RESTAURANT FINANCE MONITOR®

Volume 35, Number 7 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

July 17, 2024

It Takes Options to Deal with Effective Financing

By Dennis Monroe

There is no one answer on the best way to finance a restaurant acquisition or fund new unit development, or even financing real estate. There is no secret or magic wand, just a lot of hard work and making sure you examine all the options. With that being said, here are some ideas I have about financing your restaurants when you don't own real estate.

Getting started

The first step is to understand the true cost of your project, which means more than just the hard assets, the acquisition of the concept rights, development costs, working capital, contingencies and reserves. Develop a capital needs budget that is flexible as well as not overly conservative. Avoid a wish list of what you would like and make it a clear indication of what makes sense for a transaction.

In deciding on the overall budget and financing, look at some key parameters such as sales of two-to-three times your total investment. Also look at your debt-to-equity ratio and how much you can accomplish with senior debt. Finally, what is the optimum equity capital that is available, hopefully 20-to-30% of the project.

Equity

If you're investing your own capital, it's usually structured as common equity, where you are the last to get your money out. If you have friends and family who will participate in the venture, try to also keep these friendly investors in common equity. For outside investors you need to give them a priority return, and a good choice is to use a preferred equity. These investor should receive a reasonable market rate return, perhaps 8-to- 9%. They will get most of their money back first with an upside amount phased in with the common shares.

Debt

Once the equity piece is established, you're able to go to the bank and negotiate more effectively. You'll need to understand what kind of leverage is going to be allowed with senior debt. In today's market there is a percentage of the overall value that allows for debt and also a multiple of EBITDA to debt. When interest rates were lower, restaurants could leverage up to 5x times EBITDA, but today it's mostly in the 2-to-3 times senior debt and that also includes debt service or fix coverage ratio in the 1.4 –1.6 range (cashflow in excess of debt service).

The key is to find lenders in the restaurant industry (a good place to start is at the Restaurant Finance Development Conference in November). Also, if you have a non-franchise project, don't forget your local lenders. They often have a commitment to their local markets. Often, traditional franchise lenders will loan to a chain, not just a franchisee multi-unit group.

Other options

There are other options if you have a gap in your funding. One option is mezzanine financing or sub-debt financing. This is subordinate debt that may or may not be secured behind the bank and normally provides a level of funding of one-times EBITDA.

Also, a good source of funding is to get your landlord to commit to the leasehold improvements you intend to make. Negotiate the lowest rent possible and then see what you can get for landlord contributions without adjusting the rent.

Another source of financing is equipment leasing. It's more expensive than senior debt and there may be more difficult terms, but there are always ways to structure it to your cash flow. Plus, leasing companies tend to be flexible. They will also try to work through issues of the collateral you put up versus the bank's collateral. This is something to look at if you need sophisticated restaurant equipment.

Finally, consider franchise-sponsored financing or vendor financing for specific assets like point-of-sale equipment or other franchisor required upgrades.

In summary, your capital stack may look like equity equal to at least 20%, maybe a slice of mezzanine equal to one times EBITDA, senior debt equal to three times and fill it out with some specialty financing such as equipment leasing. And, don't forget the landlord contributions.

You have lots of options if you're creative and have cash flow to service the debt and provide a nice return to your equity holders.

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. Meet with Dennis at the upcoming Restaurant Finance and Development Conference, November 11-13, 2024 in Las Vegas.