Mergers & Acquisitions in Franchising:

Strategies for 2011 and Beyond

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The M&A market is finally picking up after some of the toughest years in recent memory. The good news for those in franchising is that there is significant investor interest in the franchise industry. This paper will address: key factors driving investor demand; exit planning considerations, and various due diligence issues.

From 2003 to 2010, dozens of significant M&A franchising transactions have closed and the trend appears to be accelerating. Most franchisors in fact are becoming more attractive acquisition candidates precisely because the capital markets increasingly are focused on quality over quantity.

A wide variety of industries and transaction sizes have been represented, including: Hollywood Tours®, Johnny Rockets®, Service Master®, Cartridge World®, the Dwyer Group®, Back Yard Burger®, Macaroni Grill® and Au Bon Pain®. These companies were acquired by other franchisors, private equity funds or other buyers. The most significant transactions included the $2.43 billion purchase of Dunkin' Brands (including Donuts®, Baskin-Robbins ice cream, and Togo's sandwich shops) by Bain Capital, Thomas H. Lee Partners and Carlyle Group from French conglomerate Pernod Ricard; the Blackstone Group's $26 billion acquisition of Hilton Hotels following its $3.4 billion acquisition of La Quinta Inns, Triarc's $2+ billion purchase of Wendy's® and 3G Capital Management's and 3G Special Situations' $4.2 billion acquisition of Burger King Holdings, Inc., at a 9.1 EBITDA multiple, and TZP Capital Partners' and TZP Group's $150 million acquisition of The Dwyer Group (further details unreported).

Two key factors drive high franchising valuations today. *The Wall Street Journal* reports that private equity groups have more than $500 billion in cash and strategic buyers have more than $2 trillion to invest. This $2.5 trillion in "dry powder" creates pent-up demand – thereby driving up prices – because both groups are under pressure to invest their cash. Private equity groups must invest their cash or return it to investors. Strategic buyers (often publicly-held) also are pressured to invest or return cash to shareholders via dividends. Both groups are seeking quality brands that are scalable. Both groups are willing to pay attractive prices for such brands. An effective auction process involving multiple investor groups competing to acquire such a company should realize a premium price for the owner(s).

Additionally, while obtaining small business financing remains highly problematic, commercial lenders remain willing to finance large acquisitions (banks financed 70% of one recent large transaction). The availability of bank financing for large acquisitions enables private equity firms to use leverage while paying higher prices for large, high-quality franchisors.

While large, high-quality franchisors can take advantage of such opportunities as our financial markets thaw, smaller franchisors continue to find M&A-driven exit strategies challenging. This really is a tale of two markets. With most private equity or strategic buyers disinclined to consider (let alone close) smaller transactions that typically boast EBITDAs of less than $3 million to $4 million, smaller franchisors must deal with a different group of potential investors that typically includes high net worth individuals, local buyers, and other franchisors seeking to add a brand. Commercial lenders rarely lend to these smaller transactions.

Distinct valuation variations between large and small franchise transactions are not unique to franchising M&A transactions but rather can be recognized across many middle market business segments.

In light of current market conditions, some franchisors have eschewed M&A exits in favor of re-franchising – turning company-owned units into franchises, including the sale of operating assets) to raise cash and manage operating expenses and capital

expenditures. Well-heeled multi-unit operator franchisees can purchase Pizza Hut®, Hardees® and Applebee's® units at attractive terms. Meanwhile, some multi-unit franchise operators themselves have become acquisition targets for such private equity firms as Sentinel Capital, Olympus Partners and Roark Capital Group.

Roark Capital Group in fact has focused on franchisors, buying a controlling stake in Carvel in 2008. Carvel's largest competitor, Dairy Queen®, was acquired by Warren Buffett's Berkshire Hathaway just a few years earlier. In partnership with FOCUS Brands, Roark owns or controls a wide variety of household-name franchisors, including: Schlotsky's®, Cinnabon®, Moe's Southwest Grill®, Fast Signs®, Wingstop®, and Batteries Plus®. With more than $1.5 billion in capital under management, Roark controls more than a dozen franchisors generating $3 billion in system-wide revenues.

Like Roark, many private equity firms successfully have invested in franchising over the years and most PEGs actively are seeking to make additional franchise investments. Large PEGs that have yet to invest in franchising are finding the space more compelling as they consider making investments in the industry.

