CREATING SHAREHOLDER VALUE: GROWTH HORMONES FOR THE FRANCHISE SECTOR

How much is your business worth? Have you thought about it? Your franchise business may be your most valuable asset and can be at significant risk unless you have determined an appropriate strategy to maximize the value of your lifetime investment in your franchise system. The *right management* will continuously strive to improve the performance of the company and ultimately *maximize the value* of the company for shareholders. All financial stockholders, investors and lenders alike, will be watching management closely, their master plan and *corporate vision for expansion* and their ability to meet the challenge of competition.

For too many, the final determination of the exit and the value of the business – which represents a lifetime work – is the most neglected decision. *Creating shareholder value is a discipline* to be adopted at the beginning. Consider these *examples of cases where value* in business assets *was lost*:

- The *illness or decease* of a principal force where the successors were incapable of continuing a non-expanding business resulted in the inability to find a buyer, with a minimal realization to the estate on wind-up.
- A *concept* that has never changed and is *stale-dated*. A serious offer to acquire a franchise system (300 sites) for a significant price was rejected out of hand at the height of a business cycle. The market is fierce and includes a wide range of new and imaginative competitive concepts. It will be a long time before this franchise system is again or at all presented with such a sizable offer.

Value mechanisms for rapid business expansion *function like growth hormones*. Franchising is one such mechanism. Growth hormones are also generated by strategies for:

- Strengthening the franchisor-franchisee relationship
- Profit enhancement and retention
- Acquisitions, mergers and divestitures and conversions
- Financing
- The international expansion stage
- The exit-payback time

Let's examine these strategies.

THE FRANCHISOR-FRANCHISEE RELATIONSHIP

Franchising provides *a viable structure for financing and managing a rapidly expanding multi-site operation*. But it requires *franchise expertise* and the *commitment* to be sensitive to the franchisor/franchisee relationship - the partnership. Consider these examples:

- A franchise system (250 sites) – initially rapidly expanding and prosperous; however, dictatorially run and completely *insensitive* to the needs and views of the *franchisees* – ran into a brick wall when the franchisees went on strike with the result that the reduced chain is now a shadow of what it might have been.
- A franchisee, although young in years, operating 5 sites with significant sales and profits per site – was quite concerned when he was presented with a first right of refusal on a new site immediately across from an existing site. He accepted rather than compete with another franchisee. The performance of the initial site was not affected and the new site has matched the performance of the initial site. The chain is well-known for its *ability to select and adequately train* the right franchisee candidates and provide them with *excellent support*.

Franchising is a *pseudo-partnership* between large business, represented by the franchisor, and small business, represented by the franchisees. It is a relationship that satisfies the needs of the smallest entrepreneur and the ambitions of those with large visions.

- *For the franchisee*, it represents a start in business.
- *For the franchisor*, it represents *rapid expansion*, *financing* via the franchisees and a worldwide *management* team.
- *For both*, it is *teamwork* and an opportunity for tapping into new and *innovative ideas*. At all times, the franchisor is the mentor and custodian of the business and its franchisees.

As with any other business, *the parties are bound by a franchise agreement* which governs the relationship and the financial sharing. It is not in the specifics, but in the intangibles and the soft issues that problems arise. *The essential components for awareness are*:

- The *due diligence* process by which *franchisors and franchisees* can *qualify one another*. Franchisees must ask the right questions about the system they have joined or may wish to join. The franchisor must undergo a self-assessment to determine what the system lacks, what is going right, in order to have satisfied franchisees, and to attract new franchisees.

  The franchisee is dependent on the latter and should investigate carefully the disclosure document or statement of material facts. Obtain a complete list of

franchisees, call a sufficient number of them. Investigate the terminations, query the validity of the financial projections submitted by the franchisor and the process for a satisfactory resolution of disputes and problem solving, training, communication and marketing, overall satisfaction, etc.

For franchisors, it starts with selecting your partners - the franchisees. Franchisors, in a rush to get going and to raise funds, too often focus on the selling of franchises instead of the selection of candidates, a choice that could mean the success or failure of the system. It takes patience, planning and skills to make the right selection. Franchisors, ask yourself: *"Is the franchise system attracting the right type of people for the business to succeed?"* If not, choose an experienced effective person to handle the interviews.

- The *appropriate attitudes* that foster healthy relationships. Identify the ***pitfalls*** and *abuses* that can lead to a failed relationship.

