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FINANCE SOURCES

Dealing With Negative Net worth

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One of the big issues for restaurants trying to secure financing is the problem of having negative equity on the balance sheet. Restaurants are notorious for running into this type of situation. In many cases accelerated depreciation and flow through entities are not conducive to increase in equity after the initial investment. The buyout of members or shareholders also will contribute to negative equity, and often it is years before companies can recover from the negative equity caused by buyouts and create positive equity.

Negative equity in a restaurant company does not necessarily mean the business is not viable. As we know, national restaurant lenders do not necessarily focus on negative equity but base their lending position on cash flow and adequate fixed charge coverage. They are concerned about how much cash flow is available to pay those fixed charges (i.e., rent, debt service, and other required items). What matters is effective leverage; that is, debt to cash flow before rent. The fixed charge cushion is really important and is how businesses are bought and sold. Negative net worth is something commercial banks focus on, and they cannot seem to get around this issue.

Here are some successful tactics for dealing with negative net worth:

1. Look at the fair market value of your assets versus the depreciated value, particularly real estate. One approach may be to do non-GAAP financials reflecting fair market value of the assets vs. the book value.

2. Prepare a detailed analysis of the equity account. How much equity has been contributed? How much has the equity account been reduced as a result of non-cash items such as seller depreciation? Have there been any other extraordinary items that will not be recurring (such as shareholder buyouts or litigation settlements)? This can all be accomplished through a detailed analysis and schedule, which results in a restated form of net equity.

3. Look at the proforma analysis. Given what the performance has been, how soon will the equity account be back in the black?

4. Convert the debt owed to shareholders to equity.

5. Convert mezzanine financing to equity.

6. Secure outside equity.

7. If you have an outside commitment from the shareholders that money will come in if necessary, that may also be a way to adjust and work through the negative equity accounts.

8. Consider making an in-kind contribution to the entity, or, as is often done, combining the real estate with the operating assets (a tactic that is normally not advisable for tax purposes but may be very beneficial for dealing with net equity).

9. Look at doing combined financials rather than consolidated financials. This may not be in total compliance with GAAP but may be more reflective of the true economic status of the enterprise.

Whatever tactics you choose to adopt, your story needs to be told up front. You also need to make it clear to the lender that there is negative equity when you begin discussing financing. Focus on cash flow, coverages and the ability to repay.

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