



## **Mergers & Acquisitions in Franchising Strategies for 2014 and Beyond**

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## A. Overview

The M&A market is very strong for franchisor and large multi-unit franchisees of scale today – good news for those looking for a sale or growth capital. What key factors drive investor demand? How should investors be thinking about their exit plans? What due diligence issues do they face?

In this paper, we look at these concerns and suggest strategies and steps for franchising mergers and acquisitions.

## B. Capital markets and franchising

The M&A market continues to be robust for franchising. Over the past three years, there have been more than 200 acquisitions involving franchising. Key acquisitions since 2013 include private equity firm Apollo Global Management's acquisition of CEC Entertainment, which operates 577 Chuck E. Cheese's restaurants, for \$1.3 billion. Other notable transactions: TZP Group recent acquisition of Snap Fitness for \$200 million, Centre Partners acquisition of Captain D's for \$175 million, TSG Consumer's acquisition of Planet Fitness and Roark Capital's acquisition of Anytime Fitness. Other franchisor transactions can be found under "Franchisor Equity News" at [www.franchisorpipeline.com](http://www.franchisorpipeline.com).

During the same time, we have seen significant capital injections in franchise systems. For instance, over the last 3 years there were more than 114 private placements involving franchise companies. Notable financings since 2013 include European Wax Center's \$24 million financing from Princeton Ventures and Brazos Private Equity in March of 2013, as well as PizzaRev financing from Buffalo Wild Wings in March of 2013, Lyfe Kitchen's \$15 million financing from an undisclosed investor and Project Pie's \$2.5 million financing from Lee Equity Partners.

Additionally, investors in capital markets have benefited from the successful IPOs of franchise systems. The IPOs of Potbelly, Chuy's, Bloomin' Brands and Noodles & Co. have brought strong returns to investors and entrepreneurs alike. The impressive gains reaped from M&A, Private Placements and Capital Markets over the past two years have cemented investor interest in the franchising industry. A list of the 100+ publicly held franchisors can be found under "Franchisor Folio" at [www.franchisorpipeline.com](http://www.franchisorpipeline.com). Going forward, the promising investment landscape offers entrepreneurs a wide range of opportunities.

## C. Investors are interested

Several key factors drive strong valuations today. Moody's estimates that private equity firms have \$1.1 trillion in cash to invest and strategic buyers have more than \$2 trillion to invest. While only a portion of these funds will be invested in franchising, this \$3.1 trillion in "dry powder" creates pent-up demand – thereby driving up prices – because both groups are under pressure to invest their cash. Private equity groups must invest, or at some point return the cash to investors. Strategic buyers (often publicly held) also are pressured to invest or return cash to shareholders via dividends or stock repurchases.

As interest rates are lower than historical averages, prospective buyers of strong franchisors have ready access to debt financing for proposed acquisitions. The Fed's credit ease (even as the Fed tightens, interest rates remain relatively low) also supports higher valuations. Most significant franchisors today have access to inexpensive debt, especially if they have private equity sponsors and strong cash flows. The availability of bank financing for large acquisitions enables private equity firms to use leverage in transactions, which further increases valuations.

Prominent private equity firms have proven that investments in franchises can be profitable. Roark Capital now owns 31 franchise brands, including investments in Anytime Fitness, Arby's, Auntie Anne's, Batteries Plus Bulbs, Carl's Jr., Corner Bakery, Massage Envy, Moe's Southwest Grill, Primrose Schools and Wingstop. Other successful private equity firms like Sentinel Capital, Levine Leichtman Capital Partners, Apollo Global Management, TZP Capital, TSG Consumer Partners and Catterton Partners have made multiple investments in franchise systems. We are now tracking over 250 private equity firms who have invested in franchising or are actively seeking to do so. Almost all these firms are looking for additional brands in which to invest.

All of this investor demand has created an imbalance and is driving high multiples. Simply put, there are not enough franchisors of scale with owners willing to take on an investment to satisfy investor demand. Many of the key private equity investors today have large funds and cannot take the time or effort to investigate a small franchise system with \$1-2 million EBITDA. The key beginning interest level for most private equity investors would be \$3-5 million of EBITDA. However, there is even more interest directed at systems with EBITDA of over \$10 million.

A consequence of strong investor interest in franchising has been an increasing investor interest in large multi-unit franchisees. A lack of franchisors of scale in the market place has prompted investments in high quality brand multi-unit franchisees. The combination of affordable debt and strong cash flow of multi-unit operators make them ideal leverage buyout targets.

