INTERNATIONAL MERGERS AND ACQUISITIONS OF FRANCHISE COMPANIES

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This article analyses the format, due diligence considerations and risk factors in relation to international M&A transactions in the franchising sector. The formats considered include a franchisor acquiring its foreign master or unit franchisee, a franchisor acquiring a foreign competitor franchise company and private equity acquiring a foreign franchise company. The international nature of the transaction results in specific due diligence requirements as regards intellectual property rights, disclosure and registration compliance and relationships with foreign franchisees. The authors finally consider the risks inherent in off balance sheet information, change mismanagement and the potential negative impact on franchisees.

1. Introduction – Unique aspects of M&A transactions with an international component*

"International mergers and acquisitions" can be defined in different ways to include a variety of transactions. Narrowly defined, an international M&A transaction involves parties in different countries. In a franchise context, however, this would be a very short paper if the definition were so limited. The fundamental concept of franchising is that it allows one company to grow its brand through cooperation with independently owned third parties – franchisees. Internationally, this is also the case. Through franchising, companies may have significant business in foreign markets without having to set up any entities there. For purposes of this paper, we will use a broader definition of an international merger and acquisition: in addition to the true cross-border transactions between entities in different countries, we add transactions between entities in the same country, but where the seller or buyer operates in foreign markets through franchising its concept to third parties.

What are "international" aspects?

In many ways, an international merger and acquisition is similar to a domestic transaction. For example, all the typical questions of corporate and securities law compliance, and real estate, tax, environmental, labor and employment law issues are

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present in an international transaction. However, there is also an "international" aspect to those issues. If the franchisor has subsidiaries or affiliates domiciled in foreign countries, those entities must comply with local law. This could include merger control compliance, corporate & securities regulations, real estate transfer laws and, so on. In some instances the topics that appear in an international merger and acquisition have a special aspect. One such example is tax. The transaction not only has to consider tax laws of different countries, but also issues that relate to their integration and connection.

Other issues are truly unique to the international transaction. For example, anti-corruption laws are most likely not considered in domestic transactions, but need to be carefully reviewed in an international transaction. Likewise, there are other areas of law that may play a minor role in in the buyer's jurisdiction, but that may be significant issues in other jurisdictions involved in the transaction. One such case is data privacy laws. In the U.S., these laws are of relatively minor importance to most franchise systems,[1] but in other jurisdictions, for example EU countries, the regulation is more stringent and likely to affect many franchisors.

With respect to mergers and acquisitions among franchise companies, there are also certain peculiarities that affect the transaction. Some are due to common practices in international franchising. Master franchise agreements are very common in international franchising, for example, while in the United States they are much less common. Other "peculiarities" are a result of geographic distance and the lesser level of involvement a franchisor will usually have in foreign markets compared to a company-owned system (assuming it is using a master franchise model). For example, to evaluate the real value of lease assignment rights under franchise agreements it is necessary to take into account both the franchisor's legal ability to exercise such rights, but also if in practice it is able to do so.

Why do they need to be addressed?

The reasons why international aspects of an international merger and acquisition have to be addressed are no different than the reasons why domestic aspects of the deal need to be addressed: in a merger and acquisition the goal of the parties is to determine a purchase price acceptable to both the buyer and the seller, allocate the risks involved in the business, and determine what format creates the most tax-efficient model for the transaction. Without understanding all the aspects of the transaction, including the international ones, these goals cannot be accomplished. The question of risk is often central in mergers and acquisitions and part of that question is how deeply the parties should delve into different aspects of the business being transferred. Ultimately, the existing and potential revenue stream from different parts of the business may be determinative of how much time and energy is devoted to a specific aspect of the business; but, the potential fall-out of issues need to be part of this analysis as well. Depending on the franchise system being acquired, the international portion may or may not be significant from a revenue perspective. The potential fall-out, however, can, at the very least, be tricky. The mere physical distance between the franchisor's home market and the foreign jurisdiction will make supervision and control difficult, and in addition a buyer would have to consider the efficiency and reliability of the judiciary. Spending a little bit more time and money on understanding the international aspects of a transaction early on can be a significant saving later on. International aspects of the transaction may also impact the buyer's ability to develop the franchise system as desired after the transaction is complete.

