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FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 12. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room:

1. Delay Franchising Until the Model is Proven
2. Carrol's and Cambridge Merger Creates Burger King 1,000 Lb. Gorilla
3. Papa John's Secures $200MM from Starboard Value LP
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Tag Line: The Restaurant Boiler Room is a one-stop-shop for multi-million dollar merger and acquisition activity and financial complexities affecting the franchise restaurant industry. We talk money, deals, valuations and risk – delivered to the front door of franchisees, private equity firms, family offices, large investors and franchisors on an every-other-week basis. Feel free to find our content at Unbridled Capital's website at www.unbridledcapital.com

Now, let's enter the Boiler Room:

A. Delay Franchising Until the Model is Proven

   a. Background: QSR Magazine recently wrote an article entitled 'Why Stalling Franchising Can Be the Best Way to Jumpstart a Brand.' Around 12 years ago, I was a franchisor of a small, start-up restaurant brand. There was one very successful unit, and we franchised it in another area of the country, hoping for success. There were several reasons why it didn't ultimately work, but I learned some valuable lessons along the way - lessons that lead me to believe wholeheartedly that franchising is almost always a bad idea when it is first brought up in a growing brand.

   b. Comments: Because of plenty of years in M&A and investment banking, I have been conditioned to think about how to sell something before you even buy it or invest in it. In the case of starting a new concept, in order to one day sell it for a high multiple, you need every location (or almost every location) to be a success in order to convince a future investor that your brand will be a great investment for them. Here are some things to consider:

      i. Too many new concepts that start successfully don't have a franchising plan at all.
      ii. Many brands will then sell a franchise to a friend in a different state. This does nothing for brand awareness, and it makes the franchise very difficult to operate.
      iii. When you do not concentrate your store development in a small territory, not only do you increase your operational costs and complexity, but there are no marketing synergies and the overall failure rate is much higher. Remember, you don't want any restaurant to fail – it messes up your story to investors in the future.

iv. If you have a few successful locations, keep gradually growing in your market until you have a critical mass. Resist the temptation to move to another city or state until your first market is built-out and successful.
v. Once this happens, replicate it in a second market that is near-by. Don't franchise yet. Grow the second market to profitability, sharing the operational expertise and marketing buzz with the first market.
vi. Once you have two awesome markets and 10-15 locations or more, then it is time to enter the next phase – franchise slowly in a nearby market, raise capital for more company unit growth or sell the entire business to an institutional investor.
vii. And if you are an existing franchisor and your performance is lagging, stop the franchising program until you fix your problems!

c. Effect on M&A: On the small franchisor side, M&A multiples have been incredibly rich, often doubling or sometimes tripling the value of a franchisee's business. As the market has gotten frothy, some small franchisors are now selling on a multiple of sales – because there is no reliable EBITDA after factoring in new store development costs and heavy G&A spend.

d. Interest is intense, and there are many buyers for successful and small franchisors. Why is this? There are several reasons, but two are primary – 1. Small franchisors can grow with incredible operating margins through franchising. In this case, the franchisor manages the brand, implements the standards and collects an annuity stream of royalties without spending much capital. The business can grow quickly in this way, and the future sale of the company will achieve a big EBITDA multiple and 2. Many family offices/private equity firms have agreements with investors that prohibit them from becoming a franchisee, most likely due to fund life or lack of control. When you own a franchisor, you instead own the brand. Sure, you take big risks that the new brand will make it, but you have freedom to grow it without anyone else telling you what to do. And really, who wants to be told what to do?

e. Franchising is one of the largest forces of nature in the US economy. It has a huge impact on the DNA of everyday Americans all over this country. If you have a brand, be patient and avoid rushing to find franchisees. First, make your business as successful and profitable as it ever could be. Good things come to those who wait.

