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Baby boomers aren't the only group aging, so is franchising. Here's what both need to know about exiting gracefully.

What does exit planning have to do with the franchise world?

By Dennis L. Monroe

The franchise world is getting older. Most of the major franchise systems were developed at least 20 to 30 years ago, and the average franchisee has aged along with the franchise. The aging of the franchise systems and the franchisees have converged to create a significant need for franchisors to embrace the issue of exit planning for their franchise community. Additionally, there is both a need and an opportunity for the franchisor to establish a significant updated brand identity.

How do we provide an exit strategy for our franchise community? A front page article in the January 7, 2007, issue of Nation's Restaurant News, "Unclear Exit Strategies Cloud Chains' Outlooks," stated that a number of the large food chains have long-standing franchisees who are interested in getting out. We have seen this interest in exit strategies as franchisee valuations have stayed strong. Even though this is changing quickly with the tightening credit market, there is still a good opportunity to plan your exit strategy.

One of my partners, Scott Husaby, is an expert in the area of exit planning. I recently interviewed him as to what needs to be looked at concerning exit planning.

Scott pointed out that according to a 2005 PricewaterhouseCoopers survey of companies in the $5,000,000 to $150,000,000 value range (which fits almost all franchisee companies), two out of three business owners plan to leave their company within the next 10 years. I estimate that in the franchise world, nearly half the franchisee community wants to leave their company within the next five years.

Scott said there are three exit-planning questions that are common to nearly all business owners, particularly to the franchise owner:

1. When does the owner want to leave the business? The real question here is how much longer does the owner want to remain active in the business?

2. How much does the owner need/want in order to be financially stable after leaving the business? This means the business will get the type of value the owner is looking for and thus create a sum of money to be used by the owner for his or her life.

3. To whom does the owner want to transfer the business? This may mean the business is transferred to someone who has the same values and approach as the owner (or to a family member or key employee). The franchise world is unique in that all transfers require franchisor approval and need to be transferred to a qualified operator of a franchise concept who has the financial strength to meet the financial guidelines of the franchisor.

Once you have addressed these three questions, Scott said the exit planning process consists of seven steps. (In the context of a franchise business, there is an eighth step in the process – franchisor approval, as discussed below.)

1. Establishing Owner Objectives. The

Scott Husaby

Dennis Monroe

Dennis L. Monroe is a partner and Chairman of Krass Monroe, P.A., a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation. Scott Husaby is a partner at Krass Monroe, P.A., specializing in estate planning and exit strategies. Scott is also a member of BEI's Network of Exit Planning Advisors™.

Dennis can be reached at (952) 885-5999

obvious starting point is to identify the business owner's objectives. This can be accomplished by answering these questions: When do they want to sell their business? What is the annual after-tax income they want after they sell their business? To whom do they want to transfer their business?

2. Establishing Business Value. While the first step establishes what the business owner needs in order to leave their business on their terms, this step determines what the business is worth today. Determining the value of the business tells us whether there is sufficient value to support the business owner's post-exit income needs. If the current value falls short of this objective, part of the exit plan will be to increase the value of the business to a minimum acceptable level. This valuation issue also must be viewed in context of the likely successor for the business. If the exit plan involves transferring the business to family members or key employees, a lower business valuation may be preferable. On the other hand, a sale of the business to a third party may require the highest possible valuation for the business.

3. Building Value and Cash Flow. A critical part of an exit plan is working with the business owner's advisors to develop and enhance the key value drivers for the business. These value drivers include: an effective management team, efficient operating systems, an established and diverse customer base, a realistic growth strategy, effective financial controls, a stable and increasing cash flow, and a tax efficient business structure. Working on these value drivers now will help ensure that the business is best positioned to fulfill the owner's exit objectives.

4. Selling to a Third Party for Top Dollar. This step focuses on two primary objectives. The first is to find a buyer willing to pay top dollar for the business through a controlled auction, a negotiated sale or other method. The second is to ensure that the sale is structured to maximize the after-tax proceeds to the business owner. Particularly important in the franchise world is the timing of the sale. As we all know, prices for franchise businesses go up and down. The franchise systems seem to run in a five year cycle, with the high point being somewhere in that five year life span and then a decline. Much of this process, however, is tied to the credit cycle as well as the franchisor's ability to keep the concept fresh.

5. Transferring to Management or Family Members. If the business owner's objective is to sell or transfer the business to management or family members, the exit plan will be structured very differently than a plan contemplating a sale to a third party. In general, a sale to insiders does not end with a closing. It only ends when the business owner gets paid. The primary obstacle with a sale to insiders is that the buyer usually lacks cash. This type of sale will generally be dependent upon the ability of the buyer to purchase the business with future cash flow. This is why we often create other revenue sources for the owner (such as deferred compensation, rent obligations, increased retirement benefits, etc.) that will allow for a lower "sales price" for the business itself.

6. Developing a Contingency Plan for the Business. Generally, owners have a more pleasant ending in mind when they think of exiting their businesses, but an effective exit plan must address the possibility of the business owner's death or permanent incapacity. Without continuity of ownership, the business will likely deteriorate. If ownership transition is uncertain, business continuity is not only uncertain—it is doubtful. Failure to be aware of the dire consequences on a business in the event of the owner's death can mean the unintended demise of the business along with its owner. A contingency plan must be developed and documented so that the business can continue and its value is preserved, even if something happens to the business owner.

7. Family Wealth Preservation Planning. The business owner's exit plan must contain the proactive design and implementation of wealth preservation strategies before ownership of the business is transferred. An effective wealth preservation plan will protect the value of the business currently, as well as in the event of the owner's unexpected death or permanent disability. Wealth preservation also encompasses the owner's plan for transferring wealth (either in the form of the business itself or exit proceeds) to future generations.

8. Franchisor Approval. A franchise owner must get the approval of the franchisor for the sale of his or her business and go through all of the steps necessary to engage the third party consent of the franchisor.

As you can see, the above steps to exit planning are fairly universal. Every business owner should consider each of these steps to develop an effective Exit Plan, which ultimately will allow the owner to leave the business on their time table with the financial security they want.

Next month's column will focus on the issue of judging fair franchising. FT