

# The Changing Landscape

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In the post World War II business environment, franchising has served as a vehicle with which small businesses have grown successfully into national chains. It has also provided individuals with the opportunity to achieve their "Great American Dream" of business ownership. Franchising will continue to be a successful strategy for those small businesses and individuals looking for prosperity and growth in the future. But, there is a shift in the traditional economic paradigm which will add to, and change, the franchise landscape.

## The Signs of Change

Most vertically integrated retailers have historically chosen to remain company owned chains and have avoided the use of franchising as a distribution method. Many of these companies are now facing severe capital constraints which are making it difficult, if not impossible, for them to exploit shifting market trends and expand. The interest of such companies in franchising as an alternative capital resource has grown to the point that the nation's leading retail association asked us to prepare a forum on franchising issues and opportunities for their members. We conducted this forum on a regional level and it will be available to the 14,000 members attending their upcoming national convention.

Increasingly, we are seeing the reorganization strategy of "retrofranchising", a financial and management strategy, utilized to transform traditional company owned retailers and service providers into franchisors. Recently a client acquired a troubled non-franchised service/retailer, created a new management structure and, utilizing the retrofranchising strategy, and successfully emerged from financial difficulty by converting the distribution system to franchising. The program was successful because they looked at the underlying assets of the company, the viability of the established locations, the value of the company's trademark, the opportunity for costs savings by the transference of obligations and management responsibilities to franchisee management and saw a potential return on investment which met their target rates. They also recognized that franchise distribution is markedly different from other methods and obtained the expertise required to achieve a successful metamorphosis. This strategy was so successful, taking only twenty months to return their original investment that they are presently looking for new opportunities to add to their portfolio. Other traditional retailers are reviewing their franchise options and one has already begun to convert substantial portions of their company owned domestic system to franchise ownership. Once established, the separate franchise company may become an IPO candidate.

Established retailers are viewing franchising as an acceptable strategy for overseas penetration, even if they do not utilize it domestically. Satisfied with their domestic opportunities, they have not looked at international expansion because they did not wish to risk either their capital or dedicate significant management resources on developing those markets. Additionally, some that have begun to penetrate certain overseas opportunities with a company owned strategy have decided not to pursue general company owned international expansion but rely instead on selective international franchising. International investors, purchasing master franchise rights enable these companies to continue their traditional strategy while taking advantage of overseas opportunities they would not otherwise have pursued.

Manufacturers, traditionally retailing through department and specialty stores, are experiencing a downturn in traffic as the "If you build it, they will come" retail strategy has come to a halt. The closing and consolidation of classic retailers and the shifting shopping patterns, due to the demographic and psychographic shifts in the 90's, have made such traditional methods of product distribution unreliable. Franchising offers these companies the ability to better control their distribution chain by opening their own retail system, with the opportunity to utilize the "in store" strategy which has been successful at times in the past.

### The Financial Investor

The success record and stability of franchising is increasingly appreciated by institutional and other sophisticated investors. Franchising has become an acceptable alternative investment strategy for investors because it meets or exceeds their target returns. With an understanding of the franchise dynamics they now appreciate how it can meet their performance requirements. Investors are taking positions as equity owners of franchise systems and multi-unit franchises to enhance and complement their portfolios.

Several of our investor clients have recently purchased established franchisors. In addition to the infusion of new capital, they have augmented the acquired company's franchise management talent and have introduced new retailing concepts. With limited additional capitalization, these companies may look at the benefits of a varied distribution system encompassing the existing franchised operations, company owned and overseas locations, allowing them to improve critical mass and maximize management resources. They are also looking at other similar franchise and traditional businesses to acquire and further strengthen the market presence of the system.

The principle benefits that financial investors bring to franchisors are capital and the benefits that come from rapid market penetration. This enables franchisors to develop a core market strategy as well as a secondary market strategy to meet critical mass objectives. The core markets, the more densely populated areas requiring larger investments to create critical mass, can be the primary focus of the franchisor. Investor groups can provide the capital required to open multiple locations in the franchisors core

markets enabling quick market development. Securing core markets for development with company units or area developers also eliminates the need to risk the problems associated with domestic master franchising.

The development of core market strategies will effectively freeze investment opportunities for individual franchisee ownership in core markets. This creates opportunity as the secondary markets can be developed with smaller and less costly operations geared to those individual franchisees. This will require franchisors to develop secondary market strategies as well as operations which lend themselves financially as well as operationally to the smaller markets. In fact, franchisors have been effectively dealing with this opportunity through the development of such smaller profile operations. Thus, the introduction of the investor's capital actually enables the company to advance their marketing strategy to take advantage of pockets of opportunity in the smaller markets years ahead of scheduled ramp up.

