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Five Reasons Franchisors Trade At High Multiples

Forbes Finance Council

FULL BIO

POST WRITTEN BY

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Patrick Galleher is the Managing Partner for Boxwood Partners, a merchant bank in Richmond, Virginia, where he leads sell-side transactions.

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If you want to invest in a franchise company and feel confident you won't have buyer's remorse, it helps if there are high multiples.

As you probably already know, "high multiples" describes the risk factors that lead to a healthy return on investment. A company with high multiples has a market/stock value that is high compared to earnings. Conversely, a company with low multiples has a market/stock value that is low compared to earnings.

Franchisors and all ownership groups like to sell at high multiples because they are likely to attract a better investment group while selling at a peak. Some potential investors are on the hunt for undervalued businesses selling at low multiples, so they can improve systems/processes/people and sell them at higher multiples for a strong ROI. However, others have a different approach, seeking high-growth companies with lower current earnings but huge upsides -- a higher multiple opportunity that has significant room for growth.

In franchising, I've seen a lot of private equity companies (those fueling franchising's private equity power boost) selling and buying at high multiples. Trading at high multiples is ideal because it can present a win-win for both sides, making for swifter and easier negotiations.

It's a topic I feel I know something about. I lead sell-side transactions as the Managing Partner for Boxwood Partners, a merchant bank located in Richmond, Virginia. Our specialty, in fact, is assisting founder-owned businesses to find strategic and/or private equity partners for their next stage of growth.

There are numerous reasons why strong franchise brands often have high multiples, and below I'll give you five reasons why they can make an excellent sell *and* buy.

Numerous Locations

It costs a lot to run any business, franchise or not, but with a healthy, expanding franchise, you have literal profit centers across multiple states and (hopefully) the entire country, if not the world. Each franchise is sending you an ongoing monthly royalty. The more locations, the more fees the business is receiving. What's more, some of the biggest costs you'll incur to help bring in more business -- like your marketing expenses -- are paid for by the franchise with its marketing fee. Obviously, the franchisor must do its part to invest those franchise fees effectively, elevating the brand nationally and driving more traffic to all locations. If the franchisor bungles the marketing and doesn't do its job on the management and administrative end, the entire system will be poisoned, and the brand's high upside potential will be compromised. But numerous locations make franchise brands attractive investments because of the ever-present growth opportunity.

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Healthy Cash Flow

This isn't guaranteed, obviously. We've all been to individual franchise locations that look like ghost towns. But, if you have a successful franchise with a lot of units, and it's a popular brand, you should benefit from an extremely dependable cash flow. And, if the franchisor has been able to expand with the incoming cash flow instead of taking out hefty loans, that's a very good sign that the company is healthy. Check out the Item 19 in the franchise disclosure document to uncover the unfiltered financial truth.

A History Of Success

This is where franchisors really shine. If a franchise system can point to years of profitability, stability and even growth -- including during economic downturns -- that should generate a lot of confidence on your end as a buyer. Franchisee validation and proven success are even more critical with smaller or emerging brands. The early adopters/first owners will be critical to the company's ongoing success, so it's very important they're doing well and will speak positively about the brand.

Predictable Costs

Every investor likes having a good sense of how things are going to go in the future from a financial perspective, and one of the benefits of becoming a franchisor is that you generally have a good idea of what your expenses are going to be. There are plenty of costs that aren't covered by franchise fees, such as compliance software programs, secret shopper programs, training, research and development. But, as noted, when you buy into a franchise system that has been operating well for years, you know what you're getting into.

A Strong Business Model In Place

Any business you buy has a business model, but a high multiple franchise model with a history of success and healthy cash flow clearly has a business model that works. You've probably noticed that there's a theme in these high multiples: predictability with room for growth.

That's the point of a franchise, after all. The franchisee wants to know that they're investing in a successful, predictable business model, and the company that buys the national brand, becoming the franchisor, wants the same thing. Because, when a company is traded effectively at high multiples, higher profits and serious growth potential are just around the corner.
