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Abstract
An individual considering a restaurant purchase must look at a number of major items that require financing. An initial cash investment is also necessary. The author enumerates and discusses what the buyer must have to start in business.

Keywords
John Stefanelli, Cash Investments Are Required For Restaurant Purchases, Financing, Assumable loan, Closing costs, Cost of closing

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Cash Investments Are Required For Restaurant Purchases

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An individual considering a restaurant purchase must look at a number of major items that require financing. An initial cash investment is also necessary. The author enumerates and discusses what the buyer must have to start in business.

A prospective business buyer is interested in the asking price and sale terms of a restaurant, but equally as important is the minimum amount of cash he or she must invest initially to acquire the business and begin to operate it effectively.

It is important that a buyer estimate as accurately as possible the initial cash investment needed. This is easy to underestimate and many business failures undoubtedly can be attributed to this problem.

Experience shows that undercapitalization, a major cause of business failure, will occur if there is an erroneous forecast of the minimum amount of cash needed to establish the business on a sound financial footing.

A buyer should first compute the initial cash investment required using the seller's asking price and terms of the sale. He or she also should then perform additional computations using varying combinations of sale price and terms in order to isolate the most favorable combination that will serve as the offer presented to the seller.

There are several major items that a buyer must finance with personal equity or with debt instruments. An investment of cash will be needed for the following: sale price; transaction costs; inventory; operating capital; deposits; licenses; legal fees; renovations; pre-opening expenses; furniture, fixtures, equipment, expendables; loan fees; life insurance; investigative costs; franchise fee; sales tax; and contingency.

Normally when a buyer purchases a restaurant he or she must be able to afford a down payment equal to about 20 percent of the purchase price. The remaining amount will usually consist of assumable loans and/or seller financing. Through effective negotiations the buyer may be able to reduce the price if the amount of down payment is a much greater proportion of it. Conversely, a higher price is required if the down payment is very small.

There are two types of costs, closing costs and costs of closing, both of which must be paid when the sale transaction is completed.

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Closing costs are those expenses that are pro-rated as of the date the sale transaction is finalized. For instance, a seller who has prepaid next year's real property tax is entitled to reimbursement from the buyer.

The costs of closing are those costs necessary to conclude the documentation needed to complete the sale. Typically these expenses amount to approximately $500, but they can be much greater if the sale contract is unusually complex.

Buyers normally expect to commence business with an opening inventory of food, beverage, and supplies equal to about one percent of the anticipated annual sales volume. In most cases it is reasonably easy to finance most of the inventory with trade payables.

If there are any inventories in the existing restaurant that the seller and buyer agree to transfer, usually a separate agreement is made which stipulates that a final inventory will be taken at the close of the sale transaction and the buyer will pay the fair market value for these items to the seller.

Buyers generally anticipate a cash balance requirement of about one-half of one percent of the expected annual sales volume. Less cash is necessary if the restaurant does not accept credit cards. More cash may be needed if credit sales are a considerable amount of total sales, if a lender requires a compensating bank balance as a loan condition, or if purveyors refuse to grant trade credit.

Deposits Are Usually Required

Usually there will be a cash deposit, or a cash-equivalent deposit, required by the utility companies, sales tax authority, payroll tax authorities, and landlord.

Deposits are demanded by creditors so that they are assured that the business owner will pay his or her bills. The deposit amounts are influenced by the customs of a particular market area as well as by the businessperson's credit rating.

Generally the total deposit amount will be equal to two to three times the most expensive monthly liability. In southern Nevada, for example, a buyer must expect to deposit two month's worth of sales taxes, electricity expense, workman's compensation expense, real property lease expense, and telephone expense.

The commercial food service operation usually needs one or more of the following licenses: retail business license, health permit, admission license, tobacco permit, fictitious name registration, vending permit, liquor license, outdoor dining permit, entertainment license, wholesale selling permit, social catering license, and mobile catering license.

In southern Nevada, for example, the initial charges for all licenses, with the exception of the liquor license, are very modest. They range from $20 for a tobacco permit to a few hundred dollars for some types of health permits.

