THE IMPACT OF PRIVATE EQUITY ON THE FRANCHISING INDUSTRY

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Introduction[1]

Over the past several years private equity (also referred to herein as "**PE**") has shown a significant interest in the franchising industry, increasingly investing in franchise systems as a whole as well as acquiring a critical mass of franchisees. This interest is well-founded and, in many instances, has proven very successful for both the PE investor as well as the franchise system (including their franchisees). Given the growth of this area, it is important for franchisors and franchisees alike to understand private equity fundamentals as well as appreciate the impact that this business model has on the franchising industry as we know it. This paper will consider private equity fundamentals, examine the historical growth of private equity's interest in franchising and will close with an assessment of the impact private equity has on key players and stakeholders in the franchise network.

Private Equity Fundamentals

What is Private Equity?

Private equity is most simply described as "non-debt" investments[2] in private companies,[3] where the investor provides funding in exchange for equity in the company.[4] The specific type of private equity investment usually varies depending upon the financial stage of a company at the time of investment.[5] These stages generally include: (a) early investments and start-ups, (b) expanding capital; (c) mature and established, (d) distressed, and (e) secondary investments, all of which are reviewed in greater detail below.

(a) Early Stage Investee Companies

The most common form of private equity for an early stage or start-up company is venture capital.[6] Venture capital investments include seed money, which refers to financing a potential business requiring substantial further research, development, and other threshold activities before revenue-generating activities may commence.[7] Venture capital investments also include early stage investments for companies that have passed through the seed-money stage and are ready to begin, or have already begun, generating revenue.[8]

(b) Expanding Investee Companies

Private equity investments can also play a significant role in the growth and expansion of a company which has a more developed business model in place. For instance, if a company needs additional capital for

[1] The authors would like to acknowledge their appreciation for all of the efforts of Debi Sutin, Gowling WLG, and Anna Thompson-Amadei, Sotos LLP, in respect of this paper.

[2] Private equity investments can take the form "debt" through, for example, convertible notes, but even here the general idea is that the investee company will at some point surrender an equity stake in their company in exchange for funding.

[3] Private equity investments are made in public companies much less often and result in the delisting of the public company in what is colloquially referred to as a "go-private" transaction. A more elaborate discussion of this transaction is beyond the scope of this paper.

[4] Darryl J Cooke, *Private Equity: Law and Practice*, 6th ed (London: Sweet & Maxwell, 2018) at para 1-01.

[5] Global Impact Investing Network (GIIN), "A Guide for Impact Investment Fund Managers" (n.d.), online: <https://thegiin.org/developing-a-private-equity-fund-foundation-and-structure/>.

[6] *Ibid.*

[7] Jack S. Levin and Donald E. Rocap, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions*, (New York: Wolters Kluwer, 2016) at para 105.1.

[8] *Ibid.*

expansion – to build new plants, develop new products, enhance their distribution abilities, or acquire an add-on business, and the capital required exceeds the amount that the business is able to raise from personal, debt, or public-market sources, a private equity investor may supply the capital needs of the business in exchange for equity.[9] These forms of private capital investments are also known as development capital, growth capital or growth-equity transactions.[10] A good example in the franchising industry is the investment by Roark Capital Group in *Orangetheory*, which is also discussed in greater detail later in this paper.[11] Impressed by the "explosive growth" that *Orangetheory* experienced in its first five-years, Roark Capital Group invested in *Orangetheory* to help improve service quality and expand those kinds of products offered by the company.[12]

(c) Mature Investee Companies

Private equity investments may become more varied where the target company is large and established, usually with more emphasis placed on efficiencies and restructuring.[13] One common method employed is a leveraged buyout ("**LBO**"). A LBO involves a purchaser's acquisition of a company through the use of a significant amount of debt, with the assets of the target company used as collateral for the acquisition debt. Indeed, LBOs are high-risk and require confidence from investors that the target company can experience continued growth following the LBO. For example, the 2006 LBO of Quiznos by private equity firm CCMP Capital Advisors ("**CCMP**"), which is discussed in greater detail later in this paper, was premised on Quiznos potential for continued growth. [14] The idea was that the capital from the LBO would help address Quiznos' inefficient unit volumes and low profits, resulting in a more efficient and profitable Quiznos, with the debt associated with the leveraged assets being an afterthought.

A leveraged buyout may also be facilitated by existing management in what is referred to as a leveraged management buyout ("**LMBO**") or the management team may pool its resources to acquire some or all of the company in a relatively less complex management buyout ("**MBO**").[15] The idea behind a LMBO and MBO is that the existing management team will use their expertise to strategically grow the company.[16]

(d) Distressed Investee Companies

A financially distressed company is a common target for private equity investment, with the private equity investment aiming to rescue or turnaround the company. One example is a management buy-in ("**MBI**"). A MBI is where an external manager, or group of external managers, seek out a target company to purchase and become new owners or co-owners in the process. The funding required for the external management team to purchase the business may be provided, in whole or in part, by private equity investors. [17] More generally, a private equity investment in distressed companies is based upon the notion that such investment will make the company more productive, which certainly formed part of the reasoning for the

[9] *Ibid* at para 105.2

[10] Cooke, *supra*, note 4 at para 1-12.

[11] Orangetheory Fitness, "Orangetheory Fitness Receives Growth Equity Investment From Roark Capital Group", *Cision PR Newswire* (17 February 2016), online: < https://www.prnewswire.com/news-releases/orangetheory-fitness-receives-growth-equity-investment-from-roark-capital-group-300221367.html#:~:text=17%2C%202016%20%2FPRNewswire%2F%20%2D%2D,growth%20equity%20investment%20in%20the>.

