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2008 Complete Guide for Restaurant Real Estate Investments

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Restaurants are a favorite commercial property for many investors because:

1. Tenants often sign very long term, e.g. 20 years absolute triple net (NNN) leases. This means besides the rent, tenants also pay for property taxes, insurance and all maintenance expenses. The only thing you have to pay is the mortgage, so your monthly cash flow is very predictable. There are no landlord responsibilities so you have time to do what is important to you, (e.g. to retire). All you do is take the rent check to the bank. This is one of the key benefits in investing in a restaurant or single-tenant property.

2. Whether rich or poor, people need to eat. Americans are eating out more often as they are too busy to cook and cleanup the pots & pans afterwards which often is the worst part! According National Restaurant Association, the nation's restaurant industry currently involves 937,000 restaurants and is expected to hit \$537 billion in sales in 2007, compared to just \$322 billion in 1997 and \$200 billion in 1987 (in current dollars). In 2006 for every dollar Americans spend on foods, 48 cents were spent in restaurants. As long as there is civilization on earth, there will be restaurants! So you feel comfortable that the property is always in high demand.

3. You know your tenants will take very good care of your property because it's in their best interest to do so. Few customers if any want to go to a restaurant that has a filthy bathroom or trash in the parking lot.

However, restaurants are not created equal, from an investment viewpoint.

Franchised vs. Independent

One often hears that 9 out of 10 new restaurants will fail in the first year; however, this is just an urban myth as there are no studies with such conclusion. There is only a study by Associate Professor of Hospitality, Dr. H.G. Parsa of Ohio State University who tracked new

restaurants located in the city Columbus, Ohio during the period from 1996 to 1999 (**Note:** you should not draw the conclusion that the results are the same everywhere else in the US or during any other time periods.) Dr. Parsa observed that seafood restaurants were the safest ventures and that Mexican restaurants experience the highest rate of failure in Columbus, OH. His study also found 26% of new restaurants closed in the first year in Columbus, OH during 1996 to 1999. Besides economic failure, the reasons for restaurants closing include divorce, poor health, and unwillingness to commit immense time toward operation of the business. Based on this study, it may be safe to predict that the longer the restaurant has been in business, the more likely it will be operating the following year so that the landlord will continue to receive the rent.

For franchised restaurants, the franchisee has to pay a one-time franchisee fee about \$30 to \$50 thousand and on-going royalty between 4% to 12% of sales revenue. In turn, the franchisee receives training on how to set up, and operate a proven and successful business without worrying about the marketing part. As a result, a franchised restaurant gets customers as soon as the open sign is put up. The king of franchised restaurants is the fast-food chain, McDonalds with 30,823 locations (about 14,000 in the US) as of 2006 with an average \$2M in revenue per US location. McDonalds currently captures 46% market share of the \$58.88 billion US fast-food market. Distant behind is Burger King with 14.3% of the market share. Fast-food chains tend to detect new trends faster. For example, they are open as early as 5AM as Americans are



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increasingly buying their breakfasts earlier. They are also selling more café latte to compete with Starbucks.

Independent restaurants will take a while to for customers to come in and try the food. Their business is especially tough in the first 12 months of opening, especially to those whose owners have not had a proven track record. So in general, mom and pop restaurants are a riskier investment for you because revenue is initially weak. If you choose to invest in a non-brand name restaurant, make sure the return is proportional to the risks that you will be taking.

Sometimes it is not easy for you to tell if a restaurant is a brand name or non-brand name. Some restaurant chains only operate, or are popular in a certain region. For example, Johnny Carino's restaurant is a very popular Italian restaurant chain in Texas and Georgia but there is only one in California as of 2007. Brand name chains tend to have a website listing all the locations plus other information. So if you can find a restaurant website from Google or Yahoo you can quickly discern if an unfamiliar name is a brand name or not. You can also obtain basic consumer information about almost any chained restaurants in the US on www.wikipedia.org.

