

Lending in the Multi-Unit Restaurant Sector

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A Practice Note examining important aspects of loan financing arrangements for medium to large-scale operators of restaurant franchises in the US. Geared towards corporate finance attorneys, this Note explores the principal considerations that may arise in a loan transaction involving a multi-unit restaurant operator. It discusses lending due diligence, with a focus on the franchise relationship, real estate assets, and other operational matters. It highlights how these agreements typically use EBITDAR, rather than EBITDA, as the primary measure of the borrower's profitability, and discusses the negotiation of permitted adjustments. The Note also discusses common financial covenants included in loan agreements in the multi-unit restaurant business and particular collateral issues in the sector.

Annual revenue in the domestic multi-unit restaurant business by some estimates exceeds \$900 billion and multi-unit operators dominate the restaurant franchise sector. The industry includes operators of a handful of locations all the way up to large-scale businesses operating hundreds of locations under multiple brands all over the country. This Practice Note, offering a perspective that is geared towards corporate finance attorneys, focuses on medium to large-scale operators of restaurant franchises, and examines important aspects of loan financing arrangements for these businesses. Large organizations in general may have access to a variety of sources of public and private capital, but commercial loans are a key source of financing for many middle-market companies in the multi-unit restaurant business.

Although not as common in multi-restaurant transactions, the Small Business Administration's SBA loan program is another source of financing for franchisees. The SBA has off and on had a franchise directory listing franchisors that the SBA had vetted for minimum compliance with the SBA's affiliation requirements, which lenders have long relied upon to fast track franchise loans.

The principal considerations that a finance attorney working on a loan transaction involving a multi-unit restaurant operator may encounter include:

- The borrower's organizational characteristics.
- Business due diligence, focusing on the franchise relationship between the borrower and the franchisor, real estate, and business operational matters.
- Collateral securing the loan obligations.
- The method of calculating the borrower's earnings, including accounting for earnings related to minority interests in the business, as well as permitted adjustments to the borrower's EBITDAR measure of earnings.
- Loan covenants and default cure rights.

Borrower's Structure

There are many types of borrowers operating within the multi-unit restaurant sector, and one of the foremost preliminary concerns for attorneys working on loan transactions in this sector is to understand the borrower's organizational structure.

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A preferred structure from a lender's perspective may be a borrower that is organized so that each of its locations is operated by a separate wholly-owned subsidiary, because of the simplicity of the structure. However, less tidy structures are common in the industry with some companies having no consistent approach across the whole business.

Businesses that acquire other multi-unit operators, for example, may have irregular ownership structures, reflecting the different approaches of the original businesses. Minority interests are also common in the restaurant industry, particularly with smaller businesses. The borrower's ownership structure will impact how the loan documents are prepared, and minority interests must be addressed carefully in the measurement of the borrower's earnings for covenant purposes, and in loan covenants permitting dividends and distributions.

Private equity ownership of businesses in the sector is widespread and sponsors generally favor streamlined structures. Sometimes the occasion of negotiating a new credit facility is an opportunity for a borrower to make changes to its corporate structure to eliminate any organizational peculiarities that might raise concerns for lenders. It is important for the finance attorneys to have a clear idea of how the borrower is organized and any changes that are required before closing, to ensure that the transaction documents properly reflect the negotiated deal.

Lending Due Diligence

In a lending transaction, the due diligence exercise forms the basis of the lender's assessment of the borrower's creditworthiness and informs the lender's decision about how much to lend and what terms. Lenders sometimes approach due diligence differently in individual cases, with varying levels of scrutiny paid to particular aspects of a borrower's business. Finance attorneys may not be heavily involved in all aspects of the business due diligence, but it is important for them to understand the full scope of the exercise and the principal findings. Specific aspects of lending due diligence that a finance attorney typically sees in a loan deal where the borrower is a multi-unit restaurant operator involve:

- Financial and accounting due diligence (see Financial Due Diligence).
- The franchise agreement under which the borrower is franchisee (see Franchise Agreement Due Diligence).

- The strength of the borrower's management team and business plan (see Business Due Diligence).
- The borrower's business locations and growth potential (see Real Estate Due Diligence).
- Other operational considerations that are relevant to the restaurant industry (see Industry Due Diligence).