[12] *Ibid*.

[13] GIIN, *supra*, note 5.

[14] Jonathan Maze, "A Brief History of Quiznos' Collapse", *Restaurant Business* (13 June 2018), online: <https://www.restaurantbusinessonline.com/financing/brief-history-quiznos-collapse>.

[15] Business Development Bank of Canada (BDC), "Management buyouts: Points to consider and ways to finance them" (n.d.), online: <https://www.bdc.ca/en/articles-tools/start-buy-business/buy-business/pages/introduction-management-buyouts.aspx>.

[16] *Ibid*.

[17] Cooke, *supra*, note 4 at para 1-07.

decision by Alden Global Capital ("**Alden**") to acquire the struggling PayLess ShoeSource ("**Payless**") in 2017, as assessed later in this paper.

(e) Secondary Purchase Investments

Secondary purchase investments do not relate to the particular stage of a company. In certain cases, the private equity investor is not providing new capital into the business, but rather replacing existing capital, or paying off existing debt in exchange for equity. These transactions involve a private equity firm purchasing equity in an existing company from another shareholder which can include a private equity investor who made an earlier investment or who wishes to exit the company, or through refinancing bank debt investments. The private equity firm becomes an additional shareholder through providing liquidity and additional funding for the company.[18]

Private Equity Firms

Having considered the various points in time that PE may make investments in companies, it is important to consider the structure of the investment entity itself. Investors behind private equity investments become co-owners of the companies they invest in, sharing in the risks and returns of the businesses, and often taking on significant advisory roles in the business, combining their provision of capital with management advice and expertise.[19]

"Private equity" is often used as a shorthand reference for professional investing firms which manage and control often very significant amounts of capital formed for the purpose of making investments in promising private companies.[20] These firms, known as private equity firms or sponsors, raise their funds from a wide range of sources, including institutional investors such as pension funds, insurance companies, endowments, as well as from high net worth individuals. Private equity firms use these funds, sometimes along with borrowed money and their own business acumen, to invest in and help grow companies they believe have significant potential and are likely to provide positive returns. The target companies, usually identified by the management team of the funds, are often referred to as portfolio investments or portfolio companies.[21]

Private equity firms can be classified as either generalists or specialists, depending on their choice of target companies. Generalist firms invest in a wide range of industries and cover all investment categories from start-up businesses to later-stage growth and expansion investments. Specialist firms only invest in certain industry sectors or product categories in which they have a particular interest or expertise, such as high-technology propositions or management buy-outs, among others.[22]

Private Equity Funds

Private equity funds used by private equity firms often take the form of a limited partnership. This business structure allows for tax flow-through treatment for investors, where income tax is not paid at the partnership level, but rather at the level of the partners themselves. A limited partnership also offers benefits for the investors in terms of limiting their liability to the extent of their capital investment.

Limited partnerships must have at least two partners, with one being the general partner and at least one being the limited partner. For private equity, the general partner of the limited partnership is usually a promoter of the fund and is, at law, responsible for the management of the business of the limited

[18] *Ibid* at para 1-10.
[19] *Ibid* at para 1-01.
[20] Alison R. Manzer, Suhuyini Abudulai, and Carla Potter, *Law in International Finance,* (Toronto: Thomson Reuters Canada, 2019) at para 5.9.
[21] *Ibid.*
[22] Cooke, *supra*, note 4 at para 1-04.

partnership. This promoter earns a fee for performing the investment management duties, which usually includes a share in the profits generated by the fund.[23] The general partner assumes all of the limited partnership's liabilities.[24] In a limited partnership fund, the investors make up a group or class of limited partners who do not take part in the management of the business of the fund. Limited partners who are found to take part in the management of the private equity fund, may risk losing their limited liability status. [25] [26]

Private equity funds can be further classified on the basis of the funds from which they raise their investments. One class of private equity fund, independent funds, raise their capital entirely from external sources such as pension funds, insurance companies, high net worth individuals, and other corporate investors.[27] In contrast, captive private equity funds acquire their funds from their parent organizations, which are often financial institutions. Semi-captive private equity funds are captive funds that, in addition to receiving funds from their parent organizations, also raise funds from external sources.[28] Regardless of their classification, private equity funds generally undertake riskier investments than other investor classes, in order to obtain a higher rate of return on their capital.[29]

Private equity funds are often short-term investment vehicles, lasting on average 10 to 13 years. Investments are made during the first few years of the fund's life, with the investors adding value, monitoring, and expecting the company to grow in the remaining years, before the investment is matured and ideally sold for a profit.[30] Unlike other forms of investment, private equity investors generally do not intend to maintain long-term control of the portfolio company or build a career running it. Instead, the private equity investors are generally evaluating alternative exit strategies while they are making their initial investment decision.

