Appraising Restaurants: Highest and Best Use Analysis

by Bradley R. Carter, MAI, and J. Tyler Leard

Abstract
The restaurant business is risky, but many valuation professionals do not fully account for the risks specific to the turbulent restaurant industry. Appraisers who value restaurant properties should fully understand the opportunities and risks inherent in restaurant operations and how these factors affect real property value. This article looks at restaurant highest and best use analysis with special focus on restaurant life cycles and most likely buyers.

Professionals involved in designing, developing, financing, and investing in restaurants understand marketability and valuation issues relating to restaurant properties and what to expect from restaurant property appraisals. Trends in the restaurant industry, market, location, and property analyses, and the three approaches to value are all important in valuation of restaurants.

Special-purpose properties like restaurants are often misunderstood. For restaurant properties, there are differing views within the appraisal community about how key valuation issues should be addressed, and even confusion about what should be valued and when. Clear definitions help facilitate discussion of restaurant valuation.

What Is a Restaurant?

“What is a restaurant?” may seem like an easy question to answer, but perhaps it is not quite as easy as it seems. The terms restaurant and restaurant property are often used interchangeably by real estate professionals. They do have distinct meanings, though, and the differences between them are important to understand.

• Restaurant refers to a place where meals are served to the public, usually on a for-profit basis, encompassing real property (which may be owned or leased) as well as the business operation, equipment, and possibly trade fixtures.

• Restaurant property refers to the real property component of an enterprise that is a restaurant.

From a restaurateur’s viewpoint, the real property is the place from which the business operates, as opposed to the real estate investment. The real property is simply necessary to conduct the business.

To help clarify the distinction between a restaurant and a restaurant property, suppose a client told a valuation professional, “I need an appraisal of Jane’s Delicatessen.” Defining the scope of work and other assignment parameters is critical, and often a function of the intended use of the assignment. Would the request be for an appraisal of the restaurant enterprise known as Jane’s Delicatessen? If so, the appraisal sought would be of a going concern. A going concern is an established and operating business, encompassing all its tangible and intangible assets. The appraisal

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2. “In real property valuation, the business entity is referred to as a going concern, which can include real property, tangible personal property (such as furniture, fixtures, and equipment), and intangible assets (such as franchise agreements, other business contracts, and business goodwill).” The Appraisal of Real Estate, 15th ed. (Chicago: Appraisal Institute, 2020), 663.
of a restaurant as a going concern includes real property, personal property, and any intangibles such as business value.

Or would the request be for an appraisal of the restaurant property that houses the enterprise known as Jane’s Delicatessen? If so, the valuation sought would be a real property appraisal, which would reflect all rights, interests, and benefits related to the ownership of real estate but exclude personal property and any intangibles such as business value.

Which would be appropriate? To answer that question, we would need to know more about the client’s needs, which identify the intended use of the appraisal.

Like most commercial real estate, restaurant properties are generally owned by either operators or investors (landlords). For properties subject to long-term leases with credit tenants, landlords are often large real estate investors with a national focus. Local investors are more commonly the landlords for “mom and pop” restaurants with shorter lease terms. Many restaurant landlords are former restaurant operators who sold their businesses and lease the properties back to the parties who purchased them. The following discusses the highest and best use analysis for restaurant properties.

Restaurant Property

Highest and Best Use

General Highest and Best Use Concepts

Highest and best use is the reasonably probable use of property that results in the highest value. The four criteria that the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity. We’ll proceed assuming that you are already familiar with the basic principles of highest and best use, and only touch on the general concepts lightly. From there, we will go into greater depth as we focus on applying these concepts to restaurant properties.

A thorough treatment of highest and best use issues provides a firm foundation for the appraiser’s analysis and helps the appraiser identify the most likely purchaser for the property being appraised.

The Stages in the Life of a Restaurant Property

Many restaurant properties begin their economic life designed for financially strong tenants who will pay rent sufficient to justify their specific requirements. These properties eventually transition through their life cycles until they are suitable only for conversion to an alternative use or redevelopment. To better understand this gradual transition, it is helpful to view the life of a typical restaurant property as having four distinct stages (see Exhibit 1). Next, we will take a closer look at each stage in this cycle.

Exhibit 1 Restaurant Property Life Cycle

3. Identification of the intended use, intended user, and relevant characteristics of the property being appraised are part of Step 1 of the appraisal process. For a more thorough treatment of these topics, refer to The Appraisal of Real Estate, 15th ed., 31.