- *Have you lived it* - a successful franchising system? If you haven't, consider acquiring franchising expertise by first working in a franchising system. To begin with, if you are starting at the bottom, you can progress from employee to manager to owner-manager (franchisee) and, finally, to franchisor, possibly initiating a new concept. The following table illustrates the levels of *skills required for someone advancing through the franchise process.*

Skills and Qualities	***Importance to***			
	Employee	***Manager***	***Franchisee***	***Franchisor***
Enjoying people	x	x	x	X
Personal interests	x	x	x	X
Managing money		x	x	X
Organizational		x	x	X
Entrepreneurial			x	X
Leadership				X

Now, many franchise systems have adopted policies to help identify and groom qualified franchisees from within the system via an *employee incentive program.* The accumulation of points or credits for performance and sponsorship provides the opportunity for employees *to acquire a franchise unit* at a discount. The risk is less and the opportunities for success is greater with a franchisee that is known to the organization compared to one selected from the outside.

The franchisor's concept should have the potential for *sufficient profit margins* (of the products or services) that can be satisfactorily shared by the parties pursuant to the franchise agreement. The higher the profit margin, the more likelihood that the franchise will succeed and good relationships will prevail. A franchisor must design the franchisee package to ensure that something is left on the table for the

franchisee – offering adequate gross margins and reasonable facility costs and royalties.

For both, most important, the *franchise agreement* must be exactly right. For the relationship to operate successfully, both sides should be protected and the pitfalls and disputes avoided. Franchisees need to know that the *franchisor is listening to* their *problems***.** However, while as franchisor you must be fair, you must also be tough – willing to take decisive action when necessary. This is a vital component of strong, successful leadership.

Ultimately, the franchisor-franchisee relationship is critical to attract the right type of franchisees to grow the chain. Unfortunately, it often does not get the attention it deserves.

PROFIT ENHANCEMENT AND RETENTION

Internal profits finances the expansion and rollout of new franchises. Your *company strengths* should include the following *to maximize cash flow and growth:*

- Strong management, visionary leadership and a continuing development of "intellectual capital"
- Market dominance, brand recognition, knowledge of the competition
- Timely and quality financial reporting, planned strategies for expansion
- A strong franchise network, strategic alliances
- Good relationships with all stakeholders including franchisees, customers and suppliers and financial community

Unfortunately, the *franchise sector* – although at a *trillion dollars worldwide* – is *not well understood* by the financial community at large, unlike, say, certain Chartered Banks who has acquired the necessary franchise expertise. Consider the following examples:

- A 250-site, rapidly growing chain was being approved for a substantial *public offering*. At the very last second it was brought to the attention of the underwriter that interviews with franchisees are an important component of the due diligence process. Final *approval was denied* when it was determined that the *franchisees*, in large numbers, were *disgruntled*.
- The closing of an acquisition/merger of two entities was in peril as a *financial proposal* was *not adequately prepared* and presented to the company's bankers on a timely basis to make available the funds on closing pursuant to the purchase agreement. It was only with the assistance of the auditors that the closing of the transaction was extended and a complete financial document submitted to the bankers who approved the funding.

To develop the profile of a successful franchise system, you require *a written business plan* in writing to get there. Often, key management consists of a few individuals who wear too many hats. A *mature franchise system has a structure* to control all aspects and complexities of the system and ensure the successful performance by all parties – your *"intellectual capital"* i.e., researchers with technical "know-how", product designers and marketers, accountants and financial analysts, strategic planners, real estate construction and leasing, franchise and industry specialists. *Develop an Organization Chart. All parties must agree to a framework to establish clear lines of decision-making and duties.*

The development of *a brand name* is essential for customer awareness and to stay ahead of potential competitors. *Customer satisfaction* is critical. It requires the *right corporate attitude* coupled with staff training and the identification of customers' preferences.

Consider other *profit centers* :

- Maintaining *your own facilities* to process or manufacture your unique product.
- Your own *central warehouse* to buy directly from suppliers.
- Franchisor, remember your industry expertise is franchising. Once you have your specialized team in place, you are *not restricted* to operating only *one franchise concept.*
- Consider strategic alliances with others, *dual or multi branding* and complimentary franchise systems to share customers, marketing programs and franchising overhead costs.

Finally, be conscious of the *business cycle.* It has a beginning and an end. To make the right decisions requires *knowledge and planning* – an understanding of world events and the business climate, and an awareness of the vulnerability of your business to such factors. As an illustration: the recession of the early 1990's provided opportunities for favourable lease arrangements on prime sites and unemployed middle managers with savings as potential franchisee candidates.

