Appraisal of Franchises Requires the Use of Unique Valuation Procedures

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Appraisers operate on the presumption that however different the individual business is from all others, businesses within a specific industry nonetheless share certain characteristics that make it possible to compare one to another and thus derive a value.

Franchise operations, however, are a breed unto themselves, and this makes the valuation of these enterprises a unique process. The chief reason for this is the fact that the relationship between franchisors and franchisees is a business partnership in which each party owns and derives value from different forms of property. Typically, the franchisor owns and manages only the intellectual property involved in the relationship, such as goodwill, logos, brands, trademarks, advertising slogans, and business systems and processes (for example, recipes in the case of the fast food franchisor). The franchisor generally does not engage in the delivery of products or services to the consumer unless, of course, it operates company-owned stores or manufactures or sells products to its franchisees.

Through its relationship with the franchisor, the franchisee, on the other hand, possesses the right to use these assets in its business but usually owns only the tangible assets it needs to conduct business, including equipment, inventory, and supplies. The franchisor may own or lease real estate, leases, and equipment and subleases these items to the franchisee, or the franchisee may own or lease these items directly.

What Is a Franchise?

Whatever the details of the particular arrangement, the task for the appraiser is to discover the degree to which each asset contributes to the success of the operation as a whole—a job that is more easily said than done.

The process begins with an understanding of the franchise relationship as defined in state law. Under the laws of many states,[1] a franchise relationship exists when the following occurs:

- The franchisee offers, sells, or distributes goods or services under a marketing plan or system "prescribed in substantial part" by the franchisor. This means that the franchisor provides the franchisee with advice and training, retains significant control over the conduct of the franchisee's business, grants the franchisee exclusive rights to operate in a given territory, or requires the franchisee to purchase or sell a specified quantity of the franchisor's goods or services.
- The franchisee's business is "substantially associated" with the franchisor, meaning that the franchisee uses the franchisor's trademark and advertising slogans to identify its business.
- The franchisee pays a franchise fee to the franchisor to engage in business, plus royalties on sales and possibly payments for inventory, supplies, training, and assistance.[2]

As these terms suggest, the relationship between the franchisor and the franchisee is intimate and ongoing. But since each party owns different assets but puts them to use in a joint effort, it is often not readily apparent exactly how much each asset contributes to the value of any given enterprise. Indeed, given the differences in the assets owned by the parties in the enterprise, franchisors and franchisees in many ways engage in different businesses that create value when joined together.

Appraising the Franchisor's Value

Consider the franchisor first. As owners and managers of intellectual property, franchisors generally do not earn profits directly from the sale of the products or services bearing their names at all. Hence, the value of the franchisor's business operation derives mainly from the skill with which the franchisor manages its intellectual property and, importantly, the relationships with its franchisees.

This skill can create substantial value in franchise versus nonfranchise operations. For example, assume two restaurant companies selling the same fast food products and generating equal revenues and profits. The first is a franchisor owning no tangible assets (that is, no real estate, no equipment, no outlets, etc.), and the second is a chain operation owning all of its outlets. In a sale, the franchisor might command a multiple of six to eight times EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), and the nonfranchisor a multiple of only four to five times EBITDA. It should be noted, however, that skill in managing intellectual property is not the only factor in creating this difference (see sidebar on page 68).

Thus, given the importance of intellectual assets in a well-managed franchise operation, the process of valuing the business begins with an assessment of the premium commanded by the franchisor's brand over similar generic brand products, and it continues with a step-by-step calculation of the values associated with every other item in the franchisor's inventory of intellectual property.

