

Lessons Learned from Challenging Times

By Robert S. Hill, Principal
J. H. Chapman Group, Investment Bankers

We are a Merger & Acquisition advisory firm. Consequently we spend a lot of time talking to clients and prospective clients about current market conditions for buying and selling companies. Because a portion of our practice involves franchisees and franchisers, our client conversations often contain reminders that a shift in current market conditions frequently has an exaggerated impact on franchise value and franchise transaction structure.

Nothing could be more relevant as we enter another year of very tight, and some would say disappointing, times for M & A activity in the middle market, where most franchise activity lies. Mid market multiples that were 6 – 7 a few years ago are now 4 – 5. The number of completed transactions is also down significantly from a few years ago.

A good example can be found in the Food Institute's tracking of M & A activity including the restaurant sector – where a lot of franchising activity exists. According to FI, the restaurant and foodservice sector normally produces more than 100 transactions annually (140 in 1998). The sector had only 48 in 2002 and 61 in 2001, and last year's total was only 34% of the 1998 high point. The exaggerated impact for franchising is evident when comparing the restaurant /foodservice sector's 34% to the entire food industry's 51% for the same time period.

Because we see encouraging signs on the horizon pointing to a stronger market, we believe it is a good time to think about lessons learned and to consider desirable preparations as owners of franchise businesses contemplate jumping into the market either as a Buyer or Seller.

Lesson Learned: Owners of cash-flow strong but asset-weak companies may have a tough time achieving their value expectations.

For owners of a franchise business, the most important development in recent years affecting their ability to close a purchase or sale transaction is the disparity in importance that cash flow plays in determining value and purchase price vs determining debt capacity. As with much of the non-public middle market, cash flow expressed as EBITDA is the single overwhelming factor determining value. Buyers, sellers and investment bankers think in terms of multiples of EBITDA, usually trailing 12 month EBITDA, as the primary method of expressing purchase price and comparing relative transaction pricing or “trading range” within industry groups.

However, many proposed transactions with Purchase Price agreements in hand have fallen apart because acquisition financing to support the agreed purchase price cannot be achieved. Why? Because most lenders active in the franchising sector today do not assess

value, and therefore loan exposure, the same way Buyers and Sellers do. While they may express the result of their analysis as a multiple of EBITDA, they frequently do not arrive at their proposed loan amount that way. For example, while they may complete a detailed cash flow analysis, lenders will often impose a limiting factor tied to their assessment of collateral value. The result has been a significant reduction in advance rates.

Our firm's annual census of restaurant M & A activity shows a marked decline in prevailing debt multiples from approximately 5.5x in the late 90's to approximately 3.8x in 2002. While there is good news according to a recent U. S. Bancorp Piper Jaffray survey which concluded that debt multiples were inching up, perhaps to the low 4's, these multiples are far below the value-creating 5's and 6's seen a few years ago.

In addition, the last few years have seen a significant rollback in the number of cash flow lenders participating in the middle market and particularly in the franchise sector. The enormous loan defaults in recent years have taught us that asset or collateral value is king when it comes to loan values, and nowhere is this lesson more evident than in the franchise sector. Lower advance rates have imposed a cap on purchase price multiples and have stifled a significant amount of transaction volume.

For Buyers and Sellers, the good news is that cash flow lending is starting to come back with the emergence of some very creative and aggressive lenders, but the market is a long way from the go-go years of the mid 90's where cash flow was king and asset collateral was a second thought.

Lesson Learned: Deal structure, deal structure, deal structure

It used to be that Buyers could obtain senior debt, add some equity and close an acquisition paying cash to the seller who blissfully retired to Arizona to live off the fruits of his good fortune. No more.

Complex transaction structures have become commonplace in today's M & A market. While transaction structure has always had a role in mid market M & A circles, never more than in the last couple of years. The reasons are many, but among the more important are the following:

1. The significant shift in lender methodology and the substantial reduction in advance rates as discussed above. If a transaction is fairly priced at 5.5 x EBITDA but the senior lender will advance only 3.5 x, a significant value gap will need to be closed. While "more equity" will work, this is typically not the option of choice for most buyers.
2. Increased competition for acquisitions between strategic buyers and financial buyers combined with the differing evaluation methods applied by both buyer types to assess acquisition opportunities. For example, financial franchise buyers may be very sensitive to the amount of pure equity going into a transaction and often will seek out a variety of "near equity" capital sources to minimize their "hard" equity contribution. Strategic franchise buyers may be somewhat less equity sensitive, but they will often be very cautious about post-closing issues including protection from seller induced competition, hidden liabilities and required capital expenditures.

3. In the franchising sector, the presence of a third constituency at the closing table (the Franchiser) who may use the change in ownership as an opportunity to achieve other capital consuming objectives like image upgrades or marketing commitments.

The end result is that Buyers need to be much more creative to achieve their desired return on equity and close a transaction while Sellers need to be prepared for a variety of post-closing consideration, continuing seller participation (usually subordinated) and residual liability indemnification.

Lesson Learned: More of a good thing is not necessarily a good thing.

The decade of the 90's saw unprecedented growth and consolidation within the franchise sector. Large franchisees grew. Small franchisees sold out. Some of this activity was actively encouraged by franchisers, some was the natural result of well intentioned synergy and consolidation analysis pointing to better profit margins, some occurred as franchising attracted growth-minded entrepreneurs very adept at raising capital.

But as boom times turned to bust for many buyers and lenders, one wonders what happened to the simple truth of franchising.

For many franchise concepts, the basic business proposition is low tech, on the street, in the neighborhood where local market knowledge and local presence counts.

Our view of the horizon shows brighter times ahead, but we think one's franchise growth strategy should keep in mind that simple truth.

1. If the expansion choice were a) same concept 1000 miles away or b) second concept at home, the latter often offers less risk, more efficient utilization of management resources and therefore better long term payback.
2. If the expansion choice were a) 30 sites leased or b) 15 sites on fee property, fee properties are often a better choice because they provide collateral value, longer term debt capacity and a diversified cash flow stream (inter company rent) less prone to the ups and downs of franchiser marketing programs. And fee properties pay a dividend for a franchisee's local market knowledge as well as provide for the owner a second exit timeframe.
3. If the expansion choice were a) keep my current level but reliable performer and buy a small position in an exciting upstart or b) sell my level performer and buy a much larger position in the same exciting upstart, choice (b) may offer more long term potential because many of a franchisee's skills and much of his market knowledge is transferable to other franchise concepts. Many business owners have missed good opportunities because they couldn't bring themselves to part with a company at current values when historical values had been higher.

In conclusion, we believe exciting times are on the horizon, but those exciting times will be characterized by vexing challenges and an increasing need to be flexible and creative. The lessons of the last few years will prove to be valuable to those who take the time to learn from them.