RESTAURANT FINANCE MONITOR®

Volume 35, Number 2 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

February 17, 2024

Time to Look at Your Leases

By Dennis Monroe

During the pandemic, restaurant leases mostly were renegotiated for an interim period, but now you must find long-term solutions for both good and bad sites.

Bad sites: Finding ways to get out

For franchised locations, contact your franchisor to discuss closing unprofitable stores. This isn't easy because franchisors are interested in keeping store counts up. Explain that a store closure will make you a stronger franchisee, and if possible, suggest an alternative site to relocate. If you must buy out the franchise agreement, make sure it's reasonable. The present value of the future royalty stream can be expensive, so negotiate a flat fee for closing a store. If you have multiple stores, don't go in one-by-one, but all at once, and attempt to stagger closings over a longer period. Franchisors are often cooperative because they want their franchisees to be successful, plus they don't want poorly run stores, which is what happens when a store isn't making money.

Overall structure

Before approaching a landlord, review your overall store structure. A combination of good stores and a few underperforming ones is a problem because it might show financials that can still service the leases on the underperforming stores. Consider spinning the underperforming stores off to a different entity which is sometimes called "BadCo." You may also consider a spin off of the good stores into a new entity, "GoodCo." If the landlord wants to go to the mat over this, it might not work, but it's still worth considering.

Approaching the landlord

Know what rights the landlord has. Make sure you and your attorney carefully review the leases and understand items like acceleration rights on a default or continuous occupancy provisions, which means it's a default if you close the store).

Here are some suggestions:

- Analyze the personal guarantees and whether there are any outs.
- With a master lease, look at your rights to separate those leases or substitute a different property.
- Review the landlord's obligations under state statues to mitigate damages, such as making a reasonable effort to find a new tenant.
- Offer to buy out the lease with six months of rent, or 12, which will is still cheaper than the negative cash flow.
- Agree to turn over non-franchise-branded furniture, fixtures and equipment. It's not worth a lot, but it may help the landlord relet the property as a restaurant.
- Talk to the landlord about keeping the store open at minimal or no rent until they find a new tenant. We have one case with a problem downtown location and the landlord has gone two years with no rent because closing it would affect its ability to lease out the office space in the building.

In all cases, go to your landlord with an approach that makes sense for them. It's difficult when a tenant closes and then ghosts the landlord or the landlord gets word you're going to close before you communicate it to them.

Good sites: Negotiate for the future

Consider: What's the term on your franchise agreement, and can you get an extension? If it's not a franchise, what is the long-term prospect for that site? I like shorter leases with multiple extensions. We commonly use five years with two or three five-year extensions, but I even like to negotiate three-year leases with four three-year extensions. The key is the lease rate at the extension point. You are going to have to pick up a Consumer Price Index (CPI) increase, so see if you can go to a base rent with percentage rent. The percentage rent should consider sales inflation and if you use a natural break point, it will mean the base rate divided by a percentage; 6% is a common number. There's no reason you can't go higher in the percentage as long as you start with a lower base.

Some other tips:

- Avoid personal guarantees or at least have them burn off.

- Look to the landlord for tenant improvements. Landlords want a long-term lease, and you'll need money for improvements. You can even approach the landlord about contributing toward nonstructural items, like marketing. Don't be afraid to ask for reasonable accommodations. Be creative.
- It's important to have an ability to buy out of the lease o sub-lease to another tenant. Have a good exit plan because you never know what might happen.

The lender

Don't leave your lender out of the conversation, because they may have a collateral interest in your lease, and you'll need their consent. Don't get an inadvertent default over lease modifications.

It's a good economy and many landlords may have put off refinancing. A major tenant with a strong, long-term lease can enhance the landlord's ability to obtain favorable financing. So, in summary, this isn't the time to let down, keep busy planning for good times.

Dennis Monroe is chair of Monroe Moxness Berg, a law firm which focuses on M&A, taxation, and other business matters for multi-unit restaurant businesses. Reach him at (952) 885-5962, or by email at dmonroe@mmblawfirm.com.