

CHAPTER 16

Financing and Leasing

LEARNING OBJECTIVES

After reading and studying this chapter, you should be able to:

- Forecast restaurant sales.
- Prepare an income statement and a financial budget.
- Identify requirements for obtaining a loan in order to start a restaurant.
- Discuss the strengths and weaknesses of the various types of loans available to restaurant operators.
- List questions and the types of changes a lessee should consider before signing a lease.
- Discuss the strengths and weaknesses of the various types of loans available to restaurant operators.



Courtesy of Columbia Patio

Photo By Rob/Harris

Once the concept, location, and menu are chosen, the next step is financing the restaurant. Where does the money come from? Many restaurants have been started by borrowing money on property, including the family home. Others have been started with a loan from a relative, a friend, or a group of friends. An experienced restaurant operator may have a lawyer put together a partnership with the operator as managing partner and investors as limited partners. Still other restaurants are financed by groups of investors who form a corporation to buy or build and operate a place. Forming a corporation is simple and can be done quickly and at relatively low cost. The corporation becomes a legal entity that can take on debts and guarantee loans. To do so, however, a corporation must be creditworthy, just as an individual must. It must pay taxes, just as any individual with income must do, which can mean double taxation for the owner. The corporation pays a corporation tax, and the individual owners receiving income from the corporation pay individual income tax as well. But there are ways to avoid double taxation, as we shall see in this chapter.

Sufficient Capital

Many would-be restaurateurs try to start restaurants with only a few thousand dollars in capital. Such ventures usually fail. Although the number-one factor in restaurant failure is said to be lack of management, lack of finance and working capital is a close second. No one knows the real rate of failure in the restaurant business because so many restaurants merely fade away, the owners taking severe losses and selling for what they can get. Dun & Bradstreet, the major firm that reports business failures, has no way of assessing the number of fadeaways. After a restaurant opens, owners often lack the working capital needed to keep it alive more than a few months. It is best to have the money in place about six months before you need it, including enough cash to carry you through two months of business.¹ You can always bargain for four to six months of rent free to get the business up and running.

In this recession, restaurant financing has slowed to a trickle as lenders reevaluate loan portfolios amid the financial uncertainty. Lenders are being “much more selective” and there are higher costs of capital, less available leverage, and tighter lending structures for operators that need funding.² You’re better off borrowing from friends and relatives; or do like the savvy restaurateurs Paul Fleming of P.F. Chang’s and Cincinnati restaurateur Jeff Ruby did to create their fundraising success stories. Fleming raised start-up money from his guest list, and Ruby actually sold \$400,000 of food shares.³

In financing any business, astute businesspeople are concerned with risking someone else’s money rather than their own. Many individuals struggle and scheme for years to come up with a way of doing this. Some people have a knack for interesting others in putting up their money for a venture that the promoter controls.

Few people entering the restaurant business have the total capital necessary to enter as a complete owner, debt free. Such a course of action would mean



Ruth Fertel,
founder of
the Ruth’s

Chris Steakhouse chain, mortgaged her house in 1965 to raise the money to start her first restaurant. This was against the will and wisdom of her brother, lawyer, and banker. She was warned that she would not be able to handle the hard work and that she would lose her home because she didn’t have any experience in the business.



To accumulate enough assets to

start a restaurant without borrowing is difficult. To borrow money wisely and to know how to get loans is a major part of a businessperson's acumen.



In buying or selling a restau-

rant, there is a simple rule to follow, say the experts: When selling, get as much cash as possible. When buying, put as little cash down as possible.

owning the land, the restaurant building, and its equipment and furnishings, plus having working *capital*—that is, a standby amount of cash to open the restaurant and to get through possibly several unprofitable months of operation.

Experienced businesspeople seek to rent or lease the building and land and to search for a loan for the furnishings, equipment, and necessary start-up expenses. Ownership of the land on which the restaurant sits is usually left to a long-term investor. The same may be true for the restaurant building. Rather than using capital for the ownership of the real property, restaurant operators believe their expertise is their investment. They usually want to conserve capital or use it in the most productive way possible. Also, they want to face limited personal risk, should the business fail.

Where does one get the money for a restaurant? Commercial banks are a common sources of funds, but the borrower must remember that the lending officers in the banks are only paid employees, not owners, and are also limiting their risks. They take minimal risks because their performance is largely judged by good loans. Lending officers tend to be ultraconservative.

They will ask questions and want proof of income, debt, employment, and credit history. In order to obtain a bank loan, often you will need to prove that you have the funds to pay mortgage insurance, taxes, the required down payment, and closing costs. You may also need to demonstrate that you have the cash equivalent to X amount of months to cover principal, interest, taxes, and insurance payments.

Ordinarily, unless the individual has established a line of credit, the bank wants at least 40 percent (and usually more) of the total needs to be invested by the individual or corporation. This can be a considerable amount. The bank also wants collateral (assets that the bank can take should the loan not be repaid) to be pledged. Loans are made for varying periods of time:

- A *term loan* is one repaid in installments, usually over a period longer than a year.
- *Intermediate loans* are made for up to five years.
- *Single-use real estate loans* typically run less than 20 years.

A *construction loan* is made in segments during the course of construction and is usually a term loan. The borrower should be clear as to when segments of a construction loan will be available—that is, before or after each phase of construction is completed. Borrowers often ask for a construction loan larger than the actual amount required, and, if granted, use the balance as working capital. (Never pay a contractor all of the money required up front.)

Preparing for the Loan Application

Obtaining the necessary amount of money to get into a restaurant is never easy—unless your friends or relatives are loaded and prepared to back you. Aspiring restaurateurs have bought the furniture and fixtures of an existing restaurant

for \$30,000. This money is paid to the previous person leasing the property, for the work that had been done to set up a restaurant, including the kitchen, storeroom, toilets, dining area, plumbing, and electrical.

This \$30,000 was paid after a due diligence—that is, a thorough check to ensure that everything works and that the health department or some other agency isn't about to shut the place down for some infringement of their regulations. The kitchen and all its equipment—stoves, ovens, grills, broilers, fryers, refrigerators, mixers, tables, shelves, storerooms—and the tables, chairs, booths, and bar out front are all part of the FF&E—furnishings, fixtures, and equipment. Obviously, it would cost considerably more to make alterations to a building to accommodate a restaurant.

Larger restaurants will naturally cost more to get into, and it's just a matter of finding a location and price that are right for you. Likewise, better locations cost more. For example, you might pay \$65,000 for a run-down restaurant in a good location. Danny Meyer got into Union Square Cafe in 1985 for \$75,000; he was smart enough to start a restaurant in an area that was on the upswing.

Given that one of the main reasons for restaurant failure is a lack of funds, it is critical to address three important financial questions from the get-go:

1. How much money do you have?
2. How much money will you need to get the restaurant up and running?
3. How much money will it take to stay in business?

A personal financial statement can answer the first question. Figure 16.1 shows the headings for the various assets and liabilities of a personal financial statement.

Figure 16.2 addresses how much money will be needed. The start-up costs need to be accurately assessed, because they must be paid for out of revenues once the restaurant is open. From the signing of the lease until opening day there is often a gap of a few weeks or months. You will need money to live on, and there will also be expenses for the restaurant. Figure 16.3 will help allocate costs for those weeks/months from lease signing to opening. Hopefully, there will be no delays and the opening will be on time. These expenses continue once the restaurant is open but will then be on the income statement.

Logically, the next step in planning the restaurant is to do a budget.

BUDGETING

The purpose of budgeting is to “do the numbers” and, more accurately, forecast if the restaurant will be viable. Sales must cover all costs, including interest on loans, and allow for reasonable profit, greater than if the money were successfully invested in stocks, bonds, or real estate. Financial lenders require budget forecasts as a part of the overall business plan. The first step in the budget process is to forecast sales. The next is to allocate costs to the forecasted sales, allowing for a fair profit margin. This must all be done in relation to the competitive price-value-quality equation.

Personal Financial Statement
 _____, 20____

ASSETS

Cash on hand _____

Savings account _____

Stocks, bonds, securities _____

Accounts/notes receivable _____

Real estate _____

Life insurance (cash value) _____

Automobile/other vehicles _____

Other liquid assets _____

TOTAL ASSETS _____

LIABILITIES

Accounts payable _____

Notes payable _____

Contracts payable _____

Taxes _____

Real estate loans _____

Other liabilities _____

FIGURE 16.1: Personal financial statement

Source: Adapted from www.sbaonline.sba.gov/starting/checklist.html

Start-up Cost Estimates

Decorating, remodeling _____

Fixtures, equipment _____

Installing fixtures, equipment _____

Services, supplies _____

Beginning inventory cost _____

Legal, professional fees _____

Licenses, permits _____

Telephone utility deposits _____

Insurance _____

Signs _____

Advertising for opening _____

Unanticipated expenses _____

TOTAL START-UP COSTS _____

FIGURE 16.2: Start-up cost estimates

Source: Adapted from www.sbaonline.sba.gov/starting/checklist.html

| Expenses for One Month | |
|-------------------------------|-------|
| Your living costs | _____ |
| Employee wages | _____ |
| Rent/lease | _____ |
| Advertising | _____ |
| Supplies | _____ |
| Utilities | _____ |
| Insurance | _____ |
| Taxes | _____ |
| Maintenance | _____ |
| Delivery/transportation | _____ |
| Miscellaneous | _____ |

FIGURE 16.3: Expenses for one month

Source: www.sbaonline.sba.gov/starting/checklist.html

In establishing an accounting format to project sales and operational costs of a restaurant, these basic categories are useful:

- Sales
- Cost of sales
- Gross profit
- Budgeted costs
- Labor costs
- Operating costs
- Fixed costs

FORECASTING SALES

Sales forecasting for a restaurant is, at best, calculated guesswork. Many factors beyond the control of the restaurant, such as unexpected economic factors and weather, influence the eventual outcome. Without a fairly accurate forecast of sales, however, it is impossible to predict the success or failure of the restaurant because all expenses, fixed and variable, are dependent on sales for payment.