Financial Due Diligence

The financial and accounting aspects of the lender's due diligence exercise are usually led by the lender's business analysts based on the borrower's financial statements. However, it is important for the attorneys on the deal to understand the findings of the lender's assessment of the borrower's financial position and the accounting concepts involved, as these are relevant to the loan document drafting.

In the multi-unit restaurant sector, EBITDAR rather than EBITDA is standard as a measure of an operator's profitability (see Calculating Earnings: EBITDAR). Other notable aspects of the financial due diligence in a restaurant sector loan transaction may include:

- Assessing the implications of the existence of minority investors in the borrower's business (see Borrower's Structure).
- Considering the impact of the borrower's planned store openings and closings (see EBITDAR Adjustments).

For more information on financial due diligence, see [Practice Note, Due Diligence: Securities Offerings: Financial and Accounting Due Diligence](#). For more information on calculating EBITDA, see [Practice Note, EBITDA: Introduction for Finance Lawyers](#).

Franchise Agreement Due Diligence

Many restaurant operators in this sector operate their businesses under franchise arrangements, where the brand of the business is owned by a third-party franchisor. The franchise agreement governs the relationship between the borrower as franchisee and the owner of the brand as franchisor. From the perspective of the borrower's lender, the borrower's rights to use the brand under the terms of the franchise agreement are essential to the success of its business.

The lender's due diligence exercise includes an assessment of the borrower's rights and obligations

under the franchise agreement. The franchise agreement may prohibit the borrower from incurring debt and liens without the franchisor's permission, which means that a consent from the franchisor would be a condition to closing the loan. A related concern for lenders is to ensure that they can exercise a borrower's rights under its franchise agreement if the borrower defaults under the loan agreement.

It is common in loan deals where the borrower is a restaurant franchisee, for the loan agreement to contain a condition precedent that the franchisor must enter into a cooperation agreement, sometimes called a tri-party or subordination agreement, with the lender directly, to which the borrower is also typically a party. The purpose of the cooperation agreement is to allow the lender to:

- Have the franchisor consent to the loan transaction.
- Allow the lender to exercise certain rights under the franchise agreement (such as the right to cure defaults) and, in some instances, continue operating the borrower's business in the event the borrower defaults under the loan and lender forecloses on the collateral.
- Set forth the understanding between the lender, the borrower, and the franchisor to find a long term solution in the event of a financial issue at the borrower.

In practice, most franchisors are focused on maintaining control over who has effective control over the operations of the franchised business and may be loath to grant unfettered takeover rights to a lender. Without the borrower's rights under the franchise agreement and the ability to keep the brand as a going concern, the value of the lender's collateral would be significantly diminished.

Business Due Diligence

The strength and experience of the borrower's management team is one of the lender's key concerns. Lenders focus on the credibility of the borrower's business strategy to successfully operate and grow the business, and the borrower's track record under the current management.

Lenders also want to ensure that the management team has a resilient operational framework and policies in place to navigate the particular aspects of the restaurant business, including effective staff

recruitment and training and effective management of inventory. Generally, although these matters are important to lenders as part of their overall assessment of a borrower and a particular loan proposal, they are not usually specifically reflected in the loan agreement's representations, covenants, and defaults.

In some situations, the borrower has an agreement with the franchisor to expand the franchise in a particular area. These types of area development agreements usually give the borrower exclusive rights to develop new locations in the specified area in return for the borrower's commitment to open new locations in an agreed timeline. The borrower's management team must ensure that their expansion plans are consistent with the loan agreement's provisions covering capital expenditures (see Capital Expenditures).

Real Estate Due Diligence

Given the importance of real estate in the restaurant business, lenders pay considerable attention to the borrower's real estate assets. The two main concerns that finance attorneys are likely to encounter in lending diligence are:

- The lender's assessment of the profitability and importance of individual locations to the borrower's business.
- The borrower's legal rights over its locations.

The lender's business due diligence typically involves a more granular analysis of the borrower's financial results to understand differences between individual locations. This helps the lender form a clearer view about the quality of its collateral and enables it to identify prime locations within the borrower's property portfolio.

