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A New Dynamic For Restaurant Profitability

by Dennis Monroe

A discussion of the financial aspects of the restaurant industry would not be complete without a look at market trends and new market segments. As the model of creating profitable restaurants continues to evolve, it begs this question: What is an appropriate operating model and what are reasonable returns?

Restaurant segments are evolving because of competition, the shortage of real estate and the "compaction" of concepts. QSR and casual dining are looking more like fast casual and vice versa. This permeates all segments of the restaurant community. The remedy involves alternative sites, as well as owner-operated or chef-driven concepts—much like McDonald's original idea of having an owner-operator in the store.

In major cities, you see a growing number of neighborhood restaurants that are filling the need for casual dining and replacing the Applebee's neighborhood model. These restaurants, from 2,000 to 5,000 square feet, are able to draw significant loyalty from surrounding areas, achieving volumes from $800,000 to several million dollars. Part of this success is due to social media's role in spreading the word about hot concepts and the inability of older national chains to be creative. The exceptions, of course, are those concepts that have successfully navigated social media such as Domino's or other ones embracing food on demand.

The anatomy of the new urban restaurant is probably the model that was used in small town America for many years. Whether family, casual or even upscale, this kind of restaurant was owner-operated. The key is to build a quick and loyal following. The uniqueness must be in décor, food, ambiance, and entertainment, or whatever the local demographic deems appropriate. Chain restaurants have a hard time attaining this flexibility. In the owner/operator model, each restaurant has its own personality.

Let me describe a few composite types of these restaurants, based on actual ones I'm seeing around the country.

1. Modified Fast-Casual: These restaurants often have ethnic food such as Mexican, Italian, ramen or bistro food. Often, the menu is limited. In many cases, the restaurant uses a modified counter service in roughly 2,000 to 3,000 square feet. I have seen a proliferation of these coffee shop-type concepts (Panera comes to mind) that offer pastries, sandwiches and other unique offerings, serving three day parts. These restaurants have volumes in the $800,000 to $1.2 million range. Normally their investment costs are from $400,000 to $700,000. Labor costs are reasonable, particularly if the owner and family work in the restaurant. Check averages run $10 to $15. The cash flow is enough to adequately provide for the owner and possibly a manager. I see the life expectancy of these restaurants at five to 10 years. Sometimes these concepts are retooled, moved, or the owner develops the next concept in the space. This type of concept is the modern day answer to Chipotle and Panera.

2. Modern Casual Dining. These eateries focus on hamburgers, pizza, Italian, or other popular foods. The volumes are in the $1.5 million to $2.5 million range in 4,000 to 5,000 square feet. The investment runs from $500,000 to $1.2 million. In most cases, there is a strong emphasis on alcohol, particularly craft beers, craft cocktails and reasonably priced wine. The alcohol mix tends to be 30%. Sometimes these concepts are multi-unit because they get a certain following around a metropolitan area. These restaurants are often something the average consumer likes, particularly millennials, because they are considered predictable, without being stale. Check averages run $15 to $25. I have seen restaurants that are hamburger driven do volumes near $5 million. I know of a unique concept in the South that is a combination of small plates and Southwest Mexican that is doing $4 million-plus. In most cases, these types of restaurants are owner driven and have a chef in the back adding some special touches. These concepts are the modern day Applebee's, Ruby Tuesday or TGI Fridays.

3. Evolved Polished Casual or Lower Upscale. These restaurants are chef-driven, and the chef has made a name. She/he has a distinguishable but not necessarily novel approach to a menu. There are enough safe harbor items (burgers, steaks, chicken, etc.) that people will come in, even if they do not like some of the more over-the-top items that feature the chef's abilities. This type of restaurant is geared toward people who want a great experience without necessarily paying $100 per person. The volumes range from $2.5 to $4 million in 3,500 to 5,000 square foot spaces with 80 to 150 seats. Check averages run $25 on up, not that different from the comparable chains. The investment is in the $800,000 to $1.3 million range. They usually have a good following with a wait list to allow for three to four table turns per night. Many of these restaurants serve only dinner, but some will serve lunch and brunch. If the restaurant is located in an urban area, parking for patrons is a must, often requiring valet parking. These concepts are the modern-day answer to Olive Garden and Red Lobster.

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4. Modern Day QSR. These restaurants normally go into strip centers, places where they can get reasonably priced real estate. They serve food people seem to crave. The investment will be in the $200,000 to $600,000 range. The check averages are comparable to the other QSRs, ranging from $7 to $12. In this category I've seen fish-and-chips, ramen, tacos, or quick-serve Italian concepts, and particularly salad concepts all with unique menus. These are usually owner-operated and generate volumes between $600,000 to over $1 million.

As more and more of these independent owners gain a foothold in the restaurant space, chains will need to adapt or be gone, except perhaps for those in some rural areas that are less populated. The restaurants I have outlined above are the key to the future in the urban and suburban restaurant scene—and creative, new spins on traditional cuisine will continue to proliferate.

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