The Appraisal of Food Service Facilities

by Stephen Rushmore, MAI, SRPA

The real growth of the food service industry is considerably less than the apparent increases signaled by steadily rising sales volumes. Nevertheless, there are opportunities for growth—and profits—for well-managed restaurants. Attracted by both the business potential and the prestige of restaurant ownership, inexperienced operators continue to enter the business—and all too often discover it is far more complex than it appeared from the vantage point of a consumer.

Perhaps more disconcerting than failing to succeed in a seemingly uncomplicated business is the hapless restaurateur's predicament in attempting to abandon his(her) venture. He often finds when attempting to sell the restaurant that its appraised value is far below its "bricks and mortar" value. The novice restaurateur has not fallen victim to an arbitrary system of depreciation, but to the belated recognition of the special nature of the restaurant business. As this article will explain, a restaurant's utility as an investment derives, in the appraiser's estimation, not from its bricks and mortar value, but from its ability to generate a return.

APPROACHES TO APPRAISAL

In general, the appraiser relies on three approaches to estimate the market value of real estate: the cost approach, the market approach, and the income approach, Although, in theory, any of the three approaches might be used to value a restaurant, practical limitations almost always restrict the appraiser to the income approach.

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In valuing a restaurant by the cost approach, the appraiser estimates the market value by computing the current reproduction cost of the improvements less depreciation. Depreciation is defined as a loss in value caused by one or more of the following factors: 1) physical deterioration—the physical wearing out of the property; 2) functional obsolescence—the lack of desirability in layout, style, and design, as compared with a new property serving the same function; and 3) economic obsolescence—a drop in value caused by factors outside the property itself.

After subtracting accrued depreciation from the value of the improvements, the appraiser adds the estimated land value. To provide the most accurate estimate of the property's overall value, the land value must be defined by market sales.

Of the three possible approaches, the cost approach probably yields the least reliable estimate of a restaurant's value. Restaurants, like hotels, are income-producing properties purchased with the intent of realizing future profits. The reproduction cost often bears little relation to the investment value of a restaurant.

Using the market approach, the appraiser estimates market value on the basis of the actual sales prices of comparable restaurants, incorporating appropriate adjustments for differences in such attributes as property location, size, decor, and condition. This approach will provide a reliable estimate of value only if sufficient data on very similar properties are available; the restaurants compared should have similar affiliation, size, location, and mode of operation, so that the adjustments required (i.e., the subjective content of the appraisal) can be kept to a minimum.

The income approach generally is preferred for income-producing properties because it reflects the usual rationale of investors. In this approach, market value is estimated through the capitalization of a projected stabilized income stream, using a capitalization rate that reflects both the cost of capital and the relative risk of the investment.

For purposes of accurate appraisal, a restaurant must be considered as both a real estate investment and a business investment.

The real estate component of a restaurant's value consists of such factors as location, access, and visibility; neighborhood and surroundings; size of improvements and land; and the quality, utility, functional layout, and design of the improvements.

The business portion of a restaurant's value includes the type and quality of furniture, fixtures, and equipment; interior decor and improvements; management expertise and ability; the value of a chain affiliation; and existing consumer attitudes (i.e., goodwill).

CALCULATING REAL ESTATE VALUE

Because of the high risk associated with restaurant investment, most lending institutions will not make mortgages on restaurants. As a result, many restaurateurs enter into lease agreements for their land and buildings. In today's market, lessors of restaurant real estate typically demand a 9%-11% return on a ground lease or 11%-13% if the lease includes land and building. Another way to calculate the economic rent of a restaurant—the approach generally used when the value of the real estate is unknown—is through determination of the percentage rent, which is based on a percentage of gross sales.

Percentage rents for restaurant leases are negotiated on the basis of such factors as mix of food and beverage sales, estimates of total sales, the expected profitability of the restaurant, the location and cost of construction, and the lessor's expenses (e.g., real estate taxes, insurance, and repairs). A percentage rent generally is expressed in one of two ways—percentage of food gross (4%-6%) plus percentage of beverage gross (8%-12%), or percentage of total gross (6%-7%)—and usually represents gross rents before real estate taxes, insurance, and structural repairs.

By estimating the total revenue of a restaurant and applying the appropriate percentage rent, the appraiser can project an economic rent which can be capitalized into real estate value. First, the lessor's expenses, including a reserve for structural repairs, are subtracted; the net to the lessor then is capitalized into value at a rate that satisfies the demands of typical lessors (10%-14%).

The net income to the operator, after paying rent, represents the return on invested capital (e.g., furnishings, equipment, tenant improvements, inventory, and working capital) and the value of the business.

This value embodies the greatest risk as a result of several factors. Used restaurant furnishings and equipment have little value, and inventory has even less. Moreover, business value (goodwill) is so dependent on such factors as management, the temperament of the chef or *maitre d',* the quality of food and service, etc., that when a restaurant is sold to another party, very little of the business value can be transferred.

Capitalization rates for a restaurateur's invested capital typically fall into one of three areas: For an efficient, profitable operation with new equipment, a typical capitalization rate is 20%; for an operation with average profitability and older but well-maintained equipment, 25%; and for an inefficient operation with old and poorly maintained equipment, 33%.

