ASSET LIGHT FRANCHISING – COMPLAINTS FROM FRANCHISEES – LET'S CLEAR THE AIR!!

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The long term investment appeal of well established franchising companies is accepted by the investment community. Most of the prominent franchisors' equities sell at price to trailing twelve month EBITDA multiples in the mid to high teens (Denny's (DENN), Dine Brands (DIN), Dunkin' Brands (DNKN), Pollo Loco (LOCO), McDonald's (MCD), Restaurant Brands (QSR), Wendy's (WEN), even higher in a couple of instances Domino's (DPZ), Shake Shack (SHAK), Wingstop (WING), lower in a number of "challenged" situations like Jack in the Box (JACK), Red Robin (RRGB), Brinker (EAT), Fiesta Rest. (FRGI).

The attraction of asset light franchisors revolves around the *presumably* free cash flow for franchisors, a steady stream of royalty income unburdened by capital expenditures to build stores. The operating leverage is at the store level. Franchisees are responsible for building the stores, then controlling food costs, labor, rent and all the other operating line items. Franchisors receive the royalty stream and have the obligation of supporting the system with brand development, site selection advice, marketing support, and operating supervision. These supporting functions, it should be noted, are optional to a degree, and we have written extensively about system support sometimes being short changed by corporate priorities such as major stock buybacks.

THE CURRENT WORD, IN THE FIELD, AS WE HEAR IT

We acknowledge that in every franchise system there will be some operators less satisfied than others. In the same way, customer reviews on Yelp or Facebook are more frequently written by critics. Bad news is more noteworthy and more customers are inclined to criticize than applaud, so we have to listen to the complaints but dig further for the reality. With that in mind, we hear the following from franchisees of various restaurant systems:

"I've been in this business for thirty years, and I've never seen it this bad. Everyone is making money but me; the landlords, the franchisor, the banks. My margins have been killed, and I'm up against my lending convenants".

"All the franchisors want to do is build sales to build their royalties. The dollar deals are trading people down. My franchisor doesn't care about my margins. I can't maintain my margins, especially with the increasing cost of labor, let alone build it".

"The franchisor is putting pressure on me to sell, even though I've always been considered a good operator, with high performance scores. I'm up to date on my development agreement, but they want somebody else to take me out, and the new buyer will agree to what I consider to be a ridiculously aggressive development contract".

"The franchisor has replaced experienced long term field support with lower priced (and inexperienced) younger people. They're cutting corporate overhead, but these kids, who never ran a store, are telling me to how to control costs.""

"I'm doing my best with the development objectives, but it is almost impossible to build stores with today's economics. Rents are too high, labor costs are killing me, and I can't raise prices in this promotional environment".

"As if things aren't tough enough, I'm being nickeled and dimed with demand for higher advertising contributions and fees on services (including software) that I thought would be provided".

The valuations provided to the publicly held companies do not reflect the situation as described by the admittedly anonymous franchisees. The commentators quoted above don't want to aggravate their franchisor, and we don't want to be unfair or misleading to particular companies by relying on just a few conversations, though they do support one another. For the most part, franchisees are strongly discouraged from talking to the press or investment community. The companies will say that "competitive" issues require some secrecy, but there are few secrets in this industry.

The *optimistic view, as represented by the valuations in the marketplace*, is that the comments above are not typical or representative of the health of the subject franchise systems. Allow me to provide a short story which leads to a suggestion.

A SHORT STORY

Twenty six years ago, in 1992, IHOP had just come public. I was a sell side analyst, thought the numbers were interesting and the stock was reasonably priced. The company, led by the now deceased CEO Kim Herzer, invited me to attend their franchisee convention, which I did. I obviously had the opportunity to interface with many franchisees and it was clear that, while all what not perfect, the franchisor was providing a great deal of support that was embraced by an enthusiastic franchise community. IHOP stock tripled over several years for me and my clients who owned millions of shares. I attended several more of their annual conventions and maintain some of those relationships to this day. Obviously, the conviction I gained from their open attitude was critical to the success of the investment. I should add, that many of those buyers in 1992 owned the stock for many years, not living and dying on quarterly reports.

THE SUGGESTION

As you are no doubt by now anticipating my suggestion to publicly held franchising companies: open up your franchisee conventions to the investment community. The companies may quickly respond that lenders are already invited to franchise conventions, but franchisees are unlikely to express their concerns system oriented concerns when they are making a pitch to a potential lender. . Companies may also respond that their lawyers think it would be a bad idea, not consistent with full disclosure and analysts would be getting “inside information”. Let’s not allow the lawyers to provide “cover”. A good lawyer will provide a solution to the problem, not just provide the pitfalls. Analysts attending a franchise convention are not being told what sales or profits are going to be. Attending a franchise convention is a “channel check”, no more than talking to a supplier or customer of a manufacturing company, which any decent analyst will do.

The anecdotal critical comments, as described above, have likely been heard by others, but may be atypical of most restaurant franchising companies. There are no secrets in this business. One of the investment appeals of this industry is its transparency. Notable news is going to leak out anyway. The objective of any publicly held company is to build stock ownership by well informed investors. Investment analysts pride themselves on their ability to “build a mosaic”, enhance the information provided in quarterly reports, SEC filings, and conference calls, with “channel checks”. What channel check would be more pertinent than meeting the franchisees of a company that is dependent on franchisee success? Putting it another way, and taking the highest valuation relative to EBITDA as an example: Wingstop (WING) is a company I have the highest regard for. However, you could call it irresponsible to pay almost *fifty times trailing EBITDA* for Wingstop stock (and I haven’t) if I couldn’t talk to franchisees *of my own choosing?*

There’s no particular need to invite this writer if I’m not considered influential enough. I have not spoken to these analysts on this subject, but qualified industry followers such as David Palmer, Nicole Reagan, Matt DiFrisco, David Tarantino, Jeff Bernstein, Andy Barish, Bob Derrington, Mark Kalinowski, Michal Halen, Howard Penney, Jonathan Maze, Nicholas Upton, John Hamburger and John Gordon provide the beginning of an invitation list. I rest my case.

Roger Lipton