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Mature brand may make fine partner for up-and-comer

By Dennis L. Monroe

We all know how difficult it is to grow a franchise system. But there is one bright spot. Strategic partners seem to have significant investment interest in early-stage concepts, and for a variety of reasons—to build more diversity, find a new growth vehicle, leverage corporate resources, or simply satisfy entrepreneurial ambitions. Some well-publicized recent examples include Buffalo Wild Wings' investment in PizzaRev, PF Changs' investment in True Foods, Ruby Tuesday's investment in Lime Fresh—the list could go on and on.

In the past, concepts worked diligently to grow to critical mass and then sell to a strategic buyer. Today's trend is a little different: The large company may invest in emerging concepts that have real growth potential and need either significant funding or the expertise of a larger strategic partner. Early-stage investment is very much in vogue.

Who are the targets? In my mind, they are emerging concepts with fewer than 20 units, with strong unit economics and consumer appeal. Let me outline the process of how to secure a strong strategic partner to grow an emerging concept.

What's the appeal?

Evaluate your concept by looking at its various attributes. For example: Is the concept capital-intensive? Highly profitable at the unit level? What are the demographic appeals? What type of operator/franchisee is successful with the concept? What is the competition?

Now look at your growth needs. How much capital is necessary to grow the concept to critical mass (50 to 100 units)? What type of expertise (in terms of franchise sales, overall development skills) is needed to carry out this growth? What are the necessary marketing skills to continue to grow the concept and the unit economics? What type of overall infrastructure is necessary to manage the franchise process? What type of sales force will be necessary?

Next it's time to look for potential strategic partners. Seek out mature, successful concepts in slow-growth segments that probably reached a peak in terms of growth (such as casual dining, QSR, quick lube, hair care and other mature categories) and need to find effective growth vehicles. Look at large companies that have been successful at incubating growth concepts, and steer clear of those that have not done well, particularly if these companies are trying to sell to the existing franchise community and the franchise community does not fit with the acquired concept.

Having identified your targets, you now need to search for the potential investor that's right for your concept. Look at franchise source books, the International Franchise Association and industry trades to see who is a good match.

Understand the culture of potential strategic investors. Usually if a company has made a strategic investment and has been successful, it has a predisposition to continue to look at opportunities.

Have they been good franchisors? Have they been successful in developing new ideas and concepts within their brand? Are they public or private companies? Sometimes being private is easier because there is no necessity to get an immediate return.

You want a strategic investor that has the skill set that matches your needs. Do they have a strong sales force? Do they have significant capital? Do they have a good development team?

Consider the CEO. Does the CEO have an entrepreneurial background? Does the CEO have the understanding of what it means to grow concepts rather than running mature systems? If the company is public, what is Wall Street saying? Has its stock been stagnant? Does the company have a franchise community that is fully developed and needs other opportunities?

If our firm has as a client an emerging concept that needs a strategic partner, we begin keeping the potential investors informed of the progress of the concept. When our client gets to certain critical mass, we go back to the investors, who are now familiar with our client, and show a compelling story.

Given all of the above, you and your adviser should prepare a hit list of six to 10 potential strategic investors/partners.

Packaging your concept

What do you do now that you have your list? There are two ways to approach this: Let your investment banker put together an effective package and then contact the potential investor to present the package, or look to your network and adviser to get good introductions for face-to-face meetings (particularly with the CEO or CFO) to sell your concept. The best sales person is always the concept founder.

You have to put together a compelling package that says why you are a worthy investment or partnership target. The package needs to lay out the current successes, growth plan, current management (and their ability to succeed to this point) and needs. Explain your needs: Are they related to financing, management, marketing, development or just strategic planning?

Most large companies in our industry watch and follow emerging concepts that have some relation to their systems. In many cases, the key leaders of these mature concepts probably already have you on their radar screen.

Passive or active

Deal structure can take on numerous forms, from a straight passive ownership interest providing some support and help (as with private equity, this usually involves supermajority rights for the investor); to licensing the concept, being a potential franchisee or taking just the right to the concept to the investor's existing system. Another option is a control position where the investor/partner wants management to stay in place but wants to control (and grow) much as Darden did with Yard House.

Still another is a hybrid where there is an initial, small investment with a right to make a larger investment and possibly gain control (until there is a certain threshold of size and economic value, the company still remains in the hands of the original founders.) And there's shared services, where the larger strategic partner provides services in return for an investment interest, such as franchise sales and development of joint sites.

No matter the structure, the sticking point is always an agreement as to value.

Once you have a deal, the key is to make the relationship go smoothly. If the relationship does not work, you need to have mechanisms in place that allow for unwinding and a buy-back of the concept. We have seen concepts bought back at a much lower price than they sold for originally.

Finding an early stage strategic investor is an idea worth exploring. Remember to plan ahead. Find a match for your attributes and a way to create significant value. FT

Dennis L. Monroe is a shareholder and chairman of Monroe Moxness Berg, a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation. He can be reached at dmonroe@mmblawfirm.com.