Coming to Terms

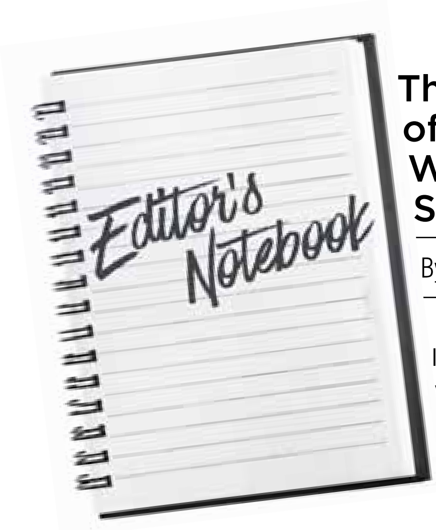
Understanding the Concepts, Provisions and Terms of Your Lease Is a Key to Restaurant Profitability

How do you know that you have the right lease for your restaurant? Unfortunately, this may be a hard question to answer since owners may not understand many of the details about the lease. Should this worry them? Maybe it should.

By Timothy J. O'Connor, CPA, MST, MPFP

The terms of a lease can make or break a new restaurant concept, yet many startup operators do not understand their implications and consequences. Location is one of the aspects of a new restaurant that cannot be easily changed, and once you sign the lease it is often difficult, if not impossible, to negotiate better terms.

The more you know about restaurant leases going into this process, the better you can work with your professional advisers — including your accountant and attorney — in securing the best arrangement for your business.



The Advantage of Working With Restaurant-Savvy Advisers

By Barry Shuster

As a practicing business lawyer, I had the privilege of working with a restaurateur, for whom I reviewed and help negotiate several leases for his expanding business.

A commercial lease is a lease is a lease, right? Well, it wasn't until I began parsing the language of restaurant leases that I truly appreciated the details and nuances that can be overlooked if they are not read with a careful eye to the business.

If you have the opportunity to work with an attorney and accountant for whom your restaurant lease isn't their "first rodeo," that is preferable. In any event, you would be best served to read your lease as carefully as your attorney, and ask questions. When it comes to the future of your business, there are no dumb questions.

For example, lessees of strip mall space, which are common restaurant sites, might encounter language restricting the type of menu fare, so as not to compete with current tenants. This language sometimes has to be carefully crafted and negotiated.

For example, if the restrictions require that you may not serve "pizza," and one of your signature items is a pizzalike flatbread that is critical and relevant to your concept — even if it is nothing like the New York-style pizza being served three doors down, it still could be a point of contention if a co-tenant business wants to take issue with it after its owners believe you are drawing business at their expense.

Another example is a requirement that the business does not emit "noxious" odors. While you might overlook this provision, given most of us associate noxious odors with chemical plants and the like, the scent of your hamburgers grilling during the lunch shift might be raised as an issue by nearby clothing retailers. You don't want to have to install expensive scrubbing units that you did not anticipate in the buildout budget.

Leases can be complex legal documents that require significant review and negotiation, as addressed by the author in the main article. As a matter of due diligence and to protect the future of your business, don't leave this part of the opening process to the last minute.

Rule of Thumb

A good lease should cost no more than 5 percent to 8 percent of annual restaurant revenues. Most experienced operators understand this and aim to find a location that will work for their concept and stay within the projected budget.

Usually, the trouble with a lease begins when forecasted revenues for a site location are overly optimistic, or the operator does not have enough experience to understand that a lease will not work for a particular restaurant.

To demonstrate this idea, let me relate two very different scenarios. First, recently, I met with a group of restaurant owners. I was referred by the banker who had financed the restaurant a year earlier. He expressed his concern over the financial reports he had recently received. He became more concerned when he noticed recent overdrafts on the checking account.

Upon meeting with the owners at the restaurant, it became obvious that the lease was a problem. The annual rent expense represented nearly 22 percent of revenues. Though the owners were not inexperienced in the restaurant industry, this particular restaurant concept was new to them and they weren't advised by any of the professionals they hired that the lease was too expensive. The short-term outlook for their restaurant appeared rocky until the terms of the lease could be modified.