As an alternative to M&A transactions, many franchisors are pursuing recapitalizations, restructurings and management buyouts. Recent transactions include: Comfort Keepers® (a $44 million buyout), Meineke Car Care® (a $128 million management-led recap), Worldwide Express® (a $15 million buyout) and Coverall® (a $59 million management-led buyout). For recapitalization funds and resources, the characteristics that make franchisors attractive M&A candidates (e.g., strong brands, unit diversification, market protection, predictable and durable cash flows, etc.) also are attractive to transactional equity and debt capital providers. Franchisors that participated in franchise concepts launched up to 20 or 30 years ago are pursuing types of financing transactions very carefully as baby boomers prepare to transfer ownership to the next generation or select management groups as an alternative to traditional M&A.

Traditionally, most recapitalizations were majority recapitalizations requiring entrepreneurs and franchisors to cede majority control to their investors. Today, some private equity investors are willing to undertake minority recapitalizations for the right brands. While valuation is important in recapitalizations, the right fit is most important for all parties. The right partner/investor can help accelerate growth and increase returns for franchisor and investors alike.

Franchisors are just as susceptible as non-franchise companies to competitive pressures, shifts in demand and demographics, or the need to respond to changes in law or technology. Mergers with or acquisitions by competing or complementary franchise systems constitute a viable response to such pressures. Franchisors most commonly consider M&A transactions with other franchisors (and non-franchise companies consider franchise systems viable acquisition targets) based on:

- The desire to add new products/services to existing lines without incurring the expense or uncertainty of internal research and development.
- The desire to address a new geographic market or customer demographic without incurring the expense of attracting new franchisees to these locations or developing new advertising and marketing programs.
- The need to grow rapidly to more effectively compete with larger companies or to eliminate the threat posed by a smaller competitor.
- The desire to increase market efficiencies by acquiring suppliers (backward integration) or existing franchisees/distributors (forward integration), and
- The need to strengthen marketing capabilities or improve management depth and quality.

Myriad complex legal and business issues arise with any company's M&A transaction. This is especially true for franchisors that must address not only issues related to taxes, securities regulation, labor laws, employee benefits, antitrust, environmental regulation, corporate governance, bankruptcy and antitrust compliance, but who also must fully understand the nature of the franchise system's assets being acquired and the unique relationships among franchisor and franchisees.

Franchisors considering their first acquisition must understand that ***the transaction is a process not an event.*** The management of the process, the quality of the franchisor's advisor team, and a clear understanding of the franchisor's transactional objectives all are critical to ensuring that the completed deal ultimately succeeds for the franchisor, shareholders and the overall system alike. A painstaking analysis as to how the proposed transaction may affect franchisor-franchisee relationships – including potential brand dilution, the overlap of territorial rights, and potential consumer confusion about post-transaction product and service mixes – is absolutely critical to success.

Many investment banking firms have entire departments devoted to exit planning or capital infusion preparation. Clarifying goals and objectives at the beginning of an exit plan should ease a process that is often highly complex and unique to a specific business and industry.

A franchisor that has grown significantly while realizing strong earnings may believe this is a good time to sell and thus may begin engaging investment bankers to launch the process. Companies that have struggled in recent years may prefer to rebuild earnings before launching a sale some years hence. Some entrepreneurs and owners may prefer to complete a recapitalization now to gain a partner that can help scale the business now while allowing them to exit later. In-depth discussions led by an experienced banker can help clarify objectives, thereby creating a road map.

Once the franchisor's objectives and goals are clarified, it is important to determine the company's value and analyze value/risk drivers. An initial valuation will create a baseline against which to compare future valuations and company progress.

Thorough, periodic valuations subsequently will constitute useful status reports highlighting value drivers and areas in which the company has realized or still needs improvement. Typical value drivers address: earnings potential, quality of earnings, projected performance and, of course, risk. Value drivers allow owners to establish strategic and tactical plans to grow their companies into highly attractive businesses in advance of their eventual sales.

A thorough analysis of the franchisor's business valuation can enable owners to better manage their companies to perform optimally against such metrics as:

- A highly-experienced management team that is not overly dependent on a single manager or owner.
- Steady revenue and profit growth rates.
- Product and/or service excellence that makes the company a leader in its business sector.
- Barriers to entry that discourage competition, and
- A broad client base that minimizes overreliance on one or more of the company's top customers (among other value drivers).

Implementing value driver-based metrics likely will increase the company's ongoing profits while steadily building its value.

