

PRIVATE EQUITY FUNDS IN INTERNATIONAL FRANCHISING

James J. Goodman, *Gemini Investors, Wellesley, Massachusetts, USA*,
Andrew P. Loewinger, *Nixon Peabody LLP, Washington, DC, USA*,
Gilles Menguy, *Gast & Menguy, Paris, France*,
Ted P. Pearce, *Nexsen Pruet PLLC, Charlotte, North Carolina, USA and*
Carolyn J. Vardi, *White & Case LLP, New York, USA*

This article examines private equity's role in franchising generally and more specifically in international franchising by considering private equity and international franchising from a variety of distinct perspectives – that of the U.S. private equity investor; that of the US acquisition counsel; that of the general counsel of a target firm; and that of a European outside counsel. The authors examine the history and growth of private equity; private equity and franchising viewed from a European perspective; the attraction of franchising to private equity and characteristics of the relationship; some of the legal issues arising in a PE group's acquisition and operation of a franchise system; and ways in which the interests and perspectives of a private equity and a franchise system may diverge.

Introduction

Private equity has been sweeping through franchising for the past decade. Increasingly, this wave has been reaching international franchising, in a variety of ways.

Private equity's role in international franchising has become multi-faceted. In part, it has simply reflected the organic growth of franchising in the United States and around the world, through expansion into international markets. However, it has added its own set of innovations, in several ways. First, in the United States, many private equity funds have been

purchasing franchisors that have burgeoning international activities. Second, increasingly, non-U.S. private equity funds have become active players in the franchise arena, by buying foreign franchisors and/or franchisors with international operations. Finally, private equity funds have used a variety of vehicles for investment – not merely, franchisors, but increasingly foreign master franchisees and developers. Examples of this follow below.

“Private equity's role in international franchising has become multi-faceted.”

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Franchises tend to have a well-developed brand, predictable and recurring revenue stream and modest capital expenditure needs, making them prime targets for many private equity firms.¹ The appeal of domestic franchising investments to private equity companies has been demonstrated by the acquisitions of many recognizable franchise players, including Domino’s Pizza, Inc., Burger King Holdings Inc., Wendy’s/Arby’s Group Inc. and Boston Market Corp. In recent years, major private equity firms have sought to translate the success of their domestic franchise portfolio companies into success abroad, investing in foreign franchises in the same industries as those that have been successful domestically. Bain Capital’s acquisition of the master franchise operator of Domino’s Pizza in Japan and the Carlyle Group’s purchase of a substantial stake in the master franchise operator of Domino’s Pizza and Wendy’s for the Middle East and North Africa are two such investments of particular note.

Bain Capital purchased a controlling stake in Domino’s Pizza, Inc., one of the largest domestic pizza delivery chains, in 1998 for \$1.1 billion.²

¹ Press Release, FRANData, As Private Equity Interest in Franchising Increases, FRANData Expands Services, <http://www.franchisesolutions.com/franchisenews/2011/01/As-Private-Equity-Interest-in-Franchising-Increases-FRANData-Expands-Services.cfm>.

² Beth Healy, *Domino’s Delivered for Bain*, BOSTON GLOBE, Jan. 26, 2012, http://articles.boston.com/2012-01-26/business/30672988_1_debt-bain-capital-high-levels.

Domino’s’ founder and CEO, Thomas Monaghan, had owned the company for 38 years prior to the sale but retired after Bain took over.³ Following the purchase, Bain Capital brought in professional management routines and practices that significantly strengthened the business.⁴ When Domino’s became a public company in 2004, Bain remained the company’s largest minority shareholder.⁵ Bain Capital reaped a 500 percent return on its investment in Domino’s domestic business over twelve years.⁶

Seeking to build on its successful investment in Domino’s domestic franchise, Bain Capital purchased Higa Industries Co., Ltd., the master franchise operator of Domino’s Pizza in Japan, in January 2010 for approximately 6 billion yen (\$66.5 million) from Duskin Co. Ltd., Daiwa SMBC Capital and Ernest Higa, the founder of Higa. At that time, Higa was operating 179 Domino’s locations in Tokyo and Osaka. Representatives of Bain Capital cited a number of reasons for its purchase of Higa. Bain’s prior knowledge of Domino’s Pizza was one such factor. In addition, Bain representatives cited significant room for geographic expansion, opportunities for the development of new products and marketing⁷ and steady growth in sales and profit despite difficult industry conditions.⁸ Scott Oelkers, President and CEO of Domino’s Pizza Japan,

³ *Domino’s Founder to Retire, Sell Stake*, LOS ANGELES TIMES, Sept. 26, 1998, <http://articles.latimes.com/1998/sep/26/business/fi-26500>.

⁴ Interview by Jeremy Hobson with Patrick Doyle, CEO, Domino’s Pizza, in Mich. (Feb 23, 2012), available at <http://www.marketplace.org/topics/business/Domino's-pizza-ceo-how-company-has-changed>.

⁵ Bret Thorn, *Bain to Buy Domino’s Japanese Franchisee*, NATION’S REST. NEWS, Jan. 24, 2010, <http://nrn.com/article/bain-buy-Domino's-japanese-franchisee>.

⁶ Beth Healy, *Domino’s Delivered for Bain*, BOSTON GLOBE, Jan. 26, 2012, http://articles.boston.com/2012-01-26/business/30672988_1_debt-bain-capital-high-levels.

⁷ Junko Fujita, *Bain Capital to Buy Domino’s Pizza in Japan*, REUTERS, Jan. 25, 2010, <http://www.reuters.com/article/2010/01/25/us-bain-Domino's-idUSTRE6001UT20100125>.

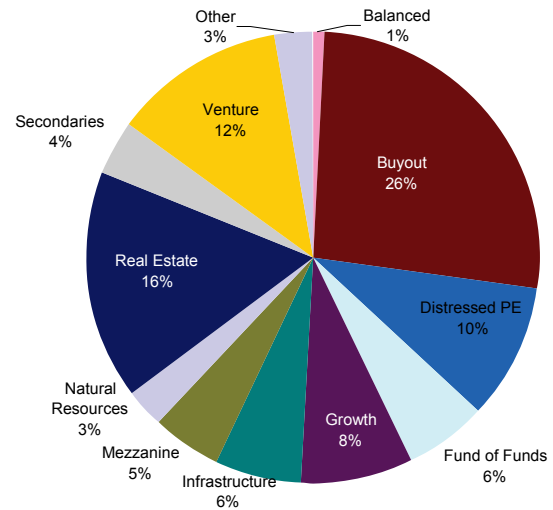
⁸ Bret Thorn, *Bain to Buy Domino’s Japanese Franchisee*, NATION’S REST. NEWS, Jan. 24, 2010, <http://nrn.com/article/bain-buy-Domino's-japanese-franchisee>.

credited Bain with increasing sales through improvements in operations and creative marketing.⁹

