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# The Deal

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**"HOLY SMOKES,  
THE TIDE IS  
GETTING HIGH"**

**"WELL, WHAT DID YOU EXPECT, BROTHER?  
IT'S TIME FOR THE  
PRIVATE EQUITY DEALS OF THE YEAR"**



## **What Private Equity Firms Need to Know Before Investing in a Franchisor**

By Richard Haigh

The time-tested distribution model of franchising has begun to attract attention from private equity firms. One of the chief advantages of utilizing franchising as a distribution mechanism is that the business has a diverse array of outlets, with none having undue leverage over the whole enterprise. In contrast, businesses that sell through conventional retail channels are often at the mercy of a few large chains. Additionally, franchisees make substantial investments in the system and sign long-term agreements to operate on the franchisor's behalf. For the private equity investor, these features translate into an ability to reach a large customer base with a relatively small capital investment, which produces potentially above-average returns on capital.

Of course, that will happen only if the franchise operation is well conceived and properly managed. A private equity firm looking to cash in on the franchise model must learn to distinguish those destined for success from those headed for trouble.

The most important hallmark of a well-run franchise operation is that the franchisor regards its franchisees not as customers but as partners working toward a common goal of delivering a quality product or service to the ultimate consumer. Franchisees in systems guided by this principle are not only more satisfied and loyal, they also tend to value the camaraderie for its own sake. Many franchisees stay with the system in part because they enjoy regional meetings and conventions where they can gather in a collegial fashion with like-minded owners.

Franchisees don't always assess the business in the same way as an institutional investor might. They are likely to include in calculations of ROI the total proceeds received from the franchise including, in addition to profits, both psychic benefits and salaries for themselves and other family members. They usually do not measure returns on capital and labor separately as the financial textbook might suggest. Franchising is often a way of "buying a job".

Lawsuits against the franchisor might seem like a major warning sign. However, litigation is inevitable in franchising. Among hundreds of franchisees, some are bound to be unhappy, and laws in many states give them great latitude to seek remedies in court. The presence of some litigation should not be a concern. In fact, its absence could be a cause for worry.

Failure rates are a more important red flag, and harder to discern accurately since failures can be disguised. For instance, the franchisor may routinely reacquire failing outlets rather than letting them go into liquidation.

Obviously, a private equity investor will scrutinize carefully the franchise agreement. This standard form of the agreement is generally reviewed and amended annually and, unlike human beings, its teeth improve with age. It is important to look for special deals with certain franchisees. It is not unusual for franchisors to make non-standard arrangements in the early years that they may be stuck with forever. A private equity firm should understand any such deals before making an investment.

Investors also should beware of a strategy that plans to achieve future growth through acquisition. Merging two distinct cultures, and sorting through problems ranging from competing brands to overlapping territories, can be exceedingly difficult, as UPS has discovered in digesting the Mail Boxes Etc. system.

Franchise operations with plans to expand overseas require especially close scrutiny. Some concepts simply don't translate. Others arrive in far-off lands (e.g. Burger King in Australia) to find that some enterprising local entrepreneur has usurped their trademark. Even if all that does not apply, it is impossible to serve a franchise in a distant time zone in the same way as one in the USA. This, in our experience, often leads to dissatisfaction and dispute.

Private equity firms contemplating an investment most likely will be considering franchise operations that are somewhat mature. But it is important to keep in mind when estimating growth potential that, as the SEC likes to point out, the past is not necessarily a good indicator of future performance. Selling the first 10% of available territories is usually quite difficult, but the next 40% is easier, as success is demonstrated. In many systems, though, it gets harder to expand after that, as qualified prospects often want to operate in a territory already granted exclusively.

Finally, it is important to consider how the franchisor generates revenue. Most license an operating method and a trademark and collect royalties based on a percentage of revenues at the franchisee level. The trouble is that franchisees may eventually tire of sending a large share of their hard-earned proceeds to headquarters. Franchisors that derive some or all of their revenues from selling products to franchisees therefore have a big advantage. Thanks to the effective absence of selling costs due to their captive franchisee base, they often can realize a respectable profit while charging at or below market for their product, boosting their bottom line and the franchisee's satisfaction.

Franchising at its best is a wonderful mechanism for building a consumer brand quickly, with limited capital investment, and with a broad base of contractually and financially committed partners who are prepared to work for very reasonable returns on capital and labor. However, if either the business model or the franchisee relationship is incorrectly structured from the outset, it can be very hard to remedy. That franchise contract does, of course, apply in both directions. Caveat emptor is a two thousand year old maxim. There is a reason for that.

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