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Restaurant Rent: How Much is Too Much?

The question of how much rent a restaurant operation can afford to pay is explored, using examples of fixed rent and percentage rent. The relationship between gross sales and rent paid is discussed.

By Richard D. Williams, MAI, October 7, 2006

In 2002 I wrote a two-part article on restaurant valuation that was published in *The Real Estate Finance Journal - Fall 2002*. The article is on the HVS International web site and I regularly receive email and telephone calls from people who have read the article and have used the information in it to lower their real estate taxes, negotiate a selling price for a partner buyout, or determine a reasonable amount to pay for the purchase of an existing restaurant business. One email posed this question: "I am looking at renting a large restaurant that is approximately four years old. In its first year of operation the restaurant did $2,000,000 in sales. Most recently the restaurant did $1,200,000 in sales. The landlord has approached me with the following offer. Base rent of $10,000 per month plus $10,000 per month triple net charges, and $3,200 per month for kitchen equipment rent, which equals $23,200 per month, or $278,400 per year. Is this too much rent to pay when the landlord thinks that sales volume of $1,500,000 can be easily attained and rent would equal 18.6% of annual sales?"

I have owned a restaurant for 28 years and have appraised restaurants and hotels for almost 20 years. Based on my personal experience in the restaurant business I stated in my restaurant valuation article that restaurants cannot afford to pay more than 5% to 8% of gross sales in rent and still have net operating income left over to provide a return on and of the restaurant operator's investment in the business. Applying this percentage rent guideline to the lease terms shown above, in order to afford $278,400 in annual rent the restaurant operator would need to generate annual gross sales as follows:

$278,400 Annual Rent ÷ 5% of Gross Sales = $5,568,000 Gross Sales
$278,400 Annual Rent ÷ 6% of Gross Sales = $4,640,000 Gross Sales
$278,400 Annual Rent ÷ 7% of Gross Sales = $3,977,143 Gross Sales
$278,400 Annual Rent ÷ 8% of Gross Sales = $3,480,000 Gross Sales

Because annual rent is a fixed amount in this example, the gross sales necessary to cover rent over the range of percentages of gross sales declines as the rent expressed as a percentage of sales increases.

The restaurant business, like many businesses, is managed by ratios of expenses to gross sales. There are fixed costs and variable costs that a restaurant owner must control in order to run a profitable operation. The two largest controllable cost categories are cost-of-goods-sold and labor. These two cost categories are called Prime Costs, and the two together cannot exceed 62% to 68% of gross sales if the restaurant is to stay in business and be profitable over the long run. All other expenses together, including rent, or occupancy cost, should be held in the range of 24% to 32% of gross sales if the restaurant is to run at a profit.

Within the category of Prime Costs, cost-of-goods-sold and labor can vary by type of operation, as long as the total of the two does not exceed 62% to 68% of sales. For example, a steakhouse that sells high cost items such as filet mignon, New York strip steak, and fresh Maine lobster may run a food cost of 38% to 40%, but have a labor cost of 22% to 30% of sales and still have a total Prime Cost of 62% to 68%. Conversely, a quick-service restaurant may need more labor to produce low-cost, low-priced food items quickly and labor cost can be 34% to 40%, with a food cost range between 22% and 34%, and Prime Costs stay within the range of 62% to 68%.

To illustrate the effect of paying rent on the profitability of a restaurant I have taken an actual operating statement for a restaurant that operates in owned real estate and pays no rent, and applied different rent percentages to gross sales to examine the effect on net operating income before income taxes, depreciation, and amortization (EBITDA).