#### **D. What transaction options do investors have?**

In working with entrepreneurs, a one-size-fits-all approach to M&A transactions does not exist. Transactions are as varied as the entrepreneurs who run these companies. Discussions always start with an honest evaluation: Where is your business today? Where would you like your franchise business to be in 3 - 5 - 7 years? What resources and capital will you need to achieve these growth objectives? Are there acquisitions you would like to make but don't have sufficient resources? Would a transaction help you achieve your results sooner? Have you met your personal goals and are you ready to sell and retire?

The following chart shows the three most common transactions that we see:

M&A Transaction	Benefit
<p><b>Full Buyouts</b></p>	<ul style="list-style-type: none"> <li>▪ <b>Maximum liquidity to the partners</b></li> <li>▪ <b>Maximum valuation for the business</b></li> </ul>
<p><b>Majority Recapitalization</b></p> <ul style="list-style-type: none"> <li>- Sale of at least 51% or more of a company's equity</li> <li>- Operating control of the business may change depending on deal structure</li> <li>- Usually some form of leverage (debt) is used in combination with a majority equity investment, primarily to enhance the equity investor's returns</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Liquidity to the partners</b></li> <li>▪ <b>Rollover of equity into the new business</b></li> <li>▪ <b>Partner to possibly help scale business quicker</b></li> <li>▪ <b>Partner to assist in building infrastructure</b></li> </ul>
<p><b>Minority Recapitalization</b></p> <ul style="list-style-type: none"> <li>- Sale of less than 50% of a company's equity</li> <li>- Operating control of the business is usually retained by current management</li> <li>- Usually some form of leverage (debt) is used in combination with a minority equity investment, primarily to enhance the equity investor's returns</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Liquidity to the partners</b></li> <li>▪ <b>Infusion of growth capital into the business</b></li> <li>▪ <b>Owners retain the majority of the equity upside in the business, "second bite of the apple"</b></li> <li>▪ <b>The capital markets and future investors may be more receptive to companies with institutional investors</b></li> </ul>

Franchisors and large multi-unit franchisees of scale have a wide variety of transaction options available.

Today, because of strong unmet investor demand, we are seeing more private equity investors willing to fund minority recapitalizations **for the right brands**. While valuation is important in recapitalizations, the right fit is the most important factor for all parties. The right partner/investor can help accelerate growth and increase returns for entrepreneurs and investors alike.

**E. Exit planning and transaction value: clarify goals and objectives at the start**

Many investment banking firms have entire departments devoted to exit planning or capital infusion preparation. Clarifying goals and objectives at the beginning of an exit plan should ease a process that is often highly complex and unique to a specific business and industry.

Once the franchisor's objectives and goals are clarified, it is important to determine the company's value and analyze value/risk drivers. An initial valuation will create a baseline against which to compare future valuations and company progress.

A thorough analysis of the franchisor's business valuation can enable owners to better manage their companies to perform optimally against such metrics as:

- Strong unit economics
- Steady revenue and profit growth rates
- Product and/or service excellence that makes the company a leader in its business sector
- Barriers to entry that discourage competition
- A broad client base that minimizes overreliance on one or more of the company's top customers (among other value drivers)
- A highly experienced management team that is not overly dependent on a single manager or owner.

A franchisor or multi-unit franchisee that has grown significantly may believe this is a good time to sell and thus may begin engaging investment banks to launch an M&A process. Companies that are struggling with stagnant sales may prefer to take the time to build earnings and sales before launching a sale. Some entrepreneurs and owners may prefer to complete a recapitalization now to gain, in addition to a capital infusion, a partner that can help scale the business while allowing them to participate in an exit at a later date. In-depth discussions led by an experienced banker can help clarify objectives, expand the understanding of M&A processes and create a road map that best suits the needs of the company and the entrepreneur.

#### **F. Think ahead: steps sellers may take to prepare before a sale**

To get the most out of a sale, or potential sale, a franchisor must anticipate the great deal of information that will be needed regarding its business. This preparation can be time-consuming as many players will need to provide documents (that are often difficult to obtain, or prepared only at certain times). Further, it is important for a franchisor to keep in mind the impact of a sale on shareholders, management, employees, franchisees and the overall health of the brand. In order to be adequately prepared, the franchisor must start early and consider what information would be needed by the prospective buyer (whether an institutional investor, private equity or other brand). The franchisor also needs to assure that the information presented to the prospective buyer is accurate, while also putting the franchisor's best foot forward.

