SANDWICH SALE

Subway's sales process was well-publicized by the media throughout 2023. The Wall Street Journal first reported the news in January, and the brand followed up a month later with confirmation.

The restaurant was seeking a company that believed in its multi-year turnaround efforts. There also had to be an "incredible commitment" to the franchise community, Chidsey says, given that Subway has partnered with operators since 1974, and there are now thousands across the world.

"Somebody that [the families] thought would love to see Subway—which I would argue we do have our swagger back—continue to be put back on the top of the pedestal where it was and where it's headed," Chidsey says. "I mean obviously they want to get a fair price for the business, but I think they were



SUBWAY IS GETTING BETTER AT CONNECTING WITH ITS PASSIONATE CUSTOMER BASE.

SUBWAY

concerned about finding the right buyer as much as they were focused on maximizing the last possible dollar."

The transaction was unique in that it was a family-owned business looking at private equity as opposed to one investment group selling to another. That's why it helped to have executives from other major restaurant companies who had experience dealing with these types of firms.

Chidsey also notes that one of the beauties of Subway's turnaround is that the company has always been private. Meaning, there's never been outside pressure from analysts or required explanations every quarter about progress.

"This a public fact—Subway never had any debt," the CEO says. "So the fact that we could devote any amount of cash flow we wanted to fix our business and growing it and not have to worry about servicing a large amount of debt like you might have to do if it was a private equity company or even if it was a public company for that matter, really made the turnaround much more enjoyable and doable."

Several companies were reportedly involved in the bidding process, including Goldman Sachs, Bain Capital, TDR Capital, TSG Consumer Partners, and TPG. Adding to the financial complexities was the fact that the federal government raised interest rates multiple times in 2023. Plus, this was one of the most expensive leveraged buyouts in restaurant history, and it "meant that the equity check that a private equity firm had to write was quite large," Chidsey says.

As a result, most of the bidding groups combined into consortiums because Subway and its 37,000-restaurant fleet were too big to handle alone. That paved the way for some confusion.

"Like wait, one group said X and Y," Chidsey recalls. "Aren't you guys in the same group? You're saying X and they're saying Y? And so I think those two factors, the financing markets and just the size of the deal and what that required, made it go on longer than it would have had it been a smaller deal."

Subway revealed in August that it selected Roark Capital— a private equity firm that's familiar with striking major transactions in the restaurant space—at a reported price of approximately $10 billion. This is the same firm that spent $11.3 billion to acquire Dunkin' and Baskin-Robbins toward the end of 2020. Those two chains fall under Inspire Brands, which also operates Arby's, Buffalo Wild Wings, Jimmy John's, and Sonic. Roark's other investments include Focus Brands (Auntie Anne's, Carvel, Cinnabon, Jamba, McAlister's, Moe's, and Schlotzsky's), The Cheesecake Factory, Hardee's, Carl's Jr., and Culver's.

Roark, based in Atlanta, has $37 billion in assets under management. Altogether, its brands span across various industries, including food, restaurants, consumer and business services, health, wellness, fitness, and education and youth activities. It generates roughly $77 billion in annual revenue across 69,000 locations in 50 states and 89 countries.

The price tag is a sizable amount for a restaurant that had its beginnings in 1964 when Buck provided DeLuca with a $1,000 loan.

To Chidsey, Subway selling for such a high number proved how valuable the chain's action plan is. Illustrating his point further, Roark's stated investment philosophy is to "partner with outstanding management teams and provide capital to businesses where sound strategies and superior execution can enhance growth and profitability."

"I think that's a testament to what buyers saw in the business," the industry veteran says. "You wouldn't pay a ton of money for a strategy that you didn't think was right for a management team that you didn't like. You would have sold the business for 70 percent of what it went for or 50 percent, depending on how messed up you thought the strategy was. Again, the fact that it went for such a price that it did indicates that the buyer liked what they saw. And the buyers, all of them to be fair, were very much focused on, 'Hey, we want to make sure the management team stays. We want to make sure you continue to nail your international growth. We want to make sure you continue your menu innovation.'"

