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A Wider Use of Private Individual Funding

By Dennis Monroe

You know the old adage "How do you make a million dollars in the restaurant industry? You start out with two million." It may not apply in today's more thoughtful restaurant business environment, but for a restaurant to make it 10 years is still tough. However, making a good return on $1 million goes up dramatically if the investment is with a proven operator.

Given entrenched doubt regarding the success of the restaurants, why do so many individuals (not professional investors) find restaurant investments attractive?

My recent article "Why do private equity firms invest in restaurants" shared three reasons: 1) Good cash flow if the restaurant is successful, 2) scalability, meaning the concept can be expanded by opening new units; and 3) just plain fun. I believe "it's just plain fun" is the best part, as I have invested in restaurants and have had a great time along the way.

Most individuals investing in restaurants are not mortgaging their houses. They are putting a reasonable amount of funds into the investment, but not at such a level it would change their lifestyles. Obviously there is some risk, but your real assurance of success is if the owner/operator has a proven track record and is putting in his or her own funds, know-how and sweat equity to make the venture succeed.

Keeping these conditions in mind, what do various investment structures look like and what are some key things we can learn about investing in restaurants? There are four general types of investments by private investors in restaurant ventures:

1. The most basic type of investment is a **straight common equity interest** in the restaurant, where all investors simply get a pro-rata share of stock or membership interest based on each investor's percentage of investment. The one exception is money put in by the owner/operator is normally given a higher percentage than that of the outside investors. For instance, if there is a need for a $1 million equity investment and the investor puts in $100,000, the investor would get 10% of the equity. If the owner/operator puts in $100,000, he or she might get 20% plus. This recognizes the owner/operator's additional contribution. In this type of investment, the profits are split pro-rata based on the investors' percentage interest in the company. It's important to note the owner/operator normally has operational control and handles the financial affairs of the business. All other decisions are made by majority control. This approach does allow for the use of bank debt to create a higher return for all of the owners. There are two key elements with this type of approach: ensure (a) the owner/operator feels adequately compensated; and (b) there is adequate working capital for the start-up.

2. The second approach, and which is probably the most common, is where **investors get their money back first with some type of preferred return** (such as 6% to 8%). Until investors receive their money back, profits and cash from the business are usually split something like 80/20—80% to the investors and 20% to the owner/operator. Once the investors have received their preferential return and their investment, then the split usually goes to something like 70/30—70% to the owner/operator and 30% to the investors. Often if the investors don't receive their return for a given period of time (such as two years), they may have the right to take control and appoint a new operator. Like approach #1 above, this scenario does allow the use of bank debt to create a higher return for all owners.

3. The third approach is the **use of debt vs. equity**. This scenario consists of the investor making a loan to the venture, with a participation right upon the ultimate sale or liquidity event of the restaurant. The loans are normally unsecured and provided by individuals in increments of $50,000 to $250,000. The interest rate is high—in the 8% to 12% range—with interest paid annually or possibly the first year accrued and then paid annually with the note coming due in five to seven years. To calculate an investor's upside, you determine the initial value of the enterprise and the note holders may, for instance, get 20% of the value over the initial value and split that pro-rata among themselves. This normally only occurs when the restaurant is sold or there is some type of refinancing. The nice thing about this debt approach is it keeps the balance sheet fairly clean because it is unsecured debt and provides all of the equity to the owner/operator except in the case of a liquidity event, when the lenders will share in the upside.

4. The last scenario is what is known as **the royalty approach**. Money is loaned to the new venture by various investors. Rather than getting a fixed rate of interest, they receive a royalty payment equal to some percentage of the gross revenue of the venture. That royalty rate is negotiated, but it does provide the investor a potentially higher rate of return as revenue increases. For instance, a 3% royalty paid either

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quarterly or monthly is deductible interest by the borrower and interest income for the investor. If revenue goes up, the note holders get more interest; thus, a higher return. This approach recognizes the potential risk from a pure debt investment. In summary, this route provides market interest payments with a real upside as the venture grows.

There are countless iterations of the above four scenarios. Of course, one approach frequently used is landlord contributions and investments. This route can get tricky if the new venture does not have a clear understanding of the rent cost, and the operators can end up paying for the landlord investment for the life of the lease rather than having it amortized out. But the landlord is always a good source of both tenant improvements and pure investment.

With the stock market performing so poorly, these types of private investments are becoming more and more popular.

Dennis L. Monroe is a shareholder and Chairman of Monroe Moxness Berg PA, a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation. You can reach him at (952) 885-5999 or by email at dmonroe@mmblawfirm.com.