Predicting sales volume, while not easy, can be done with a high degree of accuracy if a budget forecast is completed.

Sales volume has two components: the average guest check and guest counts. The average guest check is the total sales divided by the number of guests. Menu prices plus beverage sales partly determine the amount of the average check. The guest count is simply the total number of guests patronizing the restaurant over a particular period.

The first step is to estimate the year's projected guest count. This is done by dividing the year into one 29-day and twelve 28-day accounting periods, then breaking these down into four 7-day weeks. It is better to keep separate

records for each meal, because the sales and therefore staffing levels will need to be compatible. Keeping a sales history from day one is recommended (see Figure 16.4 for a budget forecast of restaurant sales for one week).

After the four weekly forecasts are complete, they are totaled on the period-one sheet. The remaining 12 accounting period sheets are then completed, giving the total sales forecast for the year (see Figure 16.5).

The totals from each of the accounting periods add up to a yearly total sales forecast. The results may be checked by discussing with other restaurant personnel and credit card representatives to gain an estimate of sales at a similar restaurant. With experience, the margin of error in estimating a restaurant's total sales generally decreases.

Budget Forecast of Restaurant Sales, Period 7 Days, Date _____, 20XX

| Period | Forecast No. of Guests | Actual No. of Guests | % + or - | Forecast Amount of Average Check | Actual Amount of Average Check | % + or - | Forecast Amount of Food Sales | Actual Amount of Food Sales | % + or - | Forecast Amount of Beverage Sales | Actual Amount of Beverage Sales | % + or - | B | L | D | Total Forecast Sales | Total Actual Sales | % + or - | |
|-----------------|------------------------------|----------------------------|----------------|---|---|----------------|--|--------------------------------------|----------------|--|--|----------------|---|---|---|----------------------------|--------------------------|----------------|--|
| 1 | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | |
| Annual Total | | | | | | | | | | | | | | | | | | | |

Note: B - Breakfast; L - Lunch; D - Dinner

FIGURE 16.4: Budget forecast of restaurant sales for one week

Budget Forecast of Restaurant Sales, Period _____, 28 Days, Date _____, 20XX

| Period | Forecast No. of Guests | Actual No. of Guests | % + or - | Forecast Amount of Average Check | Actual Amount of Average Check | % + or - | Forecast Amount of Food Sales | Actual Amount of Food Sales | % + or - | Forecast Amount of Beverage Sales | Actual Amount of Beverage Sales | % + or - | B | L | D | Total Forecast Sales | Total Actual Sales | % + or - | |
|-----------------|------------------------------|----------------------------|----------------|---|---|----------------|--|--------------------------------------|----------------|--|--|----------------|---|---|---|----------------------------|--------------------------|----------------|--|
| 1 | | | | | | | | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | | | | | | |
| 8 | | | | | | | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | | | | | | |
| 10 | | | | | | | | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | | | | | | | | |
| 12 | | | | | | | | | | | | | | | | | | | |
| 13 | | | | | | | | | | | | | | | | | | | |
| Annual Total | | | | | | | | | | | | | | | | | | | |

Note: B - Breakfast; L - Lunch; D - Dinner.

FIGURE 16.5: Sales forecast for the year

The sales forecast for the first few months should take into consideration the facts that it takes time for people to realize that the restaurant is open and that usually a large number of people are attracted to a new restaurant.

Once weekly, monthly, and yearly sales figures are estimated, the cost of sales is determined. It is then possible to allocate fixed and variable costs to reveal a predicted profit (or loss) figure.

INCOME STATEMENT

The purpose of the income statement (see Figure 16.6) is to provide information to management and ownership about the financial performance (profitability) of the restaurant over a given period of time. Information on sales and costs is provided in a systematic way that allows for analysis and comparison. The net income (or loss) is shown after expenses are deducted from sales. Notice that percentages are used in the right-hand column, making it easier to compare one statement with another or one restaurant with another.

The income statement begins with sales of food, beverage, and other sales (which could be take-out, catering, cigars, cigarettes, tobacco, telephone, etc.). The cost of goods sold is deducted from total sales. This leaves a gross profit, which is sales minus cost of goods sold.

From the gross profit, the remaining controllable variable and fixed costs must be deducted before taxes are paid and profits distributed.

BUDGETING COSTS

Costs may be budgeted according to two main categories: fixed and variable.

Fixed costs are normally unaffected by changes in sales volume—that is, they do not change significantly with changes in business performance. Whereas fixed costs may change over time, such changes are not normally related to business volume. Examples of fixed costs are real estate taxes, depreciation on equipment, and insurance premiums.

Variable costs, by contrast, change proportionately according to sales. Food and beverage costs belong to this category. Thus, a restaurant that incurs a \$30,000 food and beverage cost when sales are at \$100,000 is expected to register a \$45,000 food and beverage cost when sales rise to \$150,000.

The following simple income statement illustrates the point:

| | Week 1 | Week 2 |
|--------------|---------------|---------------|
| Sales | 100,000 | 150,000 |
| Cost of food | 30,000 | 45,000 |
| Gross profit | 70,000 | 105,000 |

GROSS PROFIT

Sales minus cost of sales equals gross profit is a standard accounting entry. Although it may be standard for the accountant, the concept is not always clearly

| | Amount | Percentage |
|---|--------|------------|
| Revenues | | |
| Food | | |
| Beverage | | |
| Others | | |
| Total Revenues | | 100.00 |
| Cost of Sales | | |
| Food | | |
| Beverage | | |
| Others | | |
| Total Cost of Sales | | |
| Gross Profit | | |
| Food | | |
| Beverage | | |
| Others revenue | | |
| Total Gross Profit | | |
| Controllable Operating Expenses | | |
| Salaries and wages | | |
| Employee benefits | | |
| Direct operating expenses ^a | | |
| Music and entertainment | | |
| Marketing | | |
| Energy and utility | | |
| Administrative and general | | |
| Repairs and maintenance | | |
| Total Controllable Expenses | | |
| Operating Income | | |
| Rent and other occupation costs | | |
| Income before interest, depreciation, and taxes | | |
| Interest | | |
| Depreciation | | |
| Net income before taxes | | |
| Income taxes | | |
| Net Income | | |

^aTelephone, insurance, accounting/legal office supplies, paper, china, glass, silver, menus, landscaping, detergent/cleaning supplies, and so on.

FIGURE 16.6: Projected income statement showing controllable expenses

Source: Adapted from Agnes L. DeFranco and Thomas W. Latin, *Hospitality Financial Management*, Hoboken, NJ: John Wiley & Sons, 2007, p. 24.

understood by the restaurant manager. Gross profit is the amount of money left from sales after subtracting the cost of sales, and it must provide for all other operating costs and still leave enough dollars for a satisfactory profit. Some of those operating costs are fixed. Some are variable, meaning that management has some control over them and they vary according to sales volume. All costs must be covered by gross profit dollars. When gross profit is insufficient to cover the remaining operating costs and provide a satisfactory profit, the sales and cost mix must be replanned. If this cannot be accomplished, the business venture is not viable.

CONTROLLABLE EXPENSES

The term *controllable expenses* is used to describe those expenses that can be changed in the short term. Variable costs are normally controllable. Other controllable costs include salaries and wages (payroll) and related benefits; direct operating expenses, such as music and entertainment; marketing (including sales, advertising, public relations, and promotions); heat, light, and power; administration; and general repairs and maintenance. Payroll is the largest controllable operating expense at most restaurants, including full-service operations with average checks of \$25 or more, according to the National Restaurant Association analysis.⁴ The total of all controllable expenses is deducted from the gross profit. Rent and other occupation costs are then deducted to arrive at the income before interest, depreciation, and taxes. Once these are deducted, the net profit remains.

Uniform System of Accounts for Restaurants

The income statement recommended for commercial food service operations is prescribed in the Uniform System of Accounts for Restaurants (USAR) published by the National Restaurant Association. USAR has several benefits:

- It outlines a uniform classification and presentation of operating results.
- It allows for easier comparisons with foodservice industry statistics.
- It provides a turnkey accounting system.
- It is a time-tested system.⁵

Accounting principles advocate the use of an income statement that clearly shows sales and costs for a specific accounting period, which is normally one month or one year. Figure 16.7 presents a balance sheet prepared in accordance with USAR.

BALANCE SHEET

The balance sheet is an important document in the restaurant or any other business. It is used to determine a sole proprietor's or company's worth, which is done by listing all the assets and liabilities. The balance sheet is a photo of the restaurant's

financial standing at a given moment in time—usually at the end of a financial period or at the end of a financial year. The title will read: Balance Sheet of ABC Restaurant as of December 31, 20XX. The balance sheet shows the restaurant's assets (what it owns) and liabilities (what it owes). A balance sheet must always balance (that is, assets = liabilities + net worth).

