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CELEBRITY ENTREPRENEURS SHAPING FRANCHISE FUTURES

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Alicia Miller offers actionable insights for founders and franchisees eager to tap into the vast power of private equity

For expert guidance on maximizing private capital for business expansion, look no further than consultant Alicia Miller. As the founder and MD of Emergent Growth Advisors, Alicia offers unrivaled expertise in franchising and private capital, drawing from her experience as both an investor in brands and multi-unit franchise operators, as well as her background as a former multi-unit operator.

Now Alicia has written an invaluable book, *Big Money in Franchising: Scaling Your Enterprise in the Era of Private Equity*, shedding light on recent events like the monumental $9.5 billion Subway acquisition by Roark Capital, unravelling the intricacies of how to leverage private capital for business growth, and empowering readers with the information needed to build enterprise value and climb the private equity profit ladder.

"I wanted to demystify how private equity operates in the context of franchising," Alicia told *Global Franchise*. "Both franchising and private equity are often misunderstood and the mash up of the two even more so! I hope the book helps franchise stakeholders to make more informed choices."

We caught up with Alicia for a fascinating conversation around PE growth playbooks, recent international case studies, and the latest investment trends shaking up the franchise scene.

"If there are any major flaws in your model, you're unlikely to attract a PE buyer"

GF: What has been the impact of private equity on franchising?

AM: More big money players are entering franchising with a mandate to deploy capital, which is creating incredible new liquidity options for founders of good systems. Valuations have been driven higher by this flurry of activity.

Another positive development is the entrance of PE investors at the unit level buying out franchisees. This activity is expanding and accelerating, creating exciting new liquidity options for franchisees as well. In some large systems, PE owns the majority of franchised units. This sets up a very interesting relationship dynamic with the franchisor, especially if the franchisor itself is also backed by private equity!

PE capital and strategic assistance is exactly what many brands and multi-unit operators need to accelerate growth. With the right support these brands can go further, faster, than they would have on their own. Tropical Smoothie Café and Wingstop are two examples of brands that experienced blow-out success under their PE sponsors. Wingstop went public and continues to expand while TSC is rumored to be preparing for an initial public offering (IPO). Flynn Group, the largest franchisee in the world with more than 2,600 units is also PE-backed. Flynn recently announced its sixth recapitalization, bringing in new PE sponsors to help it continue its growth across new brands and markets.

However, numerous other businesses find themselves excluded from the process. The reality is that most brands will never catch the eye of a PE investor. Private equity

HOW PRIVATE EQUITY IS IMPACTING FRANCHISING

- New liquidity options at both brand and franchisee level
- Higher valuations for good businesses
- More capital and support to accelerate enterprise growth
- Fierce competition to recruit top franchisee talent
- Increased demand for outsourced services (e.g., franchise sales, marketing, real estate)
- More expensive and challenging to launch new concepts
- More new concepts entering the market

firms carefully select investments according to their specific criteria and then inject capital to drive rapid growth in those chosen businesses. Consequently, the rest of the market experiences a significant uptick in competition, particularly in the recruitment of new franchisees. This heightened competition poses significant challenges for emerging brands, creating a tougher landscape than ever before.

Today, founders are not only competing with emerging brands but also contending with the challenge of competing against those already backed by deep-pocketed PE firms. Additionally, PE firms are actively consolidating fragmented sectors, such as home services, into multi-brand operating platforms. These platforms can leverage various efficiencies, including supply chain optimization, cross-marketing, and cross-selling. As a result, new concepts entering the market need to launch with stronger capitalization and a more robust strategy to stand out amidst increased competition.

All this PE money encourages a record number of new franchise starts. For example, in the U.S. market, more than 400 per year are now launching – up from a running average of around 250 per year during the last few years according to FRANdata. The shift has been a boon for brokers, outsourced sales organizations, and those who help new brands launch.

But many founders of new brands don't fully understand PE's impact and aren't prepared for its impact. They're just learning the ropes of the franchise model and don't realize there is now a PE dynamic to figure out as well.

How can PE accelerate brand growth?

Private equity firms have a straightforward playbook for growing their franchise acquisitions, but putting it all into action is no simple task. Here's how it works: PE acquires a brand and invests in various areas like marketing, product/service enhancement, bolstering franchisee support, and streamlining construction processes to reduce costs and accelerate new site launches. Their goal is to prioritize initiatives that yield rapid returns, driving interest among franchisees for expansion. This growth trajectory can persist through multiple ownership changes within the PE realm, as long as there's a steadfast commitment to improving profitability at the unit level.

Private equity firms also *love* a buy-and-build approach known as "platforming." This strategy involves starting with a strong leadership team and flagship brand and then acquiring complementary businesses, known as tuck-in acquisitions. A prime illustration of this success is Neighborly, which has expanded to include over 30 brands under its platform. Throughout this journey, there have been multiple PE ownership changes, but sponsors kept the management team focused and maintained a focus on enhancing unit-level profitability and exploring new avenues to leverage the platform's capabilities.

Another example is Inspire Brands, currently owned by Roark but likely to go public. Franchisees enjoy multi-brand expansion opportunities and marketing and supply chain efficiencies that are tough to duplicate without the scale of the Inspire platform.

For founders and multi-unit franchisees, the potential for multiple arbitrage and wealth creation is stunning. That math is discussed extensively in the book.

WHAT PE BUYERS ARE LOOKING FOR IN FRANCHISES

- Strong unit level economics, operating margins ideally 15-20% or higher
- Sustained, proven, and growing customer demand
- Proven resilience across different markets
- Good return on investment for franchisees
- Differentiated product/service; not a fad
- Any issues must be fixable within PE's hold period
- Good franchisee validation
- Some scale achieved (depends on buyer how much scale they want to see before investing)
- Strong demand for new franchise licenses, especially from existing franchisees
- Great management teams

What should franchisees do if their brand is acquired by private equity?