Although we have emphasized the benefits of capital infusion at the franchisor level, multi-unit operators that are represented by financial syndicates can be equally attractive to the franchisor. In addition to capital effectively infused into the franchisor from multi-unit sales on a non-dilutive basis, and the increased continuing revenue from additional locations coming on stream at a rapid rate, these investors bring management experienced in alternative distribution methods and other industries. They have the desire, ability and talent to effectively assist their "franchisor partner" in improving the performance and positioning of the system. They also have the experience to understand that their investment is better protected in a stable system in which the franchisee and franchisor work together for the common goal.

Some of the franchisors we have spoken to are concerned that the emergence of multi-unit franchisee investors may cause a change in the "natural" franchise relationship, the franchisor as the dominant partner, and a potential increase in franchisor/franchisee conflict. They also are concerned with the possibility of diminished local unit performance because the local management will no longer be an owner operator. The concerns have merit but should not be treated as barriers but as management challenges which can be successfully overcome. Tremendous benefits, beyond sheer monetary ones, can be achieved through the marriage of the franchisor to a strong strategic investor partner.

### Penetrating the Investor Market

It is important therefore, for franchisor's to understand that selling to the investor market may require re-thinking of the classic franchise relationship, selection process and disclosure information provided. Some of the selection and disclosure policies previously chiseled in stone must change if the franchisor wants to effectively tap into this capital source. Principally the changes required will be the development of additional earnings and management disclosure information, expansion of franchisee/franchisor interaction to promote an atmosphere of inclusion for these investors, additional operational assistance where the investors are unskilled or unable

to operate the local units effectively, additional training to the franchisee's field organization, communication and MIS programs, and opportunities for investors to both expand their investment and to exit the system. Investors will make their selection based upon the perceived value of the system and the quality of the system's management. These groups, while always striving to improve their investment, are experienced and understand that controlled evolution will improve their investment while uncontrolled changes will not. Franchisors who manage this relationship will find that these larger investor group as franchisees or investors are strong allies in improving system performance.

It will not be sufficient for management to rely solely upon the classic disclosures included in the UFOC. Management must be prepared to improve the information included in the UFOC as well as make presentations to these investors, explaining not only the background of management and the historic performance of the system, but also the future plans for the company. Investors will want to understand how management views the future and how the company intends to manage changes in the marketplace. They will be trying to ascertain if management has the ability to manage the existing business, support their existing franchisees, plan for the future and achieve expected return objectives.

Investors want to know what the potential return on investment will be in order to measure the franchise opportunity against other alternatives. Published earnings information, based upon verifiable and other properly included criteria, when coupled with existing Item VII information on initial start up costs and realistically addressing working capital requirements, are essential investor tools. With the size of their potential investment, and the benefits they will bring to the system, franchisors can expect them to be seriously interested in the system. They should not have to construct their own financial projections in a vacuum or construct them based solely on discussion with existing franchisees or other circuitous routes. Investors are more interested in the "sizzle" of the investment than they are in the "sizzle" of the slick brochure and sales presentation.

Unfortunately, we understand that some franchisors have prepared financial information for this market, and have not included it in their UFOC. This return to "cocktail napkin" disclosure opens these franchisors to unnecessary and unfortunate risks. And, will ultimately damage the industry by providing fuel for further regulations. It is far wiser for these franchisors to aggressively pursue with their legal counsel and accountants the development of a well structured presentation of earnings under new Item XIX's "reasonable basis" than risk the liability associated with improper disclosures.

Warren Lewis recently published his book "Franchises: Dollars and Sense which is a compendium of earnings claims included in the UFOCs of approximately 150 companies. The book shows the vast disparity in the types, depth and sophistication of the information included by franchisors in their UFOCs and is a worthwhile addition to every franchisor's library. In addition, according to his recent study, completed with Mark Forseth, only 14 percent of franchisors are now including some form of earnings

claim at all. If franchisors want to effectively penetrate the capital source provided by investors, it is in their interest to prepare structured earnings information in their Item XIX disclosure.

The franchise landscape continues to change. Regulations now being advanced to protect the individual franchisee may become irrelevant as market forces, not state or federal politicians require improved disclosure and changes to the basic agreements. Financial investors, whether investing in franchisors or as multi-unit franchisees, will be better capitalized, better advised and better able to determine through the due diligence process the realities of the investment's potential. Just as franchising evolved and prospered following the enactment of the disclosure rules two decades ago, the participation of larger more established investors will also cause an evolution of prosperity.