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EMERGING BRANDS

Effective Use of Private Placements for Emerging Restaurant Concepts

By Dennis L. Monroe

The one consistent issue in the restaurant industry is the inability of small, start-up or emerging restaurant companies to find a source of early-stage financing, particularly equity capital.

Further, it is rare for an intermediary (such as a broker/dealer) to do fundraising and be involved with emerging restaurant companies.

What is the solution? Let's first look at recent developments.

The JOBS Act of 2012 (the "Act") is an attempt to facilitate the flow of investment capital for early-stage companies and improve access to equity capital for growth companies. The Act allows companies to find investors on their own, thus reducing the need for intermediaries. The Act has three components:

A. Raising the Regulation A limitations from $5M to $50M

B. Allowing for general solicitation to accredited investors

C. Reducing compliance and oversight, particularly as it relates to small IPOs.

Given the backdrop of the Act, what does an equity funding look like for a growing restaurant company? The most common early stage equity investment for these growth companies is the use of private placements.

A private placement is normally facilitated through a private placement memorandum ("PPM"). The PPM structure normally provides for a preferred class of investment where the preferred investor has an absolute preference as to his investment and a preferential return (somewhere between 8% to 12%).

This preferential return is not a guaranteed return if there are not available funds to pay the investor. The operator (common investment owner) gets nothing or at most a minimal distribution until the preferred investors get back their investment plus the preferential return.

Let me give you an example of a growing company that wants to develop five corporate stores of its concept. Each store costs approximately $400,000 to open. The company is able to secure bank financing of $200,000 per store for a total of $1 million and needs to raise $1 million of equity.

Normally, this new development is facilitated using a separate legal entity controlled by the concept company. A license agreement is entered into for the use of the concept (usually at a very low rate), as well as a management agreement. This new entity develops new stores and distributes available cash to the investors.

The first distribution out of available cash is to pay the preferential return. The second distribution is to repay the investors' actual investment. Once the investors have received their total preferential return and investment, the operator then gets a significant share of the cash flow. Available cash is what is left after all expenses and debt have been paid and reasonable reserves are established. There are other governance rights that are provided to the preferred investors for their protection.

The value of the preferred investment is that it provides for high yield based on a strong cash flow model. Most restaurant companies are cash businesses and deliver a strong unit-level economics, thus making this type of investment appropriate for wealthy individuals, self-directed investment funds or family offices. In all cases, we are dealing with Accredited Investors.

The process of finding investors is tricky and normally needs to be conducted by the restaurant company owners seeking out friends, family, advisors and key contacts.

What about crowd funding?

I am aware of a start-up Italian concept that was able to raise $1M through crowd funding. In part this was done through PR pieces, local periodicals and the use of table tents at the restaurants to advertise the investment opportunity. In general, however, crowd funding has not been successful in the restaurant industry.

The capital-intensive nature of restaurants requires a significantly larger investment than most other start-ups. It is also better to have a few large investors than to have a bunch of small investors. Another problem with crowd funding is that this investment vehicle can make it significantly more difficult to raise subsequent rounds of capital.

Private placements are one of the best ways (other than a rich uncle) to raise appropriate equity for early stage and emerging restaurant companies, and with certain changes in the law, they have become a much more interesting and viable funding mechanism.

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