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Early Stage Restaurant Investing

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A good friend of mine invests in early stage restaurant companies and new concepts. The first thing he asks is, "What are my dining privileges?" and "How many gift cards do I get?" It's interesting how people get emotional about owning restaurants—they can have fun dining at what they believe is their own restaurant and keep an eye on it. If the investment doesn't go well, you at least get some free meals.

While restaurants are exciting and fun, there is substantial risk. Here are some keys to investing in early stage restaurants, particularly those that are chef driven or helmed by a first-time owner:

1. The Operator: Are you investing in someone who's successfully developed a start-up restaurant and made the concept successful, even if's not a home run? You are investing in the founder/operator, so be sure to ask these questions:

- Did investors in the founder's previous restaurants get their money back?
- Has the founder been successful in a restaurant that is somewhat related to the one you are investing in?
- Has the founder proven to be financially responsible?
- How will the founder focus on this restaurant? Does he or she have multiple restaurants that may be a diversion?

2. The Concept: The restaurant concept should be in a category that's relevant, one that will have or has consumer acceptance, and considered by consumers to be a hot concept category. Unique concepts are few and far between and are restaurants that will take a lot longer to get a return than a solid and well-run restaurant in a good demographic area.

3. Good Business Plan: Make sure the business plan you are presented with is solid, has consistent assumptions, considers all of the appropriate food, labor, rent and management costs and provides adequate funding for start-up costs. If your concept founder does not have a solid business plan that takes into account all of the various aspects of a truly strong restaurant unit, then it's probably not a good investment.

4. Skin in the Game: Make sure the concept founder has significant skin in the game, so you know he or she is not just using other peoples' money. Is the concept founder willing to guaranty the debt or asking the investors to guaranty the debt? Check the founder's credit. Has the founder personally made money in other restaurant ventures? Does the founder have good relationships with banks and the investment community?

5. Investment Itself: I like to see a reasonable split of distributions, where the investors get 70% of the distributions and the founder gets 30%. The investors will get 70% until they've received their money back and, at times, a preferential return. Once the investor money is returned, then it flips to 70/30 in favor of the founder. Additionally, the founder would share pro-rata with the investors as it relates to their actual cash investment and sometimes gets possibly two times the amount invested. For example, if an investor puts up $100,000 for a 10% interest in the preferred class, the founder (if he or she put in the same $100,000) would get a 20% interest. This rewards skin in the game.
A few other questions: Who are the other investors and are they knowledgeable and sophisticated? Why are they investing? Are they protected if there's no return on investment? Do they get a right to replace management? Do they have the right of first sale if the founder is not maximizing the investment? What are the expectations for distributions?

6. Realistic Proformas: A key element is understanding the unit economics. Sales projections must be reasonable vis a vis other restaurants in the vicinity given the size of the restaurant, number of seats and check averages. The investor needs to understand there is a ramp-up period. With hot restaurants, there may be a first year that is really superior and then tapers off the second year. Expenses must be aligned. We like to see restaurants' overall profitability in the 15% to 20% range for store operating profit. We like to see 2-3x sales to investment.

7. Rent: Except for food and labor, the third largest expense of a restaurant is normally the rent. We have certain guidelines for rent. Make sure the rent terms are market or better than market and there are market-rate leasehold allowances. I like to see a period of free rent, particularly during the pre-opening and start-up phases. In most cases, the total rent should be between 6% and 8% of sales. Higher rent could be problematic. There are exceptions, particularly in large, expensive metropolitan areas.

8. Lease: A reasonable lease term should be a 10-year lease with some renewals (normally, two to three five-year renewals). Sometimes the lease can be four, five-year renewals. You may also want to negotiate a kick out clause if the restaurant is not performing, so you can buy out the lease.

9. Management Team: The first question you should ask before investing is: Has the management team been hired (or at least recruited) and made commitments to join the restaurant once it opens? Are they experienced? Have they worked with the concept founder in other ventures? What is the management team's success record, particularly the general manager? Make sure the management team has been provided with appropriate incentives, has a real desire to be at the restaurant and has a proven history of being able to hire restaurant-level talent.

10. Overhead: Overhead items are important (this includes accounting, marketing, human resources, and management of the physical assets). Many of these items may be outsourced. Review these to make sure they are reasonable.

11. Competition: Look at the competition around the restaurant. Are there enough potential diners? Will the restaurant have national appeal where you have to look at getting potential diners? Will the diners have easy access to the restaurant?

Restaurant ownership can be fun. I am one of the biggest romanticizers of restaurants of any investor around. However, an investor needs to be logical about the investment. I hope my points above will be helpful in your future restaurant investing and result in making you a very happy investor.