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The Right Way To Do Refranchising

By Dennis Monroe

Over the years, our firm has been involved in many refranchising programs and seen both good and bad approaches. One of the most problematic programs was the Applebee's refranchising, which was initiated to pay off excessive debt and left the brand with few corporate stores and no effective way to test and improve the concept before rolling out to franchisees. Buffalo Wild Wings might have taken a similar path if the activists had gotten their way. Thankfully, it turned out differently. Yum and Hardee's have refranchised over the years and have done a relatively good job in their sale of corporate stores. Red Robin seems to be taking a very thoughtful approach to refranchising and so is Big Boy. So what does it take to do it right? Here are the five keys to executing a good refranchising program.

Refranchise for the Right Reasons

You don't want to refranchise just to come up with a financial solution. You want to achieve the right mix of franchise and corporate stores. I always become concerned when the percentage of corporate stores drops below 10%, because this can really create problems when it comes to alignment with the franchisees, the ability to test new products, prototypes, and technology. Also, it is clear that one of the primary purposes of refranchising should be to bring new blood into the system and also to reward existing franchisees. These concepts are the foundation for a successful refranchising program. Never look at the short term.

Make Sure You Provide Development Rights

Refranchising shouldn't be used just to get rid of stores, it should be used so the corporate stores can seed development in specific areas. You should seldom refranchise without corresponding development rights. While sometimes it makes sense to refranchise an isolated store because it fits with an existing franchisee's development plans, in most cases I like to see refranchising programs coupled with reasonable development obligations. The beauty of this approach is you give existing or new franchisees immediate cash flow, which provides an economic benefit as they grow the development area. One item to always keep in mind is that development rights should never be too aggressive, particularly when you are trying to integrate existing, purchased corporate stores.

Find the Right Partners

The sale of corporate stores needs to be strategic, and getting the right franchisee under all circumstances is the best strategy. Go for the potential franchisee who makes the most sense for your system and can grow and develop the stores as well as increase the revenue in the existing stores they are buying. The ideal partner should: 1) Fit the culture; 2) Have the financial resources to acquire the stores; 3) Have "dry powder" to develop the stores around the refranchised stores; and 4) Have strong operations that can be verified through a proven track record of their performance in your system or in other systems.

Price It Right

Make sure the existing stores are not overpriced. Sometimes we've seen inflated prices that create unreasonable entry costs into the system. I would prefer to see refranchising programs with market prices or even slightly below-market. The idea is to sell to the best and most appropriate potential franchisee or existing franchisee, keeping in mind they will generate significant royalties in the long run. Therefore, short-term pricing is not as important as long-term success and a sustainable royalty stream. The other problem with pricing either too high or too low is you then create concern in the existing franchisee community as to value, which may affect exit strategies and refinancing. It's always good to consult with existing franchisees prior to the commencement of a new franchising program.

Make Sure the Franchising Program is Appropriate for Refranchising

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You need to review your franchise agreement and development agreements. Specifically, you need to make sure that the provisions in all of these documents meet the needs of the potential refranchising buyers. If you're looking at private equity or family offices, you need to have provisions that fit the situation. Also, if you are looking at selling underperforming stores that need to be turned around, you need to make sure there is some latitude in the royalty arrangement to take into account these stores. In many cases, the agreements need to provide flexibility to fit the kind of situation necessary for the stores being sold and the development rights being granted.

Refranchising is a major decision that needs to be carefully thought out. It should never be a knee-jerk reaction, and certainly activist shareholders and financiers should not be the primary movers in this process. The best approaches always take into account what is best for the overall franchise system and the long-term economic health of the franchise, and making sure that the refranchised stores and the development rights create a successful and economically viable business.

Next time, a quick primer on the new tax law and how it affects you as a restaurant owner.

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