The liquor license typically is the most expensive. It can cost up to $60,000 in the city of Las Vegas. A license permitting only the sale of beer and wine, though, is very inexpensive; in some instances it can be procured for less than $100.

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A buyer must contact the proper government authority to determine the exact initial charges for the relevant licenses. The costs change periodically, so it is necessary to seek advice from the appropriate persons.

An attorney conversant with business ownership and business management should be hired to do the following:

- assist in preparing the sale contract;
- assist in preparing other needed contractual agreements;
- determine the appropriate form of business ownership; and
- insure that all aspects of the sale transaction adhere to the relevant legal statutes.

It may be possible to engage an attorney to provide the abovementioned services for one fee. Generally, though, these specialists charge an hourly fee for their services. The appropriate attorney in this example probably would charge somewhere in the neighborhood of $100 per hour and would be involved in the sale transaction for at least 10 to 12 hours.

In southern Nevada a major remodeling will cost about $90 per square foot for the typical full-service commercial restaurant. Minor remodeling, for instance, to cure an existing building code violation would be considerably less expensive.

New construction will cost a minimum of about $100 per square foot in southern Nevada. A buyer would incur additional expense if it was necessary to raze an existing structure.

Pre-Opening Expenses Can Be Minimized

One of the advantages of purchasing an existing business is the minimization of the investment in construction. However, a buyer must expect to incur some costs for pre-opening in labor, advertising, promotion, consulting, and training.

As a rule of thumb, buyers should expect to spend about two to three weeks of normal operating expense in advance to discharge the abovementioned pre-opening expenses. This amount of money can increase considerably, though, if the new owner must close the facility for a brief period.

A buyer does not expect to purchase additional durables such as furniture, fixtures, equipment, and expendables; in fact, in many instances, there might be excess merchandise in stock that can be liquidated. However, there may be a need to recondition some items, or some new things may be needed if the restaurant's format will be altered substantially.

If a buyer assumes an existing loan or applies for new financing, it is usually necessary to pay a loan fee of about 2 to 3 percent of the loan proceeds. If he or she applies for a government-secured loan, the loan fee usually is a bit less.

Similarly, if the buyer wishes to raise equity capital through a stock offering or limited partnership offering, there will be underwriting fees which usually are much greater than loan fees.

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If the seller is carrying back a loan as part of the purchase price of the restaurant, a buyer will be able to avoid a loan fee. Furthermore, he or she normally will receive a much more favorable interest rate and payment terms than those offered by a commercial lender.

The lender, landlord, and/or seller usually demands that the buyer purchase a life insurance policy naming these creditors as beneficiaries. It generally is necessary to prepay about six months' coverage.

A buyer incurs a great deal of expense merely looking for and analyzing restaurant purchase opportunities. Usually he or she will set a budget for these costs and try to live within that framework. It is very unusual to perform an adequate analysis of even the smallest restaurant purchase opportunity for less than $400 to $500.

If the buyer is assuming a franchise, there will be a transfer-of-ownership fee which typically must be paid in cash before the franchisor will allow the restaurant to operate under new ownership.

If the buyer is seeking a new franchise affiliation, the initial franchise fee must be paid before operations can begin. The costs vary. For instance, a Burger King franchise for 20 years sells for $40,000.

A new franchise may also require the owner to spend a considerable sum of money to bring his or her restaurant into compliance with the franchisor's demands. Consequently, a new franchise can easily cause the businessperson to exceed very easily the estimated initial investment requirement.

If the buyer wishes to discontinue an existing franchise affiliation that the seller now owns, normally the franchisor extracts a cancellation penalty. In some states the buyer will be required to pay sales tax on certain items that are part of the restaurant sale. For example, the non-food supplies, such as dinnerware, might be taxable. If so, the appropriate charge must be paid before ownership can transfer.

Most businesspersons recommend that a new owner reserve a contingency fund equal to three to six months worth of anticipated operating expenses. When buying an existing restaurant, the future tends to be more predictable than with a new venture. Hence, a smaller contingency fund should suffice unless the new owner expects to incur extraordinary expenses during a shake-down period.

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