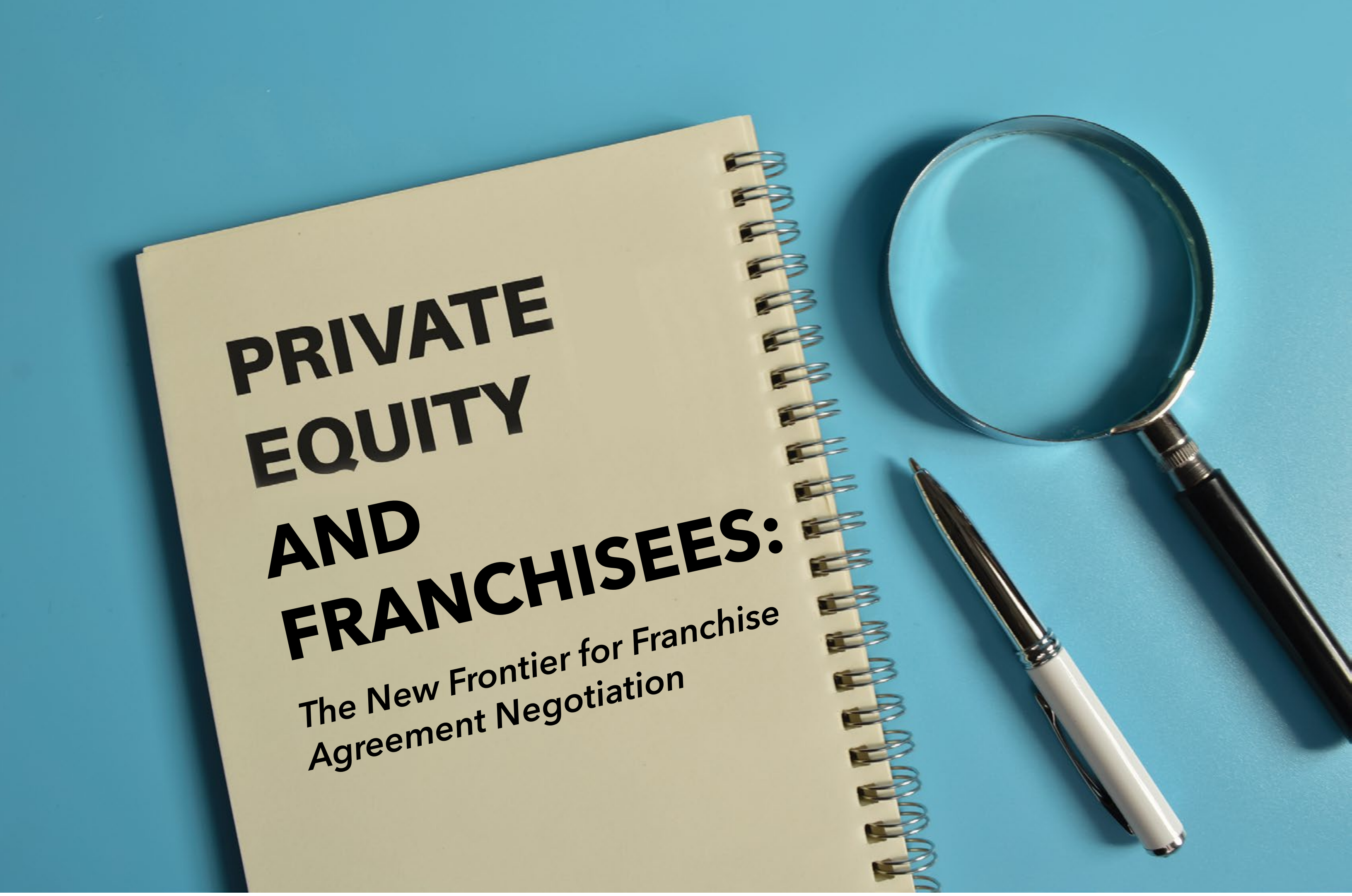
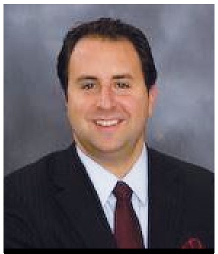


# PRIVATE EQUITY AND FRANCHISEES:

## The New Frontier for Franchise Agreement Negotiation



by Justin Klein

Private equity is not new to franchising. Indeed, many firms have sought out investment opportunities in the franchise space, including in some of the largest and most well-known brands. Historically, however, the focus by private equity has been primarily on franchisor-owned – as opposed to franchisee-owned-businesses. Yet, in recent years, private equity firms have increasingly turned their attention to franchisee-owned businesses as a viable investment strategy because of scalability, predictable cash flows and brand strength.

Strikingly, franchise agreements, which are typically one-sided agreements in favor of the franchisor, have not evolved in line with investors such as private equity investors and include several provisions that private equity firms would typically not agree to in other investment opportunities. As such, these agreements must be negotiated carefully to protect capital, align interests, enable growth, allow for transferability amongst investors in the fund, and permit the best opportunity for a profitable exit. Balancing franchisor and private equity investor interests can be challenging, and it is critical to be mindful of each side's interests before a private equity investment is made.

### Relationship Between the System and the Franchise Agreement

Before entering a franchise system, private equity firms must fully understand the franchise model they plan to invest in and how it operates. While franchising is referred to as an "industry" and is regulated uniformly on a national level, there are vast differences in how franchisors function.

