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Checking The Weather

2011 franchise climate presents challenges and opportunities

By Dennis L. Monroe

As covered in last month's column, there were a number of positive developments in franchise finance in 2010. In addition, the franchise trade press has been active with reports of many encouraging developments. Still, not all the news is positive.

In a discussion with my partners, Randy Evans and Rick Gibson, we thought it would be interesting to further elaborate on last month's column and look at the challenges and opportunities for 2011.

What is a franchise business to make of the economic climate for the balance of the year and various opportunities that it will come across?

A review of some of the recent franchise industry market developments might be a good place to start. A number of large franchisors have either announced or indicated interest in possible acquisitions and divestitures. This list includes the planned sale of the Long John Silver's and A&W – All-American Food brands by YUM! Brands, Inc. and the announcement by Wendy's/Arby's Group, Inc. that they plan to sell the Arby's sandwich chain. Other large operators have announced or have been indentified as having interest in pursuing acquisitions of existing concepts.

Although each of the announced transactions is based on specific strategic objectives, there is at least one common theme: the marketplace is receptive to transactions. This is supported by a number of underlying elements, including increased transaction activity in the debt and equity markets, more favorable views on transaction pricing by sellers, and the ability to attract buyers into deals based upon the opportunities presented by a more positive economic outlook.

Also on the positive side, most economic forecasts point to improved revenue in the franchise industry for 2011. Restaurant sales, often a bellwether in the franchise industry, are widely expected to show positive comparables over last year, possibly hitting a four year high.

However, not all of the news is positive or suggests that 2011 is the right time to proceed with a major transaction. Based on most economic reports, there seems little doubt that 2011 will see sharply rising food prices, causing a major issue in the franchise restaurant business. Increases in food prices could be accompanied by increased costs across numerous franchise sectors. For businesses that are only now returning to profitability after the difficult economic times in 2008 and 2009, increased costs could present a substantial setback.

In addition, the new health care law (while a constant topic of media coverage – both for and against) may represent a significant labor cost for many franchise businesses. Significant future labor costs represent another potential setback to franchise operators and their business plans.

Monroe Moxness Partners Randy Evans and Richard Gibson also contributed to this article.

Another sign that challenges remain is the continued bankruptcy filings (or announced hiring of bankruptcy counsel) by franchise businesses. Over the last few months, bankruptcy (or potential bankruptcy) has continued to be in the news for franchise businesses. Large QSR franchisees, well known casual dining concepts, large restaurant operators, quick lube franchisees and others have all recently been involved with bankruptcy matters. Although bankruptcy is often the tail-end solutions of problems occurring several months or years prior, the continued pace, and the size of the franchise businesses involved suggest that ongoing economic challenges still exist.

Finally, while unemployment levels have stabilized, and perhaps have started to decrease, the unemployment rate is still at levels that historically represent a serious obstacle to recovery for many franchise businesses. Given the large number of franchise businesses that are designed to serve the consumer market, high unemployment will continue to challenge the industry.

Where does this put the franchise operator for the balance of 2011? While we don't possess a crystal ball, some of the takeaways include:

- Focus on what your business does best. Whether it is evaluating multiple concepts or reviewing the performance of multiple locations, focus on the best performing parts of the business and deal with the other parts.
- Utilize the improved credit markets and low interest rate environment, either to pursue that strategic acquisition or improve the company's existing financial position.
- Anticipate and plan for upcoming increased expenses.
- Keep an eye out for good opportunities. The franchise industry developments mentioned above will likely present further change in the franchise business world and create numerous opportunities.

While the overall environment for franchise businesses continues to be somewhat of a mixed bag, we believe that 2011 will be better than the last couple of years. This is a time to be bullish on franchising as franchisors and franchisees should be on the leading edge of an improving economic and financing market. FT

Partners Randy Evans and Rick Gibson also contributed to this article.

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