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Transition Time in the Restaurant Industry

In the last couple of years we have seen a proliferation of early-stage franchisees selling. Most of these sellers are entrepreneurs and have spent their lives growing a concept. Most notably, we have seen this transition in the Applebee's, Hardee's, Wendy's, Taco Bell, KFC and Burger King systems. Many of these sales have been to financial buyers. There seem to be five reasons for these sellers transitioning out:

Pricing: Prices are currently at reasonably high levels. The prices are possibly not as high as at the time of securitized lending in the 1990's but are at strong multiples (5-6+ times EBITDA).

Abundance of Buyers: There is a good supply of buyers, especially for the major Tier 1 and 2 concepts. Most of these buyers are financial groups or consolidators. (Note that the consolidators represent a significant part of the Monitor's Top 200 list.)

Funding: There is adequate funding available for transactions and a surplus of investment money that needs to be invested so there is no need for financing contingencies or fear of closing.

Fatigue: Long-time franchisees, as they grow and mature in their companies, get fatigued with all of the issues and management challenges. Particular challenges include the rising cost of labor, demands of the franchisors for re-imaging, remodels and product rollout and a tougher business environment than when the franchisees got into the system (e.g., higher taxes and regulatory challenges). Finally, franchisors are under tremendous pressure by their shareholders to grow their systems, thus causing them in turn to pressure the franchisees for development.

Lack of Management Succession: I seldom work with companies that develop good management succession, particularly with family members. Most franchisees that got in during the early stages were entrepreneurs. As the companies matured, very few franchisees planned for ownership succession and management.

Assuming the seller truly wants to get out of ownership, the following items should be considered.

Broker: The seller needs to find a broker who has experience with the seller's franchise system. That broker will have a good list of potential buyers and be familiar with the franchise system sales prices. Often the franchisee will call friendly franchisee peers and let them know informally that the stores are for sale. (In many cases there is a geographic logic to selling to someone who has bordering stores.) However, I believe using a broker is the best approach to assure the seller of the highest price.

Real Estate: Many long-time operators who own significant real estate want to hold the real estate and lease it to the buyer at market rates. This may be wise as it relates to returns but can be a real hassle. My recommendation is that if you are going to sell out, sell out entirely to avoid issues with the buyer.

I much prefer to see the seller: (a) sell all of the real estate; (b) do a sale/leaseback prior to the sale and completely exit; or (c) do a like-kind exchange (sell the real estate and then reinvest in other real estate that is more appropriate for investment income and passive ownership).

Transition Period: The transition period can be difficult for the seller. Long-term relationships with key management and support staff will change. Other issues regarding transitioning include severance pay, home office functions (that have normally been conducted by the business), and certain perks (including health insurance, cars, planes, etc.) that will now have to be dealt with by the seller individually. It is really a time for the seller to look at a lifestyle change and let go of the entrepreneurial/franchisee relationship.

Liability Issues: I see recurring issues that come up in any sales transaction, creating concerns for the seller. Most notable is the issue of ongoing liability. Any sophisticated buyer (an existing franchisee or a financial buyer) wants the seller to continue to have liability for certain aspects of the transaction, particularly employee matters, undisclosed liabilities, or certain contracts which were not disclosed or assumed. The following is a list of more specific liability issues that create stumbling blocks for a sale transaction:

Gift Card Liability: Gift card liability is not always as easy to determine as you may think, particularly if the gift cards are administered by the franchisor. Gift card liability is incurred prior to closing and needs to be quantified. It will either offset the purchase price or be a continued obligation of the seller. In most cases, franchisors do not allow the seller to keep the gift card liability to satisfy the gift cards as they are redeemed; therefore, a liability figure needs to be agreed to during the sale process.

Employee Matters: Certain employee matters involve successor liability for the buyer so there needs to be an indemnification by the seller, and in many cases, a holdback.

Vacation Pay: Even though the buyer is a new employer, the employees still want their old vacation pay. Like gift cards, vacation pay is not always easy to quantify; yet it needs to be agreed upon as an offset to the purchase price.

Personal Guaranties: In many cases, franchisees (particularly individuals) have personally signed or guaranteed leases. It is very seldom that a lessor will release an individual from a guaranty. This lease liability needs to be addressed with the buyer. If the buyers are not individuals, and if there is no substitute guaranty, the seller needs to have protection. Money can be escrowed until the guaranties are released, or there is a letter of credit, security interest, or sublease.

There are many reasons to sell. But, for many long-time franchisees, there are many issues and decisions to make concerning the business, one's emotions and a changing lifestyle. It is not an easy process, and we lawyers make every effort to handle it with special care.

—Dennis L. Monroe