Restaurant Leases May Get Creative To Weather The Pandemic

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Variable rents have emerged as another possible tool for restaurants, as landlords and business owners attempt to find some way to pay the bills during shutdowns and reopenings.

Rather than relying only on a fixed rent, variable rents also assess a percentage of sales according to a negotiated formula. They have seen some renewed success in the wider retail world and are now being considered as one option for helping restaurateurs weather the downturn.

The situation for restaurants, some of which were in trouble even before the coronavirus pandemic, is now dire. Kayak and OpenTable CEO Steve Hafner estimates that about a quarter of U.S. restaurants will not survive the pandemic. The Independent Restaurant Coalition predicts that as many as 80% of independent restaurants will fold because of the pandemic.

If those numbers are even partly correct, that would be an enormous disruption to the industry, since the National Restaurant Association estimates that there are more than 1 million restaurants nationwide. Before the pandemic, the industry employed about 15.6 million workers.

Also complicating matters for the industry is that, at least for now, workers can be hard to find for reopening, in part because of relatively generous unemployment payments or worker concern about the safety of restaurant work.

For now, variable (or percentage) rent is seen as a temporary measure to help restaurants survive, like rent forbearance or payment plans, experts say. But after the pandemic, with the possibility of government-mandated closures still fresh in mind, variable rents might become more common.

"There's a renewed interest in percentage rents, at least in the short term, but so far only a few of our restaurant tenants have asked us about it," Cushman & Wakefield-Sage Partners Executive Vice President Tom Allen said.

"We've had a mixed bag of restaurants that have been successful or not," Allen said. "For instance, Chick-fil-A is one of our tenants, and they're doing very well with drive-thru.

"But we have some small restaurants who are suffering, and some have chosen to close permanently," he said. "As a former restaurant owner, I can understand if you're limited to 25% of your business, and you don't have drive-thru, you're losing money."

Arkansas-based Sage, which has a mixed commercial portfolio, including both quick-service and sit-down restaurants, is looking at offering percentage rents on a case-by-case basis, Allen said. Those restaurants most interested in it are those not well set up for carry out or drive-thru, and that are having a hard time generating sales at all.

"We consider it a way for us to help them get through the crisis," Allen said, though the main tool for now is forbearance of rent.

As for more permanent variable rents for tenants that don't have it, Allen said his company would entertain the idea, but only under specific conditions.

"The restaurant would have to prove to us conclusively that they're doing their best to market the restaurant and generate sales," he said.

Variable rents already exist in the restaurant industry, though they tend to be in lease agreements of larger chains and vary considerably.

In 2019, California-based BJ's Restaurants, which has 209 U.S. locations, paid about $54.3M in base rent on its leases, and $3M in variable lease rent, according to the company's 10-K filing with the Securities and Exchange Commission. With total revenue for the year of about $1.16B, the company paid about 5% of revenue for base rent and 0.25% of revenue for variable rent.

Also last year, Tennessee-based Cracker Barrel, which has 257 stores, paid $78M in base rent and $280K in variable rent, according to its 10-K for the year. Revenue for the year was $3B, with the company paying 2.6% of revenue for base rent and 0.025% for variable rent.

"Deal structures are always subject to the economic environment and a tenants' risk profile," Colliers International Executive Vice President Julie Taylor said.

In the short term, tenants will likely prefer leases with a low base rent and a high allocation of percentage rent, but in the long term, tenants may prefer fixed rent leases that allow them to keep all the upside, said Taylor, who is in the retail services group.

"The formula will also vary depending upon the type of restaurant," Taylor said. "Those with dining rooms to fill, or who have higher labor costs and social distancing requirements, will likely take a more conservative approach."

On the other hand, restaurants that are primarily to-go or are takeout only, which tend to be at the quick-service end of the spectrum, will strongly prefer fixed leases, she said.

