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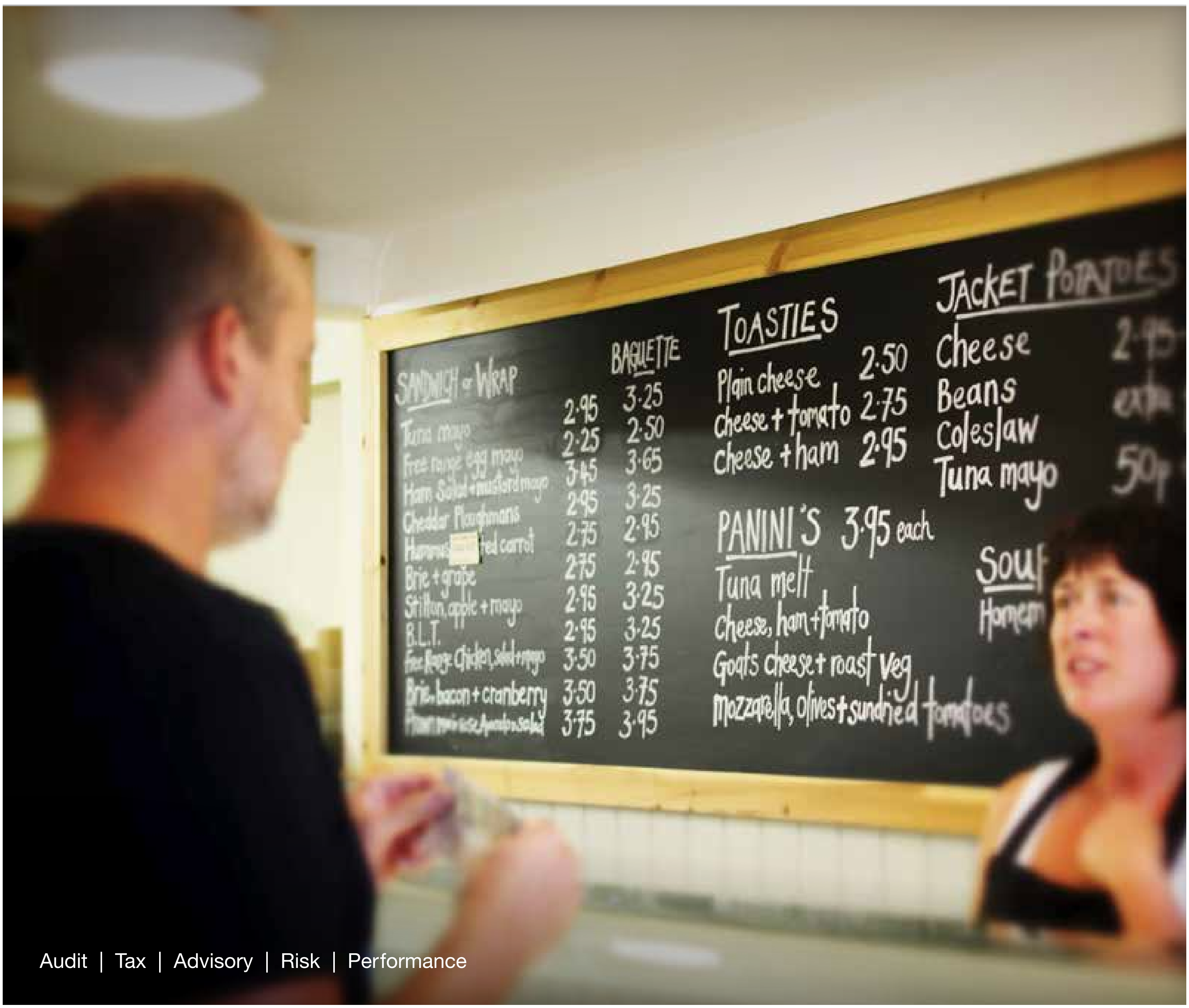
Not So Fast: Due Diligence for Quick-Service Restaurant Operations

