Lending to Restaurants

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••Despite their reputation, restaurants can be an acceptable credit risk if lenders perform initial and ongoing due diligence.

BY GREG FRAKER

THE RESTAURANT INDUSTRY plays an important part in the American lifestyle and is a key component of the U.S. economy. According to the National Restaurant Association, the typical adult in the United States visits a restaurant 5.8 times a week.[1] And approximately 44% of adult Americans believe that restaurants are "an essential part" of their lifestyle.[2]

Despite the importance of restaurants, lending to them is often perceived as a risky endeavor. Yet, a new restaurant's failure rate during its first three years of operation is the same as the average for all industries, according to data from the U.S. Bureau of Labor Statistics.[3]

This article discusses factors to investigate when lending to a restaurant—specifically, the qualitative factors that influence the success or failure of a restaurant, the quantitative measures that indicate whether a restaurant is financially healthy, and how guarantees and collateral should be evaluated. If done prudently, lending to a restaurant can be an acceptable credit risk.

Qualitative Factors

In 2005, researchers from the Ohio State University and California State Polytechnic University, Pomona conducted a study on why restaurants fail.[4] The study identified characteristics shared by successful restaurants and those common to failed restaurants.

Key Concept and Strategy

According to the study, the most distinguishing characteristic separating successful restaurants from failed restaurants was having a "clear concept that drives all activities" and "goes beyond the type of food served." Successful restaurant owners had "a well-defined concept that not only provided a food product but also included an operating philosophy, which encompassed business operations as well as employee and customer relations." Meanwhile, owners of failed restaurants "could only describe the food and could not expand their description of [their] concept beyond food production.… They would state that their concept was 'vegetarian food' or 'Alaskan seafood.'"

> ***Successful restaurant owners had a well-defined concept that not only provided a food product but also included an operating philosophy.***

While a clear concept is essential, the study concluded that having a well-defined strategy—in marketing and pricing, for example—was not critical to a restaurant's success. The researchers observed that "some of the most successful [restaurants] did not have a well-defined strategy.… Some of the restaurant owners who had been extraordinarily successful were 'going with the flow.'" On the other hand, the study noted that some restaurateurs failed despite having well-defined strategies.

Work–Life Balance and Energy Levels

Because of the immense time commitment required to run a successful restaurant, the study concluded that the work–life balance of the owner and key managers is one of the most important determinants of a restaurant's success. Successful restaurateurs were single, divorced, or good at balancing their family and work lives. Conversely, owners of failed restaurants were no longer willing to make the family sacrifices.

The researchers observed that successful restaurateurs "had a passion for business and high energy levels," whereas owners of failed restaurants "lacked the high energy levels necessary to motivate themselves and their employees." During their interviews with the researchers, every failed restaurant owner cited the "burden of the immense time commitment required for a restaurant" as a factor in their establishment's failure.

Failed restaurants often had inadequate financial management, including weak controls (cash and inventory) and poor accounting records.

Marketing and Advertising
In terms of marketing, the study concluded that successful restaurateurs considered public relations, community involvement, and customer relations important to their success. On the other hand, it found that successful restaurateurs shared a strong belief in not advertising and not using promotions. One successful restaurateur commented, "If you have to give something away, then you shouldn't be in business."

Successful restaurateurs also said that having a defined target market was not critical to their success. During the interviews, the researchers observed that some of the most successful restaurateurs could not even define their target market.

Location and Competition
The study concluded that having a great location or benefiting from a lack of competition was not critical to a restaurant's success. It also noted that a restaurant can "overcome a poor location by a great product and operation, but a good location cannot make up for a bad product or operation." Most of the successful restaurateurs interviewed were not concerned with specific competitors. They defined their competition "as any dining establishment," including dining at home, and viewed their competition as "a tool for self-measurement" rather than "something to use to develop strategic defenses."

Other Factors
The study identified several other determinants of a restaurant's success or failure. Failed restaurants often had inadequate financial management, including weak controls (cash and inventory) and poor accounting records. Another factor in failure was the lack of good managerial advice, such as that given by a CPA or other outside consultant. In addition, many failed restaurants suffered from poor food-quality controls, which often led to lower quality food. Finally, the study noted that small, independent operations typically have higher failure rates than franchised restaurants.

