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# A Challenge in Buying Franchisers

## Good payoffs reward hard work for network acquirers



By Guest Writer
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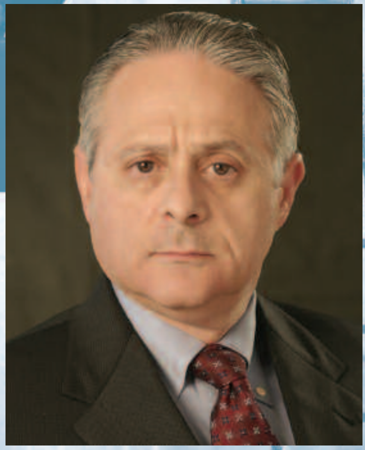

Thinking about acquiring a franchise operation? Get ready for twice the due diligence of a traditional deal — but perhaps twice the payoff if you do it right.

Indeed, caution is the byword in considering the acquisition of a franchiser, since any such deal gets the buyer a unique distribution system consisting of scores, perhaps hundreds, of franchisees who will prove critical to the success of the deal. Anyone that buys a franchising company also "buys" its relationships with its franchisees — a blend of both formal agreements and informal practice. Hence, a buyer's due diligence must explore these relationships in depth to understand just how the franchiser operates and anticipate trouble before it happens.

Still, the opportunities for buying franchisers are attractive, particularly in the restaurant industry, which houses countless franchised systems. In 2004, mergers and acquisitions in the restaurant field reached $558 billion in value, up from $317 billion the year before, according to David L. Epstein, Principal of J.H. Chapman Group, a Rosemont, Ill.-based investment bank specializing in the food service industry. The deals resulted in 86 changes in ownership, up from 52 in 2003, and they involved such big-name operations as Hamburger Hamlet, Applebee's, Chevy's, Sizzler, and Arby's.

Few traditional operating companies pursue these opportunities, in large part because franchise companies differ so much in structure and operation. But it's entirely possible to combine the two, at least in the private equity world, as shown by the examples of two investor groups — Starboard Capital Partners, a merchant bank based in Southport, Conn., and Roark Capital Group, an Atlanta-based private equity group.

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Starboard Capital's current holdings include franchise companies **Jan-Pro Holdings LLC**, janitorial and cleaning services; **Across America Collision Parts LLC**, crash-repair body parts; **Greased Lightning International Inc.**, chemical additives for engines; and **Wrenchead Inc.**, automotive after-market parts.

Strategic acquirers have shown little interest in franchise organizations in recent years because they don't easily satisfy their usual strategic goals — broadening product lines, extending market reach, acquiring new technology, or integrating vertically. The chief attraction of a franchise organization is cash flow — the key objective of the financial buyer. The buyer of a franchiser of travel agencies, for example, is more likely to be an investor seeking a specific return on investment than a hotel operator looking for vertical integration.

"With an operating company, it's clear-cut and easier to get information," says Marc Bergschneider, a managing member of Starboard Capital. "But a franchise system depends on the franchisee, and as a result, the due diligence must check out the financial and legal health of both the franchiser and franchisee. You don't want to buy a system that is inherently unprofitable for the franchisees, so you need to figure out how they're doing.

"And because many franchisers get into litigation with their franchisees, you also have to figure out the why and where of litigation, and you must make sure the uniform offering circulars are up to date and accurate in those states that require registration," he notes.

"What's more, after the deal closes, you'll find that you don't run a franchise system in the same way you run an operating company," Bergschneider adds.

"The franchisee is an entrepreneur who has a contract to run an operating business. He's not your employee, and as a result, you can't tell him when to get up in the morning and get to work or dictate how he is to run that business. With an operating company, typically you have employees, and as a result you have more control over day-to-day operations and strategy. With franchisees you lead by example and provide services to drive the business as a whole. You drive by leadership, not dictation."

Operating companies that shy away from franchisers, Bergschneider adds, miss significant opportunities.

"A franchise system has growth opportunities that should be larger than with an operating company because you have entrepreneurs out there building the business," he says. "And they supply their own capital to build their businesses, so you should be able to grow the system much faster than an operating company. Franchise systems can grow dramatically, which is why they're so attractive and trade at premium multiples to standard operating companies," he asserts.