History of Private Equity in Franchising

Private equity's expansion into the franchising industry can be tied to the broader increase in the availability of private capital generally, which goes back to the late 1970s. Beginning at that time, private and public employee benefit plans, as well as university endowment funds, began investing a small but increasing portion of their considerable assets in private equity funds, attracted by the potential for high returns on their investments. This increase in the amount of capital available provided a significant boost to the private equity investment industry.[31] Since 1980, the amount of capital that is annually committed to private equity investments has increased from less than $1 billion to well over $260 billion.[32] As the size of private equity funds grew, private equity became an alternative ownership structure for large, in some case multibillion dollar, companies.[33]

[23] Manzer, *supra*, note 20 at para 5.9.
[24] *Ibid*.
[25] This is the case for limited partnerships formed in Ontario. Please see the 1977 Ontario Court of Appeal decision of *A.E. Lepage Ltd. v. Kamex Developments Ltd.* for an example of such concern. The reader should also note that the loss of limited liability could potentially be avoided by forming a limited partnership in certain other provinces. For example, section 63(2) of *The Partnership Act* of Manitoba ensures the limited liability of a limited partner once they communicate their status as limited partners to the relevant third parties.
[26] Manzer, *supra*, note 20 at para 5.9.
[27] Cooke, *supra*, note 4 at para 1-02
[28] *Ibid* at para 1-03.
[29] Levin, *supra*, note 7 at para 103.
[30] *Ibid*.
[31] *Ibid* at para. 106.3.
[32] James J Goodman et al., "Private Equity Funds in International Franchising" (2013) 11:1 *International Journal of Franchising Law* 3 at 5, online (pdf): *Nexsen Pruet* <https://www.nexsenpruet.com/uploads/1172/doc/Private_Equity_Funds_in_International_Franchising.pdf>.
[33] *Ibid.*

The increase in the annual commitment of capital by private equity firms alongside a growing franchising industry set fertile ground for a lasting and complementary relationship between the two. An early and significant example of an investment in the franchising industry made by a private equity fund was the 1998 investment Bain Capital made in Domino's Pizza, Inc., for $1.1 billion.[34] Similarly, in 1999, Gemini Investors was part of the original round of investors in Buffalo Wild Wings.[35] Growth in the number and magnitude of investments by private equity investors in the franchising industry continued throughout the 2000s, notably with Bain Capital, the Carlyle Group, and Thomas H. Lee Partners acquiring the Dunkin' Brands in 2006.[36]

More recently, investments by private equity funds in the franchising industry have experienced continued growth. Private equity firms have recently acquired a wide range of franchises, including service-based businesses and home-office based locations.[37] In 2018, private equity funds made significant franchisor acquisitions, including, among others, Jamba Juice, Sonic Drive-In, Zoe's Kitchen.[38] Apollo Global Management, LLC purchased Qdoba Restaurant Corporation for $305 million, Roark Capital Corp, through its majority position in Inspire Brands, Inc. acquired a 12.3% ownership interest in the Wendy's Company for $450 million, and also acquired Sonic Corp in a transaction estimated at an overall figure of $2.3 billion.[39] In 2019, CorePower Yoga, Hooters, and Whataburger all attracted new investors from private equity capital providers.[40]

Where over the last two decades private equity investors have demonstrated a historic preference for franchisors, private equity investors have more recently begun taking a material interest in franchisees as well.[41]

The Impact on Key Players

The growing interest of private equity funds in the franchising space has had a profound impact on all of the industry's principal stakeholders and participants. While this impact has been most significantly felt by franchisors and their respective franchisees, private equity's emergence in this space has profoundly impacted a wide variety of additional parties, including franchisor and franchisee employees, industry suppliers and vendors, creditors, landlords, and customers, among others. Below we examine the stakeholders most fundamentally affected by private equity's growing investment focus on the franchising space.

Franchisors

Most significantly, private equity's entry into this space has had profound effects on franchisor operations, both for better and for worse. For reasons explored elsewhere in this paper, franchisors are attractive to private equity funds for several key reasons: strong franchisors will have developed recognizable brands and easily-replicated systems which generate predictable cash flow, the franchise business model allows

[34] Beth Healey, "Domino's delivered for Bain", *Boston Globe* (29 January 2012), online: < https://www.bostonglobe.com/business/2012/01/29/domino-delivered-for-bain-capital/kyMA0fIwPYvg2pa0UK1UfI/story.html>.
[35] Goodman, *supra*, note 32 at 12.
[36] "Bain Capital, The Carlyle Group and Thomas H. Lee Partners Complete Acquisition of Dunkin' Brands", Dunkin' Newsroom (1 March 2006), online: < https://news.dunkindonuts.com/news/bain-capital-the-carlyle-group-and-thomas-h-lee-partners-complete-acquisition-of-dunkin-brands>.
[37] Rick Bisio, "The Increasing Role of Private-Equity Firms in Franchising", *Franchise Gator* (4 April 2018), online: < https://www.franchisegator.com/articles/private-equity-firms-investing-in-franchising-12700/>.
[38] "Franchisors vs. Franchisees: Why Private Equity Likes Both", *Clearlight Partners LLC* (5 October 2019), online: < https://www.clearlightpartners.com/franchisors-vs-franchisees-why-private-equity-likes-both/>.
[39] Joyce Mazero, "Private Equity is Buying More Franchise Systems – Here Are They Key Legal Issues They Are Looking At", Forbes (14 January 2019), online: <https://www.forbes.com/sites/joycemazero/2019/01/14/private-equity-is-buying-more-franchise-systems-here-are-the-key-legal-issues-they-are-looking-at/#65b2e6b71b95>.
[40] "Franchisors vs. Franchisees: Why Private Equity Likes Both", *supra*, note 38.
[41] *Ibid*.

for the rapid scaling of operations with modest capital expenditures from the franchisor (and its investors), and ongoing royalties and other fees paid under each unit's franchise agreement provides the franchisor with steady and reliable revenue streams.[42]

As the *Franchise Times* points out, private equity's entry into a franchise system can have transformative and explosive results.[43] Franchisors, especially smaller and less-mature systems, often have grand ambitions for the future but not necessarily the resources to realize such ambitions. Most obviously, they may be lacking the necessary capital to rapidly scale their operations and meet growing demand. By the same token, they may have a limited network of supplier and logistical partners, an inability to obtain most favourable terms with service providers, and a management team that, while having a mastery of the brand and product, may lack the requisite skillset to realize the full growth potential of their system.