Analyzing a Restaurant's Financial Statements

Types of Financial Statements
When financing an *existing* restaurant, you should obtain at least three years of tax returns and CPA-prepared financial statements, as well as interim financial statements for the most recently ended period (Table 1). When financing the *acquisition* of a restaurant, you should obtain historical financial statements under the seller's ownership and projections under the new ownership. And when financing the *start-up* of a new restaurant, you should obtain projections for at least three years.

Most likely, restaurants will have tax returns and financial statements prepared on a cash basis. Cash basis reporting is acceptable in lieu of accrual basis reporting because the majority of a restaurant's sales are paid by cash, debit card, or credit card, rather than on trade credit (accounts receivable). Accordingly, a restaurant's financial statements should not be significantly different whether prepared on a cash basis or on an accrual basis.

Table 1
Types of Financial Statements Used in RMA *Annual Statement Studies*®

	2005	2006	2007	2008	2009
CPA audited	149	157	129	141	135
CPA reviewed	139	162	130	126	172
CPA compiled	443	465	499	502	498
Tax returns	967	1,053	1,083	1,102	1,309
Other	901	902	951	1,086	1,073
Total	**2,599**	**2,739**	**2,792**	**2,957**	**3,187**

Analyzing the Income Statement
Typically, a restaurant will request either a capital/acquisition loan or a short-term loan to support start-up costs. Since such loans are not "self-liquidating" (where the source of repayment is the liquidation of current assets during a short-term operating cycle), the restaurant's ability to generate sufficient cash flow is more critical than its liquidity and working capital. Many of the factors that influence a restaurant's cash flow can be assessed by analyzing the income statement (Table 2).

Sales
A restaurant's sales are determined by its average check per customer times the number of customers it serves. Since a restaurant's average check per customer is based on its prices, it's important to understand how a restaurant determines its prices; in other words, is price determination done

Table 2					
Income Statement: RMA *Annual Statement Studies®*					
	2005	2006	2007	2008	2009
Sales	100.0	100.0	100.0	100.0	100.0
Cost of sales	40.8	40.0	39.9	39.7	38.7
Gross profit	59.2	60.0	60.1	60.3	61.3
Operating expenses	54.6	55.2	56.0	56.9	57.5
Operating profit	4.5	4.8	4.1	3.3	3.8
Other income/expenses	1.2	1.4	1.5	1.4	1.3
Net profit before income taxes	3.3	3.4	2.6	1.9	2.5

qualitatively (for example, through management's intuition) or quantitatively?

The qualitative method is inferior because it ignores the impact pricing has on the restaurant's profitability and cash flow. Quantitative methods, on the other hand, require the restaurant's management to analyze how prices affect a desired quantitative outcome, such as net profit, cash flow, or ending-period cash balance.

The number of customers served is largely influenced by the restaurant's physical capacity, how quickly its tables turn over, the hours of operation, daily dining patterns (breakfast, lunch, dinner), and seasonal fluctuations.

Expenses

Like any business, a restaurant incurs fixed and variable expenses. (In the short term, variable expenses change due to fluctuations in sales, whereas fixed expenses do not change.) You should assess the restaurant's operating leverage, which is the percentage of fixed expenses to total expenses. If the restaurant's fixed expenses are significant relative to its total expenses, it will have a high operating leverage. Thus, its profitability (and cash flow available for debt repayment) will be greatly affected by a fluctuation in sales.

The most significant variable expense incurred by a restaurant is for food and beverages. Normally, food and beverage costs (and any other ancillary costs directly related to serving customers) are shown on a restaurant's income statement as *cost of goods sold* (COGS). The difference between the restaurant's sales and its COGS is its gross profit margin. According to RMA *Annual Statement Studies®*, the typical restaurant's gross profit margin is around 60%. If the restaurant's gross profit margin differs significantly from this figure, you should investigate the reasons for the divergence.