[1] Other than where health law or electronic payments are applicable to the transaction.

2. Formats for M&A transactions

M&A transactions in the franchise environment (buy-side and sell-side; hostile, friendly and crisis), as well as the tactical issues involved in negotiating acquisition agreements and other transaction documents are not the topic of this section. The goal here is to shed some light on some grey and little talked about areas involving M&A transactions in international franchising, in the form of reflections on real life situations. Three typical scenarios discussed in this section serve as a key thread for such purpose.

Franchisor acquiring its foreign master or unit franchisee

This first scenario arises when a pre-existing relationship between a franchisor and a contracting party acting either as master franchisee or unit franchisee located in different countries exists: an international franchise.

Retrospectively, international franchising is in its infancy in comparison to national franchising markets, the US market in particular. Searching for its roots, some observers consider the true beginning of franchising by tracing back to the contribution of Alfred P. Sloane, at that time a young VP of General Motors, for implementing the franchise model within this great company in the 1920's. Equipped with such a weapon, GM overtook "the Goliath" Ford within ten years in the US market: taylorism[2] died just then. A century has passed since the first days of A.P. Sloane's revolution and the franchise model applied within national markets has today reached an apex of sophistication, if not a science. International franchising, on the contrary, is still *terra incognita* in comparison, with a short history of 15 to 20 years.

With this background, what key issues should be addressed when considering an international acquisition by a franchisor of its contracting party

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(the subsequent developments will concentrate on the master agreement, emblematic contractual form in international franchising)? The answer to this question requires us to challenge the mainstream opinion in this regard first.

Professionals in the franchise industry consider the acquisition of a master franchisee as a different type of transaction since master franchise agreements often provide for assignment provisions of franchise contracts without financial consideration and the common law facilitates such a mechanism. These assignment provisions are usually triggered on the termination date of the master franchise agreements and the assumed consequence is that all sub-franchisee agreements are automatically transferred to the franchisor, leaving the master franchisee without its system. The reality, however, proves different.

This type of transfer remains useful if and when a master franchisee has not really succeeded in creating a sub-franchise network and if the franchisor terminates the master franchise agreement. In this situation, few master franchisees will try to retain any of the sub-franchisees, since the master franchisee, having failed to perform its obligations, has little if no bargaining power.

However, when a master franchisee has developed a substantial sub-franchise network, the termination of the master franchise agreement and automatic assignment without consideration is wishful thinking on the part of the franchisor and efficiency of said

[2] Scientific management, also called Taylorism, is a theory of management that analyzes and synthesizes workflows. Its main objective is improving economic efficiency, especially labor productivity.

transfer a dangerous and erroneous assumption. In this situation, the master franchisee can easily create a confrontational situation with the franchisor and place the existence of franchisor's brand in the territory of the master franchisee under considerable risk – litigation would create havoc businesswise and produce a dual jeopardy: first, the franchisor will not easily find a new master franchisee to replace the former one leaving the territory without direct management on the ground, and second, the franchisees will be under simultaneous pressure from the master franchisee and the franchisor and, as the child of battling divorcees, hesitate between choosing between their father or mother and may easily depart the network and join the competition.

As an alternative, the franchisor should consider the option of acquiring the master franchisee's business. The advantage is that it enables a smooth contractual transition. In order to avoid endless discussion on pricing, the master franchise agreement can include provisions that include a price formula and the procedures for implementing this process.

In summary, the international franchising industry should focus less on the theory of automatic assignment and place more concern on the dynamics and ripple effects of a master franchise meltdown and deal with the issue of economic value created by the master franchisee by bringing pricing valuators to the negotiation table, ideally on execution date rather than when the local situation and relationship is deteriorating.

Private equity acquiring a foreign franchise company

This second scenario is developing rapidly as the rhythm of globalization of the private equity industry increases.