Life Cycle Stage 1
Restaurant properties in Stage 1 of the life cycle are typically new (or first generation) and functional, with their entire (economic) life ahead of them. These properties are most commonly designed for a national operator and are often leased. However, properties that have been newly constructed by an independent restaurateur would also be classified as being in Stage 1, as would those newly constructed restaurant properties that are owner-operated (by either a chain or an independent restaurateur).

A common scenario for a restaurant property in Stage 1 of its life cycle would include the following characteristics:

<table>
<thead>
<tr>
<th>Life Cycle Stage 1 Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy</td>
</tr>
<tr>
<td>Remaining lease term</td>
</tr>
<tr>
<td>Design and appearance</td>
</tr>
<tr>
<td>Typical buyer profile</td>
</tr>
<tr>
<td>Likely capitalization rate</td>
</tr>
<tr>
<td>Preferred valuation technique</td>
</tr>
</tbody>
</table>

Life Cycle Stage 2
Restaurant properties designed for national operators are best described as having transitioned into Stage 2 after a significant amount of the initial lease term has elapsed (with a remaining term of, say, five years or less). While a limited remaining lease term is often a defining trait of a Stage 2 property, owner-operated properties beginning to show their physical age would also be described as being in Stage 2.

A common scenario for a restaurant property in Stage 2 of its life cycle would include the following characteristics:

<table>
<thead>
<tr>
<th>Life Cycle Stage 2 Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy</td>
</tr>
<tr>
<td>Remaining lease term</td>
</tr>
<tr>
<td>Design and appearance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Buyer profile</td>
</tr>
<tr>
<td>Likely capitalization rate</td>
</tr>
<tr>
<td>Preferred valuation technique</td>
</tr>
</tbody>
</table>

Life Cycle Stage 3
Restaurant properties that are no longer sought by a national operator or well-capitalized independent operator are often best categorized as being in Stage 3 of their life cycle. These types of properties often inhabit second-generation space.

Characteristics common to restaurant properties in Stage 3 of their life cycle include:

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6. First-generation space is defined as “a building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time, during which the space retains its original utility and desirability.” The Dictionary of Real Estate Appraisal, 6th ed., s.v. “first-generation space.”

7. The most likely ownership interest being appraised for a property meeting these criteria is leased fee. The capitalization rate, typical buyer profile, etc., would likely be different if the fee simple interest were to be appraised.

8. Second-generation space is defined as “a building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant. Also called relet space.” The Dictionary of Real Estate Appraisal, 6th ed., s.v. “second-generation space.”
Life Cycle Stage 3 Characteristics

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Occupancy</strong></td>
<td>Local operator</td>
</tr>
<tr>
<td><strong>Remaining lease term</strong></td>
<td>Short remaining lease term or owner-operator</td>
</tr>
<tr>
<td><strong>Design and appearance</strong></td>
<td>• Typically dated</td>
</tr>
<tr>
<td></td>
<td>• Often retains characteristics</td>
</tr>
<tr>
<td></td>
<td>• Reminiscent of its original occupant</td>
</tr>
<tr>
<td><strong>Buyer profile</strong></td>
<td>• Owner-operator</td>
</tr>
<tr>
<td></td>
<td>• Possible interest from local investors, but limited by the uncertainty of the income stream</td>
</tr>
<tr>
<td><strong>Likely capitalization rate</strong></td>
<td>High, if applicable</td>
</tr>
<tr>
<td><strong>Preferred valuation technique</strong></td>
<td>Sales comparison approach</td>
</tr>
</tbody>
</table>

An example of a restaurant property in Stage 3 of its life cycle would be a property operated as a Pizza Hut for many years that is now known as JG Chicken & Seafood, the self-proclaimed home of “off the hook fried food.”

**Life Cycle Stage 4**

Stage 4 restaurant properties are those that are no longer suitable for use as a restaurant, with their highest and best use having transitioned to redevelopment of the site or significant rehabilitation (and often conversion to an alternative use). In this scenario, the most likely buyer may well not be a restaurant operator or landlord. The improvements are likely razed, and the site is ready for redevelopment.