Preferably, owners should begin planning exit strategies one to three years in advance to allow ample time to grow their companies' investment values. In addition to identifying value drivers and developing their businesses based on those drivers, franchisors also may undertake a number of presale initiatives that should substantially enhance their businesses' salability, including:

- Creating tight financial controls and financial transparency - smaller franchisors may need to hire a CFO early in the process to prepare a transaction's financials.
- Establishing an effective management team - buyers are more likely to pay a premium for a business if they are confident the acquired company's managers will remain with the merged company to successfully execute the post-acquisition transition, minimizing risks that arise from wholesale management replacement.
- Committing the management team to stay with the company after the sale - if appropriate, a reward system to encourage this should be instated as soon as possible.
- Clarifying major contractual relationships with customers, suppliers, landlords, etc.
- Registering and protecting trademarks, patents and copyrights - while all franchisors should have marks in place, many may want to acquire trademarks in key international markets for future expansion.
- Seeking favorable media coverage for the business, products, services and personnel by retaining a qualified PR firm.
- Reviewing and ensuring compliance with Occupational Safety and Health Administration (OSHA) policies, and
- Ensuring all licenses, permits, franchise and tax registrations are in order - buyers often may want a legal opinion.

Even though a company may have diligently allotted a significant period of time to prepare for sale, many unexpected issues can arise that can hinder or halt negotiations, including:

- Changes in the macro economy.
- Force-majeure events like 9/11.
- Changes in the outlook of the company's industry.
- Sales of one or more similar companies at unexpectedly low prices, and
- Sudden negative changes in the company's financial and/or operational performance, etc.

Properly preparing to address such issues generally in the event they arise should increase a sales process' efficiency while helping maximize value. Companies considering a recapitalization/capital infusion that address such issues likely will engender confidence among investors that may translate into a more easily and more likely consummated investment.

Companies that engage an investment banker early in the process likely will benefit from the banker's efforts to facilitate an effective exit planning process. The investment banker can help the company clarify objectives. The investment banker also can

provide an initial valuation and periodic updates, make recommendations addressing weaknesses, and help determine the right time to seek a capital infusion or sale of the business.

The Buyer's Perspective: Conducting Due Diligence

Franchisors considering a merger or acquisition should begin the process by identifying transaction's objectives and potential target company criteria. A viable acquisition target may:

- Operate in an industry having demonstrated growth potential.
- Have taken steps necessary to protect proprietary aspects of its products and services.
- Have developed a well-defined and established market position.
- Possess "durable and consistent" franchise agreements with franchisees, including minimal amendments or "special exceptions."
- Have good franchisee relationships combined with strong customer satisfaction and brand loyalty to franchisees' core product and service offerings.
- Be involved in a minimal amount of litigation (especially if the litigation is with key customers, distributors, franchisees, or suppliers).
- Be well-positioned to readily obtain key third-party consents from lessors, bankers, creditors, suppliers and investors (as required); the failure to obtain necessary consents to the assignment of key contracts or to clear encumbrances on title to material assets may seriously impede the closing of a transaction, and
- Be in a position to sell so that negotiations focus on the sale terms rather than whether to sell in the first place.

In addition to strategic and post-integration issues discussed above, the following issues should be analyzed when evaluating a franchise system's potential acquisition:

- The strength and registration status of the target's trademarks and other intellectual property.
- The quality of the target's agreements and relationships with its franchisees.
- The status of any litigation or regulatory inquiries involving the target.
- The quality of the target's franchise sales staff.
- The quality of the franchisee relationships, including the regularity of the franchisor's cash flow from royalty obligations.
- The strength of the target franchisor's training, operations and field support programs; manuals, and personnel.
- The existence of any franchisee association and its relationship with the franchisor, and
- The strength and performance of the target's company-owned units (where applicable).

Sometimes, an acquirer affirmatively seeking to identify acquisition targets instead meets a target that itself seeks to be acquired. Such an acquisition candidate may offer an excellent opportunity for the acquirer, although the target's operations and financial condition should be inspected closely for any liability or potential pitfalls that may be hidden behind the sellers' strategic intentions.

Once two companies have agreed to move forward, a wide variety of legal documents and records, where applicable, should be reviewed and analyzed carefully by the acquiring entity and its legal counsel. Due diligence helps answer two very basic questions: (1) Why are we doing this deal? and (2) What risks will we assume if we decide to proceed?

