Leasing to a Restaurant? Due Diligence You Must Consider at the Outset

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The National Restaurant Association reports that there are approximately 960,000 restaurants in the United States, which will generate more than $604 billion in sales in 2011. For every dollar spent on food, 49 cents of it will be spent in a restaurant. This percentage is true for all types of food establishments and outlets—and it's increasing. Property owners know that having a visible and successful restaurant is not only lucrative, but also can be an amenity that improves the image of the property and provides an essential service to residents and other tenants or occupants of an office building, shopping center, or mixed-use project, and to the community at large. However, despite the overall increase in sales, a large number of all new restaurants close after only one year of operation. And this rate greatly increases after three years. Mexican-style restaurants and sandwich shops have the highest rate of failure, while seafood and hamburger restaurants have the lowest rate. The success rates for national chain restaurants are only slightly better than the national average.

What does this mean for property owners? Whether it's an office building with retail space on the ground floor, a mixed-use building, or any type of shopping center, property owners must perform careful due diligence before offering space to a restaurant tenant. The short-term advantage of filling a vacant space and receiving rental income may not outweigh the long-term financial risk and operational disruption if the business fails.

During the due diligence process, the owner must ask itself two questions. First, is the space within the building or center suitable for the unique requirements that restaurants typically demand? Second, is the prospective tenant capable of performing from both an operational and financial standpoint over the term of the lease? Owners should consider the following factors before signing the lease.

Assess Space's Suitability

Prior to negotiating the lease with a restaurant tenant, the owner must make an honest assessment of the space and determine whether it's suitable for a restaurant. Even if there is a market demand for a restaurant and the rent is satisfactory, it's critical to analyze five issues when making this assessment.

Legal Restrictions

The first step in an owner's due diligence is an analysis of any legal restrictions or other limitations that may inhibit or prevent the premises from being used as an eating establishment. This may include zoning restrictions such as a prohibition of the use or the requirement for a special exception or special use permit, higher parking ratios, drive-through lane limitations, or signage restrictions. Or there may be other laws or regulations that would frustrate the use, such as a prohibition on liquor licenses. Finally, the owner will need to confirm that there are not any restrictive easements or covenants that would prohibit a restaurant. For example, one industry-leading hamburger chain—billions and billions sold!—frequently places such restrictions on record before selling a store location that has been closed.

Existing Leases and Agreements

In addition to governmental and title restrictions, depending on the location and type of property, the owner must review its existing leases and agreements to determine whether a restaurant use—that is, renting a space for a particular type of restaurant—is permitted or whether existing exclusive use or prohibited use provisions in your current tenants' leases are applicable. For example, one national restaurant chain famous for its desserts requires its owners to agree not to enter into any agreement with a competing business of similar size, having comparable menu price points, or offering a wide variety of dessert selections. As supermarket chains continue to expand their take-home prepared meals, they seek concessions from owners to limit or prohibit any other establishments that offer food or beverages for off-premises consumption.

Supermarkets and other major tenants also seek restrictions on uses that are deemed to be "unacceptable"—and bars, nightclubs, and taverns frequently fall within this definition. These types of restrictions would not necessarily be disclosed in a title report or found among the land records, so owners must maintain good records for all existing tenants. This is especially true if the current owner purchased the property after it initially was developed and leased by others.

Space Availability

Once an owner has determined that a restaurant is legally permissible, it must next review whether the available space is appropriate for a restaurant and, if so, for what type of restaurant. This type of due diligence may take many forms. Following the "location, location, location" adage, an owner must make a realistic analysis of whether the premises are suitable for future success. Even an experienced and well financed restaurant tenant is likely to fail if its business is in an unsuccessful location, such as a center that is poorly visible, lacks convenient parking, or is difficult to access.

The history and characteristics of the space, its size and dimensions, its access, its visibility, nearby cotenancies, and the availability of ample parking are important considerations. If several restaurants have failed in the premises previously, there just may not be the necessary demand or traffic to support another similar venue. The size of the space is another important consideration. For example, if the space is 6,000 square feet, it may be too large for most fast food or fast casual tenants, and yet too small for destination first class dining establishments.

Location in terms of surrounding uses may also be vital. Placing a restaurant in a vacant storefront among several apparel retailers in a shopping center, even if the size is right, may be a mistake because of the tenant mix. Both owners seeking profitable retail centers and tenants among similar use categories (both food and traditional retail) tend to prefer locating similar uses near one another. A food service tenant's success may depend largely on the then-current vacancy rates and occupancy ratios for the remainder of the property.