Chidsey says franchisees responded with optimism for a handful of reasons. For one, it didn't go unnoticed by operators that when DeLuca passed, there was a moment of uncertainty. There were questions in their mind about what would be the next stage for Subway. The CEO says the unknown was emphatically eliminated with the transaction. Another factor is that Subway chose a company that "understands franchising backward and forward and understands the restaurant business very well." Franchisees also know the brand will enter Roark as a standalone entity, and they expect that many years down the road, it will exit in the same way.

It's the same business plan, same leadership, and same strategy. Chidsey is confident that operators couldn't have asked for a better outcome.

"Franchisees see how they've handled other brands," Chidsey says. "I don't think if you look at previous transactions, you don't see them doing U-turns and deciding to go in a completely different direction. I think that also gives them confidence that things should remain the same and we should continue on the same path we've been on."

REIMAGINING THE LEGACY

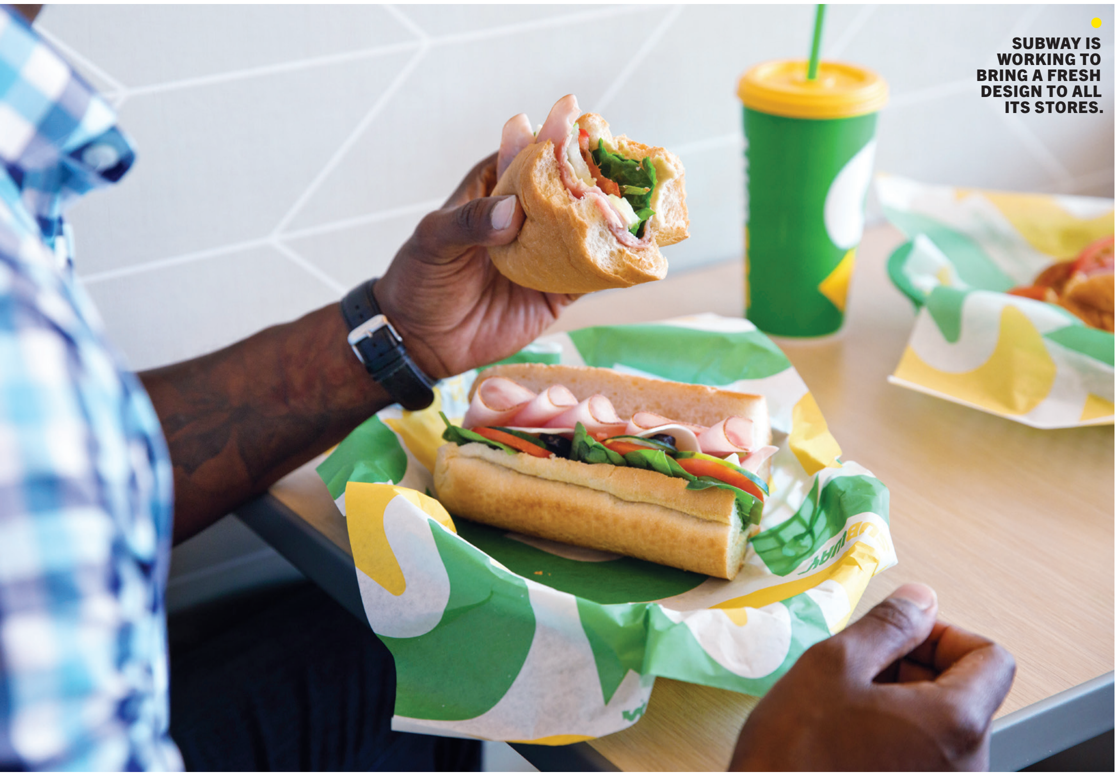
Subway's turnaround efforts touch many areas, one of the most significant being unit expansion. Last year marked the first time the brand experienced systemwide net growth since 2016, with most of it being international.

In the U.S., the story is about growing AUVs through boosting digital sales, building a catering business, continuing menu innovation, and implementing remodels.