Roark Capital's portfolio of franchising firms includes:

- **Cinnabon**, with more than 600 franchised bakery outlets selling cinnamon rolls in 40 states and more than 20 foreign countries;
- **Fastsigns**, which provides signs and graphic services through 480 franchise stores in 43 states and six foreign countries;
- **Seattle's Best Coffee International**, retailer of coffee and related products with 150 franchised locations in the U.S. and 11 foreign countries;
- **Carvel Corp.**, provider of premium soft-serve ice cream and branded ice cream cakes with more than 500 franchised and foodservice locations plus distribution through 8,000 supermarkets;
- **Money Mailer**, a direct-mail advertising company with 250 franchisees in 31 states.

"Franchise and operating companies are very different businesses," says Scott Pressly, a Partner at Roark Capital, "and they require different infrastructures. When we invest, we look at the infrastructure we'll need to grow a franchise company and the different infrastructure we'll need to grow an operating company. You get in trouble when you have the same people do both."

The franchise business is all about brands and franchisees, Pressly adds, and the two concerns interact. The brand is promoted to attract quality franchisees, and then the franchisees are supported to promote the brand. And because franchisees are keys to success, a potential buyer must focus due diligence on the company's relationships with its franchisees.

Going into its acquisition of Carvel in 2001, Roark Capital knew that the company's franchisees loved the brand but not the support they were receiving from the franchiser, Pressly says. That couldn't last if Roark was to generate value from the deal.

"Before prospective candidates buy franchises," he says, "they call up existing franchisees to ask how things are going. We chose to spend the first 18 months working with franchisees, introducing new products and marketing efforts to regain their trust. Once we began selling, our existing franchisees became the best advocates of the brand. Now we're selling more than 200 new franchises a year, but it didn't happen overnight," Pressly notes.

What does it take to do the right kind of due diligence when buying a franchiser? Where can trouble crop up, and how can you leave yourself room to structure the final terms of the deal to fit the reality you uncover?

The first step is to inspect the uniform franchise offering circulars (UFOCs) used by the franchiser in each state where it has done business over the last five years. Thirteen states — California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin — seek to protect franchisees by requiring franchisers to disclose a great deal of information in the UFOC and place it in the public record, usually by registering it with the state attorney general.

Six states — Florida, Michigan, Nebraska, Kentucky, Texas, and Utah — require franchisers to file only a one-page form, and the remaining states permit franchisers to operate as long as they meet the requirements of at least one of the 13 "registration" states. In addition, irrespective of these differing state requirements, federal law requires franchisers to give copies of their offering circulars to all prospective franchisees.

This inspection of the records reveals whether the franchiser has properly registered its offering circular where required and whether it has faced state disciplinary action or litigation by franchisees. The UFOC must detail the franchiser's business experience and that of its senior executives, including any bankruptcies and securities violations. As a result, the inspection will turn up at least a cursory notation of any such difficulties, and lead to inspection of other records, such as court filings, regulatory records, etc., that describe any problems or deficiencies in detail.

In each case, it's important to understand the nature of the complaint, the franchiser's explanation or defense, and the result. Was the violation serious or minor? Was it intentional or the result of clerical error? Was it an isolated incident or part of a pattern of behavior? A buyer needs this information to position itself, when drawing up the warranties and representations of the purchase agreement, to keep the seller on the hook for any trouble that may not be fully known at closing.

The next step is to inspect the franchise agreements in use in each state in which the franchiser operates, checking their terms against those of the standard agreements in the UFOC. The aim is to discover whether the franchiser entered into any special arrangements with one or more of its franchisees. An example might be providing special terms to favored franchisees, such as giving a franchisee in Los Angeles the right of first refusal when new or additional franchises are available in neighboring Orange County.

This is important to the buyer of a franchising company because it takes on all the obligations of the seller, except those that are expressly left behind in the purchase agreement. A buyer probably cannot escape a side deal such as granting a right of first refusal, assuming that it's a valid arrangement, but it can adjust the terms of the deal to reflect the impact of the agreement on post-acquisition plans. If the agreement proves to be too restrictive, such as limiting expansion plans in Orange County, it could impel the buyer to back out of the deal altogether. In any event, the buyer is at least informed of the situation.