In December 2011, another private equity firm, the Carlyle Group, made a Domino's investment of its own, purchasing a 42 percent stake in Alamar Foods – master franchise operator of Domino's and Wendy's for the MENA region – at an undisclosed price from the Al Jammaz family of Saudi Arabia. Al Jammaz continued to hold a majority stake. Prior to its investment in Alamar, Carlyle owned domestic and foreign restaurant franchises, including Dunkin' Brands, Inc. in the U.S. and Babela Restaurant Management Co. Ltd. in China. The Carlyle Group cited several compelling investment characteristics of the casual dining market in the Middle East as motivation for its investment in Alamar, including consistently robust GDP growth, extensive business, leisure and religious tourism initiatives and a young and growing population with a high disposable income. It noted that the young population is well-travelled and exposed to a variety of cuisines and eating habits, while foreign workers and tourists look for familiar, global food options, creating a higher demand for western and European chains and franchises across the region. In Saudi Arabia specifically, those factors led to significant growth rates of consumer expenditure on food: 6.6% in 2009 and 5% in 2010. The Carlyle Group expected quick service restaurant sales to grow at a compound annual rate of 5% between 2010 and 2014.¹⁰ Carlyle's investment in Alamar marked only its second investment in Saudi Arabia. Its decision to invest in a restaurant franchise as one of its initial investments in the region is indicative of the strength of the business model in developing regions and perhaps signals a strategy that will be popular as other developing markets open up to foreign investors.

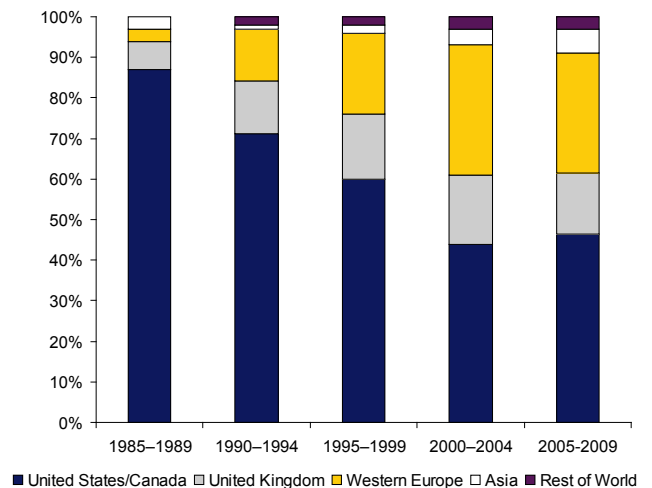
⁹ Chris Betros, *The Domino Effect*, JAPAN TODAY, May 16, 2011, <http://www.japantoday.com/category/executive-impact/view/the-domino-effect>.

¹⁰ Press Release, The Carlyle Group, The Carlyle Group acquires 42% stake in Alamar Foods, operator of Domino's Pizza and Wendy's restaurants throughout MENA and producer of food products for the casual dining restaurant industry (Dec. 14, 2011), <http://www.carlyle.com/Media%20Room/News%20Archive/2011/item12128.html>.



History and growth of private equity

Pioneered as a funding source for the buyout of small, closely-held companies lacking attractive exit opportunities, private equity (PE) has evolved to become a major part of the global economy and a funding source for the growth of many international franchisors. Since 1980, the annual capital committed to private equity has increased from less than \$1 billion to over \$260 billion in 2011. As the size of PE funds grew, PE firms became an alternative ownership structure for large and, in some cases, multibillion dollar companies, as well as a source of growth capital for promising companies too small to obtain funding from public equity markets. During this time period, PE has partnered with iconic international brands such as Hilton Hotels and Burger King.



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While PE may be best known for the leveraged buyouts that first became prevalent in the 1980s, buyouts represent less than half of the transactions completed by PE today. A number of PE groups now specialize in making structured growth investments in companies, taking either a minority or majority position. Another common structure involves making mezzanine investments – a debt instrument, subordinated to senior lenders and convertible to a portion of equity. Regardless of the type of investment or control features, PE now seeks to achieve a superior risk adjusted return on its investments by partnering with management to drive growth and/or operating efficiencies of a business.

PE activity spread rapidly to the European markets in the 1990s, and further into Asia and South America in the 2000s. Previously accounting for 87% of PE-led transactions in the mid-1980s, U.S. based companies now account for less than half of the global PE transactions. Investing in international companies offers the benefits of geographic diversification within a PE portfolio, and, in some cases, the upside of investing in a faster growing economy.

Franchising with a PE partner from the viewpoint of a non-US practitioner

Occupying the niche: the importance of market analysis and strategic plan

Whenever a PE fund wishes to invest in a franchise, the first order of business should be the analysis of the targeted franchise’s market “niche” and review of its business plan. All relevant information pertaining to the product, number and strength of the competitors in the market and consumer analysis must be assembled.

Such elements enable the PE fund to assess the past, present and future of the franchise and in particular answer the paramount question to be: can the targeted franchise system dominate its “niche” market?

For example, in France, in the general market of quick service restaurants, there are several “niche” markets. Some are closed to new competition due in particular to a complex “system to consumer” factor and strong market control of existing players: i.e., American style hamburger fast food. It has only two players – McDonald’s and Quick (1,200 and 483 outlets to date, respectively) – and will probably remain this way. Another “niche” was open to competition 5 years ago: the quick service Pasta style restaurant. In the last 5 years, four have built franchise systems, two of which are currently leading the market (Mezzo di Pasta and Nooi, composed of 140 and 70 outlets, respectively), the “followers” being Francesca and Viaggio. In this “niche”, the question would be the following: should a PE fund enter and alongside whom? Bridgepoint did and chose Mezzo di Pasta in July 2011.

PE funds and European Competition Law

On the assumption a PE fund invests in the capital of various franchisors, could there be an issue if it controls several which may be competitors? If such is the case, would the PE fund be liable for a violation of competition law? Would the risk accrue if the PE fund adopts a “hands on” approach?

In 2004, the European Commission fined Azko Nobel NV and four of its subsidiaries for price fixing and market sharing in violation of the former Article 81 (which has become article 101 in the treaty of Lisbon). Azko Nobel appealed the tribunal decision on the basis that parent’s company could not be held liable for their subsidiaries as they are two separate legal entities. The Court of Justice decided to uphold the tribunal decision and supported the EU commission’s view on parent companies.

The EU commission has an extensive view of what a parent company is, as discussed in the Azko Nobel case of 2009:

“That is the case because, in such a situation, the parent company and its subsidiary form a single economic unit and therefore form a single undertaking for the purposes of the case-law mentioned in paragraphs 54 and 55 of this judgment. Thus, the fact that a parent company and its subsidiary constitute a single undertaking within the meaning of Article 81 EC enables the Commission to address a decision imposing fines to the parent company, without having to establish the personal involvement of the latter in the infringement.”¹¹

In this view, the Commission only has to prove the shareholding. The fact that the parent company has a high shareholding interest in a company makes the parent liable for breaches of antitrust law by the subsidiary company, since the parent company is deemed by the Commission to have a strong influence on its subsidiary. Therefore a PE Fund can be liable for breaches of antitrust law by the companies it invests in. This presumption is even stronger when the PE firm owns 100% of the subsidiary.

