Franchise Times®

www.franchisetimes.com | The News and Information Source for Franchising | January 2011

Old Benchmarks vs. New Tests

From food costs to fiscal health: a half-dozen areas to double-check

By Dennis Monroe

Old benchmarks are being exacerbated by the economic downtown and the change in consumer attitudes Here's how to redefine the long-standing benchmarks for operating franchise businesses:

1. Emphasis on percentage of sales versus cash flow. Valuing an operating business by using a multiple of cash flow, particularly multiples in the 4-to-6-time range, has been an acceptable approach. There has been a trend in recent major franchise business acquisitions to have more of an emphasis on a percentage of sales for the selling price versus just a multiple of cash flow. This is particularly true for the multi-unit concept still in the growth stage. There is no certainty as to upward sales trends so multiples are volatile and hard to peg.

2. Unit Economics. We used to be satisfied with a unit level cash flow of 8- to- 12 percent of sales. This has certainly changed. Most franchise businesses that I work with are now looking at a minimum of 15- to- 16 percent and more likely a benchmark of 20 percent of cash flow-to- sales at the unit level. The idea that you can sustain a business at 8- to- 12 percent of sales is no longer an acceptable benchmark.

3. Labor and Food Costs. In today's marketplace, it is no longer true that labor and food costs will take care of themselves if the concept is executed properly. Labor should be discerned and built from a zero-based model up (where every aspect of labor and management should be looked at). Labor needs to be minimized, and food costs need to be fully scrutinized. Commodity issues need to be addressed on a daily basis. And too often in the franchise world, cost of goods sold isn't addressed very aggressively.

4. Sales to Investment. The sales-to- investment benchmark is not something we have looked at for many years. In its heyday, casual dining had a strong sales- to- investment ratio. Today, that ratio has fallen to the same ratio as QSR, of 1:1, or sometimes less. The reason fast-casual (and some of the new smaller QSR concepts) has done so well is that sales to investment are sometimes up to 5:1. This benchmark needs to be addressed. In my mind, any franchise concept with a sales ratio of less than 2:1 is suspect. Key franchise systems should be in mall locations, or other varying retail development opportunity.

5. Occupancy Costs. Occupancy costs for most franchise businesses usually ran in the neighborhood of 6- to- 9 percent. We are continuing to see downward pressure on occupancy costs, and good franchise systems are taking advantage of this. They are particularly avoiding steps in rent based on a perceived inflation in the future and are looking at fixed rents with moderate percentage rents. The idea of step rents used in the past is something that should probably be avoided.

6. G&A. Corporate overhead allocations were looked at as a given for many years. Now it is essential allocated G&A amounts be dealt with and be reasonable. I like to see G&A somewhere in the range of 3- to- 4 percent of sales, but more often it runs in the neighborhood of 7-to- 8 percent of sales. This is a critical item in determining the profitability of each unit.

Using those benchmarks should improve your GAAP profits and provide a new way of looking at your business. FT

Dennis L. Monroe is a shareholder at Monroe Moxness Berg, a Minneapolis law firm specializing in multi-unit franchises.

Reprinted with the permission of Franchise Times, January 2011 © Franchise Times, 2808 Anthony Lane South, Mpls., MN 55418