# RE-FRANCHISING: SALE OF COMPANY OPERATED UNITS TO FRANCHISE OPERATORS

PRAETORIAN GROUP: Successful Transactions Since 1998

## *A powerful strategy for:*

- Driving Growth
- Executing Remodeling
- Raising Capital

## *Praetorian Group will:*

- Create a re-franchising program to meet your specific objectives.
- Perform market responsive valuations to maximize resale value of your units.
- Negotiate competitive debt financing programs with commercial lenders to support the sale of operating units, remodeling programs and new development.
- Work with your legal counsel to create standard documents and to modify your UFOC (if necessary) to ensure a smooth and orderly re-franchise program.
- Create a franchise owner profile, which matches the complexity of your operation and enhances corporate objectives.
- Market the business opportunities to qualified buyers who match up to the franchise owner profile.
- Negotiation assistance to finalize all documentation necessary to close the deals.
- Perform deal management to ensure a timely and smooth closing process.
- Coordinate transaction closings.

## *Re-franchising Assignments successfully completed:*

- Checker's Drive-in Restaurants – over 300 units in various Southeast & Mid West markets.
- CKE, INC.
    1. Over 400 Hardees Restaurants in various Southeast & Mid West markets.
    2. Over 80 Carl's Jr Restaurants in California.
    3. 130 Taco Bueno Restaurants in Texas and Oklahoma.
    4. Currently completing a second re-franchising assignment for over 200 Hardees restaurants in the Mid West.
- Captain D's Seafood Restaurants – 4 Mid West Markets.
- The Ground Round Restaurants – 38 restaurants in the Northeast and Mid West.
- USA Baby – the Chicago market.


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Praetorian Group

*The Franchise Transaction Specialists*

# KEYS TO SUCCESSFUL RE-FRANCHISING

Many restaurant companies have come to realize that **Re-franchising** ( the sale of company operated restaurants to proven and experienced food service operators) can be a powerful strategy to enhance value and spur growth. Because of this, the number of these planned re-franchise programs is increasing rapidly.

Specifically, re-franchising can:

- Drive growth through new development commitments
- Raise capital for growth, acquisitions or balance sheet enhancement
- Accelerate remodel programs with franchisee capital

Each re-franchising program is unique and carries its own specific challenges. As a prerequisite, the new franchisees usually commit to additional development in the territory and a scheduled timeframe for whatever remodeling may be required. That said, even a well thought out plan with real world expectations, requires focused commitment, great attention to detail and the knowledge of possible unintended consequences. These elements are what truly make the difference between great and moderate success, or failure. The devil is in the details.

The following are some of the things we have learned in the last nine years re-franchising some 1,400 company operated restaurants.

EMPLOYEE PERCEPTION:

There is a need to position the re-franchising initiative as a major positive for the franchisor's employees. Most employees fear change and you run the risk of losing key managers if it is not handled properly. The reality is the new franchisees want the existing employees to stay on and generally do not change pay or benefits. Also new franchisees want to grow, usually much faster than the franchisor. This opens up significant growth opportunities to the employees. In some instances, the regional V. P. or director for the franchisor becomes the operating partner for the new franchisee. With their experience overseeing the restaurants before the acquisition and knowing their way around the corporate culture, they are a natural fit for many equity groups.

SKILL SETS AND DISCIPLINES:

The marketing and negotiation of the sale of company operated units requires different skill sets and disciplines than is sometimes found within companies. Re-franchising requires additional disclosures in order to provide historical P & L data. Valuation models that maximize value while ensuring lender support are necessary. Landlord support for subleasing, options to extend leases and execution of lender required documents must be secured. Pre-arranged financing options for acquisition, remodels and development need to be in place before launching programs. Operator commitments for remodeling and new development must be negotiated. Any of these things can be deal killers if not handled properly.

THE GROUNDWORK BEFORE THE ROLLOUT:

Having a major lender on board to finance qualified buyers is essential. They should also detail parameters for financing future remodels and new development even without a forward commitment.

Standard forms of Confidentiality agreements, Letters of Intent and sublease agreements are always needed.

An Operating Results disclaimer gives the franchisor the ability to provide historical P & L data without it being considered an earnings claim.

Sometimes there are units losing money in a package. This negative EBITDA can dramatically reduce the value of the whole package. It can also impact the coverage ratio (FCCR) that the lender requires. When this occurs, creative solutions need to be discussed with the ramifications of each understood and agreed upon prior to rollout.

AUCTION OR PRICE CERTAIN:

Some companies that attempt to re-franchise opt for an auction process to sell a multi-unit package. They may have had experience with this process when they acquired the concept and it is how investment banking firms approach a sale.

We prefer and we are quite certain most prospective buyers prefer a price certain for an acquisition. A valuation is needed of each multi-unit package to be sold using the reasonably aggressive financing terms available from the lender supporting the transactions. There also needs to be a sufficient injection of equity and a reasonable cash on cash return for the buyer. If real estate is included, current market sale/leaseback parameters are used to value the properties. The rent factors used need to be in line with supportable rents for both the concept in general and specifically for the units involved. This valuation model presents the selling price of the units with the backup of how the price was derived. It leaves little room for price negotiation.

