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My Updated View of Restaurant Real Estate

By Dennis Monroe

Participants in the restaurant industry have always faced the dilemma of whether to own or lease real estate. Financial buyers prefer leasing real estate, because they don't want to tie up capital. Owner/operators trend more towards ownership if they can find the right financing. In the current business environment, what particular issues affect such choices and provide opportunities with your real estate?

Flexibility. Given today's changing demographics and the proliferation of e-tailing and food on demand, location flexibility is more important than ever. The problem with long-term leases is the lease immediately puts the bargaining power in the landlord for items like change of use, downsizing and competitive problems in the location. So, a lease should provide for change-in-use provisions, rights to sublease, rights to lease buyouts and possibly some type of performance kickouts. These provisions become crucial if your restaurant isn't performing the way you intended. Think about shorter leases with multiple renewal options.

Limiting Liability. Given all the changes in the retail environment, it's more important than ever to minimize liability if you can't own the real estate. First and foremost, avoid giving personal guaranties, but if you have to have guaranties, try to have an effective burnoff. Consider keeping the real estate in a separate entity and subletting it to your operating entity.

Owning Real Estate Today. If you are able to secure and own the real estate, obviously these types of opportunities for subletting and change-of-use options are controlled by you as the owner. As stated above for liability purposes, it is advisable for the owner to put the real estate in a separate entity and then lease the real estate to the operating entity. These related entities in the past were an effective way to provide for tax benefits. Much of this has significantly changed with the new tax law, which particularly deals with the interest expense deduction in these entities and also the relationship of rent and management fees between the related entities. The new tax law imposes a cap on the deductibility of interest for some taxpayers. Further, investment management fees paid by a passive real estate holding company are no longer deductible. For owners of passive real estate holding companies, these recent tax changes may provide an incentive to hold the real estate in the operating entity. That being said, it still probably makes sense to separately own real estate, so you may consider a holding company for both the operations and real estate, which is disregarded for tax purposes but still provides legal protection.

Opportunity Zones. As we know, the opportunity zones ushered in by the 2017 tax reform give investors the ability to roll over gain for deferral or elimination of capital gains. So anyone who is buying real estate or developing real estate for restaurants in an opportunity zone should definitely look at this as a viable financing tool. Please note, however, that the use of opportunity zones may lose some (though certainly not all) of its appeal in 2020, unless the tax law is amended.

Like-Kind Exchanges. A significant change in the 2017 tax law is the limitation of like-kind exchange to real estate alone. So one of the things you have to ensure in a like-kind exchange, particularly if you've done a cost segregation, is that you are allocating as much as possible to pure real estate, because the furniture, fixtures and equipment won't qualify for like-kind treatment.

Long-Term Financing. Let's look at real estate financing and some of the current approaches. Obviously, banks still like dirt, but they do want equity. With significant investment dollars in the market, there continues to be interest in longer-term investments like real estate. One approach I have seen is private placements that bifurcate the money-raising activities. Some private placements involve raising money for the operating entity based on a strong restaurant concept and separately raising money for the real estate. These different investments allow for different types of investors, though sometimes you may have an investor who wants to invest in both the real estate and the operating entity.

Landlord Help. Don't forget to maximize your leasehold dollars. It's so important you negotiate fully with the landlord the leasehold allowances you receive because they are some of the hardest dollars to finance. The first step is to make sure prior to negotiating leasehold allowances that you are getting market-rate rent. Then negotiate the tenant allowances. It is important that any leasehold allowances do not increase the rent over the whole life of the lease. They should be amortized out. There is a certain level of leasehold allowances that the market is going to dictate. If that is $50 per square foot or $100 per square foot, that is just part of the base rent. If you want additional leasehold allowances, normally the rent will take into account the landlord financing. Finally, don't be hoodwinked into getting free rent and then having higher rent in the future. Just make sure that your overall rent amortized over the entire length of the lease is as low as possible. A percentage rent approach can hedge against downturns but may be more costly on the upside.

All this being said, real estate is still a great asset for restaurant owners, but it should be looked at a little differently than in the past, in light of the new tax laws, the new retail environment and just possibly, a downturn in the economy.

Thanks to my colleague, Brian Tunis, for his help on this article.

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