The EU Commission does not hesitate to fine PE firms on this basis – i.e., in its decision of 22 July 2009 the EU Commission imposed a fine of 13,300,000 Euros on Arques Industries AG (a PE firm) and its subsidiaries for violation of article 101 of the treaty of the European Union. More recently, the EU commission has addressed a Statement of

“The fact that the parent company has a high shareholding interest in a company makes the parent liable for breaches of antitrust law by the subsidiary company, since the parent company is deemed by the Commission to have a strong influence on its subsidiary.”

¹¹ Azko Nobel c/ UE Commission, C-97/08, §59.

Objection to Goldman Sachs on July 6, 2011 concerning an antitrust violation by the firm “Prysmian” which occurred at the time when Goldman Sachs, through its shareholding, was in indirect control of “Prysmian.”¹² The Statement of Objection is usually the first step of litigation; no accusation has been made by the EU commission yet.

PE firms must hence be cautious when they invest in order to avoid putting themselves in the situation where they can be held liable. Enforced compliance programs can be useful for the PE firm since it can help rebut the presumption and will reduce the fine if the firm is sentenced. The maximum fine that can be imposed is equal to 10% of the worldwide group turnover.

How to expand outside of the mother country: the choice between a joint venture and master franchise

In our area of study, the joint venture (“JV”) and master franchising are two common vehicles used by European companies to organize a franchisor’s international expansion.

Joint venture

A JV is an association of two companies for the purpose of setting up a JV company to achieve a common goal. The main idea in a joint venture is that both companies share the risk and cost linked to the development of the JV in the foreign country. The franchisor’s contribution is composed of the brand, the know-how and its experience, whilst the local partner brings the local distribution, the employees and the knowledge of the local market.

If a joint venture allows the franchisor to stay in control of the local franchise network since the franchisor is a shareholder of the JV, it implies more exposure to financial losses. Moreover, it is important for the franchisor and its local partner to work together which supposes that the two teams cooperate with each other. It is often easier said than done. Since the risk taken by the franchisor is important, a joint venture usually works best in

¹² Library.findlaw.com, Dec 2011.

expanding to a foreign, but relatively familiar and secure, area for the franchisor. When creating a JV, the franchisor must be cautious to control the capital of the JV to avoid competitors from entering its capital (i.e., by using a shareholder agreement).

Master franchise

The use of a master franchise is the most convenient way to expand internationally. A master franchise agreement is a contract by which the franchisor grants to the master franchisee the territorial exclusivity over the brand and of the development of the franchise system. The master franchisee must pay entry rights and a royalty fee. The master franchisee becomes the franchisor's "delegate" for the granted geographical area.

Master franchise agreements are generally used when a franchisor expands to foreign countries it is not familiar with and that are relatively distant. The franchisor should keep in mind that little risk does not mean immunity. If the franchisor fails in its obligations to the master franchisee, it may end up in a costly law suit for the franchisor and always commercially jeopardize the ex-master franchisee's territory for some time.

“PE funds should be careful in determining the clauses in their contracts.”

Legal issues in international franchising

The arrival of a franchisor in a new country is a legal challenge. The franchisor wants to expand in a foreign environment, which is completely out of its comfort zone.

The first thing to do for a franchisor, as for a PE fund, is to consult a local counselor specialized in the correct area of law. Analyzing local law is decisive and the new franchise must be in accordance with it. The same reasoning applies to PE funds. In their contracts they should carefully draft and check every term in order to ensure that they are enforceable before a local court.

Often, local law provides for other positive obligations the franchisor has to comply with. One of the most commonly encountered is the obligation to provide a pre-contractual information document which may have to include a market study, in addition to other information. Drafting such documents has a cost that must be predicted. This obligation of a pre-contractual information document exists in some major countries in Europe such as Belgium, France, Italy, Spain and Sweden.

Concerning PE funds, there is no uniform European legislation. Therefore, PE funds should be careful in determining the clauses in their contracts. For example, in France regarding LBO operations, the "drag along" clause is not recognized in the same manner as they are in common law in application of article 1843-4 of the civil code. Should litigation arise out of the determination of the value of the shareholding, the court's expert in charge of evaluating the shareholding is not bound by the parties' mathematical formula and may decide which is the best way to calculate the value of the shareholding interest.¹³ Therefore, the parties should be very careful when they are drafting such clauses.

In the same way, the French Supreme Court refuses to enforce "bad leaver" clauses.¹⁴ "Bad leaver" clauses are clauses of the shareholding agreement that refer to a situation when an executive is dismissed and has to sell its shares, the shareholding is bought at a lower price than the market price, as he is a "bad leaver". Under French law these clauses will not be enforceable as they are seen as a financial penalty forbidden by the French Work code.

If litigation arises, the local player should explore the ways and means of lodging its claim before the local judge, notwithstanding the existence of lex forum (or venue selection clause) pointing to another jurisdiction.

¹³ Cass. Com. February, 16th 2010, n° 09-11668

¹⁴ Cass. Soc. October, 21st 2009, n° 08-42026

Legal and economic unpredictability in the current global economic environment

As observed over the past few years, the economic situation of most countries can be dramatically altered by an international financial crisis or political change. These changes may impose themselves on the parties to a master franchise agreement and radically transform their rapport even though they might very well maintain the will to pursue their relationship.

In a first type of situation, the Master Franchisee may well encounter difficulties in the course of the relationship with its banks for instance (which may have revised their lending policies) and not be able to meet its opening obligations. Because of lack of cash is it sound, businesswise, to terminate the agreement if the cause of breach of contract by one of the parties is in fact due to external reasons?

Another consideration to be taken into account is unforeseeable economic events which one would usually disregard as pure fiction: a unilateral decision of a country to close down its borders and banking system so as to avoid overnight flight of capital, disappearance of a currency defined in the agreement, and the like. Do existing agreements cover such extraordinary circumstances? Largely accepted in M&A, a revisited Material Adverse Change (MAC) clause, adapted to franchising, could be an option.

Unforeseeable events should be taken into consideration by the parties for another simple reason: trust must be preserved and economic turmoil would seriously affect the relationship, at the very time parties need to cooperate intensely. Trust is a cornerstone of the contract, and must be preserved in good and bad times.

How should a non-US PE group deal with the acceleration and maturity phases of a franchise system?

Franchising is a well-developed concept in Europe. According to the European Franchise Federation report of 2011, over 10,000 franchise brands exist in Europe and 1,369 franchise brands exist in France alone.¹⁵ Private equity has been encouraged as a privileged way to finance small and medium enterprises (SMEs). As a result, a fund invested in private equity by individuals can lead to a tax credit in some countries, such as in France.