First, recognize that if the brand has a high-quality operating model and is growing, it will eventually attract PE attention. While some founders want to hold out or pass the business onto their children, for many there comes a time when a private equity transaction makes sense. Franchisees should be prepared for that possibility.

Second, post-acquisition there will be a push to lift same store sales. Often this is via marketing investments, new product and service launches, and other growth initiatives. But you can also expect corporate to accelerate efforts to exit underperforming franchisees and transfer outlets to better operators.

Franchisees often go into business without an end game in mind. Hopefully, owner or management team transitions bring positive changes. But if you don't like the changes, or it's no longer a fit for other reasons, you need to prepare to make a good exit and move on to other adventures. The book talks through how to prepare properly, and things for founders and franchisees to think about when preparing for an ownership change.

Finally, it's important for franchisors to establish a franchise advisory council (FAC) early on and really listen to feedback. FACs can help filter change requests, provide franchisee feedback on new product or service trials, and promote best practices in the system, providing continuity and institutional memory across multiple ownership changes.

Change is part of business. A well-functioning FAC-franchisee-corporate relationship increases enterprise value, whereas a poor relationship and communication dynamic does the opposite.

How can franchisors position their businesses to attract interest from private equity?

Private equity looks for a strong operating model and open space to add units. Any challenges need to be fixable in the short term.

The best way to attract PE investors is to build right in the first place and to remain laser-focused on improving unit level profitability. If franchisees can't make good returns, the business can't grow. PE pays for growth potential.

Some business owners think, "If I build it, PE will knock on my door." But in truth, PE is looking for very specific attributes in the businesses they acquire. And they kick tires on many concepts simply to learn about the marketplace. Sellers can waste time and get false hope having conversations that either lead nowhere or generate disappointing valuation feedback. It's better to start planning early and build what buyers covet. If you're a franchisor, this approach coincidently also creates value for your franchisees, so it's a win-win situation. This is the focus of my consulting practice.

Are there any misconceptions about private equity related to their franchise investments?

Yes – there's no bank truck rolling up to fix your problems! If there are any major flaws in your model, you're unlikely to attract a PE buyer. Some firms have gotten burned taking on turnarounds and there are case studies in the book with some of those stories.

Although the average PE hold time is six years, PE often hold franchise businesses, especially multi-brand platforms, for longer.

Although a dominant player, PE has only invested (as one example) in less than 20% of active U.S. brands. That means there's a very long tail of brands that could yet be investment targets, but most will remain too small or aren't attractive without a change in approach.

When has PE not been successful in franchising and what were the lessons?

In the early days when PE first entered franchising, many underestimated how difficult franchise turnarounds can be and were too aggressive with debt. Franchisees are independent

> *"It's better to start planning early and build what buyers covet"*

PE'S PLAYBOOK FOR FRANCHISE GROWTH

- Improve unit level profitability
- Invest in support & growth accelerators
- Back office and enabling tech
- Improve same store sales
- Upgrade/add corporate talent
- Monitor and improve key performance metrics
- Add new products & services
- Enter new markets
- Create shared service platforms
- Reduce unit level costs
- Pursue tuck-in acquisitions accretive to the platform value proposition

business owners, and it takes time to turn the ship and get franchisees on board with change. As PE investors gained experience in the franchise model, their due diligence also improved. They're now much better at avoiding overly risky franchise bets in the first place. On the flipside, this also means that stall-outs often can't get the strategic assistance they need – at least not from PE.

Today, most private equity missteps boil down to unit level profitability issues and the relationship between the management team and franchisees. If this relationship isn't well tended to, franchisees can lose their appetite for growth and their faith in the direction of the business. PE investors move fast and can be a bit clinical in their approach to things. Even when filtered through the management team, their blunt communication style and decision-making speed (often without franchisee input) can rub franchisees up the wrong way.

For example, new fees and supply chain strategies can prompt swift rebuttal from franchisees. The fall-out from franchisee dissatisfaction may not be immediately visible in business metrics but by the time it is, PE may have a turnaround on their hands!

Roark's Subway acquisition is a significant milestone in franchising. What can we expect from this change?

Roark is one of the most prolific users of whole business securitization – debt backed by franchisee royalties. Subway will take on as much as $5 billion of debt post-acquisition and we can expect Roark to take out large dividends over the next few years funded by the initial and subsequent securitizations.

We can hope – but not expect – that Roark will also put money back into the business to fund remodels and improvements to the business. Subway is still a work in progress, but has an incredible brand to lean on.

We can expect a huge push on international growth to offset challenges in over-stored mature markets like the U.S.

Roark prefers a relatively low profile which will be impossible here. Together with the big push for remodels and likely closures still to come, we can expect ongoing public scrutiny.

How Roark handles franchisees around those closures will be critically important, not only to Roark's success with Subway, but also in terms of public opinion and the opinion of franchise regulators about private equity.

'Big money' is fully on display here. The sheer number of franchisees in the Subway system makes their voices impossible to ignore. It won't be about just getting the turnaround mechanically correct. Together with good management, Roark must also demonstrate excellence in change management and relationship building to right the ship and uncover new growth. It will be interesting to watch.

ABOUT THE AUTHOR

Big Money in Franchising is an essential read for anyone keen to scale their franchise business. Available from Amazon and all good bookstores, it has received rave reviews from across the sector, and is one of our top business books of the year.