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New Approach to Old Techniques for Funding

By Dennis Monroe

Last month we talked about new security offerings, new types of IPOs and wonderful new financing techniques. When it comes to the restaurant industry and financing, there are the tried-and-true techniques that will always be around, such as traditional senior lending, sale and leaseback, and equipment leasing. I would like to address a couple of the old techniques that have new twists.

Creative Sale-Leasebacks

It wasn't that long ago that Franchise Finance Corporation of America (FFCA) was one of the leaders in financing restaurants, particularly the real estate component through sale-leaseback. In addition to financing the real estate, FFCA had a unique financing approach of adding to the real estate cost the cost associated with the furniture, fixtures and equipment (FF&E). The usual allocation to equipment was about 20% of the overall financing, which then incorporated most of the cost of the FF&E. This was creative and allowed franchisees to finance almost everything, except for the soft costs and working capital.

What was unique about FFCA financing was that this 20% allocated to equipment dropped off after seven years. However, it was less than the original cost for all of the FF&E, so there was a continuing payment for a part of the FF&E throughout the entire lease. While this sale-leaseback combined with FF&E approach fell out of favor, there are new private equity groups that are looking at providing this kind of financing with a new market approach: real estate financing with a facilitation of FF&E financing. This is achieved by providing appropriate equity to enable the operator to obtain the debt for the business operating assets (FF&E) for either the restaurant acquisition or development.

Let me give you an example: Let's assume that the restaurant real estate is $1.5 million and that the rest of the FF&E, soft costs and franchise fees, etc. are $500,000. You could borrow probably 75% of the equipment assets, or $350,000 with the remaining $150,000 requiring equity.

Under this new approach, the PE groups will do the sale-leaseback on the real estate and add in the $150,000 in equity, backing it into the sale and leaseback arrangement. In many ways, this type of equity investment is probably at a much lower rate than most outside equity sources would want, which would normally be in the 20%-return area.

The problem I see with this approach is that if it is just done in the sale-leaseback arrangement, you will pay on the equity contribution for the length of the lease. I have also seen situations where the sale-leaseback will factor in a slight increase in rent, but not for the full amount advanced. The differential would then become a small equity or profits interest in the restaurant. Instead, a rent percentage might be favorable. The bottom line is that sale-leaseback is taking on some creative twists with the availability of funding and reasonable interest rates. This can be a positive combination of both equity investment and traditional sale-leaseback approaches.

Family Offices

Another approach I have seen recently is the involvement of family offices in the restaurant business. Family offices are wealthy families, or several consolidated families, who hire private wealth management advisors to handle their investment affairs. In the past, these family offices have invested, among other projects, in public companies, private equity and hedge funds. However, hedge funds have limitations and have not performed as well as was initially expected.

Now, many family offices are looking at cash flow investments, which they believe are more reliable. If a family office is seeking cash flow investments, then of course somewhere along the way this leads them to look at multi-unit restaurant companies, whether franchised or not franchised. I have been told there is as much money in private family offices as in the private equity groups. Thus, this source of funding looks to be a big source of capital for our restaurant industry. The only problem is that trying to source family offices is more difficult than the private equity groups, which are proactive in seeking deals.

Retirement Plan Investors

Finally, private individuals are seeking alternate investments for retirement assets (IRAs and 401k) that provide a higher rate of return than what they would get from a fund-managed asset. Investing retirement assets in the restaurant industry, whether on a new acquisition or expansion of an existing company, can provide a much higher return and some predicable cash flow for the owner of these assets. This investment type can be made through a private placement or direct ownership.

So what is the tricky part? The hoops that you have to jump through are monumental. Besides the initial hoops, the biggest issue is the exit strategy, particularly if the investor is passive. The good news is that there are advisors who can help you effectively navigate through this approach.

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Keeping all these issues in mind, restaurants still represent a viable retirement investment asset, and retirement-fund investing is certainly a major source of funding for our industry.

In summary, what is really exciting is that there are a lot of new inventive financing approaches and new options being developed. It's a great time for lending and investing money and creating available capital for the restaurant industry, whether it is tried-and-true methods, a twist on old ideas, or plain new ideas just waiting to be explored.

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