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FINANCING THE FUTURE

Experts answer the biggest restaurant real estate and finance questions.

BY DAVINA VAN BUREN

Lending Lowdown

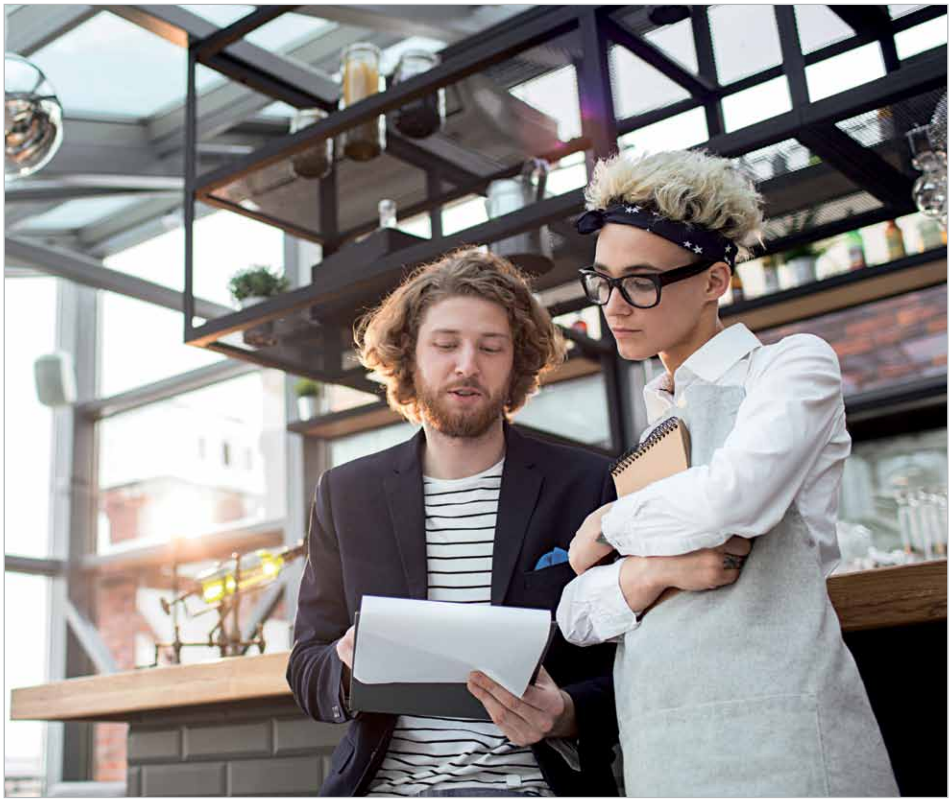
What restaurant leaders need to know about finance options.

You're ready to make the big leap into restaurant franchising, or perhaps it's your first foray into the restaurant business. Whether you are a seasoned franchisee or a fledgling restaurateur, the lending process can be quite daunting.

Typically you'll be working with a broker, and you'll need a lender to provide capital for land, equipment, inventory, and startup expenses, such as running the restaurant for a period of time before opening. Several types of finance products are available to borrowers, and some of the most common include traditional and nontraditional bank financing, equity financing, debt financing, Small Business Administration (SBA) loans, and working capital loans. "A business will want to have a discussion with their accountant or attorney to determine what may be the best option based on their business initiatives," says Len Baccaro, senior vice president of sales for **Ascentium Capital**.

The restaurant franchise finance sector is serviced by other constituents, too, including cash-flow specialty lenders, equipment finance companies, and even hedge funds. "Smaller owner-operators with one to three stores typically turn to either friends and family or SBA lenders to source funds," says Michael Vallorosi, managing director of Franchise Finance Business at **CIT Group**. "Larger owner-operators can typically tap more conventional lending sources, like specialty lenders or banks. Hedge funds usually lend to highly leveraged, fast-growth, or storied borrowers," Vallorosi says.

Which financing option is best for you depends on your specific situation. Traditional bank financing can be difficult for some franchisees to secure, as many



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banks want to see tangible assets that can be used as collateral. "For national and regional brands, the lack of control that a franchisee may have over the property or terms in the franchisor agreement can be a red flag to banks," Baccaro says.

Another option is using a build-to-suit developer that offers financing in the form of a lease structure. Typically this would entail the developer paying the costs of the new development minus some fees, such as equipment, signage, and franchise fees. "We perform all the real estate-related services for the operator from site selection to turn-key delivery at our cost," says Brenna Wadleigh, CEO at **N3**. In exchange, N3 owns the land and building and leases it to the operator over a long-term lease. This arrangement allows the operator to offload all the real estate and construction oversight and can lower investment in each store significantly. "Some operators prefer to own the real estate and get loans, and this works well for certain groups," Wadleigh says, "but the downside is slower growth and a lower return on overall investment."