In every successful franchise network development, there are mainly two phases: the acceleration phase and the maturity phase. Both of these phases are of interest to a PE fund, and depending on the desired result a PE fund will invest in one phase or the other.

The acceleration phase is a specific sequence in time characterized by the fast-paced sale of units and rapid geographical expansion. This phase is a critical moment for a franchise network, extremely cash-consuming, and any mistake in leadership or development can lead to failure of the network. During this phase the franchisor must be even more careful in selecting its franchisees, because they will be the B-team of the network: they will expect a certain standard of service. A poor selection of the franchisees, insufficient control of the information system, negligence in the survey of financial ratios and lack of investments from the franchisor can trigger an infernal spiral and lead to failure of the franchise system.

If the PE fund enters just before this acceleration phase commences, it can provide a solid answer to the franchisor's need for investment and become a true partner; timing is of the essence. By helping the franchisor with its experience, the PE fund can ensure both the success of the franchisor and the success of its investment. The risk taken by the PE fund is higher in this phase, but the reward may also be higher. Moreover, the duration of the investment of a PE fund (2 to 5 years) may match with the

¹⁵ FRANCHISING : a vector of economic growth in Europe 2011, www.eff-franchise.com

duration of the acceleration phase. On the brink of stabilization and maturity, the PE fund will have a first option to exit.

A PE fund will often take a minority investment (the current trend evolving towards a majority investment) into a company, in the way of a capital increase. There is no LBO involved in this situation usually. It is important for the franchisor to “shop” for its PE fund. The PE fund will become a partner of the franchisor in the development of the network. The acceleration phase is a hectic moment for the franchisor, which must transform the franchise system. The arrival of a new partner such as a PE fund should therefore be addressed seriously in terms of decision sharing. It is crucial to organize the executive board in accordance with the PE fund in the company. In this phase, the franchisor needs to act fast and cannot afford to be blocked in its every day action by a disagreement with the PE fund.

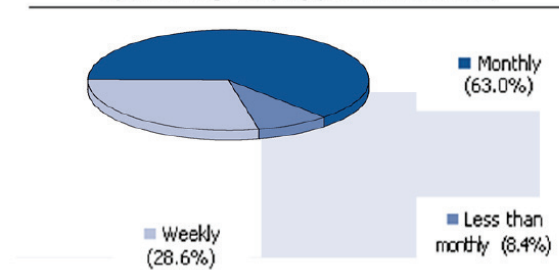
A study published by the European Private Equity & Venture Capital association¹⁶ shows interesting facts about the frequency of contact between the venture capitalist and the investee company.

Moreover, the study shows that investee companies value the venture capitalist’s strategic input regarding monitoring financial performance, regular budget reporting, financial advice, strategic advice, and network opportunities.

In Europe, most PE funds invest in firms that are in the acceleration phase. For example, in 2006, 89% of the companies which were invested in by PE funds had less than 500 employees and over 70 % had less than 100 employees.¹⁷

The mature phase is, at the opposite of the acceleration, characterized by the slowing down of the expansion. The franchisor is well established, the

Frequency of contact between venture capitalist and expansion stage company (source: NUBS/EVCA)



brand is well known, and the franchisor has a strong position in the market. The main change for the franchisor in this phase is that it focuses on the quality development of the brand more than pure territorial expansion in order to keep its position in the market. New franchisees mainly come into the network to replace other franchisees whose contracts are not renewed. Because of its focus on the quality development of the brand, the franchisor tends to give strong directives to its franchisees. The need for investment at this point comes from the development of new brands in complementary markets or the desire of the franchisor to expand internationally.

“... investee companies value the venture capitalist’s strategic input regarding monitoring financial performance, regular budget reporting, financial advice, strategic advice, and network opportunities.”

¹⁶ “Survey of the Economic and Social impact of Venture Capital in Europe”, EVCA, 2002, <http://www.evca.eu>

¹⁷ “Guide on Private Equity and Venture Capital for Entrepreneurs”, EVCA, 2007, <http://www.evca.eu>

“Both early stage and established franchisors with strong brands are attractive investment targets for PE ...”

In the case of a mature franchisor, the PE fund that invests in the franchisor mainly invests for a specific goal. Usually, this is when a leverage buy out (“LBO”) occurs. The LBO is used for different purposes. It can be used to improve the efficiency of the franchisor, or to facilitate generational change in the company. The amount of money invested by the PE fund is substantial when compared to the amount invested in the acceleration phase. PE funds’ dealings with such goals are specialized and often also provide support to the holding company to ensure its capacity to pay its debt.

Attraction of international franchising to a US PE group

Both early stage and established franchisors with strong brands are attractive investment targets for PE, as they provide visibility to a steady, recurring stream of cash flows and growth potential unimpeded by the required capital investments inherent in a company-operated model. Franchisors are perceived to be less risky by lenders due to the unit level diversification and low capital expenditure requirements to fund growth. Further, the steady nature of royalty income in established franchisors allow PE groups to apply high degrees of leverage to a transaction. As profitability of the franchisor increases throughout the life of the investment, the equity value increases disproportionately driving attractive returns.

There are also a number of PE groups actively pursuing investments in growth stage franchisors, whose cash flows are more reliant on new franchise sales than on the royalty stream generated from existing units. Franchisors that fall in this category are less likely to receive favorable terms from lenders, thus PE can be an attractive means to fund growth. A growth stage franchisor with strong unit

Select PE Investments in Franchisors			
Date	PE Firm	Company	Segment
May-98	Berkshire Hathaway	Dairy Queen	Restaurant
Mar-99	Bain Capital	Dominos Inc.	Restaurant
Dec-03	Apollo	GNC Holdings	Retail
Mar-06	Bain Capital; Carlyle Group; Thomas H. Lee	Dunkin' Brands	Restaurant
Nov-06	Carlyle Group; Clayton, Dubilier & Rice	Hertz	Rental Car
Feb-07	MidOcean Partners	Sbarro	Restaurant
Mar-07	Clayton, Dubilier & Rice	Service Master	Residential & Commercial Services
Feb-08	LNK Partners	Au Bon Pain	Restaurant
Aug-09	Friedman Fleischer & Lowe	Church's Chicken	Restaurant
Sep-10	3G Capital	Burger King Holdings	Restaurant
Dec-10	TZP Group LLC	The Dwyer Group	Residential & Commercial Services
Jul-11	Roark Capital	Arby's Restaurant	Restaurant
Dec-11	Harvest Partners	Driven Brands	Automotive Aftermarket

economics and a strong back-office to support continued franchisee development will benefit from both a high degree of operating leverage, as well as an increasingly stable income stream as the system matures. By increasing both the profitability and the stability of cash flows, a franchisor that matures during the PE investment horizon will garner a high valuation multiple upon exit.