When balance sheets are analyzed over time, it is possible to see the business trends and owner's strategies—for example, how assets and liabilities, return on investment, and inventory are managed. Assets are divided into two categories:

| BALANCE SHEET FORMAT | | |
|---|-----------------|---------------|
| ANNA MARIA RESTAURANT AS OF 12-31-20XX | | |
| CURRENT ASSETS | | |
| Cash on hand | \$20,000 | |
| Cash in banks | <u>15,000</u> | |
| | | 35,000 |
| Accounts Receivable: | | |
| Trade | 10,000 | |
| Employees | 1,500 | |
| Other | <u>1,500</u> | |
| | 13,000 | |
| Deduct: Allowance for doubtful accounts | <u>(1,000)</u> | |
| | | 12,000 |
| Inventories: | | |
| Food | 7,500 | |
| Beverages | 1,500 | |
| Gift and sundry shop | 300 | |
| Supplies | <u>1,200</u> | |
| | | 10,500 |
| Prepaid expenses | | <u>8,000</u> |
| TOTAL CURRENT ASSETS | 65,500 | |
| FIXED ASSETS | | |
| Land | 100,000 | |
| Buildings | 200,000 | |
| Furniture, fixtures, and equipment | 12,000 | |
| Uniforms, linens, china, glass, utensils | 3,000 | |
| Deduct accumulated deprec./amortization | <u>(58,000)</u> | |
| Net book value of fixed assets | | 257,000 |
| DEFERRED EXPENSES | | |
| Preopening expenses | 5,000 | |
| Loan initiation fees | <u>5,000</u> | |
| | | 10,000 |
| OTHER ASSETS | | |
| Amount paid for goodwill | 7,500 | |
| Cost of bar license | 15,000 | |
| Cash surrender life insurance | <u>3,000</u> | |
| | | <u>25,500</u> |
| TOTAL ASSETS | | \$358,000 |

FIGURE 16.7: Example of a restaurant balance sheet

Source: Adapted from Raymond Schmidgall, David K. Hayes, and Jack D. Ninemeier, *Restaurant Financial Basics*, Hoboken, NJ: John Wiley & Sons, 2002, p. 75.

| LIABILITIES AND NET WORTH | | |
|--|----------------|------------------|
| CURRENT LIABILITIES | | |
| Accounts Payable: | | |
| Trade | \$125,000 | |
| Others | <u>2,000</u> | 127,000 |
| Notes payable banks | | 18,000 |
| Taxes collected | | 4,500 |
| Accrued Expenses: | | |
| Salaries and wages | 4,000 | |
| Payroll taxes | 2,500 | |
| Real estate/personal taxes | 8,000 | |
| Interest | 1,000 | |
| Utilities | 2,000 | |
| Other | <u>1,500</u> | 19,000 |
| Deposits on banquets | | 700 |
| Income taxes — Federal (no state in FL) | | 5,000 |
| Current portion of long-term debt | | <u>12,000</u> |
| TOTAL CURRENT LIABILITIES | | 186,200 |
| Long-term debt, net of current portion | | 60,000 |
| Deferred income taxes | | 2,000 |
| Other noncurrent liabilities | | <u>1,000</u> |
| TOTAL LIABILITIES | | 249,000 |
| NET WORTH (FOR INDIVIDUAL PROPRIETOR) | | |
| Proprietor's Account | <u>108,800</u> | |
| TOTAL LIABILITIES and CAPITAL | | \$358,000 |

FIGURE 16.7: (continued)

current and fixed. Current assets are assets that will mature in less than one year. They are the accumulation of cash, accounts receivable, inventory, notes receivable, prepaid expenses, and other current assets. Fixed assets are the physical assets whose life expectancy is more than one year and include land, buildings, machinery and equipment, furniture and fixtures, and leasehold improvements.

The balance sheet shown in Figure 16.7 uses the USAR. All restaurants using the USAR method of doing balance sheets will follow this format, which was developed under the guidance of the National Restaurant Association.

PREOPENING EXPENSES

A new facility must consider preopening expenses. Although these are not present in an ongoing facility and probably not in the purchase of an existing facility, they are a consideration in the construction and opening of a new facility. One encounters the costs of preopening offices; the initial purchase of all equipment, including china, cutlery, and glassware; the hiring and training of personnel; and preopening advertising. A budget forecast should be allocated for this classification.



Learn from the mistake that a friend

of one of the authors made. Jim successfully opened one restaurant with a term loan from a bank. He was negotiating with another bank to obtain financial backing to open a second when the first bank called in his loan. Jim had to borrow from relatives he hardly knew in order to pay off the first bank before continuing on to successfully open several more units with the second bank.

Fixed Costs (if restaurant building is owned)

- Depreciation
- Insurance
- Property taxes
- Debt service

Variable costs change in direct proportion to the level of sales: food, beverage, labor, heat, light, power, telephone, and other supply costs.

CASH FLOW BUDGETING⁶

Any business needs available cash. If McDonald's, with all its potential for profit, had no cash with which to purchase necessary food and beverage items, it, like any other restaurant business, would be in trouble. In fact, the bigger the business, the greater the need for cash. Net income means nothing if bills can't be paid. Managing cash is crucial to a restaurant, especially during the first few months of operation. It is unwise to spend all your time managing the restaurant to the exclusion of maintaining an efficient cash management system. Figure 16.8 shows a six-month cash flow budget for a hypothetical restaurant.

Positive cash flow is enhanced either by increasing sales while containing costs or by decreasing costs while maintaining sales. To manage a restaurant's cash flow, the Bank of America recommends "a cash management system that can speed up the availability of incoming funds, slow down the disbursement of outgoing funds, and accurately monitor the amount of funds going in either direction."⁷

This can be achieved by:

- Keeping a cash receipts journal and a cash disbursements journal for day-to-day transactions
- Preparing period cash flow budgets to track cash flows and balance books
- Collecting cash and accounts receivable as quickly as possible
- Disbursing cash and paying accounts as slowly as possible
- Improving inventory turnover
- Consolidating cash reserves to use the money more efficiently and profitably

Fortunately, nearly all restaurant guests pay by cash or credit card, and some credit card companies have a direct debit from the guest's account to the restaurant in two days. Otherwise, the average time for credit card companies to pay restaurants for the charges that cardholders incur is about two weeks. These days, unless a credit arrangement is made in advance, many suppliers insist that restaurants that are just starting out pay on delivery. Good inventory management can assist positive cash flow. Restaurants generally turn over their inventory between four and eight times a month.

| | Month 1 | | Month 2 | | Month 3 | | Month 4 | | Month 5 | | Month 6 | |
|----------------------------|---------|--------|---------|--------|---------|--------|---------|--------|---------|--------|---------|--------|
| | Budget | Actual |
| Cash, Opening Balance | | | | | | | | | | | | |
| Cash Sales | | | | | | | | | | | | |
| Credit Sales | | | | | | | | | | | | |
| 0-30 Days | | | | | | | | | | | | |
| 31-60 Days | | | | | | | | | | | | |
| Total Cash Receipts | | | | | | | | | | | | |
| Cash Disbursements: | | | | | | | | | | | | |
| Purchase Cash | | | | | | | | | | | | |
| Purchase Credit | | | | | | | | | | | | |
| 0-30 Days | | | | | | | | | | | | |
| 31-60 Days | | | | | | | | | | | | |
| Payroll | | | | | | | | | | | | |
| Benefits | | | | | | | | | | | | |
| Payroll Tax | | | | | | | | | | | | |
| Benefits | | | | | | | | | | | | |
| Advertising | | | | | | | | | | | | |
| Telephone | | | | | | | | | | | | |
| Insurance | | | | | | | | | | | | |
| Accounting/ Legal | | | | | | | | | | | | |
| Repairs/ Maintenance | | | | | | | | | | | | |
| Office Supplies | | | | | | | | | | | | |
| Utilities | | | | | | | | | | | | |
| Taxes | | | | | | | | | | | | |
| Miscellaneous | | | | | | | | | | | | |
| Total Cash Disbursements | | | | | | | | | | | | |
| Net Cash Surplus (Deficit) | | | | | | | | | | | | |

FIGURE 16.8: Six-month cash flow budget for a hypothetical restaurant

PRODUCTIVITY ANALYSIS AND COST CONTROL

Various measures of productivity have been developed: meals produced per employee per day, meals produced per employee per hour, guests served per waitperson per shift, labor costs per meal based on sales. Probably the simplest employee productivity measure is sales generated per employee per year (divide the number of full-time equivalent employees into the gross sales for the year). An easy and meaningful measure is to divide the number of employees into income per hour. Some restaurants achieve a \$70-per-hour productivity rate.

When labor costs get out of line, the manager can analyze costs per shift or even productivity per hour to pinpoint the problem.

Without knowing what each expense item should be as a ratio of gross sales, the manager is at a distinct disadvantage. He or she should know, for example, that utilities ordinarily do not run more than 4 percent of sales in most restaurants, that the cost of beverages for a dinner house ordinarily should not exceed 25 percent of sales and could be much less, and that occupancy cost should not exceed 8 percent of gross sales in most cases. The rising cost of energy is giving restaurant managers and owners the incentive to cut back on energy costs whenever and wherever possible. Not surprisingly, about three in five operators said in an association study last fall that they were taking specific actions to combat rising energy prices, such as cutting back on unnecessary equipment use or switching to more efficient equipment.⁸ Ratio analysis must be in terms of what is appropriate for a particular style of restaurant: coffee shop, fast-food place, or dinner house (see Figure 16.9).

Moreover, the ratios must be appropriate for the region. Restaurant labor costs, for example, are usually low in the South compared with the North.

SEAT TURNOVER

Some restaurant operators consider the number of times a seat turns over in an hour the most critical number in the entire operation. This number roughly indicates volume of sales and is also an index of efficiency for the entire operation.

| | Percent |
|-----------------------------------|----------------|
| Sales | 100 |
| Cost of sales | 33.0–43.0 |
| Gross profit | 57.0–67.0 |
| Operating expenses | |
| Controllable Expenses | |
| Payroll (including manager) | 23.0–33.0 |
| Employee benefits | 3.0–5.0 |
| Direct operating expenses | 3.5–9.0 |
| Music and entertainment | 0.1–1.3 |
| Advertising and promotion | 0.8–3.0 |
| Utilities | 3.0–5.0 |
| Administrative and general | 3.0–6.0 |
| Repairs and maintenance | 1.0–2.0 |
| Occupation Expenses | |
| Rent, property tax, and insurance | 6.0–11.0 |
| Interest | 0.3–1.0 |
| Franchise royalties (if any) | 3.0–7.0 |
| Income before depreciation | 12.0–19.0 |
| Depreciation | 0.7–5.0 |
| Net profit before income tax | 5.0–15.0 |

FIGURE 16.9: Operating ratios

Source: Figures were developed by the Small Business Reporter in California.