It can be hard to determine if the highest net present value for an older property is repurposing or redevelopment without actually exposing it to the market to see what interest it draws. Therefore, highest and best use is often quite complicated as a restaurant property nears the end of its economic life. Furthermore, vacant or failing restaurants are not always well-suited for alternative uses. While there are many examples of restaurant buildings being converted to general retail space or even offices, these properties rarely generate rent levels anywhere close to what is needed to justify the replacement cost. Not surprisingly, these repurposing projects are often just interim uses until redevelopment occurs.

**Life Cycle Stage Considerations**

Some of the factors affecting which stage of its life cycle a restaurant property is in are its physical characteristics, the remaining lease term, and the sales generated by the business.

**Physical Characteristics**

As we’ve discussed, restaurant properties rarely age well unless they are fed a diet of capital improvements. Restaurant real estate expert Fred Campbell shares that not only is constant upkeep required, but a “fresh look” is typically needed every three to five years. Campbell adds that for a nice restaurant, a substantial reserve fund should be established, similar to what is done for hotels (with approximately 3%–5% of revenue being typical). Real estate expert D. Scott McLain expressed the opinion that a restaurant building operated by a corporate/national operator needs a “significant re-fit every 10 or 15 years.” Accordingly, it is not unusual for a restaurant property to slip into the next stage of its life cycle about five years or so after its last minor remodeling, with significant risk approximately 10 to 15 years after its last major remodeling.

**Remaining Lease Term**

The remaining lease term is correctly thought to influence what capitalization rate can be achieved, but it can also affect the profile of the most likely buyer. In fact, many institutional-grade buyers purchase only leased property with credit tenants, either by law or policy. Such buyers will not even consider a property with no lease, and many will not consider property with a remaining term of less than five years (unless it is a part of a portfolio purchase). Consequently, the remaining term can be a decisive factor in evaluating the life cycle stage and other marketability factors for leased properties.

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9. McLain added that many corporate users “find it easier and cheaper to redevelop than retrofit” to meet their exact kitchen specifications and other current standards. He also added that local restaurateurs often operate from the same building for 40 years, and that those restaurants look like they’ve operated out of the same building for 40 years.
The best measure of investors’ enthusiasm for a given property type is usually the yield (or capitalization rate) they require. In Exhibit 2, note the clear correlation between the remaining lease term and the capitalization rate.

The impact of remaining lease terms on capitalization rates may be even more pronounced than is apparent in Exhibit 2, since the “Under 10” category is somewhat broad. For example, there is a big difference between a remaining lease term of nine years versus, say, three years. Investor surveys rarely capture rates that are applicable to properties with leases that are nearing expiration, since such properties are rarely of interest to investors. This in itself speaks volumes about how much further into their economic lives properties with short remaining leases are in comparison to their economic lives when their leases began. Not surprisingly, the authors’ experience suggests that the increase in the applicable capitalization rate is far more pronounced when the remaining lease term falls to just a few years.

**Exhibit 2** Median Asking Capitalization Rate by Lease Term Remaining

<table>
<thead>
<tr>
<th>Lease Term Remaining (Years)</th>
<th>Capitalization Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>20+</td>
<td>5.35%</td>
</tr>
<tr>
<td>15–19</td>
<td>5.50%</td>
</tr>
<tr>
<td>10–14</td>
<td>5.85%</td>
</tr>
<tr>
<td>Under 10</td>
<td>6.45%</td>
</tr>
</tbody>
</table>

Source: The Boulder Group, 2nd Quarter 2020 Net Lease QSR Market Report

As we have seen and will continue to explore further, the remaining lease term can affect the capitalization rate that can be achieved and the profile of the most likely buyer. When the end of a lease is in sight, there is often significant risk that a period of vacancy may be near. How do investors assess the likelihood of an interruption of the income stream? One meaningful indicator of a restaurant operation’s prospect for continued viability is to analyze the sales per square foot being achieved.

**Restaurant Revenue**

The amount of rent a tenant can pay and the value to an owner-operator ultimately depend on the revenue that can be achieved at that location. Consequently, few things speak louder to a landlord, buyer, or appraiser about the viability of a restaurant than the sales being achieved. This information may or may not be obtainable. Many tenants are required to report sales to the landlord, and this data sometimes factors into the amount of rent they must pay.

