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Abstract

A common assumption in the restaurant industry is that restaurants fail at an exceedingly high rate. However, statistical research to support this assumption is limited. The authors present a study of 10 years in the life of three markets and offer new data for managers to consider.

Keywords

Chris Muller, Robert H. Woods, The Real Failure Rate of Restaurants, Hannan and Freeman

The Real Failure Rate of Restaurants

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“Restaurant Fails!” To many these two words would invoke neither interest nor suspicion. Restaurants have often been expected to fail because the industry is known to have one of the highest failure rates in the U.S. economy.

But over an extended period of time restaurants may not fail at such an astronomical rate. Indeed, according to Restaurant Business magazine and the Wall Street Journal, 1990 will see industry shrinkage for the first time in over a decade; growth through the 1980s was the best ever.¹ When one considers the growth rate of the restaurant industry in this country, it simply does not make sense to believe that the failure rate is nearly as high as popularly assumed. For example, in 1989 the National Restaurant Association estimated that there were 528 people for every commercial food service outlet in the United States.² When compared to the population per food service outlet of 10 years earlier, according to the NRA, in 1979 there were as many 800 Americans per food service outlet, 272 fewer persons per food service outlet in 1989 than in 1979. Therefore, over the last decade the number of food service outlets in the United States per person has increased by about 60 percent. Interestingly, over this same period the total population of the country increased by only about 5 percent. Such statistics would suggest that restaurants, in general, are flourishing.

Regardless of the apparent growth in total number of restaurants in the United States between 1979-1989, according to conventional wisdom, somewhere between 50 to 80 percent of all new restaurants

which open this year will fail within the first 12 months of opening their doors. This same conventional wisdom also suggests that about 50 percent of the remaining restaurants will fail in their second year of operation and another 33 percent in their third year.

This means that if 100 new restaurants were to open this year, 50 to 80 would fail before their first anniversary. That would leave 30 restaurants open in year two. Half of these 30 would subsequently fail in this second year, and a final third of those remaining would fail in their third year. As a result, if this conventional wisdom were true, after just three years, only 10 of the original 100 restaurants would remain open. As a result, there is about a 90 percent compound failure rate over the first three years of a restaurant's lifespan. However, if this were true the industry would have to have opened nearly 10 times as many restaurant units as it closed during the past decade. This phenomenal, and unlikely, 600 percent "new unit" growth simply did not occur.

Current Impact of High Failure Perception is Significant

Unproven, but widely believed statistics such as the 90 percent failure rate are significant. Such statistics undoubtedly affect how several different stakeholder groups perceive the restaurant industry. Bankers, for example, are an important stakeholder group interested in such figures because statistics such as these represent an important assumption in their screening decision when it comes to loaning money to new restaurants. Indeed, anyone who has even once asked a banker for a restaurant loan can likely attest to how broadly this group is influenced by the perceived high failure rates within the industry.

As many restaurateurs will acknowledge, it is always difficult, and often impossible to interest bankers in making loans to entrepreneurs who operate in an industry with such high perceived risks. Even when loans for restaurants are available, restaurateurs often must pay higher interest rates or provide more extensive collateral requirements to secure these "high risk" loans than might be required for other "less risky" ventures. This increased perceived risk is, of course, a direct result of the conventional wisdom which says restaurant failure rates are very high.

Negative statistics such as those promulgated by the current conventional wisdom can also be significant for potential restaurant industry managers and employees. Surely this group of stakeholders must at some point assess whether or not they are interested in working for a firm that is at high risk of failure. For that matter, potential employees must wonder whether it is wise to consider a career in an industry in which failure is believed to be more common than success. Indeed, even hospitality management students (as future employees planning careers in the restaurant industry and as potential owners and operators themselves) must, of course, also be keenly interested in such unhealthy performance statistics.

Since the perceived high failure rate for restaurants is important to many interested groups, it is also important to identify the source of

such statistics. Even though it is generally accepted that such high failure rates exist for restaurants, there is no research to support such claims. There appears to be little commonality between fact and fiction in this area.

To determine the real failure rate of restaurants, a method popularized by Hannan and Freeman in their "population ecology" studies of organizations in 1974 and 1985 and widely accepted in organizational behavior was used.

Research Shows Failure Rate is Lower

Restaurants depend primarily on their local consumer markets and secondarily on a transient or travelling market for their business. A primary means of communication to both of these market segments is by telephone. Hannan and Freeman assumed that all restaurants have telephones and, additionally, that in order to reach their two principal markets most restaurants advertise in the local Yellow Pages telephone directory.

When Hannan and Freeman applied this approach to the study of the birth and death rates of restaurants in 18 cities in California, they found that only 14 percent closed during the three-year period in which the sample was observed, and an additional 12 percent changed ownership but remained open. Therefore, it is assumed that a change in ownership is indicative of failure (which, of course, may not always be true because some restaurants change hands for other reasons, i.e., relocation of original operation, death of owner, etc.). Over the three years of the extensive Hannan and Freeman study, a total of only 26 percent of the restaurants observed experienced some form of failure.³

Hannan and Freeman selected a random sample of restaurants to observe for their study. While this approach is, of course, acceptable, rather than duplicating this method and creating a random sample of restaurants selected from the Yellow Pages, the sample markets in this study included the entire restaurant population for each of the markets studied. As a result, rather than observing the birth and death rates of some restaurants in the chosen market, these phenomena were charted for all of the restaurants in the markets. This approach is, of course, very time consuming as the following brief description of the methods outlines.