Private equity can inject these resources into franchise systems, allowing a system to rapidly scale by leveraging the fund's capital, expertise, and existing relationships. For example, the entry of a private equity fund into a franchised business can endow legacy franchisor management with a wide variety of human capital and business expertise ranging from logistics, finance, marketing, research and development, and beyond.[44] Moreover, PE funds can leverage their existing relationships and collective buying power with suppliers, landlords, financial institutions, and any number of other service providers to create synergies and more favourable terms for both the franchisor and its individual franchisees.[45]

Florida-based franchisor, *Orangetheory,* is an example of synergies that private equity can bring to a franchisor and its franchise system. The fitness system, while already enjoying significant success prior to private equity investments, brought on Roark Capital Group as an investor in 2016.[46] Following Roark's investment, the franchisor has experienced significant growth in the United States, as well as Canada and several dozen other countries*. Orangetheory* had approximately 500 studios at the time of Roark's investment in 2016, and by 2019 had opened over 1,100 studios and achieved over a billion dollars in systemwide sales.[47] While one cannot discount the strength of *Orangetheory*'s concept and the appeal it holds for its customers, the injection of funds and experienced management from Roark allowed the franchisor to quickly expand its geographic footprint and reach eager customers across the globe. Other private equity firms have clearly taken note of Roark's success in the fitness space, including Angelo, Gordon & Co., which has since taken a stake in franchisor *Crunch Fitness*.[48]

Although not a universal rule, private equity firms generally look to create near-term returns for their investors, particularly given that the investment vehicles PE funds typically utilize have a finite shelf-life

[42] Francesca R Turitto et al, "A Marriage Made in Heaven? Private Equity and International Franchising" (2015) 13:1 Intl J of Franchising L 1 at 10, online (pdf): *Plave Koch* <http://plavekoch.com/wp-content/uploads/2015/02/IJFL-Vol.-13-No.-1-republication-of-conference-paper.pdf>.

[43] Laura Michaels, "CEO Dave Long On Orangetheory's Explosive Growth", *Franchise Times* (4 October 2017), online:<franchisetimes.com/news/September-2017/CEO-Dave-Long-On-Orangetheorys-Explosive-Growth/>.

[44] Steven Beagelman, "The Impact of Private Equity on the Franchise Industry", *Forbes* (24 June 2019), online: <https://www.forbes.com/sites/stevenbeagelman/2019/06/24/the-impact-of-private-equity-on-the-franchise-industry/#30d92ac57473>.

[45] Harris J Chernow, Edward Levitt & Tom Wells, "Have Multi-Unit and Multi-Brand Franchisees Set a New Standard for Franchisors?" (Paper delivered at the 51st Annual Legal Symposium of the International Franchise Association, Washington, D.C., 6-8 May 2018), 21, online (pdf): *Dickson Wright* <https://www.dickinson-wright.com/-/media/documents/documents-linked-to-attorney-bios/levitt-510181-toronto14318662speaking--ifa--legal.pdf?la=en&hash=8CF833AB03DE89B0ED0AC5C4669B701EDD9AD134>.

[46] Michaels, *supra*, note 43.

[47] Rachel Hosie, "Why the world is obsessed with Orangetheory, the heart rate-monitoring workout that hit $1 billion in sales in a single year", *Business Insider* (3 March 2019), online: <https://www.businessinsider.com/orangetheory-heart-rate-monitoring-workout-hits-1-billion-sales-what-its-like-2019-2>.

[48] *Ibid.*

before invested funds (and the associated returns) must be returned to their individual investors.[49] Private equity firms, which are often under pressure to generate near-term returns on investments, may be incentivized to maximize short-term returns to the detriment of the long-term health of the franchisor and its franchisees. There is the potential for tension in decision-making between private equity firms and retained existing management teams due to a misalignment of time horizons as private equity investors may favour decisions that will lead to accelerated short term growth (e.g. rapidly growing the pool of franchisees; quickly expanding into new markets before adequate brand recognition and logistics networks have been established; and taking on substantial leverage and employing franchisor cashflow to service such leverage) even though alternative, more patient courses of action may provide greater prospects of long term value maximization for stakeholders,[50] as is further explored below.

Following a PE fund's investment in, or buyout of, a business, private equity funds typically introduce largescale changes to the target's management group, in order to ensure that senior management align with the objectives held by the PE fund and its principals. Since newly-installed senior management may lack industry knowledge and experience, there is an increased risk of inept business decision-making.

Distressed companies are a common target for private equity funds, especially companies that can be identified as underperforming in part due to the shortcomings of existing management. Following an investment or acquisition by a private equity fund, it follows logically that a management team failing to deliver results to their shareholders will be replaced with executives who can help the company achieve it's potential. While this may prove to be a prudent strategy in certain scenarios, it is important for private equity funds to ensure that sufficient institutional knowledge of the business and the industry more generally is retained. This includes ensuring that any new management team understands the business of franchising (which is a business in itself, distinct from whatever products or services the business in question may sell).