As a franchisor sale gets under way, a comprehensive due diligence phase will begin that consists of the review of various documents by the proposed buyer and its counsel. To prepare for this, a franchisor should (at the least) early on do the following:

- 1. Start to organize, retrieve, catalog and obtain documents** (such as FDDs/UFOCs from inception [or, as far back as possible], financial performance and earnings documentation, franchise registration certificates, undocumented or missing transfers, missing franchise agreements and renewal of any expired franchise agreements).

2. **Audit franchisee files** for proper execution (such as agreement execution and execution dates, franchisee FDD/UFOC acknowledgements of receipt, execution of state-required addenda, insurance certificates and real estate documents).
3. **Prepare employees who are critical for the transaction process** (such as those who may be performing multiple roles during the sale).
4. **Focus on resolving outstanding franchisee compliance issues** (among them, late payments, non-compliance with computer system requirements, ACH-payment issues, poor performance or circumstances of breach [without termination], non-compliance with development schedules and under-reporting of sales).
5. **Terminate franchise agreements for closed units or undeveloped units** (or find other ways to resolve such issues, such as creating new or modified development schedules).
6. **Verify there are no trademark infringements or other IP concerns.**

Even before the preliminary verification and gathering of documents – and, in fact, all along the road of being a franchisor – it is important to have documents prepared and practices in place that will assure positive receptivity by prospective buyers. Some examples of these long-term planning steps include:

- a. **Make decisions on the form of franchise agreements** to be used. Keep in mind a possible future sale -- decisions that limit a franchisor's options long into the future will affect price and/or the pool of potential purchasers (such decisions could include low fees, large territories, limited reservation of rights, and restriction on franchisor's right to assign and transfer).
- b. **Obtain guarantees, confidentiality agreements and non-competition agreements** from franchisees to avoid problems during the course of negotiations.
- c. **Prepare franchise files to demonstrate compliance with laws** (logs of required procedures, documents obtained, and critical dates).
- d. **Ensure trade secrets (and other intangible assets) are protected** (such as through confidentiality and non-competition agreements, trade secret audits, work for hire agreements with employees/vendors, social media policies and written supply agreements).
- e. **Maintain up-to-date IP registrations and compliance** for trademarks, patents and copyrights.
- f. **Utilize uniform documents** in furtherance of relations with franchisees: limit negotiated and special deals in agreements and document milestone events during the franchise relationship, such as transfers, comfort letters, default letters, and releases.

### G. Franchise due diligence: what areas will be evaluated by advisors?

In today's marketplace, a substantial amount of diligence regarding a potential franchisor acquisition target can be conducted with publically available information. Such information may include publicly available records, corporate governance documents, corporate records (for public companies/non-public companies), SEC forms and filings, analysts' reports, websites, licenses, land records, UCC filings, court dockets, intellectual property registrations and licenses, patent filings, trademark and copyright filings, FDDs, domain names and information gleaned from fee-based and online search services.

In any merger or sale, additional information must be provided by the seller as requested by the buyer and its advisors. Such information may include management presentations or briefings, third-party reports obtained by the seller, audited reports/financial statements, stock transfer ledgers, stock option plans and agreements, warrants, financing documents, physical inspections and other corporate filings and reports.

In the franchisor sales context, a buyer (and its advisors) will consider other franchise-specific information during the due diligence phase, including:

Franchise Due Diligence Items	
<ol style="list-style-type: none"> <li>1. <b>Unit-level economics</b> for franchised and company-owned units.</li> <li>2. Existence of a <b>proven, replicable business model</b> (that is adaptable across markets).</li> <li>3. Any <b>impediments to future growth</b> (e.g., territorial and exclusivity issues).</li> <li>4. Future growth prospects and <b>ability to expand the system</b>.</li> <li>5. <b>Ability to combine</b> franchise system with others portfolio brands.</li> <li>6. <b>Transferability</b> of franchise agreements and other contracts.</li> <li>7. <b>Vendor contracts</b> (e.g., supply and distribution agreements and all cooperative and joint purchaser arrangements).</li> <li>8. <b>Ownership, protection and licensing of intellectual property</b> (including a review of a schedule of trademarks, service marks, trade names, copyrights, patents and domain names that are owned, licensed or used by the franchisor and its affiliates).</li> <li>9. <b>Franchisee satisfaction</b> and continued business relationship likelihood as a result of new franchisor/management.</li> <li>10. <b>Regulatory compliance</b> (franchise registration and relationship laws, FDD compliance).</li> </ol>	<ol style="list-style-type: none"> <li>11. <b>Franchise sales process and procedures</b> (experience, internal controls, training and costs).</li> <li>12. <b>Outstanding franchise and development agreements</b> (how many are out there and what are the remaining terms).</li> <li>13. <b>Real estate documents</b> (collateral assignment of leases, leases, lease guarantees).</li> <li>14. <b>Advertising fund</b> (records of management and use of fund and expenses, loans to fund).</li> <li>15. <b>Employment agreements</b> with management and <b>confidentiality agreements</b> with employees.</li> <li>16. <b>Defaults and disputes</b> in the franchise system.</li> <li>17. <b>Threatened and pending litigation, and regulatory action</b>.</li> <li>18. Franchisee <b>default history</b>.</li> <li>19. <b>Current franchisee files</b> and files for franchisees that have left the franchise system.</li> <li>20. <b>Franchise agreement provisions</b> related to enforcement (history of updates/changes to franchise agreement).</li> <li>21. <b>Franchisee association and advisory councils</b> files and minutes.</li> <li>22. Reports on <b>supplier rebates</b>, commissions and other vendor payments.</li> </ol>

