IBA ANNUAL CONFERENCE

* * * * *

INTERNATIONAL FRANCHISING COMMITTEE

* * * * *

A MARRIAGE MADE IN HEAVEN? PRIVATE EQUITY AND INTERNATIONAL FRANCHISING

21 October 2014

Tokyo, Japan

Francesca R. Turitto (Chair)
Roma Legal Partners
Rome
Italy

Luciana Bassani
Dannemann Siemsen Advogados
Rio de Janeiro
Brazil

Dominic Hui
Ribeiro Hui
Shanghai
China

David W. Koch
Plave Koch PLC
Reston, Virginia
USA

Sajai Singh
J. Sagar Associates
Bangalore
India

TABLE OF CONTENTS

1. Introduction on Private Equity

It is no secret that private equity's fascination with the franchising business model has crossed international borders in a big way. Lawyers active in international franchising and international corporate transactions, as well as fund principals and franchisor executives, have made private equity a popular conference topic in recent years.[1] However, previous IBA programs have not focused on private equity and international franchising from a particularly Asian and Latin American perspective. This paper seeks, among other things, to fill that gap.

According to the Zephyr Annual M & A Report on Global Private Equity, 2013, the value of global private equity deals in 2013 was US$ 340.4 billion, up 18% from 2012, while the number of global private equity deals was down 6% from 2012.[2] The total 2013 deal value was a six-year high, though still far below the pre-recession level of US$ 901.5 billion in 2007. Although the Zephyr report does not include figures for franchising as a sector, even a tiny percentage of the overall deal volume would represent several billion USD of investment. Private equity firms continue to invest not only in franchisors but also in their master franchisees and multi-unit operators in other countries.

After a brief background section, this paper provides an overview of the private equity market in recent years, with a focus on Asia. It then updates and builds on previous IBA International Franchising Committee workshops examining the role of private equity in international franchising.

1.1 How PE funds are structured, operate and are successful

In the USA, private equity funds are usually structured as limited partnerships. The private equity firm "sponsor" raises capital for the fund from pension funds, insurance companies, banks, family trusts, other wealth management vehicles, charitable foundations, endowments, and high net worth individuals. Because the limited partnership interests are offered only to accredited investors, the offering qualifies for exemption from registration of the securities under federal and state law, and the prospective investors receive a private placement memorandum. The investors become limited partners whose potential losses and liabilities are limited to the amount of their capital contributions. Their commitments to contribute cash to the fund are time-limited; PE fund managers must either identify investment transactions and put the capital to use on a timely basis or return the cash to investors.

The private equity firm or its principals typically form a separate entity to serve as the general partner of the PE fund. The general partner does not have limited liability, but typically it is another limited partnership or a limited liability company (LLC). The general partner usually contributes 1% to 5% of the fund's capital,[3] with the rest coming from the limited partners. Sponsors often choose to form the limited partnership and the general partner in the state of Delaware, for the same reasons that Delaware is a jurisdiction of choice for the formation of other business entities – namely, a well-

---

[1] E.g., David Kaufmann, Tom Donaldson & Stephen Aronson, "Attracting Private Equity – What Prompts Private Equity Interest in Acquiring Your Network?" IFA 46th Annual Legal Symposium, May 6-7, 2013, Washington, D.C.; James J. Goodman, Gilles Menguy, Ted P. Pearce, Carolyn Vardi & Andrew P. Loewinger, "The Next Wave: Private Equity Funds in International Franchising," IBA/IFA 28th Annual Joint Conference, May 23, 2012, Washington, D.C.; Stephen Hagedorn, Nicholas DeCarlo & Chuck Modell, "Negotiating with Private Equity Owned Franchisees," IFA 45th Annual Legal Symposium, May 21-22, 2012, Washington, D.C.; Joel R. Buckberg, Peter D. Holt & Stephen D. Aronson, "The Franchise System Post-Private Equity Investment," IFA 44th Annual Legal Symposium, May 16-17, 2011, Washington, D.C. (hereafter cited as "Buckberg, Holt & Aronson"). In addition, conference organizer The Capital Roundtable held full-day programs on "Private Equity Investing in Franchise Companies" in New York City in 2012 and 2013, with the 2014 program scheduled for October 23, 2014.

[2] Available at *www.zephyrdealdata.com.*

[3] Buckberg, Holt & Aronson, p. 4.

developed body of case law providing guidance on governance matters and a specialized Court of Chancery where governance disputes are heard by expert judges without a jury.

The general partner of the PE fund manages the investing activity and day-to-day operations of the fund, either directly or through a management agreement with an affiliated asset manager. The general partner typically receives two forms of compensation: a periodic management fee and "carried interest." The management fee is based on a percentage of committed capital (typically 2%) and is meant primarily to cover the fund's investing and operating expenses, although it reportedly has become a more meaningful portion of the value proposition for fund managers as PE funds have increased in size.

"Carried interest" is a profits interest – specifically, a share of the profits of the fund's investments that is in excess of the proportion of capital that the general partner contributes to the fund.[4] Historically, carried interest has been the primary source of income for the fund manager. It can be thought of as a "performance fee" since it is directly tied to the results of the fund manager's investing activity on behalf of the PE fund. Typically, the limited partnership agreement for the PE fund provides that the fund manager must first return all capital contributed by the investors, and sometimes must also pay a stated additional rate of return (the "hurdle rate," typically 7% to 8%), before carried interest can be received. Typically, the carried interest profits allocation for private equity buyout funds is 20%.[5] The carried interest is distributed to the fund manager only when the PE fund successfully exits an investment.[6]

The limited partnership agreement of the PE fund typically has a 10-year term, with only limited provisions for extension. Within that lifespan, the PE fund will invest in multiple portfolio companies, try to enhance their value, and then sell or exit its investments, hopefully for a return in excess of the price paid. PE funds vary widely in their investment strategies, target deal size, industry focus, and level of involvement in the management of portfolio companies. Many, but not all, require the selling owners to "roll over" a portion of the sales proceeds, thereby remaining invested in the portfolio company and active in its management. If the existing management team has been successful, the PE fund generally wants to keep the team intact. To retain the team and incentivize performance going forward, the fund managers often set aside 10% to 15% of the portfolio company's equity for stock options, stock bonus plans, and similar programs.

PE funds commonly acquire the equity interests or assets of each portfolio company through a newly-formed special purpose acquisition subsidiary controlled by the fund. For exceptionally large transactions, multiple PE funds may team up for the acquisition, such as when Bain Capital, The Carlyle Group, and Thomas H. Lee Partners collaborated to purchase the Dunkin Donuts system for USD 2.4 billion in 2006. Once the deal is done, however, the collaboration ends and the group members pursue their own interests as independent equity investors in the portfolio company.[7]

As a limited partnership, the PE fund is a "pass-through" entity for US federal tax purposes – i.e., income and gains generated by the partnership are not taxed at the fund level, but rather are reportable by and taxed to the partners. If the investors include organizations which have tax-exempt status, those limited partners will have special concern about the impact of the flow-through tax treatment of the PE

---

[4] "Carried interest," Wikipedia.org, accessed 7-9-2014

[5] Id.

[6] A political debate has been raging in the USA for several years over the appropriate tax treatment of carried interest. Historically, carried interest has been treated as capital gain and taxed accordingly, but as the compensation of fund managers has increased, critics have argued that it should be viewed as effectively a salary and taxed as ordinary income at higher marginal rates. Id.

[7] Buckberg, Holt & Aronson at 29.

fund. To address those concerns, the fund managers may structure portfolio investments so that income and gains will be taxed at the portfolio company level or in an intermediate "blocker" entity.[8]

Fund managers may employ a variety of strategies to enhance value of the portfolio company, depending on where the portfolio company is starting from at the time of the investment. This may include concerted efforts to streamline operations and cut costs, but not to the extent of the 1980s stereotype of PE "vultures" looking to slash employees and cut costs to the bone. If the portfolio company has been well-managed but has simply lacked resources to get to the next level, more of the PE fund's investment and associated debt might be allocated to improving the platform for growth – for example, making technology upgrades, refreshing décor, expanding marketing efforts, and researching new markets. Conversely, if fund managers think the portfolio company has not been well managed, they might focus more on hiring new talent, installing new accounting and financial systems, reconfiguring supply chains, imposing more rigorous analysis of capital spending decisions, and requiring more detailed and more frequent reporting.