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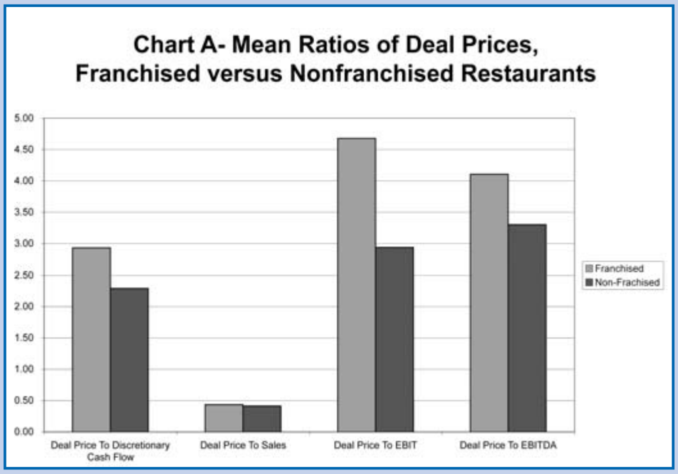
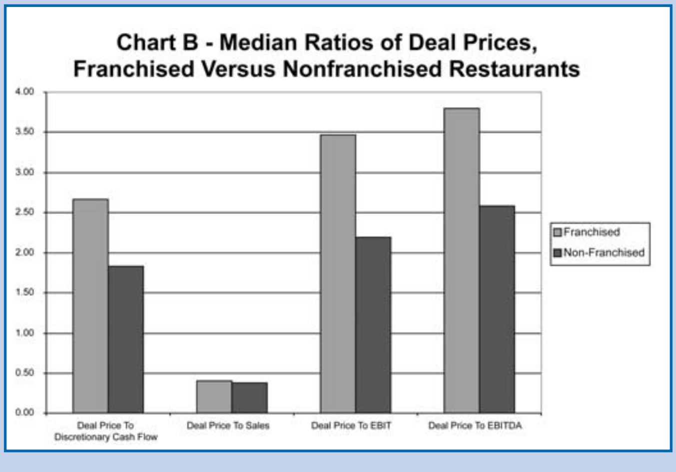
Why Are Franchises Worth More?

There is no doubt that, comparing apples to apples, a franchised business is likely to be more valuable than a nonfranchised business. But no one factor accounts for this truth, according to researchers at the University of New Hampshire.

"Franchising firms minimize agency problems and have access to cheaper capital, motivated managerial expertise, and better local market knowledge," according to E. Hachemi Aliouche and Udo Schlentrich, senior research fellow and director, respectively, of the William Rosenberg International Center of Franchising at the University of New Hampshire, in their 2005 study *Does Franchising Create Value? An Analysis of the Financial Performance of U.S. Public Restaurant Firms*.[1]

Franchised businesses minimize agency problems (that is, the problems facing any principal who delegates decision-making authority to an agent hired to provide a service) by giving the agent/franchisee powerful incentives to do well, according to the researchers. Franchised businesses gain access to cheaper capital by requiring new franchisees to front certain start-up costs, in essence requiring new franchisees to become suppliers of expansion capital for the franchisor. And franchised businesses gain access to motivated managerial expertise and local market knowledge because it is a good bet that new franchisees will sign on and risk their own capital only if they are confident that they have the managerial skill and market knowledge to succeed.





It is also true that successful franchisors, keenly aware that their intellectual property is their core asset, develop substantial skill in managing it, thereby adding to the inherent value of a franchised business.

Last, but not least, because of the maze of federal and state laws, statutes, and regulations that require franchisors to treat franchisees fairly and openly, franchisors tend to keep better books, i.e., audited financial statements, than do many nonfranchised businesses. Thus, when a franchised business goes on the block, potential buyers gain increased confidence that the numbers they see on the franchisor's financial statements represent the true state of the business.

The accompanying charts bear this out. We analyzed transaction data reflecting sales of 77 franchised and 356 nonfranchised restaurant companies over five years beginning January 2001, showing clearly that franchised restaurant companies command higher prices when they are offered for sale.

