Trinity Capital Investment Banking

Restaurant Industry Commentary and Q3 2018 SSS Update

Page 4: Power-Sharing by Franchisors and Franchisees: What Works Best?

In an ideal franchised restaurant system, the franchisor is responsible for product, pricing and promotion, and the franchisee concentrates on four-wall execution of quality, service and cleanliness. Recent squabbles between franchisees and franchisors in the Jack-in-the-Box, McDonald's and Papa John's franchise systems have highlighted powersharing issues ranging from remodeling initiatives to product and brand strategy and have, in the case of McDonald's, encouraged the formation of a franchise association.

An essential element of the power balance between franchisees and franchisors are franchise associations, which organize franchisees into a unified, constructive voice. Franchise associations can define key issues, create committees to develop expertise around those disciplines and *constructively* provide valuable customer and market feedback to the franchisor. One of the most important things for franchisor executives to keep in mind is that frequent discussions with franchisees are critical in establishing the reciprocal relationship necessary to grow and compete successfully. **Leading brands realize this important partnership can establish the foundation for successfully working together and co-investing in solutions to differentiate the brand from its competition.** This requires periodic dialogue, candid disclosure and comprehensive analysis. Effective communication is critical to success and must be accompanied by a balance of power, not franchisor hegemony. Strong franchisors recognize the importance of a strong franchise association. David Novak, former Chairman of YUM! Brands, once told franchisees at a FRANMAC (Taco Bell's franchise association) conference, "you make us a better brand."

Unfortunately, there are forces that work against dialogue, disclosure and comprehensive analysis. When a brand is on a strong upswing, the franchisor can tend to be imperious, often without realizing it. On the other hand, brands that have lost their way are sometimes so browbeaten by franchisees that they seemingly will never regain their composure. This breakdown often leads to intransigence and competing agendas instead of ideas on how to beat the competition.

Publicly traded franchisors are typically concerned with shareholder sentiment and top-line growth at the restaurants, while franchisees place greater focus on bottom-line sustainability or expansion. There is not necessarily a conflict of interest but a delicate balance between the cash flow of the brand (franchisor) and its franchisees. If a concept's franchisees have average system-wide cash flow of 10% and royalties of 5%, then the effective split of cash flow is two-thirds to the franchisee and one-third to the franchisor. The calculation becomes more complicated when you look at capital structures, debt service, remodeling costs and development. **If a franchisee is feverishly investing in remodeling, then the franchisor benefits substantially from the franchisee's investments** (assuming there is a meaningful sales bump from remodeling) without directly bearing the costs of construction. **While the franchisee will likely see improved cash flow from top-line growth, it may be negated by payments on debt**

incurred to complete the project, changing the equation. It is important that there is an acknowledgement of the relationship between royalties and free cash flow.

To analyze the equitability of the relationship, franchisees may examine and question the ways in which the franchisor is using its cash flow and debt proceeds. If a meaningful quotient of that money is used to strengthen the brand through technology enhancement, promotion, product research and the like, then franchisees can take comfort in the notion that reinvestment is occurring on both sides of the aisle. On the other hand, if the franchisor's uses of debt proceeds are heavily skewed toward share repurchases and dividends while brand performance is suffering, it may indicate the balance of power is not working well.

An additional area where a strong franchisor-franchisee relationship plays a role is product and promotional strategy**. If the franchisor acts unilaterally when determining promotional offerings – examples of which include mandating franchisees to offer unsustainable value items that cannibalize sales from high-margin products – it may lose the trust of its franchisees and exacerbate any existing relationship woes.** When the franchisor and franchisee work together and communicate effectively, the brand can launch new promotions like Applebee's Dollarita, which turned out to be an incredibly successful traffic driver and helped reinvigorate the brand, benefiting both the franchisor and franchisees.

Without an open line of communication between the franchisor and franchisees, franchisees neglecting remodeling or development can lead brand management to conclude that their growth is stifled by franchisee reluctance to reinvest. Conversely, franchisees can suffer or be impaired by unreasonably priced remodel obligations and poorly constructed technology and promotional programs that require significant capital, but do not produce meaningful results.

Successful brands maintain constructive and synergistic relationships between franchisee and franchisor. If one side is not listening, this can lead to a degradation in morale on both sides and ultimately in brand performance. Unresolved disputes compound and lead to occurrences (like legal battles) that are meaningfully destructive to both parties; **it is always best to have a full-disclosure, comprehensive discussion about a difficult matter before it breeds animus**. A healthy franchisor-franchisee relationship does not mean there will not be disagreements, but that there is mutual respect and a forum for airing grievances and solving legitimate challenges or misperceptions.

Effective franchise associations are the surest way to keep open, periodic and constructive dialogue.

Contributing Editor Kevin Burke is a Managing Director at Trinity Capital