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When is the Right Time to Sell Your Franchise Company?

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Last month I discussed the opportune time to sell a multi-unit, non-franchised restaurant company. I'd like to continue that discussion and look at the sale of a franchise company.

Behind every great franchise business is a strong and viable concept with a number of successful units. When a company decides to franchise, it takes on an entirely new business model. While in most cases it will continue to run corporate stores, franchising is a new business.

A key element to getting a strong valuation for a franchise company is knowing when the concept is ready to franchise. There's never a magic number of units that must be opened prior to franchising. Certainly one, two or three locations is not enough. A better number would probably be at least 10 locations. Let's look at some of the relevant criteria.

1. It's not just about numbers. You'll want to know if the concept has been proven out in different markets, possibly with different types of delivery systems, such as fast casual, casual, or quick-serve. In other words, has the concept been honed down in terms of expandability?

2. Do the unit economics work and do they support a franchise model? That means a royalty fee of somewhere between 4% to 6% plus an add-on advertising fee, and the appropriate return on investment for the franchisee.

3. Have you decided and proved out what kind of operator/owner you need for the units? Is it a concept that can be run by an above-store manager, or is it something that requires more specialized skills? Does the owner need to stay actively involved? These are all key questions in determining the appropriate franchisee.

Along with strong overall unit economics and the right franchisees who truly fit the concept, the next step to obtaining a good valuation is development of an infrastructure that provides strong support to the franchisees, in the start-up stage, and in the long-term evolution of the concept.

Finally, it's important to have a smart development plan. Don't oversell development. It's better to sell someone one unit and the next time sell them another unit, or sell them one unit with the right to develop one more. Don't start thinking that you're going to receive a higher valuation when you sell someone a 10-unit package, even though they haven't opened their first unit yet.

With these principles in mind, let's look at the inflection points for optimizing value.

The first point may be at 15 to 20 franchise units opened with a good base of corporate units. At this stage, you may find a private equity buyer interested in a potentially high-growth situation. You might also receive interest from a strategic buyer looking to add to their franchise system. With the right buyer, you receive possibly 8x the royalty stream after direct costs related to that royalty stream, and possibly 5x to 6x the EBITDA for the corporate units.

The next inflection point comes when you have 40 to 100 units. Now you are truly a sustainable franchise company, and the range of potential buyers is pretty broad. They can be private equity, a strategic buyer or they can even be a large multi-unit operator looking to own a concept rather than just being a franchisee. The multiples you could expect are probably closer to what the public multiples are, but in all cases, if the system is strong, you're going to receive a premium.

Let's now look at what some of the experts say about obtaining a good value for a franchise company.

First, I interviewed Jeb Ball, industry veteran and managing director at Guideboat Advisors. Ball emphasized the importance of ensuring the unit economics work with the added burden of being a franchisee—that is royalty and advertising fees. His second point was that franchisors start losing their value when they oversell development. He added that it's not easy to value unopened units. He also believes that franchisors with a reasonable amount of corporate units are going to get a higher value. In his experience, companies that have sold for a significant multiple are ones with a hot concept, very few issues with closed units or franchisee problems, and strong prospects for franchise sales.

I also talked to Lynette McKee, a longtime player in the franchise world. She is CEO and managing partner of McKeeCo Services. She believes that, in terms of size, the key inflection point is 40 to 50 units. The company may not yet be as strong as the owner would like and may need more infrastructure, but it is the time that concept units are proved out and will provide robust valuation for attracting new money.

She observed that there are even a number of buyers looking at taking on franchisors with a checkered past and turning them around as long as the long-term strategy and quality of the units are good. According to Lynette, the companies that will get the highest value are the ones that have a strong infrastructure and have shown the ability to ramp up. In that case, you are going to get a true high-growth company multiple—maybe in the 9x to 10x times EBITDA range.

The three points to keep in mind when contemplating a sale of a franchise company are: (1) make sure you have grown your concept through corporate or joint ventures prior to franchising so that you know the system works; (2) make sure your early franchisees are strong, and if there are any problems, deal with them quickly; and, (3) fund and build the franchisor infrastructure to support the franchisees and their growth.

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