So, how much does a restaurant need to gross to stay in business? A full-service restaurant would typically need to generate at least $150 of annual sales per square foot to meet expenses. At sales of $150 to $250 per square foot, full-service restaurants can usually achieve a small profit, if costs are kept in line. At sales of $250 to $325 per square foot, a full-service restaurant can usually expect to see moderate profits of 5% to 10% of total sales before income taxes. A large profit typically becomes attainable at a full-service restaurant when sales surpass $350 per square foot.

Limited-service/casual-dining restaurants typically have lower menu prices and therefore need to achieve higher gross sales to meet expenses. A limited-service restaurant that achieves less than $200 of sales per square foot is unlikely to be sustainable. At sales of $200 to $300 per square foot, a limited-service restaurant where expenses are adequately managed can typically achieve a small profit. At sales of $300 to $400 per square foot, a limited-service restaurant can usually expect to

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10. As a practical matter, many savvy landlords will renegotiate or extend a lease with a short remaining term when possible prior to marketing a property for sale.

11. Beware: In some situations, sales volume tells more about the operator than the real estate.

12. The revenue figures presented are for illustration purposes and are generalizations that commonly apply as of the date of this writing. Updated, market-specific figures would be needed to develop a credible appraisal.

see moderate profits (5% to 10% of sales, before income taxes). A large profit often becomes achievable for a limited-service restaurant when sales are in excess of $400 per square foot.14

To see how well industry norms relate to whether a specific restaurant tenant can afford to honor or renew their lease, we must also look at occupancy cost. For example, if sales at a given property are low by industry standards, that does not necessarily mean that the operation cannot support a correspondingly low rental rate. Conversely, some rent levels would be too high even for a property achieving a high sales volume. An industry rule of thumb is that rent should generally equate to no more than 6% of total sales, with total occupancy cost being no more than 10% of total sales.15 Of course, rules of thumb are generalities (at best) and often change over time. Moreover, the relevance of this particular rule of thumb is heavily influenced by the food and labor costs associated with the type of restaurant being operated. For example, $1 in pasta sales is likely to yield a far better margin than $1 in wine sales (since the cost of goods sold at restaurants can vary greatly as a percentage of the price that can be charged, such as the notoriously low cost to create many expensive pasta dishes versus the higher cost of wine).

Strengths and Weaknesses
The restaurant business presents both opportunities and risks. Reviewing a property’s relative strengths and weaknesses, in addition to where the property lies within the previously discussed life cycle continuum, is usually a good way to begin assessing those opportunities and risks. As an example, Exhibit 3 lists the positive and negative influences on a hypothetical property appraised during the COVID-19 pandemic. Recognizing which stage of the life cycle a property is in as well as its strengths and weaknesses can be enormously helpful when comparing the subject property to comparables.

Bridging the Gap: Most Likely Buyer
It would be hard to support an opinion of what someone would pay for a given property if we did not have a sense of what that “someone” was like, or why he or she might want the property. Consequently, identifying the profile of the most likely buyer is the bridge that connects the highest and best use opinion with the selection of comparables in the valuation.

Buyers New to Restaurants and Strategic Buyers
Business enterprise appraiser Mary O’Connor describes two categories of restaurant buyers: those from outside the restaurant business looking to enter the industry, and those from within the industry looking to apply their skills or capital in a new venture. O’Connor explains that the first group of buyers are people who “for whatever reason… want to own a restaurant,” and these buyers typically offer “only money.” The second group, which O’Connor describes as “strategic buyers,” are operators with strong restaurant backgrounds who usually have excellent supplier relationships, outstanding menus, and so on.

It is important to understand which buyers are in which category because they will pay different amounts, according to O’Connor. Strategic buyers, who can use their expertise to enhance the enterprise “can, and may, pay more—especially if the location fits the demographic they seek.” On the other hand, buyers with no restaurant expertise who offer only money are more limited in what they can pay to achieve a good outcome. However, the risk that the enterprise will not be successful is far less with the strategic buyer, since expertise in this challenging industry can increase the probability of success immensely.

Other Types of Restaurant Buyers
The buyers O’Connor describes account for many restaurant property purchases. In addition, some purchases are made by large restaurant companies and by investors seeking an income stream without ever being involved in a restaurant’s operation. It is not unusual for large portfolios of restaurant properties with financially strong tenants to be sold in bulk to institutional buyers who then hire property managers (and sometimes asset managers) to handle most of the responsibilities typically borne by the landlord.