B. Carrol's and Cambridge Merger Creates Burger King 1,000 Lb. Gorilla

a. ***Background***: On a recent investor call, Carrols Restaurant Group, the largest Burger King franchisee in the U.S., announced that it has entered into a definitive Agreement and Plan of Merger to acquire 166 Burger King and 55 Popeye's restaurants from Cambridge Franchise Holdings in 10 Southern states. The transaction will be structured as a tax-free merger. Cambridge is controlled by Garnett Station Partners' Matt Perelman and Alex Sloane along with several family offices. At closing, they will own approximately 16.6% of Carrols' outstanding common shares. The transaction value of $238 million reportedly values Cambridge at 5.0 to 5.5 times pro forma restaurant-level EBITDA.

b. I know Matt and Alex, and they were first-movers and trend-setters for new franchisees that have become more commonplace over the past few years – Ivy-league educated, NYC-based, millennial-aged and backed-by well-capitalized investors. Many brands have tried to clone this model that Matt and Alex created in Burger King, particularly in Wendy's and Pizza Hut.

c. Carrols' has a Right of First Refusal ("ROFR") in 20 states until it reaches 1,000 restaurants. In conjunction with the merger, Carrols has entered into a new Area Development and Remodeling Agreement that expands ROFR to 500 additional Burger King restaurants (excluding the Cambridge restaurants) and also expands the Company's ROFR territory to include most of Arkansas, Louisiana, Mississippi, and Tennessee. There will evidently also be a ROFR on Popeyes acquisitions in Tennessee and Kentucky.

d. Carrol's has in turn agreed to relinquish its ROFR where it is not currently expanding (Connecticut, Delaware, Massachusetts, New Hampshire, New Jersey, New York, and West Virginia). As part of the agreement with BKC, Carrols has also agreed to develop 200 new Burger King restaurants over the next six years and to remodel or upgrade certain of its restaurants to the Burger King of Tomorrow image.

e. Comments: This transaction is quite a big deal indeed. There is much to digest here, but here are some comments:

    i. Franchisees continue to get bigger each day – or so it seems. The small guy is going away, the mid-sized guy is starting to go away, and even the large franchisee is going away too. This up-cycle of M&A consolidation has really re-defined our preconceived notions on what is a large franchisee. I used to think a large franchisee owned 50 location. Nowadays, however, it seems a large franchisee must own at least 200 locations or more.

    ii. BK and Popeye's Corporate (owned by Restaurant Brands International or RBI) are clearly looking for consolidators. Extending a ROFR like this is somewhat un-heard of in the franchise industry. Additionally, the ROFR will be increased to 1,500 locations and has mention of the Popeye's brand too.

    iii. RBI is on a huge development push – a key component of their growth strategy. The addition of 200 new BK locations in 6 years is a great way to continue this growth plan.

    iv. This announcement gets Carrol's into the Popeye's brand. Expect gradual consolidation in the Popeye's brand, which has many smaller, undercapitalized franchisees throughout the country not including the larger Corporate markets that were refranchised to larger operators several years ago. The Popeye's franchise system has some structural disadvantages that make a consolidation very difficult to accomplish, but if Carrol's gets an expanded ROFR beyond TN and KY, that would help.

    v. Large investors and franchisees want to operate in the Midwest and Southeast where rising minimum wage is much less of a concern. Giving up a ROFR is not something a franchisee would generally do very easily. However, in this case, Carrol's has done so in the Northeast. Not many people want to own franchise businesses there anymore.

    vi. I have no knowledge of this, but I would not be surprised if Matt and Alex are using this merger as their opportunity to do something else. These guys are smart, forward-looking and ambitious. I'd be surprised to see them spending most of their time in a small ownership role at Carrol's.

    vii. And, a salient question is this – are these mega franchisees a good thing for our industry? My guess is maybe so, maybe not. We will see what happens when the next financial meltdown occurs. It is not difficult to see a franchisor losing control when their franchisees are bigger and more powerful than they are.