FINANCING THE FRANCHISE OPPORTUNITY

Adequate *financing* is required *for working capital, expansion, acquisitions or mergers.* The retention of profits, the earning of franchise fees and the assistance of financing via the franchisees are sometimes not enough for the franchisor to finance the expansion and growth of the system. It is important to know *when* and *why* you should look at alternative forms of financing and *where* to find them.

Your banker will most often be your first stop. Nonetheless, the *Canadian investment industry* is also represented by pension funds, insurance companies, trusts,

government and private sources. It is always easier to have a well-connected, well-respected *outside advisor* introduce you and "walk you in" to discuss financing. The presentation of a well-developed financial proposal that includes realistic projections is critical. The financing may take the form of *debt* or permanent *equity* or a *combination* of both.

Alternative financing structures include:

- Small business loans (SBL)
- Term lending
- Mezzanine financing
- Venture capital
- Business Development Bank of Canada (BDC)
- Asset based lending
- Private placements/joint ventures
- Public underwritings

You must meet with a number of *potential investor groups* – preferably *a short list. Seek referrals.*

For *most franchisees*, particularly single site operations, there are not the same finance alternatives available. But bankers with an intimate knowledge of many of the franchise systems have been most active in providing funds to franchisees.

Conventional financing, while available for profitable mature businesses, is however, gun-shy of *start-ups and early stage* franchise systems without a sound track record. The latter may be required to seek private investors (angels) with deep pockets, friends and relatives for financial assistance.

ACQUISITIONS, MERGERS, DIVESTITURES AND CONVERSIONS

To maximize share value and facilitate financing, *companies are seeking solutions* on all fronts. The huge *corporate overhaul* includes downsizing via job reductions and selling off non-compatible (non-core) or low performance divisions.

As an illustration of expansion via acquisitions: A franchise system (over 100 sites) adopted a strategy for expansion which included the acquisition of independently owned corporate sites and their conversion to the franchise system concurrent with the reselling of the sites to qualified franchisees. This strategy maximized the opportunities for acquiring good sites with immediate cash flow

and experienced quality staff – versus the longer time frame and risk for a new start-up to get going. The principals ultimately were offered and accepted a significant price for the business.

Business combinations may be more complex and can be structured as follows:

- Acquisition/takeover
- Merger/amalgamation
- Reverse takeover
- Asset purchase or share purchase – the choice between two forms of ownership for tax and other considerations.

Purchaser's issues to consider:

- *Compatibility* between vendor and purchaser
- The existence of *potential synergy* with a target company – creating strengths and economies of scale, one where 1 + 1 = 3 to create a superstar.
- Planning the acquisition *financing*
- A *search for a target* company will identify a list of suitable candidates. Sources will include investment dealers, chartered accountants, lawyers, bankers, other professionals, industry associations, the Canadian Franchise Association and business contacts.

The purchaser will assemble its *team to negotiate* the acquisition and perform the *due diligence* review. The potential vendor will provide information upon the execution of a confidentiality agreement. The *major points* for negotiation are the *price* and *consideration*, *management contracts* and *non-compete clauses. Management continuity* is essential. The purchaser must ensure that his corporate operations are not interrupted by the absence of key management representatives on the acquisition team.

- The outcome must be a *win-win* on both sides for a successful business transaction. *Compromise*, as well as negotiating tactics, is essential.
- For a complex transaction, you may need to *enlist the help* of your auditors, lawyers and financial and tax advisers, all of whom should have *franchise expertise.*

A company with *corporate-owned sites* may be targeted for acquisition – to be converted to a franchise system. There are *expectations:*

- Recovery of a significant portion of the purchase price via the sale of the sites as franchise outlets
- A more rapid roll-out of new franchises

- An improvement in profitability and new, creative ideas fostered by the franchisee network

To determine the viability of a conversion, it is imperative to *develop a financial model*. With the assistance of your financial analysts and advisors, stand back to scrutinize every possible eventuality until you are satisfied that your model is realistic, the proposed transaction is viable and the results will closely meet your expectations.

VALUATION OF FRANCHISE COMPANIES

The *determination of the price* of the transaction, the *major point for negotiation,* starts with the consideration of fair market value. But valuations are not an exact science. They are even more complex. Consider the following:

- Comparative data is difficult to find.
- How much of a premium does one pay for control? Should the value of a minority interest be discounted in a closely held company?

The most *traditional approach* is the normalized after-tax earnings technique.