As chart A shows, over the five-year period the mean multiple of deal price to EBITDA was 4.11 among franchised restaurants versus 3.30 for nonfranchised restaurants. It was not uncommon for successful franchised restaurants to command multiples of eight times EBITDA. The mean multiples of deal price to EBIT were 4.68 and 2.94, respectively, and the mean multiples of deal price to discretionary cash flow were 2.93 versus 2.29.

Meanwhile, as chart B shows, the median multiple of deal price to EBITDA was 3.80 for franchised restaurants versus 2.58 for nonfranchised restaurants. The median multiples of deal prices to EBIT were 3.47 versus 2.19, respectively, and those of deal price to discretionary cash flow were 2.66 versus 1.84.

Thus, it is not surprising that franchised businesses as a whole play an increasingly important role in the U.S. economy, as borne out by the University of New Hampshire study.

In 2001, the most recent year for which data were available, franchised businesses provided jobs for nearly 9.8 million people, or 7.4 percent of all private-sector jobs—about the same number of jobs attributable to all U.S. manufacturers of durable goods, including cars, trucks, aircraft, computers, communications equipment, wood products, and instruments of all kinds, according to the study.[2] In addition, franchised businesses met payrolls exceeding $229 billion and generated nearly $625 billion of output, constituting nearly 4 percent of all private-sector output.

NEVIN SANLI AND BARRY KURTZ

Endnotes

1 *Available at* www.unh.edu/news/docs/franchisingvaluereport.pdf.

2. ECONOMIC IMPACT OF FRANCHISED BUSINESSES IN THE UNITED STATES 1 (IFA 2004) (comprehensive study conducted by PricewaterhouseCoopers for the International Franchise Association Educational Foundation), *available at* www.franchise.org/files/-EIS6_2.pdf

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The franchisor's growth prospects are also important in deriving value. How large is the universe of possible buyers for the franchisor's product or service? Where are these buyers? How many more territories must the franchisor open up to reach these buyers? How long will it take the franchisor to do this? What will this effort cost? What revenues and profits will it produce?

Franchise Agreements Drive Value

The agreements between franchisors and franchisees are also important in driving value, particularly those governing the rights of each party when renewing the arrangement. These may permit the franchisor, for example, to increase royalties, fees, or rents, or require franchisees to remodel their outlets, upgrade their equipment, etc. The more these terms favor the franchisor, the more value they yield for that party—and, often, the less for the franchisee.

Although franchisors derive much value from the management of their intellectual property, such items as real estate and equipment must also be considered. The more of these assets the franchisor owns, the better. They generate rental income for the franchisor in addition to the royalty and fee income from franchisees with relatively predictable increases over time.

Royalties reflect the marketplace value of the franchisor's intellectual property, and because competition is extensive in many franchising niches, royalties are also relatively predictable. In most cases, data are readily available on royalty rates, making it possible to judge their impact on the value of a franchise operation. In the fast food industry, for example, royalty rates typically range between 3 and 8 percent, with most franchisors charging 6 percent or less.

Up-front franchise fees paid by new franchisees reflect marketplace value as well. Some top-tier franchisors charge as much as $1 million per store and sometimes more, with an obvious impact on value.

Don't Try This at Home

Clearly, these factors make for a complex valuation process best left to professionals who understand how to give proper weight to each of the factors in question.[3] The process begins with an assessment of the franchisee's hard assets, including plant, equipment, supplies, and inventory. In addition, it is necessary to judge how much value the franchisee derives from its association with the franchisor. It is also important to judge the franchisee's production capacity and its right to expand into new territories. Local economic and social conditions may enhance or diminish profitability and hence value.

When valuing a master franchisee, the questions begin with whether state law gives the master franchisee the right to bargain over royalties, fees, territories, and other factors. If so, what value does the master franchisee derive from this right? Does the master franchisee achieve economies of scale by operating its own training program, by reducing the cost of supplies through bulk purchases, or by negotiating special real estate leasing terms?

