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How One Private Equity Fund Approaches Investing in Franchises

By Jeffery Scott Keys

Private equity funds have become an increasingly popular and necessary source of financing for franchise businesses on many levels, from large billion-dollar chains with thousands of units to individual franchisees looking to add new stores to their initial unit.

United Enterprise Fund (UEF) is a private equity firm focused on restaurant franchises and, as such, a number of food industry analogies appear in this column. However, the approach that we use to evaluate prospective growth opportunities applies to other franchise types as well.

Private equity investors are active, not passive, investors. The idea that capital providers exist who will write a check and simply disappear is one of the great myths of the industry. An "active" investor does not manage the business, but he or she does manage the investment. The franchisee or "operating partner" manages the day-to-day operations while communicating with the fund on issues of strategic value and governance.

Like many private equity funds, we look for growth opportunities that allow us to generate acceptable rates of return for our investors. Our goal, once the investment decision has been made, is to help operators become as successful as they can be. We do that by providing access not only to capital but also to additional operating and financial resources.

The actual capital invested is

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only one element of the relationship UEF has with its operating partners. Networking and resource sharing are an integral part of the partnership between the equity fund and the operator. That is why the chemistry of the relationship between the franchisor/franchisee operator and the fund partners is among the most critical factors for both sides.

Typically, private equity funds are focused in the scope of their investing. That focus can be by industry sector, investment size, geography, demographics or a combination of the above.

At UEF, we focus on the franchise restaurant industry with investments of less than $10 million in low-to-moderate income markets, which tend to be urban and underserved by the franchise industry. The particular investment focus that a fund has will be important in determining which private equity funds to approach.

Just as there are many layers to an onion, there are many aspects to private equity investing in franchises. The process includes the evaluation of numerous factors, including the franchise concept, the operating partner, the unit economics, the actual physical locations, development potential, and the capital architecture.

It concludes with the negotiation of deal terms that form the basis for a working partnership and set appropriate expectations regarding both financial and operational performance.

FIRST STEP

The investment process often begins through a referral and/or the submission of a business plan.

An effective plan will not only include standards like executive summaries and financial projections, it will also address areas of high interest such as key field management personnel, back office administration, financial administration and human resources.

The franchise model is a powerful tool to help build wealth. It is proven. It is reasonably predictable, and it has redundant support systems. It has been described as many things, but it has never been described as simple. Like all (successful) businesses, franchise businesses need proper support and expertise in all functional groups.

An assessment of the risk/return profile of the investment is critical. The degree of risk has a lot to do with the development stage.

Are we looking at a virgin development of a new franchise concept or a first time franchisee? In these cases the franchise and the operator are untested and have no operating history and the risks are higher.

On the other hand, if we are looking at an established franchise and an experienced operator, we will be better able to evaluate the performance record utilizing historical data, and thus understand and mitigate the risks.

Also important to risk assessment is whether the operator wants to grow from one to three stores, three to five, five to 10, 10 to 20 and so on. Different skill sets and management structures are required in each case.

The idea that capital providers will write a check and simply disappear is a great myth.

Concept evaluation is more art than science. When UEF decided to invest in the Le Petit Bistro and Bear Rock Café franchise systems, our evaluation of the concepts, based on personal inspections and third-party sources, led to the conclusion that food quality, service and site appeal provided customers with a very positive experience. If the concept works from the customer's point of view, you have a foundation for success.

Once the concept has been verified, we look at unit economics. These include store revenues, profit margins, cash flow, costs of goods sold, and the fixed and variable cost structure. It also includes an understanding of the assets and liabilities of the business—and, very importantly, knowledge of local real estate market fundamentals.

Understanding unit economics helps determine if the business can support growth, where improvements in performance can be made (these often have more to do with non-operational issues) and whether new sites in a market are priced at a reasonable level for the economics of the stores.

It was noted earlier that the chemistry between fund managers and operators is a critical factor in establishing the basis for an investment. Typically, operators are experienced at in-store issues.

EXPERTISE GAP

Operators of a small or limited number of franchise units generally have less expertise in managing senior lender relationships or negotiating equipment leases, bank loans or credit card relationships.

Private equity managers, particularly those with strong backgrounds in the industry sector that is the fund's focus, can bring the knowledge built during successful business careers to the benefit of their operating partners. That knowledge includes developing and executing business plans, managing growth, implementing effective compensation plans, etc.

Fund managers also can leverage the purchasing power of their fund's other investments to their new investments. The only caveat is that the operating partner must be willing and eager to take advantage of these opportunities. Thus, there is a need for good chemistry—a good working relationship—between operator and investor.

Last is the issue of the capital structure of the private equity investment. Like the evaluation of the franchise concept, this is an area of art and science, although determining capital structure employs more science than art in balancing the levels of debt and equity in the investment.

There are a variety of debt and equity instruments that can be used, including secured and unsecured debt, common or preferred equity or stock, or mezzanine financing, which is a hybrid of debt and equity. Each form has its pluses and minuses. Financial structuring is critical to the success of the operator and the investor.

The use of debt can accelerate returns for an investor and provide the operator with a tax deduction. It also represents a use of cash, so must be balanced against the cash needs of the business.

Chemistry between fund managers and operators is critical in investment relationships

The use of secured or unsecured debt offers a risk/return trade-off for the operator and investor. Secured debt is less risky and therefore offers lower returns to the investor. The opposite is true for unsecured debt.

Equity instruments, such as preferred and common stock, represent an ownership interest in a business. Preferred stock typically pays a dividend but usually does not have the same voting rights as common stock.

In conclusion, running a franchise is more complicated than it looks, particularly when the goal is to grow the business. The successful deal is one that recognizes and manages the risks and returns to the mutual benefit of both parties.