Sustainable Earnings from Operations (after tax)
x
Multiplier (Capitalization rate)
=
Going Concern Value of Operations
+
Non-operating/Redundant Assets
(i.e. surplus cash available for distribution)
=
Fair Market Value of the Business Entity

You might balance this approach with *a net after tax cash flow approach*. Determine a *capitalization rate,* based on the expected rate of return appropriate to the risk. Often this is a difficult judgment call. Seek the appropriate *rates of comparable published transactions*. Often public market capitalization rates may be used but solely as a starting point for the valuation of a privately owned company – with other considerations.

PLANNING THE INTERNATIONAL EXPANSION STAGE

In most cases, it *usually begins with an enquiry* - for a potential franchise/master license - from outside a principal jurisdiction where a mature franchise system with brand recognition is operating. But you must *be prepared with an infrastructure* in place *and a strategy.* Seek international professionals with franchise expertise to provide legal, strategic and tax advice.

Seek the opportunities afforded by strategic alliances, joint ventures or master licenses *in other jurisdictions.*

- Your joint venture participants should have the appropriate franchising expertise and share your vision.
- Business customs and rules, "what's hot, what's not" differ from jurisdiction to jurisdiction. Your joint partner or licensee should know the industry trends and competition in his or her jurisdiction as well as the customs of the population.
- Do not overlook the potential of developing countries as they are growing at a more rapid pace of that of the Western World.
- Be careful, however that the lure of the international marketplace does not tempt you to take short-cuts or abdicate to others – monitor to ensure your standards of quality are in place.
- The joint venture or master license agreement should ensure that you, the franchisor, are protected in the event of default by your joint venture partner.

That is not to say that early stage companies cannot cross oceans right from the start. Help is more available today from specialists who can assist with networking and contacts to quickly build an international infrastructure for you.

THE EXIT-PAYBACK TIME

A payback may be your gratification from having started a *family tradition* that ensures your *business will continue* for the benefit of succeeding generations, providing you have the outside resources and assets not dependent on a sale of your business to finance your retirement. The major issues are fairness towards all your children and selecting the best managers for the business. However, one must never assume that the next generation can carry on the tradition and success of the predecessor or founding generation.

As previously stated, your franchise business may be your *most valuable asset* and can be at significant risk unless you have determined an appropriate *exit strategy* to maximize the realization of the value of your lifetime investment in your franchise system.

The Caveats

- *Prepare for retirement* well in advance – *seek the assistance* of professionals with franchise expertise.
- *Timing* is important, consider: the *business cycle*, *age of Principals*, *longevity of a concept* .
- *First impressions* are important – your business plan serves as a *disclosure document* that requires a professional quality to validate a higher valuation and particularly where the owner-manager has developed a *brand concept* and a *key management team*
- You are seeking a *sophisticated buyer* - not a tire kicker - with serious intent to complete a transaction. Qualify the buyer before you proceed. A high offer should be considered seriously, i.e., *special buyer* - it may never be offered again.
- *Patience is required.* Many sellers of businesses are surprised to learn that after a lifetime of work, buyers are not beating a path to their door. Finding the right buyer might take anywhere from 6 to 24 months. Negotiations can be *time-consuming,* unsettling and frustrating. For a successful transaction, you want to create an environment that engenders cooperation, chemistry and an opportunity for *a win-win* on both sides.
- *Consideration in kind is at risk - cash is not*. With an unpaid balance insist on adequate security and guarantees.
- The *sale of a franchisee's unit* in most instances may be governed by the franchise agreement with the franchisor and there may be ***restrictions,*** e.g., approval of buyer and price. These provisions should be reviewed carefully by the franchisee's lawyer.

Alternative Complex Exits Include:

- The *Management Team as Buyers.* Your key people become the successors to the ownership of your business. They will have considerable credibility to facilitate the funding of the buy-out, having demonstrated that they can run the company without the significant shareholders' assistance.
- *Business Combinations.* The owners of one company are older and seek retirement. The owners of the other business are younger, do not have the cash to buy out the former and require the former's expertise during a two-year transition period. The expectation is that the combined entities in two years' time would be of greater value to the retiring shareholders and could readily facilitate the financing of the acquisition of their shares.

- *Going Public*. The *shares* of such an entity *represent liquidity and can be sold* in the public market. The owner-manager may realize significant gains from the sale of his holdings over time - as public company shares *exact a higher price multiple* than that of private company shares.

- A merger/sale via *a share exchange with a public company*. Where you take back shares as consideration, investigate that company most carefully.

There is *a time to sell* - to receive a payback to compensate your lifetime work. Determine your *exit strategy* so you won't miss your window of opportunity.

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Growth is the key to the creation and maximization of *share value*. Successful companies focus on top line growth and intellectual capital, sound acquisitions and strategic alliances, and good relationships with stakeholders and the financial community.