



# THE CYPRESS GROUP

*"Results through Focused Expertise"*

Investment Bankers  
Exclusively Serving the  
Restaurant Industry

## Mergers: A Strategy for Franchise Companies

### SPECIAL POINTS OF INTEREST:

#### • **Restaurant Finance Conference:**

Cypress is pleased to announce that Dean Zuccarello and J.B. Hewetson will be presenting "Practical Solutions for Buyers, Sellers and Lenders to Close More Deals" at this year's 2009 Restaurant Finance Conference. The conference is being held November 9-11 at the Bellagio Hotel in Las Vegas

**The Cypress Group provides a full range of Investment Banking and Strategic Advisory Services to the Restaurant Industry**

#### Services Include:

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- Valuations & Fairness Opinion
- Litigation Support

Mergers & Acquisitions, or "M&A" as it is commonly referred to, has been an instrumental component of the franchise industry over the past two decades particularly as a growth vehicle for expanding companies. However, most historical transactions in the franchise industry have concentrated more on the "A" (Acquisitions) than on the "M" (Mergers). Some of the primary drivers for this are trends deeply entrenched in franchise culture and business; however, the current global financial crisis and industry dynamics may alter these trends as we will explore below.

### ***A slew of "A's" but few "M's" - Why Acquisitions have Dominated Mergers***

Historically, the franchise industry has been predominantly represented by entrepreneurs; clearly as franchisees, but also as emerging franchisors. Given this fact, franchise companies often have a "lifecycle" pattern similar to that of the entrepreneur that founded the organization. This lifecycle typically follows a natural path that includes the following stages: market entry, initial growth, moderate expansion, harvest, and eventual exit. It is this last phase of the lifecycle that has traditionally created the main supply of acquisition opportunities in our industry. At the exit stage, the entrepreneur is ready to retire or move on to the next venture. He is no longer interested in managing the business and/or maintaining the associated financial risk. As a result, franchisee and franchisor owners pursue a sale of the business rather than a merger. Generally speaking, a merger does not satisfy the entrepreneurs' objective to effectively walk away from all financial and personal interests in the Company and maximize exit proceeds, hence the pursuit of a sale of the business.

Equally important is the fact that historically the marketplace has largely cooperated with the strategic plans of these franchise companies. For those owners seeking an exit via a sale of their company, the availability of debt and equity capital coupled with their relatively positive financial performance has resulted in acquisition multiples that have generated profitable sell-side opportunities. Such flexibility within the capital markets facilitated a general preference for sale transactions rather than other forms of business combinations such as mergers.

Lastly, we cannot ignore the fact that many of the franchise entrepreneurs that have built our industry have great pride in their own companies and operate them in a very personal and independent manner. A merger introduces the concept of shared control into the management of the business. For many owners sharing the decision making process can be a non-starter. The thought of merging with another organization and giving up autonomy has little appeal to some entrepreneurs.

### ***Why are Mergers more likely to Occur Now?***

The current recession has had an unprecedented impact on the world's economy, and the franchise industry has not been immune to the impacts of such a widespread downturn. Although we are beginning to see signs of economic improvement recently, the underlying consumer metrics remain weak. Currently, Wall Street and Main Street appear to be on different pages of the same book. Unemployment rates remain high and are expected to grow even higher. Consumer spending remains weak with the experts predicting a slow recovery based largely on a rebound in employment. Debt and equity capital availability also continues to be fairly tight and businesses are finding it difficult to access much needed funding for their companies. All of these factors will continue to have a negative effect on the consumer driven franchise industry for the foreseeable future.

In the present economy, owners are exploring all internal options that will enhance their companies and keep their businesses financially sound. Operating practices and policies are evolving to provide maximum financial efficiencies. Staffing levels have been reduced and all aspects of internal operating expenses are being examined. In addition to these strategies, mergers can provide companies with additional benefits in these areas that may not have been previously considered.

One largely untapped benefit where a merger can provide greater financial efficiency is the area of administrative overhead. Independent companies are performing administrative and supervisory functions that when taken on a system-wide basis are duplicative and very inefficient. In the past, the acquisition / consolidation model sought to benefit from this inefficiency by acquiring these companies and eliminating the excess general and administrative expenses. The consolidation of related companies through a merger can also eliminate this excess and provide substantial financial savings to both companies.

On an operational basis, a merger can provide an opportunity to combine companies that are more powerful than their parts on a stand-alone basis. Combining businesses in adjacent markets can permit greater geographical control and market share while adding new team members in the field who can create greater depth and expertise in operational decision making. Franchisees often complain of conflicting marketing and advertising strategies within a particular market or find varying menu pricing or store conditions to be a challenge in presenting a consistent brand identity to the consumer. A merger can eliminate some of these challenges and potentially provide synergies. Finally, at the top of an organization, a successful shared system of control may combine years of talent and experience to maximize the future performance of the business.

Additionally, mergers can also assist owners of a business experiencing financial challenges in the current economic environment. A company with moderate to significant sales declines over the last two years has felt the impact of significantly reduced cash flow. Consolidating the resources of two companies through a merger can provide a solution to today's challenges while preserving the future for the equity holders.

Finally, a merger can also provide significant financial benefits when an eventual exit stage is reached. A larger organization with greater market control, significant revenue and earnings, and a deep and experienced management team generally improves access to all forms of capital. Most importantly, it dramatically increases the number of buying groups willing to entertain such an investment, which can have an impact on pricing and overall execution.

**Conclusion –**

A merger of a franchisee or independent franchisor is not a strategy for every company. However, ownership groups seeking additional alternatives to strengthen their position should consider whether the benefits of a merger could be right for their companies.

<p>Dean Zuccarello <i>President &amp; CEO</i> 303.680.4141 x111 dzuccarello@cypressgroup.biz</p>	<p>Carty Davis <i>Principal</i> 910.692.9176 cdavis@cypressgroup.biz</p>	<p>JB Hewetson <i>Vice President</i> 303.680.4141 x112 jbhewetson@cypressgroup.biz</p>	<p>Brian Parks <i>Associate</i> 303.680.4141 x113 bparks@cypressgroup.biz</p>
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