Lenders also pay particular attention to the ownership of the real estate and the borrower's rights with respect to its locations. The most common scenario for middle market companies in the multi-unit restaurant sector is for the restaurant operator to have leases over its locations, even if the real estate is owned by a property company affiliate of the borrower. Some borrowers own the locations they operate, while others may lease them from third party landlords, and it is common to see mixed property portfolios of owned and leased locations. Due diligence on the borrower's real estate may

only marginally concern the finance attorneys on a business loan, aside from ensuring closing conditions are met. Mortgages (including leasehold mortgages) are commonly required by lenders in multi-unit restaurant financings, sometimes more as a matter of course and without extensive consideration of the economic value of the lease as collateral.

Industry Due Diligence

Finance attorneys working on loan deals in the multi-unit restaurant sector may better understand the parties' approach to particular points of negotiation by bearing in mind those factors that affect the restaurant industry more broadly.

The industry itself is generally impacted immediately by an economic downturn or uncertainty in the economy that leads to concerns about rising unemployment. This can quickly impact profitability which in turn may lead to concerns about the borrower defaulting under its loan agreement. In addition, the restaurant business is highly competitive, food prices are volatile, and profit margins in the industry can be thin, all of which may weigh on a borrower's financial performance. Equally, businesses in the sector can be highly innovative and new concepts and products regularly emerge in the industry. Strong growth potential may exist in certain parts of the sector and some franchisors pursue bold development strategies to bring their brand to new markets.

Collateral

Another key concern for finance attorneys working on loan transactions in the multi-unit restaurant industry is to understand the collateral aspects of the loan. As with many other loans involving middle-market borrowers, all-assets deals are common where the loan is secured by liens on all the borrower's assets in favor of the lender, but there are particular issues regarding collateral that are notable for businesses in this sector.

Multi-unit restaurant operators may have different types of assets that can be used as collateral for the loan. The most significant asset from an economic perspective for many borrowers is the franchise agreement, giving the borrower the right to operate its business under the franchisor's brand, subject generally to franchisor consent as noted above. Since the brand itself is the property of the franchisor, it has no collateral value and is not part of the lender's

collateral. The borrower's license to use the brand and its rights and obligations with respect to the brand are contained in the franchise agreement. The borrower's leased premises, equipment, and physical assets are all important to the borrower's ability to use the franchisor's brand to generate earnings, but many of the borrower's physical assets may not have significant economic value as collateral. Finance attorneys should also ensure that the loan agreement provisions regarding collateral align with the franchise agreement, as franchise agreements commonly limit the extent to which franchisees may grant liens on their assets.

Certain business assets, such as equipment, may be specifically excluded from the lender's collateral on the basis that they are separately financed, sometimes by the equipment manufacturer or importer and sometimes by specialist equipment finance companies. The collateral documents and the UCC financing statements for the borrower's loan must correctly reflect the collateral and specifically exclude assets that the borrower is allowed to finance separately. The perishable nature of much of the borrower's inventory means that the borrower's inventory has limited relevance as collateral.

The borrower's rights under leases of its locations are often part of the lender's collateral (see Real Estate Due Diligence), and are often times at conflict with the franchisor, which above all else generally wants the property to remain under the brand. The borrower may also be required to grant liens on its bank accounts to secure the loan, which may require the borrower to deliver deposit account control agreements to the lender as a condition precedent. However, it is common to see some bank accounts excluded from the lender's collateral, especially accounts at local banks near the borrower's store locations.

Cash takings are significant in many restaurant businesses and individual locations may rely on bank accounts at local banks as part of their cash management system. Many lenders will not require liens on these specific operational bank accounts, so long as these accounts are not used to maintain sizeable deposits. Provisions may be included in the loan documents requiring account balances in these excluded accounts to be swept into an account over which the lender has a perfected security interest. For more information on security interests generally, see [Practice Note, Security: Overview](#).

Calculating Earnings: EBITDAR

Unlike many middle-market loan agreements that use EBITDA as a measurement of the borrower's earnings, loan deals in the restaurant sector typically use EBITDAR. The EBITDAR measure expands on EBITDA, by adding back the borrower's rent expense in its calculation of earnings, as well as the interest, taxes, depreciation, and amortization amounts that are relevant to EBITDA.