Next, we’ll take another look at restaurant properties at various stages in the life cycle and, this time, identify which type of buyers they might appeal to.

15. Source: Bloom Intelligence.
## Exhibit 3  Positive and Negative Influences on a Restaurant Property

<table>
<thead>
<tr>
<th>Topic</th>
<th>Positive Influences (Strengths)</th>
<th>Negative Influences (Weaknesses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restaurant property type</td>
<td>Restaurant properties have a long, documented history of being in high demand.</td>
<td>• The restaurant business is challenging, and failure and turnover rates are high.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Restaurant properties often have short economic lives, which is particularly true of those with the highest land values.</td>
</tr>
<tr>
<td>National/local economy</td>
<td>• The strength of the national economy prior to the COVID-19 pandemic could result in a quicker and stronger recovery.</td>
<td>• The impact of the COVID-19 pandemic has led to a global recession; the US economy contracted at an annualized rate of 31.4% in the 2nd quarter of 2020—the sharpest contraction in at least 73 years.</td>
</tr>
<tr>
<td></td>
<td>• The local unemployment rate is well below state and national averages.</td>
<td>• Industry reports tracking the indices of the investment-grade segment and the general commercial segment of the market show that commercial real estate prices remain below pre-pandemic levels.</td>
</tr>
<tr>
<td>Local restaurant demand indications</td>
<td>• High sales volume documents the viability of this location for restaurant use.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The owner’s plan to renovate and expand the property is presumably a reflection of the profitability of the business, which further reflects restaurant demand at this location.</td>
<td></td>
</tr>
<tr>
<td>Subject site/location</td>
<td>• The site has a corner location with extensive frontage.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The volume of traffic passing the subject is favorable.</td>
<td></td>
</tr>
<tr>
<td>Subject improvements</td>
<td>The patio is attractive and offers additional seating for approximately half the year.</td>
<td>• Restaurant improvements have a specialized design and do not typically lend themselves well to an alternative use.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The improvements have a dated appearance and design, and most buyers or tenants would anticipate remodeling costs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Parking is less than ideal to accommodate peak periods.</td>
</tr>
</tbody>
</table>
Life Cycle Stages and Most Likely Buyer Profiles

Life Cycle Stage 1
Restaurant properties in Stage 1 of the life cycle are often new or recently constructed. They are commonly designed for national operators, although some independent restaurateurs also build their own facilities. If the properties are leased, there would usually be a significant remaining term. If they are owner-operated, they would likely also have significant appeal to other owner-operators. However, it is unlikely that they would appeal to other owner-operators as much as they appeal to the property’s original occupant/designer.

Life Cycle Stage 2
Restaurant properties in Stage 2 of the life cycle are often properties that had been in Stage 1 until a significant amount of the initial lease term elapsed. Some Stage 2 restaurant properties are owner-operated; these are typically properties that had been constructed on a build-to-suit basis and a significant portion of their economic lives has since passed. For properties affiliated with a chain, image-compliance issues would often be a concern at this point.

Life Cycle Stage 3
Restaurant properties in Stage 3 of the life cycle are generally older, exhibit at least some obsolescence, and are no longer attractive to a national operator. They are typically owner operated or leased to local (“mom and pop”) restaurant tenants. It is also not unusual for such properties to be vacant.

Life Cycle Stage 4
Stage 4 restaurant properties are those no longer suitable for restaurant use without significant renovation, if at all. Instead, their highest and best use has transitioned to significant rehabilitation, often in conjunction with conversion to an alternative use, or redevelopment of the site.

Restaurant Property Buyer Profile Matrix
Let’s summarize what we have learned up to this point as it relates to what type of buyer is most likely to seek each type of restaurant property. A restaurant property buyer profile matrix is shown in Exhibit 4. This matrix incorporates scope of work considerations.

We previously defined the profile of the most likely buyer as the bridge that connects the highest and best use opinion with the selection of comparables. With the observations summarized in Exhibit 4, identifying what type of comparables are appropriate should be relatively simple once the life cycle stage and valuation premise have been established for the property being appraised.

Highest and Best Use Case Study

The following case study illustrates the highest and best use concepts discussed in this article.

The property: A local restaurateur operated a pub in a suburb of a major city. A large variety of gourmet beers were offered, along with a limited selection of food. Catering was also available.