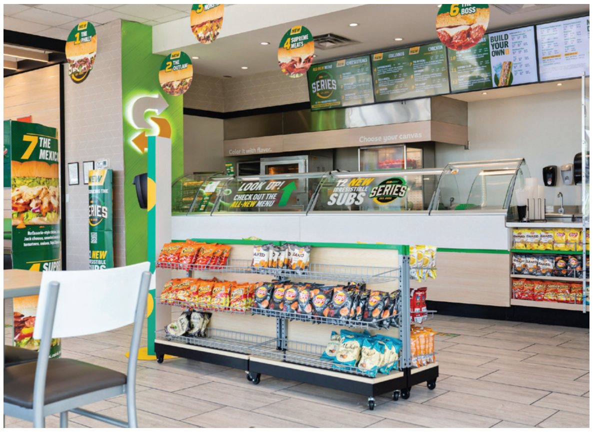
With that said, Chidsey sees domestic whitespace. Between the beginning of 2020 and 2023, Subway shuttered a net of 3,200 U.S. stores. That lost footprint would be among the top 20 biggest quick-service chains in America.

"If you think about the fact that we closed 6,000 restaurants in the U.S. over the last seven years, I'm not suggesting for a minute that you can go back and re-open 6,000 of them, but you could easily go back and probably open half of those," Chidsey says. "I think there are growth opportunities in the U.S. Smart growth opportunities."

Subway is inviting well-capitalized, multi-brand franchisees



SUBWAY IS WORKING TO BRING A FRESH DESIGN TO ALL ITS STORES.



into its system to acquire stores from other franchisees and build out viable trade areas. It's a relatively new way of thinking for the legacy brand. DeLuca's philosophy was for Subway to be the only concept within a franchisee's portfolio. It wasn't just about not having another sandwich chain. No one could be anywhere else in quick service. He also wanted restaurateurs to be small.

The chain has now largely moved on from that strategy. Chidsey told the families that if they truly want to fix the brand in the U.S. and grow it internationally, industry veterans with scale needed to enter the system. But the smaller players won't go away completely. In a town of 2,500 people, Chidsey argues that a single-unit operator is better suited to succeed.

"You can't really fault how [DeLuca] built it. It worked," Chidsey says. "But I would say when you go through a six or seven-year slide though, if you only have one or two restaurants and you get in trouble, you're not super well-capitalized. You don't have a portfolio. The beauty is somebody that has a portfolio of 30-40 restaurants, you can always have four or five over here that are not doing so well, but you've got a big enough pool over here that will help balance it out. Larger operators tend to have bank lines. They've got banking relationships with people. And so when I came here and put the team together, one of the things I said to the family is you have to be willing to pivot away. We'll always have onesie, twosies in little small towns in America."

Much growth could come from nontraditional avenues. Previously, foodservice providers like Aramark and HMSHost operated Subways through many business developers. The competing voices and opinions gave these companies a reason not to work with Subway, Chidsey explains. But the chain has since bought out these developers and removed the middle layer. "They're like, 'Now you're a much easier partner to work with. We always liked your economics. We always liked the product,'" says the CEO, recounting conversations with the foodservice entities.

Meanwhile, existing restaurants are undergoing remodels. Called the "Fresh Forward" design, the changes come with LED lighting, new floor coverings, containers, tables, colors, and chairs. The switch brings a 20-25 percent sales lift if it also involves a franchisee relocating their restaurant to a better trade area. Not including that, the increase is about 10-11 percent. Even if it were minimal incremental dollars, Chidsey says remodels would still be a competitive necessity. "If everybody else is building new shiny objects and yours is looking dated and tired, it's hard to compete. To me it's table stakes," the CEO says. However, he acknowledges that it's an easier sell in the franchise business when you can demonstrate profitable paybacks on the investment.

At last count, around 10,000 units in North America made the change. About 50 percent of the system remains, and Chid-

SUBWAY (3)

sey estimates Subway will get there in the next few years at a clip of 3,000 per year.

"It works from a franchisee standpoint," Chidsey says. "I think part of Subway's problem was, like all brands, when you go through an extended period of sales declines, brands tend to look the other way in terms of enforcing things like remodels because they're worried rightfully so that people will just hand you the keys and say, 'I'm not going to do it.' Now that we're on 11 straight quarters [of same-store sales growth], franchisees have a lot of confidence and enthusiasm in the brand. They have a lot more money in their pocket. So it's much easier to get them to do what they're supposed to do."