## H. When should you disclose a proposed franchisor sale?

State franchise disclosure laws effectively impose on a franchisor the duty to disclose "material" information, but do not define materiality. The FTC has not opined on when (if at all) a franchisor must disclose a potential franchisor acquisition, and, there are no franchise laws, rules or regulations that address whether disclosure is needed. As a result of this uncertainty, the decision of whether or not to provide prospective franchisees with information about a proposed franchisor sale is often decided by reference to certain disclosure obligations that exist under the securities laws which, essentially, seek to determine the probability that the transaction will be consummated.

The sale of a franchisor often proceeds from an intent to sell, to engagement of an advisor, to solicitation of expressions of interest, to signing of letters of intent, to due diligence, to execution of a binding buy-sell agreement, to an ultimate closing. Where along this spectrum the obligation to disclose the transaction to prospective franchisees arises will depend upon the specifics of the transaction and, even with these specifics will not always be clear. In these instances, franchisors who desire confidentiality must make a risk assessment. For those who do not wish to disclose, and are also looking for little risk, the alternative of ceasing franchise sales (sometimes called "going dark") also exists.

## I. The legal process for a franchise M&A transaction: ask yourself these questions

The following describes, from a very high level, the typical types of agreements needed for a franchise M&A transaction:

1. **Confidentiality agreements (NDAs).** These agreements are a precursor to exchanging information in business relationships – almost all franchise M&A transactions begin with a confidentiality agreement.

**Ask yourself:** Who will provide the information? To whom will information be provided? What information will be provided? What will be the scope of "confidential information" and exclusions and exceptions? What is the term of the NDA? How will confidential information be returned (or destroyed) after the term ends? What liability and remedies are part of the NDA?

2. **Letter of Intent (LOI) or term sheet.** This is a preliminary statement of basic deal terms.

**Ask yourself:** Binding versus non-binding? Usually, the substantive deal terms (*i.e.*, commercial terms) are non-binding, but other obligations (*e.g.*, confidentiality, dispute resolution, governing law) are binding.

3. **Exclusivity ("no-shop") agreements.** These are agreements between the parties not to negotiate with other parties for a set amount of time.

**Ask yourself:** Is the agreement mutual (both seller and the prospective buyer will not negotiate with other parties) or one-sided (either the seller or the prospective

buyer agrees to not negotiate with other parties)? What will be the duration for the exclusivity period, and will the agreement be stand-alone or included in the LOI?

- 4. Due diligence.** Data room must be established, organized and easily able to accommodate requests for updates and supplementary documentation.

**Ask yourself:** What issues are being uncovered related to such concerns as franchise sales, real property, environmental and other regulatory compliance, corporate compliance, material contracts, litigation, employment, intellectual property, international, insurance and risk management, financial statements, required consents.

- 5. Stock (or asset) purchase agreement (including schedules).** The main difference between the stock deal (including a merger) and an asset deal is the subject matter of the sale (stocks versus assets).

**Ask yourself:** In an asset deal, the assets (and liabilities) need to be described with specificity, and the intangible assets (such as goodwill) need to be properly described. Issues may arise with respect to shared assets (focus should be on assets "primarily" or "exclusively" used in the business). Whether an asset or a stock deal, there will be many mutual representations and warranties, with exceptions set forth in a "schedule." The buy-sell agreement may also contain certain hold-backs and escrow provisions designed to assure the accuracy of the representations and warranties and to cover for any unforeseen circumstances, as well as earn-outs designed to incentivize key individuals for successfully operating the business.