By Thomas Vande Berg, CPA



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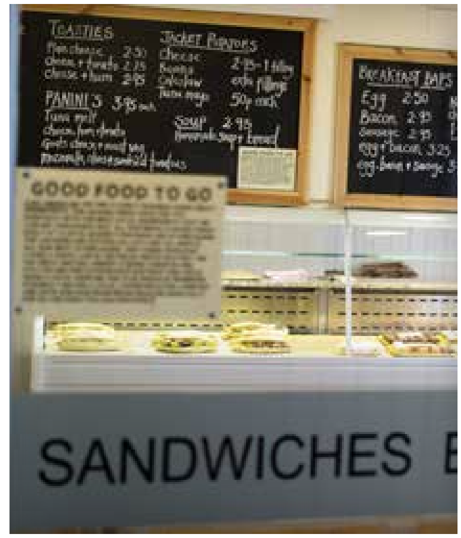
The continuing merger and acquisition (M&A) activity in the middle market stems in part from private equity groups and strategic investors targeting larger quick-service restaurant (QSR) franchisees. These operations, which often comprise many individual stores, pose particular challenges to performing due diligence.



The outlook for QSRs remains positive. Even as consumer demand for healthier food increases, consumers continue to be lured by the low price point and convenience of QSRs. To meet consumer expectations of healthier fare, QSRs are revamping their traditional menus and providing additional healthy items, such as salads and food that isn't fried.

The National Restaurant Association predicts that sales at QSRs – generally defined as locations where the primary function is to provide full meals without table service – will increase by 4.3 percent in 2015.[1] IBISWorld estimates that revenues for QSRs will top $207 billion in 2015.[2]

Not surprisingly, QSR franchisee operations are attracting the potential interest of private equity and strategic investors in the middle market.

As with any acquisition, due diligence is crucial. Valuations in franchisee acquisitions are often based on projected earnings before interest, taxes, depreciation, and amortization (EBITDA), as well as expected levels of working capital and capital expenditure. Rigorous financial due diligence is necessary to assess the seller's projections of these financial measures. Due diligence is also valuable for identifying additional risks that have the potential to affect the investor's ultimate assessment of value.

The Role of Individual Stores

Due diligence for QSR franchisee operations should reflect the critical role the individual stores play in determining the overall profitability of the franchise. A single highly profitable store undergoing an unexpected change can affect valuation dramatically.

Same-store analysis is a critical element of analyzing QSR franchisees historically, especially in periods of significant growth. Investors must determine the extent of organic growth from existing stores relative to growth derived from the addition of new stores.

Among the most important questions about the role of the individual stores are the following:

- Which stores are the most and the least profitable? Why?
- What factors are determining revenue trends (for example, location, individual store management, or advertising)?
- Is each store maintaining its gross profits, or are increasing revenues and profits the result of reducing prices or adding stores that are unprofitable or only marginally profitable?

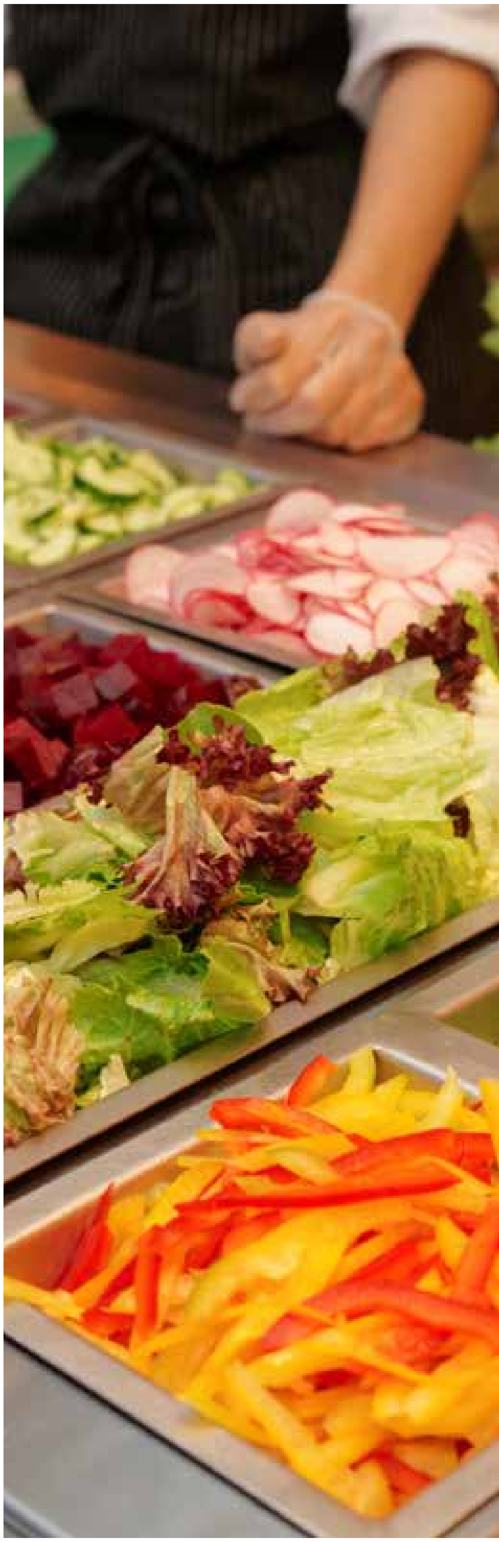
When a store experiences significant revenue growth or decline, potential investors would be wise to understand the contributing factors and the possible implications. Nearby road repairs might cause a temporary decline, and construction of a bypass around the main thoroughfare that is home to the store could result in a more permanent decline. The opening of a shopping center or big-box retailer in the area could have favorable long-term implications, while the launch of a competing QSR across the street might permanently impair revenues.

