Restaurant Rules of Thumb: How Does Your Operation Measure Up to Industry Averages & Standards?

by Jim Laube

The first and most fundamental restaurant rule of thumb is "every independent restaurant is unique." However, rules of thumb regarding the financial and operational aspects of restaurants can provide a valuable starting point for evaluating and understanding the financial feasibility and performance of proposed and existing restaurants.

Restaurants generate a lot of numbers so particularly for those new to the industry, deciding what numbers to focus on first and knowing what they mean can be more than a little perplexing. Rules of thumb can help operators determine where to look first and what to expect.

This article discusses several of the restaurant industry's basic rules of thumb. While there will always be exceptions, they have proven to be surprisingly reliable over the years that I have worked with operators who collectively manage thousands of diverse restaurant operations. Keep these numbers handy when planning your restaurant and assessing your performance after you open.

Investment Rules of Thumb

One of the primary indicators chain operators use for evaluating the feasibility of a new location is the sales-to-investment ratio. This ratio compares the projected annual sales of a proposed site with its estimated startup cost. The ratio looks like this:

Sales to Investment = Annual Sales /Startup Cost

Startup cost includes all the costs necessary to open the restaurant including leasehold improvements (or land and building), furniture and equipment, deposits, architectural and design, accounting and legal, preopening expenses, contingency and working capital reserve.

Sales to investment - leasehold. When evaluating the feasibility of a proposed restaurant in a leased space, a rule of thumb says that the sales-to-investment ratio should be at least 1.5 to 1, or a minimum of $1.50 in sales should be expected for every $1 of startup costs. This means that if the cost of opening a restaurant in a leasehold situation was estimated to be $500,000, the location should be given further consideration only if the annual sales volume of at least $750,000 could be a realistic expectation.

Sales to investment - own land and building. The rule of thumb for restaurant projects in which the operator owns the land and building calls for a sales-to-investment ratio of at least 1 to 1, or $1 in sales for every dollar of startup costs.

While there are many other considerations in deciding whether to open in a particular location, this is one ratio that many operators use as an early indicator of whether to move on to other factors in the go/no go decision process.

Profitability Rules of Thumb

Sales per square foot. While not all high-volume restaurants make lots of money, they do have the greatest opportunity to generate a sizable amount of profit. Sales volume is the most reliable indicator of a restaurant's potential for profit and a useful way to look at sales volume when evaluating profit potential is through the ratio of sales per square foot.

It's easy to calculate a restaurant's sales per square foot. Just take annual sales and divide by the total interior square footage including kitchen, dining, storage, restrooms, etc. This is usually equal to the net rentable square feet in a leased space. The ratio looks like this:

Sales Per Square Foot = Annual Sales /Square Footage

In most cases, full-service restaurants that don't generate at least $150 of sales per square foot have very little chance of generating a profit. For example, a 4,000-square-foot restaurant with annual sales of anything less than $600,000 would find it very difficult to avoid losing money. This works out to $50,000 in monthly and $12,000 in weekly sales.

Limited-service restaurants that generate any less than $200 of sales per square foot have little chance of averting an operating loss. Industry averages reveal that limited-service restaurants tend to have slightly different unit economics than their full-service counterparts. Higher occupancy costs (on a per-square-foot basis) and lower check averages are two of the primary reasons for this difference.

At sales levels of $150 to $250 per square foot (full-service) and $200 to $300 (limited-service), restaurants with effective cost controls may begin to approach break-even, with some well-managed operations able to achieve a net income of up to 5 percent of sales.

At sales levels of $250 to $325 per square foot (full-service) and $300 to $400 (limited-service), restaurants may see moderate profits, which are defined as 5 percent to 10 percent net income (before income taxes) as a percentage of total sales.

High profit can be defined as sales levels more than $350 per square foot (full-service) and more than $400 (limited-service). Generating sales at these levels affords the opportunity for some operators to generate a net income (before income taxes) in excess of 10 percent of sales.

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There are many factors that influence a restaurant's profitability besides sales volume. Two of the biggest are prime cost and occupancy costs. Without competent management and effective systems and controls over food, beverage, labor and other operating expenses, no amount of sales will produce much more than mediocre operating results.

Likewise, occupancy costs, which are not controllable by restaurant management, will have a significant effect on profitability. The sales volume rules of thumb above assume an "industry average" occupancy cost from $15 to $22 per square foot. If your occupancy costs are higher than $22 per square foot, the sales numbers above will be low when using them to evaluate your restaurant's profitability.