Shortly thereafter, I met with another restaurant group. The two owners had terrific success with an Italian food concept. They had recently been approached by a group of investors to open multiple locations and they were eager and excited about this opportunity. The investors had a great location, but the space was expansive.

After spending hours with the two owners running multiple scenarios, all of us agreed that the location was not right for them. It was too risky based upon the existing lease arrangement. At first, the investors were not happy and called to better understand the logic behind the decision. After reviewing all aspects of our forecast and the terms of the lease, the investors understood our position and agreed with the decision.

Fortunately, a few weeks later the owners found a great space located in the same neighborhood. Based upon the projections for the new location, the annual cost of this lease should be about 3 percent to 5 percent of revenues due to a better seating arrangement and better foot traffic.

Will the space work well for the restaurant and the projected growth in sales? Will the landlord allow you to sublease the space, if this option proves necessary? If sales are stronger than expected will there be enough room within the building to accommodate an expansion? Can the kitchen be expanded? To avoid future confusion, these issues should be considered and addressed in the lease.

Concepts, Provisions and Terms to Know

Common area maintenance (CAM). CAM charges are considered additional rent and are usually billed separately from the base rent. CAM charges are additional fees charged to tenants for maintenance work performed on the common areas of the building/property and should be clearly defined in the lease and understood by all parties.

When there are multiple tenants in a building, each tenant will have to share the upkeep of the common areas. These costs will include heating, snow plowing, landscaping, air-conditioning and general maintenance to the building.

These costs can be significant and therefore careful attention should be paid to these items. CAM charges can be problematic from a cash flow perspective if you have a seasonal restaurant. You should negotiate payment of the CAM charges during months when cash flow is at its highest level.

Landlords are usually open to negotiating the payment terms for CAM charges. Oftentimes, they will allow the tenant to pay an estimate throughout the year and "settle up" once the year has been closed and all expenses have been accounted for by the landlord.

Gross lease versus a triple net lease. The restaurant operator as the tenant or lessee under a lease should understand the difference between a gross lease and a triple net lease.

A gross lease typically involves a commercial lease whereby the landlord is responsible for paying the property taxes, insurance costs, and repairs and maintenance of the building. The tenant pays a fixed monthly rent based on the terms and conditions of the agreement. This arrangement is a win for the lessee because they know what the rent figure will be for each month and they do not have to be concerned with additional charges from the landlord.

A triple net lease requires that the landlord track expenses for items such as real estate taxes, insurance, and common area repairs and maintenance. The proportionate share of these items is "passed on" to the tenant based upon the tenant's occupied square footage compared with the total square footage of the building.

Most triple net leases will specify the items to be charged to the tenant. The lessee is provided with a breakdown on an annual basis of the total expenses for the year to verify the accuracy of the charges.

Under normal circumstances, a tenant would prefer a gross lease and a landlord would prefer a triple net lease. The customary arrangement is for a landlord to offer a triple net lease because the landlord is ensured that most, if not all, of the operating costs of the building will be paid by the tenants. Under a gross lease arrangement, the landlord bears the risk of an increase in the costs to maintain the building and therefore, most landlords do not offer this type of lease arrangement.

Percentage lease arrangement. Restaurant owners should be aware of a percentage rent provision that may be included within the lease. This clause allows the landlord to charge the tenant extra rent in the event the tenant reaches a break-point sales number. For example, the landlord may ask for an additional 5 percent in rent on all sales of more than $1million collected by the lessee over a 12-month period.

This clause is quite common with commercial real estate such as shopping malls and multiunit buildings, which have a predominant number of retail businesses. Landlords that structure this type of lease start with a minimum base rent that will be paid by the tenant based upon a dollar amount per square foot of space to be occupied.

There are two types of "breakpoints" in a percentage lease arrangement. The first type is called an artificial breakpoint, which means that the tenant and the landlord decide on an arbitrary number at which the percentage rent clause will apply. The landlord and the tenant may, for example, decide that the percentage rent will start after the tenant reaches $1.2 million in revenue within the year. Any sales over this amount will be subject to the percentage rent clause in the lease.