According to Duff & Phelps and Shearman Sterling's Global Private Equity Outlook 2014,[3] on average, cross-border transactions are expected to make up 30% acquisitions over the next 12 months. The notable proportion of cross-border investments by private equity funds can be attributed to attractive investment opportunities across the globe. Year-to-date, there have been 331 cross-border buyouts worth US $101 billion and 310 exits worth US $115 billion. In 2013, cross-border buyouts increased slightly in terms of volume and value to 815 transactions worth US $135 billion from 761 deals worth US $131 billion in 2012. Cross-border exits also rose in 2013 to 796 transactions worth US $156 billion from 697 deals worth US $176 billion in 2012. A majority of private equity funds interviewed (56%) plan to invest in a new country in the next 12 months.

Retail, and hence franchising, is a key industry in a private equity company's portfolio of investments. In Europe, private equity funds such as Cinven, Bridgepoint, Lion Capital, and Colony Capital own major continental franchise systems.

How does a private equity fund deal with the franchise vehicle? In general, a private equity fund's top management has little expertise in franchising.[4] Their key specialties are calculating EBITDA and financial ratios. They are concerned with investing in concepts that will truly perform and deliver the appropriate multiples within 3 to 5 years. The relationship between retailers and investors is a short-term engagement and the economics of which are delicate. A few key issues have to be kept in mind.

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[3] http://www.duffandphelps.com/expertise/publications/Pages/2014PEOutlook.aspx.

[4] Exceptions in the US include Roark Capital, Sun Capital. The Riverside Company and several other companies with significant franchise holdings.

The first issue relates to the timing of the acquisition in the development cycle of the franchise system. A purpose of the franchise model is to dominate its niche and the road to such domination crosses several momentums such as:

(i) initial experimentation test until the first fifty outlets,

(ii) first acceleration until the first one hundred outlets,

(iii) industrial development phase so as to reach several hundred outlets,

(iv) internationalization phase; and,

(v) global expansion phase.

Reflecting on each of these sequences, one can consider that each requires 3 to 5 years to be completed. If the private equity fund enters at the wrong moment, it may well be a kiss of death.

One example is the entry in the middle of any given sequence. The private equity fund will usually have negotiated a specific development plan that will be accepted by current management who need cash to pursue the development. Yet, the development will not reflect what the franchise system can effectively produce. The parties may think that new money can solve problems, which it cannot. A magic wand cannot shorten experimentation and the dynamics of these phases. Training of teams takes time. The typical reaction of the private equity fund is to replace the leader on the first warning of non-realization of the openings as defined in the development plan negotiated prior to the fund's investment. In a few words: a bad diagnosis and a bad decision.

The second issue is the modification of the economics of the franchise model by the franchisor's management under pressure from the private equity fund. A franchise concept characterizes itself by the existence of independent businesses acting as franchisees and franchise agreements with set terms which have a duration of 5, 7 or 10 years. When the private equity fund requests better financial results, the franchisor often has little room to adjust unless it deploys a strategy to invoice new services to franchisees and/or negotiates with suppliers financial advantages that triggers an increase in price of goods sold to franchisees. The ripple effect is loss of confidence from the franchisees in the system the consequences of which can be devastating since franchisees are the first clients of a franchisor.

The third issue is the exit strategy of the private equity fund. The traditional options available are a sale to another private equity fund; a sale to a supplier, vendor or competitor; a sale back to the franchise system's founder if he or she is still in charge; or, going public. At such a stage, the impact of any of these on the franchise system is remote, with one exception. The franchise company has indeed usually reached a level of great strength that can sustain a change in ownership. In some instances, the strategy of the new owner is to end franchising and buy-out franchisees. This dramatic turn often takes place when the franchise model was used as a method of expansion and never truly blended in the company's culture.

Franchisor acquiring a foreign competitor franchise company

Acquisitions of a franchisor by its competitor are common in today's franchise world in national markets. In international franchising, the trend is growing, too.

