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# RESTAURANT BUSINESS

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## NAVIGATING FRANCHISING TODAY P.42

## + 10 MARKETS TO WATCH P.50

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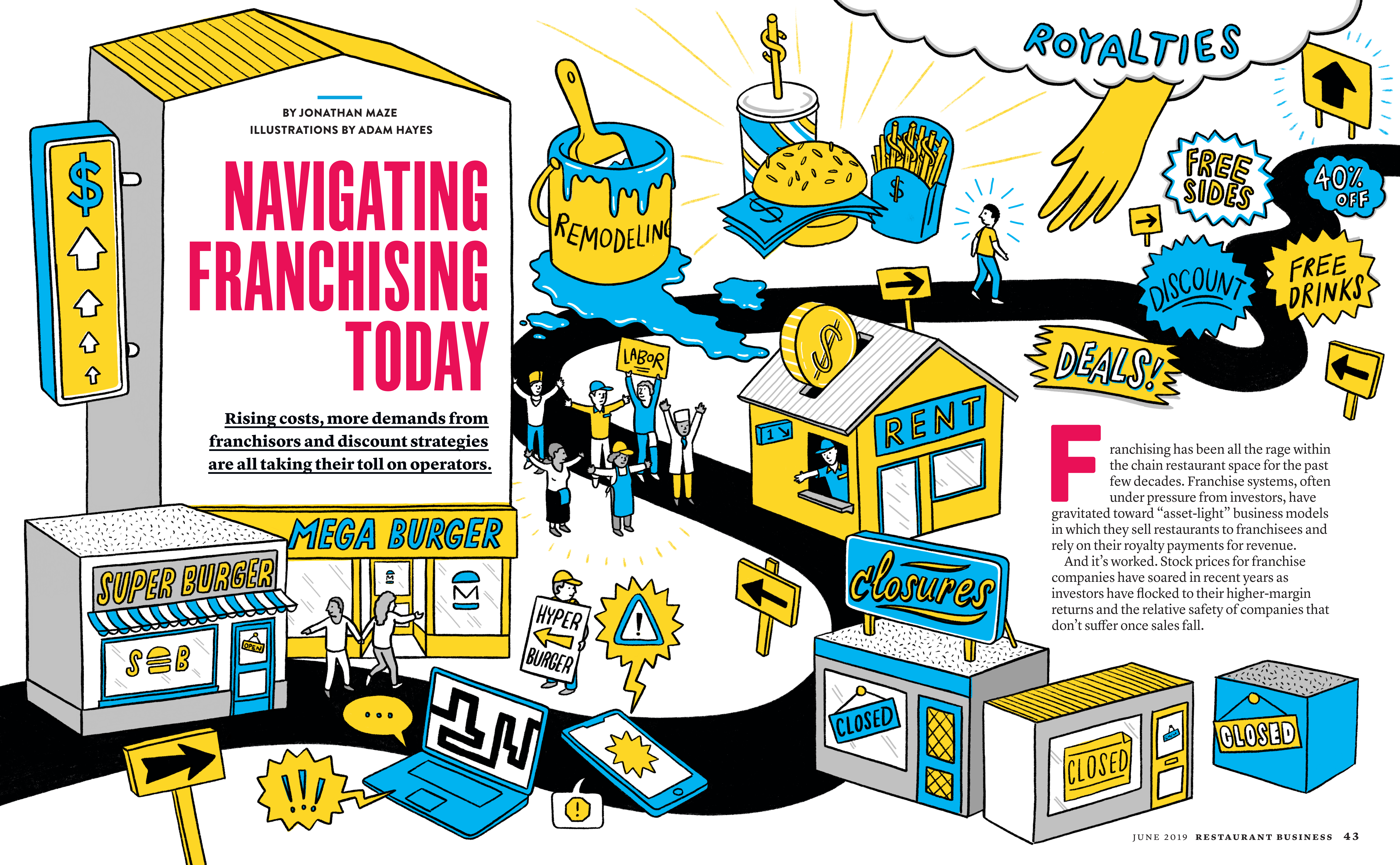
# NAVIGATING FRANCHISING TODAY

**Rising costs, more demands from franchisors and discount strategies are all taking their toll on operators.**




Franchising has been all the rage within the chain restaurant space for the past few decades. Franchise systems, often under pressure from investors, have gravitated toward "asset-light" business models in which they sell restaurants to franchisees and rely on their royalty payments for revenue.

