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Cover Story

The principal owners of Quiznos, father-and-son team Dick and Rick Schaden, officially have put up the company for sale. During a time when private equity firms have and continue to gobble up restaurant chains by the dozen, it would seem a slam dunk for the duo. But franchisee unrest, pending lawsuits and a royalty stream securitization have some industry watchers wondering if the $2.3 billion asking price could be toast.

By Julie Bennett

Quiznos, the Denver-based sandwich chain, grabbed headlines in December when New York investment bank Goldman Sachs announced it had been retained to sell the company. The national media speculated that the selling price could be as high as $2.3 billion.

Quiznos' value is based on its growth. In the 15 years since it was purchased by father-and-son team Dick and Rick Schaden, the chain has grown from 18 units to more than 4,700 franchises worldwide. In January 2006, Entrepreneur Magazine ranked Quiznos as the third fastest-growing franchise company in the world (after Subway and Pizza Hut) and the June 27, 2005, edition of Nation's Restaurant News named it the fastest-growing sandwich chain in the U.S.

But that growth has a dark side. Franchisees we talked to estimate that only about 20 percent of Quiznos 4,200 U.S. operators are making $4,000 or more a month. One-third of all stores, franchisee association leaders said, are losing money and many operators told us they are about to lose their houses or fall into bankruptcy. So many franchisees complained to them about Quiznos high food prices and encroachment policies that the Federal Trade Commission recently launched an investigation.

In a telephone interview, Quiznos CEO Rick Schaden said the majority of his system's franchisees are profitable. "Our margins are above the industry average although, like most franchises we have a top, middle and bottom third of operators. The bottom group tends to be more vocal. What is challenging is that we have many single-unit operators and we don't know how much debt they have. Sometimes such owners have fewer resources to fall back on."

Quiznos sells new franchises by hosting Business Ownership Seminars in conference rooms around the country. Prospective franchisees, the majority of whom are immigrants or first-generation Americans, pay a $25,000 franchise fee and agree to open a restaurant within 12 months. If they fail to open a store, the fee is non-refundable. Critics claim that hundreds of people have lost their payments by not opening stores; Schaden says the numbers are lower and that most of the 3,000 or so people "in the pipeline" will eventually open stores.

Like all franchises, Quiznos must include financial statements in its Uniform Franchise Offering Circular. But just before issuing their 2004 and 2005 UFOCs, the Schadens reorganized and renamed their company, publishing only a few weeks' worth of numbers from each new entity. The 2005 UFOC, however, does state that in February 2005, the Schadens put together a securitization of Quiznos future royalties. They borrowed $250 million from five large investors and will pay the money back with royalties their franchisees pay during the next 99 years. Schaden said the securitization "was just another way to borrow money" and that "it was cheaper than a bank loan."

The transaction, arranged by investment bank Lehman Brothers and the law firm of DLA Piper, was done so quietly that most of the people we spoke to in the franchise finance field were unaware it had occurred. One industry insider, who asked not to be named, speculated, "Because the numbers were so big, company management didn't want them thrown around. The franchisees might have felt they were being taken advantage of."

Encroachment, labor and the price of mozzarella

Quiznos grants no exclusive territories and their UFOC states: "We and our affiliates may establish other franchised and company-owned units anywhere we want that compete with you." Like many national franchisors, Quiznos sells franchises through area directors who are paid 50 percent of the initial franchise fee, half on receipt and half upon opening, and 40 percent of the royalties of each unit they sell.

The area directors conduct those Business Ownership Seminars and negotiate directly with prospective franchisees. Many of the complaints that triggered the FTC investigation have to do with statements made by area directors prior to a sale. Schaden said Quiznos is cooperating with the investigation.

Kelly Emerson said, "I was in construction project management and my husband and I wanted something to use for retirement income. We thought Quiznos product was excellent and in June 2003, we opened a franchise in a strip mall, right off a major highway, in the Detroit suburbs. After a year, we were breaking even and our sales put us in the top 20 percent of stores in our region.

“Before we made our investment, the area director told us they keep four miles between stores. A new store opened two miles from us and our revenues stopped growing. What they told us our food and labor costs would be was totally unrealistic. I’ve been working for free going on three years and our store is now for sale. About 85 percent of all the Quiznos in this area are on the market and I’ve met with franchisees from other states who tried to give their stores away and couldn’t. I feel like I’m in one of those old pyramid schemes.”

Glenn Keane, the former purchasing manager of a computer reselling company, said, “When my wife, Anne, and I met with our area director, he said our store, in Derby, Conn., could expect a 16 percent to 18 percent profit margin. Quiznos requires us to buy all food items through their distributors and their food costs are exorbitant. The UFOC says that the company receives rebates from its suppliers and we figure this adds to the price of their food.”

“To find out, I shopped around locally and discovered I could get the same quality products for less. For example, they were charging $84.87 for a 900-piece carton of bacon strips. I found the same quantity for $66.78. Mozzarella cheese is $1.82 a pound through their distributor, $1.54 locally.

