Why New Restaurants Fail

By Richard D. Williams, Feb 4, 2008

The high failure rate of new restaurants can be attributed in part to a lack of understanding of the restaurant's market. This article addresses the need for a market study prior to the commitment of a major investment in a new restaurant.

Every year, in every country in the world, countless entrepreneurs open restaurants. It can be a family-run affair, a small group of friends, or a rugged individualist with a concept thought to be compelling to the dining public. It may be based on a great recipe for buffalo wings or a winning personality combined with a love of entertaining guests. A few may be successful but most are not. Even with all of the advances in technology, the restaurant business remains one of the most difficult, yet fundamentally simple, businesses to operate.

It is commonly accepted in the restaurant business that it is more likely that a new restaurant will fail than succeed. Two studies of restaurant new business failure indicate failure rates in the 57% to 59% range.[1] The first study was performed by Professor Parsa of new restaurant businesses failing between 1996 and 1999 in Columbus, Ohio. This study indicated that an average of 59% of new start-up restaurant businesses fail within the first three years after opening. The study was based on a review of Department of Health records. The second study was performed by the Cline Group in the Dallas, Texas restaurant market, and was based on a review of Yellow Pages listings of restaurants over a six-year period. Professor Parsa found that the highest failure rate for new restaurants occurred during the first year when about 26% of the restaurants failed. Approximately 19% of new restaurants failed in the second year, and approximately 14% of new restaurants failed in the third year. Among franchised chains, the failure rate was 57% over the three years; and among independent restaurants, the failure rate was 61% over the three years. Professor Parsa reported that these findings are similar to those of a 1991 study by hospitality professors at Michigan State and Cornell universities, which found a failure rate of 57 percent over three years and 70% after 10 years. The Cline Group study, based on the six-year period from 1997 to 2002, indicated a first year failure rate of 23%, with 14% of new restaurant businesses failing after two years, and an additional 7% failing in the third year. The survey of Yellow Page listings was considered to be less accurate than the survey of Health Department listings because restaurant listings may survive in the Yellow Pages for up to a year or more after the restaurant has closed.

One of the most common causes of restaurant failure is under-capitalization of the business. Because there are no traditional lending sources for new, independently operated restaurants, money to start a restaurant typically comes from personal savings, loans from family members, or small investments by friends and business associates. Occasionally a talented chef will come along who develops a following while working for someone else, and then gets the backing from a few devout fans to open his or her own restaurant. Why then do so many start-up restaurants fail?

My theory as to why the failure rate is so high is related to the lack of traditional lending sources, such as banks. While there are some lenders which specialize in restaurant loans, they typically require the borrower to have an operating history of at least three years and two or more restaurant properties as collateral. As a result, the individual operator new to the business is unlikely to be able to obtain access to outside lending sources. When a traditional lender is involved, as is the case when building a hotel or retail center, the lender requires that a market study and appraisal be performed prior to making a loan. The market study assists the lender in determining whether there will be a demand for the real estate product and the potential value of the improved real estate that will be the collateral for the loan. The lender is then able to assess the risk of being repaid by the borrower, which in turn determines the amount of the loan, terms of the loan, and interest rate on the loan. The market study and appraisal process provides a level of checks and balances before the bulk of the money is spent to build the project. Although real estate developers do not like to spend money on market studies and appraisals anymore than a restaurant entrepreneur does, the market study/appraisal process has been accepted as a cost of doing business.

Big egos run rampant in both the restaurant business and traditional real estate development. The loan process present in financing traditional real estate deals help in preventing or reducing the size of mistakes. When mistakes are made in real estate deals, typically the lender has no option but to restructure the loan because the lender does not want to own and operate the Big Name Hotel or Shopping Center, but would rather let the real estate developer dig himself out of the mess.

Without traditional lenders, there is no process in place to prevent would-be restaurateurs from blundering into a financial disaster. The successful restaurant chains have learned over time what elements they need in place to provide the greatest probability of success. Even McDonald's doesn't get it right 100% of the time, but

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it succeeds more than most because it has developed a long list of criteria necessary to open a successful restaurant. The large chains have in-house real estate departments and use demographic specialists who usually have the word “econometrics” in their company name. The individual operator, on the other hand, is operating on a limited budget and frequently is penny-wise and pound-foolish. Consequently, while he may be willing to spend hundreds of thousands of dollars on the décor and the building, he may be unwilling to spend the relatively minor amount up-front to pay for a market study. It is the market study that would tell him whether there is adequate demand for the concept to provide a return on and return of his investment (i.e., a return on the money invested in the business as well as an eventual return of the money invested in the business). Without a lending institution requiring a market study and appraisal as a condition for making a loan, the independent restaurateur passes up an opportunity to save hundreds of thousands, if not several millions of dollars, by discovering early in the process whether or not there is a market for his concept.

Market studies can be obtained at a relatively modest cost in a time frame that will not unduly delay the development timetable for the new restaurant. The person performing the market study will expect the operator to provide information regarding such items as menu concept, theme of décor, target market, price points, opening target date, seating capacity, and intended location. It is important to note that in today’s “information age”, there is more data available than any one small restaurant operator can absorb. Further, it is not enough simply to gather the available and appropriate data, one must have the ability and experience to analyze and draw conclusions from the data. An experienced restaurant consultant travels frequently to different markets around the country and consequently, is exposed on a regular basis to both successful and unsuccessful new concepts. The value that the restaurant consultant adds to a potential operation may be the factor which tips the scale in favor of success. With input at the front-end from a consultant experienced in both operations and market analysis, the likelihood of an operator’s restaurant falling within the failure rate statistics quoted previously can be reduced significantly and it won’t end up on national television as a “kitchen nightmare.”

For more information on restaurant market studies and other available consulting services or appraisals, contact Dick Williams, MAI at 303-771-4104 or by email at dwilliams@hvs.com.

[1] Restaurant Study, H.G. Parsa, Professor of Hospitality Management at Ohio State University, 2003. *Restaurant Start & Growth Magazine Unit Start-Up and Failure Study*, Cline Group, Dallas, TX, 9/13/03.

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