The Hannan and Freeman method is a longitudinal approach to observing movements in the market. Therefore, to effectively utilize this method a benchmark must first be established. This was done by first culling a list of all restaurants in the Yellow Pages in each of the three markets studied. The relevant telephone books for each successive year were used to duplicate this first step, i.e., to identify and list each restaurant advertised in the Yellow Pages.

Firms which were continuously listed were assumed to be still in operation, while those which were no longer listed were assumed to have been closed. Since telephone directories customarily require payment for each directory listing in advance of going to press, this is a fairly reliable judge of recent (less than one year) business viability.

New restaurants were added each year and others were identified as being in continual operation; those enterprises no longer listed were considered to have been closed by their ownership. Therefore, by observing restaurant markets over a period of time, it was possible to chart both the lifespan of restaurants in each market as well as their openings and closings. The observation period in each of the three markets was 10 years; then the total observations were combined.

Environmental Conditions Are an Influence

Results for the three observed markets were combined to reveal an average overall failure rate of just 27 percent during the first year, less than 50 percent by the end of year three, and about 60 percent at the end of five years of operation. Indeed, the failure rate over the entire 10 years amounted to less than 70 percent. These failure rates are, of course, considerably lower than those which the prevailing conventional wisdom anticipates. In addition to the discovery that restaurant failure rates are much lower than those suggested by conventional wisdom, some additional trends were evident. These trends are discussed in the following chapter.

In each individual market, and therefore in the combined markets, restaurant failure rates went up during times immediately following an economic disruption, such as the recession of the early 1980s, or following a major localized economic event, such as the opening or closing of a factory or other large employer. This finding may appear at first glance to appear normal. However, the implications are, in fact, far from "normal." Indeed, from this information it can be assumed that individual firm failure, while generally attributed to operator mismanagement, may rely more on environmental conditions than on individual management practices. In fact, the statistics collected tentatively suggest that restaurant closings are hastened more by external factors within the environment than the prevailing view implies. If proven true by further research, this observation would tend to contradict the notion that good management can always overcome negative environmental conditions.

Implications Exist for Managers and Owners

While this research is only preliminary, some observations and implications are suggested for restaurant managers and owners. These implications appear to have special significance for operators anticipating decisions about unit expansion and entry/exit decisions, as well as those planning strategic marketing strategies.

- **Economic stability likely means "1 birth=1 death":** During periods of relative economic stability, there is also a "general" stability in the total restaurant population in most local markets. This means that over the short to middle run (9 to 24 months) when a new restaurant opens, one or more existing restaurants will be forced to close within a relatively short period of time.

- **Strategic marketing should target weak players:** In stable markets with no significant external environmental conditions, new entrants should aggressively target weaker players in the market with campaigns designed to take away existing market share from those players within the first year of operation. In this way new restaurant market entrants can “choose their victims” from the existing competition by assuming that the first contention of 1 birth=1 death will likely prevail. Companies that do this will, of course, be able to compete on a more individualized or localized scale rather than attempting to compete with the entire market population.

- **Identify market niches:** Prior to site selection and opening, new entrants should identify vulnerable market niches where there is a strong potential for niche domination within 24 months. In this way restaurants may be able to somewhat insulate themselves from the 1 birth=1 death phenomena effects of new market entrants in the future. (This implication is based on the finding that birth and death rates are different in different market segments.)

- **Plan for longer market establishment periods:** In the past, conventional wisdom has suggested that restaurants need sufficient cash to sustain the first three months of operating budget. Preliminary results of this study suggest that, in fact, the first three years are crucial to long-term viability. Therefore, the implication for managers is that cash flow budgeting should be extended for at least this long in order to ensure success.

- **Purchase restaurants that are three years old:** A conclusion that can be drawn from observing this three-year success pattern is that when looking to purchase an existing restaurant, operators should seek those firms that are just concluding their third year of operation—since these restaurants have already apparently weathered the real “shakeout years.” Therefore, contrary to popular opinion, current operator profitability at this point may in fact be less important than the implied capture of sufficient market share to retain niche strength.

- **Study the external environment carefully:** Finally, it is of paramount importance that individual restaurant operators maintain a constant understanding of the external economic variables that have an effect on overall restaurant demand. Much of the conventional wisdom in restaurant management circles emphasizes cost containment and concentration on other internal variables. The initial results of this study suggest that extreme factors, such as variations in both the prime and local lending rates, cost-of-living index, factory lay-offs or hiring, and general unemployment levels, may be at least as important to eventual success as concentration on internal performance variables.

A case in point to illustrate this implication is that it appears likely from preliminary research that as local economies take a downturn and workers are displaced, a flurry of new restaurant openings occurs within the following two years. These marginal players, most likely lured by the apparently low barriers to entry into the restaurant business, will likely dilute the overall local demand for restaurants, and may speed both the decline of otherwise viable operations or weaker operators. The observant operator will sense these external factors and take the steps necessary to ensure a continued dominant market presence.

This research must still be considered preliminary⁴, but research is being expanded into other cities, other researchers (whether educators or operators) should conduct similar studies on their own local markets because the broader the reach of such studies, the more understanding there will be of the real causes of restaurant failure.⁵

References

¹Brent Bowers, "Enterprise," *The Wall Street Journal*, (October 23, 1990), p. B1.

²National Restaurant Association, *1989-1990 Food Service Industry Pocket Factbook*.

³Michael T. Hannan and John Freeman, *Organizational Ecology*, (Cambridge, Mass.: Harvard University Press, 1985), pp. 315-316.

⁴In Syracuse, N.Y., over 1000 restaurant listings were observed from 1977 to 1987, while in Boone and Shelby, N.C., another 500 restaurant openings and closings from 1979 to 1989 were observed.

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