Franchise Times®

www.franchisetimes.com The News and Information Source for Franchising May 2012

Good Partners, Bad Partners

Because investors aren't equal, finding the former takes work

By Dennis L. Monroe

The number of outside investors teaming up with good operators to buy into franchise systems is proliferating of late. In particular, private equity has served as the funding for consolidation of franchisee units and the acquisition of franchisors. But not all professional investors are created equal. Operators who want to bring in a financial partner while staying actively involved have due diligence to do.

There are two types of financial partners: the investor who wants control (this does not necessarily mean operational control, but actual majority interest); and the investor who is more passive and interested in investing alongside a strong operator without a control position. Either way, consider these questions:

- **Do backgrounds match?** Make sure your prospective financial partner understands your business and market segment, whether you are a franchisor or franchisee. If you own a food concept, find a financial partner with experience in the food industry. If you are a service franchise, seek a partner who understands those intricacies. It sounds simple, but I have often heard potential investors say, "I understand business in general and that should be good enough." I disagree: I do not think general business understanding is adequate. A good financial partner needs a history in the type of business where it invests.
- **Where's the value?** Even though your goal in securing a financial partner is to bring in money, this arrangement should also be a value-added proposition. Can your partner provide financial expertise? What resources does your partner have to help grow your company or bring in necessary talent? Besides providing its own funds, what financing can your partner attract? A good financial partner brings a myriad of support to an investment other than just dollars.
- **Are constraints understood?** Potential investors frequently ask me about constraints imposed on them by existing franchise documents. Constraints are real and numerous. In a franchisor investment, for instance, potential officer or director liability issues and disclosure requirements may exist in the franchise disclosure document. In a franchisee investment, potential issues include guarantees, rights of first refusal, lack of ability to assign interest without the franchisor's consent, non-compete agreements and confidentiality deals.
- **Are growth plans aligned?** A potential financial partner needs to understand true growth potential and the dollars needed to get there. It may not be realistic for a financial partner to look at an accelerated growth plan in order to provide extra value for an exit. Fast growth can beat up on performance. One bad site can offset three good ones. Concepts have life cycles, and there are times when sales decline. Does your potential partner get this?
- **What about oversight?** From a cultural standpoint, operators need to understand the financial partner's position on managing both the day-to-day operations and future growth and development. How often does the partner want to meet? What type of information does the partner want on a monthly or quarterly basis? How much say does the partner want in decisions such as leases, hiring, suppliers or operating agreements? In the case of a franchisor investor, will the financial partner want to oversee entering into new franchise and development agreements? Vet these issues in the initial stage of the relationship, before signing any investment agreement.
- **What's the company worth?** What value does the potential financial partner bring to the company? Is there an agreement as to the multiple of earnings applied to determine value? Is there recognition of the pro forma analysis and future value? Are incentives provided to the management team

where they can take advantage of the value increase? In general, is the financial partner's position reasonable in light of the company's potential?

- **Who has control?** A financial partner with 51 percent of the voting rights does not necessarily have a control position. Control is really a qualitative issue vs. a quantitative issue. Explore this question: "What ways can the company act without the involvement of the financial partner, such as being able to enter into financing arrangements, issue additional stock, acquire other companies or terminate key executives?" Most financial partners with a significant investment want certain control rights where actions cannot be taken without their consent. Most financial partners do not want to oversee everyday decisions or non-major decisions; they usually want to only be involved in structural changes of the company, substantial dollar expenditures, or additional debt.
- **What is the structure?** The investment can come in three main forms, each with its own challenges and variations: subordinate debt with an interest in the company's equity; preferred interest, where the financial partner gets its money out first along with a share of the upside and possibly a preferential return; or common interest, where the financial partner shares ownership with the operator on a straight pro-rata basis. Consult with advisers to examine all the nuances.
- **Where's the exit?** Normally there is no clear exit strategy when a financial partner invests in a company, but the philosophy of the exit strategy needs to be understood. How many years is it before your financial partner wants to exit? Does your financial partner have the ability to force a sale (that means the partner can force the company to be sold if the company has not been sold after a given period)? What are the financial partner's expectations on its return—does the partner want a 20 percent return or a 40 percent return? (Remember, the expected return will dictate some of the issues concerning an exit strategy.) Who are the potential buyers (other franchise companies or other franchisees)? Clearly understand these questions so expectations can be met.

A financial partnership can provide tremendous value when growing a franchisor's concept or a franchisee's number of units. But as is often said, you cannot make a good deal with a bad partner and you probably cannot make a bad deal with a good partner. 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.