A restaurant's fixed expenses include insurance and management salaries. If the restaurant used debt financing to purchase the real property from which it operates, fixed expenses will include interest expense. If the restaurant leases its location, fixed expenses will include rent expense. Insurance, management salaries, interest expense, and rent expense are nondiscretionary. They cannot be avoided in the short term. On the other hand, some of a restaurant's fixed expenses, including advertising, training, and charitable contributions, may be discretionary. The restaurant's management can reduce or cut these expenses in the short term to meet debt-servicing obligations, if the need arises. When lending to a restaurant, you should evaluate its ability to reduce or cut discretionary fixed expenses, if such an action becomes necessary to service the loan.

Before lending to a restaurant, you should always assess a restaurant's break-even sales level and continue to do so periodically throughout the term of the loan.

Profitability

To be profitable, a restaurant needs to generate enough sales to cover its expenses. By knowing a restaurant's average check size per customer, its average variable cost per customer, and its (dollar) level of fixed expenses, you can determine the number of customers needed to break even.

A restaurant's break-even point in customers can be determined by dividing its fixed expenses by the difference between its average check size per customer and the average variable cost per customer, or:

Fixed costs / (Average check size per customer – Average variable cost per customer)

From there, a restaurant's break-even level in sales can be calculated by multiplying the number of customers needed to break even by its average check size per customer. Before lending to a restaurant, you should always assess a restaurant's break-even sales level and continue to do so periodically throughout the term of the loan.

A restaurant's net profit (sales less all expenses) indicates overall profitability. Equally important is the restaurant's net profit margin, which is its net profit divided by its sales. According to RMA *Annual Statement Studies®*, the net profit margin for a typical restaurant is 2.0% to 3.5%. If the restaurant's net profit margin is significantly different from this, be sure to investigate why.

Table 3

Assets: RMA *Annual Statement Studies*®	2005	2006	2007	2008	2009
Cash	14.0	14.5	13.7	13.9	14.7
Trade receivables, net	2.6	2.4	2.6	2.1	2.0
Inventory	6.1	6.0	6.2	6.4	6.2
Other current assets	2.9	3.2	3.2	3.2	2.8
Total current assets	**25.6**	**26.1**	**25.6**	**25.6**	**25.7**
Furniture, fixtures, and equipment, net	53.0	53.5	53.1	52.6	52.8
Intangible assets, net	10.7	9.9	11.4	10.9	11.4
Other noncurrent assets	10.7	10.5	9.9	11.0	10.2
Total noncurrent assets	**74.4**	**73.9**	**74.4**	**74.4**	**74.3**
Total assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Table 4

Liabilities and Net Worth: RMA *Annual Statement Studies*®	2005	2006	2007	2008	2009
Short-term notes payable	5.0	5.2	5.2	6.2	5.4
Current maturities of long-term debt	4.4	4.3	4.8	4.7	5.0
Trade payables	11.1	10.0	10.1	10.1	9.7
Income taxes payable	0.3	0.1	0.2	0.2	0.1
Other current liabilities	19.6	19.2	19.8	20.6	21.5
Total current liabilities	**40.3**	**38.8**	**40.1**	**41.8**	**41.7**
Long-term debt	37.4	34.9	36.5	35.9	36.3
Deferred taxes	0.1	0.1	0.1	0.1	0.1
Other noncurrent liabilities	11.5	11.3	11.3	11.7	13.2
Total noncurrent liabilities	**49.0**	**46.3**	**47.9**	**47.6**	**49.6**
Total liabilities	**89.3**	**85.1**	**88.0**	**89.4**	**91.3**
Net worth	**10.7**	**14.9**	**12.0**	**10.6**	**8.7**
Total liabilities and net worth	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Analyzing the Balance Sheet

A restaurant's balance sheet provides less information about its ability to service a loan than its income statement, but it should still be analyzed. The balance sheet will provide insight into how the restaurant funds its operations and how it financed fixed-asset acquisitions such as equipment.

Since most of a restaurant's sales are paid in cash, debit cards, and credit cards, its balance sheet should reflect a greater level of cash than accounts receivable. If the balance sheet reflects a considerable level of accounts receivable, the restaurant most likely provides catering services. Inventory generally consists of food and beverages. Typically, this inventory is delivered to a restaurant two or three times per week, so it has a limited shelf life and is turned over very quickly.

