Good Connections

Drawn by steady cash flow and an asset-light structure, buyout firms gravitate to franchisors

By Kelly Holman

Franchises: The word just links naturally with more specific names to create winning combinations in a widely diverse range of commercial activities.

Donuts, franchises. Vacuums, franchises. Coffee, franchises. Hotels, franchises. And on and on.

But each of those two-word descriptions also translates to something else, something broader: a lucrative route for private equity firms to deploy capital and generate solid returns.

Buyout shops are attracted to franchisors because they are stable, easily understandable and easy-to-find businesses that generate predictable cash flows and strong margins. Franchisors carry little in the way of capital expenditures or huge work forces, and they often feature established consumer brand names. And they operate in industries of all stripes.

As a result, upper-tier private equity houses — such as Texas Pacific Group, Bain Capital LLC and Goldman Sachs Capital Partners, which teamed up to execute the $1.4 billion buyout of Burger King in 2002 — and middle-market buyout firms alike have gravitated to the businesses in recent years.

Moreover, the strong free cash flow and relatively asset-light nature of franchisors also appeals to lenders. Hence, banks are keen to provide debt financing to financial buyers that are interested in purchasing franchisors or multiunit franchisee operators, bankers say.

"There is much more availability of debt today for companies that do not have a heavy asset base," says J. Richard Haigh, a principal at Mayfair Securities in Los Angeles.

Quality franchisors are typically commanding purchase multiples these days that range from 5 to 9 times Ebitda, according to observers.

Buyout firm interest in franchising may be a relatively new development, but the concept of corporate franchising itself is more than 150 years old. The practice is largely believed to have been started in the 1850s by Singer Sewing Machine Co., which began selling distributorships to individuals who paid a fee and subsequently received training on how to sell the sewing machines, according to Mark Siebert, chief executive of iFranchise Group Inc., a Homewood, Ill.-based consulting firm that specializes in franchising.

Since the first Singer's distributorships, the activity has mushroomed to encompass almost every industry imaginable as entrepreneurs have flocked to the format as a way of achieving business success with less risk than found on many other commercial paths.

"In September, Mayfair sold Line-X Franchise Development Corp."

A study conducted by PricewaterhouseCoopers LLP for the educational foundation of the International Franchise Association reported that franchise businesses account, at a minimum, for 3.2% of all U.S. business establishments.

M&A deal volume statistics

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involving franchised companies are difficult to come by, since franchising is largely considered a business format rather than an industry. However, investment banks are shopping a steady stream of such businesses to financial buyers, say industry observers.

"The market for franchising deals has never been hotter — everyone is attracted to the [investment] opportunity," says Jason Schmidly, a partner at Carousel Capital, a Charlotte, N.C.-based private equity firm that's a seasoned veteran in the franchise space.

Investment banking firms Harris Williams & Co., Banc of America Securities LLC, Houlihan Lokey Howard & Zukin, Mayfair Securities LLC, North Point Advisors and Piper Jaffray & Co. are all engaged in M&A assignments involving franchise businesses.

Restaurant franchises, the largest category in the sector, have generated sizzling auction action in the past year.

Piper Jaffray has shopped several restaurant franchises, including a six-month auction of Restaurant Co., the Memphis-based operator of the Perkins Restaurant & Bakery chain. The sale ended with New York private equity firm Castle Harlan Inc. agreeing to buy the company for $245 million in early September.

Just one month earlier, Atlanta's Roark Capital Group acquired McAlister's Corp., the operator of 170 franchised and company-owned McAlister's Deli eateries in 19 states for an undisclosed sum through a sale process run by Raymond James & Associates.

Meanwhile, Citigroup Inc. is shopping Checkers Drive-In Restaurants Inc., the Tampa, Fla.-based operator of the 788-unit Checkers and Rally's Hamburger chains.

Chris Spahr, a principal at Chicago investment bank William Blair & Co., says private equity interest in the restaurant segment is being driven in part by solid exits from restaurants through initial public offerings.

"There's been a number of notable IPOs that have performed well in the last two years in the restaurant space, and that always drives financial sponsor interest in a category."

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>
> ***- J. Richard Haigh, Mayfair Securities, LLC***

The latest auctions follow a string of restaurant franchises that were acquired by private equity firms in 2004.

In November 2004, Charlesbank Capital Partners and Grotech Capital Group bought Nashville-based fast-seafood chain Captain D's Inc., and Atlanta private equity firm Arcapita Inc. agreed to purchase fried-chicken chain Church's Chicken from AFC Enterprises Inc. for $390 million in cash.