Utilities and Systems Review

In addition to an analysis of the premises, an owner contemplating a lease to a restaurant must satisfy itself that the building's utilities and systems, which include heating, ventilation, and air conditioning (HVAC) and electricity, gas, and roof rights, are of sufficient capacity to meet the demand of a user that typically places a higher demand on such utilities and systems. If the space is currently inadequate, then a determination must be made whether a financial investment to upgrade current systems is reasonable and can be recouped with a long-term lease.

Potential Impact on Other Tenants, Occupants

Finally, the owner needs to be sure that leasing to a food establishment will not result in any adverse impact on existing tenants or occupants—whether they are residents, office tenants, traditional retailers, or other restaurants. A nationally recognized, high-end restaurant may become the owner's trophy destination tenant for the property and may positively impact the other users. However, by their nature, food service tenants create unique effects on property owners and surrounding uses: There are kitchen exhausts and other odors, noise, garbage and recycling demands, rodent and pest controls, security measures, loading dock demands, and a need for storage space. The restaurant's long-term benefit may be outweighed by its impact on the other tenants or if it becomes a nuisance for the owner.

Selecting the Right Food Service Tenant

If the owner concludes that its space is appropriate for a restaurant, the next step is to choose the right tenant. The owner will want to require any prospective tenant to present a thoughtful business plan that covers the restaurant's concept, cuisine, financing, management structure, supply chain, marketing, and day-to-day operation. Careful consideration of the following factors will result in a higher probability of long-term success for both the owner and the tenant.

Restaurant Concept

First, the owner will need to decide whether the prospective tenant's concept can be clearly defined so as to distinguish it from other tenants. The owner should try to determine whether it is more than just a fad that may not last and whether it can draw repeat business. Restaurants focused on Hollywood or sports memorabilia, or that have a specific tropical climate theme, may not be able to increase sales after a single visit if the food experience is not enjoyable too.

One positive indicator is whether the concept has had sustained success in other locations. That's why so many owners choose to seek the national chains or franchises first. While the owner is not likely to be an expert in the food service industry, some evaluation of the proposed menu and its price points must be made to determine if they are suitable for the market. Overall, the owner will want some positive indications that the operation will be viable over the term of a typical restaurant lease.

Financial Health

The owner's review of a potential restaurant tenant must include an analysis of its financial condition. At a minimum, it must be creditworthy enough to make the initial capital expenditure in the business and to make the monthly rent and other monetary obligations that will be required by the lease. If the tenant can't meet these expectations, the owner should find out whether there are any partners or guarantors available to make the owner comfortable.

Also, an assessment of the tenant's finances will determine whether it will be able to secure adequate bank financing for the construction buildout of the premises, including the furniture, fixtures, and equipment, and the ongoing operation of the business. The owner may have to become a "partner" in the deal via a large construction allowance at the commencement of the lease term, or provide all or a substantial portion of the buildout prior to delivering the space to the tenant. Based on the nationwide failure rates for restaurants, this is a risk the owner will need to accept, as the improvements may not hold any value to the next tenant.

Tenant Experience

Even a financially strong potential tenant may be too risky if it has never operated a restaurant before. The tenant's experience and reputation in the food industry may be just as important as its finances in making a determination of the business's long-term viability. Many failed restaurants have been started by lottery winners, former executives spending their "golden parachutes," and professional athletes. In addition to all of the factors discussed above, most successful food service businesses require excellent management and careful attention to operating costs and other daily details. Net worth or fame is not enough.

Often, the owner's investigation will reveal that the potential tenant is a franchisee of a national operator. For example, the country's leading submarine sandwich shop typically requires an investment of less than $300,000, no prior restaurant operation experience, and only a few weeks of training, but a leading well-known bakery-café has a net worth requirement of over $7 million and requires the franchisee to have prior restaurant experience and to open multiple units within its territory. The owner's focus in such instances may be narrowed to determining whether the prospective tenant, as a franchisee, has been properly qualified and trained by the franchisor.

With the high failure rate of new restaurants, the owner should try as a general rule to limit its exposure by seeking operators with past success in similar food service businesses. If that's not possible, the owner needs to consider how long the premises have been vacant and the likelihood of finding alternative uses before entering into a long-term relationship with an inexperienced tenant.

Due Diligence Is Key to Success

A successful restaurant will often depend on whether the restaurant has good food with good service at reasonable prices. Even the most prudent of owners may not be able to predict restaurant failures caused by such things as poor service and management, spikes in operating costs, changes in the market trends and customer tastes, changes in the law like smoking bans or moratoria on liquor licenses, and a general downturn in the economy.

However, the likelihood of a long-term, profitable owner-tenant relationship will improve if the owner does careful and prudent due diligence of both the space and the prospective tenant in advance of signing a lease. Once the owner has done its due diligence and found a suitable tenant under acceptable business terms, then the owner can turn to carefully preparing and negotiating the lease document.

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