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Ideas for Financing an Emerging Franchise Concept

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I am more convinced than ever that restaurant concepts have to look at new and creative ways to spur growth. This is particularly true for franchise concepts. It seems like every franchisor I know is looking to access large multi-unit operators to drive growth. Unfortunately, to attract these kinds of operators, they must seed growth by allowing franchisees to purchase existing stores. Growth concepts often don't have corporate stores to sell, since they generally need their corporate stores as a source of cash flow to provide the infrastructure to keep growing.

Those challenges notwithstanding, there are techniques that can be used to help systems grow by attracting both franchisees and outside investors. One method that is tried and true is when the promising company "seeds a market" with stores. Once those stores have matured or at least gotten to a point that you can see they'll be successful, a company can look at franchising the stores and selling the development rights for the corresponding areas.

Market "seeding" sounds great but what are the techniques to accomplish this?

Let's use the example of an emerging fast casual Asian concept that locates primarily in strip centers and wants to franchise. The footprint needs about 3,000 square feet or less, has unit volume of $1 million to $1.5 million dollars and has strong unit economics.

The franchisor picks a number of development areas they believe will be receptive to the concept. In most cases, if the concept is a typical fast casual concept, it's probably good to be in a major metropolitan area that has NFL or NBA-type teams and has consumers that seem to be open to emerging concepts. (One area I really like is Indianapolis, which seems to be a good location to try new concepts.)

The key issue many fledgling franchisors have is funding new development. Most emerging brands, whether they franchise or just want to have corporate-owned stores, don't have the kind of resources to extensively develop new stores. But, with good unit economics and strong unit cash flow, it's possible to raise both debt and/or equity to develop a given area.

The structure I generally recommend to fund new unit development is with a private placement. Private placements entail finding investors who are both interested in cash flow and knowledgable about your restaurant. These investors are, in almost all cases, accredited investors, and with the liberalization of some of the securities laws, can readily be found to invest in these types of deals.

Ultimately, the first approach is to sell existing company stores in conjunction with development rights to a potential franchisee, or use the private placement to entice investors to build new stores. The beauty of using a private placement that focuses on cash flow is that there is a definable exit strategy for the investors. If the stores have gotten to a certain point of maturity, they should have a much higher value than the initial investment and can be rolled up into the concept company or sold to another franchisee.

Now let's look at how to find investors and how to put this whole project together. The first thing to do is develop a pro forma business plan and have the necessary securities documents drafted. The people who are most likely to invest are going to be those who are familiar with the concept or the company. These may be friends and family or those originally invested in the concept. The optimum size for most developments I've seen is a three-to-five-store development area. More than that takes too long to grow and exit.

Another approach I like, particularly in a franchise system, are joint ventures. You can take existing franchisees that may have some strong existing stores, but don't have enough funding for additional growth. These franchisees , and we've done this with a number of concepts, are worth investing in for future growth.

What we've done in the past is to create a new entity funded by investors and, in part, by the franchisor and franchisee. There are certain accounting rules regarding consolidation that need to be considered, however, this is the kind of investment that certain investors like to be involved in. It provides a wonderful potential exit strategy, because the franchisee, once the stores have matured, can probably find financing by then and take out the investors and franchisor. If, for some reason, the franchisee doesn't want to acquire the stores completely, the franchisor could absorb them and make them corporate stores.

A third approach involves putting together a new unit development financing program back-stopped by the franchisor with a limited guaranty and remarketing agreement, or credit enhancement, thereby making funds available to franchisees. This is something that was done quite frequently in the past and has recently been revisited. The lender, with assistance from the franchisor, administers the loans. Sometimes this type of program involves a slice of mezzanine financing (high yield debt). The key here is that this type of funding for franchisees often has terms better than they could obtain on their own.

With plenty of money available today, these three approaches can be helpful for growth. They are thoroughly tested and seem to work. As rates go up and the economy cools down, these approaches may again help to jump-start and continue growth for the systems that may have temporarily stalled.

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