Percentage of Cost Rules of Thumb

Food cost. Food cost as a percentage of food sales (costs/sales) is generally in the 28 percent to 32 percent range in many full-service and limited-service restaurants. Often, more upscale full-service concepts, particularly those that specialize in steaks and/or fresh seafood can have food cost of 38 percent, 40 percent and even higher. Conversely, I'm familiar with some gourmet pizza restaurants in upscale areas that are able to consistently achieve a food cost of 20 percent and sometimes even less.

Alcoholic beverage costs. Alcohol costs vary with the types of drinks served. Among the reasons that bar service is so desirable are both the relative profitability of alcohol and the ability to control costs, as long as servers are trained to pour accurately, and theft is not a significant problem. Below are typical costs in percentages:

- **Liquor** - 18 percent to 20 percent.
- **Bar consumables** - 4 percent to 5 percent as a percent of liquor sales (includes mixes, olives, cherries and other food products that are used exclusively at the bar).
- **Bottled beer** - 24 percent to 28 percent (assumes mainstream domestic beer, cost percent of specialty and imported bottled beer will generally be higher).
- **Draft beer** - 15 percent to 18 percent (assumes mainstream domestic beer, cost percent of specialty and imported draft beer will generally be higher).
- **Wine** - 35 percent to 45 percent (the cost percentages of wine can vary dramatically from restaurant to restaurant depending primarily on the type of wines served. Generally, the higher the price per bottle, the higher the cost percentage).

NOTE: *All percentages above are the ratio of each item's cost divided by its sales, not total sales or total beverage sales. For example, liquor cost percentages above are based on liquor costs divided by liquor sales. This applies to the nonalcoholic beverage costs discussed below as well.*

Nonalcoholic beverage costs. It is standard industry practice to record nonalcoholic beverage sales and costs in Food Sales and Food Cost accounts, respectively:

- **Soft drinks** (post-mix) - 10 percent to 15 percent (another rule of thumb for soft drinks is to expect post-mix soda to cost about a penny an ounce for the syrup and CO2).

- **Regular coffee** - 15 percent to 20 percent (assumes 8-ounce cup, some cream, sugar and about one free refill).

- **Specialty coffee** - 12 percent to 18 percent (assumes no free refills)

- **Iced tea** - 5 percent to 10 percent iced tea is the low food cost champ of all time. Cost of the tea can be less than a penny per glass. Biggest cost component in iced tea is usually the lemon slice.

Paper cost. In limited-service restaurants paper cost should be classified as a separate line item in "cost of sales." Historically, paper cost has run from 3 percent to 4 percent of sales. However, the recent run-up in the cost of many paper goods has increased the paper cost percentage to more than 4 percent of sales in many restaurants. In full-service restaurants, paper cost is usually considered to be a direct operating expense and normally runs from 1 percent to 2 percent of total sales.

Payroll and Salaries

Payroll cost as a percentage of sales includes the cost of both salaried and hourly employees plus employee benefits, which includes payroll taxes, group, life and disability insurance premiums, workers' compensation insurance premiums, education expenses, employee meals, parties, transportation and other such benefits. Total payroll cost should not exceed 30 percent to 35 percent of total sales for full-service operations, and 25 percent to 30 percent of sales for limited-service restaurants.

Generally, you don't want management salaries to exceed 10 percent of sales in either a full- or limited-service restaurant. This would consist of all salaried personnel including general manager, assistant manager(s), chef or kitchen manager.

One caveat on this would be in a situation in which a working owner fulfills the role of the general manager and/or chef and takes a salary in excess of 3 percent to 4 percent of sales. When this occurs, management salaries can easily exceed 10 percent of sales and total payroll cost can appear excessive as well.

To compensate for a highly paid working owner when comparing costs and margins that contain management salaries, subtract the amount of the owner's salary that exceeds 4 percent of sales. This will make comparisons to industry averages and rules of thumb much more meaningful and useful.

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Hourly Employee Gross Payroll

- **Full-service Restaurant - 18 percent to 20 percent**
- **Limited-service Restaurant - 15 percent to 18 percent**

Limited-service restaurants generally have lower hourly payroll cost percentages than full-service restaurants. In limited-service restaurants, managers often perform the work of an hourly position in addition to being a manager. In some cases, however, hourly workers may also perform management roles on some shifts, which could lead to higher hourly payroll costs in these restaurants.

