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Private Equity Power Boost: Why Private Equity-Owned Franchises Thrive

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Consumers probably haven't noticed -- and there's no reason why they should, though the business world has -- but private equity-owned franchises are flourishing.

For most of the 21st century, private equity firms have found franchises attractive investments, but lately, the relationship seems to be really heating up. For instance, as Reuters recently reported, in late November, Roark Capital Group, which owns Arby's, bought Buffalo Wild Wings Inc for $2.4 billion. In October, Ruby Tuesday was purchased for about $335 million by NRD Capital. And, in the last two years, JAB Holdings boughtPanera Bread and Krispy Kreme Doughnuts.

But the trend isn't only in restaurants. In recent weeks, for instance, in-home care services and fitness centers (notably Planet Fitness) have been purchased by private equity groups. Even an eyelash extension franchise is considering a sale to a private equity firm.

I have my own experience in this dynamic between private equity firms and franchises. Over the years, as managing director of the Richmond, Virginia-based Boxwood Capital Partners, we've invested in online yoga retailers, coffee wholesalers, snack retail websites and office supply stores. On January 31, 2015, we bought the remaining controlling shares of a frozen yogurt chain, sweetFrog Frozen Yogurt, a process we began by becoming a minority investor in April 2012. Working together with hundreds of fantastic franchise partners, we have since turned sweetFrog into the nation's fastest-growing frozen yogurt chain.

So, why do private equity-owned firms find franchises so appealing? There are multiple reasons, although I will state the obvious: not just any franchise will work. Obviously, a private equity group wants to avoid purchasing a

poorly run, mismanaged franchise. But, assuming the firm buys a quality franchise with a lot going right or at least a lot of potential, some of the pros include the following:

• **A continuous royalty stream.** Of course, you hope that there will be steady income with any business you buy, but every month or quarter, depending on how it's structured, each franchise is sending in its royalty fee, which is usually 5-9% of the gross sales. Much of that is invested back into the franchise, but it isn't hard to see that the more franchises you end up with, the wider your profit margins and the stronger the potential for continued growth.

• **You have an army of people working for and with you.**You don't have only employees building profits; you have *entrepreneurs*. The people who own the franchises want to succeed as much as you do. So, you wind up working with owners who are invested in the business model and working as hard as they can, hiring the best people they can find and marketing aggressively, knowing that their own sales and profits will only rise.

• **You can effectively evaluate the health of the company before you buy.** Franchises, generally, have few assets; the assets are tied up with the franchisees. This makes it very difficult for a founder and/or currently operating franchisor to fudge the numbers, if you will, to make the company look more valuable than it is, and you can always talk to the franchisees to get a sense of how well the business is run.

• **You're buying a proven business model.** In many cases, you're buying a business in which the business model is proven to work. If it's a large franchise, it became large because customers liked the product or service enough that they kept coming back -- and people kept buying franchises to get in on the action. Even if your private equity firm purchases a small franchise, if it has been growing and shows promise, then the business model is working. That's no guarantee it will continue to work, of course, but there are no guarantees when you buy *any* company. But, a franchise is safer and more predictable than many business operations.

• **You can grow without a lot of risk.** The capital spent on buying new locations and upgrading them is spent by franchisees. That means your firm can spend its time, talent, money and intellectual capital on making the company run more efficiently --which will attract more franchisees. But

again, thanks to the initial franchise fee and the royalty fee structure, you can grow while risking less capital.

And, being interested in growth is the reason private equity firms get involved in franchises -- and should continue doing so. When we purchased sweetFrog, we could see the potential beyond the delectable treats the founder was serving up. The company was clearly going places -- literally, as it was already dipping its toe into international waters. But the founder felt, for the company to really grow, that it needed a firm like Boxwood that could help it thrive. When Boxwood became a minority investor, there were 180 sweetFrog units; today, there are more than 340.

There's a lesson here and a warning to all private equity firms interested in investing in a franchise. The best franchise and private equity firm arrangements are the ones in which you know your company has something to add to the relationship. Otherwise, you risk taking a fully functioning franchise and having *your company* be the reason it becomes poorly run and mismanaged.