The dangers of failing to heed this lesson were vividly explored in Neil Irwin's recent article in the New York Times, "*How Private Equity Buried Payless*", which explored the demise of prominent American shoe retailer PayLess following its acquisition by Alden in 2017. Although Payless was not a franchised system, many of the lessons learned from this case are nonetheless relevant for brick and mortar franchise systems. Despite the dramatic title of Irwin's article, we caution that Payless was already facing monumental challenges to its business and future when it was acquired by Alden and was concurrently emerging from bankruptcy at that time.[51]

Multiple stakeholders have accused Alden of mismanaging Payless following its acquisition, and making a variety of poor business decisions that ultimately sealed the retailer's fate and made its resurgence impossible. Payless' creditors, for instance, have complained that Alden installed its own unseasoned executives in leadership positions at Payless following the acquisition. It has been alleged that this new management team lacked experience in not just the footwear industry, but also the retail industry more generally, and failed to grasp both the monumental challenges faced by Payless and the business currents present in these industries. [52] Many of Payless' existing management and decisionmakers were let go following the acquisition, removing human capital and industry experience it had spent decades building.

Creditors and other stakeholders also complained that Alden, following its acquisition, had placed itself in a variety of business conflicts of interest with Payless, and that Alden was prioritizing its own business

[49] Goodman, *supra*, note 32.

[50] Jonathan Maze, "Is Private Equity Bad for Franchising?", *Restaurant Business* (4 June 2019), online: <https://www.restaurantbusinessonline.com/financing/private-equity-bad-franchising>.

[51] Neil Irwin, "How Private Equity Buried Payless", *The New York Times* (31 January 2020), online: <https://www.nytimes.com/2020/01/31/upshot/payless-private-equity-capitalism.html>.

[52] Kevin McCoy and Nathan Bomey, "As Payless wades through bankruptcy again, creditors say hedge fund may be to blame", *USA Today* (29 April 2019), online: <https://www.usatoday.com/story/money/2019/04/29/payless-shoesource-bankruptcy-creditors-lenders-question-alden-global-capital-hedge-fund/3340048002/>; WSJ article.

interests over the wellbeing of Payless' stakeholders.[53] A variety of potential conflicts of interests were raised, including Alden's decision to move Payless' corporate headquarters to Dallas, which was alleged to have been done to benefit an Alden affiliate that owned the building housing the new headquarters; subjecting Payless to shared service contracts with other Alden-controlled businesses that had limited business rationale or benefit for Payless; and the fact that Alden-linked Payless board members were voting on matters that concerned the interests of both Payless and Alden.[54]

While the veracity of these complaints is far beyond the scope of this paper, the mere existence of these public allegations serve as a stark reminder that serious consideration of both the franchisor's and private equity investors' goals and values must be undertaken prior to any potential partnership being struck. Compare the above with the example of Roark Capital, which has majority or minority stakes in a variety of franchise systems, including Arby's, Auntie Anne's, Orangetheory, and Pet Valu.[55] Roark has been praised for consistently employing a "buy and hold" strategy with franchisors which emphasizes "long-term focused decisions that improve the business".[56] When private equity understands franchising and how it differs from other business models, and aligns its goals with those typically held by a franchise system, it can result in, as one author put it, a match made in heaven.[57]

Leveraged Buyouts and their Impact on Franchisors

No discussion of private equity's role in franchising would be complete without mentioning private equity's affinity for LBOs. As popularized by Bryan Burrough's and John Helyar's 1989 best-selling book, *Barbarians at the Gate: The Fall of RJR Nabisco*, a LBO involves a purchaser's acquisition of a company through the use of a significant amount of debt, with the assets of the target company used as collateral for this acquisition debt. Investors looking to carry out an LBO look for targets that have strong and consistent cash flows, as such cash flows will be critical to help service the significant amount of leverage placed on the target company post-acquisition.

The franchising industry has seen its share of LBOs over the past several decades, though perhaps none have been more newsworthy than CCMP's acquisition of submarine sandwich chain Quiznos in 2006. Following CCMP's acquisition of Quiznos by way of an LBO, the franchisor was burdened with hundreds of millions of dollars in acquisition debt.[58] Faced with a variety of adverse challenges unrelated to the acquisition, including strong competition and a weakening economy, Quiznos was unable to adequately grow and sustain its revenues at a level sufficient to meet the substantial debt obligations that arose from the LBO.[59] These debt obligations weakened the company's ability to adapt to changing market conditions and consumer preferences, invest in new technology or innovation, or otherwise effectively assist franchisees who were increasingly struggling as a result of these aforementioned issues.[60] Research unrelated to the Quiznos matter has suggested that highly-leveraged businesses may also incur a substantial deterioration of the quality of their product offerings versus businesses that are not significantly leveraged.[61] Although this research was not conducted with respect to the franchising industry, it seems

[53] *Ibid.*

[54] McCoy and Bomey, *supra* note 52.

[55] "Portfolio Companies", online: *Roark Capital Group* <https://www.roarkcapital.com/portfolio>.

[56] Barney Wolf, "Inside Roark Capital", *QSR* (May 2014), online: <https://www.qsrmagazine.com/growth/inside-roark-capital>.

[57] Turitto, *supra* note 42.

[58] Maze Quizno's *supra* note 14.

[59] *Ibid.*

[60] *Ibid.*

[61] David A Matsa, "Running on Empty? Financial Leverage and Product Quality in the Super Market Industry" (2011) 3:1 American Economic J: Microeconomics 137, online (pdf): <https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1646097_code524777.pdf?abstractid=970790&mirid=1&type=2>.

likely that any company servicing significant leverage will explore every cost-cutting measure available to maximize possible savings, including cuts which may jeopardize product quality and innovation.

