A Promising Structure For Multiunit Franchise Acquisitions

By **Matthew Ertman, Nathan Kiyam and Bryce Ellis** (November 30, 2022)

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In the last couple of years, there has been a steady increase of multiunit franchise acquisitions in a variety of industries, including the food and automotive sectors.

Franchise businesses continue to show strength, with ample opportunities for the strategic investment of capital in new unit acquisitions and the development of new units. For investors looking to capitalize on franchise investments, you should carefully consider the investment structure.

Below, we explore some of the factors to consider when you are evaluating acquiring franchise businesses and the strengths and benefits of a particular investment structure: the operating company/property company, or opco/propco, structure.

The Rise of Franchise Businesses

According to the International Franchise Association's 2022 franchising economic outlook report, 2021 saw an explosive rebound in the economic output of franchise businesses, which topped nearly $788 billion, an increase of 16.2% from 2020.[1] Even more encouraging, the IFA expects to see similarly strong economic output from franchise businesses in 2022.

For 2022, the IFA forecasts that, despite economic headwinds, the output for franchise businesses should improve by 4.9% to $826.6 billion. The IFA expects that franchising will end 2022 with more than 792,000 establishments, adding a net gain of 17,000 new locations at a growth rate of 2.2%.

Private Equity Driving the Rise in Franchise Acquisitions

The rise of private equity activity has been a driving force behind many of these franchise acquisitions and growth. Private equity-led acquisitions in 2021 were 50% higher than any previous record.[2]

Private equity firms have been bullish on the franchise industry due to its significant growth and ability to provide a scalable revenue stream. They have not only been investing in franchisors, but also investing in multiunit franchisees, franchise broker networks and franchise sales organizations.

According to Ryan Morita, managing principal of Oak Cap Ventures, the current market for multiunit franchise business acquisitions is constantly changing.

Macroeconomic shifts in the capital markets, consumer sentiment and demand, inflationary pressures and labor shortages create challenges to structuring and closing transactions. Morita is seeing an uptick in opportunities but not the same transaction velocity as 2021. Nonetheless, he emphasized that Oak Cap Ventures is still bullish on the sector and is opportunistic in the acquisition of multiunit franchise businesses.

Factors to Consider in Acquiring Multiunit Franchise Businesses

When evaluating the acquisition of a multiunit franchise business, you should consider the following factors, among others:

- The franchisor approval process, including franchisor training, industry experience and minimum financial requirements;
- The growth trajectory of the franchises;
- The sustainability of the product or service;
- The operating history of the various locations and the ability to develop additional units in additional geographic locations,
- The potential for future growth and expansion on a per unit and portfolio basis;
- Current cash flow;
- Any headwinds, such as outsized labor costs, material costs or other cost growth; and
- Consumer appeal for the franchise.

Given current market conditions, the following macroeconomic factors, and the possible challenges such factors may pose, are pertinent to consider as well:

- Interest rates remain high and with the Federal Reserve System's target rate of +/- 4%, benchmark rates will continue to rise as well, thereby driving the cost of capital higher;

- The decline in sales, coupled with the rising cost of goods as well as a labor shortage, while improving, still remains tight, together are causing constant changes to enterprise values;

- Potential risks to operating profits recovery have complicated how deals are structured, in particular the seller earnout provisions, as investors strive to avoid escrow holdbacks; and

- Construction costs and lead times have burdened capital improvements and new unit development.

As with any acquisition, there are other factors to consider and due diligence to undertake prior to acquiring a franchise business, such as the:

- Effectiveness of existing franchise management;

- Underlying accounting controls and quality of earnings analysis;

- Current and future lease terms;

- Employment and labor costs and corresponding regulatory concerns;

- Deferred maintenance and necessary capital expenditures to refresh franchise locations; and

- Ability of the franchise business to keep pace with inflation.

Of course, none of these factors alone should determine a decision. Rather they should be part of the overall, deal-by-deal approach toward making such acquisitions. And as for the macroeconomic factors discussed above, the constant change such factors are indicative of should not be viewed as a deterrent to investment, but rather as the healthy level of risk that naturally accompanies such potential high-upside investments, like those in the multiunit franchise acquisition space.

The Opco/Propco Structure

As you consider the possibilities of a multiunit franchise acquisition, we would point you toward an important consideration for how to structure such acquisition; the opco/propco structure.

In discussing the current market for multiunit franchise business acquisitions, according to Oak Cap Ventures' Morita, the structuring of deals is becoming evermore important when negotiating asset purchase agreements, with respect to the operating company, or real property purchase agreements, with respect to the property company, to protect interests when acquiring an enterprise.

At its foundation, the opco/propco structure involves splitting a company into two entities, in some cases held by one holding company and generally under common management: (1) an operating company, owning the underlying franchise operating businesses, and (2) a property company, owning the real properties underlying the franchise store locations.

To establish the structure, either the assets are acquired separately from the seller into the two structures or the operating company assigns all the real property assets and liabilities to the property company and the property company leases these real properties back to the operating company.

For a multiunit portfolio, each operating business and real property is often held through special-purpose entities below the operating company and property company entities.

This structure allows for greater efficiency with regard to separate ownership of the business operations through the operating company and greater loan flexibility with the separate ownership of the real estate assets held through the property company.

If necessary, the opco/propco structure facilitates meeting strict tax and government regulations of real estate operating companies, through the property company while maintaining the business operations separately through operating company.

Additionally, the property company can use the real estate assets as security to obtain loans on more favorable terms to advance the real estate business while the operating company can avoid dealing with debt responsibilities, credit rating issues and other debt issues.

Moreover, substantial tax benefits may be obtained, and the investor base may be broadened to include more foreign and tax-exempt investors, if structured so that the property company is, or is qualified to be held by, a real estate investment trust.

The operating company and property company, while generally managed by the same management company, often have different ownership. The structure allows the sponsor to leverage the purpose of each business separately and improve credit ratings and debt ratios of each to facilitate their requirements and businesses.

Possibly more important, the structure accommodates investors with varying investment considerations and at various levels of the organizational structure, e.g., whether to invest at the operating company, property company or holding company level.

Legal Considerations in Opco/Propco Structure

As with the acquisition of any business, there are a number of customary legal

considerations like the scope and duration of representations, warranties and indemnity, and the creditworthiness of the seller to perform on any post-closing indemnity.

With multiunit franchise acquisitions, there are additional legal considerations to keep in mind. If you will be funding the acquisition with outside capital, it is important to determine at what level of the structure investors will participate, and applicable franchise disclosure obligations, limitations or covenants that may apply to the investors based on the structure.

Franchise agreements may include noncompete, nonsolicit, confidentiality, restrictions on transfer — including approval of the franchisor — or other protective or restrictive obligations upon the owners of the operating company, which can be problematic for investors.

Furthermore, the franchise agreements may impose upon the owner or manager of the enterprise additional personal time and location requirements.

Finally, it is crucial to evaluate the tax efficiencies of the acquisition and holding structure within the framework of the acquirer's overall business plan.

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[1] https://www.franchise.org/franchise-information/franchise-business-outlook/2022franchising-economic-outlook.

[2] https://www.rbccm.com/en/gib/ma-inflection-points/episode/private-equity-ma?v=1&watch.