Location, Location, Location

A QSR's performance depends largely on its location. It is impossible to account for all the attributes and potential dynamics of each location – a competitor can move in after the deal closes, for example, thus undermining that store's business. Effective due diligence can, and should, assess the general sustainability of individual franchise revenues based on known risks and opportunities at the time the investment is contemplated.

Due diligence must determine whether existing risks, such as a landlord unwilling to extend the lease on a highly profitable store, could force a store out of business or into relocation. If the revenues are tied closely to its location, the same store in a different place might not sustain the same revenues and EBITDA.

Due diligence therefore should include an examination of franchise agreements and lease expiration dates to determine the potential risk of losing locations, especially those stores that are in the top quartile of the franchisee's stores in terms of profitability.



QSR Due Diligence: A Five-Point Checklist

To determine valuation, rigorous due diligence should include an analysis of the following factors:

1. **Store analysis.** Because a highly profitable or unprofitable store can skew valuation, prospective buyers should evaluate the sustainability of individual store performance when determining overall profitability. Investors should analyze whether factors such as location, individual store management, or advertising are affecting profitability. If the store cannot be made profitable, what are the costs to close it? Same-store results should also be analyzed to evaluate organic growth versus growth generated by opening a store.
2. **Location.** Revenues at QSRs are tied closely to location, so determine the risk to profitability if something about the location changes. Factors to consider include road construction that makes getting to the store difficult, the loss of a lease that forces a move, or a competitor moving in nearby.
3. **Fixed costs.** Consider whether opportunities exist to make changes that will reduce general and administrative expenses, including salaries and benefits, rents, and advertising.
4. **Franchise agreements.** Operational restrictions imposed by national chains can affect profitability. Review franchise agreements to understand franchise fees, advertising fees, royalties, qualitative requirements, renewals, corporate-level overhead (nonstore costs), and required capital expenditures and maintenance.
5. **Fraud and inventory management.** In addition to the risks of fraud and theft in a cash-based business, the increasing use of credit and debit cards requires due diligence related to internal systems controls and processes. Review the strength of inventory management controls, including how inventory is recorded and tracked and how waste is minimized.

General Profitability Factors

QSR franchisees typically are not valued at high multiples of EBITDA; however, these operations generally are considered to have predictable cash flows. With QSRs hawking hamburgers, tacos, or submarine sandwiches to price-sensitive customers, franchisees are usually precluded from aggressive pricing.

Accordingly, the profitability of a franchise operation depends in large part on scale and size as well as locations. Although a new owner might find fewer opportunities to make dramatic changes, increase revenues, or cut costs than would, for instance, a new owner of a manufacturer, generating additional profitability from QSRs is quite possible.

If the seller has grown attached to a certain store and finds closing it difficult even when the store proves to be unprofitable, for example, a new buyer might be focused on maximizing investment returns and unlikely to have such difficulty. Potential investors could make closing unprofitable stores a prerequisite of the purchase agreement.

However, even if investors are willing to close unprofitable stores, they need to consider what the actual cost of closing stores will be, including costs associated with terminating a lease commitment. Such nonrecurring costs typically are excluded from the calculation of normalized EBITDA but reflect real future cash outflows to the buyer.

Recent changes in minimum wage levels should also be included in any modeling of store profitability. Numerous states across the country – including California, Minnesota, Massachusetts, and New York – have announced increases in minimum wage levels effective within the next two years. Increasing labor costs above the rate of inflation will pressure margins and need to be considered during an assessment of projected store profitability.

