Advanced Issues in Mergers and Acquisitions in Franchise Systems
SPEAKERS

• Stuart Hershman, DLA Piper LLP (US) (Moderator)
• Jeffrey A. Brimer, Faegre Baker Daniels LLP
• David W. Oppenheim, Greenberg Traurig, LLP
• Scott Pressly, BIP Capital
• Leonard Vines, Greensfelder, Hemker & Gale, P.C.
• Les Wharton, Coverall North America, Inc.

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Overview of Program

• Introduction
• Practical Considerations in Buying/Selling Franchise Companies and Valuation
• Franchise-Specific Regulatory and Legal Issues
• Negotiating Key Provisions in Contracts
• Roundtables – 2 Rotations
• Break
• Due Diligence Issues
• Real Estate, Intellectual Property, Tax and International Issues
• Franchise Relationship Issues
• Roundtables – 2 Rotations
• Closing

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Practical Considerations in Buying/Selling Franchise Companies and Valuation

Scott Pressly

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• Why do investors like franchise companies?
  – Buying long-term and diversified revenue stream
  – Can generate meaningful free cash flow
  – Large and growing industry
  – Distribution for developing a brand
  – Low capital requirements to grow
What do investors look for in franchisor deals?

- Attractive unit-level economics
- Growing same store sales
- Proven business model in multiple markets
- Franchisee satisfaction
- Quality of senior management
- Sound infrastructure
• What red flags do investors look for?
  – High franchisee turnover / poor franchisee satisfaction
  – Weak unit-level economics / declining same-store sales
  – Macro economic and political environment
  – Lack of financial / accounting controls
  – Poorly structured franchise agreements / incomplete files / significant variety among agreements
• Why do franchisors raise capital?
  – Accelerate company growth
  – Gain a partner to increase the likelihood of success
  – Partial liquidity for early shareholders
  – Exit: full shareholder liquidity
Potential Sources of Capital

**Venture Capital**
- Smaller deal sizes
- Bank debt rarely used
- Emerging companies
- Negative or break even cash flow
- Minority positions
- Valuation more an art than science
- Run by entrepreneurs

**Private Equity**
- Larger deal sizes
- Bank debt almost always used
- Established companies
- Profitability is crucial
- Majority positions
- Valuation metrics (multiple of EBITDA)
- Run by experienced operators

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Valuation Drivers

- EBITDA (and growth of EBITDA)
- Unit economics
- Growth of number of units
- Growth in same-store sales
- Quality of management
- Market trends
- Brand awareness
- Financing markets / available leverage
Valuations by Deal Size

- Valuations are at all time highs
- Growth potential will drive higher valuations
- Macro trends matter:
  - Are people eating out, can new locations be financed
- 9x median EBITDA multiple over last two years (restaurant chains under $500 million in deal size)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Size of Franchisor</th>
<th>Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early</td>
<td>Cash flow negative</td>
<td>Varies. More art than science.</td>
</tr>
<tr>
<td>Growth</td>
<td>Cash flow positive; less than $10 million in EBITDA</td>
<td>7x – 10x EBITDA</td>
</tr>
<tr>
<td>Mature</td>
<td>Great than $10 million in EBITDA</td>
<td>8x – 12x EBITDA</td>
</tr>
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### Key Recent Acquisitions

<table>
<thead>
<tr>
<th>Company</th>
<th>EBITDA Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benihana</td>
<td>9.1x</td>
</tr>
<tr>
<td>Burger King</td>
<td>9.0x</td>
</tr>
<tr>
<td>Captain D's</td>
<td>5.8x</td>
</tr>
<tr>
<td>Caribou Coffee</td>
<td>11.0x</td>
</tr>
<tr>
<td>CEC Entertainment (Chuck E. Cheese's)</td>
<td>7.4x</td>
</tr>
<tr>
<td>Fogo de Chão Churrascaria</td>
<td>8.0x</td>
</tr>
<tr>
<td>J. Alexander Corp</td>
<td>9.0x</td>
</tr>
<tr>
<td>Krispy Kreme</td>
<td>11.0x</td>
</tr>
<tr>
<td>Mastro's</td>
<td>10.0x</td>
</tr>
<tr>
<td>McCormick &amp; Schmick's Seafood Restaurants</td>
<td>7.9x</td>
</tr>
<tr>
<td>O'Charley's</td>
<td>5.9x</td>
</tr>
<tr>
<td>P.F. Chang's China Bistro</td>
<td>8.5x</td>
</tr>
<tr>
<td>Papa Murphy's</td>
<td>10.0x</td>
</tr>
<tr>
<td>Red Lobster</td>
<td>9.2x</td>
</tr>
<tr>
<td>Rita’s Water Ice Franchise Company</td>
<td>7.0x</td>
</tr>
<tr>
<td>Taco Mac</td>
<td>10.0x</td>
</tr>
<tr>
<td>Tim Horton's</td>
<td>16.0x</td>
</tr>
<tr>
<td>Yard House USA</td>
<td>12.5x</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>9.3x</strong></td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td><strong>9.1x</strong></td>
</tr>
</tbody>
</table>
Roundtable Discussion

