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The More Franchised, the Better

Chains refranchise stores as a growth strategy

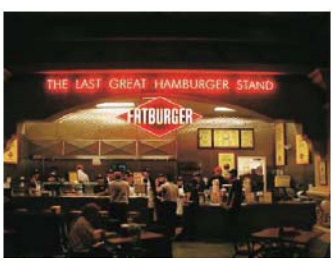
Some franchisors are finding local is better, at least when it comes to running certain restaurants. Restaurant chains are converting corporate restaurants into franchises as part of a growth strategy, and are going through the process slowly and with much thought.

Andy Wiederhorn, chief executive officer of Beverly Hills, Calif.-based Fatburger, said sometimes a franchisee who lives in the area is better suited than corporate to run a restaurant. "For a franchisor to think they can operate a restaurant in the community where the franchisee lives better as a corporate store is naïve," he said. "Why are you going to do a better job?"

Fatburger has 150 locations, and all are franchised except for a couple company units, Wiederhorn said. A few years ago the chain was about half franchise, half corporate. Then, the recession hit. "We were struggling with our ability to execute financing of additional stores because the market was such a mess," he said. "We felt significant overhead was required to run company stores."

Running company stores also requires significant operations, said Amit Kleinberger, chief executive officer of Encino, Calif.-based Menchie's. "It is too complicated to carry the infrastructure and systems to serve both," he said. "When you find yourself with both corporate and franchise systems, you have challenges because you have to build both platforms."

Kleinberger said the frozen yogurt chain has 390 locations, and only one is corporate-owned, a training facility near headquarters. The chain used to have more corporate



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Charlotte, N.C.-based Bojangles' is 60 percent franchised, and chief development officer Eric Newman said the chain is working on more franchised units.

locations, and those were converted over the past few years. "I had existing franchisees in the markets who expressed they wanted more stores, so I gave them the opportunities, and some were completely new franchisees looking for new locations," he said.

The franchisees were pleased that they did not have to choose real estate and handle many of the start-up challenges. Some chains say franchisees often prefer to buy existing locations. "It tends to be a lower risk transaction than building a new store, because they buy an existing stream of EBITDA," or earnings before interest, taxes, depreciation and amortization, said Frank Paci, president and chief executive officer of Alpharetta, Ga.-based McAlister's Deli. "They can come in, look at a business, see how it's running, look at the P&L, and say, 'Hey I may be able to save a couple points in labor because I am more efficient in running the store.'"

That ability to look at past performance is one detail that makes refranchising different from offering a franchisee a new, not-yet-built location, said Amy Cheng, partner and co-founder of Cheng Cohen, a franchise law firm in Chicago. A franchisor is typically prohibited from giving the franchisee financial performance representations in the franchise disclosure document. However, if the franchisor is selling an existing location, the company can provide operating results of that location. "You cannot promise them that they will make a certain amount, but you can provide them with historical operating results," she said.

Some franchisees specialize in improving locations that are not performing well. "We have one franchisee who has done a very good job taking over restaurants we haven't run as well in difficult markets," said Eric Newman, executive vice president and chief development officer of Bojangles' in Charlotte, N.C. "We let him have stores we struggled with, and he improved them. He's up to eight or 10 restaurants."

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That doesn't happen very often, Newman said, and refranchising is not a decision to enter into lightly. "We have studied this question for 15 or more years," he said. "The common wisdom seemed to be don't run restaurants, franchise them."

He added that Bojangles' is not following common wisdom but doing a mix of franchise and corporate. The chain has 580 units: 60% are franchised and 40% corporate. He said Bojangles' would like that mix to be closer to 67% franchised, 33% corporate. While some chains sell blocks of corporate stores at a time, Bojangles' is taking a more strategic approach.

Sometimes, corporate will refranchise because a store is geographically isolated. We will sometimes, through accidents of history, find ourselves with isolated units or isolated markets, and find franchisees nearby who we think are strategically better situated to have those stores," Newman said.

The franchisee would not be able to do much about the store's location but can make other changes, such as with personnel. The employees of that location would cease being employed by corporate, and the new owner is not obligated to hire the workers. The franchisee would have to assess the staff's strengths and weaknesses, Newman said, or figure out whether there are enough managers and whether the scheduling has been effective. "They can do some strategic hiring," he said.

Cheng noted that another issue is retirement plans and benefits. If the corporate employees were participating in a 401(k) plan, they will be unhappy if the plan ends with the unit's new ownership.

Menchie's franchisees make these staffing decisions on a store-by-store basis, Kleinberger said. Sometimes, the corporate managers stay for two weeks during the transition, to make sure the change is seamless. "You want guests to know nothing about this transition," he said. "It needs to be business as usual."

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Other chains say they occasionally build corporate stores in a new market, then sell them to franchisees. "We could make a decision to jumpstart a market by opening the first 10 stores," said Grant Benson, vice president of franchising and business development for Canton, Mass.-based Dunkin' Brands. "Our intent is once we get a certain number of stores, franchise those out."

Dunkin' Brands does not do that very often, Benson said, and almost all of the company's 18,000-plus locations are franchised. Still, when corporate does sell existing Dunkin' Donuts or Baskin-Robbins locations to franchisees, the new owner usually rehires the same employees. "We can't guarantee employees the new operator or owner would want them, but if you have a well-oiled machine, that would be an asset, as opposed to going out and having to recruit," he said.

Other details, such as liquor licenses, are more complicated. Cheng said corporate should make sure if it sells a store to a franchisee that the landlord approves the sale, if the lease had that stipulation. Sometimes, landlords assign certain conditions to a sale, such as that the new owner has a minimum amount of liquid assets.

Also a franchisee might not automatically get that location's liquor license. "You do want the process to go seamlessly," Cheng said. "You don't want a server to say, 'I cannot serve you a drink because it will take us months to get a liquor license.'" ■