Employee Benefits

- **5 percent to 6 percent of total sales**
- **20 percent to 23 percent of gross payroll**

Employee benefits can vary somewhat depending primarily on state unemployment tax rates and state workman's compensation insurance rates. California, for example, has had for the past several years very high workers' compensation premium rates as compared with rates in other states. Restaurants that are new or have had a large number of unemployment claims may have state unemployment tax rates that could cause their employee benefits to be higher than the rules of thumb above.

Prime Cost Rules of Thumb

Prime cost is one of the most telling numbers on any restaurant's profit-and-loss statement. Prime cost is arrived at by adding cost of sales and payroll costs as shown in the Prime Cost Calculation chart below:

PRIME COST		
Cost of Sales -		
Food	$ 15,000	
Liquor	1,500	
Beer	1,000	
Wine	1,200	18,700
Payroll Costs -		
Management	5,000	
Hourly Staff	12,000	
Taxes & Benefits *	3,400	20,400
Prime Cost		$ 39,100

Prime cost reflects those costs that are generally the most volatile and deserve the most attention from a control standpoint. It's very easy to lose money due to lax or nonexistent controls in the areas of food, beverage and payroll. Many successful restaurants calculate and evaluate their prime cost at the end of each week. (For more information, see "How to Make Your Profit & Loss Statement One of Your Most Important Management Tools.")

In the chart, if total sales were $60,000, then prime cost would be running $39,100 or 65 percent of sales.

Prime Cost

- **Full-service - 65 percent or less (total sales)**
- **Table-service - 60 percent or less (total sales)**

As prime cost exceeds the above levels it becomes increasingly difficult to achieve and maintain an adequate bottom-line profit in most restaurants. When looking at a restaurant's overall cost structure, prime cost can be very meaningful, particularly in cost of sales and payroll cost. Some restaurants, such as steak and seafood restaurants, may carry very high food cost and yet be extremely profitable. Again, this can be exhibited by looking at prime cost.

Some people might be surprised that some of the most profitable restaurants in our industry have a food cost in excess of 40 percent. I'm familiar with a seafood

restaurant outside of a major Midwest city that, according to reliable sources, consistently operates with a food cost of 45 percent or higher, which is not all that uncommon in restaurants specializing in high-quality steak and/ or seafood.

You might be thinking, though, how any restaurant could make money let alone be highly profitable when its food cost gets close to 50 percent of sales. Well this particular restaurant does more than $20 million in annual sales in about 20,000 square feet. This means that its sales are more than $1,000 per square foot, which is among the highest in the industry.

Even though their food cost is as high as say 45 percent, what do you think is their labor cost as a percentage of sales when they generate a sales level this high? I'm fairly certain it's much lower than the industry average, which is around 30 percent to 35 percent. In fact, their payroll, including management, hourly staff and taxes and benefits is probably around 15 percent to 18 percent of sales, but let's say it's 20 percent to be conservative.

Let's also assume that their sales mix is 85 percent food and 15 percent liquor, beer and wine. If their combined beverage cost is, say, 25 percent of beverage sales, here's an estimate of their prime cost percentage (see below):

Sales:	
Food	85%
Beverage	15%
Total Sales	100%
Cost of Sales:	
Food	45%
Beverage	25%
Total Cost of Sales	42%
Payroll Costs *	20%
Prime Cost %	62%

* Including management, hourly staff and payroll taxes and benefits.

If our assumptions about beverage and payroll costs are fairly accurate, you can see that its prime cost is well below the 65 percent threshold. This means that even with a very high food cost, this particular restaurant should be very profitable, assuming its remaining costs and expenses are in line with restaurant industry averages.

Some restaurants, like many ethnic concepts, have relatively low food costs, with some well under 30 percent of sales. You might think that these restaurants would be extremely profitable. They might be, but often these restaurants have lower check averages and are more labor intensive, so their payroll costs are much higher as a percentage of sales than, say, a steak or seafood restaurant.

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Looking at cost of sales and payroll costs together as prime cost usually provides a much more meaningful and valid indication of a restaurant's cost structure and potential for profit. restaurant. ”

Rent and Occupancy Cost Rules of Thumb

Rent (6 percent or less). Rent used here is the ongoing payments made by an operator to the lessor for the use of premises. Rent payments may be fixed or based on a percentage of sales. Generally, the goal is to limit rent expense to 6 percent of sales or less, exclusive of related costs such as common area maintenance (CAM) and other occupancy expenses.

Occupancy cost (10 percent or less). Occupancy cost includes rent, CAM, insurance on building and contents, real estate taxes, personal property taxes and other municipal taxes. Many operators want to keep occupancy cost at or below 8 percent of sales, however, 10 percent is generally viewed to be the point at which occupancy cost starts to become excessive and begins to seriously impair a restaurant's ability to generate an adequate profit.