Lease & Rent Guaranty

The tenants often sign a long term absolute triple net (NNN) lease. This means besides the base rent they also pay for all operating expenses: property taxes, insurance and maintenance expenses. For investors, the risk of maintenance expenses uncertainty is eliminated and their cash flow is predictable. The tenants may also guarantee the rent with their own or corporate assets. Therefore, in case they have to close down the business, they will continue paying rent for the life of the lease. Below are a few things that you need to know about the lease guaranty:

1. In general, the stronger the guaranty the lower the return of your investment. The guaranty by McDonalds Corporation with a strong S&P corporate rating of a public company is much better than a small corporation owned by a franchisee with a few restaurants. Consequently, a restaurant with a McDonalds corporate lease normally offers low 6% to 7% cap (return of investment in the 1st year of ownership) while McDonalds properties with a franchisee guaranty may offer 6.5% to 7.5% cap.
2. Sometimes a multi-location franchise will form a parent company to own all the restaurants. Each restaurant in turn is owned by a single-entity Limited Liabilities Company (LLC) to shield the parent company from liabilities. So the rent guaranty by the single-entity LLC does not mean much as it does not have much assets.
3. A good, long guaranty does not make a lemon a good car. Similarly, a strong guaranty does not make a lousy restaurant a good investment. It only means the tenant will make every effort to pay you the rent. So don't judge a property primarily on the guaranty.
4. The guaranty is good until the corporation that guarantees it declares bankruptcy. At that time, the corporation reorganizes its operations by closing locations with low revenue and keeping the good locations, (i.e. ones with strong

sales). So it's more critical for you to choose a property at a good location. If it happens to have a weak guaranty, (e.g. from a small, private company), you will get double benefits: on time rent payment and high return.

Location, Location, Location

A lousy restaurant may do well at a good location while those with a good menu may fail at a bad location. A good location will generate strong revenue for the operator and is primarily important to you as an investor. It should have these characteristics:

1. **High traffic volume:** this will draw more customers to the restaurant and as a result high revenue. So a restaurant at the entrance to a regional mall or Disney World or a major shopping mall is always desirable.
2. **Good visibility & signage:** high traffic volume must be accompanied by good visibility from the street. This will minimize advertising expenses and is a constant reminder for diners to come in.
3. **Ease of ingress and egress:** a restaurant located on a one-way service road running parallel to a freeway will get a lot of traffic and has great visibility but is not at a great location. It's hard for potential customers to get back if they miss the entrance. In addition, it's not possible to make a left turn. On the other hand, the restaurant just off freeway exit is more convenient for customers.
4. **Excellent demographics:** a restaurant should do well an area with a large, growing population and high incomes as it has more people with money to spend. Its business should generate more and more income to pay for increasing higher rents.
5. **Lots of parking spaces:** most chained restaurants have their own parking lot to accommodate customers at peak hours. If customer cannot find a parking space within a few minutes, there is a good chance they will skip it and/or won't come back as often.
6. **High sales revenue:** the annual gross revenue alone does not tell you much since larger—in term of square footage—restaurant tends to have higher revenue. So the rent to revenue ratio is a better gauge of success. Please refer to rent to revenue ratio in the due diligence section for further discussion.
7. **High barriers to entry:** this simply means that it's not easy to replicate this location nearby for various reasons: the area simply does not have any more developable land, or the master plan does not allow any more construction of commercial properties, or it's more expensive to build a similar property due to high cost of land and construction materials. For these reasons, the tenant is likely to renew the lease if the business is profitable.

Financing Considerations

In general the interest rate is a bit higher than average for restaurants due to the fact that they are usually single-tenant properties. To the lenders, there is a perceived risk because if the restaurant is closed down, you could potentially lose 100% of your income from that restaurant. Lenders also prefer brand name restaurants. In addition, some lenders will



not loan to out-of-state investors especially if the restaurants are located in smaller cities. So it may be a good idea for you to invest in a franchised restaurant in major metro areas, e.g. Atlanta, Dallas.

When the cap rate is higher than the interest rate of the loan, e.g. cap rate is 7.5% while interest rate is 6.5%, than you should consider borrowing as much as possible. You will get 7.5% return on your down payment plus 1% return for the money you borrow. Hence your total return (cash on cash) will be higher than the cap rate. Additionally, since the inflation in the near future is expected to be higher due to rising costs of fuel, the money which you borrow to finance your purchase will be worth less in the following years due to inflation. So it's even more beneficial to maximize leverage now.