C. Papa John's Secures $200MM from Starboard Value LP

a. Background: Starboard Value took control of Darden's board in 2014, resulting in a turnaround and huge appreciation in its stock price. Darden owns a host of casual dining brands including Olive Garden, Longhorn, Cheddars, and others. Steve Ritchie will remain as Papa John's CEO, and the board of directors will be expanded. At $200MM, it appears that Starboard will own between 11-15% of the outstanding common stock of Papa John's, and Papa John's plans to pay down debt and provide financial flexibility with the proceeds. Starboard has the option to place another $50MM into the deal. Interestingly, John Schnatter voted against the deal.

b. Comments: It is no surprise that Papa John's has been struggling. Q1-Q4 2018 North American same store sales growth was (5.3%), (6.1%), (9.8%) and (8.1%), respectively. The brand has been looking for a rebound, which has proven somewhat elusive despite leadership changes, new loyalty programs and assistance to franchisees.

c. Effect on M&A: I don't quite know what to say here. Papa John's has a great product and a strong presence in the Midwest and Southeast. Obviously, as a Louisville, KY resident, I know the brand well – their headquarters is near my house. Starboard does indeed have a turnaround reputation, so perhaps this capital and strategic investment will help the business improve in the near-term as franchisees and the franchisor alike are struggling with a sales 'reset' as they roll-over poor comps and look to stabilize in 2019, especially in late Q2/early Q3.

D. A Day with David Novak, Former Yum CEO and Founder of oGo Lead

a. Background: Recently, I was honored to be invited to a day-long Round Table discussion at Yum Brands with 6 Louisville business leaders and David Novak, former CEO at Yum Brands. David Novak founded and now runs oGo Lead, an on-line leadership development company. The topic of our discussion was to discuss best practices on recognition in the workplace and to learn from David's vast Yum experience at developing a recognition-based culture that improves morale and reduces turnover. I'm a restaurant and investment-banking guy, and the other local business leaders were in the fields of IT, investment management, marketing, leadership and telecommunications.

b. I hope you won't mind taking a slight detour here from what we normally discuss in the Restaurant Boiler Room. Over the years, a big portion of our Company's success is due to Yum franchisees. Tony Petrunin in our office is a former Pizza Hut Corporate employee, and I worked at both Yum Corporate and KFC Corporate. David Novak's leadership and legacy have had a big impact on Unbridled as well as the success of many franchisees over the world for decades.

c. Comments: It was a fantastic day, I must admit. We did about 4 hours of videos around a board-room table. Much of the day was a question and answer session on recognition. David Novak has a remarkable talent and passion for appreciating and recognizing people. He developed awards to recognize employees – a floppy chicken when he was at KFC, a big cheese-head when at Pizza Hut and a clattering-teeth with feet when at Yum. David's office – which is still intact and is a museum-of-sorts at Yum today – is filled (even on the ceilings) with pictures where he recognized people around the world for their contributions to Yum. David created the How We Work Together

Principles at Yum and was a champion of the phrase – ‘People Capability First, then Customers and Profits will follow.’

d. Here are several take-aways that I won’t forget:

    i. A recognition program needs to be well-planned out and supported.
    ii. Any recognition must be specific and sincere.
    iii. Recognition needs to tie back to your company’s principles or what you are trying to achieve as an organization.
    iv. Most employees feel badly under-appreciated and under-recognized.
    v. Some studies show that recognition is more important than compensation.
    vi. Peer-to-peer recognition is a big deal and needs to be fostered between co-workers.
    vii. David uses props and trinkets to recognize people – but he personalizes each recognition award by writing the specific action he wants to reinforce on it.
    viii. When developing a recognition culture, it can be a trial and error approach – just go for it and adjust as you learn.
    ix. Almost everyone in an organization will appreciate being recognized for a job well done, regardless of the personality type.

Closing: Thanks so much for entering the Boiler Room today. You can find our podcasts on iTunes, Google Play, Stitcher, TuneIn and Spotify. If you like these podcasts, please listen, rate and review! I also encourage you to visit our website at www.unbridledcapital.com for the best franchise M&A and financial resources in the industry. Our website includes podcasts, videos, white papers and a list of our M&A transactions.