When the portfolio company is a franchisor, a master franchisee or a multi-unit operator, franchise system growth is generally a key part of the strategy to enhance value. Depending on the opportunities presented, fund managers might focus on selling off company-owned units to be operated as franchises, encouraging existing franchisees to add more outlets, recruiting new franchisees, offering franchises in new places to fill market gaps, or "rolling up" independent operators under the franchise brand through acquisitions.

Subject to the PE fund's limited partnership agreement and the terms of repayment of the acquisition financing, fund managers typically have flexibility on how long to hold investments and by what means to exit. Historically, the principal exit strategy was to conduct an initial public offering of the securities of the portfolio company, with a secondary offering by the PE fund to liquidate part or all of its equity position. Taking the portfolio company public remains an option, but it is of course dependent on market conditions for IPOs. Alternatively, the PE fund might sell the portfolio company to a strategic buyer (i.e., one that operates business units and is not simply a financial investor) or to the portfolio company's management. Increasingly, the exit strategy is a sale to another PE fund (called a "secondary buyout"). Depending on credit markets, the PE fund might also achieve returns by refinancing (and increasing) the portfolio company's debt and using the proceeds to pay a preferred or special dividend to the PE fund. Finally, if the portfolio company's business is unsuccessful, the exit might consist of turning over the PE fund's interest to creditors of the portfolio company, directly or through a bankruptcy proceeding.

Once all of the PE fund's investments have been liquidated or "harvested" and the proceeds have been distributed to the investors and to the fund manager, the fund comes to an end. By that time, the private equity firm sponsor has likely formed its next fund and raised capital to start the process all over again, often with many of the same investors if the prior fund achieved its targeted returns.

1.2 PE vs venture capital

Private equity funds are just one category of private capital that might invest in a business. Others include hedge funds, family offices, angel investor networks, and venture capital firms. All have their particular niches, but only private equity funds have developed a major presence in franchising. To understand why, it is helpful to examine, as an illustration, the differences between private equity funds and venture capital.

---

[8] Buckberg, Holt & Aronson at 8.

Two principal factors distinguish private equity from venture capital: the stage at which the investment occurs, and the use of borrowed funds or "leverage" to make the investment. Venture capital is the first outside money into an emerging business after the capital provided by the founder, friends and family (and perhaps angel investors). Venture capital investment typically occurs at an early stage in the life of the company, when cash flow is negative or breakeven at best. Without positive cash flow to support debt service, bank financing to support the venture capital investment is rare, and without leverage, deal sizes tend to be small. Typical valuation metrics may be of little or no use; for example, if the company has no earnings before interest, taxes, depreciation and amortization (EBITDA), there can be no multiple of EBITDA, which is the typical valuation metric for PE funds. Accordingly, valuation of the company and of the investment is mostly in the eye and gut of the venture capitalist. These investors expect and tolerate losses while the business develops, betting on progress toward stable cash flow through growth and refinement of the company's operations. Venture capital is, therefore, "risk" capital with an expectation of very high rates of return. Typically, venture capital investors take minority positions and leave the business in the hands of the founding entrepreneurs.

Private equity funds, by contrast, invest at a later stage of the business, after a stable cash flow has been achieved. Generally this has meant that the company has EBITDA of at least $5 million to $10 million, although the large current "overhang" in the market (i.e., capital that PE funds have raised from investors but have yet to invest), as well as the sheer number of PE firms and the resulting competition for deals, may be exerting some downward pressure on deal size.[9] Profitability of the business (and of other portfolio companies in which the PE fund invests) is crucial in order for the PE fund to generate the targeted returns for its own investors. Positive cash flow means that the target company can support debt service, which means that the PE fund can borrow from banks to enlarge its position without investing more capital from the fund itself. If all goes well, using debt increases the ratio of investment returns to invested capital – hence the "leverage" moniker.

Unlike venture capital investors, PE funds typically (but not always) take control positions in companies. Holding all or a majority of board seats typically gives PE fund managers the ability to dictate the outcome of major business decisions. PE funds are far more likely than venture capital investors to have power to, and in practice to, make changes in management or even sweep out current management entirely. However, the degree to which PE firms exercise their governance control varies based on, among other things, the size of the private equity firm, its industry focus, management style, and the circumstances in which the prior owners are selling (e.g., founders cashing out for retirement versus raising capital for expansion).

1.3 The differences between small market/middle market PE funds and large cap PE funds.

Of the thousands of private equity buyout firms in operation, only a fraction have invested in franchise companies, although the number is steadily growing.[10] They include some of the most famous names in private equity, such as The Carlyle Group, Bain Capital, Kohlberg Kravis Roberts, and

[9] Early in 2013, *Bloomberg Businessweek* reported that there were 4,500 buyout shops with $3 trillion in assets. According to the article, these firms had put to work only 28 percent of the "unprecedented" $702 billion that they raised from 2006 to 2008. Further, the article reported that fund performance had "sagged" and, in turn, weaker performance was hindering the ability to raise new capital for new funds, thereby setting the stage for a "purge" of private equity players in coming years. "Private Equity Shakeout" (February 25-March 3, 2013).

[10] One investment banking firm recently reported that it is tracking "more than 250 private equity firms who have invested in franchising or are actively seeking to do so." The McLean Group & DLA Piper, "Mergers & Acquisitions in Franchising: Strategies for 2014 and Beyond," at 3 (available at http://www.mcleanllc.com/Publications/FranchisingWhitePaper2014/).

Blackstone. These firms, with billions of dollars under management, undertake deals of enormous size, such as Blackstone's 2007 leveraged buyout of Hilton Worldwide for $26 billion, of which $20 billion was bank financing. As noted above, these transactions sometimes involve multiple PE funds working together. The financing for the transactions can be extraordinarily complex, such as the securitization of pledged franchise agreements in connection with the 2006 acquisition of the Dunkin Donuts system.

While these huge transactions grab the headlines, most franchise companies are too small to attract the attention of the giants in private equity. The deal size for a typical franchise company acquisition is simply not big enough for a PE fund that is looking to put tens or hundreds of millions of dollars to work at a time.

Much of the private equity activity in franchising is driven by PE firms specializing in small market and middle market transactions, which is where most franchise operators fall -- especially young and emerging brands, multi-unit operators, and master franchisees. Small market/middle market PE firms typically have just one or a few funds in operation at a time, with overlapping life spans. The private equity giants, by contrast, may have many funds in operation at the same time. Small market/middle market PE firms typically have a specific industry focus and investment strategy, whereas the big firms may pursue multiple industry sectors and multiple investment strategies, each through a different fund. Small market/middle market PE firms typically have a relatively small staff, whereas the big firms have more personnel at their disposal to populate the boards and management of portfolio companies.

These distinctions are meaningful for franchisors, master franchisees and multi-unit operators who might be seeking a private equity partner. Potential targets should understand that "private equity" is not a monolithic term; that even among small market/middle market firms, deals will be of interest only to PE funds with a relevant industry focus; and that, within that smaller subset of PE funds, real differences in style and philosophy create opportunities for better or worse "fit" with portfolio companies.

2. Overview of the PE market in recent years with a focus on the Asian Market and Brazil

The opening decade of the 21st century has been a collage of macroscopic and microscopic events that have refined and redefined how business is done within and outside national borders. From regional economic slowdown, market volatility, rising importance of emerging markets to movement of skilled workers, capital and technology, the perception of value creation has been continuously evolving and with it, so has the flow of investment. Investors have made a beeline for geographies and asset classes where value is created, where value can be retained and where value has the potential to be scaled substantially.

Private equity activity continues to rise in Asia-Pacific, with China being the most active market. Investments in Southeast Asia are on the rise and expected to expand significantly in the region. Acquisitions, raising new capital, and improving the performance of portfolio companies constituted the majority of activity in 2013.

Under the strong challenge from e-commerce competitors such as Taobao, jd.com and yhd.com in the retail sector, distribution franchises are currently in the course of redesigning their business model, and many PE funds prefer to directly invest on many b2c platforms. Therefore, catering, hospitality and other personal services (except the high-end and luxury brands, as there is a decline in this respect since early 2013), which are less affected by the challenges from these e-commerce giants, are now the dynamic of private equity growth in the franchising sector. Some major and high-profile transactions in China recently are/were:

- CVC Capital Partners in early 2014 acquired the 450-units quick-serve dumpling franchise chain DaNiang Dumpling at an undisclosed amount, and according to certain reports, DaNiang Dumpling is planning to start their IPO process in Hong Kong in 3-5 years' time .[11]

- The budget hotel franchise chain 99 Inn received an investment of US$7.5 million from SIG and two other institutional investors in 2012. 99 Inn plans to start their offshore IPO process around 2015. In fact, 99 Inn was the third budget hotel chain receiving funds from PE/venture capital in 2012.