The other type of arrangement is known as the natural breakpoint, which is calculated by dividing the base rent by the established percentage. For example, if the base rent is $60,000 and the percentage rent is 5 percent then the natural breakpoint would be calculated by dividing the $60,000 by 5 percent, which would give a value of $1.2 million. Any revenues collected over the $1.2 million would be subject to the percentage rent.

Tenant improvements. The real estate definition of leasehold improvements, also known as tenant improvements, are the customized alterations a landlord makes to rental space as part of a lease agreement in order to configure the space for the needs of the tenant.

Oftentimes the tenant improvements can be negotiated with a landlord. Depending on the condition of the space, and current rental market, many landlords will work with a tenant to assist with the tenant improvements.

For example, a landlord may be willing to pay for a portion of the improvements if the landlord believes the restaurant will help bring more customers to the other tenants within the building. Also, the restaurant may be a nice anchor tenant for the location, which will attract better tenants in the future.

For example, let's assume a franchisee of a national coffee chain would like to open a store in a strip mall. The landlord may be willing to negotiate a more favorable deal to the franchisee if it can be demonstrated that the increased traffic count and foot traffic will substantially benefit the other tenants.

This would be especially true if the landlord has a percentage rent clause with all tenants in the mall. The landlord may be willing to contribute more to the deal if vacancies exist in the mall. The landlord does not want the property to look vacant because it is unattractive to potential tenants and it weakens the landlord's negotiating power.

Renting new space versus used space. Many owners will choose to open a new restaurant in a location formerly occupied by a failed restaurant. This option is attractive because the landlord may offer rent concessions to fill an otherwise vacant space in the building. Also, the kitchen may be ready for use and the former owner may be willing to sell/provide the furniture and fixtures at a substantially reduced price.

This represents a huge benefit to someone starting out in the business with limited capital. However, caution should also be exercised. Many times the limitations and negative aspects of the location cannot be overcome.

There has to be something very special about a new restaurant concept for people to visit a location they know failed in the past. History has a way or repeating itself and great caution must be exercised before signing a lease for a location that could be doomed to fail from the start.

The other alternative is to build a restaurant on a new site. This can represent both a great opportunity and a great risk. The potential benefit is that the restaurant can be designed to the owners' needs and in a way that provides optimum conditions for success. However, this is also the most expensive option. Failure could be financially disastrous for the owners and investors.

Care has to be exercised and due diligence has to be considered with every aspect of the restaurant down to the tiniest of details. The biggest concern is always competition. Will the restaurant have what it takes to draw new customers away from other local, well-established restaurants?

Special clauses within the lease. An operator may also want to give consideration to specialty clauses in the lease if the restaurant boasts a special theme or has a specific concern. For example, the owner of an Irish pub may want to have a clause within the lease allowing them to have extended hours on St. Patrick's Day.

Other restaurants include clauses for parking, especially in urban settings where parking may be difficult. Many new restaurants have an entertainment theme. Special consideration should be given to the lease under these circumstances. A restaurant that has live music should carefully negotiate with the landlord to ensure noise levels are considered and neighbors are not disturbed. It will be important to discuss these types of issues with the landlord and address them within the lease to avoid a future conflict.

Summary of Best Practices

- If the restaurant is opening under a new location, be conservative with your projection of revenues and expense items.
- Engage professionals who specialize in the restaurant industry. It may cost more in the beginning but the cost savings will be substantial in the long run.
- Ensure you have read and understood the lease before signing it. Review the lease with your attorney and your accountant to make sure that the terms will work for your location.
- Develop a good relationship with the landlord. This will be beneficial when your lease renews. Also, a good relationship with the landlord will benefit you in the event you need to renegotiate the lease before the term expires.
- A bad lease can ruin a restaurant's opportunity for success.
- Do not rent more space than you need. It's better to have a line out the door with people waiting to enter your restaurant than to have a restaurant that looks empty. Perception is everything.
- Focus on projecting accurate annual revenue. Many operators overestimate the potential revenue because they are too confident in the potential success of a location.
- Do your best to find a location and negotiate a lease in which the annual rent will represent 5 percent to 8 percent of revenues.
- Be cautious in choosing a location where a prior restaurant failed.

A restaurant operator who follows these steps will have a far better understanding of their lease and be in a better position to determine that the lease and the location is right for their restaurant. **RS&G**

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