Gemini Investors Investments in Franchisors				
1999 – 2004	2003 – 2010	2006 – 2011	2006 – 2010	2008 -
				

“... an equity investment from a PE firm will likely be coupled with higher levels of senior and subordinated debt.”

Gemini Investors has successfully invested in a variety of established and growth stage domestic and international franchisors across a wide range of industries – from restaurants to cleaning services. Gemini’s strategy is to partner with franchisors that carry strong brands, are supported by positive system-wide performance, and have unit economics that are extremely attractive to franchisees. Typically, Gemini targets franchises that are highly replicable with the payback period for a new unit averaging less than three years and unit level ROIs exceeding 30%.

In 1999, Gemini was part of the original round of investors in Buffalo Wild Wings. At the time of investment, Buffalo Wild Wings had 26 company-owned units and 62 franchised units. When Gemini helped guide the company through its initial public offering in 2003, Buffalo Wild Wings had grown to 460 company owned units, of which 70% were franchised.

Similar to its investment in Buffalo Wild Wings, Gemini also invested in Wingstop during the company’s growth stage. At the time of investment, Wingstop had two company-owned units and 86 franchised units. When Gemini sold the company to Roark Capital in 2010, Wingstop had opened over 470 company owned units with 95% franchised.

In 2008, Gemini, along with Webster Capital and JHW Greentree, acquired Jan Pro, an established commercial cleaning services franchisor. At the time, Jan Pro was one of the fastest growing franchises with more than 7,000 units in 80 domestic and four international markets. Since then, Jan Pro has targeted international expansion, including the \$8 billion cleaning industry in Brazil, and today has more than 12,000 franchisees in 118 regions.

Characteristics of the PE/franchise relationship

The PE relationship with its portfolio companies can differ based on the type and structure of the investment. However, in general, an equity investment from a PE firm will likely be coupled with higher levels of senior and subordinated debt. For buyout transactions of established franchisors, senior lenders remain willing to finance up to 60 or 70% due to the franchisor’s reliable royalty stream.

As an alternative to exiting its investment, a PE firm may seek partial liquidity through recapitalizations and issuance of one-time dividends. Perhaps the largest recent example was the dividend recapitalization completed by Dunkin’ Brands, which returned \$500 million to its financial sponsors in 2010 before the company filed to go public in 2011. After paying down a portion of the debt used to fund the transaction in 2006, the borrowing capacity of Dunkin’ allowed its financial sponsors to issue the one-time dividend by raising new debt. The dividend recapitalization allows the PE sponsor to return a portion of its investment while retaining the equity upside.

Recapitalizations may also provide management or other investors in a PE sponsored company the opportunity to increase their equity stake as the PE firm reduces its stake or exits completely. In 2005, management led a \$128 mm recapitalization of Meineke Car Care, in which Carousel Capital and Halifax each exited the investment.

Compensation packages for management of a PE-backed company are typically richer and are structured to align the management's goals with the goals of the PE firm. Management option pools between 5% and 15% are a common technique to incentivize the day-to-day operators of the company to increase the value of the company. Options typically vest over the life of a PE's investment and liquidity is provided when the PE firm exits its investment. Annual bonuses and other incentive packages are usually tied to various performance metrics set upon the PE firm's initial investment.

Of course, the goal of every PE investment is to exit at a higher valuation than the original purchase price. Holding periods for PE investments can range from three to seven years depending on the strategy of the PE firm, company performance and exit opportunities that present themselves. A successful PE investment, such as Dunkin' Brands or Buffalo Wild Wings, may lend itself well to an IPO, which creates a public market for the company and allows the PE firm to exit its investment over time rather than all at once.

“... successful international franchisors typically prefer to either sell territory development rights or master franchise agreements.”

Expansion of a franchise system both domestically and internationally

In 1970, 55% of the 330,000 franchise units in the United States consisted of gasoline stations. Since then, the franchise model has been widely accepted and implemented throughout a wide range of industries – from residential services to restaurants. Further spurred by favorable credit markets in the 2000s, the number of franchised establishments peaked in 2008 before credit tightened and economic pressures caused unit contraction.

Franchisors looking for the next stage of growth, have actively sought international expansion opportunities in fast growing and lucrative markets. Over 400 U.S. franchise systems have expanded internationally accounting for nearly one-third of their worldwide units. While originally focusing on economies similar to the U.S. (e.g., Canada and U.K.), emerging markets such as China, India and South America have been targeted by some of the most established U.S. franchisors, including Yum! Brands, which has opened more than 4,000 KFC, Taco Bell, and Pizza Hut units in China alone.

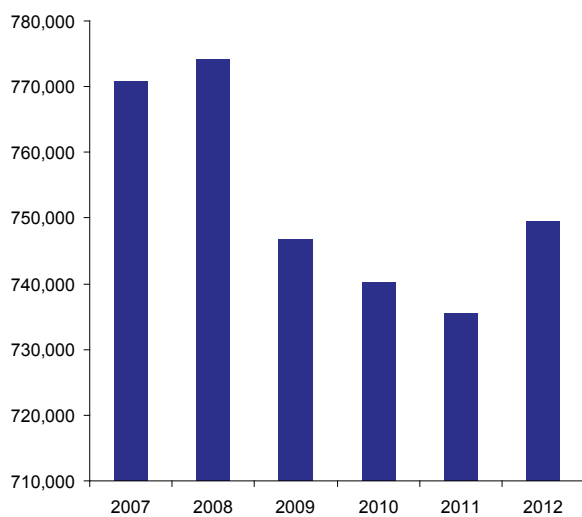
Similar to domestic franchising, there are three international franchising models to consider including selling 1) individual units to franchisees; 2) territory development rights; and 3) master franchise agreements. Few franchisors have successfully expanded internationally by marketing individual units due to the operational difficulties associated with supporting and regulating franchisees abroad without first-hand knowledge of the local regulatory and economic environment. Instead, successful international franchisors typically prefer to either sell territory development rights or master franchise agreements.

Domestic v. international expansion

International franchising offers an exciting opportunity for concepts to maintain and even accelerate growth enjoyed domestically over the past 35 years. However, it also presents a different combination of socio-economic trends, regulatory factors, and language barriers for the international franchisor.

Before expanding internationally, a franchisor must first confirm that its concept and brand delivery appeal to the international franchisee and consumer. Provided that the concept does not have cultural limitations (e.g., name or concept that is culturally unfavorable outside the U.S.), a franchisor with more than 20 units operating domestically is generally considered large enough and proven enough to consider international expansion. To test this further, it is common practice for established franchisors is to hire a consultant to test their strength in a particular region.

**Number of Franchise Establishments in the U.S.
(2007 – 2012E)**



It is imperative to obtain legal counsel that understands the franchising laws of a foreign nation, as the regulatory environment and labor laws will differ by country. U.S.-based franchisors have avoided expansion altogether into a select number of countries due the lack of enforceability of franchising agreements, limiting the franchisors’ ability to protect its most valuable asset – its brand. However, the majority of foreign nations protect the international franchisor as long as its trademark is registered in that country.