- Valor Equity and Tang Investment Group, through their subsidiary, have secured the franchise rights in Shanghai city and several surrounding provinces from Dunkin' Donuts.

One of the typical models of PE in China for franchising sector is:

- Selecting a small franchise network with less than 50 units, and acquiring 40% of the shareholding at the very beginning.
- Using the newly injected capital to expand the network to more than 50 units within 1 year, and then secure further finance from other institutions. By this time, the assets value should have increased by 5-10 times, and the initial investors can sell 10% of the shareholding.
- Upon securing further finance, the speed of expansion should accelerate and the target is the assets value shall grow by 20-30 times within 2-4 years, and the initial investors can sell their interests gradually.
- With more investments coming in, the chain will be listed in a stock exchange.
- Throughout the process, efforts should be made to enhance brand image, management and marketing of the franchise chain.

At the same time, around USD 200 billion of new capital went to PE and venture capital management partnerships globally in 2012. For the first time, 20% of that total, equivalent to approximately USD 40 billion, went to fund managers in emerging market countries and only USD 15 billion went to BRICS.

India was the fastest-growing private equity market in Asia in 2011. PE firms in the country closed 531 deals, which was 40% more than the year before. For PE to realize its full potential, important regulatory hurdles like uncertainties in India's tax regime and limited investment opportunities for foreign investors in several regulated sectors such as retail trade need to be addressed.

Even as the Indian start-up ecosystem has evolved over the last few years and entrepreneurs have experimented with several industry segments, the e-commerce and internet segments continue to be the hot-spots of software product industry in the country. This reflects in the fact that 50 per cent of the 159 merger and acquisition (M&A) deals that took place in the software product industry since 2010 till May 2014, were in the e-commerce and internet segments, a report published by software product think-tank, Indian Software Products Industry Roundtable (iSpirt) and technology-focused middle market advisory boutique Signal Hill showed. In value terms, 51% of the around USD 1.78 billion that was spent on M&A

[11] http://pe.pedaily.cn/201403/20140310361575.shtml

activity in the software product space in India went to these two segments, the report said. The report named Indian e-commerce majors like Flipkart, Myntra and Snapdeal among the leaders in receiving marquee investments.

PE investors, who have been struggling to make exits from their investments, have finally found a way out in India's booming stock markets. With the Indian stock market touching 25,000 points in 2014, a lot of PE investors are on exit mode. The figures of the past couple of months show that exits have gained momentum. Bain Capital, which encashed the feel-good factor by selling one third of its stake in Hero MotoCorp for about USD 250 million, has made a 2x return on its two-year-old investment. In the unlisted space, another PE major ChrysCapital, which invested a mere USD 10 million for a 12% stake in Intas Pharmaceuticals, sold about 11% stake from its 10-year old investment for USD 160 million to Temasek in early June, 2014.

Earlier in Japan, Bain Capital also acquired 100% interests in 3,600-outlets strong Skylark, the Japanese giant in franchise restaurant chains in 2011 at USD 2.1 billion, which was the largest financial deal in Japan after the economic turmoil. It is anticipated that Skylark will be listed on the Tokyo Stock Exchange shortly.

However, not all stories are so rosy, at this point of time in China:

- ARC Capital Holdings, which injected USD 10 million in 2008, has withdrawn from WOWO convenience stores franchise chain because the local partner would not agree to stop selling cigarette products in response to the local regulatory requirement that foreign invested retail stores cannot offer cigarette products. [12]

- CVC Capital Partners is negotiating with Zhang Lan and her existing PE partner CDH for acquiring 69% of the interests in a well-known Xichuanese restaurant chain (with some franchise units) Southern Beauty at USD 0.3 billion.[13] There are some speculations that the sale was initiated by CDH [14] after an unsuccessful listing attempt in China in 2010 due to certain policy changes and the change of economic climate, [15] and the proposed transaction is facing resistance internally.

In Brazil, it is important to mention that franchises are considered a highly attractive business model. The ability to grow without investing directly, and the fact that Brazilian franchise law exempts franchisors and master franchisors from labor liability in relation to franchisee employees already accounts for the sector's growth rate of 16.2% in 2012, when it achieved total sales of 103 billion Reals, despite the unstable economic environment. In 2013, the sector experienced a growth rate of 12%, reaching sales of approximately 115.5 billion Reals, and the current growth estimate for 2014 is 10%.

PE firms have been investing in franchising companies in Brazil with great growth potential, renowned franchise brands and already established franchise system concepts, for instance:

---

12 http://www.360doc.com/content/12/0520/21/7241223_212397468.shtml
13 http://finance.ifeng.com/a/20140429/12214105_0.shtml
14 http://news.xinhuanet.com/fortune/2014-03/14/c_126266120.htm
15 There are reports stating that one of the conditions in the transaction is if Southern Beauty fails to be listed before the end of 2012, CDH shall be entitled to request the founder (Zhang Lan) to acquire the stock held by CDH.

- A Brazilian PE firm, 3G Capital Management, acquiring the Brazilian operation of Burger King for USD 4 billion, in 2010;[16]
- BTG pharmaceutical division acquiring Farmais, a drugstore franchise business and making an IPO in 2011;
- Carlyle Group's acquisition in 2012 of 85% equity participation in Ri Happy, a toy store franchise business and only 90 days later acquiring PB Kids, a competitive business;
- ACTIS, an English PE firm recently acquiring CNA, an English lesson franchise business for USD 68 million; and
- Gavea Investimentos, a PE firm controlled by JP Morgan, recently acquiring almost 30% equity participation in Chilli Beans, a franchise business of sunglasses stores and kiosks.[17]

According to the Brazilian Franchise Association (“ABF”), PE firms have infused capital in the following franchise chains:

*	PRIVATE EQUITY	COUNTRY	FRANCHISE	AREA
1	**3G CAPITAL**	Brazil	**BURGER KING**	FOOD
2	**3i**	England	**ÓTICAS CAROL**	JEWELRY AND GLASSES
3	**ACTIS**	England	**CNA**	LANGUAGE SCHOOL
4	**AXXON GROUP**	Brazil	**MUNDO VERDE**	BEAUTY, HEALTH AND NATURAL PRODUCTS
5	**BRAVIA**	Brazil	**ODONTOCLINIC**	AESTHETIC, MEDICINE AND DENTISTRY
6	**CARLYLE GROUP**	United States	**RI HAPPY / PB KIDS**	ENTRETAINMENT, TOYS AND LEISURE
			CVC	HOSPITALITY AND TOURISM
7	**ENDURANCE CAPITAL PARTNERS**	Brazil	**ESPAÇO ÁRABE**	SPECIALISED TYPICAL FOOD
8			**VALMARI**	BEAUTY, HEALTH AND NATURAL PRODUCTS
9	**GÁVEA INVESTIMENTOS**	Brazil	**CHILLI BEANS**	PERSONAL ACCESSORIES (Sunglasses), FOOTWARE AND SNEAKERS
10	**LAÇO MANAGEMENT / RIATA CORPORATE GROUP**	Brazil/United States	**CHINA IN BOX**	SPECIALISED TYPICAL FOOD
			GENDAI JAPANESE FAST FOOD	SPECIALISED TYPICAL FOOD
			THE FIFTIES	FOOD
11	**MERCATTO / BOZANO INVESTIMENTO**	Brazil	**AMOR AOS PEDAÇOS**	BEVERAGES, COFFEE, CANDIES AND ICE CREAM
12	**SQUADRA INVESTIMENTO**	Brazil	**IMAGINARIUM**	FURNITURE, DECORATION AND GIFTS
13	**TREECORP**	Brazil	**SUPLICY CAFÉS**	BEVERAGES, COFFEE,

[16] http://economia.estadao.com.br/noticias/geral,fundo-de-investidores-brasileiros-compra-burger-king-por-us-4-bi-imp-,604509
[17] http://www.ecofinancas.com/noticias/gavea-compra-quase-30-rede-oculos-chilli-beans/relacionadas

				CANDIES AND ICE CREAM
14	**ADVENT**	United States	**DUDALINA**	CLOTHING
15	**WARBUG PINCUS**	United States		

Normally, Brazilian franchise networks seek out PE funds to expand within their domestic markets, before expanding internationally. However, some corporate transactions are planned with international PE funds for the specific purposes of expanding to other countries. In this scenario, such franchise companies already have professional management and high annual revenues, requiring only financial funding and assistance from the PE funds to gain new territories.