What should seat turnover be per hour? This figure varies with the style of operation and what the operator is trying to accomplish. Restaurants featuring bar sales may wish to slow down seat turnover, making it possible for the patron to indulge in several drinks rather than none or a few. At the other end of the spectrum, the restaurant where people line up to wait for lunch is concerned with as rapid a turnover as possible.

Some restaurants have set a turnover rate as high as seven in an hour; others have one turnover every two hours. The rapid-turnover style of restaurant generally has a low check average, which produces high sales volume. The fast-turnover restaurant features rapid-production menu items—those that are already prepared or those that can be prepared quickly.

A dinner house on Friday or Saturday night—the busy periods—may want to feature roast beef, which is already prepared. The cooks merely slice it and place it on the plate. The concept is known as stored labor, preparing as much as possible during slow periods for use during rush periods.

Restaurants that depend on fast turnover have a number of techniques for speeding service. Servers are instructed to clear the tableware as soon as possible. One technique is to ask the guests if they would care for anything else. Guests who are due back at work may not mind such rush treatment, whereas those eating in a dinner house would resent it.

Servers and the entire staff can be tuned to rapid service. A clumsy or slow waitperson is a *liability* in an operation that depends on turnover for sales volume. The rush period may last only an hour or an hour and a half. Maximum sales must be achieved in that period. Rapid seat turnover may be critical not only for the operator but also for the patron who needs and wants fast service. The menu, the kitchen production, the service, and the style of operation all affect seat turnover and help determine the appropriate target figure for seat turnover.

Seating guests who cannot be served quickly can be a problem. The guests expect service that does not appear and might be happier sitting at the bar. Yet operators have been known to ask patrons to wait in the bar in order merely to increase bar sales. The guest, however, seeing empty tables, may become infuriated and leave.

Any new restaurant that relies heavily on a lunch business must do it right, from the start. Guests will expect that lunch can be completed within about 45 minutes.

Securing a Loan

The best-laid plans go nowhere without funding. Only people who are independently wealthy (or have rich backers) can ignore the funding issue. Everyone else will need to secure a loan.

COMPARE INTEREST RATES

When operators or would-be restaurateurs have a choice of lenders, they should, by all means, compare *interest rates*. A difference of 1 percent over a period of years is big money. Lenders often ask for *points*, dollars added to the interest rate. If possible, these should be avoided.

Over the past years, interest rates have gone up and down like a yo-yo. Not so long ago, interest rates were in the 20 percent range. They then went down to 11 percent, then as low as 5.5 percent. If at all possible, delay borrowing during the very high range, even though it may mean delay in starting a restaurant or expanding it. For the past few years, the Small Business Association (SBA) loan interest rate has hovered around 7 to 10 percent, depending on the amount being borrowed and the collateral pledged.

Beware of bankers who demand interest discounted in advance or a *compensating balance*. Borrowers are often pleased to receive a loan no matter what the cost, and they may overlook conditions placed on the loan. One such condition is when interest on a loan is discounted in advance. The borrower pays interest on a lower amount than was actually received.

Another condition that may be placed on a loan is the requirement of a compensating balance. Here the banker requires a certain amount to remain in the bank at all times. In effect, the borrower is not borrowing the full amount, but rather the amount minus the compensating balance.

REAL INTEREST RATES

The interest deductions allowable by the Internal Revenue Service (IRS) cut the real cost of a loan considerably. The higher the tax bracket, the lower the net cost of the interest paid.

Suppose a restaurant owner is in the 28 percent tax bracket and takes out a loan on his restaurant at 11 percent effective interest. The real cost of interest is less than 7.5 percent after tax deductions (on federal income tax and considering the state income tax deductions). As federal income tax laws change, of course, the real cost of interest also changes.

Deduction of interest cost when paying federal income tax explains why the higher interest rates charged by banks do not seem quite so high to business borrowers. This also helps explain why companies are not dismayed by interest rates that seem overwhelming. Tax laws change frequently and the example just given could become irrelevant at any time.

LOAN SOURCES

In seeking funds for financing a restaurant, a number of possible sources can be approached.

- *Local banks.* Usually the banker wants at least one-third to one-half more collateral against the loan as a lien against the loan. In other words, if an individual wants to borrow \$50,000, she must have collateral of perhaps \$80,000 to \$100,000. Banks are very reluctant lenders for restaurant ventures.
- *Local savings and loan associations.* Local savings and loan associations usually insist on similar security against any loans.
- *Friends, relatives, silent partners, syndicates.* Funds secured from these sources often have no security other than a lien against the property to be purchased or built. Individual arrangements vary considerably, from noninterest loans to active participation and ownership in the project.
- *Limited partnerships.* A limited partnership, where the managing partner calls the shots, is a good way for some restaurants to start debt-free. The partners invest; the managing partner—often the one with the expertise but little or no money—makes the decisions and the other partners receive a percentage of any profits. The advantage of this method of financing is that the restaurateur may start up a restaurant using very little of his or her own money. The downside risk is that a piece of the business is given away in the form of profits. However, creative limited partnership agreements include clauses for buyouts, payback, and, possibly, a percentage of profit as rent for the first few months.

SMALL BUSINESS ADMINISTRATION

The Small Business Administration (SBA) is user friendly and has an excellent success record in lending money to restaurants. In fact, there is a 65 percent success rate of the SBA loans to restaurants, compared to the often-quoted failure rate of restaurants: 50 percent fail in two years and of that 50 percent, half are not profitable, meaning that only 25 percent of the restaurants that open are profitable after two years.

Over the years, the SBA guaranteed loan program has helped launch some of the nation's biggest entrepreneurial success stories—companies such as Apple computer, Federal Express, and Intel—that had no place to go for financing when they got started.⁹

In the past few years, thousands of restaurant owners have utilized the SBA loan guaranty program to start, acquire, or expand their business.

The SBA now guarantees loans up to 90 percent. The maximum guarantee on loans exceeding \$150,000 is 85 percent and up to 75 percent on loans greater than \$150,000.¹⁰ The SBA can generally guarantee up to \$750,000 of a private-sector loan. It works like this: If you can borrow money from the banks, Uncle Sam cosigns the loan.



BEFORE SIGNING A LEASE

Bruce Barteldt, of Little and Associates Architects, offers these tips:

- *Don't guess about the size and shape of the building:* Do a feasibility study; all 2,500-foot retail spaces are not created equal. Depending on the shape of the space, you may be able to fit in 80 seats or only 50 seats. The difference could have a major impact on the restaurant's bottom line.
- *Don't let sunlight wash out your profit:* Harsh sunlight streaming in will annoy diners and wash out the effect of accent lighting and artwork. Window blinds or tinting will control the glare but, unless designed properly, create a less than welcoming atmosphere.
- *Negotiate for extra HVAC:* In most leases, the landlord will provide heating, ventilating, and air conditioning, or HVAC, or give a tenant an improvement allowance to cover HVAC costs. But as a result of new energy codes adopted around the country, restaurants are required to increase the rate of outside air coming in, which in turn increases the required HVAC capacity.
- *Know how the kitchen hood will exhaust:* Codes governing kitchens are strict and complicated. Before you sign a lease, inspect where the hood exhaust ducting will be located. That exhaust must run through the roof and be at least 10 feet from any door, window, or fresh-air intake. In a multistory building, this may mean constructing a shaft through each tenant space above; that can be costly and should be negotiated into the lease.
- *Get the power supply plugged in:* Typical retail spaces are provided with 200 amps of electrical service, but even a small restaurant requires approximately 400 amps for running the appliances, coolers, and lights. Who pays if the retail space isn't equipped to handle such a heavy power load?
- *Preserve the roof warranty:* Restaurants require a large number of roof penetrations for hood, gas, and bathroom exhausts, fresh-air intakes, and HVAC ducting. The more times the roof is punctured, the more it is likely to leak. Always employ the roofer who installed the building's original roof to make the penetrations and holes. Often the best option is to ask the landlord to coordinate the roofing work. Yielding it to the landlord and his or her roofing contractor will keep the roof's warranty intact and prevent you and your contractors from being blamed if a leak occurs.
- *Strive for perfect timing:* A retail store can be designed, given a permit, and become operational within 90 days, so most developers give retailers 60 to 90 days after the lease is signed before rent is due. But restaurants take longer to design, permit, and construct. Negotiate for a longer grace period before rent must be paid, or work into the budget the cash needed to pay the rent before the restaurant is opened.

Source: Bruce A. Barteldt, "Strategies for Negotiating the Best Restaurant Lease," Nations Restaurant News 31, July 21, 1997, no. 28.



Never sign a restaurant lease until you have had a thorough due diligence conducted. Due diligence is a legal term, borrowed from the securities industry, that means, essentially, to make sure that all the facts and figures are available and have been independently verified. In some respects, it is similar

to an audit. All the documents of the firm are assembled and reviewed, and the management is interviewed by a team of financial experts, lawyers, and accountants. The health department, fire department, and Liquor Control Board are contacted to ensure that the restaurant is in compliance with all

regulations, because the one-time licensing authorities can step in and require extensive alterations to bring a restaurant up to code when there is a change of ownership. So make any lease contingent on gaining all necessary licenses.

There are three principal parties to an SBA-guaranteed loan: the SBA, the small business borrower, and the private lender. The lender plays the central role. The small business submits a loan application to the lender for initial review. If the lender finds the application acceptable, it forwards the application and its credit analysis to the nearest SBA office. After SBA approval, the lender closes the loan and dispenses the funds. The borrower then makes loan payments to the lender.

Loans cannot be made at more than 2.75 percent interest over the prime lending rate¹¹, so if the prime rate is 6 percent, the total loan interest would be 8.75 percent. However, if banks are eager to lend money, they may drop that rate by up to 1 percent. There are no points involved, and the borrower has to pay only out-of-pocket expenses. The bad news is that there is a 2 percent fee for the guarantee.