And it's worked. Stock prices for franchise companies have soared in recent years as investors have flocked to their higher-margin returns and the relative safety of companies that don't suffer once sales fall.

Yet there are growing signs of stress on the franchisees that have been tasked with operating these restaurants. Operators in many systems are closing locations, forcing franchisors to take more desperate measures to keep stores open. Franchisees in many cases are pushing back against these moves more aggressively: filing lawsuits, forming associations and even calling for new leadership.

Many see the current operating environment, as well as the all-franchising strategy many companies have adopted, as unfriendly toward franchisees. “We are operating in an environment today of 3% unemployment, quickly increasing wages, more complicated operations, too many restaurants that have been built and ever-changing remodel demands,” says Keith Miller, a Subway operator and franchisee advocate. “It’s a perfect storm squeezing the margins of franchise owners.”

At the same time, however, that perfect storm might be an unfortunate reality of today’s competitive landscape.


## OPERATING IN A TOUGH MARKET

**Signs of stress among franchisees have been everywhere in recent months, especially among chains with smaller operators and low unit volumes.** Subway franchisees have closed 2,000 locations over the past two years as the chain’s sales have struggled. Dickey’s Barbecue Pit operators closed 44 locations in 2018, leaving it with a total of 526 stores and leading to a 7.4% reduction in system sales last year, according to Technomic data. Over the past two years, operators of take-and-bake pizza chain Papa Murphy’s have closed 137 units, or 9% of the chain’s locations. It now operates 1,400 restaurants and has been taken private by Canadian franchisor MTY.

It’s not just the small restaurant operators, either: NPC International, which operates more than 1,200 Pizza Hut and Wendy’s units, recently had its credit downgraded by both Moody’s and S&P 500. The credit ratings agencies both cited a combination of high capital costs and weak operating performance. Moody’s, for instance, cited NPC’s “high leverage and modest interest coverage driven by weaker operating trends and cost inflation related in part to labor and wages, commodities and pricing.” It also noted its “high level of capital investment, including relocations, new units and remodel initiatives.”

McDonald’s franchisees have seen their cash flow decline by $30,000 per store over the past two years, company CFO Kevin Ozan told investors in January. This happened despite improved same-store sales both years as the chain increased average check. “That original algorithm of, ‘If you get check, you should be able to grow cash flow’ is under more stress these days,” Ozan said.

McDonald’s franchisees formed the independent National Owners Association last year, and the company has worked to address operator concerns—cutting some items from the menu, for example, and giving franchisees more time on some remodels. Tensions between the franchisor and franchisees have eased since.

“If I go back to 2018, [there was] a lot of change, a lot of disruption in the marketplace for us,” Ozan said. “We’re asking the franchisees to put in fresh beef, to adopt a new value platform, to add restaurants on delivery and to invest their money in [remodels]. At the same time, their cash flow has been going down for at least a couple of years.”

Jack in the Box operators were more aggressive, passing a vote of no confidence in management, calling for the replacement of CEO Lenny Comma and then suing the franchisor.

Operator cash flow is again a concern. “A lot of guys are really struggling financially,” said Michael Norwich, chairman of the National Jack in the Box Franchisee Association, earlier this year.

## AN ERA OF REFRANCHISING

**To be sure, franchisors themselves have been under a lot of pressure. Sales challenges have puzzled many management teams.** Quarterly earnings reports often force short-term decisions at publicly traded companies, which must often answer to activist investors if they don’t perform. And many CEOs have short life spans at the top of their companies, giving them little time to see changes through.

“I think it leads to a tension between building a long-term service model that attracts and retains customers, and a short-term cash-flow generator that produces the earnings that the Street wants,” says Kevin Burke, managing director of Trinity Capital. “I think that’s extremely difficult for franchise executives to be dealing with that tension.”

For years, investors have pushed franchisors into a specific operating model, one that de-emphasizes store operations and emphasizes franchising. For much of the past 15 years, refranchising strategies have dominated publicly traded restaurant companies. While franchising generates less revenue, because franchise systems take only a small percentage of sales as a royalty, the margins are much stronger, as the company doesn’t have to pay for new buildings, hire mass numbers of employees or incur other expenses franchisees pay.

