10 Potential Deal Breakers

For Sophisticated Investors Looking to Acquire Franchise Systems

BY ANDRAE MARROCCO AND MIKE BIDWELL

The investment community has been increasingly interested in franchise systems as potential targets. They present a valuable investment proposition for strategic and financial investors. The appeal of robust, long-term, and diversified royalty income streams, proven business concepts, potential for scalability and expansion, shared expansion costs (i.e. with franchisees), and the goodwill and strength of an established brand has caught the attention of private equity funds, family offices, and other sophisticated acquirers. The strategy and structure of investments is also becoming more creative and flexible as investors get more comfortable with the franchise business model, including investments at the master franchise level, and aggregation of brands in the same industry (or similar industries) to achieve economies of scale. However, sophisticated acquirers (as many know), explore, consider, and pass on far more opportunities than they take up. So what are the critical franchise specific considerations that raise red flags for sophisticated investors looking to acquire a franchise system?

1. **Immediate Red Flags.** (i) Sophisticated investors will quickly discover whether there has been high franchisee turnover, and together with that (or independent of it), there exists a poor franchisee satisfaction and culture within the system. Franchise systems will not thrive in those circumstances and, moreover, may be on the precipice of decline. Unless the acquirer is specifically looking for a turnover play, a discovery of high turnover or poor franchisee sentiment will likely cause an interested investor to turn down the opportunity. (ii) Weak unit economics, declining same-unit sales, or challenging broader economic conditions (e.g. emerging or shifting market dynamics or disintermediation with respect to the concept/industry) will present an upfront concern for investors. Franchise units are the customer-facing engine of a franchise system; if the engine is not functioning at its optimum, the franchise system's value is impaired and its viability in danger. (iii) An overall lacklustre rating on legal documentation, system compliance (and enforcement), and high percentage of litigation with franchisees and third parties may signal an engine running without oil. These important elements of a franchise system's infrastructure, while individually may be explainable and ameliorated with a tune up, when put together may be a perilous sign.

2. **Weak Brand Strength.** Growth and expansion is at the heart of a sophisticated investor's strategy. As a foundation, a franchise system must possess a proven, replicable business concept that is adaptable across markets. On top of that, the platform and infrastructure to operate the existing franchise system's operations and units must be sound. That includes manuals, training, ongoing consultation, franchisee communication strategies, compliance monitoring, marketing, technology, processes for modification, and updating products and services, etc. Moreover, there should be a blueprint to facilitate building out that platform and infrastructure for future growth and expansion. Has the franchise system experienced consistent growth by number of franchise units, and if not, why? Franchise systems operating in an industry or market that is (or may be) subject to potential negative changes also lack appeal. Weak brand strength stands in the way of sophisticated investors achieving their investment goals.

3. **Poor Economics.** The royalty stream must pass the stress test. Investors will analyze the certainty and recurring nature of the ongoing royalty revenue (together with other revenue such as technology fees, supply arrangement fees, etc.) independently of one-time fees (e.g. initial franchise fees). This will include considering the remaining term on franchise arrangements and the likely percentage of renewals together with the age, demographic, and level of sophistication of the franchisee population, jurisdiction and regional trends or differences, and payment delinquencies. Of particular concern will be revenue generated from suspect sources such as self-dealing or fading mechanisms, as will concentration as between a small pool of franchisees (or national account customers). Consideration will also be given to future potential for royalty stream growth, whether through increased same-unit sales, an increase in the franchisee population, the introduction of new products and services, and other strategies. These indicators and factors inform the economic condition of the franchise system and its potential. Sophisticated investors (aka "financial investors") want to see strong economics to make the investment worth their while.

4. **No Protection.** The core assets of a franchise system typically are the intangible assets such as intellectual property (the trademarks, trade secrets, copyright material, patents, etc.). Sophisticated investors will look to see whether the existing franchisor has taken appropriate steps to protect its owned or licensed intellectual property rights (through registration, contractual covenants, and conduct with franchisees and third parties). Also important is the assessment of whether the franchisor has conscientiously policed its intellectual property rights. Finally, sophisticated investors will look to the growth and expansion possibilities with respect to the intellectual property, and investigate whether there is scope to protect the intellectual property in jurisdictions that form part of the growth strategy.

5. **Impaired Human Capital.** Sophisticated investors will often look to keep existing management (or at least part of it) in place.

This typically necessitates due diligence on each member of the team, their current roles and responsibilities, together with an analysis of where they might fit within the post-acquisition structure. A number of circumstances with respect to human capital can create inauspicious conditions. Most notably, the imminent retirement of key personnel without trained replacements is a major concern. Equally of concern is the potential for key personnel leaving upon completion of the acquisition. Accordingly, existing franchisors who fail to address these issues and concerns prior to approaching sophisticated investors are not putting their best foot forward.

