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Why Valuing Franchise Businesses is Different from Valuing Other Businesses

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It is estimated that franchising accounts for more than 40 percent of all retail sales in the U.S. with one out of every twelve retail establishments being part of a franchise network. According to a 2004 study done for the International Franchise Association, the 767,483 franchise businesses operating in 2001 employed an estimated 9.7 million workers and produced output of $625 billion. Franchising has even greater economic impact than is indicated by the activity in franchised businesses alone. Franchised businesses stimulate additional economic activity of non-franchised suppliers through their own purchases and those of workers on their payrolls.

Valuation professionals should be aware that franchising encompasses a variety of business arrangements that generally fall within two categories: product and trade name franchises and business format franchises. Product and trade name franchises include arrangements in which franchisees are granted the right to distribute manufacturers' products within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark.

Examples of product/trade name franchises include automobile dealerships, gasoline service stations, soft drink bottlers, and farm equipment dealers. Until the mid–1970s, gasoline stations epitomized the typical business franchise. But the oil shocks of the 1970s, together with significant changes within the oil industry in general, reduced the number of gasoline franchises by half. Although product/trade name franchises continue to account for a large portion of all franchise sales, they now represent a far smaller percentage of all franchise businesses.

The business format franchise is a newer development that generally incorporates trademark licensing with the conveyance of a business format or an entire business system to franchisees. The franchisee is required to comply with the franchisor's guidelines governing the operation, appearance, and location of the business. The quality of the products or services provided by the franchisees is typically controlled by the franchisor. The most common examples of business format franchises include restaurants, fast–food establishments, hotels, real estate agencies, convenience stores, and automobile service centers. Clearly the fastest growing segment of franchising, business format franchises account for more than 75% of all franchise businesses. These two types of franchises are quite different.

Many economic studies have examined the franchise phenomenon. Most of these focus on the franchisor's motivations which are basically to establish a rapid market presence, to obtain off balance sheet financing, and to expand and exploit their trademark and goodwill. Some have cynically noted that firms offer franchises when the cost of monitoring management is high.[1]

With franchising such a ubiquitous force in the economy, sooner or later the valuation practitioner can expect to encounter situations involving franchises. It may come up in estate and succession planning, in annual valuations for ESOPs or buy/sell agreements, or to set and justify an asking price for potential buyers. It may also come up in more contentious areas like the computation of damages in franchise litigation or arbitration, or in matrimonial disputes. However, there is precious little information available about franchise valuations. For example, the vast NACVA database has no valuations that are franchise specific and CCH's massive "Business Valuation Guide" does not even have the word "franchise" in its index and has nothing on valuing franchises in its tens of thousands of pages.

Franchise Valuations Are Not the Same

Some scholarly analyses of how franchises differ from other businesses, with extensive data and graphs, may be found in the following:

- Nevin Sanli and Barry Kurtz, "Appraisal of Franchises Requires the Use of Unique Valuation Procedures," *Franchise Law Journal,* Vol. 26, Number 2, Fall 2006, p.67; and
- E. Hachemi Aliouche and Udo Schlentrich, "Does Franchising Create Value? An Analysis of the Financial Performance of US Public Restaurant Firms," from the William Rosenburg International Center of Franchising at the University of New Hampshire.

One important thing should be noted: when using the "market" or "comparable sales" method of valuation, a practitioner should be aware that the best, and often only, repository of comparable sales information within the same franchise system is the franchisor, which has a right of approval with respect to any transfers. This data is generally not available in Biz Comps or Pratt's Stats and frequently the franchisors are reluctant to provide the information. And considering that valuing a franchise business can be very different from valuing other businesses, valuation analysts, litigators and accountants need to familiarize themselves with some of the basic elements of franchising.

(1) Contract Right, not Outright Ownership – First and foremost, ownership of a franchise is not the same as outright ownership. The full bundle of rights attributable to owning something outright is absent in a franchise agreement and all rights to own and/or alienate the property are determined by the franchise agreement. The asset is merely a contract right; whatever the benefits or burdens of ownership, they are to be found in the franchise agreement – not in the common law. That is not the case with a family farm. Therefore, the first obligation of the valuation professional when dealing with a franchise is to very carefully review the franchise agreement itself because that is the asset being valued.

(2) Management Analysis – Although any sensible valuation of a business takes into account the strengths and weaknesses of management, in the franchise context this is a two-tiered analysis. The valuation must focus on the management skills of both the franchisor and the franchisee. Again, that is not generally the case with a business owned outright.

(3) Franchisor/Franchisee Relationship – In no other business context is the value of the enterprise so dependent on one relationship; the franchisor usually owns the trademark, creates and controls the marketing strategy, designs store layouts and fixtures, creates and owns operating manuals, and may even own the real estate on which the store is built. Normally such complete dependency upon one other entity would be considered an inordinate business risk, like

a dependency on a single customer. But in the franchise situation it is more often strength than a weakness.

(4) Regulation – There is a new Federal Trade Commission rule which becomes finally effective in July, 2008 governing the disclosures that franchisors are required to make to prospective franchisees. Plus, there are 14 states that require the registration of franchise offerings. No other business sector (other than the securities industry) is as highly regulated in as many areas and separate jurisdictions as franchising. This alone makes it vastly different from other forms of business.

One of the key aspects of valuing a franchised business (i.e. a franchisee as opposed to franchisor) is determining the appropriate discount, if any, for the risk of termination and/or non-renewal. In making this determination the appraiser must be aware of not only the franchise agreement but the statutory controls which may override the terms of the contract.

For example, there is no general federal law dealing with the franchise relationship. There is, however, federal legislation regulating franchise relationships in several specific industries, including the automobile, gas station and liquor industries.