The location: The property was in a pedestrian-friendly area that had become somewhat of a fashionable district for high-income diners. This was largely the result of an eclectic mix of popular restaurants that had opened in recent years and drew big crowds.

The improvements: The building contained 3,200 square feet, nearly half of which was a second-floor office. The floor plan for the main level was designed for restaurant use, although the kitchen was somewhat small. The first floor had been recently renovated, and most of the customer areas were in good overall condition. The mechanical systems, however, were fairly old. There was limited furniture, fixtures, and equipment (FF&E), which was also old.

The business: The business met its expenses but did not thrive the way most of the nearby restaurants did. The operator was new to the restaurant industry and never achieved the sales goals upon which his initial investment was based.

The disposition: Tired of struggling, the owner listed the property for sale. An offer of $1,400,000 was received and accepted shortly thereafter. The purchase price included the real estate, FF&E, and the business, but the real property accounted for almost all of it. The contributory value of the FF&E was minimal, and there was no discernable business value.

The buyer: The buyer was a small local restaurant group that had established an impressive record of
### Exhibit 4  Restaurant Property Buyer Profile Matrix

<table>
<thead>
<tr>
<th>Stage/Occupancy</th>
<th>Interest Appraised/Valuation Premise</th>
<th>Appeal to Investors</th>
<th>Appeal to Owner-Operators</th>
<th>Primary Valuation Technique</th>
<th>Comment(s)</th>
</tr>
</thead>
</table>
| Stage 1/tenant-operated  | Leased fee/real property only         | High                | Low                       | Direct capitalization                                            | • Often a build-to-suit, with cost justified by rent  
|                         |                                      |                     |                           |                                                                  | • Lease term is usually long  
|                         |                                      |                     |                           |                                                                  | • Tenant quality is also key, and a financially strong tenant is not unusual  
|                         |                                      |                     |                           |                                                                  | • Particular appeal to 1031 exchange buyers  
|                         |                                      |                     |                           |                                                                  | • Institutional investors often interested in large portfolios of these properties  
|                         |                                      |                     |                           |                                                                  | • Value can be more than cost  
| Stage 1/owner-operated   | Fee simple/real property only, going concern, or real property only as a component of a going concern | Low                  | High                      | Sales comparison approach (or parsing income method* or ratio of gross revenue for a business appraisal) | • Often a build-to-suit, somewhat reflective of the owner’s personal preferences  
|                         |                                      |                     |                           |                                                                  | • Appeal to owner-operators is high, although they often opt for new construction of their own design  
|                         |                                      |                     |                           |                                                                  | • Value sometimes less than cost  
| Stage 1/vacant           | Fee simple/real property only         | Low                  | High                      | Sales comparison approach                                       | • Often a distress situation  
|                         |                                      |                     |                           |                                                                  | • Appeal to owner-operators is high, although they often opt for new construction of their own design  
|                         |                                      |                     |                           |                                                                  | • Value is often less than cost (may be far less than cost)  
| Stage 2/tenant-operated  | Leased fee/real property only         | Moderate            | Low                       | Discounted cash flow (DCF) analysis or direct capitalization (with an adjustment to reflect risk at the end of the base lease term) | • Remaining lease term is a detriment to marketability  
|                         |                                      |                     |                           |                                                                  | • Unlikely to appeal to institutional investors unless bundled as part of a portfolio  
|                         |                                      |                     |                           |                                                                  | • Value likely to be far less than replacement cost  
|                         |                                      |                     |                           |                                                                  | • Sales volume achieved by tenant could be a major enhancement to or detraction from marketability  
|                         |                                      |                     |                           |                                                                  | • Image-compliance issues could be a concern if part of a chain  
| Stage 2/owner-operated   | Fee simple/real property only, going concern, or real property only as a component of a going concern | Low                  | Moderate/high             | Sales comparison approach (or parsing income method or ratio of gross revenue for a business appraisal) | • Value likely to be less than replacement cost, unless a successful business is part of the valuation  
|                         |                                      |                     |                           |                                                                  | • Sales volume achieved could be significant to value  
|                         |                                      |                     |                           |                                                                  | • Image-compliance issues could be a concern if part of a chain  

CONTINUED >
### Exhibit 4 Restaurant Property Buyer Profile Matrix (continued)