Likewise, there can be significant differences in the terms of a franchise agreement from one system to another. As such, it is critical to appreciate what constraints such agreements may have especially as it relates to the goals of the private equity investors. For instance, franchisors typically retain the right to approve key decisions and may limit changes to branding, suppliers, marketing or transfers of the business assets or equity. So, operational control is often limited.

The fee structures are also unique, often including an initial franchise fee, ongoing royalties based on revenue, marketing contributions and renewal fees. In addition, territory rights can be exclusive, semi-exclusive or non-exclusive. Finally, termination and renewal clauses define how long the agreement lasts, and the conditions under which it can be terminated or renewed. Private equity firms must assess how restrictive these terms are and how they might impact growth strategies.

### Due Diligence Efforts Must Be Meaningful

Prior to negotiations, private equity firms should conduct comprehensive due diligence on both the franchisor and the franchise system. This involves reviewing the franchisor's financial stability and whether they are actively reinvesting in brand development, support systems and innovation. Understanding the financial health of the franchisor is critical as it directly affects the long-term viability of the investment.

The performance of current franchisees is another crucial factor. Metrics such as average unit volume, margins and unit-level economics give insight into profitability and operational efficiency. Legal due diligence is equally important; any history of litigation, disputes or regulatory issues must be reviewed carefully.

A thorough analysis of the Franchise Disclosure Document (FDD) is essential, as it outlines key information, including the franchisor's background, financial performance representations, litigation history and fee structures. The FDD also includes contact information for all current and former franchisees, which information can and should be used to engage with as many as possible to gain insight into their experience with the franchisor. Engaging legal counsel that specializes in franchise matters is also strongly advised.

## Identifying the Structure and Goals

A clear investment thesis provides the foundation for a negotiation strategy. Some private equity firms invest with the intent to scale a single brand across a region, while others seek to build a multi-unit, multi-brand platform. Certain firms may focus on acquiring underperforming units and improving operations, while others aim to exit through a resale to another investor or via public offering.

The capital structure used – whether through a direct investment, a portfolio company or a roll-up of units – may influence negotiated terms. A private equity firm acquiring dozens of stores will have very different priorities from one operating a single location. For instance, large-scale investors may need flexibility around unit transfer, rights of first refusal in new territories and more robust development terms.

## Negotiating Terms of the Franchise Agreement

While smaller operators may have less leverage to meaningfully negotiate franchise agreements, private equity firms often bring substantial capital, operational sophistication and growth potential to justify more flexible terms. Critical provisions to focus on include territorial protections, transferability, development commitments, performance standards, royalty or fee structures, and franchisor obligations.

Territory rights should be negotiated to ensure exclusive or protected markets, helping avoid cannibalization from nearby franchisees or corporate stores. It may also be wise to secure rights of first refusal or options for expansion into neighboring regions. Transfer provisions must allow for smooth exits or ownership changes. Private equity firms should ensure that transfer fees are reduced or waived for exit events and that pre-approval of successor ownership is included.

Development schedules must be realistic and aligned with available capital, market conditions and build-out timelines. Aggressive requirements can lead to defaults and potential loss of the rights. Performance metrics should be grounded in market realities, with grace periods and room for adjustment. Royalties and fees – especially for multi-unit operators – should reflect economies of scale. Negotiating reduced royalty rates, temporary fee abatements for new stores, or tiered structures can materially impact profitability.

## Franchise Counsel Should be Part of the Team

Given the complexity and specificity of franchise law, private equity firms should engage attorneys with experience in franchise negotiations. As a matter of practice, general corporate counsel may overlook industry-specific nuances or spend time, energy and money on terms that would be market for other types of relationships but not common in a franchise relationship. Counsel should provide the client with guidance on unfavorable provisions and develop a negotiating strategy based on the growth and operational expectations of the fund, which may include other investment opportunities that may impact certain provisions such as restrictive covenants.

## Prepare for Exit

From the outset, private equity firms must ensure their franchise rights are structured to allow for a smooth and profitable exit. This means negotiating transfer rights that allow for the sale of franchise units or development rights without unnecessary or over-restrictive hurdles. Such provisions may restrict transfer, require obstacles to approval, or impose new terms on the purchaser that may be significantly less favorable, which can impact price on exit.

## Things to Consider in Franchise Negotiations

Despite their investment expertise, private equity firms unfamiliar with franchising can miss critical issues inherent in the franchise relationship. A main misconception by private equity investors new to franchising is the nature of the relationship between franchisor and franchisee. That is, private equity investors are often skilled and experienced in various industries but decision making in the operation of the franchise is often dictated by the system standards of the franchisor. Thus, the private equity investor will be largely restricted in certain decisions that they may be used to controlling in the other business relationships. How the franchise agreement and the enforcement of same is handled could impact the fund from achieving its investment goals.

Another potential pitfall is failing to ensure that business terms, such as fees, are clearly defined and fixed during the term. Oftentimes, franchise agreements include provisions that entitle the franchisor to modify fees or expenses charged to the franchisee at the franchisor's discretion. Locking in those fees is especially important for planning purposes to manage cash flow.

## Conclusion

As in any business relationship, the agreements governing said relationship must balance against the contracting parties' goals. In the franchise relationship, goals of the franchisor and franchisee may not always be aligned. Having a clear and well-negotiated franchise agreement can help avoid disputes or unaligned expectations. This is especially so for private equity companies that may not be experienced in franchise investments. Completing appropriate and meaningful diligence, engaging experienced counsel and having a clear and reasonable growth plan will help to avoid situations that could cause tensions between the franchisor and franchisee. Having a clear and well-negotiated franchise agreement will also help to maximize the success of the private equity investment.

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