• Hypothetical example of the acquisition of Moonshine Franchise Inc.
  – Purchase price analysis / sources and uses of cash
  – Summary P&L and Balance Sheet analysis
  – IRR and “multiple of investment” calculations
  – Pre and post cap table analysis
  – The proverbial “2nd bite of the apple”
  – Calculation and discussion of “carried interest” or “promote”
  – Sensitivity of returns based on purchase price multiple and leverage

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Unique Regulatory and Legal Considerations

David W. Oppenheimer

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Unique Regulatory and Legal Considerations
Overview of Topics to Be Addressed

• Disclosure considerations
• Franchise-specific regulatory issues
• Franchise relationship considerations
• Possible causes of action based on sale of the system
Disclosure Considerations

• Prospective franchisees in the pipeline
  – Conflict between “material facts” and “confidential” sales process
  – How do we define “materiality”?
  – Is the standard different for public and private company transactions?
Timing of Disclosure to Prospective Franchisees

- Board determines to explore strategic alternatives
- Term Sheet
- Letter of Intent
- Definitive Purchase Agreement
Franchise Sales After Signing of Definitive Agreement

- Sales may continue so long as proper disclosure is made
- What is proper disclosure – pre-closing?
- **Best Practice** – Disclose the transaction in Item 1 of the FDD (or in a supplement, if law permits)
- What about the sale to a competitor?
Sample Item 1
Pre-Closing Disclosure

- On [DATE], [FRANCHISOR] entered into an Agreement and Plan of Merger with [PURCHASER], an affiliate of [PARENT], a private equity firm located at [ADDRESS]. As a result of the merger, FRANCHISOR will become a wholly-owned subsidiary of PURCHASER. The merger is subject to customary closing conditions and the parties expect the transaction to close within 30 – 45 days. [PARENT] through its affiliates owns other franchise companies, including [LIST OF COMPANIES].
Methods of Disclosure

• Ideally disclosure is made in the FDD
• Is disclosure outside of the FDD permitted?
  – FTC States
  – Franchise Registration States
Resumption of the Franchise Sales Process

• FTC States v. Registration States
  – What if the franchisor is exempt?
• What about prospects in the pipeline?
  – Must the franchisor re-disclose and observe the required 14 day waiting period?
  – What if the transaction qualifies for an exemption?
• Transfers, renewals and sales to existing franchisees
Post-Closing Regulatory Issues

• The Post-Closing FDD
  – Item 1 – Identity of the franchisor and its parents and affiliates
  – Item 2 – Franchisor control people
  – Item 3 and 4 – Litigation and Bankruptcy Disclosures
  – Item 12 – Competition within a Franchisee’s Territory
  – Items 13 and 14 – Ownership and licensing of intellectual property
  – Item 21 – Financial condition of the company
Post-Closing Regulatory Issues

• Registration requirements (franchise and business opportunity filings)
  – Asset Purchase Agreement v. Stock Purchase Agreement

• Beware of financing and its impact on the financial condition of the company
Roundtable Discussion

- Pre-signing disclosure issues
- Post-signing disclosure issues
- Regulatory compliance throughout the sales process (pre- and post-closing)
- Impact of the sale process on the development pipeline
- The post-closing disclosure document and unique disclosure issues
Key Provisions of Operative Agreements (and Remedies for Breach)