In general, capital funding from PE firms effectively allows the franchise business to expand by either increasing the number of units within the original territory or even enabling an international expansion, as mentioned. Besides money, funding from PE also brings expertise and professionalism, which also allows franchise operators to concentrate on growing their business.

It is also important to mention the American experience. PE firms have been demonstrating their interest in franchising by many acquisitions of well known American franchise networks, such as, Domino's Pizza, Inc., Burger King Holdings Inc. and Wendy's/Arby's Group Inc. Major PE firms, in recent years, have invested in the same activities as those that have been successful in the United States. For instance, it is worth mentioning Bain Capital's acquisition of the master franchise operator of Domino's Pizza in Japan and Carlyle Group's purchase of a substantial equity participation in the master franchise operator of Domino's Pizza and Wendy's for the Middle East and North Africa.[18]

Last year, PE firms invested in approximately 250 franchisors and multi-unit franchisees, with thresholds up to USD 50 million or more, in a wide range of activities within the franchise industry. However, it is worth mentioning that not only PE firms are becoming more specialized in franchising, improving their knowledge in connection with franchise laws and regulations, but also some segmentation has happened since some PE firms became more involved in particular business sectors, such as food & beverage.

3. The role of private equity in franchising

3.1 Why franchising is attractive to private equity

Franchises tend to have a well-developed brand, predictable and recurring revenue stream and modest capital expenditure needs, making them special targets for many PE firms. As a franchise system provides a relatively predictable cash flow, coming from steady stream of royalties, supplier rebates and initial franchise fees, this allows the purchaser to leverage their investment with a substantial amount of debt. In addition, buying a successful but new or small system may create opportunities for future and continued growth, including increase of number of units or points of sale.

The PE firm may also have advantageous synergies by acquiring multiple franchise systems in connection with back office functions of the franchise operation, such as accounting, legal, real estate,

[18] "*The Next Wave: Private Equity in International Franchising*", during IBA/IFA 28th Annual Joint Conference, in Washington D.C., in 2012.

franchising, even though marketing and strategic expansions may not be viewed as synergy by franchisees of competitive brands.

The franchisor's management team is also a good reason for the PE firm to purchase a franchise business, as they may rely upon a strong and experienced team that certainly knows the franchise operation and may effectively contribute with its development and expansion. Notwithstanding, in addition to funding, PE firms also help managers to professionalize their financial expertise in connection with franchise business, which, for franchisors or master franchisees, is a tremendous incentive.

3.2 Investing in master franchisees and developers from the franchisor's viewpoint

The most common structure for franchisors to expand internationally is selecting a master and executing a master franchise agreement. Master franchise agreement is a contract by which the franchisor grants the master franchise the territorial exclusivity over the brand and of the development of the franchise system. The master must normally pay an initial master franchise fee and monthly royalty fees. This type of structure is usually used when franchisor expand to foreign countries it is not familiar with and that are distant, as this does not entail unknown risks for the franchisor.

Another option for the franchisor would be executing an area development agreement, by which the franchisor only grants the right for the developer to open a certain number of locations within an exclusive territory and a certain timeframe. The area developer does not have the right to grant sub-franchises or use of other intellectual property rights owned by the franchisor.

The franchisor may also incorporate a subsidiary, which will normally act as the master franchisee in a given territory, but will be entirely owned by the franchisor's holding company, or decide to also set up a JV company with a local partner. It is important to mention that corporate structures normally entail higher risks and costs, but could also allow greater control of the franchise business and operation and, in certain circumstances and countries, tax advantages if compared to contractual arrangements. In a JV structure, the franchisor's contribution is generally composed of the right to use the brand, the transfer of the respective know-how and its experience, while the local partner brings the local distribution, the employees and the knowledge and cultural aspects of the local market. However, when creating a JV, it is important to execute a protective shareholder's agreement, ensuring not only control of the JV to avoid competitors from entering its capital, but also corporate mechanisms to fully and effectively control the intellectual property rights in connection with the franchise system, owned by the franchisor.

When a PE firm is participating in such an expansion, directly investing in the master franchisee or area developer, there are both opportunities and challenges from the franchisor's viewpoint. For obvious reasons, if there is a capital funding and the subsequent business growth, the franchisor will financially benefit from it and so will do its brand position in the market, along with the reputation of its franchise business, in a successful deal.

On the other hand, as the prime intention of PE firms is to drive the company's growth for future sale or even an IPO in 3 to 5 years, exiting with high returns, such growth could be jeopardized if the PE management team starts to interfere with a successful operation. For instance, implementing a concept change (customization, for instance), which normally is not allowed without the consent of the franchisor under the terms of the master franchise.

If the PE firm acquires a substantial equity participation enabling control, which means having the power to appoint managers and effectively interfere in the company's decisions on a regular basis, another challenge that might appear would be obtaining the express consent of the franchisor.

Generally, a master franchise agreement contains a change of control provision by which the master franchisee is not allowed to sell a substantial equity participation (or another corporate transaction achieving the same results) without franchisor's consent, as such agreement is executed on an intuitu personae basis. Therefore, the analysis of the terms of the master franchise agreement is very important, as there might be provisions restricting change of control and/or even an IPO.

4. Main drivers of a PE deal in the franchising industry

4.1 What a PE fund should consider in order to invest in a franchising system

Most commonly the fact that a large franchisee holds the right to open up new outlets in specific areas is an important factor which is considered. This is often the chief allure in the eyes of an investor, but the analysis of value must take other factors into account as well. Some important factors that a PE fund needs to consider before before investing in a franchising system are:

- The profitability of the units the franchisee has up and running at the time of the investment.
- The efficiencies of scale the franchisee enjoys.
- The equipment held by the franchisee, whether owned or controlled through leases.
- Real estate owned or leased by the franchisee, including outlets at large shopping malls, which often command a particular premium because of their locations.
- The franchisee's management team.
- The legal relationship between the franchisee and the franchisor.
- The terms under which the franchisor offers marketing, training, financing or other support to the franchisee.
- The number of additional outlets the franchisee has committed to opening up in its exclusive territory in a given period of time.
- The demographic and economic conditions in the franchisee's exclusive territory.
- The franchisee's access to financing and other resources necessary to taking advantage of expansion.

Amongst the many benefits of PE investing in franchising, one is that it gives access to resources of a large PE firm to a far smaller franchisor, one which the latter is unable to afford. Examples would range from technology, resources, human resource and capital, legal advice to access to operators. These factors may directly result in profitability to the franchise and they also may improve the way of operation of a franchise. Also, access to private equity actually may lead to the franchisor not getting constantly cash strapped and able to take on some new initiatives or expansion previously not affordable.

Key considerations for a PE firm before getting into the negotiations – "Sweet spot" to enter

Leading PE firms flesh out their growth through differentiation strategy by drawing a tight ring around the investment areas where they will hunt for the vast majority of their deals. The "sweet spot" for a particular PE firm may lie along any one of several dimensions from industry sector or deal size, to the degree of control the firm seeks in the deals it does, to whether to focus primarily on growth opportunities, turnarounds or cyclical plays.

Defining the sweet spot is crucial. By providing greater focus and knowledge of where to look, it enables deal teams to identify potential investments earlier and evaluate them faster than other investors. It sharpens the firm's due diligence by highlighting core issues that need to be tested in every deal. It takes advantage of the firm's experience and expertise, enabling deal teams to stretch their bids to secure deals they are best qualified to convert into winners. And it guides the firm's internal investments to build capabilities it will need to reinforce its distinctiveness or move into attractive adjacencies as the firm grows.

Getting the sweet spot right is one of the most consequential decisions for a PE firm. Defining it too narrowly can result in a shortage of deals. Defining it too broadly can undermine clarity, resulting in poor investment decisions and organizational confusion.

4.2 What a franchisor should consider to accept a PE fund as a partner

PE investment surely does bring up specific capital for the franchisors which makes them financially healthy. This also leads to expansion of franchisors business and helps to gain more customers. However, there are some other important factors to consider.

