

Franchise system's size, structure dictate private-equity payout

By BARRY KURTZ
By NEVIN SANLI

(Sep. 24) Private-equity groups have eagerly stalked restaurant franchisors in recent years, snapping up such companies as **Dunkin' Brands**, owner of the **Dunkin' Donuts**, **Baskin-Robbins** and **Togo's** chains, as well as Hamburger Hamlet, **Applebee's**, Chevy's and Worldwide Restaurant Concepts, the owners of the **Sizzler** chain.

These days, however, in their eagerness to put their money to work in the restaurant industry, private-equity groups are stalking large franchisees, too, and even other private-equity groups with franchised restaurant holdings. Last year, private-equity groups bought out large franchisees of **IHOP Corp.** and the **Papa John's Pizza** and **Church's Chicken** chains, and in 2005 Sun Capital Partners Inc. bought Garden Fresh Holdings Inc. from the private-equity firm Centre Partners Management LLC. For that matter, even large franchisees have gone on buying sprees. Heartland Food Corp., for example, which operates about 250 **Burger King** outlets in half a dozen states, has been out snapping up smaller operators in recent years.

Clearly, successful, large franchisees are desirable commodities these days, leading many of the people who run such businesses to wonder what their own operations might fetch in such a hot market.

But the value of a successful, large franchisee company lies hidden in a web of assets and ownership rights, some attributable to the franchisee, some to the franchisor and some to other parties altogether. And the key to deriving that value is to tease apart that structure of ownership, analyzing each layer as well as the whole. That is not an easy task, since relationships among the parties in a franchise enterprise are so complex as to make the whole sometimes worth more than the sum of the parts—and sometimes worth less.

In examining the value of the operations of a large franchisee, the game begins with a disciplined effort to understand who owns what in that web of assets and rights and to determine how much each factor contributes to the whole system or detracts from it.

Of primary importance, of course, is the fact that the large franchisee holds the right to open up new outlets in specific areas. This is often the chief allure in the eyes of a buyer, but the analysis of value must take other factors into account as well, among them:

- The profitability of the units the franchisee has up and running now
- The efficiencies of scale the franchisee enjoys
- The equipment held by the franchisee, whether owned or controlled through leases
- Real estate owned or leased by the franchisee, including any restaurant pads at large shopping malls, which often command a particular premium because of their locations
- The franchisee's management team
- The legal relationship between the franchisee and the franchisor
- The terms under which the franchisor offers marketing, training, financing or other support to the franchisee
- The number of additional outlets the franchisee has committed to opening up in its exclusive territory in a given period of time
- The demographic and economic conditions in the franchisee's exclusive territory
- The franchisee's access to financing and other resources necessary to taking advantage of expansion.

The good news in all of this is that a profitable, large franchisee with, say, 50 outlets up and running, and with rights to open up another 50 in a promising market, may well command a substantial premium in a sale to a private-equity group.

This is true not only because it costs less to buy 50 businesses from one seller than from 50, but also because a successful, large franchisee stands in good position to command financing on good terms, attract professional management, and achieve efficiencies of scale in overhead costs—for example, by building its own warehousing.

Similarly, the large franchisee may be less subject to downturns in local market conditions than unit franchisees who depend on particular neighborhoods.

Size, in short, can do good things for the large franchisee's business in the eyes of a buyer, and although factors unique to any such business will determine how much it will bring in a sale, what is certain is that franchise companies as a whole command higher multiples than nonfranchise companies.

In fact, data from recent transactions show that fast-food franchisors bring multiples of six to eight times EBITDA—or earnings before interest, taxes, depreciation and amortization—whereas nonfranchise fast-food companies bring only four to five times EBITDA.

It is equally clear that, given the increasing importance of large franchisees in the restaurant industry, they are likely to continue attracting attention from private-equity groups, particularly now that a number of franchisors—for example, the **Quiznos Sub** and **Subway** sandwich chains as well as **Sonic Corp.** of the Sonic drive-in chain, and IHOP Corp.—expect much of their growth to come as a result of area developers.

Private-equity groups are drawn to this dynamic, and that pushes values up—good news for large franchisees, because it means that, having devoted themselves to building successful businesses, they now stand in good position to realize a profitable exit.

Barry Kurtz, of counsel to the Encino, Calif., law firm of Greenberg & Bass, specializes in franchise law. Nevin Sanli is president of Sanli Pastore & Hill, Inc. in Los Angeles, a specialist in business valuation.

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