



A franchise check-up keeps a brand fit

Even in the best of times, franchisors of everything from restaurants to muffler shops have little insight into how well or how poorly their franchisees are doing. But in a downturn, the risks of working in the dark are multiplied: There can be a cumulative effect as franchisees across the network struggle for survival. Franchise failures can hurt the brand, scare off potential new franchisees and end up in costly litigation. For their part, franchisees may worry that their franchises could be pulled if they get behind in royalty payments. Based on our experience, both parties opt to ignore the possibility of franchisee distress until it's too late.

In addition to not knowing fundamentals such as the health of the franchisee's operations, their cash situation or the strength of their balance sheet, franchisors don't know when a franchisee who appeals for help really needs it. Some franchisees approach the franchisor for help long before making tough choices such as reducing their owner distributions or closing underperforming operations. Harder still for the franchisor is determining whether operations improvements or royalty relief will be enough to help the franchisee.

Consider the situation facing one major franchisor. The company knew that many of its franchisees were in trouble—60 percent were either not paying royalties or were asking for relief. Because of legal responsibilities to treat all franchisees equally, the franchisor could not just pick and choose where to provide assistance. What the franchisor needed, before taking any action, was a clear view into the seriousness of each franchisee's situation. Only then could the franchisor determine which requests for royalty relief were legitimate.

Bain & Company worked with the brand to take a proactive approach—one that helps both franchisors and franchisees gauge their situation and identify opportunities to improve performance in good times and bad. By conducting a detailed assessment of the financial and operational health of its franchisees, the franchisor discovered a startling statistic: 30 percent to 40 percent of its franchisees were at risk of default within a year, a situation that had a potentially significant impact on the viability of the brand. Recent Bain experience suggests the brand is not alone.

For franchisors whose revenues have declined during the downturn, we have observed that between 20 and 50 percent of their franchisees could be in financial distress.

Why do it?

A franchise health check-up, performed with the full participation of franchisees, provides a holistic view of everything from operating metrics to capital structure. One company that recently conducted such a check-up was able to help almost all of its at-risk franchisees develop strategies to weather the storm. Despite franchisees' requests for relief that totaled many millions of dollars, the franchisor invested less than 5 percent of that sum to save almost all of its troubled franchises.

One of the key success factors of a franchise health check-up is that, when done cooperatively, it deepens a franchisor's relationship with franchisees. Also, the analysis helps identify opportunities where a franchisee could improve operations. In one meeting, a restaurant franchisor determined it could help a franchise improve its margin by 2 percent overnight through a simple change in how it ordered its poultry. That level of insight is not something franchisors can typically provide when they know only the revenue performance of the business. A check-up also uncovers the challenges franchises face due to their cash positions or capital structures, bringing a rigor that all but the most sophisticated franchisees are not able to bring on their own. We've found that most franchisees feel that going through the process helps better align the interests of both sides and that the franchisor better understands their situation.

Another practical benefit of a franchise health check-up is that it enables a franchisor to evaluate whether financial assistance is needed. In our experience, franchisees who ask for relief can typically be segmented into three groups:

- Those who either don't need it or can be helped with operations improvement support.
- Those who need help, but for whom relief alone won't be enough to avoid default over the long term due to misaligned capital structures. These franchisees should be encouraged to develop a plan to restructure their debt.

- Those who cannot be saved and are likely to lose control in bankruptcy or face liquidation. The franchisor should demonstrate the seriousness of their situation, and encourage them to develop an exit strategy to minimize the impact on their own financial situation.

Helping franchisees shape up

Bain has developed a three-step process for maintaining the health of a franchise brand.

1) Conduct an annual holistic check-up. Franchise operations work best when both franchisors and franchisees work collaboratively for their common benefit. Franchisors can encourage franchisees to take part in such a check-up as a requirement for participation in any current or future royalty abatement programs.

A holistic check-up should look at a franchise's capital structure, cash flow and other indications that it could be at risk of default. For example, a check-up could evaluate contingent liabilities that might be draining a franchisee's finances in tough times. It's not uncommon for a franchisee to use the cash flow from one successful business to fund troubled holdings.

2) Prioritize your investments. Franchisors seldom are able to satisfy all the requests for financial assistance from franchisees, nor should they. Franchisors need to make hard choices about how to invest their limited funds to have the most impact while treating all franchisees with equal consideration. That means prioritizing investments based on the depth of need and the potential impact on the network.

3) Design a playbook to improve network health. Franchisors need a decision-making framework for taking action that reflects both franchisor and franchisee priorities, including guidelines that ensure that any actions taken by

the franchisor represent fair and equal treatment. In one case, a franchisor is using its new understanding of each franchisee's cost structure to identify the level of same store sales performance at which each franchisee is likely to encounter trouble. By monitoring each franchise's revenue, the franchisor can proactively identify and respond to any risk of distress.

This three-step approach has helped franchisors overcome serious threats to the health of their network. Empowered with information, they can better prioritize resources and collaborate with franchisees. Some franchisors have used this as a basis for transforming their approach to working with franchisees—not just to stem the risk of default but also to position the healthiest franchises to grow at their full potential as the economy improves.

Signs your network could be in trouble

- Falling same-store sales for franchises
- Declining franchise revenues due to store closures
- Concentration of more than 30% of the brand's franchise outlets in the hands of relatively few franchisees
- Rising requests from franchisees for royalty relief or other assistance
- Sale-leaseback transactions among your franchisees between 2004 and 2008
- Franchisee exposure to risk from their other holdings
- Franchisees grappling with capital structure issues

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