Since PE investments are focused on pre-existing established companies, the acquired franchise by the PE investors will expect number of changes which may or may not be suitable for it. PE investors also tend to gain profit and look for an exit strategy which again is not a beneficial aspect for the franchisors, at least not for the long term. Tough PE investment may lead to adding value and in that process, enhancing the brand value of a franchise which is looking for an exit.

A Franchisor should consider whether or not the PE investment firm lacks experience in franchising, as it might bring about various problems to an established franchise business. The inexperience of the PE firm may bring up unwanted conflicts and losses to the franchisor. The PE, as they intend only to make profits, for their growth, may direct the franchisor to introduce new products, services or marketing strategies which might not be suitable for the franchisor and could be resisted. Cost cutting and financial issues of the PE firm will directly affect the franchisor and its business.

A Franchisor should get a partner who understands its company and its culture, is supportive of the management team and its position, understands how to deliver value without infringing on management's role, and is oriented towards the long-term successful building of franchisor's enterprise. The capital that a firm will bring is necessary, but what one really ought to be focused on are these other elements.

5. The right time for the investment

5.1 For the franchisor/its owners

There are times when the franchisor or its owners need additional capital for expansion, but differently from venture capital, PE Funds normally will take the less risky route and focus on brands with proven records. In the South Beauty case (China), Zhang Lan concluded an agreement with CDH when the group was still relatively small, and needed funds for expansion. In other cases involving introduction of a PE investment, the point of time of making such decision is usually shortly after the brand has already acquired some degree of local reputation and business model has been adapted to the local environment to a certain extent. This mentality is actually reflected in the strategy taken by a PE Fund as mentioned in section 2 above. If the franchise chain has secured a considerable degree of market share, the franchisor should have no difficulties in securing funds to support its further expansion, and PE Funds will then be just one of the options.

In practice, there are occasions that the franchisor/its owner is/are approached by a number of PE Funds. In such case the franchisor/its owner shall have more bargaining power in controlling the time of investment, at the most favorable terms.

5.2 For the PE fund

As discussed in section 2 above, PE Funds usually prefer to invest when the franchise chain is relatively small. Another approach is that the PE Fund will take over a less performing location of a strong brand, and then invest on improving the performance of that particular location. However, in any event, PE Funds seldom invest in saturated markets or very mature systems for obvious reasons.

Likewise, the bargaining powers of the parties are also relevant, as if the PE Funds are approached and requested to provide the funds, the PE Funds can then dictate the time of investment and the terms thereto.

6. Organizing and preparing for the deal

The chain of events leading to a private equity transaction starts with an internal sense by the franchisor or multi-unit franchisee (or its owners) that new capital is needed for some reason. As noted in Section 1.2, private equity is only one possible answer to that need. Sorting through the options is a daunting task, for various reasons. The majority of franchise operators, as previously noted, fall into the small market and middle market sectors, and for them, raising significant new capital may be an unfamiliar exercise, one for which management lacks the time as well as experience. Large franchisors may have CFOs and CEOs who "know the drill" much better, but their potential transactions probably will be more complex, and they may have to answer to a board of directors, public shareholders, and market watchers who will closely scrutinize the available capital-raising options.

For these reasons, franchisors and multi-unit franchisees, like other companies, typically hire an investment banker to help them weigh the options. Investment banks, like PE firms, come in different sizes. Giants like Goldman Sachs, Morgan Stanley, and JP Morgan Chase provide advisory services to big companies for huge transactions. These banks are generally organized into groups focusing on a specific industry – such as healthcare, financial institutions, industrials, technology, media, and telecommunication – or on specific types of financial "products" – such as mergers and acquisitions, leveraged finance, public finance, asset finance and leasing, structured finance, restructuring, equity, and high-grade debt.

Other investment banks specialize in small market and middle market deals, paralleling the size range of PE firms. The smaller investment banking shops, like smaller PE firms, often have an industry focus, sometimes on industries in which franchising is common.

The franchisor or multi-unit franchisee may interview several candidates before choosing an advisory firm, because fit is important. The client will then sign an engagement letter with the investment bank setting out the services to be provided and the fees to be paid. Typically, the engagement letter provides for: (1) a fixed-fee retainer to be paid up front or in installments; (2) reimbursement of the advisory firm's out-of-pocket expenses; and (3) a success fee equal to a percentage of the capital raised in a completed transaction, payable if and when the transaction closes.

The investment banker will assist the client in developing a general strategy based on the reasons for raising capital (e.g., liquidity for the founders versus resources for growth), valuation expectations, the relative cost of different types of capital, general market conditions, etc. The strategy may involve subscribing investors to a security issuance, coordinating with bidders, or negotiating with a merger target. The investment bank often prepares a "pitch book" of financial information to market the client to potential lenders and investors and assists the client in screening potential transaction candidates. If a transaction takes shape, the investment bank assists the client in assessing offers, negotiating terms, responding to due diligence requests, and closing the transaction.

If the strategy points to a sale to a PE firm, the investment banker can accelerate the franchise operator's preparation for a potential transaction and the due diligence that will precede it. For example, the banker might work with a franchisor to firm up its record-keeping on franchise law compliance, franchisee files, and vendor arrangements, because PE firms will view record-keeping as a reflection of a target company's organization – or lack thereof. For a potential PE buyer or investor, the integrity and care in record-keeping systems might communicate more about the target company than the actual content of its records. In general, PE firms will be looking for problems, because problems decrease valuation. Accordingly, record-keeping that has been consistent, meticulous, and objective (that is, recording the bad with the good) can enhance the overall value of the enterprise. Conversely, if the franchisor's records or contracting processes are sloppy, potential PE investors might assume that they reflect sloppy thinking, sloppy strategy, and sloppy execution.

Franchisors and multi-unit franchisees can also have the advisory firm help with listing intellectual property assets, identifying relationship problems in the system, charting territory issues, assessing non-compete restrictions and litigation risks, and previewing a myriad of other points that will arise in due diligence. While this effort is partly designed to enhance readiness, it is also designed to enhance the franchisor's credibility. Up-front disclosure gives the franchisor the opportunity to present any not-so-good news in a controlled fashion, in its own words. It is much better for the franchisor to be forthcoming about problems and risks than to explain them after independent discovery by the PE investor.

According to one investment banker at a Capital Roundtable conference on private equity investing in franchising, the advisory firm must counsel the seller to "leave meat on the bone" in any PE transaction.[19] That is, the seller(s) should not try to squeeze every dollar of potential company value out of the sale, because the PE fund must have the opportunity to achieve its own target returns when it exits the investment. Comments from other investment bankers on the same panel were equally illuminating. One noted that the "dynamic" in a private equity transaction is different depending on the ratio of company-owned outlets to franchised outlets, and that PE firms have different philosophies on how many company-owned outlets a franchise system should have. Another panelist observed that, despite PE firms' focus on whether the unit-level economics allow franchisees to make money, franchisors sometimes lack good data on franchisee financial performance. A third panelist pointed out that lenders have lost money when drastic changes were imposed on the franchise system, and so the lender in a leveraged transaction will want details about the PE fund's plan for the business after closing. All of these comments exemplify the development of a genuine ecosystem of PE firms and investment bankers in the franchise sector.

7. The structure of the transaction

7.1 Key legal issues in the pre and post acquisition phase

The corporate transaction's structure may be drastically changed, depending on whether the PE's acquisition is full or partial. It is common for PE groups to begin by acquiring only part of the capital, but they always seek to gain some kind of influence or control, to enable the required growth without resistance from the former owners of the franchisor company. It is also crucial to define clear exit or acquisition options, in order for the PE firms to achieve their goals.

[19] The Capital Roundtable, "Private Equity Investing in Franchise Companies: Finding Excitement in Scalability, Recurring Revenue & Low Capital Needs," University Club, New York City, October 18, 2012.

Besides buying equity, there are other options for the PE firms to achieve the same results, such as:

(i) The franchisor company issuing convertible debentures, allowing PE firms to fund it through this debt instrument and to acquire substantial equity participation on a later stage (or even directly selling the debentures issued to a strategic buyer);

(ii) the franchisor's company proceeding with a spin-of and dropping down assets; or

(iii) the PE firms simply acquiring assets.

