Acquiring a Franchise System: Due Diligence Tactics to Assess Value

Appropriate steps a buyer should take in assessing the value of a potential target.

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ACQUIRING A FRANCHISE SYSTEM presents both special opportunities and unique challenges. As several seasoned private-equity companies have shown, a successful franchise system can be highly profitable and generate large amounts of cash without requiring significant capital investment. The key assets which drive the value of a franchise company, however, are all intangible: franchise agreements, trademarks and other intellectual property, the franchisor's management team and the franchisees. The challenge for a buyer is to assess the quality and long-range potential of those intangible assets.

This article highlights areas of concern in acquiring a franchise system and appropriate steps a buyer should take in assessing the value of a potential target.

The State of Intellectual Property

The intellectual property of a franchise system - its marks, logos, proprietary software, copyrights and trade secrets - form the foundation of the franchise system. Assessing the vulnerability of those assets is a key aspect of a comprehensive due diligence plan. The marks which identify a franchise system are critical. The buyer must closely examine whether the marks are strong and distinctive so that they can be legally enforced. Has the seller effectively protected and policed its trademarks both domestically and in future foreign markets? Are there questions regarding the seller's ownership of its trademarks or other issues relating to their legal validity? To what extent does the seller maintain other valuable IP that can increase the long-term value of the franchise system? Proprietary software and other system-specific IP can distinguish a system from its competitors so long as the seller preserves clear ownership of and has appropriately protected this IP.

Assessing the Strength of the Franchise Agreements

The value of a franchise system depends largely on the quality of the franchise agreements that document the relationship and the royalty stream. Measuring the worth of that royalty stream will require, among other considerations, the buyer's legal team to conduct a thorough review of the target's franchise agreements. The review should summarize key areas, including royalty, marketing, technology and other fees and territorial rights. Franchise agreements should strike a balance between providing well-defined current terms and flexibility to respond to future marketplace changes. Can the franchisor modernize the system, add new product lines, change suppliers, create value programs and add services? What constraints exist that may hamper growth, such as overbroad territory grants or the failure to reserve rights for the franchisor as to types of locations (e.g., captive markets like airports, hospital or military bases) or alternative channels of distribution (e.g., national accounts, Internet or packaged product sales)? Franchisors often are inclined to forego such rights in the infancy of a franchise system due to a lack of foresight.

The franchise agreements should require compliance with an operations manual through which the franchisor can

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change standards. Has the franchisor updated its operations manual, transmitted the changes effectively and avoided vicarious liability landmines?

Has the franchisor stuck to a standardized contract or made changes to gain sales, such as concessions, "one-off "deals and side offerings? A franchisor who has gone through difficult times may have offered compromises to keep franchisees in the system. Special concerns are provisions that present risks to the royalty stream or that permit franchisees to easily terminate the franchise agreement. The buyer will need to catalog these negotiated deals and consider the implications of administering a non-uniform system.

Do the written franchise agreements reflect the actual relationship between the parties or are they unreliable and outdated documents that can mislead a buyer as to its rights as a franchisor? A savvy buyer will identify real and apparent expectations that have been created by past actions or communications with franchisees. Have sellers' practices led to lower franchise standards? For example, if the franchise agreement requires minimum sales requirements, has the franchisor actually terminated outlets at this threshold or only at much lower levels, creating changed expectations?

Compliance With Franchise Sales Laws

Franchisors are subject to franchise and business opportunity laws. Failure to comply can lead to costly regulatory actions, franchisee legal claims and rescission of the franchise. The buyer must examine the franchisor's federal disclosure document, advertising materials and sales practices for compliance with disclosure and registration requirements. Disputes involving the seller deserve particular attention, but the buyer also should evaluate regulatory and litigation trends in the industry. For example, if the Federal Trade Commission has investigated a questionable practice in the target's industry, states may pursue "copy-cat" investigations and plaintiffs may initiate class actions, often at great expense to the franchisor.

Financial performance representations merit detailed scrutiny. The franchisor should have complied strictly with the FTC's standards, and the salesforce should have kept their financial representations within these limits.

The franchisor should have records for each franchisee of the franchise disclosure document provided documents, delivery receipts, amendments, inspections, communications, notices of default and termination letters.

Review Franchisee Relationships

The buyer must determine whether the franchisor and its franchisees have complied with their contractual obligations and applicable law. Have franchisees paid their fees and complied with system standards and other obligations? Has the franchisor met its obligations under its franchise agreements, and complied with state relationship laws regarding transfers, terminations and non-renewals, the allowance of free association among franchisees and no discriminatory treatment of franchisees? Has the franchisor properly administered its advertising fund programs and complied with laws regarding suppliers and kickbacks?

To discover hidden issues, the buyer should interview franchisees to assess their performance and satisfaction and understand the franchise advisory council's role. If a significant number of franchisees have left the system, the buyer should discern the reasons for departures.

Other Due Diligence Issues

What special regulations affect the system? For example, restaurants have seen increased costs associated with new menu laws, and senior care companies have been affected by changing minimum wage and overtime requirements. The Affordable Care Act will affect numerous franchise systems.

Are there supply chain issues? As an illustration, Bloomberg News reported recently that the Chipotle chain has faced difficulty maintaining its supply of antibiotic-free meat, which is becoming scarce and expensive. The buyer must assure there are contractual arrangements that shield the system from supply interruption and price increases.

Negotiating Process and the Purchase Agreement

The representations and warranties in the purchase agreement and the disclosures made by the seller in response to them are another major source of information about the target. The representations should address and confirm the areas of due diligence discussed above. Indemnification for breach of the representations can provide protection for the buyer. In addition, the purchase agreement can specify other requirements, such as conditions requiring that key employees will continue with the business and that relationships with major suppliers will not be disrupted.

Potential for System Growth

The ability to expand or develop new revenue generators within an acquired franchise system is central for any buyer. Is there room for geographic expansion, both in the United States and internationally? Can the franchisor modify or expand the system to increase revenue, such as adding complementary products or services? Has the franchise system been tested outside the United States? The buyer should consider these and other factors which could contribute to or impede growth. ■

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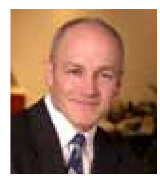

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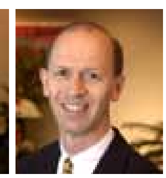

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