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FRANCHISE INVESTMENT BANKING

Title: Welcome to The Restaurant Boiler Room Episode 5. I'm your host, Rick Ormsby, Managing Director at Unbridled Capital.

Today, in the the Boiler Room, I answer Round 2 of questions in a two part series from a recent interview with Chris O'Cull, Consumer & Retail Analyst for Stifel Financial Corp:

A) What do you advise franchise clients to consider when purchasing a company-owned location?
B) What red flags should investors look for when a chains' franchisees are consolidating or getting flipped?
C) How has the rapid expansion of family-office consolidators impacted restaurant M&A financing?
D) Has there been any changes in the credit market to making financing easier for operators?

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. What do you advise franchise clients to consider when purchasing a company-owned location?

Interestingly, buyers of company-owned restaurant packages and buyers of franchisee restaurants are often two different groups. They will sometimes cross over but normally not.

Refranchising of Corporate-owned units generally has the following benefits:

1. Greater confidence in the financial information presented.
2. Easier lease assignment process since the franchisor typically will remain guaranteed on the leases.
3. Pricing upside in the P&Ls since Corporate typically keeps pricing much lower than that of franchisees. This is a huge benefit – just a 5-6% increase in pricing could have a tremendous positive effect on EBITDA as pricing generally flows-through at 85%+.
4. Ability to increase margins since franchisors almost universally run poor P&Ls.
5. Franchisors generally own in big markets, so they typically sell a consolidated group of stores, which is appealing to many from a G&A standpoint and for traveling purposes.

Corporate-owned locations are not desirable to some buyers for the following reasons:

1. Pricing is generally way too high based on a market multiple of EBITDA.
2. Corporate deals can be difficult to finance since the price can be more arbitrary.
3. Franchisors generally have more near-term remodeling obligations than franchisees – they generally don't keep up with capex as well.
4. Franchisors will often add huge development obligations on their Corporate refranchise markets, often greater than what you will find on a franchise-to-franchise acquisition. Additionally, some franchisors will have liquidated damages if new unit development doesn't occur.

5. Some franchisors will mark-up third party leases. In addition to being a bad business practice, in my opinion, it also affects lease adjusted leverage and makes borrowing more difficult.
6. In recent years, some franchisors have started requiring acquirers of corporate locations to guarantee to keep the assets for a minimum of 5 years or give back the profits from sale if the assets are sold to another franchisee during this time period.
7. Many franchisees don't like the Corporate culture at the store level and experience significant management turnaround post-acquisition when compared to franchisee locations.
8. Key operators for franchisors have often never run a true P&L and therefore struggle with doing so when they work for a franchisee.

For franchisee-owned businesses, the upside and downside are typically the inverse of the company-owned locations just mentioned.

B. What red flags should investors look for when a chains' franchisees are consolidating or getting flipped?

When I see a chain experiencing significant turnover in its franchise base, the first question I ask is – why is this happening? Franchisee turnover of 2-4% is probably a healthy on-going annual number. Life just happens – we get older, partners get in fights, people get divorces, some brands fall out of favor geographically, some owners want to monetize a big gain, kids want to get into the business, etc.…

But there are definite inflection points when M&A spikes. Here are a few:

1. When prices are high, operators sell opportunistically. This isn't a bad thing; however, when prices get abnormally high for a long time, there is concern about the long-term health of the acquiring franchisees at such high debt levels. For any brand that has been trading at 7X+ of EBITDA for a long-time, the brand needs to have a fantastic sales comps and a great product innovation platform, or there will likely be casualties in the franchise base at some point, especially for newer entrants at the end of an upcycle.
2. When a brand is struggling, franchisees will generally want to sell or might be forced to sell by their lenders. If you see certain brands with a struggling market position or prolonged negative sales comps, and there is a big exodus of the franchisees, this can be a worrisome sign. On the other hand, this transition can be healthy too if it replaces legacy franchisees with younger operators and fresher capital.
3. M&A typically increases in brands that have near-term and significant remodeling costs, often when they are newly rolled-out by the franchisor. Remodeling obligations are possibly the most notable indicator of the future financial health of a franchisee. Most legacy franchisees cannot afford to remodel many of their assets in a 3-5-year period. And, most franchisors cannot produce a reasonably-priced remodel that will drive additional revenue in the stores.
4. If a brand is comprised mostly of mom-and-pop franchisees, then consolidation is happening rapidly right now. Smaller operators cannot juggle increasing labor costs, more regulation and thinning margins. The question here is – how is a brand like this going to maintain its franchisee base without losing unit count?
5. Be cognizant of brands that have high concentration of their stores on the West Coast or Northeast. These markets have huge minimum wage concerns and are likely to show increased M&A activity. Very few brands have an answer right now on how to handle this transformation in these areas.

C. How has the rapid expansion of family-office consolidators impacted restaurant M&A financing?

1. The method of financing has changed. In the past, franchisees wanted to keep real estate assets. They loved real estate, its flexibility, and its long-term value, especially in the hometowns where they operated. Family offices backed-operators typically want to monetize real estate assets by financing through sale leasebacks. They typically do this either simultaneous to closing on the acquisition, through a sale to a REIT, or post-closing through single sales on the 1031 market.
2. Higher borrowing requests – family-office consolidators typically want higher leverage, so they can invest a smaller amount of equity into a deal. Leverage typically takes a front seat instead of interest rates, for example.
3. Proliferation of lenders that specialize in smaller brands. As family offices look beyond the highest valued brands, we are starting to see professional money pour into lesser brands that previously did not have sophisticated capital. This is spawning several types of lender specialties – within the different tiers of brands, in different geographies and in brands that have struggling performance.
4. Lenders are becoming more willing to make larger loans to unproven groups, based not on their operational experience but more on their capitalization and future growth plans.
5. Consolidation is creating larger deals and more lender competition. It is also leaving a huge vacuum for smaller M&A financings, which are largely happening at regional banks and through SBA financing.

D. Has there been any changes in the credit market to making financing easier for operators?

1. Over the past few years, there has been an increase in covenant lite loan packages and a slight increase in lease adjusted leverage ratios to enable higher borrowing.
2. We continue to see a trend of bifurcating acquisitions into two separate loans – one for the operating company (OpCo) and the other for the property company (PropCo). Buyers are increasingly doing this to get higher LTVs on the property side and longer amortizations, as high as 25 years – which is longer than historic levels.
3. A big trend is the Term Loan B financing in the marketplace. Term Loan B is a term loan structured for sale to institutional investors. Term Loan B loans are starting to happen with larger operators – typically $30MM or more in EBITDA. There have been several in the Taco Bell system, for example, and a few of our clients are going through them now. They are very expensive to structure – several million dollars or more – and interest rates can be higher than what a traditional lender might offer. However, the loans are generally interest only or at least have very little amortization, and leverage can be pushed to 7X or sometimes higher. Franchisees are using these loan proceeds to pay-back debt obligations and fund acquisitions and remodels. Generally, there is also a big dividend that is issued to shareholders as well.

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