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A Real Estate Plan for 2022

By Dennis Monroe

Let's start with the obvious, but often overlooked: Controlling your real estate in some form of ownership, especially in today's restaurant market, is preferable to leasing. Control gives you the option of converting your investment into cash using a variety of tools, such as a sale-leaseback. More importantly, real estate can be a lucrative investment. A well-known restaurateur explained his thinking on it this way: Controlling all of your real estate allows for buildout concepts that make the investment more valuable. Since we don't yet know what the long-term effects of the pandemic will be, the more control you have over the real estate in question, then the more options (and flexibility) you'll have when that picture becomes clearer.

We also know ownership is not always possible. In some areas there is no opportunity to own the land, but you may be able to do a ground lease and own the building. If the ground lease is favorable, this may be a good option.

The second key point is that if you own, you need to determine your sales level in terms of what's an acceptable rent factor is, even if it is a related-party lease. You need to secure your debt service with a reasonable amortization. Instead of a 30-year, look for a shorter amortization on the real estate and see if reasonable rent can service a reasonable debt service.

Another consideration is whether the real estate has multi-purpose value. We are seeing many people offering development services, and even some who will do joint ventures, so the concept owner has some ownership interest. Look for creative approaches.

Finally, make sure the real estate is in a separate entity, with a market lease between the real estate and the operating entities.

If ownership is not in your pocketbook, leasing is your next best option, with the goal of attaining a reasonable rent. As discussed above, a key principle for a restaurant is to have rent as a reasonable percentage of revenue. We like to use a formula of percentages of sales for casual dining, with utilities and other occupancy expenses, not to exceed 8% to 10% occupancy cost. For fast casual it's normally a little higher; and for QSR with its bigger margins, lower labor costs and the importance of easily accessible locations, it can sometimes be as high as 10%. When you throw in additional occupancy costs such as taxes and insurance, that puts it at 12% or 13%. Always be conscious of the occupancy as a percentage of sales.

Make the most of any leasehold allowances provided by the landlord. Once you've negotiated your lowest rent, you have to deal with the cost of your leaseholds. It's always helpful if you can acquire an existing restaurant site, particularly in the casual-dining sector. In core urban areas there's a higher inventory of closed restaurants. The toughest area to find existing restaurant sites is the high-populated suburban areas or QSR sites with drive-thrus.

When you lease the property, landlords normally contemplate a leasehold allowance. Start with trying to get the lowest rent and then go back and figure out what your leasehold costs are going to be. Try to get the landlord to fund somewhere between 25% and 50% of your leaseholds (and note that equipment may not be included in this). In many cases, the landlord looks at a smaller amount, maybe 10% to 20% of your costs, and they may want to adjust the rent if your leasehold amounts are higher. Leaseholds are always problematic to finance with a lender, so push landlords.

If you have underperforming locations that you realize post-pandemic are not going to work, don't hold on to them. Don't get stuck thinking they may turn around and that the landlord will keep giving concessions. Be realistic and talk to your landlord. If you have a personal guaranty, accept that you may have to buy out the guaranty and turn the property back. If that's not the case, look at what your options are, particularly if your legal structure is such that you have that site in an entity that doesn't have other assets.

Lease-to-own situations have become more common with stand-alone restaurant sites. When negotiating a lease, always ask for right of first refusal and option to purchase. The worst that could happen is the landlord says no. Be proactive in negotiating real estate, so that you get a reasonable cost that your restaurant can afford.

And while there are other options to consider, owning provides the most flexibility. But just as important as we enter the second month in 2022, don't put off dealing with troubled real estate.

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