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When Your Ownership Structure Doesn't Meet Your Growth Needs

By **Dennis Monroe**

One of the common problems I've seen over the years is the overly complex legal structures of many restaurant companies. When I wrote an article a number of years ago called "Beg, Borrow or Steal," I made the point that to get your first one, two or three restaurants open, you need to be creative. This creativity in many cases results in unique and problematic structures. And, the result is the ownership is either overly complex or so diverse that you cannot really tap the inherent equity in the existing restaurants. This issue also arises not just in the case of diverse ownership, but also when a company needs to make a capital call for additional funding and one of the owners does not want to contribute. All this creates ownership issues that need to be resolved.

Let me give you an example: A few years ago, I counseled a company that was going to be sold to a public company and had approximately 20 restaurants. Each restaurant and each piece of real estate associated with it was under a different ownership; each asset group was held in separate partnerships, so we had approximately 40 partnerships (or LLCs). This is an extreme example, but it does represent all the issues associated with diverse ownership that have to be dealt with for this type of restaurant company to grow.

The other problem we see in growing restaurant companies is their mix of different types of entities. In today's legal environment, the most common structure is LLC, but many restaurant companies have a number of S Corporations, and the two don't always mix. So what we're normally trying to accomplish is a structure that combines the entities to tap the overall equity in the underlying assets.

Let's look at the solutions. The businesses with diverse ownership and various operating entities need to look at the valuation of each entity. Sometimes we'll use an expert and other times we'll just use what we believe is a market formula valuation for each entity, such as a multiple of EBITDA. If specific entities just own real estate, our valuation approach is easier. We determine what is a reasonable market CAP rate and then determine the value of the rental stream, which is normally a reasonable percentage of sales. In all cases, even if we need to use an expert, it is still a matter of negotiations among the various owner constituencies.

Let's continue with a specific example of a company with five stores and three pieces of real estate. Each of the stores has a different ownership structure. If it's a fast casual concept, we'd probably use some kind of agreed-to multiple, like 5x EBITDA for each store, and then we'd subtract out the debt and add any current assets to come up with a valuation per store. Then we would aggregate those values together and, we hope, get everyone to agree to convert and transfer their interest into a holding company. The holding company would be the owner of single-member subsidiaries. This holding company structure should allow the company to efficiently utilize its equity to borrow money or 0secure additional investors.

In addition to the holding company, sometimes we'll create an entity to hold the intellectual property. The intellectual property entity would grant a license to the individual operating entities, so that even if the operating entity is sold or a lender takes an interest in the operating entity, the intellectual property is protected in the case of lawsuits or other adverse developments concerning the holding company or its subsidiaries. Additionally, sometimes we create a management company that charges a management fee to each subsidiary operating entity. This creates uniformity in valuing the subsidiaries, because we have uniform management fees based normally on percentage of sales.

Now let's look at entities with different tax attributes. First, consider a couple of principles. LLCs cannot own S Corporations, while S Corporations can own LLCs. In the case of a combination of LLCs and S Corporations, we will create a new LLC holding company which then, for tax purposes, is treated as a qualified S holding company, even though we utilized the LLC structure. This allows the LLC holding company to own both LLC and S Corporation subsidiaries and not in any way violate the S elections which can be problematic. Another benefit to creating this holding company is its subsidiaries can be sold off individually, which may create some tax advantages for the buyer.

As to the real estate, if individual pieces are held in separate entities, we may create the same structure we propose for operating companies, putting all real estate entities under one real estate holding company. This way the real estate can have a common ownership structure. Again, we have to look at valuation to perform this effective roll-up. To do so, we need to examine all the leases in terms of a percentage of sales of the operating agreement—normally in the range of 6%-8% for fast casual, or a higher multiple (maybe 8 to 9x sales) in QSR. Once the normalized lease rate is determined, the prevailing CAP rates will be applied. If it's a highly rated national franchise, you may use a 6% CAP. If it's a local concept that's being rolled up, you may use a 9% CAP. It all depends on the market. Again, this is a structure that's used for overall financing and to take advantage of the equity in your real estate.

The key is to look at the overall structure and determine what's most tax-efficient and how to consolidate entities to optimize the use of the inherent equity in the assets. This equity then is used for either refinance or injection of additional growth capital.

The beauty of restaurant companies is they are cash flow entities and they lend themselves to application of market valuations. But creating the right legal structure for continued growth does take someone with a skillset in this area and substantial knowledge of what's current in the market for valuations and tax structuring.

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