<table>
<thead>
<tr>
<th>Stage/Occupancy</th>
<th>Interest Appraised/Valuation Premise</th>
<th>Appeal to Investors</th>
<th>Appeal to Owner-Operators</th>
<th>Primary Valuation Technique</th>
<th>Comment(s)</th>
</tr>
</thead>
</table>
| Stage 2/ vacant  | Fee simple/real property only        | Low                 | Moderate                  | Sales comparison approach   | • Often a distress situation  
• Value often far less than replacement cost |
| Stage 3/tenant-operated | Leased fee/real property only | Modest               | Low                       | DCF, or direct capitalization (with an adjustment to reflect risk at the end of the base lease term) | • Lease usually has a short remaining term and/or a local tenant  
• Buyer is usually a local investor  
• Value often just a fraction of replacement cost |
| Stage 3/owner-operated | Fee simple/real property only, going concern, or real property only as a component of a going concern | Low                 | Modest                    | Sales comparison approach (or parsing income method or ratio of gross revenue for a business appraisal) | • Value likely to be far less than replacement cost, unless a very successful business is part of the valuation  
• Sales volume achieved could be significant to value |
| Stage 3/ vacant  | Fee simple/real property only        | Low                 | Modest                    | Sales comparison approach   | • Often a distress situation  
• Value sometimes just a fraction of replacement cost  
• Highest and best use determination can be complex |
| Stage 4/ vacant  | Fee simple/real property only        | Low                 | Modest                    | Sales comparison approach   | • Buyer may not intend restaurant use  
• Buyer could be a restaurant operator planning substantial renovation and therefore views the property as being somewhat competitive with a vacant development site  
• Value is sometimes similar to land value (and can actually be less, if demolition cost should be deducted)  
• Highest and best use determination can be complex |

*The parsing income method is an adaptation from the business valuation method called the excess earnings method and is explained further in Chapter 9 of A Guide to Appraising Restaurants (Chicago: Appraisal Institute, 2021).*
turning around struggling businesses. They were attracted to the property because of its location in a market they had sought to enter for some time.\textsuperscript{16}

**The vision:** Prior to making their purchase offer, the buyers developed a strategy to increase revenue and profits. They began this process by identifying what was wrong with the property, summarized as follows:

- There were limitations with the existing kitchen, which was small and had a choppy layout. The ventilation hood was too small, as it was apparently designed primarily for catering. Consequently, the kitchen would not accommodate a “full” menu without some modifications. The catering business never got much traction, so as a practical matter the kitchen was mostly used for appetizers.
- The amount of office space was far in excess of what was needed.
- The bar was too far from the kitchen.
- Few design changes could be accomplished without modifications to the sprinkler system, which meant upgrades and updates to the property's plumbing.

**The renovation:** The new owners designed and executed the following renovation plan:

- The kitchen was upgraded to allow for a “full” menu.
  - A new ventilation hood and related equipment were installed.
  - Additional sprinkler lines and heads were installed.
- A partial demolition of the second floor resulted in a first level with a much larger, more open feel. The remaining second floor area was used for additional seating and special events.
- The bar area was relocated to be near the kitchen for improved flow.
- Customer restrooms were refurbished.
- HVAC systems were upgraded as needed.

**The cost:** The cost was budgeted at $155,250, summarized as follows:

- Partial demolition of second floor: $30,000
- Engineering and design, permits, interest, and bank fees: $21,750
- Iron work, sheetrock, framing, vanities and countertops, paint, cabinetry, and case work: $21,230
- Entrepreneurial incentive (15% of cost): $20,250
- New ventilation hood and related equipment to be “bolted” to the floor: $19,000
- Plumbing, electric, and fire protection: $13,000
- Rental, cleanup, general contractor fees, and insurance: $11,700
- Mechanical and HVAC: $11,400
- Masonry and concrete: $2,500
- Miscellaneous: $1,550
- Contingency: $2,870

**The value:** An appraisal performed when the property was purchased confirmed that the $1,400,000 purchase price was reasonable at that time. An appraisal done after construction indicated a post-renovation value of $1,550,000. Both appraisals reflected real property only.

**Return on investment:** The contributory value of the proposed construction is the difference between the value of the property prior to construction and after, or $150,000 ($1,550,000 – $1,400,000). By comparison, the investment required to achieve this $150,000 increase in value was $155,250, which included entrepreneurial incentive of $20,250 (or 15% of cost). The capital investment (without entrepreneurial profit) totaled $135,000.

