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September 2005

Private equity: Where it's been, where it's going

By Paul Olson

Asked to find a common thread that runs through the likes of Apple, Starbucks, Amazon and Microsoft, any number of similarities come to mind. And while all four are public companies backed by hoards of public equity, each one relied on private equity to get them to where they are today.

Private equity is a term that pops up frequently in the current financial lexicon. During the 1980s, it often referred to the flurry of leveraged buyouts that occurred, many of which ended badly, a fact that colored the term with negative connotations. In a broader, general sense, private equity can describe any ownership in private companies by investment entities such as limited partnerships. Today, more specifically, private equity is the term used to describe the capital raised and the investments made by the increasingly numerous venture, buyout and mezzanine funds.

While the first private equity fund in the United States was formed back in 1946, the so-called "prudent man" rule of 1978, which eased restrictions on investments by pension funds, ushered in the

industry by providing a significant increase in fundraising resources. By the year 2000, when dot-com mania was at its apex, private equity firms were swimming in capital, raising some \$183.4 billion in that peak year alone, according to data compiled by Thomson Venture Economics/National Venture Capital Association (NVCA).

The result, as Emily Mendell of NVCA puts it, "was absolutely not a good thing. If you get too much money and too much liquidity in the system, then you wind up chasing deals that just aren't going to work out." Funding to private equity firms dropped off sharply in the following years, reaching a low of \$30.3 billion in 2002. The biggest hit came on the venture capital side, where fundraising dropped more than 95 percent to just \$3.8

billion.

Today, funding for private equity funds has returned to what Mendell terms the "right" level. Through the first half of 2005, buyout and mezzanine funds had raised \$35.6 billion, a pace that puts them comfortably ahead of last year's \$52 billion total. Venture capital funds are likewise ahead of last year's pace, amassing nearly \$11.8 billion thus far in 2005.

For franchisors and franchisees looking to take advantage of this source of capital, interest from private equity firms is coming on, at least on the buyout side. "I think the private equity firms have just recognized that a lot of the franchise concepts have pretty stable recurring revenues, they tend to be pretty simple business models as a general rule, so I think those things are appealing to buyout firms," says **Nick Peters, president and CEO of Prometheus Partners**, an Atlanta-based, private equity firm that focuses on smaller, middle-market service and distribution businesses.

"If you have a good franchise, there are aspects of the business like product development and marketing that

you can spend less time on as a franchisee and focus more on operations," adds David Shryock, general partner at SB Partners, a private equity firm with both franchisors and franchisees in its portfolio. He sees the brand name that so many franchise companies offer as particularly appealing, as it "provides some barrier to competition. Not a perfect barrier, but some barrier."

Michael Shepardson, executive vice president for Trustreet Properties, a firm that advises on private equity deals in addition to facilitating sale-leasebacks, echoes that sentiment. He lists the value of a recognizable brand, leverageable assets like real estate, and ample financing capacity as big pluses for the restaurant industry in attracting private equity, stressing that "the most important thing is that these restaurant companies have sustainable, predictable cash flow."

Ample cash flow is vital to firms looking to acquire companies, because on top of servicing debt, the additional cash flow capacity enables them to grow the business more quickly. Since most funds typically operate on a five-year timeframe, the ability to add units in rela-

tively short order is paramount for the funds' growth. This makes franchise companies a compelling investment sector.

When a private equity firm is interested in acquiring a franchisee, the firm is assessing the concept itself as much as it is the operations it's looking to buy. "It's very important that both of those pieces are strong," Peters emphasizes. His firm acquired IHOP franchisee **CFRA Restaurant Holdings** in May, in large part because they were impressed with IHOP's management and product promotion. Peters describes the relationship with IHOP as a symbiotic one: "IHOP wants somebody with the capital to grow, and clearly what we have is capital and financial resources to partner with them to build additional restaurants and improve the existing restaurants."

According to Shepardson, just as buyout firms evaluate the operations of the parent company in a franchisee acquisition, so will the franchisor cast a critical eye on the firm. "If you're a private equity firm and you feel pretty good about a franchisee, in relatively short order you have to get in front of the franchisor" and get approval, he cautions. In most cases this shouldn't be a problem, since the interests of the two are generally aligned, yet a relationship needs be cultivated.

Perhaps the most important relationship in a buyout acquisition is that between the private equity firm and the existing management of the acquired company. Ultimately, it's management that will decide the success of the venture, as they have both the vision and the operational know-how, yet the firm has an important role to play as well.

"Our job is to be a partner to them in every sense of the term," explains Glen Kaufman, managing director with American Securities Capital Partners, a firm that invests largely on behalf of high-income individuals rather than institutions. He sees his firm's role as the provider of a number of resources—analysis, industry best practices, access to people, experience from other concepts—in addition to capital.

"Our job is to deliver on all of those things, without becoming intrusive to the team," he says. "That's hard, but it's enormously valuable when you do it."

Prometheus's Peters agrees, describing his firm's role with operational decision making as "anything that would rise to the board of directors' level." So while site selection, for instance, would be left to management, the firm would review the economic analysis on the site to assure it makes sense. "It's really things that are more at the strategic level. It's putting good incentive plans together for the management team and monitoring the performance of the business," Peters says.

For now, the amount of private equity finding its way to the consumer products and services sector, those companies that comprise so much of the franchise world, is dwarfed by that invested in sectors like software and biotechnology. Venture capital has proved especially hard to come by, particularly for restaurants, in large part owing to the highly risky nature of startups in the industry. Even on the acquisition side, as Peters observes, "it's tough for buyout firms to invest in the franchise space because the companies tend to be small."

And yet, the private equity market is vibrant, with an ever-increasing number of firms. With them comes greater fundraising, meaning promising investments will have access to capital and firms, no matter the industry. As Kaufman sees it, "a good concept, a good team, a good company with a strong position has the luxury of choosing their partner and has the luxury of choosing someone who has an approach that matches something they are happy with. There's no shortage of capital and there's no shortage of firms." ^{FT}