The rationale for also including rent amounts from the calculation of the borrower's earnings lies in the significance and consistency of the borrower's rent bill in its business. The rent expense of similar franchisees may differ significantly based on location. The theory follows that if rent charges were deducted in the calculation of the borrower's earnings, this may obscure the underlying picture of the borrower's financial success from its operations. Adding back rent in the calculation facilitates a closer analysis of the operational efficiency of the borrower's business in relation to its industry peers and gives more reliable insights into its underlying financial performance.

In the same way that EBITDA is only the starting point for earnings calculations and financial ratios in loan agreements that use it, so it is with EBITDAR. Loan deals with multi-unit restaurant operators typically involve detailed negotiations of adjustments to EBITDAR for loan agreement purposes (see EBITDAR Adjustments). A good deal of the discussion on this topic focuses on the same types of add-backs to EBITDA that are negotiated in loan deals in general, such as add-backs for unusual and non-recurring expenses. As with loan agreements that use EBITDA, non-operating income, such as gains from asset sales or investment returns, is also generally excluded from EBITDAR to reflect the company's sustainable operating profitability. For more information on EBITDA and adjustments to EBITDA in loan transactions, see [Practice Notes, EBITDA: Loan Agreement Negotiating Considerations](#) and [EBITDA Adjustments in Loan Negotiations](#).

Minority Interests

Where a multi-unit restaurant business involves minority investors, this presents issues regarding the borrower's accounting treatment for loan agreement purposes. Ownership structures in multi-unit restaurant businesses can be complex (see Borrower's Structure). It is important for the

attorneys in a loan transaction to ensure that the negotiated EBITDAR adjustments appropriately reflect the ownership of the business. Generally, the lender will want any portion of the operator's earnings that relates to a minority investment to be excluded from the borrower's EBITDAR, reflecting that a portion of the profits of the business belong to the minority investor, but the point is negotiated.

In situations where the borrower itself is a minority investor in other restaurant businesses, the borrower may adjust its EBITDAR figure by adding back expenses relating to those minority stakes on the basis that these are not a part of the borrower's core business operations. However, the same result can be achieved by simply omitting all revenues and expenses relating to minority investments owned by the borrower from the calculation of its net income.

EBITDAR Adjustments

In a given loan agreement, the negotiated EBITDAR adjustments may reflect both the relative bargaining strength of the parties and standard approaches in the borrower's industry. These adjustments are meant to normalize earnings by removing certain unusual or one-time costs that might obscure the true picture of the borrower's profitability from its business operations.

A common issue in the restaurant industry is how to account for new locations that the borrower opens. The expenses of building and opening a new location are all incurred before any revenue is generated, and the expenses associated with a new build may be significant. Since these are one-off expenses, borrowers may argue that these sums should be added back to EBITDAR since they are not representative of the company's normal cost of operations. Add-backs are also common for refurbishment and renovation expenses, although the extent of a permitted add-back is negotiated and some lenders will insist on limiting the add-back believing that some upgrading of business premises and equipment is a regular expense in the ordinary course of the borrower's business.

Another approach is to include in the borrower's revenue numbers an imputed amount for revenue that might have been expected to be earned had the location been operational during the relevant accounting period. Run-rate earnings figures, which estimate revenues based on the borrower's

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performance during other periods or at other locations, may be used in loan agreements that allow the borrower to use pro forma earnings figures for periods during which particular locations may not be fully operational.

