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Detailed guidelines are available for figuring the valuation of a franchisor or franchisee, but there are some points to keep in mind first.

What's my franchise worth?

Calculating the value of franchisors, franchisees

In these tough economic times, the question I am asked most often is, "What is my franchise business worth?" This month's column will outline a few key points that may be helpful in determining that worth.

In many cases, the key index of valuations is the public market. As the public market has been in such disarray, I am not sure it is indicative of an arm's length valuation selling price for most private companies. For instance, in the week ending July 11, 2008, DineEquity stock lost 22 percent and other losing stocks included Jack In The Box at 15.1 percent, Red Robin at 14.5 percent, Wendy's at 13.2 percent, and Triarc Companies at 11 percent. This is not necessarily the best news, but we do know most private equity companies have stabilized more than public markets.

There are a number of important points to recognize, and these points have changed the landscape of looking at the value of franchise businesses. Please keep in mind the following points when discussing the worth of your business:

- So called "Restated or Normalized Earnings" are not going to carry much weight. Buyers are looking to base value off of real GAAP earnings.
- Any potential buyer is going to factor in the trends looking forward. For example, if sales are declining, the potential buyer will assume sales will continue to decline. The idea of "average sales" over the past few years is not going to work.
- Most conservative value assumptions are going to be made as it relates to growth, capital expenditures and cost controls.
- High multiples and speculation are gone.
- The flexibility of a concept and the ability to react to changing economic conditions will add a premium.
- Historic multiples may not be relevant. Franchise business sales transactions that occurred six months prior to your valuation and received a premium pricing are a thing of the past.

Keeping the above contextual points in mind, let us look at some key valuation guidelines. If we are going to dig deep into the valuation issue, we must distinguish franchisor from franchisee businesses.

Franchisor valuation guidelines

Franchisors can be divided into three segments:

Tier One: Emerging Concepts. Tier One concepts are small emerging franchisors that have yet to prove themselves but have started to gain some critical mass (roughly 40 to 100 stores). These companies have not shown fast growth but have a fairly stable and growing franchise system.

Valuation Guideline: This class is the hardest to value because these companies usually have entrepreneurial management with a focused vision. Many times this first tier of franchisors lacks professional management. Tier One franchise companies will trade in the 5x to 7x EBITDA range (for a franchisor this is usually defined as the sustainable franchise and royalty income less the cost of administering the franchise system). If there are corporate stores involved, these stores are normally valued more under a franchisee scenario.

Tier Two: Old Concepts. Tier Two concepts are franchisors that have been around for a long time and have critical mass but have not had

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good performance over the last year or two.

Valuation Guideline: This class is made up of older systems that are somewhat problematic and have had slow or no growth. These systems are generally in need of additional capital improvements and may be somewhat tired but are still valuable. In most cases, these systems will trade somewhere in the 6x to 8x EBITDA range with 8 being on the high side and applicable to those franchisors who have definitely determined a turn around plan, with 6x being the more likely multiple. Again, the multiple would be applied to the franchisors' earnings, as discussed above.

Tier Three: Hot Concepts. Tier Three concepts are franchisors that have hot, fast-growing concepts. These are businesses that have been able to easily sell franchises.

Valuation Guideline: They are highly valued businesses and command a concept premium. Economic downturns are not terribly relevant and the upside is key. The businesses have demonstrated significant growth opportunities and have a strong pipeline of franchise sales. In most cases, you will see an 8x to 10x earnings multiple for these concepts. It all depends on the story being presented by the franchisor and the belief of the investor or buyer in the ability to continue to grow the concept. In many cases, the people looking at the value will be strategic buyers, and they are going to pay more than financial buyers in today's marketplace.

Franchisee valuation guidelines

Franchisees have always traded at a more compressed band than franchisors because, in most cases, you are buying a franchisee that has limited potential upside but usually has stable cash flow.

Tier One: Small Franchisees. Tier One franchisees are developing units but have not yet reached critical mass so they probably have excessive general administrative expenses.

Valuation Guideline: Tier One franchisees are the bread and butter of the franchise world. They are the majority, the middle 40% to 50% of all franchisees and are not in the list of top 200 franchisees. In most cases, you will see Tier One franchisees trading in the 3.5x to 4.5x EBITDA range. A lot of this will depend on the capital improvements necessary to comply with the franchise and the type of development rights the franchisee owns.

Tier Two: Mega Franchisees. Tier Two franchisees are a part of a stable, national concept that has moderate development rights but has not grown significantly in the last few years but represents a significant business with moderate growth.

Valuation Guideline: Tier Two franchisees are members of the top 200 franchisees, and they do have a sizable business that requires professional management. In many cases these will trade in the 4.75x to 5.25x EBITDA range. These businesses do trade in a fairly narrow band with slightly under 5x being the norm. These franchisees also require the highest degree of financing and probably have the lowest potential upside but have very stable cash flow and professional management.

Tier Three: Emerging Franchisees. Tier Three franchisees have significant development rights in a strong emerging franchise company. They have been able to achieve strong unit volumes.

Valuation Guideline: Tier Three franchisees are probably the most difficult franchise businesses to value. Normally, I would look at valuing Tier Three franchisees in the 4.5x to 6x EBITDA range. There are not a lot of Tier Three franchisees, and buyers are reluctant to pay a premium over 5x for a franchisee. The key is there are situations where a franchisee has cornered an absolute valuable market and is able to grow sales in their franchise units and expand units through development rights.

The one key thing to take from this column is that the market is in flux. I do not think the market valuations have gone through the floor like some industry folks have said. Also, the private market has not reflected the volatility of the public market. The issue may not be multiples as much as the amount of time needed to get the transaction done, the ability for the buyer to finance the transaction, and the necessity of the seller to carry paper in any transaction. Once again, valuations are driven by the availability of financing. FT

Next month's column: "Franchisors, We Need Your Help!"