Owing to the cash nature of its sales, a restaurant generally does not require significant short-term borrowings to finance its operations, although it may finance its inventory purchases through trade payables. Besides any trade payables, a restaurant's balance sheet may reflect other current liabilities, including taxes payable (payroll taxes, property taxes, sales taxes) and insurance premiums payable. When lending to a restaurant, be sure to investigate initially and then periodically whether the restaurant is current on its taxes and all its insurance policies are in effect.

Because restaurants are usually very capital intensive, long-term assets such as equipment and real estate (if owned) represent the majority of its assets (Table 3). According to RMA *Annual Statement Studies*®, fixed assets represent approximately 50% to 55% of a typical restaurant's total assets. Also, restaurants are typically highly leveraged, as their fixed assets are generally financed by long-term financing. According to RMA *Annual Statement Studies*®, the typical restaurant's total liabilities are between six and 10 times its net worth. A restaurant having more liabilities relative to its net worth could be a reason for concern (Table 4).

Analyzing Cash Flow/Debt Service Coverage

A restaurant's EBIT/interest expense ratio can be used to measure the degree to which its cash flow adequately services its debt. According to RMA *Annual Statement Studies*®, a restaurant typically has an EBIT/interest expense ratio of around 2.50X to 3.00X. A ratio significantly less than this may suggest debt-servicing difficulties. Also, since RMA's ratios are based on annual statements, a restaurant's EBIT/interest expense ratio should be analyzed at its seasonal low point to account for seasonality (Table 5).

Table 5

Selected Ratios: RMA *Annual Statement Studies*®	2005	2006	2007	2008	2009
EBIT / Interest expense	2.9	3.0	2.5	2.3	2.8
Debt / Worth	8.3	5.7	7.3	8.4	10.5
Sales / Net fixed assets	6.9	6.8	6.8	6.8	6.7
Sales / Total assets	3.3	3.3	3.2	3.3	3.2
Pre-tax profit / Total assets	7.8	9.2	7.6	5.9	7.3
Pre-tax profit / Tangible net worth	39.6	37.5	37.2	34.1	36.5

Personal Guarantees

Before making a loan to a restaurant, you should always obtain personal guarantees from the individuals with a significant ownership interest. Evaluate the quality of their guarantee by examining personal financial statements, personal credit reports, and at least two to three years of personal income tax returns. Also, if ownership interest is held in a trust (a family trust, for example), obtain a guarantee from the trust and a copy of the trust document to verify that the trust can indeed supply the guarantee. Of course, a guarantee will be stronger if a guarantor has income outside the restaurant or personal liquidity that can be used to supplement the restaurant's cash flow in the event that it underperforms.

Collateral

Typically, collateral consists of restaurant equipment or real property (land and buildings). Before taking restaurant equipment as collateral, you should obtain serial numbers and, if possible, perform a third-party appraisal or some other estimate of value. Because both restaurant equipment and real property may be difficult to liquidate, except to another restaurateur, it's best to use conservative loan-to-value ratios. And because restaurant equipment has a limited purpose, be sure to investigate its functional obsolescence and any other factors that could impair its liquidation in the event of default.

Conclusion

Lending to a restaurant can be an acceptable credit risk, provided that initial and ongoing due diligence is performed. Risk can be managed appropriately if the borrower's qualitative factors are found to be similar to those of successful restaurants and if its financial performance is assessed to be at or above industry norms. Additionally, the strength of both personal guarantees and assets pledged as collateral can help in determining the level of risk inherent in lending to a restaurant. ❖

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Notes

1. National Restaurant Association, *2008 Restaurant Industry Factbook.*

2. National Restaurant Association, *2010 Restaurant Industry Factbook.*

3. Kerry Miller, "The Restaurant-Failure Myth," *BusinessWeek*, April 16, 2007.

4. H.G. Parsa, John T. Self, David Njite, and Tiffany King, "Why Restaurants Fail," *Cornell Hotel and Restaurant Administration Quarterly*, August 2005.