In a franchise commercial relationship, assets mean the material rights established in the franchise agreements to conduct the operation. Consequently, any provision inserted in the franchise agreements denying or restricting franchisors' assignment without the franchisees' consent, could be a serious obstacle for implementing an asset deal and could decrease the PE firms interested in a particular transaction.

Another challenge could be the existence of non-compete provisions in the franchise agreement that could restrict the future sale to a competitor or similar system, as this would also decrease liquidity and marketability on PE firms' point of view.

If the equity acquisition is partial, in addition to the purchase agreement, a shareholders agreement is also required to enable the PE groups' professional management. If the acquisition is complete, it is important to ensure that key persons have a seat on the Board of Directors or execute service agreements, so that the expertise of the franchise's creators or certain managers is duly absorbed, especially if there is a transition phase. In other words, if there are any key persons who should remain in the franchise, due to their know-how regarding the created or acquired system, or the leadership image they project with the franchisees.

There other several challenges arising before, during or after the acquisition of a franchise business and key legal points to be fully asserted.

One of the most important aspects would be (i) the confidentiality in conducting the initial phase of the corporate transaction; and (ii) the analysis of how and when the franchise network should be informed of the transaction, following execution of the purchase agreement, depending on the necessary conditions precedent, either after the corporate transaction is concluded, if legally possible, whether through the franchisees' committee or not. In other words, if there is a franchisees' committee ready to assist in the transaction and the future growth of the network, following the acquisition.

As mentioned, the contents of the franchise agreements is another key point, especially if the agreements allow the franchisor company to make changes in its ownership control or assign such control without the consent of the franchisees, preventing franchisees from interfering in the corporate transaction or even generating a loss of receivables, if the agreements have to be changed.

In addition to negotiating how key persons will remain in the business, even if only for a transitional period, it is essential to ensure that all the franchise system's know how is effectively disseminated and learned, so that the franchisor can begin training the network and new franchisees under the management of the PE, especially if the PE is acquiring 100% of the equity participation.

The need of submitting such transactions to the local antitrust authorities should also be considered, and obtaining their prior approval or not, if applicable, after the analysis of whether the transaction modifies or could potentially modify the market's structure or may produce negative effects on consumers as a result of the elimination of competition.

The change in the management of franchisor companies undertaken by PE - entirely fulfilling the terms of the franchise agreements and granting fewer prerogatives and waivers - may be challenged by franchisees, generating legal consequences for buyers and sellers alike.

The existence of corporate conflicts or disagreements that may discourage interest or hinder the implementation of capital contributions by the PE groups, especially in the case of family companies, should also be considered during the acquisition, as well as the existence of stock call options, rights of first refusal or similar rights for minority partners or former partners that may delay or encumber the operation for one of the parties.

After closing the corporate transaction, one of the reasons for failure would be the discovery of several liabilities or risks not revealed or disclosed during the due diligence investigation, which cannot always be compensated, especially when affecting the operation of the franchisees and the franchisor.

7.2 Key points in the due diligence of a franchising system

As mentioned before, in a franchise commercial relationship, assets mean the material rights established in the franchise agreements to conduct the operation. In other words, franchising is all about relationships and besides analyzing the franchise agreements provisions, a due diligence should verify any recurring complaints from franchisees and its committees, of all kinds, and how long franchisees have been in a particular system, as an indicator of a healthy and possibly profitable system.

In this sense, in countries where delivering a disclosure document is mandatory in a pre-contractual phase, the litigation in connection with or that could affect the franchise system should be described therein. On the other hand, if the country where the target is established does not oblige the delivery of a franchise disclosure document, the task of the due diligence will be assessing in detail this litigation and its effects. For this purpose, it is crucial to fully verify any judicial battles that could block or harm the expansion in a given territory.

Briefly, a due diligence of a franchise system, whether the target company is a franchisor or master franchisee, should consider many specific key points, such as:

- Performance of financial, legal and operational due diligence proceedings regarding the franchisor or the master franchisee company, but, if possible, including information pertaining to the franchisee companies – maintaining the necessary confidentiality – as the business depends upon the receivables of the network's franchisees, including the franchised brand's acceptance and any recurring complaints from franchisees, of all kinds.

- The due diligence must consider and analyze the legal situation of the brands and intangible assets that make up the franchise system and how this is reflected in the disclosure document and the franchise agreements, if applicable, or how this will affect the agreements in force. If possible, it is also recommended to proceed with a commercial due diligence in connection with the franchised trademarks to check if there is a potential to increase the market position in a particular segment.

- If the disclosure documents were properly and timely delivered in compliance with the requirements established by any specific disclosure law, if applicable, or any pre-contractual good faith principle and the related legal consequences.

- If, notwithstanding the terms of the franchise agreements, the franchisor companies grant the franchisees prerogatives that significantly alter the flow of receivables and the enforcement of rules agreed to in the franchise agreements, thus hindering the PE group from taking over management, as well as any other changes in management relating to the network, which may result in the withdrawal of franchisees.

- If the PE firm is acquiring or funding a master franchise company, the analysis of the master franchise agreements in force, in order to verify the rights granted to such master and if the conditions contained therein are too risky to allow this medium-term and high investment.

- In Brazil, franchise law exempts franchisors and master franchisees from labor liability in relation to franchisee employees. However, this is not a legal reality in many countries and a due diligence should also consider whether the target franchise company could have exposure to labor liability for its franchisee or their staff.

- Among other aspects that should be verified there is any breach and disclosure of customers' personal data by franchisees or any violation of customers' rights, normally governed by strict liability legal provisions that could also affect the franchise target company.

7.3 Contractual agreements and key points for franchisors and its owners

Financial [20]

• Debt service coverage ratio – a multiple of 1.x times annual debt service, perhaps separate for the senior lender and the mezzanine lender.

• Working capital – positive working capital (current assets must exceed current liabilities) at a particular level to monitor short term financial condition.

• Net Worth – set at a certain threshold to assure sufficient long term capital for sustaining the business; this measure may allow debt to the PE Fund subordinated to third party lender debt to count as capital.

• Average Days Receiveables – depending on royalty payment frequency, lenders may watch for longer payment cycles as a mirror to the financial health of franchisees.

• Default Ratio – percentage of franchisee accounts past due more than a specific time period, e.g. 60 days, to serve as an early warning of more serious system issues.

• Return on Equity – dividends plus increase in retained earnings or a deemed market capitalization based on comparable companies to assess whether the PE Fund is achieving its financial objectives.

[20] The joint paper prepared by Joel R. Buckberg, Peter D. Holt, Stephen D. Aronson for IFA 2011 Legal Symposium Private Equity Program, pp.20-23.

Affirmative / negative covenants [21]

- No incurrence of indebtedness above the threshold necessary for seasonal working capital lines and authorized debt, and no pledge or encumbrance of assets.

- No issuance of new equity or rights to obtain equity except approved management and employee equity plans.

- No loans to managers, employees, franchisees or third parties except relocation programs and extensions of credit in conjunction with accounts receivable workout plans or approved financing disclosed.

- No purchases of franchisee units or other businesses.

- Compliance with local laws and regulations.

Representations

- Ownership of the intellectual property rights and trade secrets – the franchisor has full rights on these core assets of the operation and there are no unresolved third party interests.

- System and the operation do not infringe any third party's rights – proper licences have been secured for third party rights.

- Disclosed information as to operation, financial data, risks, existing and potential disputes is accurate and complete.

- Food safety/product safety – this is particularly important, in China for instance where food safety is now on the national agenda as there were so many food safety incidents in the last few years, and the supply chain should be reviewed altogether. Usually investors would request insurance coverage be acquired to control the risk exposure.

- For beauty centers or certain personal services, the employees handling treatment process should have been duly trained and are holding the required qualifications.

Governance

- Board composition and decision making process – number of board seats for each side, quorum, and required votes for certain decisions.

- Matters to be approved by all/majority shareholders.

- Related party transactions and transfer pricing.

- Financial officer appointments.

- Transparency of financial management system.

[21] The joint paper prepared by Joel R. Buckberg, Peter D. Holt, Stephen D. Aronson for IFA 2011 Legal Symposium Private Equity Program, pp.20-23.

- Employment and remuneration of certain officers, and any restrictions on participation by founders' family members.

- Right of access to information.

- Special reports – monthly dashboard of key operating metrics, franchise development reports, franchise compliance reports, supply chain reports on vendor activities, advertising schedules, consumer and franchisee feedback reports, litigation reports etc.