One of the most famous and remarkably intelligent precursors is the Regis Corporation. In 2002, Regis entered continental Europe with the acquisition of Vidal Sassoon, Jean Louis David and Saínt Algue, the most well-known salon brands in Europe. In 2007, to further facilitate the growth of the beauty school business, the company merged its accredited cosmetology schools with Empire Education Group, Inc., creating the largest beauty school operator in North America. Regis maintains a 55% ownership interest in the combined company. In 2008, Regis merged its continental European franchise salon operations with the Franck Provost Salon Group, resulting in a 30% ownership interest in the largest hair salon company in Europe. In 2012, Regis sold their ownership interest in Provalliance, which operates salons primarily in Europe, under the brands of Jean Louis David, Franck Provost and Saint Algue.

In Europe, and in France in particular, some observers have pointed out that Regis Corporation made a defensive move by acquiring Jean Louis David in particular. The French brand was on a fast track of global expansion in the 1990's, and had made an inroad in the US. Feeling the menace and the opportunity of controlling a strong competitor, Regis Corporation acquired the French brand in 2002. After that moment, the system was not as diligently propelled forward as it could have been had its founder stayed at its helm.

3. Due diligence

In every merger or acquisition transaction the review, or due diligence, of the franchisor or the other target company being acquired, its business and its assets, is a crucial component. The purpose of due diligence is to assess the value of the target's assets and business, and determine if there are defects that may either prevent the transaction from going forward, or that may warrant purchase price adjustments. Due diligence is most often risk focused. Time and money restraints will often make it impossible to review all documentation relating to the target company and, instead, the buyer will have to determine how to focus its efforts so as not to miss significant potential risk exposure.

In the international scenario, the purpose and goals of due diligence are no different than what is described above. There may however be additional considerations that make the process more complex. For one, the use of master franchisees adds a wrinkle to international deals. The interaction between franchisor, master franchisee and subfranchisees creates unique issues.

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Another complexity is that the lawyers principally involved in the acquisition are usually from the same jurisdiction as the franchisor. Even if they may have some knowledge of the local laws in foreign jurisdictions, it is unlikely that they have the depth of knowledge necessary to evaluate the direct or indirect business activities of the franchisor in such jurisdictions. Further, understanding the "soft" factors that will impact the value and risk involved in the foreign operations is made more difficult by geographic distance and often by language aned cultural barriers. At the very least, when a franchisor's international presence is significant, or there is a desire for significant international growth, a buyer should consider hiring local counsel in the markets where the franchisor has a presence. The same is true in the acquisition of a master franchisee by the franchisor.

In this section we review some of the areas of law that should almost always be part of the due diligence of the international aspects of a franchise system. There are countless other areas of law that could be added to the list which may, depending on the franchise system, have a profound impact on the target company's business.

Intellectual property

A trademark license is at the heart of every franchise agreement. As such, the franchisor's intellectual property should be reviewed carefully in every market where the franchise system has a presence. How thorough the review will be in each market may be dependent on the degree of the franchisor's current and potential future activities in the market; but, at the very least, some minimal due diligence should be done so the target can represent and warrant that it has the trademark rights it claims to own.

Trademark rights protected?

Due diligence should ascertain that the franchisor has adequate protection for its primary trademark as well as other marks it uses in the applicable market. There are a few different aspects to trademark protection: (i) has the franchisor adequately protected its rights vis-à-vis the master franchisee or other third parties that franchise the system in the market; (ii) has the franchisor taken adequate steps to register its trademark rights; and, (iii) in practice, are trademark rights enforceable in the market.

– *Contractual trademark protection*

The buyer should review applicable master franchise agreements or other agreements that grant third parties the right to franchise or otherwise use the franchise system in the local market. Usually, the agreement should contain provisions that reserve ownership of such rights for the franchisor. These provisions should extend to marks that are confusingly similar to the franchisor's marks. Typically, the master franchisee should at least also be required to assist the franchisor with enforcement in the event of a trademark infringement.

Subfranchisees' rights to use the trademarks should preferably also be regulated in the master franchise agreement. The buyer should also review the forms of subfranchise agreements that the master franchisee uses in the market. One aspect of trademark rights that buyers should pay attention to is: what will happen to these rights if the master franchisee is terminated. Do subfranchisees' trademark licenses terminate upon master franchisee termination? If not, for how long may the subfranchisee continue to use the trademarks and what right does the franchisor have to address non-compliance with system trademark rules and guidelines?

