

Have Your Cake and Eat It Too with Royalty Transactions

BY GREG GUTMANIS



A royalty transaction is a new liquidity option available to owners of high quality franchisors. It provides the liquidity of an outright sale while allowing franchisor owners to retain 100 percent ownership.

A private equity transaction, an outright sale, and a debt recapitalization have been the three standard options available to franchisor owners seeking full or partial liquidity. There is now a fourth alternative: a royalty transaction. Franchisor owners seeking liquidity should evaluate all four alternatives to determine which one optimizes their personal objectives.

PRIVATE EQUITY TRANSACTION

A private equity transaction provides significant liquidity and

often values franchisors at attractive multiples of earnings before interest, taxes, depreciation and amortization (“EBITDA”). If needed, private equity firms can sometimes add value by recruiting high quality board members to provide industry expertise and relationships. However, private equity firms typically require control (50-plus percent ownership), own preferred shares, lever up the business with debt, and require an outright sale in three to seven years. By completing a private equity transaction, the franchisor owner is selling 50-plus percent of the future growth of the business in exchange for a significant liquidity event.

A private equity transaction is optimal for franchisor owners needing help running or growing their businesses, or for early stage franchisors needing capital and industry expertise to scale their businesses to profitability.

OUTRIGHT SALE

An outright sale provides maximum liquidity to franchisor owners. Private equity firms and strategic buyers often model synergies (cost savings) to enable paying a premium multiple of EBITDA. By completing an outright sale, the franchisor owner is selling 100 percent of the future growth of the business for a significant liquidity event.

An outright sale is optimal for franchisor owners of a mature businesses with limited growth prospects seeking a full exit.

DEBT RECAPITALIZATION

A debt recapitalization (levering up the balance sheet and paying out the proceeds to the franchisor owner as a dividend) provides the least amount of liquidity (up to four times EBITDA) but allows owners of franchisors to retain 100 percent control of their business.

A debt recapitalization is optimal for franchisor owners with modest liquidity needs and a desire to retain 100 percent ownership of their business.

ROYALTY TRANSACTION

There’s an old expression “you can’t have your cake and eat it too.”

However, a private equity or outright sale transaction allows the franchisor owner to eat their cake (i.e. substantial liquidity) but doesn't allow them to have it too as their ownership is less than 50 percent. A debt recapitalization provides only a small slice of cake (limited liquidity). A royalty transaction allows franchisor owners to eat their cake (significant liquidity event) and have it too (retain 100 percent ownership of their business).

A royalty transaction is optimal for a franchisor owner that wants a substantial liquidity event, doesn't want equity partners (especially selling control) and strongly believes in the continued new store growth prospects for the business.

HOW DOES A ROYALTY TRANSACTION WORK?

Imagine ABC Franchisor, a strong business with 200 locations, \$200 million in system sales, \$10 million EBITDA, an excellent track record of same-store-sales growth, and continued prospects for new store growth. Compare the following transactions:

Initial Royalty Transaction: Approximately 90 percent of ABC's current EBITDA would be converted to a royalty at an outright sale multiple (nine to 10 times) for estimated proceeds of \$85 million. Thereafter, ABC would pay a 4.5 percent royalty on the sales of the existing 200 locations.

Annual Royalty Transactions: ABC has the right to sell a 4.5 percent royalty on net new locations opened each year thereafter. If ABC Franchisor opens 20 new locations, it has the right to sell a 4.5 percent royalty on those net new stores for approximately \$9 million (4.5 percent royalty x 20 stores x \$1 million average sales per new store x 10 times multiple).

Incremental Royalty Transactions: ABC has the right to sell incremental 1 percent royalties as it becomes more profitable through continued new store growth. An incremental 1 percent royalty could be worth \$36 million when ABC gets to 400 stores (1 percent incremental royalty x \$400 million in system sales x nine times multiple).

ROYALTY TRANSACTION HISTORY

Royalty transactions have a 15-year track record in Canada, with many of Canada's most successful franchisors entering into them. Imagine that Canada's largest casual dining pizza chain, who for example purposes we'll call "Pizza Franchisor," entered into a royalty transaction in 2002 when it had 154 locations and \$261 million of system sales. The initial royalty transaction generated approximately \$100 million of liquidity. Over the next 15 years, Pizza Franchisor opened 218 net new stores and sold royalties on those stores for cumulative proceeds of approximately \$150 million. In early 2015, Pizza Franchisor was so profitable (after paying its 4 percent royalty) that it sold an incremental 1.5 percent royalty for proceeds of over \$150 million.

The owners of Pizza Franchisor received \$100 million in 2002 (approximately 90 percent of an outright sale value), got paid very well for new stores (\$150 million), were able to sell an incremental 1.5 percent royalty for \$150 million, and still own 100 percent of Pizza Franchisor. The owners of Pizza Franchisor were able to realize significantly more value over time under the royalty transaction than an outright sale because of the strong new store growth. They were also much better off than if they completed a private equity transaction.

First, they had been running the business for 20 years and so didn't need help executing their continued growth plans and second, they were able to retain 100 percent ownership thereby didn't have to share the upside with outside investors.

The owners of Pizza Franchisor were also minority owners of the imaginary leading quick lube service franchisor in Canada, "Quick Lube Franchisor." The owners of Quick Lube Franchisor were seeking a significant liquidity event, ran a full auction process and selected a \$140 million royalty transaction with Diversified Royalty Corp. in 2015, the only franchisor-focused royalty transaction company. DIV's royalty transaction optimized the liquidity event, future value creation, while allowing the owners to

maintain 100 percent ownership. The extremely positive experience of the owners of Pizza Franchisor with the royalty transaction was a key factor in their decision.

WHO CAN DO A ROYALTY TRANSACTION? THE "ROYALTY(ABLE)"

A royalty transaction seems almost too good to be true -- outright sale-like liquidity, ongoing monetization of new stores and retaining 100 percent equity ownership. The key element of a successful royalty transaction is the quality of the franchisor: multi-location business, strong store level economics, track record of new store and same-store-sales growth, strong new store growth opportunities, market leaders in their category, profitable, long operating history and experienced management team.

Franchisors with these characteristics are "royaltyable," i.e. established businesses with solid franchisees and continued growth prospects. These franchisor owners are able to realize a significant liquidity event while retaining 100 percent ownership: They can have their cake and eat it too!

OWNER OBJECTIVES DETERMINE OPTIMAL LIQUIDITY EVENT

Ultimately, a franchisor owner seeking a significant liquidity event should base its decision on its personal and business objectives. A private equity transaction, an outright sale, a debt recapitalization and a royalty transaction each satisfy different objectives.

Franchisor owners that are "royaltyable" should explore a royalty transaction if they are considering a significant liquidity event. ■



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