Exit

- Timeline of IPO.

- Onshore or offshore IPO – particularly relevant for countries with foreign exchange control (e.g. Chinese groups listed in Hong Kong or US).

- Put option.

- Re-capitalization.

- Pre-IPO sale of PE Funds' interests (all or part) at certain points in time.

Transfer rights

- Right of First Refusal.

- Drag along Rights.

- Tag along Rights.

8. Challenges arising during the transaction and after, that may lead to the success or failure of the transaction. Success and war stories

This section contains some general considerations on the Private Equity market along with real stories showing some of the critical aspects, sometimes underestimated, which lawyers and operators in the sector need to take into account in a Private Equity transaction involving a franchising company.

On the PE market in general, an interesting point to make is that the Private Equity industry in some countries, for instance in India, has lost a bit of its shine in the past few years. PE funds are struggling to exit portfolio companies or secure investments at good valuations. PE funds are finding it difficult to raise funds from foreign investors given the current global economic scenario and the lackluster performance of the Indian economy. Perhaps the private equity industry in India which is currently overcrowded with several hundreds of funds needs consolidation.

However, there is no doubt about the fact that for India to grow at 9%, private equity investments are indispensable especially in sectors such as infrastructure, education, healthcare, IT/ITes and retail industry. Retail industry is the key impetus for prospective PE investors to invest in franchising. PE has a big role to play in helping companies grow, increasing employment, raise productivity, improve corporate governance in small and midsized firms; foster growth and encourage innovation and entrepreneurship. However, for PE to realize its full potential, important regulatory hurdles like uncertainties in India's tax regime and limited investment opportunities for foreign investors in several regulated sectors such as retail trade needs to be addressed. Going forward the Indian industry should aim to foster its faith in the long term growth potential of the Indian economy to attract more investments.

A success story of a PE investment in India would be that of India Value Fund Advisors (IVFA) into major cab service provider in India, Meru Cabs. Presently, investment bank JP Morgan has a mandate from IVFA to seek potential buyers for Meru Cabs, which could include buyout private equity funds and domestic and international radio taxi companies. A short history of the investment is hereinafter stated.

- V-Link, the operator of Meru Cabs, began as an operator of taxicabs in Mumbai, in 2006. Prior to the IVFA PE investment, Meru Cabs could not be reserved over the phone, though they owned a license from the state to operate radio taxis. Meru Cabs lacked funds for expansion and installation of radios in their taxis;
- IVFA invested USD 33.3 Million in Meru Cabs in 2006, and took a majority holding.
- Apart from expanding its fleet, IVFA brought in professionals to manage its operations. IVFA facilitated the recruitment process, attracting high-end talent from reputed companies including global organisations.
- It also created the franchising model based on a study of similar systems globally, focused on air-conditioned cabs fitted with high technology, including data terminals and GPS systems in each Meru cab.
- IVFA also helped Meru Cabs raise debt to purchase vehicles standing in as guarantor.
- Meru Cabs operates in most key cities of India, and has consolidated its position as the largest taxicab operator in India.
- Meru Cabs is aiming at a turnover of USD 100 Million this fiscal year and plans to expand further.

In late 1990’s Mr. Fred Mouawad launched one of India’s first pizzeria chains ‘Pizza Corner’ (franchise of Pizzeria) in Chennai. While he considered becoming a franchisee himself, he quickly realized that becoming a partner of an established international chain without being a large corporation or having direct experience in the restaurant business was nearly impossible. Therefore, within three years of opening his first outlet, he secured PE funds for his business and expanded the brand across South India. Fuelled by the growth of his brands in 2002, he founded Global Franchise Architects (GFA) with the object of building one company with one operating system to manage multiple brands in multiple countries. Around 2011, GFA operated over 90 outlets of six brands across South India, with 60% of its total outlets being sub-franchised.

Speaking of regulatory hurdles in a different part of the world, an issue which has recently arisen for Private Equity funds operating in Europe, is the European Union’s Antitrust watchdog (the European Commission) approach of holding investment firms and parent companies liable for the antitrust conduct of their portfolio companies. In April 2014, this approach led the Commission to impose one of biggest fines (Euro 37 million) on Goldman Sachs for antitrust breaches committed by a portfolio company formerly owned by its private equity arm, GS Capital Partners.

This story begins in 2005 when GS Capital Partners bought a controlling stake in an Italian company, Prysmian, then held all the voting rights for about two years and was involved in making strategic decisions for the company until 2010. According to the European Commission, Prysmian was part from 1999 until 2009 of a cartel with other manufacturers of underground and submarine high-power cable producers.

Under EU competition rules, the entire undertaking or economic unit is liable for the antitrust breaches and not only the portfolio company or subsidiary which effectively committed the breach. This is attributed to the decisive influence that the parent exerts or has the possibility to exert on its subsidiary or portfolio company. Decisive influence can simply be established where the subsidiary does not decide independently its conduct, as for instance where the parent company is able to veto strategic commercial decisions. What is interesting is that a parent company (or a member of a joint venture company) can be held liable even though it had no involvement in or awareness of the antitrust breach and did not encourage the operating company to commit such breach. Apparently, this was the case of Goldman Sachs in respect of the Prysmian's participation in the cartel triggering the fine by the Commission.

With the following surprising report, we remain in the field of national authorities' intervention and changes of governmental policies, this time in China. Although the Chinese economy is growing in a very fast pace in the last three decades, the recent growth is largely driven by the governmental financial policies. As mentioned earlier, PE funds are now more selective in entering into transactions to avoid betting on certain sectors excessively, especially under the changing economic climate and geography. Having said that, service franchises and catering franchises remain the favourite areas for PE funds because the incomes are relatively constant and the governmental intervention is relatively low. However, the saga about South Beauty (the listing attempt failed due to change of governmental policy) reminds investors that the governmental policy should be closely monitored, bearing in mind the Chinese economy is still preserving some characteristics of a planned economy:

- Zhang Lan, the CEO of South Beauty, started working with CDH in 2008 around the time when South Beauty had around 40 units in China, as South Beauty needed cash for expansion. CDH then injected around RMB 200 million and secured 10.526% of the shares of South Beauty.
- South Beauty started to expand rapidly, and it also expanded its high-end dining brand "LAN club". South Beauty's franchise network was also expanding at the same time.
- Shortly afterwards, South Beauty commenced its IPO process in 2011, but the IPO was refused due to the change of government policy – the security commission took the view that all catering operators had traditional problems of tax avoidance (failure to issuing tax invoices) and there was widespread non-compliance of social security contribution obligations.
- In late 2012, the Central Government started a campaign to reduce unnecessary expenditures of various departments, causing a recession in high-end catering sector. Naturally, the IPO process had to be interrupted.
- Zhang Lan then pushed for an IPO in Hong Kong but the attempt failed due to an incident relating to Zhang Lan's change of nationality (changing nationality means lack of political loyalty). In such case, an IPO within a short period of time was no longer realistic. It was reported that the transactional documents between the parties set out that if South Beauty failed to complete the IPO process by the end of 2012, then CDH had the possibility to demand Zhang Lan to purchase the stocks held by CDH or was free to sell the stocks to a third party. Zhang Lan publicly mentioned that introducing CDH as a partner was a "mistake".
- In early 2014, there were reports that CVC Capital Partners is negotiating with Zhang Lan and her existing PE partner CDH for acquiring 69% of the interests in a well-known Xichuanese restaurant chain (with some franchise units) Southern Beauty at USD 0.3 billion. [22] There are some speculations that the sale was initiated by CDH. There are also reports about Zhang Lan is resisting such transaction.[23]

[22] http://finance.ifeng.com/a/20140429/12214105_0.shtml
[23] http://finance.ifeng.com/a/20140218/11678721_0.shtml

This section concludes with a couple of stories regarding transactions which were disrupted by apparently minor details. As mentioned, a change of the franchise system or concept, suggested by the PE's financial management team may not be very well received by the network or by the consumers themselves. For example, a Brazilian "all you can eat" steakhouse (churrascaria) network, at the suggestion of its new professional managers, began selling à la carte dishes with pre-defined portions at a lower, fixed price. The suggested change, which aimed to attract other consumers, almost changed the franchise network's entire concept, but was dismissed in time, due to its catastrophic effects.