For the same reasons, it's also important to track down the agreements with franchisees in all states in which the franchiser operates. It may be impractical to check each. These agreements may number in the hundreds, or even in the thousands, making it costly and time-consuming to inspect every one. The solution is to collect a fair sampling and require the

## Beyond Restaurants

In addition to restaurants, these industries have heavy franchising involvement:

- Auto parts and services
- Commercial janitorial services
- Florists
- Gyms and fitness centers
- Hair salons and beauty shops
- Hotel and lodging
- Postal services
- Travel agencies

franchiser to warrant that there are no undisclosed side deals with franchisees that materially affect the terms of the acquisition.

In checking these records, the buyer's investigators must take special note of all obligations taken on by the franchiser regarding training, advertising, marketing, and other business functions, all of which represent costs affecting the value of the deal.

For the same reason, the buyer must look for other financial arrangements between the franchiser and its franchisees. A primary target for inspection should be the promissory notes and security agreements that are in place if the franchiser offers financing to help purchase the franchise.

It's equally important to inspect the franchiser's records of all leases tied to its franchise agreements. In some cases the franchiser itself will lease the property in question and sub-lease it to the franchisee. In others, the franchisee will lease the property directly. Either way, a buyer must match up each lease with its respective franchise agreement, making sure that the terms agree. The buyer also must be certain that no third-party clearance is needed, such as approval of lease transfers by real estate owners.

A great deal of examination can be done in the offices of the franchiser, where other important but unpleasant items may be found, such as notices of late payments or default by franchisees, correspondence regarding disputes between the franchiser and franchisee, or records detailing the processes followed in terminating franchise agreements. In essence, the goal is to find out what went wrong between franchiser and franchisee so that a purchase agreement requires the seller to stand behind appropriate representations and warranties.

During all of this, it is crucial to step carefully, since few deals close without a hiccup or two.

The giant liquor distiller **Diageo PLC**, for example, found revenues at its Burger King unit falling steeply in 2002, just when it sought to sell the second-largest hamburger chain. The result? Diageo had to do the deal twice, taking a haircut in the process.

In July 2002, Diageo initially announced a $2.3 billion deal to sell Burger King to a group of private equity investors including Texas Pacific Group, Bain Capital, and Goldman Sachs Capital Partners. As Burger King's troubles deepened, however, the investors dug in their heels, negotiated a new deal, and ended up paying just $1.5 billion.

There is risk for both the buyer and seller in any acquisition involving a franchiser, but don't let that make you run away from the idea. The due diligence necessary to any such acquisition is tough, but it's really just a measure of the possible payoff.

"You've got to recognize that franchise and operating companies are different businesses," says Pressly. "The franchise model, if done correctly, is a great model for developing a brand but, if done poorly, is a horrible model. If you develop a diversified group of successful franchisees, you get a stable of brands and predictable cash flow over the long term. That's where it's a great model." ■

### Buying Into Growth Based on New Trends

A deft acquirer may find that a nimble franchising company sits at the strategic intersection of rapid growth and an emerging industry trend. Not an accidental combination because franchising enables the company to rapidly spread a product or service designed to cash in on the trend — and at a relatively low cost.

Take the late August acquisition of **Line-X Inc.**, provider of spray-on bedliners for pickup trucks, by **Graham Partners**, a Newtown Square, Pa.-based private equity firm.

Graham likes companies that benefit from product substitution or raw materials conversion in a variety of industries, and Line-X fits that bill. Compound sales growth has exceeded 22% over the last three years as pickup trucks have grown in popularity and their owners are turning increasingly to spray-on bedliners from the drop-in versions, often to help extend the lives of their vehicles.

The Line-X network, consisting of about 540 franchisees in the U.S., Canada, Mexico, Latin America, Asia, Europe, and Australia, includes auto and truck dealers, vehicle service operations, and even independent specialists.

Christina Morin of Graham says that Line-X distributes a proprietary urethaneresin formulation, as well as technology and spraying equipment, to the franchisees that then apply it to customers' trucks.

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