International growth is the immediate prize. Subway has the fourth-most restaurants outside of the U.S., trailing McDonald's, KFC, and Starbucks. Globally, the chain has inked 15 major franchise deals over the last couple of years, resulting in over 9,000 restaurant commitments spanning across Europe, the Middle East, Africa, Asia Pacific, Latin America, and the Caribbean. Notably, in June 2023, the brand unveiled a monumental agreement in China, adding nearly 4,000 units to its portfolio and expanding its presence in the country by a factor of seven.

As of late October, at least three to four more deals—all in large sizes—were expected to happen in the next one to two quarters. Then, through the next two years, Chidsey hopes Subway can ink another 12-15 agreements. Some potential future countries include Spain, Italy, Japan, Mexico, and Vietnam.

Subway has almost 17,000 international units in 100 countries, but Chidsey says the chain is "a mile wide and an inch deep" in most of these markets. Other brands like McDonald's, Domino's, KFC, and Burger King have a roughly 2:1 ratio—or greater—of international to domestic units. If Subway rose to the same proportion, that would put its international footprint past 40,000.

"Now, I would argue we should do even more than that because Subways are smaller, cost less money," Chidsey says. "So in theory, if you went to an international developer and they said I want to put $50 million into the brand, you can build a lot more Subways with $50 million than you could Burger King."

JOURNEY ISN'T OVER

One of the hallmark moments of Subway's comeback came in July 2021 when it unveiled the most significant menu launch in its history. There were over 20 updates, including 11 new and enhanced ingredients, six new or returning sandwiches, and four reimagined signature sandwiches.

Chidsey says this effort came at a time when franchisees were disillusioned about not seeing menu innovation for a long time. The launch two-and-a-half years ago conveyed a message to customers and franchisees that a new era had officially begun. The other feedback Subway heard from consumers centered on craveability. So the chain came back in July 2022 with the Subway Series, a category of chef curated sandwiches that can be ordered by name or number. A year later, the brand pushed the envelope further by introducing a Deli Hero lineup featuring sandwiches with freshly sliced meat. The company invested $100 million in providing meat slicers to all of its 20,000 U.S. locations.

"We'll never walk away from customization," Chidsey says. "We can't because that's how the brand is built. But I think one day we've always said we'd love to be 50/50. Just continue to build the Series but still have what people have known forever if that's the direction they want to go."

The innovation not only appeals to customers' taste buds but also their growing need for convenience. From a digital perspective, it's easier for guests to order pre-constructed sandwiches than to check individual ingredient boxes. And Subway is motivated to drive people to toward this because the website and app are its most profitable channels. Global digital sales increased 12.9 percent through the first three quarters of 2023. In North America, it lifted 22.4 percent during the same stretch. The mix is around 16-17 percent, a huge jump from around 3.5 percent prior to the pandemic. Subway's end goal is to push it to 30-35 percent.

Chidsey understands that's a distant future, but the brand has levers to pull, like seriously diving into the catering business—a sales channel that didn't get much attention before the CEO came on board. Loyalty will play a role too. Subway enhanced its rewards program in the fall, and within the first month, it signed up an incremental 704,000 guests. That was a 60 percent increase year-over-year.

Menu innovation and digital strategies reel in new customers, but recent marketing initiatives have proven how passionate core customers are. Around 8,000 signed up to ride a branded Subway blimp, including one who lived in Portland and flew across the country to cash in his ticket in Orlando. Another time, the chain wanted to see how many would be willing to legally change their name to Subway to get free sandwiches for life. Apparently, 10,000 would.

The initiatives have put the brand "in a completely different place" compared to before the current C-suite took over, Chidsey says. Subway surveyed operators in 2020, not having ever done it before. It did the same at the beginning of 2022 and found that belief in the brand was up double digits.

He believes all signs indicate that Subway will continue to maintain its position as the No. 1 global sandwich player.

"We have an ability to do things that our competitors in our space sandwich space can't really do," Chidsey says. "Because of our scale, we obviously can purchase food packaging cheaper than they can do, we can afford to invest way more money in technology in terms of loyalty programs, digital, etc. I think we have the scale and the benefit and the blessings of that scale and size to really do pretty much what we want to do. The onus is on us to take advantage of the financial scale that we have and just the brand presence that we have to continue to elevate the guest experience. And I think as long as we do that, it's going to be very hard for anybody to catch us just because we're so far ahead and we have that opportunity that would take them decades to get to that level of funding and brand trust."

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