The following is an illustrative list of some questions the acquirer and its legal and accounting representatives will try to answer as they draft acquisition agreements to memorialize the deal:

- What approvals will be needed to effectuate the transaction (e.g., director and stockholder approval, governmental consents, lenders' and lessors' consents, etc.)?
- Are any antitrust problems raised by the transaction? Will filing be necessary under the premerger notification provisions of the Hart-Scott-Rodino Act?
- With what, if any, federal or state securities registration or reporting laws must the client comply?
- What are the potential tax consequences of a transaction for buyer, seller and their respective stockholders?
- What are the buyer's potential post-closing risks and obligations? To what extent should the seller be held liable for such potential liability? What steps, if any, can be taken to reduce potential liabilities? What will it cost to implement such steps?
- What if any impediments exist to transferring the target company's key tangible and intangible assets, including real estate, intellectual or other property?
- What if any issues relate to such environmental and hazardous waste laws as the Comprehensive Environmental Response Compensation and Liability Act (the Superfund law), and others?
- What are the buyer's and seller's obligations and responsibilities under applicable federal and state labor and employment laws (e.g., will the buyer be subject to successor liability under federal labor laws and as a result be obligated to recognize the presence of organized labor and negotiate existing collective bargaining agreements)?
- Should employment, consulting, confidentiality or noncompetition agreements be created, or modified in connection with the proposed transaction?
- What are the terms of the target's agreements with its existing franchisees? Are these agreements assignable? Do they contain clauses giving the franchisor discretion to change the system or ownership? Could any of these terms cause problems for the acquiring franchisor at a later date?
- Is the target currently involved in litigation with franchisees, creditors, competitors or suppliers? Threatened litigation? Potential litigation? What risks of exposure does the acquiring franchisor face?
- Have the target's registration and disclosure documents been properly filed and updated?

The acquirer's business and accounting advisors will focus on the following issues:

- Does the target franchisor fit into the acquiring franchisor's long-range growth plans?
- What are the target franchisor's strong points and weaknesses? How does the acquiring franchisor's management plan to eliminate those weaknesses?
- Has the acquiring franchisor's management team developed a comprehensive plan to integrate the target's resources?
- What is the target franchisor's ratio of company-owned outlets to franchisees?
- Are the target's products and services competitive in terms of price, quality, style and marketability?
- Does the target franchisor manufacture its own products? What proportions are purchased from outside sellers?
- What is the target's past and current financial condition? What about future projections? Are they realistic?
- What is the target franchisor's sales history? Has there been a steady flow of franchise sales and royalty payments?
- What is the target franchisor's attrition rate? Have there been many recent terminations or transfers? Have any of these been contested by franchisees as lacking good cause?

Figure-A. Common Due Diligence Mistakes

Common Mistakes Made By The Franchisor Buyer During Due Diligence

- Mismatch between seller-provided documents and skills of the buyer's review team. The seller may have particularly complex financial statements or highly-technical reports that must be understood by the buyer's due diligence team. Ensure that the buyer and seller's advisors are compatible.
- Poor communication and misunderstandings. Communications should be open and clear between buyer and seller teams. The process must be well orchestrated.
- Lack of planning and focus in the preparation of due diligence questionnaires and interviews with the seller's team. The buyer should focus on preparing questions based on quality—not quantity. Sellers will resent wasteful "fishing expeditions" that make the buyer's team appear unfocused. There should be a clear fit between questions asked and the compelling strategic rationale underlying the transaction.
- Inadequate time devoted to tax and financial matters. The buyer's (and seller's) CFO and CPA must play an integral part in the due diligence process, gathering data on past financial performance and tax reporting, unusual financial events or disturbing trends or inefficiencies.
- The buyer must insist that its team be treated like welcome guests, not enemies from the IRS! Buyer's counsel too often is sent to a dark room in a far distant corner of the building to inspect documents without coffee, windows or phones. Sellers who provide reasonable accommodations and support for buyer due diligence team will enhance and expedite the transaction.

- Failure to closely examine intangible factors that drive a deal's success. A lack of shared vision or conflicting corporate cultures kill many deals. The franchisor's due diligence must include a process for measuring the likelihood that the two cultures and systems will complement each other post-closing.

The Role of the Franchisee in a Proposed Merger or Acquisition

Unlike other types of growing companies involved in mergers and acquisitions, franchisors have existing contractual vertical distribution systems in place through their franchisees. Franchisees' interests should be taken into account when the franchisor's counsel analyzes the legal consequences and potential costs of the proposed merger or acquisition. Franchisees are clearly "interested parties" whose contractual and other legal and equitable rights must be considered.