The best part about an SBA loan is that the government cosigns the loan by guaranteeing it. When applying for an SBA loan, the borrower must have 33 to 50 percent of the project cost, and this must be debt-free; you cannot borrow \$10,000 on your credit cards.

There are only three forms to complete in order to fulfill the SBA requirements: an application, a disclosure, and a personal disclosure. The SBA cites poorly presented financial information as the number-one reason why loans are rejected. Loan applications to the bank and the SBA must contain accounts that are prepared in accordance with generally accepted accounting principles.

SBA loans have four basic requirements:

1. The right type of business
2. A clear idea of which loan program is best for you
3. Knowing how to fill out the application properly
4. Willingness to provide the detailed financial and market data required¹²

SBICs *Small Business Investment Companies (SBICs)* are licensed by the SBA. They are independently owned and managed companies set up to provide debt



Talking with an SBA loan officer. Being prepared for a meeting with a loan officer makes it easier to obtain a loan

Banks that participate in the SBA's Low Doc Program do not have to submit all of the usually required financial data to the SBA for analysis and review. Rather, the borrower completes a one-page application form and the bank completes a one-page analysis. The SBA processes these loan applications quickly—usually in 48 to 72 hours. Most traditional SBA

loans can be processed under this program as long as the amount of the loan is under \$100,000. The approval process focuses on the lender, as well as certain income tax returns.

Source: Jenny Hedden, "The Bucks Start Here," *Restaurant USA* 16, November 1996, no. 10, p. 13.

and equity capital to small businesses. They are permitted to leverage their private capital by using federal funds.

A variation of SBICs, *Minorities Enterprise SBICs (MESBICs)*, specialize in loans to minority-owned firms. Amounts loaned range from \$20,000 to \$1 million or more. A free directory of SBICs can be obtained from the National Association of SBICs, 618 Washington Building, Washington, D.C. 20005.

Soliciting an SBA Loan The SBA was established for the purpose of getting small businesses like restaurants going. The federal government encourages small business, especially those owned by minority groups. Funded by the federal government, the SBA, headquartered in Washington, D.C., has dozens of field officers spread over the country. The term *small business* is defined to include almost every independently owned and operated or even contemplated restaurant.

The SBA can help in a number of ways, but primarily through guaranteeing loans to start or expand a business and through providing expert consulting and counseling service via an auxiliary organization called the *Service Corps of Retired Executives (SCORE)*. This organization is made up of successful retired businesspeople who work on a volunteer basis to help businesses with specific problems. In some areas, SCORE executives are among the most knowledgeable in the business and are available to consult with any restaurant operator, whether fledgling or veteran.

As no one can know everything about the restaurant business, SCORE executives who are expert in disciplines such as accounting, layout, food purchasing, menu planning, and so on can be requested, and their services are provided at no charge.

The SBA is in business to make business loans, not outright grants, and the loan applicant must meet certain qualifications:

- Be of good character.
- Show ability to operate a business successfully.

- Have enough capital in an existing firm so that, with an SBA loan, the person can operate on a sound financial basis.
- Show that the proposed loan is of such sound value or so secured as reasonably to assure repayment.
- *If the request is to cover an existing business:* Show that the past earnings record and future prospects of the firm indicate ability to repay the loan and other fixed debts, if any, out of profits.
- *If a new business:* Be able to provide from the person's own resources sufficient funds to withstand possible losses, particularly during the early stages.

Like any other lender, the SBA, when guaranteeing a loan or making money available otherwise, wants collateral, which may take the form of mortgages on land, liens on equipment, guarantees, or personal endorsements. The SBA also wants, in writing, a great deal of information concerning the proposed or current business. For a restaurant, the information desired by the SBA encompasses:

- A detailed description of the proposed restaurant
- A description of the experience and management capabilities of the applicant
- An estimate of the applicant's worth and how much he or she and others will invest in the business and how much will be borrowed
- A financial statement (balance sheet) listing the personal assets and liabilities of the owner(s)
- A detailed projection of earnings for the first year of the restaurant's operation
- Collateral offered as security for the loan, with an estimate of the present market value of each item listed



WHERE TO FIND THE SBA POT OF GOLD

If you're eligible for an SBA-backed loan, the money may be in your own backyard, according to Mike Stampller, public relations officer in the SBA's office of Public Communications. All SBA loan paperwork is initiated at the local level, so Stampller recommends talking with your banker

first to determine if an SBA guarantee would help you obtain the financing you need. If your banker doesn't handle SBA loans, call the SBA district office in your area to locate banks in your state that are approved SBA lending sources. To find the district office's telephone number, consult the Small

Business Administration listings under United States Government in the Telephone book, or call (800) 8ASK-SBA or 827-5772. Internet users can access the SBA home page at www.sbaonline.sba.gov.

Source: Jenny Hedden, "The Bucks Start Here," Restaurant USA 16, November 1996, no. 10, p. 13.

Sequence for Securing an SBA Loan The SBA guaranteed loan-application process consists of four stages. First, the applicant requests a list of participating banks in the area from the SBA. Second, the applicant completes the SBA's six- to eight-page loan application (available at most commercial banks) and submits it to a lender for review. The form may take only about an hour to complete but the supporting documents can take time to track down, and no one can ever predict what the SBA will request. A restaurant owner, for example, must provide a copy of the lease and liquor license. Third, on completion of the loan request, the lending bank sends the application to the local SBA for approval. Fourth, if the SBA approves the loan, the borrower is requested to visit the bank to sign the loan documents. Keep in mind that the SBA also wants to see these six items for all loans it guarantees:

1. A current business balance sheet listing the company's assets, liabilities, and net worth
2. Income statements for the current period and the three most recent fiscal years, if available
3. A current personal financial statement of the proprietor or each partner or stockholder owning 20 percent or more of the corporate stock
4. A list of collateral to be offered as security for the loan, along with an estimate of the current market value of each item, as well as the outstanding balance of any existing liens
5. A statement noting the total amount of the financing you are trying to raise and the specific purpose of the loan
6. Tax returns for the most recent three years, which may be your personal returns or your company's returns, depending on how long you've been in business¹³

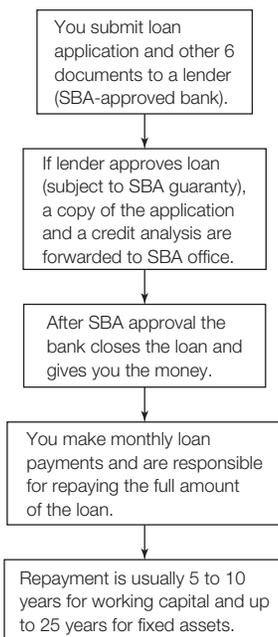


FIGURE 16.10: Sequence for obtaining an SBA loan

The applicant first approaches the SBA for a list of participating banks, then selects five banks to ask for a loan under SBA's Loan Guarantee Plan. If a banker finds the application acceptable, he or she will contact the SBA. The SBA approves 50 percent of loans in three days and a further 35 percent in 10 days.

The details for making a loan application can be extensive. The loan application can be a number of pages or it can be rather brief, depending on the relationship between the lender and the loan applicant and the amount of the loan requested. A detailed business plan, including a statement of resources, abilities, and experience of the applicant and a forecast for the business, tends to support the application. Figure 6.10 shows the sequence of obtaining an SBA loan.

STOCKPILING CREDIT

The borrower should not wait to request a loan until just before it is needed. Processing a loan may take time. Much of the required information can be put

together in draft form, ready to be updated when a loan is needed. You can make the process smoother by assembling this information and keeping it current:

1. A personal financial statement:
 - a. Education and work history
 - b. Credit references
 - c. Copies of federal income tax statements for the previous three years
 - d. Financial statement listing assets and liabilities and life insurance
2. If in business:
 - a. Business history
 - b. Current balance sheet
 - c. Current profit-and-loss statement
 - d. Cash flow statement for last year
 - e. Copies of federal income tax returns for past three to five years
 - f. Life and casualty insurance in force
 - g. Lease
 - h. Liquor license
 - i. Health department permit

SELLING THE PROPOSAL

Borrowing money involves selling the lending officer on the belief that the borrower will be successful. To do this, the borrower must be able to convince the officer that a carefully thought-out business plan is ready and can be put into effect once the funds are available. The business plan not only presents what is proposed but also includes a financial and work history of the applicant—information necessary to support the view that the applicant will be successful in the restaurant. The business plan is evidence, to some extent, of the applicant’s ability to think logically and project plans into the future. The manner of presentation can be impressive and has an effect similar to a well-conceived resume. (Applicants sometimes turn to specialists who develop business plans for a fee.)

Any lending bank will check your credit history. So, before going to the bank, you should check your credit rating. First, get your personal credit report. You can obtain a copy by calling Trans Union, TRW, or any credit bureau. Remember, personal credit may have errors or be out of date. People often find that they paid off a bill but that it was not recorded on the credit report. It can take three to four weeks to correct this kind of error, and it’s up to you to do the double-checking. On the credit report you will see a list of all the credit you have obtained in the past—credit cards, mortgages, and, yes, student loans. Each credit is listed along with how you paid. Any credit where you had a problem in paying appears near the top and may make it difficult to get a loan.

The Bank of America provides an outline (see Figure 16.11) for a business plan that can be followed in drawing up a loan proposal package.