In the course of a decade during and following the LBO, Quiznos shed over 4,000 locations in the U.S. alone.[62] The end result of the Quiznos instance provides a stark example of how a heavily-leveraged LBO target, post-acquisition, may be limited in its ability to weather business downturns and adapt to current trends absent sustained growth.[63]

This point was further emphasized during the emergence of COVID-19 in the first quarter of 2020. Take for example upscale American pizza chain California Pizza Kitchen. Acquired by Golden Gate Capital ("**GGC**") by way of LBO in 2011.[64] In 2012 Standard & Poor Ratings Services revised its outlook on the franchisor downward as a result of its "highly leveraged financial risk profile as a result of the GGC LBO".[65] California Pizza Kitchen struggled to absorb the debt incurred as part of the GGC acquisition, including substantial debt incurred in 2013 to allow GGC to pay itself a multimillion dollar dividend.[66] Ultimately, as a result of its debt profile, it was unable to weather the shock and changing circumstances brought about COVID-19, and declared bankruptcy in July 2020.[67]. Although the chain continues to operate as of September 2020, whether the chain will continue to operate in the long term remains to be seen. In the California Pizza Kitchen and Quiznos examples, measures taken by PE investors, coupled with adverse market conditions, left the businesses too fragile to pivot in response to adverse circumstances.

It should be reiterated that private equity's acquisition of businesses often occurs when the business in question is already facing substantial challenges to its operations and outlook. When assessing the impact private equity has on a business, post-acquisition, the impact should be considered through a lens that considers the challenging task that the private equity firm is inheriting. Private equity firms have the capital, and often the expertise, that can be crucial to a business overcoming challenges and remaining viable in a changing marketplace. Incentives must exist for private equity firms to risk investing in distressed companies.

Multiple examples of successful LBOs in the franchise space also exist, such as Blackstone Group's acquisition of the Hilton chain of hotels, which it took private in 2007 as part of a LBO transaction.[68] Blackstone achieved incredible success for itself and Hilton, which is more profitable and larger than it was

[62] *Ibid.*

[63] Julie Jaron and Mike Spector, "LBO, Recession Singe Quiznos", *The Wall Street Journal* (21 July 2011), online: <https://www.wsj.com/articles/SB10001424052702304567604576454284093198552>.

[64] Sharon Bernstein, "California Pizza Kitchen to be acquired by private equity firm for $470 million [Updated]" *Los Angeles Times* (28 May 2011), online: <https://latimesblogs.latimes.com/money_co/2011/05/california-pizza-kitchen-to-be-acquired.html>.

[65] "TEXT – S&P revises California Pizza Kitchen rating outlook", *Reuters* (28 August 2012) online: <https://www.reuters.com/article/idUSWNA420020120828>.

[66] William Louch et al., "Coronavirus Puts Private-Equity-Backed Restaurants and Their Workers in Limbo*" The Wall Street Journal* (1 April 2020), online: <https://www.wsj.com/articles/coronavirus-puts-private-equity-backed-restaurants-and-their-workers-in-limbo-11585765999>.

[67] Luca Casiraghi et al. "California Pizza kitchen Lates Chain to File for Bankruptcy" *Bloomberg* (30 July 2020) <https://www.bloomberg.com/news/articles/2020-07-30/california-pizza-kitchen-is-latest-chain-to-file-for-bankruptcy>.

[68] Javier Espinoza and Mark Vandevelde,"Blackstone sells out of Hilton Worldwide", *Financial Times* (18 May 2018), online: <https://www.ft.com/content/4ea26dba-5ab1-11e8-bdb7-f6677d2e1ce8>.

at the time of the purchase,[69] as well for itself, generating billions of dollars in profits for investors at the time Blackstone fully exited its investment in 2018.[70]

Franchisees

As the saying goes, a rising tide raises all boats. The injection of private equity into a franchisor, for the same reasons expressed above, can also have a tremendously positive impact on individual franchisees of the franchisor.

Private equity investors can provide the capital and expertise to drive substantial innovation and brand awareness within franchise systems, all aimed at increasing profitability. As ongoing royalty payments are one of the primary sources of franchisor income, it follows logically that enabling franchisees to grow their own business benefits not just the individual units, but also the franchisor as a whole. As noted, private equity can help grow brand awareness for a franchise system, which results in increase exposure for the franchisor and brand, and presumably, increased traffic and profitability for its franchisees. Likewise, private equity can inject capital and expertise into a system necessary to develop and roll out improved and new product offerings, achieve better terms with suppliers, landlords, and other service providers, and streamline the system's operations, logistics, and processes. Logically, such innovation and expertise provided by the private equity investor should have a marked positive change not only for the system as a whole but also for individual franchisees, provided investments by franchisees are designed to have a reasonable payback.

Whereas well-executed private equity investments in franchisors can have positive trickledown effects on its franchisees, a poorly-executed investment can have negative trickledown effects on a system's franchisees.

Restaurant Brands International's ("RBI") acquisition of Tim Horton's donut chain is an example of such disputes going public and attracting unwanted attention to the brand. According to some commentators, the imposition of new more formulaic management processes created tension between the franchisor and its franchisees who had become accustomed to more informal channels of communication coupled with ongoing active dialogue. The shift from what was once a casual and open relationship between franchisor staff and the system's franchisees to a more formal communication approach created a rift that ultimately led to public disputes. The Tim Horton's example, underscores the need for a PE fund to ensure any investment does not alienate the franchisees who are at the forefront of a franchisor's operations. It also speaks more broadly to the importance of understanding existing structures and relationship dynamics as maintaining good relations between a franchisor and its franchisees is necessary to maximize the benefits of the transaction.