In the automobile industry, the Automobile Dealer's Day in Court Act requires the automobile manufacturer to act in "good faith" in performing its obligations under the franchise agreement and in determining whether to terminate or not renew the franchise. "Good faith" is defined under the Act to mean acting in a "fair and equitable manner" without coercion or intimidation.

The PMPA, or Petroleum Marketing Practices Act, regulates relationships in the gas station industry. It requires "good cause" for the termination of a franchisee. "Good cause" means:

(i) the failure of a franchisee to comply with any reasonable provision in the franchise agreement which is of material significance to the franchise relationship;

(ii) the failure of the franchisee to make good faith efforts to carry out the provisions of the franchise agreement;

(iii) the occurrence of any event which makes termination reasonable; or

iv) a written agreement between franchisee and franchisor in which both agree to the termination.

(5) System-wide Goodwill – All operators in a franchise system are closely bound. In no other type of business would a tainted hamburger or scallions sold in an eatery in Washington or New Jersey so heavily impact or affect other businesses in states across the country (as was the case in recent years with Jack in the Box and Taco Bell).

Additionally, and uniquely, in practically every franchise agreement there is a specific clause which provides that all goodwill from the operation of the unit inures to the franchisor – not the franchisee that is operating the unit. Thus, the most valuable intangible asset usually owned by any business is specifically disclaimed in the franchise context. Although there may be an asset comparable to goodwill (sometimes denominated franchise rights) a testifying expert will be severely attacked if he is not aware of the contract reservation.

(6) Restrictions on Transferability – Usually a franchise is not freely alienable. Customarily there are conditions in franchise agreements which impact the valuation such as i) the risk of non-renewal, ii) the risk of non-approval of a proposed transferee, and iii) the presence of rights of first refusal (ROFRs) in the franchisor. The U.S. Tax Court has characterized ROFRs as difficult to value but probably causing a 10-15% discount from the total enterprise value.[2]

Another issue that comes up in franchising but not in the ordinary business context is: what is the value of a "wrongfully terminated" franchise? To make this determination, the expert must first determine whether the termination was, in fact, wrongful. This involves determining (1) Was the relationship a franchise within a specific statutory definition, and (2) Was it violated without "good cause" which is a legal term of art specific to the statute controlling the dispute. The results show extraordinary variations. For example, in computing damages for a wrongfully terminated franchise, the courts of New Jersey measure the value as what a purchaser would pay for a terminated franchise (rightfully or wrongfully terminated) and consider it to be basically worthless. In contrast, the courts of Wisconsin provide that the wrongfully terminated franchisee is entitled to fair market value of the business computed by a discounted cash flow method plus a discounted terminal value. In one case the difference was between $9,000,000 and zero.[3]

Finally, there are also significant issues when valuing franchisors. For example, in a recent U.S. Tax Court proceeding one valuation expert took the position that the restrictions imposed by a state's termination/relationship law justified a 90% discount in the value of the franchisor's enterprise.

Also, of paramount importance, an appraiser must be aware that the most valuable assets of any franchisor are its intangible properties – usually constituting almost 80 percent of the total enterprise value – an asset which because it is self-created does not appear on the franchisor's balance sheet.[4] Also, in terms of predicting the future growth in a discounted cash flow model, the appraiser must be aware that franchisors, almost uniquely, have the ability to exploit their intangible assets by licensing the same assets over and over - in other locales and in other countries. For example, McDonald's receives about 65 percent of its revenues from operations outside the U.S. This gives rise to additional complexities when an appraiser is trying to determine how to value this IP. The intangible properties most frequently at issue in franchise companies are the trademarks and goodwill and there are several generally accepted methods for valuing trademarks: the profit split method, the selling price differential method, the econometric method, and the relief from royalty method.[5]

In conclusion, valuation experts must be cognizant of the many differences between franchises and other businesses and determine the values in such engagements accordingly.

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[1] Osteryoung, et al., "A Valuation Model for Franchise Contracts," Business Valuation Review 61 (6/93).
[2] See e.g. *Estate of Heck v. CIR*, T.C. Memo 2002-34
[3] The New Jersey case holding the franchise valueless is *Cooper v. Amana*, 180 F3d 542 (3rd Cir. 1999) while the Wisconsin case holding the value to be computed using the DCF method is *Baur Truck v. Svedala Industries*, (Wis.Ct.App. 1993) CCH Business Franchise Guide Para. 10,193.
[4] See Bruce S. Schaeffer and Susan J. Robins, "Valuation of Intangible Assets in Franchise Companies and Multinational Groups," *Franchise Law Journal*, Volume 27, Number 3 (Winter 2008).
[5] See Byron E. Fox and Bruce S. Schaeffer, *Franchise Regulation and Damages*, Section 20.02 (CCH 2005).

These methods are defined as follows:
1. Profit Split Method: This is based on the division of after-tax operating margin that a licensee would be willing to pay, after taxes, to a hypothetical licensor for the use of a trademark or trade name.
2.Selling-Price-Differential Method: This calculates the value of trademarks and trade names by determining the incremental price differential attributable to trademarks and trade names over unbranded products or services and then splits the premium portion of the price between the hypothetical licensor and the hypothetical licensee.
3. Econometric Method: This method purports to derive implied economic values for trademarks expressed as a percentage of sales. Several cases have recognized the validity of somewhat similar regression analyses.
4. Relief-from-Royalty Method: This method relies on an analysis of third party license agreements to determine an appropriate royalty rate. Once such comparable royalty is determined, three steps follow: (1) determining the projected excess earnings for the branded product or service, (2) selecting an appropriate royalty rate for the license, and (3) computing the present value of the royalty payments using a discounted cash flow method.