- I. Summary
 - A. Nature of business
 - B. Amount and purpose of loan
 - C. Repayment terms
 - D. Equity share of borrower (equity/debt ratio after loan)
 - E. Security or collateral (listed with market value estimates and quotes on cost of equipment to be purchased with the loan proceeds)
- II. Personal information (on persons owning more than 20 percent of the business)
 - A. Educational and work history
 - B. Credit references
 - C. Income tax statements (last three years)
 - D. Financial statement (no older than 60 days)
- III. Firm information (whichever is applicable — A, B, or C)
 - A. New business
 - 1. Business plan
 - 2. Life and casualty insurance coverage
 - 3. Lease agreement
 - B. Business acquisition (buyout)
 - 1. Information on acquisition
 - a. Business history (include seller's name, reasons for sale)
 - b. Current balance sheet (not older than 60 days)
 - c. Current profit and loss statements (less than 60 days old)
 - d. Business's federal income tax statements (past three to five years)
 - e. Cash flow statements for last year
 - f. Copy of sales agreement with breakdown of investors, fixtures, equipment, licenses, goodwill, and other costs
 - g. Description and dates of permits already acquired
 - 2. Business plan
 - 3. Life and casualty insurance
 - C. Existing business expansion
 - 1. Information on existing business
 - a. Business history
 - b. Current balance sheet (not more than 60 days old)
 - c. Current profit and loss statements (not more than 60 days old)
 - d. Cash flow statements for last year
 - e. Federal income tax returns for past three to five years
 - f. Lease agreement and permit data
 - 2. Business plan
 - 3. Life and casualty insurance
- IV. Projections
 - A. Profit and loss projections (monthly, for one year) and explanation
 - B. Cash flow projection (monthly, for one year) and explanation
 - C. Projected balance sheet (one year after loan) and explanation

FIGURE 16.11: Sample loan package outline

Source: From Bank of America, "Financing Small Business," *Small Business Reporter*

The SBA places emphasis on the business plan required of the borrower as part of the loan application. The SBA suggests the plan be written in seven sections:

1. Cover letter, including the amount of the loan being requested, the terms, and the repayment period
2. Business summary with the restaurant's name, location, menu, target market, competition analysis, and business goals, and profiles of the management
3. Market analysis explaining the kind of restaurant and where it fits into the overall industry
4. Menu analysis, including a copy of the proposed menu, the signature (special) items that will be offered, and a comparison of the menu with those of the competition
5. Marketing strategy, including promotion and advertising plans for reaching the target markets
6. Management plan, including the organization chart, job descriptions, and résumés for the officers
7. Financial data, including a financial history of the borrower(s) and financial projections month by month for the first year, by quarter for the second year, and for the third year as a whole; projections of the key ratios such as food, labor, and beverage costs as a percentage of sales and how the projections compare with industry averages and those of competitors

Quite correctly, the SBA would like loan applicants to have had at least three years of experience working in a restaurant similar to the one being proposed. The SBA also wants the loan applicant to personally invest at least 20 percent of the total cost of opening the restaurant.

OTHER SOURCES OF MONEY

Several other loan sources are often overlooked. These sources include:

- *Borrowing from the landlord.* Often the landlord is as interested in the restaurant as the operator. He or she may help in financing the restaurant with start-up costs and allow the loan to be paid back in higher rent.
- *Borrowing from the landlord's bank.* The landlord may have more credit than the operator and may even be prevailed upon to endorse a loan.
- *Borrowing from the local government.* Many municipalities have raised large sums of money by selling industrial revenue bonds. That money is usually available at rates lower than the going rate. A number of quick-service chains have tapped this source of money and saved large sums ordinarily paid in interest charges.
- *If the restaurant owns the land or restaurant building, selling it and leasing it back.* Several restaurant chains have been built on the sale-and-leaseback

plan. Investors who buy the restaurant are promised a good yield on their money plus depreciation on the building and, sometimes, on the equipment as well.

- *Borrowing from the public.* Sell stock in the restaurant company to the public. Stock offerings of less than \$1.5 million can be done simply with the help of good legal advisors.
- *Selling bonds or convertible bonds.* Bonds are debts, taken on by a company, that pay the bondholder a certain rate of interest and must be repaid in full by a fixed date. Convertible bonds are the same but can be converted into common stock of the issuer according to fixed terms.
- *Getting a bank loan guaranteed by the Farmer's Home Administration.* These loans are made to businesses in rural areas and cities with fewer than 50,000 people. The loan must be used to create jobs or add to the tax base of the community.
- *Borrowing from the Economic Development Administration (EDA).* The loans are made for businesses that can create jobs or add to the tax base of a community.
- *Borrowing from a city with the help of the Urban Development Action Grant (UDAG) program.* The UDAG was created to help 320 large cities and more than 2,000 small cities defined as "distressed." The borrower goes to such a city or town government with a proposal for an investment that will benefit the town or city. The government then applies for the grant.

COLLATERAL

What security does the borrower offer in return for the loan? Collateral, security for the lender, is the personal property or other possessions the borrower assigns to the lender as a pledge of debt repayment. If the debt is not repaid, the lender becomes the owner of the collateral. The most important collateral is the character of the applicant. How does the lender determine character?

- By personal observation—knowing the borrower over a period of time.
- By references—provided by the borrower and records of previous borrowings and payments.
- By credit reputation—established in previous credit transactions. Lenders, especially banks, refer to credit rating firms for credit reputation.

Unless the borrower has already established a line of credit with the lender (for example, a bank), the lender wants collateral (any asset acceptable to the lender). These forms of collateral are customarily accepted by banks:

- *Real estate (homes, other buildings of value, land).* The lender determines the value of the property and the amount of insurance carried on it.
- *Stocks and bonds.* Banks use loan securities, discount stocks and bonds are offered by as much as 50 percent to allow for decline in value.

- *Chattel mortgages.* Liens (legal claims) on specified physical assets, such as automobiles or machinery, are used.
- *Life insurance.* Insurance companies commonly lend money against paid-up insurance policies, usually at interest rates below bank rates. Banks will lend up to cash value of a life insurance policy provided the policy is assigned to the bank.
- *Assignment of lease.* Commonly, a bank lends money on a restaurant building and takes a mortgage. A lease is worked out between the operator and the franchiser such that the bank automatically receives rent payment. In this manner, the bank is guaranteed repayment.
- *Savings accounts.* Sometimes a loan can be made on a personal savings account. In this case, the account is signed over to the bank, which keeps the savings account passbook.
- *Endorsers, co-makers, and guarantors.* Closely related to other forms of collateral are loans guaranteed by others who must prove themselves capable of repaying the loan and who are liable for the debt if the borrower does not pay.

An endorser is contingently liable for the loan. If the borrower does not pay, the lender expects the endorser to do so. An endorser may be asked to pledge collateral in the same way as the borrower.

A co-maker joins the borrower on equal terms of obligation to the lender. The lender can collect directly from either the maker or the co-maker of the loan. A guarantor signs the note and guarantees payment.

Private and government lenders often require officers of corporations to sign as guarantors, which makes them personally liable for repayment.

KEEPING THE LOAN LINES OPEN

In seeking a plan, it is important to keep in mind that one loan may lead to another. The development of a line of credit is a valuable asset, one that is nurtured by businesspeople. Friendship with a lending officer can help, but more important is a series of loans that have been repaid as scheduled. In other words, try to borrow money under circumstances where you may go back for more when necessary.

AVOIDING PERSONAL LIABILITY

Large corporate chains usually have sufficient credit standing to command loans without the necessity of personal guarantees. The shrewd individual who guarantees a sizable loan sees to it that very few personal assets can be claimed in case of default. Ownership of automobiles, homes, land, and other personal assets is transferred to a spouse or other relative with the thought that, should the business fail, the creditor has little to claim. Giving one's assets to another, however, may be hazardous. For example, the spouse may end up with the assets after an estrangement or divorce.

Leasing

Restaurant buildings and equipment are more likely to be leased than purchased by the beginner because less capital is required for leasing than for building or buying. The beginner reduces the investment and, should the venture fail, reduces loss.

Keep in mind, however, that signing a lease obligates the signer to come up with the lease payments for the entire period of the lease. This means that if a building is leased for five years and the restaurant fails in the first year, the lessee has to find someone suitable to sublet or make the lease payments for the entire five-year period, or try to get the landlord to terminate the lease. If the lessee is truly in desperate financial straits, he or she can declare bankruptcy.

A restaurant lease should be good for both parties—the landlord (lessor) and the tenant (lessee). Established restaurant companies often sign 20-year leases. Beginners probably should try for a five-year lease with an option to renew for several additional five-year periods. If the beginning restaurateur is apprehensive about failing, a shorter lease period with options to renew, or even a month-to-month lease, might be desirable.

The option to renew can be a large financial factor if it permits a renewal at the same dollar amount as the original lease. If this is possible and inflation is high during the period of the original lease, the restaurateur can be a big gainer. Most leases, however, are in terms of a fixed dollar amount per month plus a percentage of gross sales. The percentage reflects the effects of inflation.

Be aware of the normal leasing terms of 60 to 90 days to get set up before rent is paid. Remember it often takes much longer to get all the permits and construction done. Get a head start with the design and negotiate for a longer grace period before beginning to pay rent.

Beginning restaurateurs who are short of cash often lease restaurant equipment as well as the building. The building and equipment are sometimes available as a package lease. The beginner may also lease individual pieces of equipment. For example, a coffeemaker may be leased from a coffee supplier. A dishwashing machine can be leased. Ice cream cabinets are frequently loaned, provided the ice cream is purchased from the lender.

Beyond location and square footage, there is more to consider when selecting restaurant space within a retail center. For example do not let sunlight wash out profits. Sunlight and glare streaming in through south-facing windows will annoy diners.¹⁴ The sunlight will play havoc with the restaurants lighting and ambiance plus add to air-conditioning costs. Window blinds will detract from the appearance of the restaurant.

Negotiate for extra heating ventilation and air conditioning (HVAC). As a result of energy codes, restaurants are required to increase their outside air ventilation rate, which in turn increases the required HVAC capacity. In the southeast, restaurants now require one ton of HVAC per approximately 150 square feet, which is almost twice as much as required in a typical retail space.¹⁵



CAUTION WHEN TAKING OVER AN EXISTING RESTAURANT LOCATION

Just as you think you've found the perfect location for your restaurant, think again! The transfer of restaurant ownership is the one time when licensing authorities

may demand costly modifications to bring the restaurant up to code. Be sure to hire a lawyer skilled in restaurant leases and build in conditional clauses that say the

lease is contingent on all necessary licenses and permits being obtained.