Les Wharton
Key Provisions of Operative Agreements (and Remedies for Breach)

1. Non-Disclosure/Confidentiality Agreements (NDA)
2. Letters of Intent (LOI)
3. Asset Purchase Agreements (APA)
4. Stock Purchase Agreements and Merger Agreements
5. Escrow Agreements
6. Transitional Services Agreements (TSA)
NDAs

• Definition of “Confidential Information”
• What happens if the deal blows up—return and use of confidential information
  – Two competitive systems
  – Private equity or non-competitive system acquirer
LOIs - Binding vs Non-binding

• Binding
  – Confidentiality
  – Non-solicitation/non-compete
  – Exclusive dealings

• Non-Binding
  – Purchase price
  – Indemnity
LOIs - Access to Information

• When
• How
• How much
LOIs - Announcement

• When

• To Whom
  – Employees
  – Franchisees
  – Vendors
  – Customers

• How

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Asset Purchase Agreement

• Representations and warranties
  – Knowledge
  – Material adverse change
  – Franchise law compliance
  – Franchisees
  – Disputes/litigation
  – FACs/associations

• Price adjustments
  – No default in franchise agreements
  – Franchisees in compliance
  – Franchisees vs employees
  – Financial information correct
  – Franchise brokers
  – Intellectual property
Asset Purchase Agreement (cont.)

- Pre-closing covenants
  - Access
  - Operation of system
  - Exclusivity
- Conditions to Closing
  - No litigation to enjoin the transaction
- Termination
- Indemnity
- Remedy mechanism
Stock Purchase Agreement and Merger Agreement—Differences from APA

- Liabilities
- Consents
- Tax Issues
- Broader Reps
Other Agreements

- Escrow
- TSA
Roundtable Discussions

- Non-disclosure/confidentiality agreements
- Letters of intent
- Asset purchase agreements
- Stock purchase agreements and merger agreements
- Escrow agreements
- Transitional services agreements
First Set of 3 Roundtables

• Practical Problems in Buying/Selling Franchise Companies and Valuation – Scott Pressly

• Franchise Specific Regulatory and Legal Issues – David Oppenheim and Len Vines

• Negotiating Key Provisions in Contracts – Les Wharton and Jeff Brimer

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Advanced Issues in Mergers and Acquisitions in Franchise Systems

BREAK
DUE DILIGENCE

Leonard Vines and Jeffrey Brimer
Purpose and Timing

• Will royalty stream continue?
• Evaluate underlying value of business, liabilities, and potential “defects”
• Timing: Depends on circumstances (i.e., multiple suitors, etc.)
Franchise-Specific Due Diligence

• Due diligence checklist
• FDDs (but many important factors not in FDD)
• State registrations
• Franchise agreements
• Area development agreements
• Pipeline sales
Franchise-Specific Due Diligence (cont.)

- Correspondence with franchisees, suppliers
- Operations manual
- Marketing and advertising materials
- Marketing fund
- Website
Key Items of FDD

- Item 1 – Corporate structure
- Item 2 – Key management
- Item 3 – Litigation
- Item 4 – Bankruptcy
Key Items of FDD (cont.)

- Item 5 – Negotiation of initial fee
- Item 8 – Rebates and anti-trust issues
- Item 10 – Financing
- Item 11 – Computer systems and technology
Key Items of FDD (cont.)

• Items 13 and 14 – Trademarks, patents and copyrights
• Item 19 – FPRs (substance and legal compliance)
• Item 20 – Franchise system data
• Item 21 – Audited financial statements
Key Terms of Franchise Agreement

- Ability to modify the system and operations manual and require updates
- Territorial protection – potential conflicts
- Rights reserved to franchisor – right to operate competing brands and alternative methods of distribution
Key Terms of Franchise Agreement (cont.)

- Termination rights of franchisor and franchisee
- Franchisor’s buy-out right
- Transfer rights
- Covenants not to compete
- Proper signatories and guarantors
Legal Red Flags

• Disclosure/registration non-compliance
• Poorly drafted agreements
• State enforcement actions
• Franchisee defaults and delinquencies
Legal Red Flags (cont.)