“An investment by a private equity firm in a franchise has different considerations than the typical acquisition by a strategic buyer.”

Labor laws will vary by industry and line of work. In the MENA district, there are restrictions on the type of work performed by nationals. In these areas, franchisors must have a local entity, usually the regional developer or master franchisee, and import labor from surrounding countries. Labor laws in other parts of the world may dictate everything from minimum wages and work hours to mandatory lunch breaks and uniforms.

As in the United States, there is often a disclosure process (and may be a registration or filing process) associated with selling franchises internationally. However, that process can differ both in the scope of information required and the time it takes to obtain approval. The pre-sale regulatory approval process in government agencies can range from 48 hours to 90-120 days. In several South American countries, for instance, a foreign franchisor must be approved by multiple organizations, including a franchise council or other independent franchisee organization, the central bank, and local government agencies. In contract, there is no regulatory body governing the GCC. The lack of a regulatory body, combined with good banking and liquidity in the region make it very attractive to international franchisors.

PE/franchise relationship from a U.S. practitioner’s perspective

Private equity funds contemplating investment in international franchises must consider a number of issues when structuring a transaction, including the firm’s compatibility with the franchisor, its desire to maintain preference in the franchisor’s capital structure, the degree to which the firm may want to contribute follow-on capital to the franchise, the franchise’s compliance with domestic and international laws and regulations, and other diligence-related inquires.

An investment by a private equity firm in a franchise has different considerations than the typical acquisition by a strategic buyer. In contrast to a strategic buyer, a private equity investor seeks to make a relatively quick profit on its investment and may be less familiar with a target company's industry. The fund identifies a way to build value in the target and is not usually interested in overhauling all aspects of the target's business. As a result, a private equity firm looking to acquire a portfolio company places particular emphasis on the quality of the target's existing management team. Funds are not likely to invest in a franchise unless the target has an excellent management team, or unless the fund has already recruited its own management team to run the company.¹⁸

Private equity firms usually obtain a stake in the preferred stock of the target franchise when making an investment. Preferred stock is desired by funds because it protects them from the risk of a decline in the value of the target company. Preferred stock does this by giving private equity investors certain preferences and rights over common stockholders. Convertible preferred stock provides investors with the best of both worlds, protecting private equity funds from the target's downsides while allowing the fund to share in the growth and profits of the target company via the conversion feature. For that reason, convertible preferred stock tends to be more popular than straight preferred stock. The desired tax treatment often drives the structure of the preferred stock investment and must be considered when drafting its terms.¹⁹

In a distressed market, or when capital is needed quickly, portfolio companies often turn to their private equity firm investors to provide needed funds. These follow-on financings can be structured as follow-on financings at the same valuation as the previous round, down-round financings, convertible promissory notes or promissory notes with warrant coverage, bridge loans into future financing rounds, or more extensive restructurings. The form of the financing will depend on various factors, including

¹⁸ *Buyouts: Overview*, PRAC. L. CO.

¹⁹ *Preferred Stock in Private Equity Transactions: Significant Tax Issues*, PRAC. L. CO.

the portfolio company's financial situation and outlook and the perspective of the private equity fund. It should be noted that the approval of follow-on financing may be subject to heightened judicial scrutiny.²⁰

Like most buyers, private equity companies conduct due diligence before committing to an investment in a franchise. Due diligence seeks to determine the target's compliance with domestic and international law, confirm that the seller has good title to the stock of the target, investigate potential liabilities or risks associated with the investment, confirm the value of the target, learn more about the target's operations and identify necessary third-party consents and other impediments to the transaction.²¹ Funds often conduct more extensive due diligence reviews than strategic buyers and may seek greater contractual protections. This elevated inquiry may stem from lack of familiarity with the target's industry.²² A threshold inquiry when investing in a franchise, whether domestically or internationally, is whether the franchise is operating in compliance with all applicable laws and regulations.

“Funds often conduct more extensive due diligence reviews than strategic buyers and may seek greater contractual protections.”

²⁰ Jason R. Boyea & Christine Stanitski, *Private Equity 2011 - Caveat Investor: What to Consider and What to Watch Out For When Investing Additional Capital Into a Portfolio Company* (Finn Dixon & Herling, Stamford, CT), Nov.-Dec. 2011, at 1, available at http://www.fdh.com/news/data/0040/_res/id=sa_File1/Article%20-%20Private%20Equity%202011%20-%20Caveat%20Investor%20_01293374-3_.pdf.

²¹ *Due Diligence for Private Mergers and Acquisitions*, PRAC. L. CO.

²² *Buyouts: Overview*, PRAC. L. CO.

“A private equity buyer purchasing a nascent franchise system can expect a system that will need a great amount of attention relating to the development of processes for the managing franchisor.”

Corporate governance and defining the relative rights of the various stockholders are two key concerns for financial sponsors generally and certainly private equity firms. Financial sponsors typically insist on detailed stockholders’ agreements and governance provisions giving the sponsor broad control over management and operations of the company, corporate transactions, transfers of equity interests and other liquidity events. Private equity companies often push for substantial control over board composition, but may yield one or more board seats to key executives or co-investors (if applicable).²³ Institutional investors with an international portfolio have helped drive foreign companies to adopt corporate governance policies similar to those found in the U.S. International institutional investors, such as CalPERS, have explicitly conditioned their investments in specific countries or companies on adoption of various corporate governance practices.²⁴

The private equity/franchisor “partnership”

Characteristics of the franchise system before its acquisition

The growth and development of a franchise system is evolutionary and not revolutionary. Much like geological history a franchise system’s evolution

starts with its creation. The founders of a franchise system will have very distinct ideas on how to develop, grow, and operate their franchise system. During the development stage their primary focus will be on the development of their business model. Their resources will be employed to build a sound and unique business model that when successful will provide the operator of a franchised unit with sustainable profits, making their investment in the system worthwhile. Often this period of germination can be substantial and devoid of attention to company-wide policies and concerns. The founders are forever tinkering with the system that they develop. Only after they develop a workable and successful model will they turn their attention to the more mundane requirements of managing their company or the franchise system.

As a result of their attention being focused on the creation of the business model, the founders will not have the same sense of discipline that more seasoned franchise systems may have. Business disciplines, like budgets and long term business planning, will take a back seat to the development of the actual business system. Moreover, the development of franchise units will be on a more haphazard basis as the founders will look to sell their franchises to any willing purchaser. As a consequence, the franchisor may grant special considerations to its pioneer franchisees including greater than contractually-mandated territories. Additionally, the franchise agreement prepared for the system may not contain all of the necessary provisions that are particularly germane to the specific system. Likewise, in this early stage of development, a franchisor will likely show little attention to international development or expansion. A private equity buyer purchasing a nascent franchise system can expect a system that will need a great amount of attention relating to the development of processes for the managing franchisor.