LEASE COSTS

The amount of a lease is dependent on the length and type of lease negotiated. Depending on location, leases are generally approximate 5 to 8 percent of sales, but in exceptional circumstances they may go as high as 12 percent. Leases are normally triple net leases (meaning that any alterations made to the property come out of your pocket). Lease costs are calculated on a square-foot basis, with charges ranging from \$2 to \$50 per square foot per month, depending on the location. A suburban strip mall will be around the \$2 range; Main Street U.S.A. will be around \$14 to \$18; and yes, you guessed it, New York City will be in the \$50 range. That's why the tables in New York are so close to each other. The restaurant operator forecasts the amount of sales to determine if the lease cost is fair. A choice location could be suitable for one restaurant concept, much too expensive for another.

Sales per square foot or per seat depend on the average customer check amount and the speed of seat turnover. California Pizza Kitchen, which has very high sales per square foot, has an average table turnover of 10 or 11 times on weekends. High seat turnover, an average check of about \$10, and relatively small kitchens help account for the high per-square-foot sales. With high sales and relatively low labor cost, the California Pizza Kitchen can afford to lease in affluent malls and neighborhoods where rents are high.

DRAWING UP A LEASE

Ask these questions before agreeing on a lease:

1. Why is the building up for rent? Will an airport locate nearby? Is the highway being expanded? Is it a high crime area? Is there sufficient parking? Is the building in bad repair? Is it a bad location—for example, near a fertilizer plant? Are there rodents? fire hazards? Check with the fire department, police, and health department for information.
2. Who was the last tenant? Why did the tenant leave?

A lessee of a restaurant would want to consider including these and other clauses in the lease:

- Names and addresses of the parties—landlord and tenant; period of time the lease is in effect.

- Amount of lease payment.
- How paid. Rent is payable on the last day of the month, unless there is a clause in the lease saying “Pay in advance.”
- Occupancy (how many people are allowed to occupy the space?); facilities available and time of availability.
- Parking (exact amount of space to be available).
- Appliances and equipment included as a part of the lease.
- Specification of party responsible for repair or replacement of appliances.
- Security deposit to be returned at the end of the lease, provided tenant has not damaged property.
- An assignment or sublet clause—for example, “the tenant has the right to obtain a new tenant with the landlord’s permission” (and this permission must not be unreasonably withheld) and the new tenant pays the rent directly to the landlord. The original tenant is released from further liability for the balance of the lease. In the sublet arrangement, “the new tenant pays the rent to the old tenant, who continues to pay the landlord. The old tenant remains liable to the landlord for the balance of the lease.”
- A clause stating “the landlord agrees not to withhold unreasonably his consent for the tenant to assign or sublet.”
- Common area maintenance (CAMs) costs, yes or no. Landlords often try to pass on to tenants the tax, insurance, and maintenance expenses of operating the property, usually in proportion to the amount of occupied space. If you are paying CAMs, then the landlord has no incentive to control costs. If there are CAMs at the location you want, one suggestion is to insist on a cap—for example, 10 percent of minimum rents. Thus, if rent is \$3 per square foot, CAMs would be 30 cents or less.¹⁶
- A condemnation clause. A successful business housed in leased property may find that the leased property is condemned. A clause in the lease protects the tenant.

In the lease, include statements that you have:

- The right to operate a restaurant.
- Permission to alter the building.
- Permission to erect a sign (a sign can be a risk that forces the landlord to pay higher insurance).
- Permission to landscape and put up outside lighting.
- An exact amount of parking (describe it).
- The right to paint the building the color you wish (interior and exterior).
- A wine and liquor license, health permit, business permit, fire department permit. Include a conditional clause stating “This lease will have no effect if any of the above permits are denied. The lease is conditional on obtaining the necessary licenses and permits.”
- An option to renew the lease and the method of computing the rent at that time.

- The right to remove equipment that you have installed provided you put the building back in its original shape.
- An exclusive provision—a clause saying that the landlord will not rent to another restaurant within a certain radius.
- A clause protecting the tenant in case of death or insanity, such as “wife or partner may terminate the lease.”
- A clause stating that unpleasant odors that cannot be eradicated easily will terminate the lease.
- The broadest clause possible to eliminate restrictions. You do not want to limit the products you are able to sell. One day you may want to sell subs, and after a while you may want to include pizza. Also, a more broadly defined use is more attractive to potential buyers.
- A co-tenancy clause. If you move to a shopping center and three months later the anchor tenant moves out—along with most of the foot traffic—you could lose a lot of money. Include a clause that says if there are major losses of occupancy in the center—to, say, 65 percent—you have the option, after a certain period of time, to move out with 30 days’ notice. An alternative is to specify that rent will be reduced during times of low occupancy. Normally landlords are permitted a reasonable period of time (say, six months) to fill the vacancy before you can exercise your option.

LEASE TERMINOLOGY AND LENGTH

In making a lease, both parties should consult a lawyer versed in real estate terminology to avoid misunderstandings. An example of lease language that has a specialized meaning is *triple net lease*. In short, the term refers to a lease in which the landlord, the lessor, passes on to the lessee the responsibility for building leasehold improvements and paying for increases in taxes and insurance. This guarantees that the landlord incurs no expense beyond the investment made at the time the lease is signed. In other words, the restaurant operator who has a triple net lease assumes the burden of upkeep, taxes, and insurance on the building. Clearly agreeing on who is responsible for what avoids confusion and ill will.

Operators have different opinions about the length and details of an ideal lease. Some specialists recommend obtaining a renewable lease for as long a period as possible—normally, a long lease is about 20 years (30, if you can get it). The option to renew for periods up to 20 years appeals to some. There is a security in knowing that the restaurant may be around for some time.

Others prefer a five-year term plus three five-year renewal options. The shorter the lease time lock-in, the better, they say. Be sure to lock in the renewal and a fair method of computing the rent at renewal time. The rationale for this option is that circumstances can and do change quickly in the restaurant business, and you might not want to tie yourself into a business that you can’t get out of. An additional option is to use a short-term lease that includes a clause that says at the end of the X-year lease, the operator may leave without penalty, providing a one-year notice is given.

A big point to remember in leasing anything: If the business does not survive, you, the lessee, are still liable for the payment if you have signed a personal guarantee. You can be burdened with the debt for the rest of your life if it is not paid off.

SPECIFICS OF MOST RESTAURANT LEASES

The annual rent for lease space is calculated per square foot per month and is known as the base rate. Chez Ralph, a hypothetical restaurant, is a space of 4,000 square feet leased at \$5 per square foot.

The annual rent would be:

$$4,000 \text{ (square feet)} \times \$5 \text{ per square foot} = \$20,000 \text{ per month}$$

The annual rent would be:

$$\$20,000 \text{ (monthly rent)} \times 12 = \$24,000$$

On average, total rent cost should be about 7.3 percent of yearly gross sales. If the rent costs go as high as, say, 10 percent, then other costs must be proportionately lower, in order to maintain suitable profit margins.

Term of Lease Most foodservice business leases are for five years, with two more five-year options, for a total of 15 years. In addition to rent and percentage factors, it is not unusual to have an escalation clause in the lease detailing a “reasonable rent hike after the first five-year term.” The increase may be based on the Consumer Price Index (CPI) or the prevailing market rate (what similar spaces are being rented for at the time the lease is negotiated). Make sure the lease agreement clearly spells out the basis for any rent hike.

Power Supply Typical retail spaces are provided with 200 amps of electrical service. But even a small restaurant requires approximately 400 amps to run the appliances, coolers, and lights. Who pays if the space isn’t equipped to handle such a heavy power load? Be prepared to negotiate with the landlord for the cost of repair to the site and to run lines from the main panel to the tenant space.¹⁷

Financial Responsibility Early in the lease negotiations, you should cover the touchy topic of who will be responsible for paying off the lease in case, for any reason, the restaurant must close its doors. If an individual signs the lease, that person is responsible for covering these costs with his or her personal assets. If the lease is signed as a corporation, then the corporation is legally liable. As you can see, it makes sense to pay the state fees to incorporate before signing a lease.

Within your corporation, multiple partners must have specific agreements about their individual roles in running the business. You should probably also outline how a split would be handled if any partner decides to leave the company. Your peace of mind will be well worth the attorney and accountant fees when you have these important contractual agreements written and reviewed.

Preserve the Roof Warranty Restaurants require a number of roof penetrations for hoods, gas and bathroom exhausts, fresh-air intakes, and HVAC ducting. The more times you puncture a roof, the more likely it will leak. Always employ the roofer who installed the building's original roof and ask the landlord to coordinate the roofing work because the roofing warranty will be kept intact. The restaurant owner can either pay the landlord or decrease the tenant improvement allowance.¹⁸

Maintenance Agreement Another important part of a lease is the complete run-down of who is responsible for repairs to the building. Some leases give the tenant full responsibility for upkeep. Others give the landlord responsibility for structural and exterior repairs, such as roofing and foundation work, while tenants handle interior maintenance, such as pest control or plumbing and electrical repairs. These items are easy to gloss over if you have your heart set on a particular site. Remember, however, that all buildings need maintenance, and costs can really add up. How much are you willing to do—and pay for?

Real Estate Taxes Each city and county decides on the value of land and buildings, and taxes an address based on its assessed value. These taxes are typically due once a year, in a lump sum, but most landlords ask that the taxes be prorated and paid monthly, along with rent and insurance. A triple net lease is the term for a lease that includes rent, taxes, and insurance in one monthly payment.