- 6. Assignment agreements/bills of sale.** Written instruments that transfers title to the purchaser.
- 7. Employment agreements.**
- 8. Real estate documents.**

## J. Enter the market

As indicated above, the M&A market is very strong for franchisor and large multi-unit franchisees of scale. When you are considering a merger or acquisition, dedicated counsel can assist you with the intricacies of the process.

This paper is a joint project of DLA Piper and the McLean Group, created to address key factors driving investor demand for franchisor system mergers and acquisitions, transaction options, exit planning considerations, and various due diligence and legal documentation issues. We hope that both sellers and buyers of franchisors and multi-unit franchisees will find this information helpful.

## ABOUT THE AUTHORS

**Bret Lowell** is a partner in the Washington, DC and Northern Virginia offices of DLA Piper. He is an internationally recognized leader in franchise and distribution law, has counseled and represented clients across a broad spectrum of industries, and is heavily focused on the buying and selling of franchisors. Bret has worked on both sell-side and buy-side transactions, representing private equity, investors and strategic players. He regularly provides legal advice concerning strategy, document preparation and due diligence in connection with franchisor dispositions, acquisitions, mergers, public offerings, financings and investments.

**Abhishek Dubé** is an associate in the Washington, DC and Northern Virginia offices of DLA Piper. Abhi focuses his practice on international transactions related to franchising, licensing and distribution, and works closely with both domestic and international clients on a variety of matters involving general corporate advice, corporate governance, contract drafting and negotiation, franchise planning, franchise formation (including master franchising, multi-unit licensing, single-unit licensing, area development and other structures) and mergers and acquisitions.

**Burt Yarkin**, Managing Director of The McLean Group's San Francisco office, has more than 25 years of experience in the retail and franchising businesses and a history of growing strong businesses. Burt leads The McLean Group's franchise and consumer practices, advising global companies on mergers and acquisitions and capital formation. Previously, Burt held senior management positions with such well-known international brands as Cartridge World, Gymboree and 1-800-Flowers and spearheaded efforts to grow those brands globally. As past CEO of Cartridge World, Mr. Yarkin oversaw one of the fastest ramp-ups in US retail franchise history and was instrumental in completing a large private equity transaction for a sale of the company. Burt is a popular speaker at franchise and finance conferences and has been featured in articles in *The Wall Street Journal*, *Business Week*, *The New York Times* and *Entrepreneur Magazine*, as well as other newspapers, magazines and news programs.

### DLA Piper

DLA Piper is a global law firm with 4,200 lawyers located in more than 30 countries throughout the Americas, Asia Pacific, Europe and the Middle East. The firm has been widely recognized for its achievements in the franchise, private equity and M&A areas, including:

- Hailed as the number one global law firm for franchise law by Who's Who Legal in every year since 2005
- Ranked the Top Franchise Practice in the United States by the respected research firm Chambers & Partners, which calls us "the world's most recognizable force in franchising" and comments that DLA Piper "stands in a class of its own"
- Ranked #1 globally for total private equity and venture capital deal volume by Dow Jones *Private Equity Analyst*
- Ranked the most active law firm for global M&A deals by *mergermarket*

Our franchise group frequently assists franchisors and private equity firms of all sizes pre-acquisition and post-acquisition. We also help to establish, modify, restructure and expand franchise programs and networks. Our M&A and franchise lawyers have extensive experience collaborating to offer complete corporate M&A legal services that are fully

integrated with, and cognizant of, the special aspects of a franchise acquisition or disposition. Our M&A and franchise lawyers have experience in virtually all franchise sectors, and our world-wide platform enables us to provide seamless services wherever the target's assets may be located. When you are buying or selling a franchise company, we will tailor our approach to suit your unique transaction, calling on our franchise knowledge and our corporate experience specific to franchisors.

**The McLean Group**

The McLean Group is a leading independent investment bank that provides mergers and acquisitions (M&A), business valuation and strategic consulting services to middle market businesses. Our M&A advisory and valuation services reflect our comprehensive industry knowledge, extensive transactional successes, commitment to provide senior-level attention to every client engagement, and real-time understanding of industry-specific valuation drivers. Through our commitment to partnering with clients and providing strategic advice throughout every phase of a company's development, The McLean Group is uniquely positioned to build lasting relationships and contribute measurable value to each client's long-term success.

If you have any questions about the topic discussed in this white paper please contact:

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