In a certain transaction involving a Brazilian target company, the existence of a family disagreement almost prevented the PE firm from closing the deal: the manager was married to one of the shareholders that created the system and such manager did not want to sell the company at all. Besides the long due diligence, it was a very time consuming negotiation to convince such manager, who was responsible for the company's growth in the past. In the end, the deal closed, with full participation of former owners in future management and such franchise system experienced tremendous growth and expansion throughout Brazil.

The key to success as in all relationships is picking the right partner that matches your style, culture, and goals. Then, nurture the relationship from the earliest stages. Avoid doing negative things like portraying the franchise differently from what it is, over-promising, or developing an attitude that does not promote constructive dialog such as blocking the other party from the discussion.

9. Conclusion

Across the globe, private equity is one of the most influential factors transforming franchising sector. Franchises tend to have a well-developed brand, predictable and recurring revenue stream and modest capital expenditure needs, making them special targets for many PE firms. As a franchise system provides a relatively predictable cash flow, this allows the purchaser to leverage its investment with a substantial amount of debt. PE allows franchisors to be more ambitious in their business strategies and ruthless in their efforts to improve profitability.

Private investors are in turn much more demanding and aggressive in their growth targets, and will push the limits of franchisors to the maximum. The funding and expertise provided by PE will enable franchisors to explore new markets. With a smaller number of investors when compared to public companies, a private franchise has the license to be more experimental and daring in its strategies. With the new liquidity that PE generates, mergers and acquisitions will become high on the agenda of many big franchisors, eventually leading towards a consolidation of the franchising sector. Therefore, there is no doubt that the growth of PE in franchising sector reflects the maturing business model and projects the future franchising business in a more sophisticated, organized and efficient dimension.

Inevitably, private equity professionals and franchising professionals – fund managers, brand owners, operators, and their investment bankers, lawyers, accountants and consultants – have influenced each other deeply as they have worked together more often in the last decade. Through exposure to each other's talents and blind spots, they have undergone an intense mutual education on how private equity and franchising work together. PE firms have learned from buying, selling, and managing franchise brands that returns on investment are a function of the overall health of the franchise system, which in turn depends on the quality of the franchise relationships. Franchise system owners and their advisers, on the other hand, have learned much from PE firms about how to enhance the value of their brands. Whether or not a "marriage" and "made in heaven," it has been a mutually beneficial relationship so far.

Biographies

Luciana Bassani

Luciana Bassani, Partner with a Bachelor of Law from the São Paulo State University, joined the law firm of Dannemann Siemsen Advogados in July 2003. Has a postgraduate degree in Contract Law from the Centro de Extensão Universitária of São Paulo (1997) and in Economy and Corporate Law from the Getúlio Vargas Foundation in Rio de Janeiro (2002).

Luciana has extensive experience in corporate agreements, especially in the preparation, revision and analysis of M&A documents, especially involving intangible assets and closely-held companies, and distribution, franchising, agency and intellectual property agreements, incorporation of Brazilian companies, as well as the production of legal opinions in the aforementioned fields of expertise that also address intellectual property, commercial and civil aspects.

She is also the Franchising Country Expert for Brazil of the International Distribution Project, Torino, Italy and the website Officer of the International Franchising Committee of the International Bar Association. Luciana has published several articles on corporate and commercial issues, especially related to franchising. Luciana has been nominated as a leading franchise lawyer for the publication "The International Who's Who" for the years 2011, 2012, 2013 (including for Brazil, in 2013) and 2014. Luciana is a regular speaker at international conferences.

Domini Hui

Dominic Hui is a corporate commercial law partner of Ribeiro Hui, and has led practice groups in these areas in China. He has over a decade experience in representing multi-nationals in the Greater China Region, particularly on franchising law issues and cross-border intellectual property transactions.

Dominic's practice emphasizes on delivery of practical and timely solutions. He is experienced in dealing with different governmental and quasi-governmental bodies, and negotiation with PRC joint venture or other business counterparts to bring about expeditious conclusion of assignments to accord with client's objectives. He travels extensively in China to represent clients in their business affairs.

Dominic speaks at international conferences organized by International Bar Association (IBA) and International Franchise Association (IFA) on intellectual property law, commercial law and employment law.

David W. Koch

David Koch co-founded Plave Koch PLC in 2007 after many years of large law firm partnership. He has 25 years of franchising experience with clients in foodservice, hotels, educational services, staffing, car rental, automotive aftermarket, insurance, homeowner services, retail, veterinary services, and other industries.

Mr. Koch has served as Editor-in-Chief of The Franchise Lawyer, the newsletter of the American Bar Association's Forum on Franchising. He is a member of the ABA's Section of Antitrust Law and the International Bar Association's International Franchising Committee. Mr. Koch has spoken at numerous franchise legal and business conferences, including programs in India, Poland, Romania, England and Canada. He has authored or co-authored more than 30 published articles and conference papers.

Mr. Koch also holds an appointment as Adjunct Clinical Assistant Professor at the University of Michigan Law School, where he supervises students in the International Transactions Clinic.

Before founding Plave Koch PLC, Mr. Koch was a partner at Wiley, Rein & Fielding LLP in Washington, D.C., where he chaired the franchise practice group and served on the firm's management committee. He had previously been a partner at Rudnick, Wolfe, Epstein & Zeidman and Brownstein Zeidman and Lore in D.C.

Before entering private law practice, Mr. Koch served as Attorney-Advisor to the Hon. Daniel Oliver, Chairman of the U.S. Federal Trade Commission. He began his career as a staff attorney in the FTC's Bureau of Consumer Protection. He also served a stint as Counsel to the Minority Leader of the Illinois House of Representatives.

Mr. Koch graduated cum laude from the University of Michigan Law School and received his undergraduate degree in economics with high honors from the University of Iowa.

His legal work focuses on structuring franchise programs and license arrangements, supply chain issues, private equity investments in franchising, corporate and commercial transactions, regulatory compliance, antitrust counseling, advertising and marketing, and international expansion. He is admitted to practice in Virginia and the District of Columbia.

Sajai Singh

Sajai has been with J. Sagar Associates for over twenty two years and is Chair of the Corporate Commercial practice at the Firm. He undertakes transactional work with a focus on representing emerging Technology companies in areas of Inbound Investments in India, Venture Capital (VC) & Private Equity (PE) investments, Joint Ventures, strategic alliances, Mergers & Acquisitions. In Venture Funding & Private Equity transactions, Sajai has represented both funds and investee companies. During his career he has represented clients in a cross section of industries including Media, Communication, Entertainment and BPO (Business Process Outsourcing).

He has assisted many international businesses and funds to funnel investments in India. These clients include established and high technology companies, Internet start-ups, connectivity specialists, e-commerce ventures, conversion technology and technology based entertainment industries. He leads the Firm's Technology, Media & Telecommunication Practice.

Sajai conducts two professional skills development courses at the National Law School of India University in Bangalore - one on Negotiation Skills and another on Transactional Skills for lawyers. Sajai is the President of ITech Law (http://www.itechlaw.org/officials.htm), the International Technology Lawyers Association. He is also the India representative for ABA International along with being the Co-Chair of the India Committee of ABA SIL. He is the Chair of the International Sub-committee of the PE / VC Committee of the ABA Section of Business Law. He is very active with TiE and ABA (American Bar Association) globally, and is often called to speak at international events.

The Asia Pacific Legal 500 has described Sajai Singh as 'highly recommended' by clients and counterparts in overseas law firms. "We have had very positive experience with Sajai Singh for IT matters", says one UK-based commentator.'

Francesca Turitto

Francesca Turitto is an of counsel to the law firm Roma Legal Partners. She has developed an in-depth expertise in the sector of domestic and International franchising representing companies wishing to expand their network in Italy and abroad. She also has an extensive experience in corporate and financial transactions, both national and international, including mergers and acquisition, spin off, joint ventures, privatizations, corporate finance and private equity.

She has coauthored several articles for the Internal Journal of Franchising Law as well as written articles on various aspects of financing and corporate matters published by “Butterworths Journal of International Banking and Financial Law” and contributed to the book on “International Acquisition Finance” published by the Oxford University Press. She is a lecturer at the Master in business law, jointly offered by the LUISS university in Rome and the Italian association of corporate counsel (AIGI). Francesca is a member and an officer of the International Bar Association International Franchising Committee.

She has been constantly recognized in the last years by the International Who's Who of Franchise Lawyers as one of the world's leading practitioners in the field of franchise.