RESTAURANT FINANCE MONITOR®

Volume 25, Number 5 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

May 20, 2014

What Happens When You Think Big?

By Dennis L. Monroe

In last month's lead article "Five Things That Set Good Operators Apart," Jonathan Maze had a wonderful discussion of the success of large, multi-unit franchisees. One of the things Jonathan pointed out is that even large operators need to think small. For years, this has been a key tenet in restaurant franchising, a world which was initially dominated by owner-operated businesses. These roots have certainly changed over the years and now the dominant players are large, multi-unit operators, some of them genuine behemoths. But most large operators are sophisticated business people who have sophisticated operations and operate one or more concepts.

These large, multi-unit operators seem to be the prettiest girls at the restaurant franchising dance, and they certainly attract a lot of attention, particularly from emerging restaurant franchisors. Many large operators that have either single or multiple concepts are looking for ways to leverage their overhead and develop a concept within their existing trade areas. Often their existing concepts do not afford them a great opportunity for growth. The obvious remedy is to try to find a successful, emerging concept that the large multi-unit operator can grow in order to take advantage of its success.

While the emerging concept franchisor may want to secure the large operator as a franchisee, knowing if this is the right route to take requires a great deal of thought and consideration. It may be better for some franchise restaurant concepts to opt for the owner/operator model rather than casting their lot with a large, multi-unit operator. It's a strategy that can be effective, but it does take patience, a great deal of infrastructure and time.

Here's what the large, multi-unit operator (LMUO) wants:

1. **Unit Economics.** The LMUO wants a clear understanding of the unit economics it is investing in. Those unit economics need to equal or exceed the existing concept's unit economics within which it operates. The LMUO always benchmarks off what profit it can make on its existing concepts. If the operator is out of the development territory, it may not be possible to continue its current economics; but the multi-unit operator does not want to have less favorable economics or its profitability diluted by a new concept.

Here are several things that attract the LMUO: (a) unit level profitability in the 15% to 20% range; and (b) below-market labor costs, reasonable food costs, and options to have reasonable occupancy as a percentage of sales.

2. **Reasonable Return on Investment.** The LMUO wants a reasonable return on its capital investment. In many cases the amount of capital investment is tied to sales. If this is a QSR concept, the sales-to-investment ratio is probably 3 to 1; if it is fast casual, the sales-to-investment ratio is probably 2.5/3 to 1; if it is casual dining, the sales to investment ratio is probably 2 to 1. Moreover, the capital investment needs to be deployable in an manner. Many emerging concepts spend too much for a unit. Good operators can normally lower that cost by 20% to 30%.

3. **Tested Concept.** The LMUO also needs assurance the concept has been tested. This means the concept has found consumer acceptance, and understands its customers and potential demographics. Further, it means the concept has a good idea as to what will and will not succeed. Most multi-unit franchisees are not experts in creating concepts or determining the consumer fit, so they rely on the franchisor to come up with something that works and evolves.

4. **Value Proposition.** The LMUO wants to know what it gets for its royalty. Is it the standard 5% royalty, or is there a graduated royalty as profitability goes up? Does the operator get more than it would get with an established franchise company? Are the marketing dollars being used correctly? What is the marketing fee? Will the LMUO control its own marketing dollars? All of these questions need to be addressed by the operator.

5. **Development Rights.** The LMUO wants a clear understanding of the development rights. What is the approach the emerging franchise is taking regarding development? Is the franchise looking at selling the entire country in large blocks, or is it being more thoughtful and selling it with a reasonable development schedule? Is there right of first refusal to adjacent sites? The LMUO's role in the development process is key. While LMUOs often want the right to develop many stores, it is still crucial that development be thoughtful, conservative and cognizant of the markets and real estate.

Now let's look at the investment process from the franchisor's perspective. The franchisor, while it loves the idea of multi-unit operators, has to understand that if things go wrong, the LMUO has greater resources and can sink the franchise system. Further, the resources the franchisor has to provide the LMUO may be less than those needed by an owner-operator, but they certainly must meet a higher standard of sophistication. What type of help does the franchisor provide concerning: (a) point of sales; (b) IT help; (c) product development; (d) site approval and proto-types; and, (e) getting the concept recognized for potential financing? The franchisor needs to think about each of these items in order to be adequately staffed and provide the appropriate infrastructure to align well with a large, multi-unit operator. The franchisor might not have to be as hands-on, but the franchise has to be structured as a sophisticated company ready for growth.

A word of caution: Jonathan's article talks about the big operators moving ahead while still thinking small, and I would agree with that. I think franchisors should be careful when they think too big. Good systems evolve slowly and momentum comes with reasonable growth.

Dennis L. Monroe *is a shareholder and Chairman of the law firm of Monroe Moxness Berg PA. Reach him at (952) 885-5999.*