2005 Profit and Loss Statement for Sample Restaurant

	$	%
SALES		
Food Sales	$1,621,000	77.4%
Beverage Sales	$460,000	22.0%
Miscellaneous Sales (Net)	$13,040	0.6%
Total Sales	$2,094,040	100.00%
COST OF SALES		
Food	$589,000	36.3%
Beverage	$141,500	30.8%
Total Cost of Sales	$730,500	35.1%
GROSS PROFIT		
Food	$1,032,000	63.7%
Beverage	$318,500	69.2%
Total Gross Profit	$1,350,500	64.9%
OPERATING EXPENSES		
Salaries & Wages	$525,086	25.1%
Employee Benefits	$164,609	7.9%
Occupancy Costs (Property Taxes & Insurance Only)	$20,456	1.0%

Direct Operating Expenses	$99,161	4.7%
Music & Entertainment	$23,394	1.1%
Marketing	$129,770	6.2%
Utility Services	$43,097	2.1%
General and Administrative Expenses	$78,476	3.7%
Repairs & Maintenance	$40,032	1.9%
Other Income	$(5,817)	-0.3%
Total Operating Expenses	$1,118,264	53.4%
NET OPERATING INCOME (EBITDA)	**$232,236**	**11.1%**

Source: HVS Food & Beverage Services

The prime costs for this restaurant are 35.1% for cost-of-goods sold, and 33.0% for labor, resulting in prime costs of 68.1%, which is at the upper limit of acceptable prime cost ratios. All other operating expenses equal 20.4% of gross sales, leaving a net operating profit of 11.1% before income taxes, depreciation, and amortization. Because no rent is paid in this example, the net operating income must cover a return on and return of investment in the real estate, personal property, and business enterprise.

The occupancy costs category in this example consists of real and personal property taxes and insurance premiums for the building and contents. Total sales were $2,094,040 in 2005. Without paying rent, the restaurant showed a net profit of $232,236. If the restaurant paid rent on the building of between 5% and 8%, the annual rent would range between $104,700 and $167,500, which leaves net income of between $64,700 and $127,500 to provide a return on and return of investment in the furniture, fixtures, and equipment (personal property) and the business enterprise (going concern). There is greater risk in operating a restaurant business than in owning the real estate that supports the business, yet the income to the landlord is greater than the income received by the owner/operator of the business.

Returning to the question posed in the email, if the sample restaurant paid $278,400, or 13.3% of gross sales in annual rent ($278,400 ÷ $2,094,040 = 13.3%), the restaurant operator would lose approximately $46,000 and, in effect, would be operating the restaurant solely for the benefit of the landlord.

I have observed over the years, as a restaurant owner, consultant, and appraiser that full-service restaurants grossing less than $1,000,000 to $1,500,000 per year in revenue have a difficult time operating profitably after paying rent and all expenses incurred in the operation of the business. High-grossing restaurants can show a profit of 10% to 20%, after occupancy costs, because the cost of labor decreases as a percentage of sales as the existing staff becomes more productive with each incremental customer served over the break-even point. When a restaurant operates with a full staff at a high sales volume, labor becomes a fixed cost, although it is usually considered a variable cost because management can control it to some degree by scheduling dining room and kitchen staff to meet the expected demand, i.e., more employees are scheduled for a Friday and Saturday night than on a Monday night when fewer covers are expected to be served.

Rent is negotiated for a period of years when a lease is first signed. Many leases set forth a base rent which is a fixed amount, and a percentage rent which is calculated as a percentage of sales in excess of a specified breakeven sales volume. If the lease terms specify that rent is a fixed amount, the annual cost is indeed a fixed expense. If the lease terms specify a minimum base versus a percentage of gross sales, whichever is greater, rent becomes a variable cost after the breakpoint is reached. In other words, rent is a variable cost once percentage rent begins to exceed the minimum base rent.

When a restaurant operator is considering rental space for the operation of a restaurant concept, the restaurateur must estimate the annual sales volume that will be necessary to cover occupancy costs and still return a profit to the operator to compensate for the operator’s investment in the business. The likelihood of reaching the potential sales goal should be realistic based on the pricing of the menu, demographics of the surrounding neighborhood, and public acceptance of the restaurant concept. This is a business decision on the part of the restaurateur and each operator should have a target return on investment in mind before signing a lease and investing in a restaurant business.