• Franchisee discontent – newly formed association; lawsuits; threat of litigation; non-compliance
• Disorganization/poor recordkeeping/lost files
• Wide discrepancy in franchisee success and reasons for same
Contacting Franchisees

- When?
- Who? How many?
- How?
- What?
- Advisory councils and franchisee associations
Special Issues

- Dependency on material suppliers
- Rebates
- Anti-trust
- Intellectual property
- Data protection/privacy
Special Issues (cont.)

- Industry specific laws
- Gift cards
- State taxation
- Vicarious liability/joint employer issues
Other Sources of Information

• On-site visits
• Inside and outside counsel
• Field reps
• Internet (i.e., Lexis/Nexis, Google, bluemaumau.org, unhappyfranchisee.com, class action sites)
Roundtable Discussions

• Key documents
• How much is enough?
• Timing for access
• Gauging franchisee (dis)satisfaction
• What can come back to haunt you?
• War stories
Real Estate Issues

Jeffrey Brimer and Leonard Vines
Real Estate Due Diligence

- Determining scope of review based on type of transactions
  - Entity acquisition
  - Asset purchase
Real Estate Due Diligence (cont.)

• Documents to review
  – Seller’s office lease/ownership documents
  – Franchisee leases and subleases
  – Company-owned unit leases
  – Unit ownership documents
  – Collateral assignments

• Due diligence “reports” and summaries
Warranties, Representations and Closing

• Scope of warranties and representations
• Conditions to closing
Intellectual Property

Jeffrey Brimer and Leonard Vines

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Types of Intellectual Property

- Trademarks and service marks
- Trade names
- Patents
- Copyrights
- Domain names
Importance of Intellectual Property to Franchising

• Significant portion of valuation
• Future “brand” value
• International expansion opportunities
Pre-Closing Issues

• Valuation
• Due Diligence – assessment of domestic and international IP rights
• Warranties and representations in agreement
Post-Closing Issues

• Assignments and transfers of IP registrations
Tax Issues

Jeffrey Brimer
Types of Transactions

• Taxable Transactions
  – Asset Sales
  – Sales of Equity Interests

• Tax-Deferred Transactions
International Issues

Jeffrey Brimer

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Unique Aspects of International Transactions

• Compliance with foreign franchise registration and disclosure laws
• Due Diligence
International Tax Issues

• Transaction Structure
• Permanent Establishment/Tax Nexus
• Employee Tax Issues
• Withholding Taxes
• Reporting foreign bank accounts
• Using flow-through structures

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Non-Franchise US Laws Affecting Mergers and Acquisitions

- USA PATRIOT Act and SDN Lists
- Foreign Corrupt Practices Act
- Export Controls
Foreign Laws Affecting Mergers and Acquisitions

• Intellectual Property
• Data Privacy
• Attorney-Client Privilege
• Competition Laws

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Working with Foreign Counsel

• Selecting the Right Foreign Counsel
• Tips on working with Foreign Counsel
Roundtable Discussions

• How do you conduct due diligence?
  – Trademarks
  – Master franchisee and subfranchisee relations
  – Use of local counsel

• How do foreign competition and tax laws affect a transaction?

• What post-closing obligations affect the transaction?
Franchisee Relationship Issues

David Oppenheim
Disclosure to Existing Franchisees
(Post Signing)

• Critically important to include franchisees ASAP
• What do franchisees want to know?
  – Management changes
  – Operating experience of purchaser
  – Future plans for the brand
  – Competition amongst newly affiliated brands
• Conference calls and regional “town hall meetings”
  are the preferred method of communication
Possible Legal Claims

• Fraud for failure to disclose the transaction or other relevant information
• Breach of the implied covenant of good faith and fair dealing
• Breach of Contract
  – Improper assignment
  – Encroachment
Possible Legal Claims (cont.)

- Sale to unqualified franchisor
- Tortious interference with contract or prospective business relations
Possible Legal Claims (cont.)

- When competitors merge
  - Claims related to intra-chain competition
  - Claims related to brand conversion
Roundtable Discussions

• Impact of sale on existing franchisees
• How to ensure a seamless transition for franchisees
• Claims advanced by franchisees
Second Set of 3 Roundtables

- Due Diligence Issues – Len Vines and Scott Pressly
- International Issues – Jeff Brimer
- Franchisee Relationship Issues – David Oppenheim and Les Wharton
Closing Comments and Adjournment