In June, Charlesbank recapitalized Papa Murphy's International Inc., a Vancouver, Wash.-based group of eateries that sell unbaked pizza that customers take home to finish in their own ovens.

And in May, Castle Harlan agreed to acquire Burger King Corp.'s San Juan, Puerto Rico-based fast-food restaurant chain, Caribbean Restaurants LLC, for $340 million from Oak Hill Capital Partners LP of Fort Worth and American Securities Capital Partners LLC, a New York buyout firm.

One of the larger franchisor auctions taking shape in 2005 is J.P. Morgan Chase & Co.'s sale of Canton, Mass.-based Dunkin' Brands Inc. on behalf of Allied Domecq plc. Dallas-based private equity house Hicks, Muse, Tate, & Furst Inc. is among a bevy of flagship buyout firms that have expressed interest in acquiring the quick-service outfit, whose units includes Dunkin' Donuts, Baskin Robbins ice cream and Togo's Eateries Inc. franchisors. Dunkin' Brands could command a valuation of $1.8 billion, a source said.

The business contains more than 12,000 points of distribution, including 7,600 units in the U.S. and 4,400 units in 46 countries around the world. It generated $4.8 billion in system-wide sales in fiscal 2004.

But restaurants aren't the only source of franchise activity.

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A number of deals involving other franchisors have come to fruition over the summer alone.

For instance, in September, Mayfair sold Line-X Inc., which franchises outlets that apply a spray-on lining to truck beds, to Newtown Square, Pa.-based buyout firm Graham Partners for more than $57 million. Santa Ana, Calif.-based Line-X oversees a network of 500 U.S. outlets and more than 50 international outlets.

Secondary buyouts of franchises through auctions have produced solid returns for sellers of franchises this year.

Carousel and Washington-based Halifax Group's sale of Meineke Car Care Centers Inc. — the Charlotte, N.C.-based automotive maintenance franchisor that features former heavyweight boxer George Foreman as its television pitchman — to Allied Capital Corp. netted a return of more than 3 times their 22-month investment in Meineke. Allied acquired its majority stake in the company through a $127 million recapitalization and auction run by Wachovia Securities.

Another profitable exit involved the sale of the nation's second largest automotive transmission service franchisor, Fort Washington, Pa.-based Cottman Transmission Systems LLC, through an auction by Goldsmith, Agio, Helms & Lynner LLC. In April, New York private equity firm Sentinel Capital Partners announced the sale of portfolio company Cottman Transmission to American Capital Strategies Ltd. of Bethesda, Md., for $77.3 million. The deal netted Sentinel a return of 3 times its investment, or a 31% internal rate of return over the 4-1/2-year life of its holding.

David Lobel, Sentinel managing partner, says under the firm's stewardship Cottman's sales grew 25% annually.

When a franchise system grows, he says, it is generally the franchisee, not the the franchisor, who puts up the lion's share of the funding.

Franchisees feed a franchisor's growth by making annual royalty payments in return for receiving marketing and operational support. In addition, when a franchisee opens a franchise, it is generally required to pay an upfront fee to use the franchisor's name and sell its products or services under a particular brand name. Often, franchisees sign five- to 10-year contracts to run a franchise, which are generally renewed.

But while there can be plenty of upside in franchise deals, they aren't without their share of risks, says Neal Aronson, founder and managing partner of Roark Capital Group, one of the buyout industry's top investors in franchisors.

"The industry is riddled with the potential for litigation," he says.

Individual franchisees may turn to litigation over breach-of-contract issues or if they feel the franchisor has shortchanged them in some way, such as by not providing enough marketing support, Aronson says.

Roark — which has investments in franchisors Fastsigns International Inc., Carvel Corp., Money Mailer LLC, Cinnabon International Inc. and Seattle's Best Coffee International — has been relatively fortunate to buy "very healthy franchises," Aronson says.

In November 2000, Roark sold U.S. Franchise Systems Inc., an Atlanta-based hotel system operator, to Chicago's Pritzker family for roughly $100 million. The exit produced a return of 5.5 times Roark's equity investment and an internal rate of return of 269%.

"We're all here to come together for a common goal, and that's to make money, expand the brand and beat the brains out of these other guys," Keith Sirois, chief executive of Checkers Drive-In Restaurants, says in a comment on his company's Web site.

It's a statement that pretty much sums up the no-nonsense goal of the rest of the franchisor sector — and of their private equity backers too.

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