

2018 IFA

# LEGAL SYMPOSIUM

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# NAVIGATING THE NEW NORMAL WITH FINANCIAL PERFORMANCE REPRESENTATIONS

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# NASAA FPR COMMENTARY

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- Adopted by NASAA on May 8, 2017
- Effective Date - Later of:
  - 180 days after adoption
  - or
  - 120 days after franchisor's next fiscal year end following adoption
- The future is now!

# WHY WAS THE NASAA FPR COMMENTARY ENACTED?

- Provide clarification to what constitutes a 'REASONABLE BASIS'.

FPRs are still NOT required.

# DEFINITIONS AND DISCLOSURES OF FPRS GENERALLY

- 8 definitions
  - Average
  - Company-owned outlet
  - Gross profit
  - Gross sales
  - Managed outlet
  - Median
  - Net profit
  - Operational franchise outlet
- Establish common understanding of terminology

- 3 Categories of definitions:
  - Universally defined and generally understood
  - For purposes of interpreting and understanding the FPR Commentary
  - Terms expected to have same meaning both in FPR Commentary and if and as used in an FPR

# QUESTION: 19.8

- If a franchisor has operational franchised outlets, it cannot make a gross sales FPR based on company-owned data alone.
  - Franchised outlets open less than a full year.
  - Seasonal business.
  - Reasonable basis.

- If a franchisor only provides gross sales information of either franchised and/or company-owned locations, can cost or expense data be provided to the prospect?
  - Footnote 8
  - Cannot be expressed as a % of revenue.
  - Potential trap for franchise sales personnel.



# QUESTION 19.10

- When a franchisor discloses gross or net profit based on company-owned outlets alone, how to disclose adjustments to reflect all actual and reasonably expected material financial and operational differences between franchised and company-owned outlets?
  - Some are easy: Royalty and advertising fees.
  - Some are not: Management/Supervisory costs.
  - Other costs?
  - Example.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Total # of _____	39	34	23	9
Year-End Membership	4,593	5,224	5,208	5,333
Gross Sales	\$1,189,440	\$1,460,797	\$1,584,819	\$1,456,203
Personnel Costs	\$264,673	\$265,975	\$287,121	\$279,570
Supplies & Maintenance	\$34,513	\$33,734	\$35,199	\$31,873
Utilities	\$81,022	\$79,051	\$70,797	\$84,609
Product Cost of Goods Sold	\$14,890	\$19,265	\$16,896	\$13,849
Other Club Expenses	\$91,394	\$106,295	\$113,360	\$134,511
<b>EBITDAR</b>	<b>\$702,947</b>	<b>\$956,478</b>	<b>\$1,061,446</b>	<b>\$911,792</b>
<b>Rent &amp; Occupancy</b>	<b>\$374,544</b>	<b>\$557,801</b>	<b>\$527,338</b>	<b>\$515,691</b>
<b>EBITDA</b>	<b>\$328,403</b>	<b>\$398,677</b>	<b>\$534,109</b>	<b>\$396,102</b>

**Annual Franchise Expense Not Encompassed in Table Above (assuming median annual Gross Sales)  
(See Note A below)**

Royalties (5%)	\$59,472	\$73,040	\$79,241	\$72,810
Technology and Support Services Fees (\$600 monthly)	\$7,200	\$7,200	\$7,200	\$7,200
Brand Fund (2%)	\$23,789	\$29,216	\$31,696	\$29,124
Local Marketing (5%)	\$59,472	\$73,040	\$79,241	\$72,810

# QUESTION 19.12

## SUBSETS

- Best performing/lowest performing.
- Geographic basis – Question 19.15.
- Climate based?
- Rural v. Urban?
- Different product offerings/formats?
- Can't have a subset if less than 10 outlets total – Question 19.14



# QUESTIONS 19.16 – 19.18

## AVERAGES AND MEDIANS

- Why both?
- When is disclosure of highest/lowest in range required?
- What can be excluded – Question 19.18
  - # of closed franchised outlets
  - # of closed company-owned outlets
  - # of outlets closed after less than 12 months of operation

# Data Set Example

Outlet	1	2	3	4	5	6	7	8	9	10
Revenue in Thousands \$	170	185	190	205	220	245	255	305	875	940

The mean average revenue for these outlets is \$359,000. However, looking at the revenue from those outlets, the mean may not be the most accurate way in an FPR to express the typical revenue of the outlets, because most of the outlets tend to have revenues in the \$190,000 to \$250,000 range. The reason the mean is higher than that range is because of two outlets included in the data set with much higher revenues.

# QUESTION 19.21 – 19.23

## DISCLAIMERS VS. EXPLANATIONS

### Standard Admonition

- Historical FPR: “Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”
- Projection FPR: “These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.



# Admonition Requirements

- Separate paragraph
- Clear and conspicuous (e.g., bold)
- May not be in all capital letters, underlined or larger type
- What about FPR metrics that do not involve sales or earnings?

# Examples:

- Disclaimer or Explanation?

"Your Gross Sales and financial results will depend upon, among other thing factors such as local and national economic conditions; how much you follow our methods and procedures; your sales skills; your management skills; experience and business acumen; whether you personally manage your Franchised Business or hire a manager; the region in which your Franchised Business is located; the competition in your local market; the prevailing wage rate; and the sales level reached during the initial period."

- These results are averages of specific [ACME franchisor] programs and should not be considered as the actual or probable results that you will realize. The information presented does not indicate whether these programs operated profitably. We make no representations about the programs not included above. As each program serves a different age, economic, business or social segment of the population, you should not rely on any information provided in this Item 19 as basis for determining the financial performance of another program not included.



- “results are determined by the quality of management....energy and dedication of the franchisees....”
- “You are likely to achieve results that are different, possibly significant and adversely, from the results shown above.
- “The average franchised business included in the above calculations is a mature business; accordingly, a new franchisee’s individual Gross Sales and financial results are likely to differ from the results stated above.”

# Examples (continued):

THE FRANCHISOR MAKES NO REPRESENTATIONS, GUARANTIES, OR WARRANTIES, EXPRESS OR IMPLIED, WITH RESPECT TO THE ACTUAL VOLUME. ACTUAL RESULTS MAY VARY SUBSTANTIALLY.

# QUESTION 19.19

## FORECASTS AND PROJECTIONS

- Must be based on historical data.
- Will a projection ever be “reasonable”?
- Under what circumstances can revenues or expenses diverge from historical pattern?
- Projections not based on data from competitive brands.



# CONCLUSIONS

- Has/will FPR Commentary accomplish its goals?
- What are we seeing?
  - More thorough Item 19 reviews.
  - Maybe fewer FPRs?
  - Probably fewer projections.

# QUESTIONS?