"In fact, most coffee and quick-service restaurants are very reluctant to pay percentage rent," Taylor said. "Conservative, risk-averse restaurants will favor variable leases, while those who are bullish about the future, and have deeper pockets, will favor fixed leases."

At the beginning of 2020, there were nearly 200,000 quick-service restaurants, which de-emphasize table service. Full-service restaurants total about 33,700 locations.

Restrictions on indoor seating are hurting full-service restaurants particularly hard. In a May survey of 483 New York City restaurants done by the NYC Hospitality Alliance, about two-thirds of the respondents said they needed to operate with at least 70% occupancy to survive. A month later, New York hasn't allowed restaurants to reopen for interior seating and other places that have, such as Texas and Florida, allow only 50% capacity.

How much should variable rent be in a restaurant context? Considering the peculiar economics of the restaurant industry, there is no clear answer, because how much base rent ought to be to meet the needs of a landlord (mortgage and other expenses, and a profit) without swamping a restaurant, whose margins can be quite thin.

Restaurant consultants estimate that rent ranges from 5% to 10% of gross sales over a certain threshold, restaurant industry investment adviser Patrick Gleeson writes. Depending on a restaurant's profitability, there is some flexibility on rents, as opposed to the larger fixed costs of food and labor.

"There's going to be a lot of bargaining on the exact language of percentage rents in the future," said Mize CPAs Inc. Tax Accountant Alex Gray, whose metro in the future," said Mize CPAs Inc. Tax Accountant Alex Gray, whose metro Kansas City, Kansas-based firm has a number of restaurant clients.

So far, Gray said, he isn't seeing a lot of percentage rent language in the restaurant leases he has reviewed. He expects that to change in the post-pandemic era, with the details yet to be worked out.

"We might see a variety of hybrids [like] base payment plus percentage charges, but neither of them absolutely fixed," Gray said. There might be certain circumstances, which would have to be clearly defined, such as a government-ordered shutdown, that call for a lower base or a cap on how much income is subject to a percentage rent.

"We're hearing a lot about rents, but not a lot yet about percentage rents," National Restaurant Association Vice President of State and Local Affairs Mike Whatley said.

"We're still in the stage of rent forbearance since many restaurants are struggling simply to pay rent," Whatley said. "Their immediate concern is survival, which also tends to be their landlords' concern since restaurants tend to be very important in generating business for the rest of a retail property."

It isn't clear yet how long the restaurant slump will last, he said, though the industry did a little better in May than April, with sales nationwide up $9B month-over-month.

Still, for the three months from March to May, sales at eating and drinking places were down more than $94B from expected levels, the NRA reports. Add lost spending at non-restaurant food service operations, such as at hotels and schools, and the total shortfall was more than $120B during those three months.

But the longer the crisis goes on, the more likely the idea of variable rents is to gain some purchase in the industry, Whatley said. For some restaurants, it would be a kind of insurance against sudden, government-mandated closures that leave them with little income to cover one of the businesses' prime fixed costs, rent.

Tenants naturally have an incentive to keep percentages as low as possible, Gray said, but landlords have to be careful that a percentage rent scheme doesn't disincentivize restaurants driving additional sales.

"If you're a landlord, that restaurant is probably driving traffic to the rest of your property, so you don't want to squeeze a restaurant too hard," Gray said. "A rent structure needs to incentivize additional sales, rather than discourage them."

Congress is now mulling a specific bailout for the restaurant industry, something that few other countries have done so far, though some bailout money, including the Paycheck Protection Program in the U.S., has gone to restaurants as small businesses.

On Thursday, Sen. Roger Wicker, a Republican who represents Mississippi, and Rep. Earl Blumenauer, a Democrat who represents Oregon, introduced the "Real Economic Support That Acknowledges Unique Restaurant Assistance Needed to Survive (RESTAURANTS) Act of 2020," in Congress. It would provide $120B in grants to non-chain restaurants through the end of this year.

See Also: Restaurant Industry Fears Mass Closures, Asks State For Lifeline After Governor Closes Bars, Reduces Capacity

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