Sales Value of Restaurant Business Rules of Thumb

Accurately determining the potential sales value in any restaurant requires the services of a professional business appraiser, preferably with experience appraising independent restaurants.

However, there are two rules of thumb that may be helpful to arrive at an initial, rough estimate of what your restaurant may be worth, assuming you operate in leased space:

Sales value of business (gross sales method) - 38 percent to 42 percent of gross sales. Sales value of business (cash flow method) - annual cash flow (basically net income before depreciation, debt service and owner compensation) times a multiple of three to four.

On this page, we show how to estimate business value, based on the cash flow method.

Business Value Estimation - Cash Flow Method	
Net Income - Annual	**$ 50,000**
Add back:	
Depreciation	15,000
Interest Expense	12,000
Owner's Salary & Other Compensation	75,000
Cash Flow - Annual	**152,000**
Multiple	3.5
Estimated Value of Business	**$ 532,000**

When determining the value of a restaurant in leased space, one of the most important determinants is the terms, particularly the transferability and the

amount of time, with options, remaining on the existing lease. Lease factors such as these and other terms can have a significant effect on the value of any business.

In restaurants where the operator owns the land and building, the inherent value of the business will be influenced significantly by the underlying value of the real estate. For this reason it is difficult to value the business in a meaningful way using rules of thumb.

Final Rule of Thumb: Not Every Rule of Thumb Fits Every Restaurant

Most restaurants will probably deviate from one or more of the rules of thumb discussed in this article. That's to be expected. Rules of thumb, as discussed above, are merely guidelines, not an ironclad collection of industry mandates from which no successful restaurant can deviate.

Where your numbers do stray from these norms, it may be useful to determine "why." Determining the reasons for any differences may prove to be an insightful process in learning more about the financial and operating nuances of your restaurant.

Another rule of thumb says that the more you understand how your restaurant works, the better the manager you will become. Using these rules of thumb could go a long way in helping to better understand your restaurant and provide insights for building a more successful business.

-- Restaurant Startup & Growth

At a Glance: Rules of Thumb

Sales to Investment (Annual Sales/Startup Cost)

- **Leasehold -** at least 1.5 to 1.
- **Own land and building -** at least 1 to 1.

Sales Per Square Foot

- **Losing Money** Full-service - $150 or less. Limited-service - $200 or less.
- **Break-even** Full-service - $150 to $250. Limited-service - $200 to $300.
- **Moderate Profit** Full-service - $250 to $350. Limited-service - $300 to $400.
- **High Profit** Full-service - More than $350. Limited-service - More than $400.

Food Cost

- **Generally -** 28% to 32% as a percentage of total food sales.

Alcoholic Beverage Costs

- **Liquor -** 18% to 20% as a percentage of liquor sales.
- **Bar consumables -** 4% to 5% as a percentage of liquor sales.
- **Bottled beer -** 24% to 28% as a percentage of bottled beer sales.
- **Draft beer -** 15% to 18% as a percentage of draft beer sales.
- **Wine -** 35% to 45% as a percentage of wine sales.

Nonalcoholic Beverages

- **Soft drinks (post-mix) -** 10% to 15% as a percentage of soft drink sales.
- **Regular coffee -** 15% to 20% as a percentage of regular coffee sales.
- **Specialty coffee -** 12% to 18% as a percentage of specialty coffee sales.
- **Iced tea -** 5% to 10% as a percentage of iced tea sales.

Paper Cost

- **Full-service -** 1% to 2% as a percentage of total sales.
- **Limited-service -** 3% to 4% as a percentage of total sales.

Payroll Cost

- **Full-service -** 30% to 35% as a percentage of total sales.
- **Limited-service -** 25% to 30% as a percentage of total sales.

Management Salaries

- 10% or less as a percentage of total sales.

Hourly Employee Gross Payroll

- **Full-service -** 18% to 20% as a percentage of total sales.
- **Limited-service -** 15% to 18% as a percentage of total sales.

Employee Benefits

- 5% to 6% as a percentage of total sales.
- 20% to 23% as a percentage of gross payroll.

Prime Cost

- **Full-service -** 65% or less as a percentage of total sales.
- **Table-service -** 60% or less as a percentage of total sales.

Occupancy and Rent

- **Rent -** 6% or less as a percentage of total sales.
- **Occupancy -** 10% or less as a percentage of total sales.