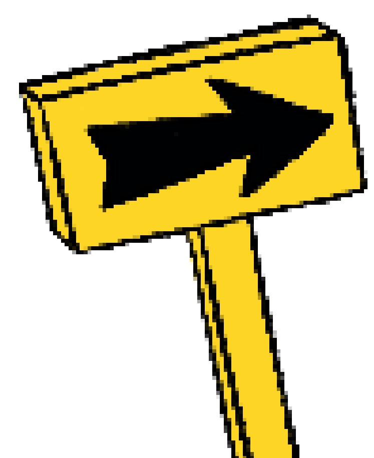
As an example, Burger King refranchised nearly all of its U.S. restaurants from 2011 to 2013. Company restaurant sales fell from $1.6 billion in 2011 to $223 million in 2013, and total revenue over that period was cut in half. Operating income during that period, however, increased to $234 million from $88 million.

Jack in the Box, Wendy’s, Yum Brands and even McDonald’s—which had long resisted refranchising demands—all sold off company stores. Restaurants operated by the 50 largest franchise systems, according to Technomic’s *Top 500 Chain Restaurant Report*, declined by 4.4% over the past two years—even as those systems’ total unit growth increased 1.4% over that period.

But franchising doesn’t necessarily mean better sales. Median sales growth over the past two years for franchise systems on Technomic’s Top 500 was 3.4%. For nonfranchised systems, that growth was 8.2%.

And chains are far more likely to refranchise restaurants when their own company operations struggle. Luby’s Inc. is refranchising its Fuddruckers chain, where same-store sales have declined nearly 9% in the first half of its 2019 fiscal year. Struggling chains such as Famous Dave’s and Papa Murphy’s have also refranchised stores. “They do it because they don’t have a better alternative,” says John Gordon, a restaurant consultant based in San Diego. “Really, it’s a bearish symbol.”

**“If you operate restaurants, as a franchisor, it doesn’t mean you have an operating culture. If you don’t operate restaurants, it doesn’t mean you can’t have one.” —Kevin Burke, Trinity Capital**



## THE CHALLENGES OF REFRANCHISING

**Some investors have been pushing back against these strategies.** Jim Chanos, an investor known for betting against stocks—known as short selling—famously bet against franchise stocks in 2018, including Dunkin’ Brands and Burger King owner Restaurant Brands International. His conclusion: Passing on the responsibility for operating restaurants onto franchisees is a losing bet over the long term.

Critics have long said that refranchising strategies distance the corporate office from store operations, intensifying tension between franchisors that make money off the top line and franchisees forced to make profits off those sales.

Burke, for his part, believes that any franchising strategy can work as long as the franchisor is cognizant of operator profits. After all, franchisees that make money are more likely to expand. “If you operate restaurants, as a franchisor, it doesn’t mean you have an operating culture,” Burke says. “If you don’t operate restaurants, it doesn’t mean you can’t have one. It’s important for asset-light franchisors to be staffed with executives that are steeped in operating experience and culture.”

Another part of the asset-light strategy

## 3 QUALITIES OF A GOOD FRANCHISOR

What should franchisors do to have good relationships with their franchisees? We took this question to a pair of experts, franchisee attorneys Adam Wasch of Florida firm Wasch Raines and Chad Finkelstein of Canadian firm Dale & Lessmann. They gave us three best practices for maintaining a positive, productive relationship.

### 1 FAIRNESS

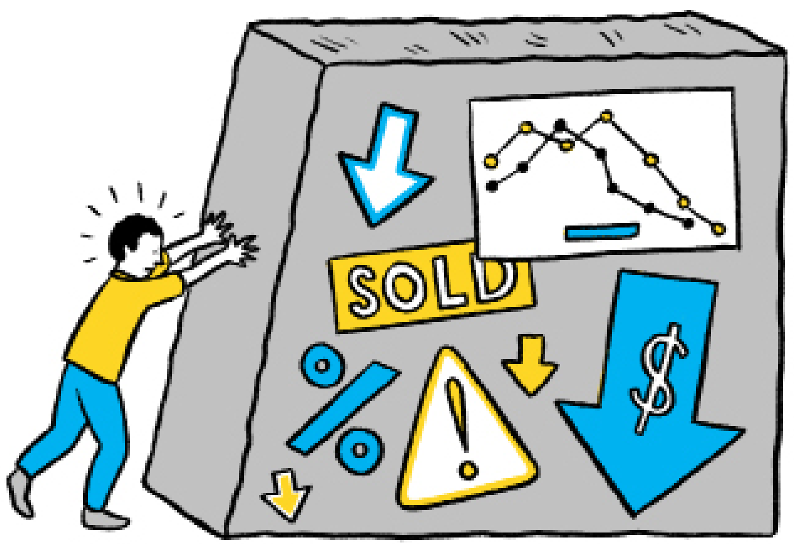
Good franchise systems work to support struggling franchisees, even at good corporate expense, says Finkelstein. “They avoid litigation because they treat franchisees like actual partners and not royalty streams,” he says.