Your best prospective franchisees are usually existing multi-unit operators in non-competing concepts and equity groups backing strong management teams. These potential buyers are more likely to expend the time, energy and money required for initial due diligence if they feel there is a high probability of their getting the deal if they come in at the valuation price.

This is a critical point. From an operator's viewpoint, if they are going to take time and resources away from running their existing business, they want to know they have a reasonable chance of acquiring.

## GETTING THE TRANSACTION CLOSED:

Once the buyer is identified, the most critical part of the process is deal management. Every multi-unit transaction is unique with its own set of issues to be addressed.

The deal management process breaks down a transaction and outlines each step to be accomplished in order to close. We call this outline the responsibility meeting checklist. The checklist is updated after each deal management meeting. The deal management meetings are generally conference calls. The participants include buyer, seller, attorneys for both sides, accountants when needed and the person chairing the call. Each item on the checklist indicates the person who is responsible to deliver that item and the date they have committed to deliver by.

These weekly or bi-weekly responsibility meetings are crucial in moving a deal along swiftly and identifying any issues or problems early on in the process.

Some of the key items each responsibility meeting checklist includes:

- financial due diligence
- negotiation of remodeling and development schedules
- lender financing commitments
- building and equipment inspections
- assumed contract review
- lease assignment or sublease and possible options to extensions
- franchisor approvals, both financially and operationally
- good and marketable title if real estate is included
- environmental studies
- lender documentation (estoppels, phase ones, etc)
- negotiation and approval of the Purchase and Sale agreement and related exhibits.

## AFTER CLOSE PROMOTION

As each transaction closes, it provides a positive P.R. event for the company when handled properly. After each closing, the ensuing press release helps depict a growing company with new development commitments and strong lender support, all of which help attract other prospective franchisees.

The new franchisees are also an excellent source of referrals. There is no better time to ask for them than just after the closing.

# Concept diversification
# A powerful strategy for multiple unit operators

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Successful multiple unit operators need to consider diversifying their companies by shifting from the management and operation of one concept to two or more proven concepts. This is a powerful strategy that can result is significant benefits, as follows:

**Benefits of concept diversification**

- Leverages the cost of corporate G&A, particularly in the following disciplines.

    1. Senior management
    2. Accounting
    3. Purchasing
    4. Advertising
    5. Distribution

- Able to leverage an existing asset base, instead of cash reserves, to grow. The enterprise (business value) and real estate values of an existing operation can be used (instead of cash) to provide the equity injection necessary to secure financing for the acquisition of a compatible concept.

- Balances concept risk and segment trends.

    All concepts move through up and down cycles resulting from competitive intrusion, business cycles, various fades and advertising program miscalculations. For example, quick service concepts experienced sales declines when customers shifted to quick casual & casual dining concepts, primarily because of healthier food choices. QSR's have since reversed the trend by adding a broad variety of salads, lower fat content offerings and aggressive advertising. A multiple concept operator who operated within both segments benefited from one segment while adjusting in the other.

- Provides growth opportunities for existing organization. Many operators have developed their concepts to or close to saturation in their markets. These companies have well-trained employees, many want upward mobility. Without providing a career path these companies run the risk of employee turnover. Adding another concept can provide the opportunities they desire and allow the operator to grow with employees whose strengths they understand. This will help ensure the retention of good employees at the unit level as well as field and corporate personnel.

- Geographic focus will help reduce both the cost and risk of expansion. The following will be best utilized by acquiring another concept in the same market.

  1. Familiarity with the dynamics of the market.
  2. Knowledge of local real estate, developers and zoning requirements.
  3. Leveraging of employee base, as previously mentioned.
  4. The opportunity for unit cost savings for vendors, suppliers and advertising mediums.
  5. Public relations opportunities with local press will be maximized.
  6. Co-marketing opportunities with both the existing concept as well as larger local retailers will emerge.

- Creates the possibility for co-branding. Depending on the compatibility of an additional concept, co-branding can result in better utilization of real estate for both existing and new locations.

*Once a decision is made to attempt to acquire another concept it is important to first analyze the requirements and conditions of your existing operation.*

**Analyzing existing operations**

- Review existing lease agreements to determine the remaining lease-term, including options to extend, for your leasehold units. It is important that there be a minimum of ten (10) years remaining, if not, contact landlords and negotiate options to extend. This is important to ensure the continuity of existing operations. It is also critical if you plan to use the enterprise value of your operation for the equity injection required by senior-debt lenders to acquire other concepts.

- If the existing operation is a franchised concept, review existing franchise agreements to determine the following.

