6 Facts to Know Before Investing in a Restaurant

If you are interested in backing a chef or restaurant operator, here are some helpful tips.

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Before jumping into a restaurant deal, review the business plan and cash-flow projections to ensure they meet your standards. (GETTY IMAGES)

David Steele, the founder and managing partner of the Ne Timeas Restaurant Group in San Francisco, jokes that his role is creating restaurants – not investing in them.

"A lot of people assume because I have a background in finance that I'm a rich guy who wanted to buy my way into the restaurant industry," says Steele, who is also the CEO of One Wealth Advisors, an independent advisory firm. "What a lot of people don't realize is that I'm a restaurateur, not a restaurant financier."

While many financial experts advise against investing in one-off concepts, Steele says such an arrangement can be successful.

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Start by asking if you want to be an active or passive investor. "It is critical that you make that differentiation," he says. That's because most single restaurant investors are lifestyle investors who like the cache of owning a restaurant.

"The restaurant industry is very romanticized," Steele says. "And it attracts people who aren't strategic thinkers, people who have an abstract relationship with money. I don't believe the restaurant industry is riskier than any other industry if you remove the romanticized players that aren't real business people."

The National Restaurant Association estimates that on average, about 60,000 restaurants open each year – and 50,000 close. "These closings aren't all failures," says Christin Fernandez, the association's director of media relations and public affairs. "Some may be owners shutting down one location to open a new location, but it does illustrate the churn in the industry on a regular basis."

There are a variety of ideologies. "I believe that if you use local investors who are passionate about your concept they become ambassadors," says Steele, who had 11 investors for the group's Flour + Water restaurant, and about 25 to open three others – Trick Dog, Central Kitchen and Salumeria. "But I am one of the unusual ones. A lot of people don't want a lot of investors, because they think investors can be a pain in the ass. But I say screw that, these people enable you to open your businesses."

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That symbiotic relationship between those with capital and those with ideas and operational skills creates a delicate balance.

For Steele, all of his passive investors are from the Bay Area and can regularly dine at his establishments. None are partners. Instead, he shares monthly profit-and-loss statements via a bullet-point narrative so investors can "take the temperature," even if most of them don't. He also hosts a bi-annual investor meeting to discuss evolutions in the menu, renovations and listens to suggestions – which prompted adding pasta to Central Kitchen's menu and turning down his blaring classic rock music, after much resistance.

[See: 8 Soaring Stocks That Suffered the Big Bounce.]

"I was stubborn," Steele says, but admits the investors were right.

Investing in such an illiquid asset starts by setting proper expectations about the tenor of the relationship. Steele says he always tells investors he will take their ideas under consideration, but won't be beholden to them. "Very few restaurateurs are looking for active investors, in fact I don't know any," Steele says. "I know restaurateurs who have mislead investors into thinking they would be taking an active role because they couldn't get the capital from anybody else because they weren't aggressive enough in finding people."

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Review the business plan and cash-flow projections. A new restaurant doesn't have past performance to review in the way of records or tax returns. Instead, would-be investors must use some logic to test the numbers about the "reasonableness" of the projections, Steele says. See if the business plan is well-written and if there's a narrative that makes sense with local projections.

While Wall Street looks at earnings before interest, tax, interest, depreciation and amortization, restaurants look at the cash flow from operations. "If I'm seeing projections that equals less than one-third of the capital they are looking to raise, I'm suspicious if that's a good investment," Steele says.

That means if a restaurant says it needs an investment of $1.2 million, it should have a projected cash flow of $400,000.

Spending too much money to open is another big mistake many operators and investors make. "The upfront capital to open up a restaurant is a really important thing to keep your eye on," says Doug Jacob, partner of Toro Restaurant Group in New York.

He cautions against spending millions on an aesthetic design that doesn't have a functional component, and to be wary of the restaurant industry given the high cost of entry in the current real estate and rental market conditions. "Restaurants are one of the hardest businesses to operate and one of the simplest business models," Jacob says. "If your fixed costs are above a certain percent you're not going to make money. It doesn't matter how good you are."

Look at occupancy costs. "That's a key indicator whether they did the deal properly or not," Jacob says. "Or if they aren't going to make enough income for an investor."

Review how much money it takes to occupy and maintain a space including rent, insurance, common area maintenance and taxes. The industry standard says this should be no more than 8 percent of sales, but in New York, 10 percent is fine, Jacob says.

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Understand the projected rate of return. When Steele needs investors, he bases the percentage of the business he is willing to give away on the cash flow projections and what will yield a 20 percent rate of return or higher via a 10-year calculation.

For example, Flour + Water required less capital than some of his other restaurants, so investors were only given 23 percent of the business, Steele says, versus 40 percent equity in Central Kitchen and Trick Dog. "It's not the number of investors, but the projected cash flow versus capital needed to open," he says.

Consider a restaurant's scalability. Unlike Steele, Jacob says he doesn't advocate single restaurant investments. "I think restaurants are one of the riskiest investments you can make unless there's an opportunity to scale and sell the brand," Jacob says.

Institutional investors who are more interested in the exit value should consider how a corporation is hiring the right talent to scale a chain and how it's investing in the brand, instead of focusing on the cash flow.

[See: The 9 Best Investors of All Time.]

Then look for restaurant operators with prior experience. "The best opportunity is with an operator who has already done it once or twice and now wants to build a brand, because the risk is not as high," says Greg Wank, leader of Anchin, Block and Anchin's food and beverage service group in New York. "I'd much rather invest in an owner operator who has failed once and now done it successfully."

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