“Their business model says that crew labor should run 13 percent of sales, but ours was much higher. I finally realized that they based their numbers on wages of $6.15 to $6.50 an hour. In Connecticut, the minimum hourly wage is $7.10.

“Although Derby is the smallest city in Connecticut, Quiznos allowed a second franchisee to open here last summer. My sales dropped from $15,000 a week to $8,000 and since then, I’ve taken out no money for myself. We had to put in a $10,000 equity injection to keep going.”

Schaden said Quiznos’ food and paper costs are “a little lower than the average for the industry. New operators often have trouble controlling costs.”

Schaden said he, too, had heard criticisms about stores being built too close together. “Encroachment is a big challenge in our business. We’re a convenience item and we’re putting restaurants where consumers can grab a quick lunch. In the country that may be four miles apart, but in the city it may be every five blocks. When you look at the overall numbers, we have a lot fewer restaurants in any market than Subway, McDonald’s or Burger King.”

But do other franchisees make more money?

According to Technomic, a Chicago-based restaurant research firm, average unit volumes for Subway in 2004 were $370,000; Quiznos were $430,000. But Subway owners, some Quiznos franchisees said, make more money because their food costs are lower.

Jehad Majed, who opened a Quiznos in Dearborn Heights, Mich., a year ago, said, “I do $10,000 to $13,000 a week in sales and I don’t make anything. It’s embarrassing. I pay myself $500 a week and at the end of the month my dad, who’s my partner, and I pull out $3,000 for both us. The week my buddy with a Subway store did $13,000 in sales, he made a $4,000 profit. His food and paper goods average 24 percent to 27 percent a week; ours are 30 percent or more.”

Schaden said food and paper costs for Quiznos run 28 percent to 35 percent of sales and that the chain is beginning a new program in 2006 to help franchisees “manage and control variable food and labor costs.”

How about two stores for the price of one?

According to their 2005 UFOC, Quiznos had 3,334 stores open at the end of 2004. Ten percent, or 334 stores had transferred owners, 118 franchisees were terminated and another 116 operators closed their doors and left the system. Before franchisees walk away, they try to sell their units and the Internet lists dozens of Quiznos for sale.

The Sunbelt Business Brokers site, for example, advertises 55 Quiznos, with asking prices of $80,000 to $350,000. Bob Baber and his wife, Ratti, opened two Quiznos in Long Beach, Calif., in the late 1990s and made money, Ratti said, “until the development team allowed other stores to open nearby and cannibalized our market.” They closed one down and just managed to sell the second.

Baber said, “If you look at the published selling price of $2 billion for 4,000 stores, that means each store is worth $500,000. But we owners can’t get $150,000 for a store, or half of what we paid for it. We’re the ones with everything to lose. We’re like indentured laborers.”

Schaden said the number of stores on the market “is where it ought to be. There’s a lot of turnover in small-business franchises and after a period of time, many of our owners want to leave, take their money off the table, and do something else.”

Like many Quiznos operators, the Babers were not born in the United States. In August 2004, franchisees formed the Quiznos Franchisee Association, “so we could speak with one voice,” Ratti Baber said. “But everybody is afraid that if they join the association, Quiznos will terminate them.” When we called a Pennsylvania franchisee from India he said, “Don’t use my name. I’m scared of what they might do to me. I might lose my house.”

Schaden said Quiznos keeps no statistics on how many of its franchisees are immigrants. “There’s no question that we have a lot of new Americans in the chain. They make great franchise owners,” he said.

The lucky ones

Attorney Justin Klein, of Marks & Klein in Red Bank, N.J., represents 17 New Jersey residents who paid the $25,000 franchise fee and failed to open stores within a year. Their case is now in arbitration and he will not talk about it. But he called the people who forfeited their franchise fees “the lucky ones, because the ones who have opened up are losing hundreds of thousands.”

David Leonard of Woodridge, Ill., was one of about 120 Illinois residents listed in the 2005 UFOC as having paid a fee but not opened a store. “The area director made empty promises. At the seminar, he showed me a big board with lots of sites, but after I chose one, he said it wasn’t available,” Leonard said. “Then he offered a site that was just a piece of land. That’s when I really lost confidence.”

Leonard, who also lost his $25,000, said, “The whole thing left a bad taste in my mouth. I liked the food at Quiznos, but now I can’t even go there to eat.” Les Winograd, a spokesman for Subway, said that chain does refund its $15,000 franchise fee if someone can’t find a suitable site.

A former area director, who asked not to be named, said, “Since our payment comes from a share of the royalties, we had motivation to get new stores opened. As markets became more saturated, especially in metro areas, it got harder to find sites.”

