Unbridled Capital
FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 4. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room, I answer Round 1 of questions in a two part series from a recent interview with Chris O'Cull, Consumer & Retail Analyst for Stifel Financial Corp:

1. Why is restaurant M&A hot?
2. Which restaurant franchises are in the most demand? Why?
3. How do buyers and sellers think about valuation when considering a transaction?
4. What are the biggest obstacles to overcome when completing a franchise-to-franchise transaction?

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. Why is restaurant M&A hot?

Many asset classes have appreciated significantly in the past 5-6 years. For example, real estate prices currently are high, and the stock market has had an unbelievable run. If you are reviewing your investment returns over the past few years, you are likely very happy, but you are probably having trouble deciding where to invest now to get a decent yield on your money. Everything seems fully valued.

For institutional investors, this same problem exists. Increasing wealth and cheap debt have created huge appreciation in most asset classes, and businesses and real estate don't look as cheap as they used to look. With a ton of cash on hand, these investors begin to ask themselves – 'Where can I go to find a better return and get some diversification?'

The answer to this question inevitably leads them in two different directions: 1. Acquiring different types of businesses that previously were overlooked and 2. Journeying down-market to find smaller businesses that are undervalued, can be consolidated and don't have access to sophisticated capital.

As the ball has rolled down-market, franchise restaurants have benefited from this trend. When I first started working for Yum Brands Corporate in the early 2000's, there were almost no private equity investors as franchises, for example. No one even knew what a family office was. Most legacy franchise systems were populated with the original franchisees who were smaller in size and unsophisticated as to their capital structure. Only a few franchisees in each brand were doing larger acquisitions.

Imagine the famous painting American Gothic by Grant Wood. It depicts a farmer with a pitchfork and his daughter. This visual can give you a rough idea of how franchising started for many operators.

Fast forward to 2010-2013 timeframe, and the consolidation trend started to pick up. It started mainly by independent operators acquiring smaller franchisees. The mid-sized franchisee started to double in size while there was an occasional large institutional buyer entering the business, making big headlines.

Smaller operators didn't have a succession plan and no longer wanted to fight tighter profit margins and increased regulations. This initial consolidation was instrumental to what we are seeing today because institutional investors would never have had the patience to acquire 5 restaurants and grow little by little through smaller M&A consolidation, but the mid-sized operators were happy to do it.

In recent years, franchise M&A has really snowballed. Professional investors have started following the cycle I mentioned earlier and, all the while, the size of the average franchisee has increased dramatically as mom-and-pop operators were replaced with mid-sized franchisees who eventually became large franchisees.

We now see $2MM - $10MM in EBITDA as the entrance point for investors in franchise businesses, which is quite a bit lower in size than what we've ever seen – again, going down-market has created more opportunities for investment. Deal flow is now high, credit remains relatively cheap, new family offices are looking at deals seemingly every day, and acquiring restaurants is suddenly a cool thing to do!

B. Which restaurant franchises are in the most demand? Why?

The answer to this question is more difficult than you'd expect. Initially, consider the restaurants with the most loyal customer following, most innovative products, highest unit count, biggest unit growth rate, most years of consecutive positive sales comps and brands with a dominate position among their competitors in a narrow segment of the market, such as burgers, pizza, tacos, and chicken.

You'll come up with names such as McDonald's, Starbucks, Chick-fil-a, Taco Bell, Domino's, Panera and Dunkin'. These are a handful of the brands that are the best at what they do. However, their franchise models are very different from one another. McDonald's, for example, controls the real estate under most franchisee's buildings, and it therefore has a heavy hand in who enters and exits its brand. The M&A process here is severely restricted.

Starbucks, Chick-fil-a and Domino's are three other examples. Starbucks doesn't franchise, and Chick-fil-a has a very selective, owner-operator model that limits franchisees to only several stores and invests alongside them as a financial partner. This greatly lessens M&A since franchisees don't really have control. Domino's limits a franchisee from becoming actively involved in another business – this effectively cuts out M&A for anyone who isn't raised up in the Domino's system or isn't an existing franchisee.

Adjusting for scenarios like this, you are left with a different set of high-demand concepts that are more of a 'free market' investment for a franchisee: Taco Bell, Panera, and Dunkin' would be at the high end from a demand perspective.

The next tier contains names such as Wendy's, Popeye's, Buffalo Wild Wings, KFC, Pizza Hut, Burger King and Arby's. Further down are larger national brands not already mentioned and some fast-casual brands.

Finally, the lower tier are regional brands with lower unit count, sandwich brands, casual dining brands and various pizza brands. There is demand here but typically at lower valuations unless the individual franchise is special in some way.

C. How do buyers and sellers think about valuation when considering a transaction?

The restaurant industry has a very particular way to think about valuations, and this is different than what most people learn in business school. The methodology is simple, but like everything in restaurants – from financing to marketing to operations – it is difficult to execute correctly and easy to mishandle.

Restaurant valuations are determined based on several criteria on a Trailing Twelve Month or Rolling 13 Period basis: Net Sales, Real Estate Owned Versus Leased, Pre-G&A EBITDA, Implied or Actual G&A Expenses, the famously known EBITDA Multiple, Remodeling Dates and Remodeling Costs. If the real estate is owned, important factors are Implied Rent, Cap Rates and Rent Coverage Ratios.

For a simple example, a valuation for a restaurant that is not fee-owned would essentially take pre-G&A EBITDA less a G&A allocation, then multiply by an EBITDA multiple and finally reduce the result by a discounted value of several years of future remodeling obligations. Real estate would be valued at implied rents and prevailing cap rates, subject to rent coverage ratios and term of remaining franchise agreements. From a high-level, post-G&A EBITDA multiples generally range from 4.5 – 8.0X. Cap rates are generally between 5.75 – 7.50%.

However, it takes much experience to correctly apply the various criteria based on brand, geography, size, performance, tenure, operational track record and other factors. For example, a 2-unit Taco Bell business in Montana with no real estate and long remaining franchises has an entirely different valuation methodology than a 50-unit Pizza Hut business in Atlanta with 20 pieces of real estate and 15 remodels due in the next three years.

The iterations can expand infinitely, and there are three problems that happen when franchisees throw around valuation metrics with their friends: 1. Most of them have no idea what their true post-G&A EBITDA is, 2. Most will misapply an EBITDA multiple or cap rate to their assets and 3. All of them think their business is worth more than it actually is worth!

D. What are the biggest obstacles to overcome when completing a franchise-to-franchise transaction?

There are several obstacles: financing contingencies, franchisor approval, due diligence, lengthy contract disputes on indemnification clauses, lease assignments, restaurant facility inspections, environmental Phase 1’s on real estate, sales declines during due diligence, acts of God and lastly, egos of the buyers and sellers.

Financing contingencies haven’t been such a big deal recently, but several years ago, they dominated the uncertainty of deal closings.

Franchisor approval is becoming much more difficult, especially as Corporate organizations are cutting staff amidst an increase in transactional activity. Also, franchisors are becoming much choosier on who they will approve, and they are more mettlesome than ever with slapping new unit development obligations on transfers.

One item I would point out is that due diligence and asset purchase agreement negotiations are becoming much more difficult than in previous years. Why? Many operators are now backed by investors, and they have a fiduciary responsibility since they aren’t spending their own money. In the not too distant past, a deal could almost close on a handshake. Nowadays, the buyer comes from Kansas City with an investor from New York. It is the opposite of a handshake deal.

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