There is no statutory or legal basis for disclosing the intent to engage in a merger or acquisition. Nor is there typically any contractual requirement to obtain franchisee approval. However, good "franchisee relations" would dictate that franchisees should be aware of and involved in a transaction to some degree. The level of cooperation between the buyer's and the seller's franchisee networks can greatly facilitate the transaction or quite literally kill the deal, depending on how such communication challenges are handled.

Clearly, the franchisee will have some legitimate questions and concerns when it first learns of the proposed transaction. The savvy franchisor will anticipate these concerns and integrate the proposed solutions into its acquisition plan and communications with the franchisees and/or the franchisee association. Such concerns include:

1. What are the acquiring franchisor's plans for the acquired system? Consolidation and conversion? At whose cost? Liquidation? Growth?

2. What is the acquiring franchisor's reputation and management philosophy? What are its attitudes toward field support and ongoing training?

3. Will the acquiring franchisor be sensitive to the rights and concerns of the franchisees? Or will the franchisees adopt a, ``we'd rather fight than switch'' mentality toward the new buyer in anticipation of hostile negotiations?

4. How strong is the acquiring franchisor's financial position? Will the acquiring franchisor open up new opportunities for franchisees, possibly including access to new product lines, financing programs for growth and expansion, produce purchasing, and cooperative advertising programs?

5. If the target franchisor owns property that it leases to franchisees, will the terms and conditions of the current leases be honored by the acquiring franchisor? What about other contractual obligations? Will any special relationships with third-party vendors be affected or damaged by the transaction?

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ABOUT THE AUTHORS

Andrew J. Sherman is a Partner in the Washington, DC office of Jones Day**,** with more than 2,500 attorneys worldwide. Mr. Sherman is a recognized international authority on the legal and strategic issues affecting small and growing companies. Mr. Sherman is an ***Adjunct Professor*** in the ***Masters of Business Administration (MBA)*** program at the ***University of Maryland and Georgetown University*** where he has taught courses on business growth, capital formation and entrepreneurship for more than 23 years. Mr. Sherman is the author of 19 books on the legal and strategic aspects of business growth and capital formation. His eighteenth 18th book, **Road Rules Be the Truck. Not the Squirrel.** (http://www.bethetruck.com) is an inspirational volume published in the Fall of 2008. Mr. Sherman can be reached at 202-879-3686 or e-mail ajsherman@jonesday.com.

Burt Yarkin, Managing Director of The McLean Group's San Francisco, CA office, has more than 25 years' experience in the franchising business and a history of growing strong businesses. Mr. Yarkin has held senior management positions with such well-known international brands as Cartridge World, Gymboree and 1-800-Flowers and spearheaded efforts to grow those brands globally. As past CEO of Cartridge World, Mr. Yarkin oversaw one of the fastest ramp-ups in US retail franchise history and was instrumental in completing a large private equity transaction for a sale of the company.

Mr. Yarkin also was president of Next Development Group, a consulting firm that assists growth companies in strategic planning, business development, management building, global expansion and financing growth strategies.

He is a popular speaker at franchise, printing and imaging, and other business conferences and has been featured in articles in The Wall Street Journal, Business Week, The New York Times and Entrepreneur Magazine, as well as other newspapers, magazines and news programs. He is a FINRA registered representative and holds Series 79 and 63 licenses.

Jones Day

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THE MCLEAN GROUP

MERGERS & ACQUISITIONS

The McLean Group has an experienced team of senior investment bankers dedicated to a variety of market specializations including

franchising. We had a very strong year in 2010 and 2011 is starting off at an even more aggressive pace. Our seasoned professionals combine in-depth industry knowledge with M&A best practices to help middle market companies achieve their strategic objectives. We work closely with our clients to develop a comprehensive set of strategic alternatives and then evaluate and execute the most suitable approach.

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As a core competency and complement to its merger & acquisition business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes. We are the largest valuation practice in the Mid-Atlantic region, outside the big-four accounting firms. We average over 250 valuations annually, and over 40% of these are for government contractors and defense companies.

CORPORATE FINANCE

The McLean Group helps clients determine and implement the most desirable capital structure to support future growth while managing risk effectively. Within the defense and government space, we have unmatched access to both debt and private equity sponsors focused on the sector.

MARKET INTELLIGENCE

Our market intelligence group leverages superior competitive analyses and its expertise in the defense and government contracting community to provide executives with comprehensive market intelligence reports which serve to reduce risk and uncertainty in strategic decision making.

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