6. **Unhealthy Systems.** Franchisees have been referred to as the "lifeblood" of a franchise system. It stands to reason that the franchisor's relationship with franchisees is critical to the health of the system. If that relationship is characterized by constant tension, disagreements, defaults, and a high turnover of franchisees, it will not bode well for the franchisor's exit options as far as it relates to sophisticated investors. The existence of franchisee associations can be a symptom of an unhealthy system (e.g. particularly where the association was established for the purposes of mounting a challenge against the franchisor). On the flip side, the non-existence of a franchise advisory council (or other such body) established to permit franchisees a forum to voice their ideas and concerns, and to have regular meaningful communication with the franchisor, can also be a symptom of an unhealthy system.

7. **Breaking the Rules.** Franchising has become increasingly regulated and is also an increasingly litigious area of law. The remedies available to franchisees under franchise laws are strict and extreme. It is critical that franchisors be in a position to demonstrate compliance with all applicable franchise laws. This includes keeping appropriate documentary records to establish that: (i) franchise sales, disclosure, and other processes were carried out in a manner that complied with applicable franchise laws, (ii) any earnings projections or estimated operating costs provided were based on reasonable assumptions and were appropriately substantiated, (iii) there has been ongoing compliance with franchise laws. Non-compliance with franchise laws creates significant exposure for acquirers, and is not taken lightly in their due diligence and assessment.

8. **Bad Deals.** The franchisor's contractual rights and obligations with respect to its franchisees frames the franchise system's legal structure. A second-rate approach to drafting, negotiating, and implementing franchise agreements (and ancillary agreements and arrangements) with franchisees may render a franchise system unacceptable to sophisticated investors. Numerous versions of franchise agreements with different terms, "one-off" side deals, and/or poor record keeping may telegraph to potential acquirers that understanding their rights and obligations vis-à-vis the franchise system may be a lengthy, complex, and uncertain undertaking. Any respite or concessions made with respect to a franchisee's financial obligations may be harmful to the economic assessment and viability of the franchise system from the investor's perspective.

9. **Stuck or Prohibited.** Continuing along the lines of terms and conditions in franchise agreements, there may be prohibitive unfavourable provisions that stand in direct opposition to the growth and expansion plans of a prospective sophisticated investor. Examples of such provisions and corresponding issues include: (i) term and renewal provisions - investors may prefer near ending arrangements (so that they can replace underperforming units) or, alternatively, may find that state of affairs to be of major concern, (ii) the precise breadth and limitations of system modification rights and obligations may be incongruent with the investor's strategic plans, (iii) the nature and scope of territorial rights granted to franchisees (including exclusivity terms) may stifle an investor's growth strategy and structure for particular regions (for example, where large development areas have been granted with long development terms), (iv) inferior reservation of rights provisions by the existing franchisor may prevent an investor from achieving economies of scale (e.g. not being able to leverage the same infrastructure across multiple franchise systems) or expanding alternative distribution channels, or (v) termination rights that are too lax for franchisees and too onerous for the franchisor may present challenges for a prospective acquirer. A lack of "white space" for continued growth and expansion can be a deal killer.

10. **Outdated Technology.** Franchisors are facing a precarious three-way intersection of increased accountability and regulation over consumer privacy, the growing volume and sophistication of cyberattacks on consumer data, and the expanding boundaries of franchisor liability for matters arising at the franchise unit level. It is imperative that franchisors maintain, update, and make continual investments in their technology systems to ensure that they are operating at optimum levels. Separately, in many cases, technology is a critical aspect of the competitive advantage that franchise systems have in their particular market. Accordingly, outdated technology can translate to loss of market share, adding an undesirable attribute to the investment profile.

The above list of concerning attributes of a franchise system may not in and of themselves cause a sophisticated investor to walk away from a potential acquisition. However, they provide insight into some of the factors that potential acquirers will consider hurdles and challenges to overcome. Moreover, such considerations will certainly be factored in the determination of the purchase price sophisticated investors are willing to pay. Franchise systems looking to prepare for an eventual exit should take stock of their systems early on to ensure that they have the right processes, record keeping, culture, documentation, infrastructure, technology, and IP protection (to name a few) in place long before they made a determination to run a sale process.

ABOUT THE AUTHORS

Andrae Marrocco is a partner in Toronto office of McMillan. His transactional practice is focused on advising domestic and international businesses on franchise & distribution matters and corporate/M&A transactions. He has particular expertise in complex franchise arrangements, franchise system mergers and acquisitions, and cross-border/international transactions. Andrae can be contacted at andrae.marrocco@mcmillan.ca.

Mike Bidwell is the current President and CEO of Dwyer Group®, a franchisor of 20 businesses in the repair, maintenance, and enhancement of homes and properties with over 3,300 franchisees. Mike can be contacted at mike.bidwell@dwyergroup.com.