Due diligence for QSR franchisee operations should entail consideration of all the factors that affect EBITDA and non-EBITDA items. These factors include the selling, general, and administrative expenses, particularly salaries and benefits; rents; and advertising. Some pertinent questions to ask include:

- Is management operating the stores at sustainable personnel levels?
- Are any unusual factors present, such as related-party ownership of a company-owned store, which could artificially reduce rent expense?
- Are stores located in a state that has announced plans to increase minimum wage levels?

The answers might require analysis to assess normalized EBITDA on a prospective basis.

Cash Management and Fraud Prevention

QSRs tend to be cash-based businesses, which makes theft and fraud major concerns. An employee skimming a mere $10 from the cash register every day can make a difference in the bottom line.

However, an increasing number of consumers, particularly younger ones, are replacing cash with plastic. A CreditCards.com survey found that consumers age 49 or younger are just as likely to use plastic as cash to pay for a $5 purchase.[3]

Although the increasing use of credit and debit – and less cash handling – minimizes the risks of employees stealing cash, prospective buyers must determine whether internal systems controls and processes provide adequate fraud protections.

Fraud-related losses vary from store to store, but certain procedures can minimize the risk at all locations. For example, integrating point-of-sale terminals with centralized-reporting functionality provides more effective cash-and-credit monitoring than segregated systems do. Due diligence should determine the design and operational effectiveness of internal controls for deterring and detecting management and employee fraud. The absence of effective internal controls could indicate that additional investments in systems and process controls are required.[4]

A Data-Intensive Endeavor

Due diligence for the acquisition of a QSR involves specific issues and risks not commonly encountered in other types of acquisitions. With a typical acquisition, due diligence might include an analysis of the target company's historical financial results over a three-year period, whereas acquiring a franchisee operation with 250 stores calls for the equivalent of 750 separate analyses.

Aggregating profit-and-loss and income statement data into tools such as pivot tables using spreadsheet software can make analysis less time-consuming and more manageable, but adequately assessing the investment value and potential returns of a franchise requires a level of effort that prospective buyers must plan for.

Contact Information

Tom Vande Berg is a partner and the transaction services leader with Crowe advisory services group in Dallas and leads the firm's transaction services team. He can be reached at +1 214 777 5253 or tom.vandeberg@crowe.com.

Other Considerations

Franchise agreements, especially agreements with large national chains that impose numerous operational restrictions, can affect profitability greatly. Investors should pay close attention to provisions related to franchise fees, advertising fees, royalties, and other payments; qualitative requirements; and renewals.

Inventory management is another area of concern with QSRs. How is inventory recorded and tracked? Does the individual location have procedures to minimize inventory waste? Most QSRs use frequent physical counts rather than perpetual inventory systems, so it is important that the operation has strong controls related to inventory management.

Corporate-level overhead (nonstore costs) can also prove to be critical if the buyer is carving out the stores rather than acquiring the corporate group, or if the corporate group operates multiple entities.

Often, QSR valuations are based initially on comparative multiples of EBITDA, a practice that ignores the timing and magnitude of necessary or required capital expenditures. Capital expenditure requirements can add up, though. A store's building might need remodeling or upgrades that would incur a capital cost. If many of the stores in a franchisee operation are nearing the end of their buildings' useful life spans, capital costs could increase considerably in a few years. With QSRs' tight margins, these costs can have a significant impact on short- and long-term cash flows. Due diligence also should focus on whether the sellers are deferring significant capital expenditures and maintenance in an attempt to push this cost to the seller.

[1] "2015 Restaurant Industry Forecast," National Restaurant Association, www.restaurant.org/Downloads/PDFs/News-Research/research/ForecastExecSummary2015-FINAL.pdf

[2] "Fast Food Restaurants in the US," IBISWorld, February 2015, www.ibisworld.com/industry/default.aspx?indid=1980

[3] "Poll: Cash or Card for $5 Purchase?" CreditCards.com, Aug. 26, 2014, www.creditcards.com/credit-card-news/poll-small-purchase-card-vs-cash-1276.php

[4] For more information about mitigating PCI-related risk, see Angie Hipsher, Jonathan Sharpe, and Craig Sullivan, "PCI: How Are Organizations Limiting Liability and Reducing IT Risk at the Same Time?" recording of Oct. 24, 2015, webinar presentation, http://www.crowe.com/ContentDetails.aspx?id=12976

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