The profit/loss of this venture can be measured in a number of ways:

<table>
<thead>
<tr>
<th>Profit from construction</th>
<th>$15,000</th>
<th>($150,000 – $135,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on investment</td>
<td>11%</td>
<td>($15,000 ÷ $135,000)</td>
</tr>
<tr>
<td>Recapture of investment</td>
<td>$1.11 per dollar of capital investment was recovered ($150,000 ÷ $135,000)</td>
<td></td>
</tr>
</tbody>
</table>

From a real estate investment perspective, the profit was somewhat modest and the opportunity for a $15,000 gain may not have interested many real estate investors. However,

\textsuperscript{16} This purchaser is an excellent example of what could be described as a “strategic buyer.”
many owner-operated properties are renovated without the incentive of any real estate profit at all and are often done at a loss (therefore not meeting the financial feasibility test of highest and best use). The motivation for the new owners was to reposition the property in such a way so that they could pursue greater business profits, which would be a result of the functional enhancements made.

**Conclusion**

The highest and best use analysis for restaurant properties requires more depth than is needed for many other types of properties, as restaurant properties can transition through their life cycles quickly. As with most retail properties, a restaurant can reach the end of its economic life suddenly with the construction of an overpass that redirects traffic, the closing of a local demand generator, or some similar event. Other challenges facing restaurant properties include turbulence within the businesses they house. Restaurants often operate at low margins and must contend with a perpetual influx of new competitors.

**Key Takeaways**

The following is a summary of the key points we covered in this article:

- Thorough treatment of highest and best use issues creates a firm foundation for the valuation analysis.
- Listing the strengths, weaknesses, threats, and opportunities of a property can be enormously helpful for assessing which stage of its life cycle it is in and for analyzing comparables. It can also provide useful information to the reader of the appraisal report.
- Many restaurant properties begin their economic life designed for financially strong tenants who will pay sufficient rent for a property that meets their specific requirements. Restaurant properties transition through several life cycle stages and eventually become suitable only for conversion to an alternative use or redevelopment. This gradual transition has four distinct stages.
- It is not unusual for a restaurant property to slip into the next stage of its life cycle about five years after its last minor remodeling and to be significantly at risk approximately 10 to 15 years after its last major remodeling.
- Corporate users often find it easier and cheaper to redevelop a site than to retrofit an existing restaurant building that no longer meets their current standards.
- Defining the profile of the most likely buyer is the bridge that connects the highest and best use opinion with the selection of comparables.
- The remaining lease term influences the profile of the most likely buyer.
- The sales per square foot being achieved at the business is particularly helpful in determining the highest and best use of a property with a lease that is approaching expiration.
About the Authors

Bradley R. Carter, MAI, CRE, CCIM, CDEI, has background in both the restaurant industry and valuation profession. Prior to beginning an appraisal career, Carter served as a corporate area supervisor for the Domino's Pizza Corporation, where he helped pioneer the company's efforts to enter the competitive Long Island, NY, market. He later owned and operated his own restaurant. As an appraiser, his experience with special-purpose retail properties includes having authored the Appraisal Institute book A Guide to Appraising Automobile Dealerships, winner of the 2016 George L. Schmutz Award, along with A Guide to Appraising Automobile Dealerships, second edition. He is also developer and instructor of the Appraisal Institute’s Appraising Automobile Dealerships seminar. Carter has authored several studies and articles that have appeared in The Appraisal Journal as well as journals published by The Counselors of Real Estate, the CCIM Institute, and numerous industry magazines, including Pizza Today. He has significant court testimonial experience and has been interviewed by The Wall Street Journal as a real property valuation expert. Carter has appraised property in 48 states and served six years as an Appraisal Institute demonstration appraisal report grader. He currently serves as a managing director for Specialty Valuation Group. Contact: bcarter@specialtyvaluation.com

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute
   Lum Library, External Resources, Resource Links [Login required]
   Knowledge Base Bibliographies—Restaurants

National Restaurant Association—Resource Library
   https://restaurant.org/education-and-resources/

Research and Markets.com—Restaurants, Bars and Cafés
   https://www.researchandmarkets.com/categories/restaurants-bars-cafés

Restaurant Business—Consumer Trends
   https://www.restaurantbusinessonline.com/consumer-trends

Restaurant Data.com—Products and Services
   https://www.restaurantdata.com/product-services/