– *Trademark registration*

Aside from ensuring that a franchisor is adequately protecting the franchise system's trademarks contractually, a buyer's due diligence should also determine if the franchisor has taken the necessary steps to register the trademarks in markets where it is doing business and in markets that it expects to enter.

There is a split among jurisdictions on how trademark rights are obtained. In some jurisdictions, such as the U.S., basic trademark rights are obtained by use of the mark (though additional rights can be obtained by registration in the U.S.). In many other jurisdictions, including France, Germany, Spain and China, trademark rights are, instead, obtained by filing. The party that is first to file will obtain rights to the trademark. For example, in November 2013 the European Office for Harmonization in the Internal Market denied the opposition of U.S. based Pinterest to a registration of the Pinterest mark by a U.K. based company, Premium Interest. Thus, especially in first-to-file jurisdictions it is important to ascertain that the franchisor has all necessary registrations of its marks.

Ownership of foreign modifications and innovations - copyrights, trademarks, inventions.

Having ownership of the original trademarks is usually not sufficient. It is typical that trademarks and other aspects of the franchise system are localized to the requirements and preferences in the local market. When the trademark is modified, when slogans are translated, who owns the modified or translated material? The buyer should ensure that the relevant agreements give the franchisor the necessary rights to such materials.

A related issue occurs in countries that use a different alphabet than used in the franchisor's home market. For example, if the franchisor uses the Latin alphabet, the buyer should ensure that the franchisor has retained rights not only in the Latin alphabet version of its trademarks, but also their translations into the Arabic alphabet in the relevant Middle Eastern markets. Likewise, they should ensure that trademark registrations cover both versions of the trademark.

"... the master franchisee should at least also be required to assist the franchisor with enforcement in the event of a trademark infringement."

Copyright law: translations, modifications, new materials and innovations

Many of the same issues that arise with trademarks also arise with respect to copyright: often, marketing materials and operations manuals will have to be translated into the local language, as well as modified to fit the conditions, requirements and preferences of the local market. However, there are potential additional issues relating to copyright law, in particular, regarding the accuracy of the translations used.

Most countries are party to the *Berne Convention for the Protection of Literary and Artistic Works*[5]. Under the Berne Convention, each signatory must grant foreigners the same copyright protection as it grants its own nationals. The Berne Convention requires signatories to permit the original copyright owner to retain the right to authorize translations, but once translated the translated work may be considered an original work in which the translator has some rights.

While the Berne Convention will provide some level of protection, a buyer should also ascertain that the relevant agreements between a franchisor and local parties protect not only the original language versions of materials provided to the local parties, but also specifically address both translations, modifications and materials that are developed in reliance on the original materials. Likewise, it is preferable if the local parties waive all rights, including moral rights in the works (if possible). If local law would vest such rights in the master franchisee the franchise agreement may have to specify that the rights will be assigned to the franchisor. In some countries moral rights cannot be waived and then it is important to permit the franchisor the unlimited right to alter and use the revised manual and materials.

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Disclosure & registration compliance

Foreign franchise disclosure and registration laws

While their scope and requirements may differ broadly, franchise disclosure and registration laws abound today. A critical part of due diligence in international franchise matters consists of ascertaining whether disclosure and registration laws have been complied with, and if not, what the potential exposure to a franchisor may be. About 30 countries have disclosure and registration laws today (including those with trademark license registration requirements). The laws range from simple pre-sale disclosures, to more complex disclosure and registration requirements. Some of the statutes may also require that disclosures and agreements be provided in the local language.

Disclosure obligations under general laws

Even where a country does not have a franchise-specific disclosure law, buyers should review whether a disclosure obligation may exist under other general laws or judicial decisions. This is the case for example in Germany and Austria, which follow the civil law system.

[5] (1886) (828 U.N.T.S. 221)

Registration of franchise agreements

Yet in other countries, the registration requirement may not relate to the disclosure document. Instead, the franchise agreements themselves must be registered. This is the case in Brazil, Mexico and Belarus, for example. Usually, this type of registration is tied to IP protection and is required in order to preserve the franchisor's rights in its trademark.