Some other examples of negotiated add-backs from recent publicly filed credit agreements are as follows:

- Expenses for modifications to pension and post-retirement employee benefit plans (see [What's Market, OSI Restaurant Partners, LLC Third Amended and Restated Credit Agreement Summary](#)).
- Employee severance expenses (see [What's Market, Cracker Barrel Old Country Store, Inc. Second Amended and Restated Credit Agreement Summary](#)).
- Losses from discontinued restaurant operations (see [What's Market, BJ's Restaurants, Inc. Fifth Amended and Restated Credit Agreement Summary](#)).
- Costs and expenses associated with remodeling or improvement of a restaurant and replacement of restaurant equipment (see [What's Market, Texas Roadhouse, Inc. Credit Agreement Summary](#)).
- One time transaction and integration costs related to the acquisition of certain restaurant brands (see [What's Market, Darden Restaurants, Inc. Loan Agreement Summary](#)).
- Restaurant pre-opening costs (see [SEC: Good Times Restaurants Inc. Third Amendment to Credit Agreement](#)).
- Expenses associated with termination of real property leases (see [What's Market, Potbelly Sandwich Works, LLC Credit Agreement Summary](#)).

Covenants and Cure Rights

Covenants are a major focus of the negotiation of many middle market loan agreements. In the multi-unit restaurant business, loan agreement covenant packages often include financial maintenance covenants to monitor the borrower's financial health and impose financial discipline on the management team.

Common financial covenants include:

- Fixed charge coverage ratios (see Fixed Charge Coverage Ratio).

- Post-distribution fixed charge coverage ratios (see Post-Distribution Fixed Charge Coverage Ratio).
- Lease-adjusted leverage ratios (see Lease-Adjusted Leverage Ratio)
- Capital expenditures (see Capital Expenditures).

Fixed Charge Coverage Ratio

A fixed charge coverage ratio in a restaurant deal is typically defined as the ratio of the borrower's EBITDAR to its interest expense, any scheduled principal payments on borrowed money indebtedness, and taxes. It gives an indication of the borrower's ability to pay its fixed charges. The definition of the covenant can vary, often including additional items like rent payments and capital expenditures. Fixed charge coverage ratios are popular in restaurant deals where the borrower's ability to pay its fixed charges is a more meaningful measure of the borrower's financial strength than showing the aggregate amount of its outstanding debt relative to earnings.

Post-Distribution Fixed Charge Coverage Ratio

Some restaurant deals include an additional fixed charge coverage ratio, that also takes into account distributions that the borrower makes to its owners. From a lender's perspective, this is an additional financial control to prevent excess leakage of funds from the borrower that depletes the business, while recognizing that the borrower's business model depends on its owners taking regular distributions from the borrower as a source of income. Measuring the borrower's earnings using a lower figure that deducts distributions the borrower makes to its owners makes it more difficult for the borrower to meet the fixed charge coverage ratio. The lender relies on the post-distribution fixed charge coverage ratio to instill in the owner the financial discipline to put the needs of the business ahead of their own personal needs.

Lease-Adjusted Leverage Ratio

A lease-adjusted leverage ratio calculation is a variation of the more typical leverage ratio seen in many middle market loans. The lease-adjusted leverage ratio measures the principal amount of the borrower's debt plus a multiple of rent expense to its EBITDAR.

Capital Expenditures

In the restaurant industry, business costs associated with the acquisition of new capital assets and building out the business can usually be capitalized, which involves depreciating the cost of the asset over its useful life. Loan agreements can take different approaches regarding capital expenditures, depending on the individual circumstances of the borrower. Sometimes loan agreements include a minimum requirement for the borrower to make capital expenditures, which may be appropriate for businesses with expansion plans or obligations to open new stores under an area development agreement with the franchisor. More commonly, loan agreements may limit or cap the borrower's capital expenditures during given accounting periods or included capital expenditures (or maintenance capital expenditures) in the fixed charge coverage ratio. When loan agreements contain limits on the borrower's capital expenditures, the parties agree on set amounts that the borrower can use each year

for capital expenditures and may permit unused amounts from previous accounting periods to be carried forwards to subsequent periods.

Equity Cures

Equity cure provisions are common in middle market restaurant loan deals, especially in sponsored deals, allowing the sponsor to inject additional capital into the borrower to rectify financial covenant breaches by increasing the borrower's EBITDAR by an amount equal to the proceeds of the equity issuance or contribution up to the minimum amount necessary to cure the financial covenant default. When they are included, equity cure provisions often have limits and restrictions similar to those that are seen in the large corporate market, such as limits on cure amounts and the frequency of their use.

For more information on equity cures in corporate loans, see [Practice Note, What's Market: Equity Cure Rights](#).

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