PRIVATE EQUITY: TAKE YOUR FRANCHISE TO THE NEXT LEVEL

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Private equity can be a likely source of capital.

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The uncertainty of the financial markets and credit crunch that has materialized during the second half of the year has many businesses concerned about their capitalization. Private equity has emerged as a prominent alternative for companies seeking outside investors ranging from a minority shareholding to a full-control sale. Let's look at some key considerations as to whether or not private equity is a likely source of capital that will allow franchisors to take their systems to the next level. Batteries Plus went through this process in 2007 as our founding shareholders looked to exit the business after 20 years. Having completed what we believe is a successful and exciting ownership transition for our franchise system (Batteries Plus was acquired by private equity firm Roark Capital in 2007), I will provide some insight into several things a franchisor, both its ownership group and its management team, should consider as part of this decision-making process.

There are three different topics that should be addressed that will be helpful if you prepare for and consider this path for your franchise system. First, are you ready for a private-equity investor? Second, what criteria are typically used by private-equity investors? And finally, what are the potential benefits of a private-equity investor?

Are you prepared for a private-equity investor?

• **Why are you seeking an outside investor?** There are many good answers to this question (growth trajectory, succession planning, a founder looking to monetize equity, and so forth), but it is absolutely critical that the ownership and management team are clear on this objective.

• **Have you built the case for your business?** With a clear objective (i.e., selling control of the business) a franchisor must build a case for its business. Historical, current and future performance and plans must be clearly summarized.

• **Do you know what you want?** This is often the trickiest part of "transaction preparedness." Financially, management teams are often both sellers (for the current owner) and buyers (shareholders and management for the new owner). Strategically, conducting some research on private-equity firms you want to pursue is also important. Through outside advisors or rigorous internal discussion, get aligned on acceptable outcomes before you pursue a transaction, not while you are in the middle of one.

• **Are you prepared for the investment in management time required to finish a deal?** Outside advisors may provide a process to secure a private-equity investment, but pursuing a transaction requires management time and effort. Be prepared to invest your time and effort into management presentations, due diligence and interaction with potential investor groups. And by the way, remember you still have your "day job" to perform.

• **How, what and when will you communicate to franchisees?** There is no right or wrong recipe for this issue, each system is different. However, careful forethought to how and when you will communicate with franchisees about potential changes to your investment or ownership structure should not be overlooked. Positive communication can create new energy and excitement (and in some cases, relief when it's perceived by franchisees that an owner isn't "passionate about the business" anymore). Poor communication (timing or content) of even the most positive of changes, can lead to unnecessary conflict in your system.

What criteria are typically used by private-equity investors?
Preparing for potential private-equity investors also includes understanding some of their key evaluation criteria. Generally, private-equity firms have similar criteria in evaluating investment opportunities. Here are five important ones:

- **Strength and sustainability of the management team**: Private-equity firms usually don't run businesses, and they are looking for management teams that want to stay with the business following a transaction. Sometimes a founder or group of owners may want to transition out of the business as part of a sale. That's okay, provided there is a strong management team that wants to take the system to the next level. If appropriate, have a clear succession plan defined for potential investors.

- **Unit economics**: However your franchise system defines a "unit" (a store, a truck, a territory and so forth), private-equity firms will want to clearly understand the strength and consistency of your unit performance. Clearly, strong unit economics are important, but other factors such as average growth rates, the number of troubled units, the number of closures and re-sales, and other factors will be analyzed. Investing in franchising is investing in a business model, so be prepared for a thorough examination of your model.

- **Franchisee satisfaction**: Most franchisors immediately translate this to imply litigation. While the absence of litigation is generally a big plus in the eyes of a private-equity investor, many will also want to understand the dynamics and culture of your system. Many private-equity firms will want to talk to franchisees as part of due diligence or at least have access to their feedback through "blind" franchise - survey techniques.

- **Transparency in financial statements**: Pursuing a private equity investor is certainly easier with a strong balance sheet and income statement however, that is not always imperative. What is important however, is transparency and clarity of the company's financial statements. Be prepared to clearly explain the financial state of your business (good and bad) accurately.

- **Fit**: Private-equity firms pursue investments that fit their portfolio on multiple fronts. First, they have charters or guidelines established in their relationships with their own capital sources For example, many private-equity firms will only invest in a company if they can obtain majority control Second, private-equity firms have strategic criteria that guide the investments they pursue. This may include business structure (i.e., franchise businesses), business sectors (i.e. retail), geographic considerations (i.e. Midwest focus) or others.

What are the potential benefits of a private-equity investor?
If you pursue a private-equity investor and select the right partner, there can be many benefits for your business including:

- **Making key managers shareholders**: Private-equity firms align the interest of management through ownership, and for many management teams this is a key objective during this process. If management is seeking to obtain or potentially increase their equity participation, private-equity is the likely investor path for your franchise.

- **Capital for growth**: Because private equity firms secure commitments for large amounts of capital they are often best prepared to put it to work quickly and decisively.

- **If the private-equity firm has other investments in the franchising industry and a strong relationship with its companies, there is a great benefit of sharing best practices with their other companies**: We are proud plagiarizers and have implemented at least a dozen significant ideas from other companies that are in the portfolio. When you have sibling franchise systems that have "been there or done that" your system can accelerate itself through the shared practices of your peers.

- **Discipline in business planning and governance**: Most private-equity firms provide a level of discipline and governance that will improve your company. We have found this to be anything but bureaucratic, it just makes us sharper. Regular dialogue with shareholders that challenge your strategies and assumptions almost always leads to an improved work product. This can be a very healthy process, particularly for a growing franchisor.

A private-equity investor can be a great vehicle for many franchise systems looking to take their business to the next level. Preparation, coupled with an understanding of the key private-equity evaluation criteria, are important elements toward determining if now is the right time for your franchise to consider this strategy.