Due Diligence

You may want to consider these factors before deciding to go forward with the purchase:

1. **Tenant's financial information:** The restaurant business is labor intensive. The average employee generates only about \$55 thousand in revenue yearly. The cost of goods, e.g. foods and supplies should be 30% to 35% of revenue; labor and operating expenses 30% to 50%; rent about 6% to 15%. So do review the profits and loss (P&L) statements, if available, with your accountant. In the P&L statement, you may see the acronym EBITDAR. It stands for **E**arnings **B**efore **I**ncome **T**axes, **D**epreciation (of equipment), **A**mortization (of capital improvement), and **R**ent. If you don't see royalty fees in P&L of a franchised restaurant or advertising expenses in the P&L of an independent restaurant, you may want to understand the reason why. Of course, we will want to make sure that the restaurant is profitable after paying the rent. Ideally, you would like to see net profits equal to 10% to 20% of the gross revenue. In the last few years the economy has taken a beating so restaurants revenue has dipped. So don't get panic if you to see around 3% to 4% reductions in gross revenue. This seems to have affected most if not all restaurants everywhere. In addition, it may take a new restaurant several years to reach potential revenue target. So don't expect new locations to be profitable right away even for chained restaurants.

2. **Rent to revenue ratio:** this is the ratio of base rent over the annual gross sales of the store. It is a quick way to determine if the restaurant is profitable, i.e. the lower the ratio, the better the location. As a rule of thumb you will want to keep this ratio less than 10% which indicates that the location has strong revenue. If the ratio is less than 7%, the operator will very likely make a lot of money after paying the rent. The rent guaranty is probably not important in this case.

3. **Parking spaces:** restaurants tend to need a higher number of parking spaces because most diners tend to stop by within a small time window. You will need at least 8 parking spaces per 1000 Square Feet (SF) of restaurant space. Fast food restaurants may need about 15 to 20 spaces per 1000 SF.

4. **Termination Clause:** some of the long term leases give the tenant an option to terminate the lease should there be a fire destroying a certain percentage of the property. Of course, this is not desirable to you if that percentage is too low, e.g.

10%. So make sure you read the lease.

5. **Price per SF:** you should pay about \$200 to \$500 per SF. In California you have to pay a premium, e.g. \$1000 per SF for Starbucks restaurants which are normally sold at very high price per SF. If you pay more than \$500 per SF for the restaurant, make sure you have justification for doing so.

6. **Rent per SF:** ideally you should invest in a property in which the rent per SF is low, e.g. \$2 to \$3 per SF per month. This gives you room to raise the rent in the future. Besides, the low rent ensures the tenant's business is profitable, so he will be around to keep paying the rent. Starbucks tend to pay a premium rent \$2 to 4 per SF monthly since they are often located at a premium location with lots of traffic and high visibility. If you plan to invest in a restaurant in which the tenant pays more than \$4 per SF monthly, make sure you could justify your decision because it's hard to make a profit in the restaurant business when the tenant is paying higher rent. Some restaurants may have a percentage clause. This means besides the minimum base rent, the operator also pays you a percentage of his revenue when it reaches a certain threshold.

7. **Rent increase:** A restaurant landlord will normally receive either a 2% annual rent increase or a 10% increase every 5 years. As an investor you should prefer 2% annual rent increase because 5 years is a long time to wait for a raise. You will also receive more rent with 2% annual increase than 10% increase every 5 years. Besides, as the rent increases every year so does the value of your investment. The value of restaurant is often based on the rent it generates. If the rent is increased while the market cap remains the same, your investment will appreciate in value. So there is no key advantage for investing in a restaurant in a certain area, e.g. California. It's more important to choose a restaurant at a great location.

8. **Lease term:** in general investors favor long term, e.g. 20 year lease so they don't have to worry about finding new tenants. During a period with low inflation, e.g. 1% to 2%, this is fine. However, when the inflation is high, e.g. 4% to 5% as it is now, this means you will technically get less rent if the rent increase is only 2%. So don't rule out properties with a few years left of the lease as there may be strong upside potential. When the lease expires without options, the tenant may have to pay much higher market rent.

9. **Risks versus Investment Returns:** as an investor, you like properties that offer very high return, e.g. 8% to 9% cap rate. And so you may be attracted to a brand new franchised restaurant offered for sale by a developer. In this case, the developer builds the restaurants completely with Furniture, Fixtures and Equipment (FFEs) for the franchisee based on the franchise specifications. The franchisee signs a 20 years absolute NNN lease paying very generous rent per SF, e.g. \$4 to \$5 per SF monthly. The new franchisee is willing to do so because he does not need to come up with any cash to open a business. Investors are excited about the high return; however, this may be a very risky investment. The one who is guaranteed to make money is the developer. The franchisee may not be willing to hold on dur-

ing tough times as he does not have any equity in the property. Should the franchisee's business fails, you may not be able to find a tenant willing to pay such high rent, and you may end up with a vacant restaurant.