  1. For the same reasons discussed for the lease agreements, there needs to be at least ten (10) years, including renewal options, available.
  2. Determine remodeling requirements for not only the existing franchise agreement term, but also required to renew the agreement. It is important to ensure you have the financial resources reserved to meet these remodel requirements. You do not want to commit resources to an acquisition that will be required later to properly manage your current operation.
  3. Carefully review the non-compete clause to determine which classes of concepts you are precluded from operating. Obviously, such concepts must be eliminated from you concept search.

- If there is senior debt in place, review loan documents to determine if additional debt is allowed. For those companies that financed through securitized lenders (before those lenders disappeared) they are precluded from securing additional debt with the same collateral. If additional debt is not allowed, attempt to renegotiate prepayment penalties or look to other assets for acquisition equity.

- Analyze the existing organization to determine the following.

  1. Which employees can be dedicated to a new concept?
  2. What training will be required to replace employees you are planning to move to a new concept?
  3. Which key field and support positions will have to be filled from outside the organization?

- Review Profit & Loss statements and balance sheets to ensure they are accurate, verifiable and current. The lender you select to support your future acquisition and possibly the franchisor of another concept will want to review them before moving forward.

- Screen the various commercial and portfolio lenders who are actively supporting acquisitions. For smaller deals you may consider a national SBA lender. To find a list of lenders go to the IFA website (www.franchise.org). It is important to determine the following:

  1. Which industry segments do they support? Many lenders prefer to specialize.
  2. For franchised concepts, determine the minimum number of operating units required to approve a concept for lending. Generally, lenders will require anywhere from twenty (20) to fifty (50) existing franchised units. If an independent chain is your target, a minimum of five (5) profitable operating units will be required.
  3. Determine the basis for establishing interest rates. Typically the rate is determined by a spread over a benchmark such as the prime rate or LIBOR.
  4. Determine loan term. For leasehold, seven (7) to ten (10) years and for fee simple real estate fifteen (15) years is typical. Longer terms are possible.
  5. There are both fixed and variable interest rate programs. If you go with a variable rate, ask if there is an option to convert to a fixed rate.
  6. Determine the minimum debt coverage or fixed charge coverage ratio required. These ratios will have a big impact on loan value and the amount of equity injection required. Generally, the equity injection necessary will range from 15% to 20% plus soft costs (closing costs, inventory and working capital).

**Predetermining the likely lender that will be used for acquisition financing will not only save time, it will create a competitive advantage when negotiating the**

**acquisition.**

*With the aforementioned preparation complete, the search for the right acquisition that will best compliment your existing operation can begin in earnest. The following steps should be used to ensure a successful and timely acquisition.*

- Contact the franchisor of a target concept and advise that you have an interest in joining their system, preferably through the acquisition of operating units. Also make it clear that you have a desire not only to acquire units but also to continue to develop additional units within the territory. The franchisor may be able to assist you in determining a potential acquisition.

- Network at well attended conferences.

- Reach out to existing franchise operators of your target systems.

- Contact selected lenders and advise them of your desire for an acquisition, they may know of an opportunity.

- Select an experienced and proven intermediary, such as the Praetorian Group, to ensure a successful and timely acquisition effort. Look for a firm with experience and a track record of success in the following areas.

    1. Many transactions completed, especially in the industry segment you have chosen.
    2. Experience in completing franchise industry transactions. Look for firms that have represented franchisors for re-franchising programs. There are unique aspects to the franchise industry that many business brokers and investment bankers simply do not understand. Experience in working through franchisor approval, securing franchise agreement extensions, structuring achievable territorial development agreements, dealing with remodeling requirements and many other issues are critical.
    3. A firm that has demonstrated they are truly transaction specialists is important. Knowledge and skill in the following areas is critical.

        a. Valuation.
        b. Contract negotiation.
        c. Securing financing commitments.
        d. Deal management – there are so many aspects to moving a deal from the letter of Intent stage to the actual closing.
        e. Lender closing procedures.

- Once you have identified a potential acquisition, work through the following steps.

    1. Negotiate a deal that provides a reasonable return on your investment. One measure to consider is cash-on-cash (equity) returns – 35% for enterprise value and 25% for real estate value is a reasonable expectation. Do not fall in love with a deal, remain objective.
    2. Make sure the size of the deal can be supported with your existing financial and operational resources. Do not over extend yourself.
    3. Do not over commit to territorial development schedules.
    4. Retain the services of a highly experienced attorney. Determine if the attorney has both transaction and franchise industry experience. Select a deal maker, not a deal killer.
    5. Retain a CPA to assist in financial due diligence. Make sure the CPA has acquisition and franchise industry experience.
    6. Work closely with your intermediary and lender to help ensure a timely and smooth closing.

In conclusion, diversifying by moving from a single concept multiple unit operator to multiple concepts can be a powerful financial strategy. The strategy will leverage existing financial and organizational resources, build equity & wealth, provide growth opportunities for your organization, help balance cycles within industry segments and create a future exit strategy. Advance planning, proper preparation and the careful selection of experienced professionals to assist you in acquiring another concept will help ensure a successful venture. Above all, stay within the affordability of your resources.