Municipal Approval Just because you sign a lease does not mean you will ever serve a meal at this site. Cover your bases by insisting, in writing, that this lease is void if city or county authorities do not approve the location to operate as a restaurant (or bar, or cafeteria, or whatever you're planning). Potential roadblocks: Do you intend to serve alcohol? Is your concept somewhat controversial—scantily clad waitstaff, for instance? You will save yourself a lot of time and money if your lease allows these items in writing and if you also obtain permission from the county or city first. Politely inquire about all the necessary licenses and permits before you begin work on the site.

Leasing and Insurance Generally the tenant is responsible for obtaining insurance against fire, flooding, and other natural disasters as well as general liability insurance for accidents or injuries on the premises. The lease must specify how the policy should be paid—monthly or yearly are the most common stipulations—and also the amount of coverage required. Both tenant and landlord are listed as the insurance parties, so the landlord should be given copies of all insurance policies for his or her records.

RESTAURANT INSURANCE

Restaurant owners must also consider a variety of insurance policies including (but not limited to) these types:

- *Property/Building Insurance.* This type of insurance generally covers holders for a variety of unforeseen losses, such as fire, vandalism, and so on.

Additional coverage can be added for other possible losses due to floods, earthquakes, and hurricanes.

- *General Liability Insurance.* Liability insurance covers the business in the event of a lawsuit if someone is injured or if property is damaged. It is crucial for a restaurant to carry extensive liability insurance. By nature restaurants are fast paced and have a lot of consumer traffic. Accidents such as slip and falls happen. It is best to be safer now than sorry later. Additional liability insurance can also be added to protect the business against disgruntled employees who may claim wrongful termination, sexual harassment, discrimination, and the like.
- *Business Income Insurance.* If a business is interrupted and normal operations are suspended, business operation insurance takes over and provides the income that the business would have generated under normal circumstances.
- *Workers' Compensation and Employers' Liability Insurance.* In most states, this insurance is mandatory if the business employs more than three individuals. It covers on-the-job injuries and illnesses. It generally pays medical and rehabilitation bills, income in the event of a disability, and death benefits.
- *Employee Benefit Liability Insurance.* Employee benefit liability is optional. It may include benefits such as dental plans and health plans.
- *Liquor Liability Insurance.* In a number of states laws are in effect that make the person who serves liquor liable for crimes, as well as accidents, that happen as a result of the patrons' intoxication.
- *Equipment Breakdown Insurance.* This insurance provides coverage for equipment, such as computer systems, air conditioning, heating equipment, and telephone systems. As restaurants have become more dependent on computer systems (and the Internet), this insurance is increasing in value.
- *Food Contamination/Spoilage Insurance.* As the name implies, this insurance provides coverage in the event of food becoming contaminated or spoiled. For example, this coverage would take effect if there was a long-term power outage or unsanitary food handling.
- *Crime/Employee Dishonesty Insurance.* This insurance covers the expenses if business is lost due to dishonest acts committed by employees.
- *Auto/Valet Liability Insurance.* If the restaurant uses a car to make deliveries, cater events, or valet parking, this insurance protects the automobile in the event of an accident or damage. In addition, it protects the vehicle in the event that he or she is injured.
- *Umbrella/Excess Liability Insurance.* Once a policy has reached its limits, this type of policy provides additional coverage for the specifics that would not be ordinarily covered by the other insurance plans.
- *Fire Insurance.* There is no need to point out the necessity of carrying fire insurance on a restaurant. However, we offer a few suggestions:

- If you are leasing or renting the building, it must be very clear who carries the fire insurance—the operator or the landlord.
- Is the restaurant insured by business interruption insurance—insurance that is paid over a definite period of time in case the restaurant is closed because of fire or other reasons? (Because of its expense, many—probably most—operators do not carry this insurance.)
- Is insurance carried on inventory as well as on the building?
- Is current insurance coverage sufficient to replace losses? Inflation and new equipment make it necessary to update insurance coverage periodically to reflect replacement costs.
- Is a sprinkler system in place and operative? Sprinkler systems reduce insurance costs. Insurance rates also reflect construction material, alarm systems, cooking hood protection, fire extinguisher protection, exit signs, and housekeeping practices.

What Is a Restaurant Worth?

What is a fair price to pay for a restaurant building? A restaurant has two potential values: its real estate value and its value as a profit generator. The two values should be considered separately. A restaurant building may actually detract from the real estate value, especially if the building has failed as a restaurant one or several times or is unattractive. The real estate value may be greater than the operational value.

A restaurant buyer is much concerned with the real estate value, a potential lessee less so. However, even the person wanting to lease a restaurant must consider the real estate value (or potential value) because, if the value increases, the owner will increase the rent (unless the lease agreement is written to prevent such an increase).

What is the real estate value? The value is usually determined by competitive values in the community. The market value of real estate tends to follow the value set by similar properties in the area. Is the asking price above or below the market value for the area? Potential changes in property zoning by local or state zoning boards affect market value. Will highway or other changes be made in the near future that will affect the value of the property? Is the area going downhill or being revitalized? Is the area getting better or worse for a particular kind of restaurant? As an area changes, the kind of restaurant that will be supported also changes. A declining area may need a lower-check-average restaurant, fast-food place, or coffee shop. As affluence grows, more dinner houses can be introduced.

A final note: Just because a sweet financial deal has been put together, the success of the restaurant is not assured. Too often, a group of businesspeople are afflicted with the restaurant-ownership bug. They figure all of the angles, find a cheap source of money, contemplate the benefits of investment tax credits and depreciation, and can hardly wait to become restaurant owners. They fantasize

about all of those wonderful meals they will provide clients in their restaurant, all tax deductible. What they overlook is the need for concept development, menu development, location, and other planning. They may also lack a qualified general manager and chef. Financial planning is only one aspect of the success or failure of a restaurant.

Going through all the steps to open a restaurant takes time and perseverance; ask Korianne Hoffman and her partner, well-known and respected chef Dudley, who, when setting up a great upscale casual Mexican restaurant in Chicago, at first, looked for a suitable location in the upcoming and trendy South Loop warehouse area. There were a couple of funky restaurants already there. Unfortunately, there were no decent restaurants to take over, and the cost of conversion of a warehouse-type building was \$1.5 million. The lease costs ranged from \$18 to \$35 per square foot per month. They planned to make money by “making the turns” (restaurant lingo for turning the tables, meaning you eat dinner and then vacate the table and then someone else uses the table, that’s a turn), but they hadn’t planned on that many!

Their real estate broker advised them of a location in the suburbs—this was a new twist, because Korianne and Dudley were used to the city, not the suburb of Oakbrook. However, an existing 30-year-old French restaurant was for sale, and the price included the building. The good news was that the SBA had a special loan interest rate of 3 percent for the first six months, after which it would be prime plus 2 percent—or currently, 8 percent. More good news was that the amount they would be paying in mortgage costs would be less than the lease costs in the South Loop area. Just think of the upside potential for equity appreciation in the value of the building.

Physically, the restaurant was on the ground floor of an eight-unit condominium building. The restaurant was about 6,000 square feet, plus basement. Since it had been a French restaurant, there were plenty of burners but no grills, so they had to purchase a grill or two. Luckily, all the other kitchen equipment was good to go. The French restaurant had 115 seats, but that was a more formal layout, so the new owners considered stretching that to 125. They anticipated an average check of \$15 for lunch and \$31 for dinner. The area is upscale, with average household incomes of \$187,000. There are several nearby office buildings that draw about 40,000 people to the area during the week. The restaurant has virtually unlimited parking plus 40 valet spots.

Korianne and Dudley had a friend who is an architect. He took care of the plans for modification, and they are shopping for a designer—several friends who know the area are advising on the peculiarities of the likely clientele. They are also clipping design ideas from books and magazines. They are talking with local area bartenders to find out which one would be the most suitable to make the move and bring some of his regulars with them. The servers will all be experienced and will either have worked with them before in other restaurants or be from local restaurants. Korianne is working on press releases and public relations to give the chef-driven restaurant an opening boost. They expect to break even in two

months, and with a glowing restaurant review they will. Good luck, Korianne and Dudley and partners.

Summary

Each step in the process of the restaurant evolution, from concept to operation, is important. Finance and leasing are of equal importance to the overall success of the restaurant. The amount of capital required, how much to keep in reserve for the first few months of operation, where the capital is obtained, and how much it will cost to borrow the money are all critical issues. Soliciting a Small Business Administration loan is a lengthy and complex process. Other sources of loans are discussed.

Leases are also a complex commitment. Generally leases are for a fixed dollar amount per square foot per month plus a percentage of gross sales, depending on the negotiated terms of the lease. With triple net leases, the restaurant operator assumes the burden of upkeep, taxes, and insurance on the building.

Key Terms and Concepts

| | |
|----------------------|--------------------|
| Capital | Liability |
| Collateral | MESBICs |
| Compensating balance | SBICs |
| Interest rates | SCORE |
| Leasing | Stockpiling credit |

Review Questions

1. In drawing up a sales budget for a casual Italian restaurant, what percentage of weekly sales should be forecasted for Friday and Saturday evenings?
2. A casual restaurant with a \$1-million sales volume should have how many full-time equivalent employees?
3. What labor, food, beverage, and occupancy costs should the above restaurant have? Express your answer as both a percentage of sales and as a dollar figure.
4. Aside from its value in planning, why is it essential to do a budget forecast of sales, costs, and profit?
5. Suppose that after forecasting sales and deducting expenses, you are left with 3 percent operating profit before interest charges and taxes. What would you do?
6. List, in order of priority, four sources of financing you would approach in seeking funds for your restaurant.
7. In seeking a construction loan, would you expect to have the entire amount of the loan given to you in a lump sum? Explain.

8. The procedure in seeking a loan from the Small Business Administration is fairly elaborate. What is the usual sequence for this process?
9. The recommendation is made to “stockpile your credit.” What does this mean?
10. Is it possible (not probable) to start a restaurant without any cash of your own? Explain.

Internet Exercise

Go to www.sba.gov and seek information on business start-up finance that will be helpful to your restaurant start-up. Be prepared to share the information with your class.

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