### 2 CONSISTENCY

Wasch said management consistency is important in good franchise systems. “Turnover often causes a break in communications with franchisees,” he says, recommending that franchisors ensure there isn’t a revolving door in the corner office.

### 3 TRANSPARENCY

Franchise systems have to be transparent with owners. Good ones provide as much information as possible. Domino’s, for instance, is one of the only systems to publicly report operator cash flow.




has led to pushback: Some franchisors have made cuts to corporate overhead, which has often led to a reduction of services provided to franchisees. Jack in the Box, for example, is being especially aggressive with its plans to cut its corporate overhead to just 1.6% of revenues. This followed a long-term refranchising strategy that saw the brand shift from 80% company-run in 2004 to 6% company-run by 2018.

Operators began pushing back against those cuts last year, blaming them for the chain's weakening performance and franchisees' own struggles. "They're cutting personnel that are beneficial to the brand health and franchisee health," Norwich said last year.

Gordon believes Jack in the Box refranchised too many restaurants and can't afford to fund sufficient franchisee support. Now, he says, the corporate team can't run the brand, so franchisees are resisting. He believes restaurant chains should have a healthy dose of company stores to provide enough support to the franchisee base, as well as to develop talent that can support the system into the future. "If I was putting together a best practices handbook, I'd say that the amount of company stores needs to be material, so you have infrastructure in place," he says.

## COST PRESSURES

**Franchisees have to make do with less, once they do operate a store.** That's because a percentage of their revenue is automatically paid to the franchisor in the form of a royalty, about 5% to 6%. And then they have to contribute to the ad fund, another 3% to 4%. Thus, a franchisee is working with only about 91% of revenues. That makes them particularly prone to cost challenges and can cause problems when certain costs rise or when sales stagnate.

Both of those challenges are happening now: Same-store sales in many chains have been weak for three years. At the same time, labor costs are skyrocketing.

To add to the difficulties, there are also demands for new units and for remodels. Franchisors are urging operators to add more locations. According to a survey of franchisees by TD Bank, 71% of operators say they are under pressure to expand. More than half also said they plan to remodel restaurants this year.

Remodels are essential in any system. "It's tremendously important to have updated stores," says Mark Wasilefsky, head of the Restaurant & Franchise Finance Group for TD Bank. "There's a capital cost associated with that."

And the cost of many projects is on the rise, especially as delays have become more common. "Construction costs have been increasing about 1% a month for a couple of years now," Burke says. "The cost of developing and remodeling has quietly snuck up on everybody."

## WOES OF DISCOUNTING WARS

**On top of all these costs, restaurant companies have been aggressive in pushing discounts to get customers to come in the door.** This has been especially true among burger and pizza chains, where the market is very competitive.

While this strategy may bring guests in during the promotion, it hurts margins for franchisees running the stores. An example comes from Carrols Restaurant Group, which operates more than 1,000 Burger King locations. This February, it offered the deals its parent brand deployed in late 2018: $1 10-piece chicken nuggets, a $6 King Box, a two-for-$10 Meal Deal and a $3.49 King Deal. The promotion did help the company increase same-store sales 2.7% in the fourth quarter. But its profit margins declined by 141 basis points.

The trend of shrinking margins will only continue, according to lenders. "We do see some margin compression across the board," Wasilefsky says, noting that franchise margins are roughly 8% to 12% and thinning.

But might discounting be a necessity in today's market? Jack in the Box had been avoiding such promotions for some time, only to see its same-store sales stagnate. Same-store sales in the quarter that ended Jan. 20 underperformed its market by 320 basis points. That forced the company to change its direction. "Half of our customers are value-oriented," CEO Comma said in February. "We have to present something to them."

Wasilefsky argues that franchise systems need value meals and discounts to remain competitive, and says many lenders understand this and know that profits will thin in the short term.

"As lenders, we accept that," Wasilefsky says. "We accept margin pressure. Companies are selling product cheaper, and they're paying people more. But folks attacking this most aggressively are the ones who are going to win."