As a franchise system progresses and its business system becomes a proven commodity, the franchisor will concentrate its efforts on growth in order to make the franchise system a sustainable business. Processes will begin to form, business plans may take root, and budgets may be put into place. Often times during this stage the franchisor will try to

²³ *Key Corporate Governance and Exit Considerations for the Sponsor-backed IPO Candidate*, PRAC. L. CO.

²⁴ Bob Tricker, *The Cultural Dependence of Corporate Governance*, Nov. 7, 2011, available at <http://corporategovernanceoup.wordpress.com/2011/11/07/the-cultural-dependence-of-corporate-governance/>.

reach a point of development that will make the system marketable to a third party like a private equity group. When a private equity group purchases a franchise system at this point in the system's development it is likely that they will find a system whose income has been mainly predicated on revenues derived from initial franchise fees with the royalty revenue ramping up. At this time the founders and members of the original management team will be looking to cash-out and leave the franchise system. Therefore, the private equity group purchasing the franchise system will need to replace or bring in its own management team. In addition, during its due diligence stage it will need to check very closely to see if there are any special deals given to the franchisee base, including royalty deferrals or /and extra-contractual territory grants.

As the franchise system's stage reaches the end of its primary or premiere growth phase, the franchisor will turn its attention to the operational needs of the franchise system. It is not uncommon to see some stage of restiveness on the part of the franchisees during this period since many of the pioneer franchisees may feel that the system has become less personal than when they purchased their unit. They may long for the days when the founders would visit their units and seek their advice in developing the system as if they were the founders' virtual partners in the franchise concept and development. Depending upon how long it has taken the franchise system to ramp up to its critical mass of franchise units there may be some wear and tear on the first entrants into the system.

A private equity buyer who buys a more established system will need to consider not only the continued growth possibilities of the system, but also the welfare of the existing units. Questions that will become top-of-mind are the continued relevancy of the existing business model. Moreover, is the franchise system amenable to changes and tweaks that may be necessary to further sustain the system? As markets change will there be a need to change the franchise system? What were the expectations of the franchisees coming into the system at the beginning? Were they told, "this is the system and these are the products, services, and offering format that we intend to continue?" Once franchisees make

their investment into a system, which could be their life savings, how easy will it be, or how willing will they be to change their model to adapt to the changing market? If the franchisees are asked to broaden their product and service offerings will these changes generate the same margins that their initial products and services offered? Accordingly, will they push the franchisor to make modifications to the royalty fee and advertising contribution structure? These are all factors that a private equity investor will need to take into consideration when purchasing a franchise system. It is at this time that the franchisor may develop or be asked to recognize a dealer council or association that represents the franchisees' interests in many issues arising in the franchise system.

What does a franchisor or franchise system offer to a private equity purchaser?

For a private equity purchaser a franchise system at any stage can be an attractive purchase. Firstly, a franchise system provides a relatively predictable cash flow, which is very important to a purchaser who will likely leverage their purchase with a substantial amount of debt. Additionally, if the private equity group buys a proven but young system there usually remain opportunities for continued growth of the system. When purchasing the franchise target the PE group will examine the quality of the earnings to examine its sustainability. That cash flow likely will come from a steady stream of royalties, some vendor or supplier rebates, and initial franchise fees. Each one of these components form the core of the revenue streams for most business format franchise systems.

Another aspect of franchising that a private equity group will find attractive is the ability to grow the system in many different development directions. Domestic growth will surely continue either on an organic path, which is to say grow the sale of single units, or it can accelerate its growth through area development or master franchise relationships. Each growth vehicle has its advantages and disadvantages, which will be up to the private equity purchaser to examine with the franchisor's management team. From an international standpoint the development

“Since a private equity group is not prone to actually manage the system as part of their investment it will be reliant upon a strong and experienced management team not only to continue the operations of the target franchise system, but also to contribute to its further development.”

vehicles likely will focus on area development or master franchising, which will put more responsibility on the master franchisee or area developer for developing the business system in the specific international territory. Domestic and international growth have their different touch points, with each development route requiring its own expertise and individual needs.

Other advantages for a private equity purchaser, that owns other franchise systems or purchases multiple systems, are the synergies that a PE group may realize from the ownership of multiple systems. Many synergies will be realized in the back office function of the franchise operations such as real estate, accounting, legal, and franchise development. Other synergies may not as easily lend themselves to such cost synergies such as franchisee-operations or marketing and advertising function because they may be viewed by members of the different brands as interfering with their operations.

One of the reasons that a private equity group is motivated to purchase a franchise system is the in-place management team. Since a private equity group is not prone to actually manage the system as part of their investment it will be reliant upon a strong and experienced management team not only to continue the operations of the target franchise system, but also to contribute to its further development. Often when a PE group purchases a franchise system there are really three transactions involved. The first is a sale of the system by the

seller, which requires its own set of negotiation skills. The second transaction involves the franchise system itself, meaning the franchisees. At some point during the sales process the buyer is going to need to feel comfortable that the franchise system will be accepting of the new buyer, and that the sale will not trigger an avalanche of problems or concerns raised by the franchisees in the system being purchased. One thing that the franchisee leadership will probe is the intent or goals of the buyer both as to the continued quality or improvement in the operations of the chain and the longevity of ownership. The third aspect of a sale to a private equity group is the group’s ability to negotiate a continued relationship with the management team to keep them motivated and incentivized to continue the growth and success of the system. Often, it is the negotiations with the existing management team that can be the most complex and tricky part of a franchise system acquisition, especially in cases where the management team has been through previous sales of the franchise system. Suffice it to say that a strong and motivated management team is a key component to the future success of a franchise system.

Management of a franchise system post acquisition

Depending upon the continuum of the franchise system development cycle, the management of a franchise system after an acquisition can be either seamless or fraught with challenges both for the private equity group and the management team. Also, as mentioned above, the impact upon the franchise system and specifically the franchisees may be very pronounced depending upon the ownership and development strategy of the new owner.

Once the private equity group purchases a franchise system the critical questions will be what are the group’s goals or strategies for the development of the system and what is the group’s time-line for its exit? Most purchases by a private equity group are funded by their particular investment fund that has its own specific fund life with specific financial return goals. These goals and the strategy to be

implemented will have a direct bearing on how a franchise system will be managed under the group's stewardship. The franchisees will want to know what type of investments will be made into the system. The corollary question will be, given the likely greater debt load placed on a purchased franchise system what, if any, aspects of the management of the system will suffer from the competing needs for financial resources of the company to pay down its debt. If the franchise system has been under the stewardship of its founders, who arguably have poured all of their financial resources and sweat equity into the development of the franchise system, franchisees will expect the same commitment from a private equity purchaser and therefore will be suspect of any ownership that makes a lesser commitment. It is not uncommon to have a franchise system that displays an immediate resistance to changes imposed by the franchisor to the system post-acquisition.