One thing restaurant operators should never do, Wadleigh says, is pay to build a building on a ground lease. If you default in any way by missing payments—or in certain cases closing for a remodel or changing the brand—you may lose the right to the building. In addition, the cost to lease the land plus the payment on the building financing is generally 10–20 percent higher than bundling them together. "Unless you are certain that you will never miss a rent payment and you have at least 75 years' worth of known lease extension options, paying for a building on land you do not own is a very risky investment," she says.

Just like with buying a home, lenders will want to see that you have your financial ducks in a row when they meet with you, so make it easy for them by coming prepared. "Lenders will want to see your financials, a lease abstract, a five-year business plan, and an organizational chart showing key positions such as CEO, CFO, district managers, the head of HR, and legal officers," says Kevin Burke, managing director at **Trinity Capital**. "Be organized with your documents and have a proposal that shows sources and uses of funding."

It is also critical that owner-operators share their vision and plans for the business and the financial projections that tie into that vision, including any expansion plans or upgrades and expenditures associated with facilities or other physical assets. In addition, if the company or its owners have had financial issues in the past, this information should be shared with the lender, along with any insights as to what happened and how it was resolved. "Lenders do not like surprises, so it is always best to share information directly rather than have it reported by third parties," Vallorosi says.

"Having a good idea of where your company can be a few years down the road and knowing what your capital needs might look like then is an important choice when deciding on the appropriate debt capital solution."

Knowing how lenders measure a business is a powerful tool for any business owner, but especially important for restaurants who may not have the tangible assets mentioned earlier. Lenders want to know that a potential borrower not only fully understands day-to-day operations, but that they also directly (or indirectly via a strong CFO) have a strong handle on the financial strengths and characteristics of their business. "Understanding key metrics like same-store sales, peer ranking comparisons, free cash flow generation amounts, unit-level economics, and cost of goods or labor trends tells a lender that the owner is a student of his or her industry and is likely going to be a good steward of their capital," says Robert O. Daniel, managing director and group head of **Regions Restaurant Banking**.

The good news? In the midst of a prolonged strong economy, there is ample liquidity available for borrowers. The bad news? Interest rates are on the way up, Burke says. "Restaurant operators should pay attention to their loans and see if they are strategically well-situated for a rising interest rate environment." Make sure there is adequate room on loan covenants, that there is sufficient time before loan matures, and that adequate cash reserves are on hand. "All can facilitate preparation for a raised interest rate environment," Burke says.

As with any business, restaurateurs should be actively looking toward and planning for the future—even before they have secured financing. "Having a good idea of where your company can be a few years down the road and knowing what your capital needs might look like then is an important choice when deciding on the appropriate debt capital solution," Daniel says. SC

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The Perfect Position

Real estate selection is crucial to restaurant success.

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Choosing the right location is the most crucial aspect of opening a restaurant. Even with excellent management, a dedicated crew, and an exciting menu, a restaurant can't survive if it doesn't have the clientele to support it.

"Site-selection errors are the No. 1 cause of restaurant failures," says Kevin Burke, managing director at **Trinity Capital**. As such, it is crucial to delve deeply into this aspect of your business during the planning phase. It's worth investing a considerable amount of time, effort, and research into site selection to make sure your restaurant is set up for success from day one.

First, restaurant operators should work with reputable data analytics firms to learn what the competitive profile is in a given area. The profile should include a demographic report, crime rates, analysis of current and future traffic patterns and competition, a summary of development activity, and what development costs are for a given area. Sales tax data should reveal the sales numbers for competing concepts. Get as much information as you can and try to get an overall feel for the area.

"Site selection errors are the number one cause of restaurant failures."

"If you're operating in a top concept, there will likely be other sites of your brand, and you can see how they are performing," Burke says. "If a good site comes up, you have to be decisive. If it's a really good site, it won't be on the market for long."

Armed with this information, restaurateurs can view sites with a critical eye. Brenna Wadleigh, CEO at build-to-suit real estate firm **N3**, says her company evaluates four key components related to franchisee investment decisions: the real estate quality, the rent level compared to the expected annual sales, the operator's experience and credit, and the brand's current competitive position and expected future success. "As a landlord, we pay for all the land, the construction costs, and the design and soft costs; the operator pays only the franchise-related costs, the equipment and signage. Therefore, it is critical to make sure they will succeed at the location and be able to afford the rent, especially in the event of periodic sales or market declines," she says.

With up to 70 percent up quick-serve

revenues flowing through the drive thru, it's essential to make sure a site is conducive to your concept. "You need an adequate drive thru that can funnel a number of cars in the stack, plenty of room to make the turn, and two drive-thru windows," Burke says. Space should be laid out intelligently—if the site is on a busy corner, where consumers perceive it as too difficult to get in and out, they will pass by—and be able to accommodate dine-in customers as well. "Then you need to find a space that will accommodate the specs from your brand," Burke says.