Relationships with foreign franchisees

In addition to the various disclosure and registration laws that apply to franchise relationships throughout the world, many countries also regulate the relationship itself. In their simplest form, these laws may limit a franchisor's right to terminate or not renew franchise agreements except for good cause. However, in several jurisdictions the laws go significantly further, limiting the parties' right to contract freely. These limiting provisions can be found all over the world's franchise laws. For example, for EU countries, the EU Block Exemption limits a franchisor's ability to prohibit sales outside of the franchisee's territory; in Indonesia the sourcing of goods to franchisees is severely restricted and the agreement must be for at least 5 years (to mention a few). Malaysia is another country with extensive regulation of the franchise relationship.

In addition to the true franchise relationship laws, there are many other laws that may affect the franchise relationship. For example, many countries have adopted commercial agency laws that are intended to protect distributors from arbitrary terminations or non-renewals by manufacturers. While those statutes do not always cover franchise relationships, they should be reviewed to ensure that is the case. Where they apply, a manufacturer may be unable to terminate except for good cause and, frequently, significant termination damages or penalties are imposed. These laws are common in South and Central America, but also in the Middle East and in the EU.

Understanding if the franchisor has complied with foreign franchise laws is only part of the due diligence on the foreign aspects of a franchise system. A prospective buyer will also have to assess how the system is doing: are master franchisees and subfranchisees profitable and happy? What controls are permitted by contract of the operations in the foreign market and to what degree is the franchisor exercising those controls? And, what are the franchisor's rights to take action against poorly performing master franchisees? Do the contractual terms and local laws permit the termination of a non-performing master franchisee? What happens to the subfranchise agreements in the event the master franchisee is terminated? Even where there is no immediate need to terminate the relationship with a master franchisee, or where the relationship is a good one, it is important to ascertain that the franchisor has the necessary flexibility to terminate the master franchise agreement and take over management of the subfranchisees, if the relationship was to sour.

Post-term covenants not to compete

Yet another area of law that prospective buyers need to pay attention to is the limitations and enforceability of covenants not to compete. The laws vary with respect to permitted scope (geography, time, and substantive scope) and in certain jurisdictions additional qualifiers may be present, such as payment of a fee.

4. Risk Factors

Successful acquisitions of franchise systems are legion. The media usually talk about them at two particular moments: when the buyer makes its investment and when the buyer successfully resells its interest, which may be several years later, with a profit.

More interestingly are those situations where such an investment was not successful. They are little publicized, yet should be studied in detail if one wishes to understand the underlying dynamics that cause such failures.

The purpose of this section is to propose a map of key risks to be wary of.

Iceberg factor: off balance sheet information

The way investor's and franchisor's management commence discussions on a possible acquisition is different each time. Any generalization regarding the appropriate method would be incomplete. There still is one constant requirement: determining the correct price. Seasoned private equity funds or competing offerors normally make the best out of the negotiation and reach a fair price.

On such a matter, there is, however, an "inherent flaw" in the method of calculation if the buyer is a financial institution with little real life franchising experience. This type of buyer should indeed be wary of being duped by the aggressive franchisor CEO.

Why is this so? The reason relates to the false assumption that the franchise system will be able to provide the same multiple of growth for the coming 3 to 5 years, as it was able to produce in the prior 3 to 5 years. Parties will be exchanging worksheets with scenarios of growth, number of openings per market, etc., with the naïve belief that growth is exponential and cannot be questioned. Many franchise systems seeking to raise capital are in the middle of their acceleration or industrialization phase and consider they need cash to sustain their growth. Such franchise systems can easily make a case to support strong future growth because they have the numbers to show real past growth. In these situations, the correct line of analysis is not exclusively in the worksheet and, hence, not entirely visible on the balance sheet.

The analyst needs to take into consideration a collection of additional data which collectively could be combined in a mathematical index to be labelled for instance as the "FDI" or "Franchise Development Index" of any given franchise system. Such an index with a mathematical formula still needs to be determined.