Management and Employees

For the management and employees of a franchisor, introduction of the expertise of a private equity fund and its management can inject sophisticated talent and expertise into the system's operations. A recent study found that private equity owned-firms typically "have significantly better management practices than almost all other ownership groups such as family-run, [and] founder-owned" firms.[71]

[69] David Gelles, "A Surprise From Hilton: Big Profit for Blackstone", *The New York Times* (12 December 2013), online: <https://dealbook.nytimes.com/2013/12/12/a-surprise-from-hilton-big-profit-for-blackstone/>.

[70] *Ibid.*

[71] Nicholas Bloom, Raffaella Sadun & John Van Reenen, "Do Private Equity Owned Firms Have Better Management Practices?" (2015) 105:5 American Economic Rev 442 at 442, online (pdf): *Stanford* <https://nbloom.people.stanford.edu/sites/g/files/sbiybj4746/f/aer_ep20151000.pdf>

PE funds possess the expertise to introduce a culture of financial and operational discipline and professionalism into a business, especially in smaller and less sophisticated franchise systems.[72] A recent study found that in the two years following a buyout, private firms see labour productivity levels rise by 8%.[73] Target company productivity gains, meanwhile, are even larger.[74] The introduction of private equity into a business can provide management with new insights into how to optimize its operations, and provide its employees with the tools and mentality necessary to more efficiently go about their work.

Franchisor management, especially when the system's founders and visionaries remain actively involved in the system's operations and leadership, must understand that the introduction of a private equity into their operations will require a spirit of cooperation and compromise that may not have been fully necessary prior to the transaction.[75] Both PE fund principals and franchisor management teams should conduct substantial due diligence on one another, and consider where each parties goals and values are aligned. Part of the appeal of franchisors to private equity funds is gaining a driven and knowledgeable management team; alienation of the management team, or its unwillingness to cooperate with PE investors can jeopardize the success of the entire venture.

By the same token, private equity funds would be wise to not totally disregard the experience and knowledge of existing management teams and the human capital they have amassed. In the case of Payless, for instance, it is noted that local management, who had vast experience in the retail footwear industry, were repeatedly overruled by their new private equity masters, who seemed uninterested in their input on how to best operate the business.[76]

While takeovers can have substantial impacts on the employment security of a firm's pre-existing employees, the results vary depending on the approach used. Specifically, one study found that "[e]mployment at target firms shrinks 13% over two years in buyouts of privately held firms"[77] while also finding that employment increased by the same amount (13%) following a private equity takeover at private firms.[78] Moreover, consistent with private equity's approach to "trimming the fat", a recent study showed that "[a]verage earnings per worker fell by 1.7% at target firms after buyouts" by PE funds.[79]

Customers

Without customers, there can be no franchise system. At the heart of franchising is the system's brand; this is what ultimately resonates with customers, and keeps them coming back. For fans of McDonald's, customers can easily picture the glow of its signature double arches. For Tim Horton's, meanwhile, the brand spent decades masterfully associating itself with the concept of "Canadiana". As the *Globe and Mail* wrote in 2014, Tim Horton's "has insinuated itself into the Canadian identity with such remarkable success that for some it has become enmeshed in the very idea of Canadianness."[80]

[72] Goodman et al, *supra* note 49 at 16.

[73] Steven J Davis et al, "The Economic Effects of Private Equity Buyouts" (2019) Becker Friedman Institute Working Paper No 2019-122., online (pdf): <https://bfi.uchicago.edu/wp-content/uploads/BFI_WP_2019122.pdf>.

[74] *Ibid*.

[75] Goodman et al, *supra* note 49 at 16.

[76] Irwin, *supra* note 51.

[77] Steven J Davis et al, "The Economic Effects of Private Equity Buyouts" (2019) Harvard Business School Working Paper 20-046, at 3, online (pdf): < https://www.hbs.edu/faculty/Publication%20Files/20-046_ceb00b98-e62a-45db-8d5f-9793ffd0226e.pdf>

[78] *Ibid*.

[79] Davis et al, Harvard Business School, *supra* note 77*.*

[80] Joe Friesen, "Tim Hortons: How a brand became part of our national identity", *The Globe and Mail* (27 August 2014), online: <https://www.theglobeandmail.com/news/national/tim-hortons-how-a-brand-became-part-of-our-national-identity/article20217349/>.

As this paper has explored, private equity's entrance into a franchise system can have a variety of impacts on a system's stakeholders, both positive and negative. Undoubtedly, the significant transformations brought about by PE funds, post-acquisition, will trickle down to a system's franchisees and ultimately its consumers. PE funds can drive system growth, product innovation, and improve franchisor operations, all of which can result in better service and decreased costs for consumers.

But as RBI's acquisition of Tim Horton's demonstrates, even the mere presence of a private equity firm as part of a business' operations can significantly alter the very essence of a brand's identity, customers' perceptions of that brand, and ultimately, the brand's results.

Of course, any brand that aims to position itself as being intertwined with a nation's cultural identity should ensure that such positions come off as genuine to customers. RBI, which was primarily controlled by 3G Capital, a Brazilian hedge fund, acquired Tim Horton's in a high-profile transaction, and simultaneously merged Tim Horton's with Burger King, a leading American franchisor. It clearly was not lost on consumers that a brand that for decades had staked a claim on delivering an authentic Canadian experience was, in fact, no longer Canadian (never mind the fact that Tim Horton's was owned by another American chain, Wendy's, a decade before).[81] In studying Tim Horton's results over the previous several years, and as evidenced by studies conducted on customers' perceptions of the brand, RBI's acquisition of Tim Horton's has done considerable damage to the brand, and ultimately, its profitability.[82] Moving forward, it is prudent for all parties to take care and ensure that any potential transaction is carefully managed, with particular attention to possible publicity and marketing considerations.

