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Why Is There a Disconnect in Selling Prices?

By Dennis L. Monroe

2016 was an interesting year in restaurant finance. All the year's action—the growing impact of activist shareholders, changes at the SBA franchise registry, the overall beating in casual dining's performance and yet, new finance players in the restaurant space— leads me to see a disconnect in the pricing of recent restaurant sales transactions.

There appears anecdotal evidence of an increasing gap between what sellers are asking and what buyers are willing to pay. Perhaps it's because during the past few years, there are many examples of completed transactions at abnormally high valuations that still resonate in most sellers' minds.

My thinking on valuations relies on more than 30 years of experience, where I have been involved with enough transactions to provide some insight into what may happen durng the next two or three years.

Obviously a lot of pricing power is driven by the availability of financing and the eagerness of a buyer to make a deal. There's no shortage of money to finance a transaction here, particularly for the franchisee consolidator or the private equity buyer seeking a high-growth concept. Consumer buying patterns may lead to a different story in 2017.

As we all know, valuations in restaurants are expressed in terms of a multiple of EBITDA, which is earnings before interest, taxes, depreciation and amortization. However, over the last three to four years I've seen some transactions, particularly for high-growth concepts, trading on a multiple of revenue. I don't think this is a long-term phenomenon.

Let's look at three transaction sectors in terms of the selling prices:

1. Franchisee to franchisee—These are normally the highest-dollar volume of sales transactions in the restaurant industry. While this market has been robust for the last three years due to financing availability, we're seeing a softening of selling prices, particularly in the casual-dining sector and most notably in Applebee's. I've seen multiples drop by around two turns, from a high of 6x EBITDA. In a number of cases, sellers may be pulling sales transactions until things turn around in their segment, or in the industry in general.

In my opinion, even though Applebee's has been hurt the most by the malaise in casual dining, lower selling multiples apply to the entire sector of casual dining.

QSR has held up better with multiples in the 5x-plus range. A lot of this is driven by refranchising activities of some of the major franchisors, which in my view, always seem to inflate franchisee selling prices. Still, I think the proper price for a franchisee-to- franchisee QSR transaction should be no more than 5x, but I know there are transactions, especially in Taco Bell, that end up higher.

Fast-casual franchisee-to-franchisee sales are all over the board. The pricing of these transactions have more to do with the success of the franchisor, so I see multiples somewhere between 4x and 5.5x. Again, historically I think fast casual franchisees should settle in the 4x to 5x range.

2. Non-Franchised Chain Restaurants—This segment, consisting of four to 200 units, has become very popular because of the shortage of other deals and the availability of money. The issue here is growth potential, so the selling and investing prices can range all over the board.

Restaurant concepts that have been around for a number of years, with little growth potential yet good cash flows, typically command a multiple of around 4x to 5x EBITDA. Concepts that have growth potential and possibly a franchise opportunity may fetch a higher multiple closer to 6x perhaps, with the norm settling in around 4.5x to 5x.

A high-growth restaurant concept, with growth of 10-plus units per year and showing positive comparable sales gains year-over-year, will definitely command the upside of the multiple range. My thought is a high-growth chain should probably max out at 6.5x EBITDA.

3. Franchisor—Franchisor transactions are more problematic as prevailing multiples are all across the board. These transactions require different matrices and thought processes. The first thing to do is to separate the valuation of the corporate-owned stores, which are a pure cash-flow business very similar to a franchisee-to-franchisee sale, then what is left is the core franchising business.

Early stage franchisors create unique valuation difficulties. In many cases they are not profitable and begin franchising far too early, thus valuing them on a multiple of EBITDA is tricky. Sometimes rather than deal with valuation, an early stage franchisor may bring in private equity and use a preferred class of investment. This investment is not necessarily valuation-sensitive. The new investment is used to get the business to an earnings or revenue level to be able to look at a growth valuation.

There is always the dilemma for early stage franchisors of trying to capture the growth potential even though current earnings and revenue are not sufficient to justify a high valuation. As stated above, sometimes these franchisor valuations are based on pro forma analysis with a realistic level of franchise sales, and then a cash flow discount factor of 20% to 25% on the pro formas. In most cases, a good multiple for a growth franchisor is 7x or 8x.

The next group of franchisors consists of the more mature concepts that have shown sustainability and are the types of concepts that may be acquired by an institutional investor such as Roark Capital. The EBITDA multiple is strong because of the critical size. From what I have seen over the last six years, I think the correct multiple for a mature franchisor (300 units or more) is probably 7x EBITDA.

Finally there are franchisors who have mature concepts with fewer than 300 units, significant history of steady growth and good cash flow. These franchisors can be good targets for franchisees who are looking to diversify, or for buyers seeking reliable cash flow. I see this mature group having multiples in the 5x to 6x range.

It is important to understand what the buyers are looking for, and whether the target is growth-oriented or inclined to let cash flow dictate the appropriate multiple for the selling price.

Also the sector that the franchisor is involved with is important, particularly if it is consumer-favored like fast casual or the food-on-demand sector. Also, if the franchisor is a candidate for an IPO, that can also dictate higher multiples.

One final note: In determining valuation when sellers are getting ready to sell, they are often anxious to restate their profit-and-loss statements. In many cases what is known as restated cash flow or restated EBITDA is presented, which varies from the normal GAAP statements. There may be reasonable justifications for the restatement, but most selling prices should be based on historic GAAP numbers and not on restated numbers.

If a business is going to be sold, it is best the potential seller does a good job of cleaning up the P&L and balance sheet items prior to putting the property up for sale rather than going through this restatement process, which is always somewhat suspect.

I think we will see a stabilization of values in 2017 and possibly a decrease in some sectors that may be a result of higher interest rates. In my view, valuations during the last couple of years have been an example of market over exuberance.

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