

2018 IFA

# LEGAL SYMPOSIUM

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# Basics Track: Franchise-Related Mergers & Acquisitions

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Mergers are like marriages. They are the bringing together of two individuals. If you wouldn't marry someone for the 'operational efficiencies' they offer in the running of a household, then why would you combine two companies with unique cultures and identities for that reason? *Simon Sinek*

# What are we going to cover?

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- Acquisitions of Franchise Systems
- Seller and Buyer Perspectives/Goals
- Valuation Considerations
- Diligence
- Key Definitive Agreement Provisions

# Overview of the Deal Process

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- Assess the seller's goals
- Who is buying?
  - Financial
  - Strategic

# Overview of the Deal Process

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- Get ready to sell
  - Working with a M&A advisor and Assessing Valuation
  - Operational; financial; legal
  - Process
- Deal Structures
  - Asset
  - Equity (direct or merger)

# Overview of the Deal Process

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- NDA and Letter of Intent
  - Non-disclosure agreement
  - Sellers may limit access to information
  - Letters of Intent are typically non-binding
    - exclusivity period is binding

# Overview of the Deal Process

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- Due Diligence
  - Structure of deal affects liabilities assumed
  - Level of diligence (and length of time to complete)
  - Buyer and seller diligence
- Purchase Agreement
  - Sign and close; sign and then close
  - Franchise specific provisions



# Overview of the Deal Process

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- Closing the Deal
  - Immediate to 90 plus days
  - Pre-closing franchise sales issues
  - Buyer must be ready to with post-closing amendments and activities to manage franchise sales and the system

# Preparing to Sell a Franchise Company

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- Starts with the very first franchise sale
- Assess the franchise agreements
  - Do the agreements limit a transaction?
  - Do they have M&A friendly provisions?
  - Are there territorial issues?

# Preparing to Sell a Franchise Company

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- Assess the franchise agreements
  - Evaluate regulatory matters
  - Assemble and catalog versions and negotiations
- Evaluate whether changes can be made
- Weed out underperformers?



# Preparing to Sell a Franchise Company

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- Evaluate intellectual property
  - Registration
  - Infringers
- Resolve litigation and reduce claims
- Evaluate and update sales process
- Enhance future value enhancement opportunities

# A Note on Franchise Regulatory Issues

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- Franchise laws generally require an amendment when there is a material change
- Timing
- Multiple factors affect amendment or “go dark”

# Assessing Valuation

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- Buyers highly value franchisors for a number of reasons:
  - Stability of royalty stream
  - High margins / cash flow
  - Low cost geographic expansion
  - Scarcity value / unique brand and business



# Assessing Valuation (cont.)

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- Royalty Stream - % of Revenue tied to Royalties vs. other recurring and non recurring revenues
- Same Store Sales – Higher is always better, but lower isn't bad. It is all about the growth story and dynamics
- Company-Owned Contribution –
  - >75% Franchised = ~15x EBITDA
  - < 25% Franchised = ~6x EBITDA

# Assessing Valuation (cont.)

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- Profitability & Payback
- Tenure and Renewal Rates
- Franchisee Cohorts / Vintage Performance
- Franchisee Pipeline and Whitespace
  - Cost per lead and closing ratios
  - Number of available territories

# Assessing Valuation (cont.)

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- Competitive Landscape / Positioning
- Technology Systems and Infrastructure
  - Visibility to data
  - Stability of applications, ease of use, modern architecture
- Cyclicity
- Capital Expenditures
  - Usually a non-issue, except for software and company-owned stores



# Assessing Valuation (cont.)

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- Franchisor vs. Franchisee Valuations
  - Franchisors generally trade at 8-10x+ whereas franchisees often trade at <8x.
  - Driven by limited territory, lack of control of brand and required investment in the business
  - Franchisees by definition are not unique
  - Franchisors ultimately have significant control over the business and brand can be deteriorated by factors outside of franchisee's control

# Buyer's Due Diligence

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- Getting What You Pay For
  - Identifying “Red Flags”
  - Feeding the Reps, Warrants & Indemnities
  - Can you do what you want to do post-Closing?
  - Verifying Value

# The Checklist

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- Key Contracts
- Franchise Regulatory Compliance
- Franchisees and Sales Issues
- Disputes, Litigation and Regulators
- Supply and Distribution



# The Checklist (cont'd)

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- Ad Fund
- Franchise System
  - Manuals
  - Training
  - QA and Audit Reports

# The Checklist (cont'd)

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- IP & IT
  - Trademarks and Service Marks
  - Software
  - Websites and Social Media
  - “Secret Sauce”

# Franchise and Related Agreements

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- Review all versions
- Quality of Drafting
- Special Deals?
- Assignability

# Franchise Agreements (cont'd)

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- Flexibility Going Forward
  - Scope of Grant/Reserved Rights
  - Encroachment Issues
  - System Changes Possible?
  - Ability to Re-Brand

# Regulatory Compliance

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- FDD Review
  - Consistent Disclosure
  - Litigation
  - FPRs

# Regulatory Compliance (cont'd)

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- Franchise Sales Compliance
  - Receipts
  - Waiting Periods
  - Other Sales Materials



# Other Inquiries

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- Searches
- Talking to Stakeholders
  - Franchisees
  - Landlords
  - Suppliers
  - Employees

# Cross-Border Issues

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- Local Counsel – “Call early; call often”
- Regulatory Differences
- Tax!

# Seller's Due Diligence

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- Can the Buyer Close?
- Are they a “Good Fit”?
  - Will Employees be taken care of?
  - Values and Reputation – Do they matter?
  - Will there be an ongoing relationship?

# Keeping a Hand In

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- Seller (Owner/Operator) may stay on with post-closing Employment/Consulting Agreement
- Often tied to performance and Purchase Price payout/earn-out
- Purchaser visibility is key

# Impact on Definitive Agreement

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- Reps and Warranties; Disclosure Schedule
- Indemnities (Baskets/Deductibles)
- Holdbacks/Escrows
- Covenants
  - Operate “business as usual”
  - Maintain Zee/landlord/employee/supplier relations

# Questions?

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**Thank you!**