Thus, to estimate the value of a well-maintained and well-equipped restaurant with average profitability, the appraiser would perform the following calculations:

1) Estimate the total subsidized gross and calculate the economic rent by multiplying:

$$\text{Gross sales} \times 6\% = \text{Economic rent}$$

2) Calculate net economic rent by subtracting ownership expenses (e.g., real estate taxes, insurance, and reserve for structural repairs), then capitalize it into the value of the real estate:

$$\frac{\text{Economic rent (net)}}{12\%} = \text{Value of real estate}$$

3) Subtract the economic rent from the projected stabilized net income to determine the return to the restaurateur:

	Stabilized net income
Less:	Economic rent (gross)
	Return to restaurateur

4) Capitalize the return to the restaurateur to estimate the value of the equipment and business:

$$\frac{\text{Return to restaurateur}}{25\%} = \text{Value of equipment and business}$$

5) Finally, adding the value of the real estate to the value of the equipment and business yields the total value of the restaurant:

	Value of real estate
Plus:	Value of equipment and business
	Value of restaurant

The most important aspect of restaurant valuation is the projection of stabilized gross and expenses. For existing restaurants that will remain under the same management, audited financial statements for the preceding three to five years often provide indications of future trends. These should be compared with national statistics to determine whether or not the operating results are in line with those of other operations.

For new or proposed restaurants or those in which a change in management is expected, the appraiser must base a projected statement of stabilized gross and expenses on either operating data for a comparable restaurant or on national averages.

The best source of restaurant operating data is the National Restaurant Association's publication, *Tableservice Restaurant Operations Report.*[1] Other data are published periodically by such journals as *Restaurant Hospitality*[2] and *Restaurant Business.*[3]

ESTIMATING GROSS SALES

National statistics provide a starting point for estimating gross sales. The

1. The National Restaurant Association (One IBM Plaza, Suite 2600, Chicago, IL 60611) has published reports on the years 1976 and 1977.
2. *Restaurant Hospitality*, 614 Superior West, Cleveland, OH 44113.
3. *Restaurant Business*, 633 Third Avenue, New York, NY 10017.

figures in *Table 1* represent typical sales per seat for different types of restaurants:[4]

Table 1

By location:	**Food**	**Beverage**	**Total**
Downtown	$2,470	$1,018	$3,248
Neighborhood (urban)	3,568	1,169	4,782
Suburban	2,662	693	3,386
By volume:			
Under $750,000	$1,854	$ 749	$2,324
$750,000–$1,249,999	3,029	906	3,987
$1,250,000 and over	3,745	980	4,990

To refine the estimate of gross sales, the appraiser should thoroughly investigate the local market and evaluate the forces of supply and demand. With this information, an estimate of gross sales is based on the following calculations:

Number of seats × estimated turnovers per seat ×
average check = gross sales per day

Consider, for example, a 200-seat restaurant with an average check of $6.00—$4.75 food, $1.25 beverage. Daily turnover is shown in *Table 2*.

Table 2

Monday	1.5 (i.e., 300 covers)
Tuesday	1.6
Wednesday	1.75
Thursday	1.7
Friday	2.1
Saturday	2.0
Sunday	1.8
Total:	12.45 × 52 = 647.4 (annual turnover)

Food:	200 × 647.4 × $4.75 =	$615,030 ($3,075/seat)
Beverage:	200 × 647.4 × $1.25 =	$161,850 ($ 809/seat)
Total Gross:		$776,880 ($3,884/seat)

Expense data also can be obtained from national averages but should be supplemented with local information and appraisers' judgments whenever possible.

If the operation in the above example is a suburban table-service restaurant, the expenses shown in *Table 3* might be expected.

4. These figures may be found in *Tableservice Operations Report 1977* (Chicago: National Restaurant Association, 1977), p.17. All figures, including totals, are medians for the year 1976.

Table 3

Sales:	Total	Per Seat	Ratio to Sales
Food	$615,000	$3,075	79.2
Beverage	162,000	810	20.8
Total:	$777,000	$3,885	100.0
Cost of sales:			
Food	264,000	1,320	42.9
Beverage	48,000	240	29.6
Total:	$312,000	$1,560	40.2
Other expenses:			
Payroll & benefits	$224,000	$1,120	28.8
Direct operating	42,000	210	5.4
Entertainment	5,000	25	.6
Advertising	12,000	60	1.5
Utilities	18,000	90	2.3
Administrative	31,000	155	4.0
Maintenance	11,000	55	1.4
Total:	$343,000	$1,715	44.0
Income before occupancy costs	$122,000	$ 610	15.8

Using the procedure previously discussed, this restaurant would be valued as follows:

Estimate of economic rent:

$777,000 × .06 = $47,000

Value of the real estate:

Gross rent		$47,000
Less: Taxes	$ 8,000	
Insurance	3,000	
Reserve	1,000	12,000
	Net rent:	**$35,000**

$$\frac{\$35{,}000}{.12} = \$300{,}000 \text{ — Value of real estate}$$

Value of the equipment and business:

Income before occupancy costs:	$122,000
Rent	47,000
Net to restaurateur	$ 75,000

$$\frac{\$75{,}000}{.25} = \$300{,}000 \text{ — Value of equipment and business}$$

Total value of restaurant:

Real estate:	$300,000
Equipment & business:	300,000
Total value	$600,000

CONCLUSION

The restaurant business always will be a high-risk venture, requiring considerable management expertise in numerous disciplines and characterized by a high rate of failure. By following the approach set forth in this article, restaurateurs will reach a reasonably accurate estimate of the real estate value and business value of their operation. And should they, sometime in the future, decide to sell, they will face one less unpleasant surprise when the operation is appraised.