If the real estate location and quality are there, make sure the site is affordable. "Analyzing total occupancy cost against high and low projected sales scenarios is critical," Wadleigh says. A great site may never generate enough sales to pay high rents or mortgage payments to cover the cost of the real estate, construction, and finish-out. On the flip side, a poor real estate location or access issue will almost always ensure poor sales. "Balancing affordability and real estate quality is the most important aspect of selecting sites," Wadleigh says.

Something else to consider is neighbors. Just like in residential neighborhoods, some are more desirable than others. These days, restaurants are extremely personal to consumers. Much of quick-serve advertising focuses on fun, family experiences, and indeed, many loyal customers treat the experience of dining with certain brands like having dinner with a trusted loved one. As such, the restaurant's location must resonate with its targeted customers on that personal level. "If a consumer wants healthy choices for their family's dinner, they don't want to walk their kids into a restaurant next to a vape shop," Wadleigh says. "Likewise, if the consumer is headed to a group dinner of craft beer and hamburgers, then they don't want to walk into a spot next to Weight Watchers." Knowing who your target customer is and ensuring you are in a location that attracts them is key. Wadleigh also says quick serves should stay abreast of trends: mobile order pick-up, third-party delivery services, and kiosk order boards are changing the real estate criteria. "Don't buy or lease more land than you need to if a good bit of your business is off-premises dining," she says.

Finding the right broker for you is also of critical importance. Build-to-suit real estate companies engage with brokers directly, so that the operator can focus on operations and acquiring more franchises. If you do wish to engage a broker directly, drive the market personally and see who the most prominent brokers are and who has the most listings in the area that are similar to the type of space you need. Narrow down a few options and then interview each formally.

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"Ensure you both run the numbers and agree and document the maximum rent or land purchase price you can afford as well as the detailed site criteria," Wadleigh says. If your broker is also a developer, discuss how to resolve that conflict so that you see all the opportunities in the market and can make more informed decisions. "A good broker respects that the real estate process is important enough to be formal with mutually acceptable expectations for reporting, communication, and results," she says.

Once you do choose the right broker, stay loyal. Don't ask several brokers to look for sites for you or send out social media blasts soliciting sites. "As soon as a developer or broker hears that you have someone else also scouting sites for you, all meaningful work on your account stops and sites start getting sent to other operators first," Wadleigh says. "The key is choosing the right developer or broker, setting clear expectations for results on both sides, and giving them a formal engagement so they know the assignment is a real one." SC

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Managing Expenses

How restaurants can plan for necessary purchases.

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Securing a location and a physical building are by far the biggest expenses restaurant operators incur when opening a new location. But, like all businesses, several other items must be factored into the finance planning equation.

"After the land and building, the biggest expenses are equipment and startup costs—which would be running the restaurant for a week or so before they open so everyone gets a feel for their jobs—and then inventory," says Kevin Burke, managing director at **Trinity Capital**.

For existing restaurants, remodels are another costly venture. While ongoing maintenance and small improvements should be covered by ongoing profitability and cash flows, larger expenditures like major remodels generally require some level of financing. "Oftentimes for franchisees, the extent of the remodels can be driven by requirements from the franchisor and in some cases can exceed the total buildout cost of the original restaurant," says Robert O. Daniel, managing director and group head at **Regions Restaurant Banking.** Restaurant operators may also need financing for a "refresh"—think of it as a mini makeover—or for extensive equipment upgrades.

Quick-serve operators who are looking to expand will want to become well-versed in acquisition costs. "Some of the biggest expenses outside of real estate for a restaurant owner can be construction costs related to new unit development or expansion expenses related to the acquisition of existing units," says Len Baccaro, senior vice president of sales for **Ascentium Capital**. "Additionally, furniture, fixtures, and equipment (FF&E) acquisition and upgrades can become costly as well."

In some cases—such as those when rapid expansion is expected—restaurant operators may want to consider leasing options. Leasing allows the operator to spend their capital on acquiring new brands or more stores within their existing brand instead of using their capital for large down payments on new projects. "Leasing your real estate and equipment is usually a bit more expensive annually but allows operators to grow faster and open more stores," says Brenna Wadleigh, CEO at **N3**. "By leasing, operators can open double or triple the amount of their locations opening per year, resulting in higher bottom line profits compared to owning real estate." When an operator is trying to meet a development commitment or simply earn as much operating profit as possible while the markets are favorable, leasing can be a valuable tool in an operator's financial tool belt.

Finally, you'll need to market your new business. For most large concepts, marketing is handled by a franchisor in an effort to unify branding and is included in their national ad budgets. Franchisees can also contribute to their local market or in-store marketing campaigns, typically at a rate of about 2 percent.

"We have seen many businesses in this sector factor about $20,000 on average into their marketing cost to start up," Baccaro says. "A working capital loan can be a solution to meet these out-of-pocket expenses. Credit approval and funding can occur within 24 hours, helping business owners quickly meet any unexpected costs." **SC**