The Internet

In recent years, the Internet has become another source of value for both franchisors and franchisees, and sometimes a point of contention between them. Does the franchisor possess the sole right to sell to catalog or Internet customers within the territories of its franchisees? If so, this may increase value for the franchisor and decrease it for the franchisees. Conversely, if the franchisees have the right to sell to catalog or Internet customers irrespective of territory, the impact on value for the franchisor is obvious.

To avoid conflict over Internet sales, many franchise agreements give franchisors sole right to such sales but require them to funnel orders to franchisees in whose territories the sales originate, thus enhancing value for both enterprises. Nevertheless, the remaining gray areas give rise to a good deal of litigation between franchisors and franchisees over the value of intellectual and other items of property that are held by each party, with consequent impact on value for each. Most franchise agreements specify that goodwill, for example, is the sole property of the franchisor as an item of intellectual property, but case law shows that a franchisee's specific goodwill can become an item of community property in a divorce action.[4] In addition, under certain circumstances a franchisee may generate goodwill specific to its own operations and hence lay claim to compensation for its loss when a local governing body condemns the property on which the franchisee operates in an eminent domain action.[5]

Terms of Agreement?

Franchisors and franchisees frequently contest other terms in their legal arrangements, including those that permit franchisors to terminate agreements with undesirable franchisees. Hence, it is necessary to step carefully when judging the impact of such terms on valuation. Not surprisingly, many such terms affect franchisors and franchisees in opposite ways. If the franchisor, for example, has ample leeway to terminate undesirable franchisees, this will tend to enhance the valuation of the franchisor and depress that of the individual franchisee. Conversely, an agreement giving the franchisee solid renewal or territorial rights favors the franchisee but may reduce the growth prospects and hence the value of the franchisor.

Impact of Liability on the Franchise

Liability can also affect valuation. Most franchise agreements specify that franchisors are not liable for the debts or torts of franchisees and vice versa. Even so, plaintiffs commonly try to involve franchisors in any liability action against franchisees on the theory that the franchisor is likely to have the deeper pockets.[6] The courts may side with plaintiffs where the franchisor exercises enough control over the franchisee to trigger vicarious liability, for example, when the franchisor requires the franchisee to follow an employee manual produced by the franchisor.[7]

Endnotes

1. Fifteen states have franchise registration and disclosure statutes. *See* CAL. CORP. CODE ANN. § 31110 (Deering Supp. 2004); HAW. REV. STAT. ANN. § 482E-3(b) (Michie 2004); 815 ILL. COMP. STAT. 705/10 (2004); IND. CODE ANN. § 23-2-2.5-9(1) (Michie 2004); MD. CODE ANN., BUS. REG. § 14-214 (2004); MICH. COMP. LAWS § 445.1507a (2004); MINN. STAT. ANN. § 80C.02 (West 2003); N.Y. GEN. BUS. LAW § 683 (McKinney 2004); N.D. CENT. CODE § 51-19-03 (2003); OKLA. STAT. ANN. tit. 71, § 806 (West 2004); R.I. GEN. LAWS § 19-28.1-5 (2004); S.D. CODIFIED LAWS § 37-5A-6 (Michie 2004); VA. CODE ANN.

§ 13.1-560 (Michie 2004); WASH. REV. CODE ANN. § 19.100.020 (West 2004); WIS. STAT. ANN. § 553.21 (West 2003). Oregon law does not require a franchisor to register but is considered to be a registration state because it does require proper disclosure by the franchisor. *See* OR. REV. STAT. § 650.010 (2003). *See also* Mark Miller, *Unintentional Franchising*, 36:2 ST. MARY'S L.J. 331 nn.27, 28 (2005).

In addition, nineteen states—Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Virginia, Washington, and Wisconsin—have franchise and distribution relationship laws on the books. *Id.* Even business arrangements that are drafted to avoid regulation as a franchise may fall under the FTC Rule (see endnote 2) and state business opportunity laws. Twenty-three states have enacted business opportunity laws. *See also* PHILIP F. ZEIDMAN, FRANCHISING AND OTHER METHODS OF DISTRIBUTION, 1526 PLI/Corp 461 (Practising Law Inst. 2006); Leonard D. Vines, Gina D. Bishop & Rupert M. Barkoff, *Damage Control for Violations of Registration and Disclosure Obligations*, 24:4 FRANCHISE L.J. 191, 199 n.1 (2005).

2. Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchise and Business Opportunity Ventures, 16 C.F.R. § 436.2(a)(1)(i) (FTC Rule).

3. A Rhode Island case, *Guzman v. Jan-Pro Cleaning Systems, Inc.,* 839 A.2d 504, Bus. Franchise Guide (CCH) ¶ 12,695 (R.I. 2003) shows what can go wrong when the right factors do not receive the proper weighting. In *Guzman*, the Rhode Island Supreme Court ruled that the trial court had erred in accepting a valuation provided by the franchisee's accountant rather than that offered by the franchisor's expert witnesses, one of them an expert in the commercial cleaning business and the other a professional business valuator. The accountant relied on generally accepted accounting principles in deriving a valuation but did not factor labor, payroll taxes, or other operating costs into his calculations. The franchisor's expert witnesses, on the other hand, showed the accountant's valuation to be substantially inflated by presenting detailed figures representing typical costs in these and other categories among commercial cleaning franchisees nationwide.

4. See BARTH H. GOLDBERG, VALUATION OF DIVORCE ASSETS § 12.6, at 315 (1984):

> Obviously, each attorney knows that during the past 25 years this nation has seen a vast rise in the number and types of franchises granted to individuals, whether in the hotel industry, the fast food industry, or otherwise. Thus it has become commonplace for many spouses to have franchises, the rights to which must be fully explored and their valuation determined; e. g., a husband may be a franchisee of a McDonald's hamburger restaurant.
>
> At time of dissolution, both community property and equitable distribution must value marital assets. Generally, these assets are easily valued, though some are more difficult than others. Yet one group of assets invariably causes great difficulty at the time of dissolution when valuations are requisite: the intangible assets, and the like.

See also, with respect to intangible property treated as community property, *In re* the Marriage of Hewitson, 191 Cal. Rptr. 392 (Cal. Ct. App. 1983); *In re* the Marriage of Monslow, 912 P.2d 735 (Kan. 1996) (affirming lower court decisions that awarded patents to husband, subject to a lien of 40 percent of the net income from the patents in favor of the wife); 2 RUTKIN, VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, 23.07 [1], at 23-133-35 (1995).

5. In *Redevelopment Agency of the City of Concord v. International House of Pancakes, Inc.*, 12 Cal. Rptr. 2d 358 (Cal. Ct. App. 1992), the California Court of Appeal ruled that state law specifically precluded a franchisor from obtaining compensation for loss of goodwill in a condemnation proceeding. The ruling noted that under the terms of most franchise agreements, no partnership, joint venture, or agency relationship exists between franchisor and franchisee, which the court characterized as "independent contractors," and that compensation for loss of goodwill should flow exclusively to the franchisee.

6. *See* William L. Killion, *Franchisor Vicarious Liability—The Proverbial Assault on the Citadel*, 24:4 FRANCHISE L.J. 162 (2005).

7. Uneven application of vicarious liability demonstrates "how different courts evaluating the very same franchisor controls reach opposite conclusions about the vicarious liability of a franchisor." *Id.* at 165. *Compare* Hoffnagle v. McDonald's Corp., 522 N.W.2d 808, Bus. Franchise Guide (CCH) ¶ 10,570 (Iowa 1994) (franchisor not liable for third-party assault of franchisee's employee because it did not control day-to-day operations), *with* Miller v. McDonald's, 945 P.2d 1107, Bus. Franchise Guide (CCH) ¶ 11,248 (Or. Ct. App. 1997) (franchisor found liable when franchisee's customer bit into a gemstone that had fallen into a Big Mac).