10. **Track records of the operator:** the restaurant being run by an operator with 1 or 2 recently-open restaurants will probably be a riskier investment. On the other hand, an operator with 20 years in the business and 30 locations may be more likely to be around next year to pay you the rent.

11. **Trade fixtures:** some restaurants are sold with trade fixtures so make sure you document in writing what is included in the sale.

Sale & Lease Back

Sometimes the restaurant operator may sell the real estate part and then lease back the property for a long time, e.g. 20 years. A typical investor would wonder if the operator is in financial trouble so that he has to sell the property to pay for his debts. It may or may not be the case; however, this is a quick and easy way for the restaurant operator to get cash out for good reason: business expansion. Of course, the operator could refinance the property with cash out but that may not be the best option because:

1. He cannot maximize the cash out as lenders often lend only 65% of the property value in a refinance situation.
2. The loan will show as long term debt in the balance sheet which is often not viewed in a positive light. This is especially true when the current market value of the property is much higher than the book or tax value in the balance sheet.

You will often see 2 different cash out strategies when you look at the rent paid by the restaurant operator:

1. **Conservative market rent:** the operator wants to make sure he pays a low rent so his restaurant business has a good chance of being profitable. He also offers conservative cap rate to investors, e.g. 7% cap. As a result, his cash out amount is small to moderate. This may be a low risk investment for an investor because the tenant is more likely to be able to afford the rent.
2. **Significantly higher than market rent:** the operator wants to maximize his cash out. Investors are sometimes offered high cap rate, e.g. 9%. As a result, the restaurant business at this location may suffer a loss due to higher expenses, i.e. rent. However, the operator gets as much money as possible for his investment, e.g. business expansion. This property could be riskier for you. If the tenant's business does not make it and he declares bankruptcy, you will have to offer lower rent to another tenant to get your building leased.

2008 Inflation: Impact on Commercial Real Estate Investments

According to US Bureau of Labor Statistics, the US consumer price index for all urban consumers (CPI-U) in May 2008 was 4.2% higher than in May 2007 (refer to the article "Indexes Investors Should Know" for more info about CPI). In previous

years, the increases were somewhat mild: 2.8% in 2007, 3.2% in 2006, 2.8% in 2005, 2.6% in 2004, 2.3% in 2003, 1.6% in 2002, and 2.8% in 2001. The average increase for the first 5 months of 2008 has been 4.06%. 4.2% increase in the CPI-U means it now costs 4.2% more to buy the same thing compared to a year ago. Another way to look at this is the same one dollar bill is now worth 4.2% less compared to a year ago. This is expected as rising fuel prices have driven significant increases in the cost of food and other basic goods and services. There is evidence that the inflation is expected to rise in the foreseeable future. J.P. Morgan economist Michael Feroli predicts the consumer price index will be up 5.1% in August 2008, the biggest year-over-year increase since 1991.

If you borrow to finance your real estate purchase, inflation is good for you from a real estate investment viewpoint. The same loan you borrow is actually worth 4.2% less compared to a year ago due to inflation. When the cap rate is higher than the interest rate, you get double benefits. You make a profit on the loan you borrow and also earn a 4.2% "bonus" because the loan is worth 4.2% less compared to a year ago. So it is a good idea to maximize leverage during the period of high inflation.

If you are a landlord of commercial properties then long term leases with fixed rent increases, (e.g. 20 years NNN lease with 2% annual rent increase) will not be in your favor. The 2% rent increase is less than the inflation so your rent is actually worth less next year. Long term leases from credit tenants like Walgreen's are the worst performers as the rent is flat. So you will have to make a difficult decision whether the corporate guaranty from a credit tenant is worth the flat rent when you purchase the property. Shorter leases, e.g. 3 to 5 years will give you an opportunity to increase to higher market rent when the tenants sign new leases or exercise the options. Higher rents in turn will have positive impact on the value of your properties when it's time to sell.



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