Vendors and Suppliers

Although perhaps not obvious at first glance, private equity's entry into a franchising system can also have a significant impact on the vendors and suppliers servicing the system, especially in instances of smaller vendors and suppliers where the franchise system constitutes a substantial portion of the vendor or supplier's overall sales. As was explored above, private equity firms, post-acquisition, will look to cut unnecessary costs and increase efficiencies wherever possible in their quest to generate significant near-term returns for the funds' investors. In particular, many firms will look to reduce the target franchisor's working capital.[83] To do so, they may undertake measures such as reducing the inventory kept on hand at the franchisor's corporate and franchised locations, while also increasing the amount of time between receiving shipments from suppliers and remitting payment. Of course, when examining the effects these actions will have on a macroeconomic level, an increase in one firm's efficiency with respect to working capital will generally lead to a comparative decrease in another firm's efficiency with respect to working capital. In effect, the franchisor is transferring working capital costs it previously incurred to the supplier[84], placing additional stress on the supplier's operations and bottom line.

David Brown, C. Edward Fee, and Shawn Thomas, in their paper, *Financial leverage and bargaining power with suppliers: evidence from leveraged buyouts*[85], similarly concluded that leveraged buyouts of target firms can have dramatically negative effects on supplier firms (and their shareholders) of the LBO target.[86]

[81] Jason Kirby, "Tim Hortons, the Brazilian coffee chain that wants to be Canadian again", *Maclean's* (10 February 2020), online: < https://www.macleans.ca/economy/business/tim-hortons-the-brazilian-coffee-chain-that-wants-to-be-canadian-again/>.

[82] *Ibid*.

[83] John Gilligan & Mike Wright, *Private Equity Demystified – An Explanatory Guide*, 3rd ed (ICAEW: 2014), at 113, online: http://www.vardis.com/media/63360/tecplm12976_privateequityiii_full-edition-1.pdf>.

[84] *Ibid* at 114.

[85] David T. Brown, C. Edward Fee & Shawn Thomas, "Financial Leverage and Bargaining Power With Suppliers: Evidence from Leveraged Buyouts" (2009) 15:2 Journal of Corporate Finance, online: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=813025>.

[86] *Ibid* at 2-6.

In their paper, they found that firms recently acquired by an LBO have increased bargaining power over its supplier firms, and that supplier firms' "operating margins generally decline following the completion of a downstream LBO and… these declines are most apparent… for those suppliers that have likely made relationship-specific investments".[87]

While a variety of authors have contributed to the analysis of why buyouts of target firms may result in adverse effects for the target's suppliers[88], one under-considered reason may be the target firm's increasingly-leveraged position.

As stated elsewhere in this paper, LBOs generally involve placing substantial leverage on a target company and its cash flows in order to complete the private equity firm's acquisition of the target. Although counterintuitive, the dramatic increase in a target firm's leverage can actually increase its bargaining power in its dealing with supplier firms. Franchisors can utilize the threat of bankruptcy or a discontinuation of dealing with the suppliers, such actions necessitated by the dire capitalisation position a firm may be in and the stressed nature of its cash flow, to extract concessions from the supplier firm in question.[89] The presence of substantial leverage on a franchisor makes such a threat credible, and threatens the profitability of the supplier firm should it fail to compromise. Failure to grant concessions to the franchisor may jeopardize all business activities between the two, as the LBO has dramatically impeded the franchisor's ability to continue business relations with the supplier as they existed prior to the LBO.

Worth bearing in mind is that the entry of private equity into a franchisor does not necessarily need to result in negative effects for the franchisor's suppliers. In fact, the increased expertise and capital can lead to increased demand for the supplier's offerings or demand for new offerings as the franchise system may undergo significant and rapid growth.

Conclusion

Private equity has had a profound impact on the franchise industry in the past several decades, and this impact is only set to grow in the coming years. Prior to proceeding with any transaction, franchisors and private equity funds alike should ensure that they critically consider their objectives (both short and long term) with a view to ensuring that this partnership and structure will achieve both parties' goals. All industry stakeholders, and private equity actors themselves, should be aware of their counterparty's priorities, needs, and concerns in order to ensure a proper working relationship is established, and to ensure that there are no unmet expectations or other surprises once the dust has settled. Private equity has the potential to drastically transform franchise systems for the better, but both parties must agree beforehand on what the goal of any investment is, and how that goal will be achieved.

[87] *Ibid* at 5.

[88] See, for example Stephen G. Bronars & Donald R. Deere, "The Threat of Unionization, the Use of Debt, and the Preservation of Shareholder Wealth" (1991) 106:1 The Quarterly Journal of Economics 231, online: <https://www.jstor.org/stable/2937914?seq=1>; Enrico Perotti & Kathryn E. Spier, "Capital Structure as a Bargaining Tool: The Role of Leverage in Contract Renegotiation" (1993) 83:5 American Economic Review 1131, online: <https://econpapers.repec.org/article/aeaaecrev/v_3a83_3ay_3a1993_3ai_3a5_3ap_3a1131-41.htm>; and Dan Kovenock & Gordon Phillips, "Capital Structure and Product Market Behavior: An Examination of Plant Exit and Investment Decisions" (1995) U.S. Census Bureau, Center for Economics Working Paper No. 95-4, online: <https://www2.census.gov/ces/wp/1995/CES-WP-95-04.pdf>.

[89] David A. Masta, "Capital Structure as a Strategic Variable: Evidence from Collective Bargaining" (2009) Journal of Finance, Forthcoming at 31-32, online: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=933698>.