Yet the reasoning is not entirely different from the route taken by the UN when it created in 1990 the Human Development Index complementary approach to the traditional GDP – used to evaluate the potential human development of countries. Goldman Sachs itself elaborated the Next Eleven theory (known also by the numeronym "N-11") which are the eleven countries – Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, the Philippines, Turkey, South Korea and Vietnam – identified by Goldman Sachs investment bank and economist Jim O'Neill as having a high potential of becoming among the world's largest economies in the 21st century. The calculation methods of these indexes was regarded as highly unorthodox at the time, yet have progressively occupied the public space.

Franchising valuation, in particular of future growth, can and should be viewed with a similar method. Eleven key factors can be proposed as follows:

1. The average duration of each franchisee in the network and the proportion which have renewed their agreements;
2. The level of revenue and profit of each franchisee and ROI observed;
3. The payment rate of invoices by franchisees by the due date;
4. The geographical spread of franchisees in any given market;
5. The level of domination of the niche market and position of competitors;
6. The level of advertising;
7. The level of product quality, logistical efficiency;
8. The quality of the information system;
9. The level of innovation;
10. The level of franchisor/franchisee conflict; and
11. The optimal pricing

"Many franchise systems seeking to raise capital are in the middle of their acceleration or industrialization phase ..."

It rests with mathematicians to come up with a formula, but taking factors such as these into consideration when valuating franchise systems will help investors better understand the franchise system's value than solely conducting a financial statements analysis.

Change mismanagement

Once the acquisition is effective, franchisor's top management has to adapt to the new situation created by the existence of a board holding quarterly if not monthly meetings. The board suddenly takes a new importance since it is the moment when the investor's representative and franchisor's top management determine jointly the franchise system's strategy. In addition, all major decisions are decided by the board, all those at least which have, or may have an impact on assets and debts.

Contrary to the common belief, the fate of the franchise system from then on does not rely on the way the new money injected in the franchise system is used. Nor does it depend on the capacity of the franchise system to follow through with the new development plan defined in conjunction by the investor and the franchisor's top management. The reality is that the franchise system is in the hands of two individuals: the investor's representative on the board and the franchisor's CEO. The issue is that of balance of power between them. The way the relationship plays out depends on the momentum. There are three critical points.

The first point is when both individuals get acquainted and strike the deal on how the investor and the franchise system will coordinate themselves. Naturally, there may be modifications here or there, but usually parties manage to agree on the common plan. The problem at this point lies in the antagonistic interests of each, kept well beneath the surface. The franchisor's CEO is often inclined, out of necessity, or tempted to oversell what the franchise system can generate in terms of additional value and may try to take the money and keep the power. The investor has a tendency to rely on the CEO's vision for the future, in particular if the P&L that has been defined for the future is in line with past growth. The way the initial negotiation has been conducted by each party impacts, at least partially, on the destiny of the franchise system in the aftermath of the negotiation. If the franchise system has been oversold then the risk is great of derailment of the P&L plan in particular, with all the ripple effects one can easily foresee.

The second point is when the franchise system is confronted with a major difficulty that could jeopardize its future, it could be:

1. Poor operational decisions, the accumulation of which generates a financial crisis;
2. Derailment of the P&L plan defined on day one;
3. Strong competition outclassing the franchise system, or
4. Confrontation between franchisor and franchisees, resulting in the departure of franchisees in such proportions that it causes structural damage to the network and franchisor's revenues.

In such a situation, the "couple" is in a crisis situation and the error here would be making the wrong decision under pressure of events: replacing the CEO, when, in fact, it is the system which requires to be fixed or the reverse.

The third point is the most delicate. In the face of the franchise system's mutation and entering into a new period of its development and new challenges, there comes a day when the board must reorganize the franchisor's top management, including replacement of the CEO, in the best interest of the franchise system. Not all founders are great developers. The investor has to be trained to identify when this day comes and not confuse it with some other difficulty.