In 200-2004, Quiznos signed three times as many franchise agreements as it opened new stores. At the end of 2004, the pipeline of unopened stores was 3,003, and 1,457 of those were agreements signed in 2003 and in danger of termination. “Of the 3,003,” Schaden said, “1,000 will have new sites open in the next nine to 10 months. About another 1,000 are ‘green stores,’ that will go into real estate that is yet to be built. The last 1,000 are either current operators who had signed up for additional stores and haven’t opened them yet, or people who have had a life change since signing the agreement. We extend agreements rather than terminate them” He would not reveal how many people have forfeited their fees, but said that the backlog of unbuilt stores had been reduced to 2,940 at the end of 2005.

Another person called at random from the list in the UFOC, Susan Golubski, said she did open a store, in Belvidere, Ill., in July 2005. “I’m breaking even and I don’t need to make money until I’ve been open a year. Quiznos has a good product, and I’m happy to sell it,” Golubski said.

Klein also represents the Toasted Subs Franchisee Association, organized by Christopher Bray, a Texas franchisee. Like the Quiznos Franchisee Association, the group has attracted a few hundred members. Klein said he expects to soon file “a major lawsuit” on behalf of Toasted Subs members. Franchisees in Toronto, Canada, have also proposed a class-action lawsuit, claiming that Quiznos practice of not refunding the franchise fee to people who never open stores violates Ontario Franchise Law.

The $24 difference

Lawsuits are not new to Quiznos. The 2005 UFOC lists 12 actions, including two settlements of lawsuits arising out of the transformation of Quiznos from a public to a private company. The Schadens took their company public in 1994, but soon regretted the decision. The small-cap stock attracted no attention from analysts and traded in the $6 to $8 range. In 1999, the men, who own two-thirds of the shares, tried to buy out the other shareholders, at $8 a share.

The shareholders, which included Dallas investor William Fagan, turned down that and subsequent offers until the Schadens simply outvoted them, and, in late 2001, bought the company back at $8.50 a share, a price that pegged its value at about $25 million. Fagan and other dissenters claimed the Schadens knew the company was worth more and sued. In January 2004, a judge ruled they should be paid $32.50 a share for their stock. Jay Horowitz, of Horowitz, Wake & Forbes of Denver, said that the former wives of both Rick and Dick Schaden, who had been substantial stockholders, also sued and negotiated settlements.

So what is this company worth?

The earlier dispute over value caused several industry insiders to question how much Quiznos is really worth today. According to The Wall Street Journal, the $2.3 billion pricetag was based on Goldman Sachs' suggestion that Quiznos EBITDA (earnings before interest, taxes, depreciation and amortization) of $135 million could attract a price of 11 to 17 times that figure. Dunkin' Brands sold in December for $2.43 billion to a trio of private-equity firms.

"If Quiznos value jumped from $25 million to over $2 billion in four years, that puts the company's growth on a par with Google," said Adam Landa, vice president of Harpeth Capital in Nashville.

David Epstein, principal of the J.H. Chapman Group of Rosemont, Ill., said, he questioned a valuation that puts Quiznos' price close to Dunkin' Brands, which has three concepts—Dunkin' Donuts, Baskin-Robbins and Togo's —and around 12,000 units. Quiznos has only two company-owned units. Epstein said he feels that valuable franchise companies are about one-third corporate owned, "so management can see how something like couponing affects their stores as well as their franchisees."

Allan Hickok, a restaurant consultant in Minneapolis, called the price "obscene, especially if they've done a royalty securitization." Securitizations are a means of borrowing money today and paying it back out of a sure source of future income. The federal government's Fannie Mae and Freddie Mac programs, in which pooled mortgages are sold off to investors, are a form of securitization. In Canada, four public franchise companies securitized their royalty streams several years ago.

The only major U.S. franchisor to successfully complete a securitization was Arby's, whose executives said they wanted the funds for expansion. As with any loan, securitizations can be paid off early, and Arby's did that last year.

Schaden would not comment on Quiznos' finances, but said that if the company were sold, "the securitization could be paid off or taken into the new company," just like any other debt. He would also not comment whether two large Quiznos suppliers, American Food Distributors and Source One Distribution, now owned by Schaden and his father as part of a family holding company, Cervantes Capital, would be included in a possible sale.

Most of the franchisees we talked to support the sale. A franchisee in Ohio, who asked not to be named, said, "There's a huge opportunity out there. With the right leadership and the right approach, this could be an outstanding concept."

But for others, the sale will be too late. Rita Atikian, whose family bought two Quiznos, in Livonia and Macomb, Mich., said, "It was the biggest mistake I ever made. We've been drained of our inheritance, my 401(k) and my savings account. We closed one store in early January 2006, after we got behind on our sales tax, rent and loan payments. We're trying to sell the other one, but once a banker sees my financials, he won't approve a loan to a new buyer. If I can't at least sell the equipment from the other store, I'll have to file for bankruptcy.

"I'm not a dumb person and I did a lot of research before getting into this," Atikian said. "I kept reading that Quiznos was one of the fastest growing franchises. So I trusted them."