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Investment Guide

No Free Lunch

Emily Lambert, 06.09.03

One in two new restaurants fails within two years. If you're thinking of trying to beat the odds, here's the dish.

Three and a half years ago Gary Fuller was vice president of operations for a Cincinnati Bell affiliate. But what he really liked to do was cook. Two years and \$400,000 into a new career, Fuller and his wife, Kelly Kimberly, a public relations consultant to Enron's Kenneth Lay, run the well-reviewed 50-seat Laurier Cafe & Wine in Houston. Moving from telecom to New American cuisine has meant a lifestyle change for Fuller. He loves the good reviews, the satisfied customers and the challenge of the trade. But these rewards don't come easy. Fun? "That's a word that has never crossed my mind," he says on a rare day off.

If you dream of restaurant riches, you should know a few things before setting up kitchen. This is an industry riddled with failure. Profit margins, at 1% to 5%, are as paper-thin as the finest carpaccio. One in three new restaurants doesn't last a year. Denver celebrity chef Kevin Taylor has shuttered two of his five restaurants in the past year--one because of the economy, the other because construction out front chased away a third of his revenue. And if you happen to succeed, you may be working too hard to enjoy your success.

Opening a new restaurant can cost anywhere from \$185,000 for a franchise outlet to \$5 million for a 10,000-square-foot, high-end eatery with custom decor, although we found enterprising folks who got going for less. Daniel Bendall, vice president at industry consultant Cini-Little International, says the cost of setting up an average restaurant, like a diner, is around \$300 per square foot. That includes tables, chairs, carpets, kitchen equipment and paint for the walls--but not property costs.

Bankers don't like to lend into a trade with such a high failure rate. Try hitting up family and friends for capital. Or go plastic. The Small Business Administration turned down New Yorkers Brian Karp and Christopher Evans, both 32. So they used credit cards for most of the \$125,000 it took them to start Brooklyn's hot sandwich shop Press 195 last summer. That financing is costing them 9% interest. Now that they're a going concern, they're hoping to pay off the cards' balances with a bank loan.

Don't under budget. Besides costing you for construction and equipment, the business may run an operating loss in its early days. One reason restaurants go under is under capitalization, says Edward Engoron, president and chief executive of Perspectives/Consulting Group, a restaurant business adviser.

Location is crucial. Fuller, the Houston restaurateur, opened across the street from a strip joint. At least his rent is cheap, and he's not far from offices and residential neighborhoods. He opted for a dead rent, one not figured as a percent of sales volume. That's a good idea if you can swing it, says consultant Engoron. Rents with a percentage kicker, common in franchise operations, may be more affordable to a startup. Stephen Hanson, owner of New York's Blue Fin and Ruby Foo's, says that the monthly rent bill for a healthy restaurant is ideally no more than its sales on one busy day.

Next, permits. You'll need them for occupancy, sanitation, fire safety and liquor. Plan badly and you will open months late--and be owing on a construction loan all the while. After that come insurance policies, for liability, workman's compensation and fire.

Construction delays can be deadly. Consider the advantages of using a space that was a restaurant before, with kitchen and dining room in place. If you modify a building and aren't a Handy Andy, set aside enough money to hire an architect and contractors. Theodore Adamstein, a founder of Adamstein & Demetriou Architects in Washington, D.C., says it costs \$125,000 to \$250,000 for the design of a chichi restaurant.

Think about starting off with used equipment, recommends Cynthia Renzi, coordinator for continuing education at the

French Culinary Institute. Scour auctions and garage sales. Fuller's only new piece of equipment in his Houston place was an ice machine. Karp and Evans opted for new appliances in their Brooklyn eatery and say that was, with hindsight, wise: A warranty covered two espresso machine repairs.

You can be clever with capital expenses and still get killed by your variable costs if you don't know how to hold them down. Labor will typically eat up 25% of your expenses. You can pay your chef \$30,000 a year and a percent of the gross, or you can hire a celebrity for \$150,000.

Food accounts for another third of costs. Don't be wasteful: Old bread can find new life as croutons. Consultant Engoron says to budget 4% to 6% of revenue for marketing, although having the right buzz or location may make that unnecessary. Hanson, the Blue Fin owner, doesn't spend a dime on ads. Also eating away at your cash: garbage service, the sign out front, having someone clean the grease traps, printing menus--and the temptation to eat or drink up the profits yourself.

Whether or not to invest in software to print and tally receipts is a \$10,000 question. A point-of-sale system, essentially a computer-linked cash register, helps track expenses and revenue; that's also helpful if you find yourself audited by either the booze police or the taxman. Restaurants often deal in cash, and so raise the suspicions of the enforcement agencies. A point-of-sale system also deters staff pilfering. The average annual theft per restaurant employee is \$218, according to a Pearson Reid London House survey.

Booze is a lifesaver for many a restaurant. The typical markup on a bottle of wine is around 300%. Wine provides a third of the revenue at Fuller's Houston eatery. To encourage people to drink up, he sells wine by the half bottle and by the glass. Press 195's Karp and Evans design their menus around people's drink preferences in different seasons. If you're selling wine, be sure to have a storage area, and know a zinfandel from a merlot. "There's no point in having a great wine program if your staff doesn't know how to pronounce the wines or how to serve them," says the French Culinary Institute's Renzi.

If a restaurant is going to make it, it probably will show a profit within 90 days. "About 80% of people who walk through in the first 90 days, that's your customer base for the next five years," says consultant Engoron. Flailing owners often fiddle with the menu or the concept, but it rarely works. Nor does discounting. A steak offered at half price never recovers its value in the customer's eyes, says Engoron.

Rest up now. The hours are late and long. One in ten owners works 80 hours a week or more. Looking for respect? You won't find it here. Houston's Fuller, who as a corporate executive used to have vendors at his beck and call, found at first that many suppliers not only didn't return his calls, they insulted him.

At least the trend is your friend. Hudson Riehle of the National Restaurant Association predicts restaurant sales will rise 4.5% this year to \$426 billion. Americans spend 47 cents of every food dollar eating out, up from 25 cents in 1955. Alas, all this does not guarantee your own success. As with all investing, that depends on a large element of luck.