Negative impact on franchisees

The franchise system characterizes itself by the fact that its immediate "clients" are the franchisees themselves, who, in turn, serve consumers. One of franchising's key mottos is indeed that of partnership for profit between franchisor and franchisees. The virtues of the dynamics of this relationship are key to a successful franchise system: the franchisor is expected to entirely focus its effort to serve franchisees, develop and keep the system competitive and ensure the marketing of the trademark.

The arrival of an investor in the franchisor's capital creates a new situation where the franchisor must adapt to the presence of a new "client", the investor. The challenge is that franchisees' and investor's interests are not aligned and can even be contradictory. The franchisor may very well be confronted with a loyalty conflict between the two. In practical terms, how and when does such a dilemma occur? Problems arise at three levels.

First, the board's strategy may not take the importance of nurturing the relationship with franchisees sufficiently into consideration, usually out of sheer ignorance on the part of the investor of the crucial role of franchisor-franchisee dynamics. If and when a profit is made, how is it distributed? Is the investor compensated first through distribution of dividends or is it reinvested in the franchise system. When the investor is excessively greedy and uses its domination over the boardroom, then franchisees get concerned if they do not see sufficient effort to maintain franchise services and innovation at the required level to compete.

Second, if and when the board adopts a new strategy, the franchisor's top management may not be entirely certain that franchisees will accept and adhere to it. The investor, however, usually believes that because the board made a decision and since franchise contracts give leverage to thefranchisor to impose onto franchisees such new direction, the strategy will be followed. Nothing is less automatic. Franchisees are independent partners who have signed an agreement and have adhered to a certain strategy. Making a significant shift in strategy requires true interpersonal skills to convince the network it will work. This must not be underestimated, as it is too often.

"The challenge is that franchisees' and investor's interests are not aligned and can even be contradictory."

Third, the fate of franchise systems is not different from that of any living being: they are very delicate organizations which thrive if the cycle is kept rolling: great services to franchisees, strong marketing, fantastic products, loving consumers connecting with the brand, etc. But, if it derails with a high risk of melt down, the instinctive reaction of the investor will certainly be to salvage what can be, instead of reinvesting, which would be the first reaction of the franchise founder with the support of its franchisees. If the investor jumps ship, loss of confidence by the business community of bankers and lenders in the system may very well be the killing blow and gravely impair franchisees' hard work of developing locally successful stores under the brand.

5. Conclusion – Why "international" M&A transactions are different

Just as any merger and acquisition, the driver behind an international merger or acquisition is financial. How the parties determine if the transaction will be financially beneficial to them, however, will differ between a domestic and an international transaction. In a purely domestic transaction, the lawyers representing the parties are usually familiar with the applicable law and meeting with both franchisor management and franchisees can be accomplished with little difficulty. In an international transaction, the situation is different. The lawyers will likely only have a cursory knowledge of the various laws in the foreign jurisdictions involved in the deal. There may be language barriers involved in reviewing documentation related to the franchise system. The geographic distance can make it hard to visit with franchisees and cultural differences may make it hard to assess the state of the franchise system. The cost of hiring local counsel, translating documents, and travel for on-site due diligence usually makes the investigation of the foreign aspects of the deal by default less intense than of domestic aspects. There is a carry-over effect to these difficulties into the drafting of the purchase agreement – if the buyer is uncertain about the potential risks in the foreign aspects of the franchise system, it may try to protect itself against these uncertainties by requesting further reaching representations and warranties about them. Whether such representations and warranties are appropriate is a matter that must be decided on a case-by-case basis.

Another aspect of an international transaction that must be taken into account is if the acquiring company has sufficient appreciation of foreign cultures and the way business is done in other countries. Doing something different does not mean that it is being done wrong. Just like the franchisor who begins its initial international expansion and learns that its way of doing business may need to be modified to be successful in a foreign country, the acquirer cannot step in and try to undo those things that have been learned over long periods of time.

Mergers and acquisitions with international aspects also increase the complexity of the transaction. Timing issues need to take into account different time zones and, at times, the differences in the length of time it takes to get things done. These are what help to make these transactions exciting.

"if the buyer is uncertain about the potential risks in the foreign aspects of the franchise system, it may try to protect itself against these uncertainties by requesting further reaching representations and warranties about them."

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