Using the example that began this article, if a landlord requires annual rent of $278,400, the restaurant operator will need to generate at least $3,480,000 in sales to cover rent equal to 8% of sales, or $5,568,000 in sales to cover rent equal to 5.0% of gross sales. So how much rent is too much? Acting in his best interest, a landlord will seek to maximize income to the real estate by charging the maximum rent that the market will bear. Enlightened landlords also realize that excessive rent charges will put a tenant out of business, and the costs of having frequent tenant turnover are substantial. The stigma that attaches to a property that has had a string of restaurant failures also is a potential problem for a property owner. When valuing restaurant real estate that has been plagued by high tenant turnover, an appraiser would need to consider increasing the percentage allowance for vacancy and credit loss, as well as using a higher capitalization rate to reflect the increased risk to the future income stream from the real estate; both of which would result in a lower indication of value for the property via the income approach than if the property had a stabile rental history.

Real estate appraisers consider different types of rent definitions when valuing the leased fee interest (landlord’s interest) in real property. These types of rent include market rent, contract rent, and excess rent, which are defined as follows:

- **Market Rent**: The most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the specified lease agreement including term, rental adjustment and revaluation, permitted uses, use restrictions, and expense obligations; the lessee and lessor each acting prudently and knowledgeably, and assuming consummation of a lease contract as of a specified date and the passing of the leasehold from lessor to lessee under conditions whereby: (1) lessee and lessor are typically motivated; (2) both parties are well informed or well advised, and acting in what they consider their best interest; (3) a reasonable time is allowed for exposure in the open market; (4) the rent payment is made in cash in U.S. dollars, and is expressed as an amount per time period consistent with the payment schedule of the lease contract; and (5) the rental amount represents the normal consideration for the property leased unaffected by special fees or concessions granted by anyone associated with the transaction. [1]

- **Contract Rent**: The actual rental income specified in a lease. [2]
- **Excess Rent**: The amount by which contract rent exceeds market rent at the time of the appraisal; created by a lease favorable to the landlord (lessor) and may reflect a locational advantage, unusual management, unknowledgeable parties, or a lease execution in an earlier, stronger rental market. Due to the higher risk inherent in the receipt of excess rent, it may be calculated separately and capitalized at a higher rate in the income capitalization approach. [3]

From the restaurant operator's point-of-view, contract rent should be negotiated at or below the market rent for similar properties. The probability that a restaurant can achieve profitability and remain in business for the term of the lease if above-market rent is paid is lower than the probability of remaining in business paying at or below market rent. Therefore, the risk to the income stream from the excess rent is greater than the risk to the income stream from rent at market and the decreased value of the excess rent income stream should be capitalized at a higher rate.

From the landlord's perspective it is not in the long term best interests of the landlord to write leases at above market rents. A restaurant tenant and landlord are effectively business partners and the success of each party to the lease depends on the continued success of the tenant and a fair return to the landlord. Therefore, the answer to the question "How much rent is too much?" is "Any excess rent paid over market rent is too much." Ideally, rent should not exceed 6.0% of gross sales unless there is a special benefit received by the restaurant operator by virtue of the superior location of the real estate or the quality of the improvements that result in increased revenue potential over what is typical for an average location. There are sites with extremely high foot or car traffic that result in increased business that might justify paying more than 6.0% of gross sales in rent. Locations with spectacular views or high barriers to entry for other restaurant competitors might also justify paying a higher percentage rent. The key determinant is whether or not the perceived advantages of the location result in higher gross revenue from restaurant operations.

If both parties to a lease are honorable and fulfill the terms of the lease for the duration of the lease time period, both parties need to earn a fair return on their investment in real estate, personal property, and the business enterprise. The time to consider the financial consequences of the lease on the successful operation of the restaurant business is during the initial lease negotiation. This is the time to measure the potential expense of rent compared to the potential gross sales of the restaurant concept, and make a business decision regarding the concept's capacity to generate the gross sales necessary to cover rent at 5.0% to 6.0% of gross sales, and in special circumstances, as much as 7.0% to 8.0% of gross sales.

[1] *The Dictionary of Real Estate Appraisal, Fourth Edition, Appraisal Institute, 2002, p. 176.*

[2] *Ibid., p. 63.*

[3] *Ibid., p. 104.*

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