FRANCHISOR LIQUIDITY OPTIONS

How To Evaluate Liquidity Options,

Including Private Equity

INTRODUCTION

Every great franchisor has multiple liquidity options and should evaluate:

1. Private Equity Transaction
2. Outright Sale
3. Debt Recapitalization
4. Royalty Transaction

As a franchisor, you've grown your business to scale. Your business is profitable, you believe in its continued growth prospects, and you are looking to take some money off the table. You've read the headlines of other franchisors selling to private equity – what should you do?

Traditionally, the liquidity options to consider are limited to the following: debt recapitalisation, outright sale, or private equity transaction. There is another option to consider: royalty transaction.

Depending on your objectives, managerial bench-strength, growth prospects and stage of growth, each of these liquidity options could be the right solution for your franchisor business. Evaluating each option relative to a "do-nothing" status quo will narrow down the best outcome in this potentially once-in-a-lifetime important event.

PRIVATE EQUITY TRANSACTION

Private equity transactions have created a lot of headlines since the early 2000's. 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+% ownership), own preferred shares, lever up the business with debt, and require an outright sale in 3 to 7 years. By completing a private equity transaction, the franchisor owner is selling 50+% of the future growth of the business in exchange for a significant liquidity event.

A private equity transaction is optimal for a franchisor owners needing help running/growing their businesses or for early-stage franchisors needing capital and industry expertise to scale their businesses to profitability. However, it also has an operational impact and can create stress in the franchisee community following the change of control.

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% 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. It is truly new ownership, so the impact on the franchisee community and operations will be significant.

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 4x-5x EBITDA) but allows owners of franchisors to retain 100% control of their business. The debt must be paid back over time and there are stresses of financial covenants; however, there is essentially no impact on the operations of the franchisee community

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

ROYALTY TRANSACTION

In the right circumstances, a royalty transaction can provide a franchisor owner with the ability to realize the best of both worlds – the liquidity of a private equity transaction (at double-digit EBITDA multiples) with the control of a debt capitalization (100% equity retained).

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.

<u>How Does a Royalty Transaction Work?</u>

ABC Franchisor: 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.

Initial Royalty Transaction – approximately 90% of ABC's current EBITDA would be converted to a royalty at an outright sale multiple (9-10x) multiple for estimated proceeds of $85 million. Thereafter, ABC would pay a 4.5% royalty on the sales of the existing 200 locations.

Annual Royalty Transactions – ABC has the right to sell a 4.5% 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% royalty on those net new stores for approximately $9 million (4.5% 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% royalties as it becomes more profitable through continued new store growth. An incremental 1% royalty could be worth $36 million when ABC gets to 400 stores (1% incremental royalty x $400 million in system sales x 9 times multiple).

Who Can Do a Royalty Transaction?

A royalty transaction seems almost too good to be true – outright sale-like liquidity, ongoing monetization of new stores and retaining 100% 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* – they are established businesses with solid franchisees and continued growth prospects. These franchisor owners are able to realize a significant liquidity event while retaining 100% ownership.

SUMMARY

Ultimately, a franchisor owner seeking a significant liquidity event should base their decision on their 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.

DIVERSIFIED

ROYALTY CORP

Suite 330 – 609 Granville Street
Vancouver, BC V7Y 1A1

SCAN THIS CODE TO
LEARN MORE OR VIST US AT
DIVERSIFIEDROYALTYCORP.COM