From a process standpoint the presence of a private equity group owner may constitute a one hundred-eighty degree turn from what the franchisor is used to. If the buyer is buying a franchise system directly from the founders there is a good chance that system has never worried about achieving a financial budget. Consequently, its culture with its franchisees may be loose and forgiving. These characteristics likely will not sit well with a private equity purchaser whose investment success will be the direct result of the increase of its earnings or EBITDA during its tenure as the owner of the franchise system. As an example, the management of a franchise system prior to an acquisition may have tolerated a 60 day aging of franchise fees and other financial obligations to the franchisor by the franchisee. After the acquisition franchise fee aging may become more restrictive.

Most likely, after an acquisition of a franchise system by a private equity group, the franchisor will be subject to a credit agreement associated with the purchase debt that will most certainly affect how a franchisor can operate. Financial ratios that were never part of the franchisor's lexicon pre-acquisition will suddenly be reviewed on a monthly basis for fear that if these ratios are not met it will be in violation of its loan covenants with the creditor.

“Most likely, after an acquisition of a franchise system by a private equity group, the franchisor will be subject to a credit agreement associated with the purchase debt that will most certainly affect how a franchisor can operate.”

Whereas before the acquisition a franchisor may have had the habit of taking promissory notes for unpaid franchise fees from the franchisee this practice may be no longer permitted or significantly curtailed post-acquisition. Likewise, while a franchisor may have entered into leases for what it considered strong locations that it would subsequently sublease to a franchisee a creditor may look upon this lease relationship as a contingent liability that would upset either one of its financial ratios or just be an unacceptable liability. Moreover, if a franchisor opens company-owned centers to seed markets, but which are not expected to earn a profit until they are franchised, a creditor may restrict the number of company or franchisor owned centers that a franchisor may develop or operate at one time.

How much prior experience a private equity group has in franchising will likely affect its risk tolerance. It is important that a private equity purchaser understands the dynamics of franchising and the importance of relationship building within the franchise system. For example, a private equity owner must understand the so called “hot button” issues in franchising. It must understand the sanctity of the territorial grants to each franchisee and that shoe-horning another location outside a contractually granted territory may still breed discontent, if the placement of the center will have more than an immoderate effect on a franchisee's business.

Another example that is more applicable to a more mature system is whether there is a need to change-out the existing franchisees who refuse to change with the market or who have grown tired of their

participation in the franchise system. How this is accomplished without creating conflict will be something that a private equity owner will need to address.

The timeline that a private equity group will set for its exit will directly affect its development goals. It is more than likely that a private equity group's timeline will not extend much beyond five years from its purchase, and could be shorter. In order to realize its budgeted return on investment the franchisor will need to show an upward trajectory of earnings that will be a function of an increase of

- (i) its unit sales growth;
- (ii) growth of new franchise units domestically and possibly internationally; and
- (iii) growth or stability of supplier revenue.

Coupled with this actual growth a selling private equity group will want to be able to market its system as being on the cutting edge of the products and services it is offering, and that these services are relevant to the existing market. Moreover, the selling private equity group will want to show to putative buyers that not only has the franchise system shown sustained growth, but also that there is additional growth available.

There are marked differences between ownership of a franchise system by a strategic owner and a private equity buyer. With a strategic owner, especially one that owns no other franchise systems, their goals

“It is more than likely that a private equity group’s timeline will not extend much beyond five years from its purchase, and could be shorter.”

may focus on seeding their other portfolio businesses. In some cases strategic owners may purchase a franchise system as a captured audience to purchase its products or services. Accordingly, the ability to sell its products to the franchisees will become as important as the royalty stream upon which it purchased the franchise system. Moreover, the ownership time-line of a strategic owner may be longer than that of a private equity group. Whether the franchisee body will be more comfortable with a strategic or PE owner will be measured by them in similar fashions. Will the owner continue to support the system in the way that they had come to expect under previous ownership? In many cases, the level of support may be greater and more comprehensive than the franchisee experienced under prior ownership, which will bode well for the new owner, whether or not they are a private equity group or strategic purchaser.

International vs. domestic expansion

More than likely, international expansion will follow domestic expansion of a franchise system, and more often than not the debut into international expansion will be done on an opportunistic basis. In other words, the franchisee candidates will approach the franchisor and inquire into franchising opportunities in their specific country. Many of the initial forays into international development will not be well-thought out and will be driven by the master franchise fees that a master franchisor can realize from the sale of a region of a country or even the entire country. When a private equity group looks to purchase a franchise system it may look at the income derived from such international development and bake those results into its earnings model thinking that such development is sustainable. However, as most experienced franchisors will report, international expansion is more labor-intensive and costly than the initial master franchise fees that they garner.

Most international development contracts award a master franchise to a master franchisee that is given the exclusive right to develop a market by opening a specific number of franchised and company-owned units within a given time frame. Often, the underlying development schedule may be arbitrarily

arrived at and likely subject to post-contract negotiations.

When a private equity group purchases a franchise system it should discuss with the franchisor its philosophy for international expansion. The franchisor should articulate how it best sees international expansion; specifically, whether it will become a core component of its development. If yes, then how they will determine the best means for developing the international portion of their business recognizing that any platform will require its own strategies? One thing that is certain is that the franchisor will need to invest significant resources in personnel and expertise in order to build and sustain international growth. Most importantly, the private equity owner must understand that for an international master franchise relationship to work the economics for the master franchisee must work as well as the unit economics for the unit franchisee. For example, how the continuing royalty fees are structured must be well thought out to ensure that there is enough money for the franchisor to provide continuing support to the master franchisee. For the master franchisee the ongoing royalty split must provide it with enough revenue to be able to support its unit franchisees. How the master franchise fee is structured and whether there will be any initial royalty deferment during the start-up phase for the master franchisee will have a direct

effect on how ultimately the franchise system is valued on a going forward basis. Again, the timeline of private equity ownership of the franchise system will have a direct impact on how international development is structured. Historically, in many cases, international development has been treated as an after-thought in the acquisition of a franchise system. As globalization becomes the norm international development of franchise systems will become a more integral part of a franchisor's development and the private equity group's investment strategy.

“As globalization becomes the norm international development of franchise systems will become a more integral part of a franchisor's development and the private equity group's investment strategy.”

James J. Goodman, Gilles Menguy, Ted P. Pearce, Carolyn Vardi and Andrew P. Loewinger

James J. Goodman is President of Gemini Investors. He has been an investor in private middle market companies for the last 24 years. Since 1993, when he founded Gemini's predecessor firm, he has raised five private equity funds and completed investments in more than 105 different companies. From 1989 to 1993, Mr. Goodman completed over \$400 million in private equity transactions at Berkshire Partners, a Boston-based private investment firm. Previously, he was a management consultant for five years with Bain & Company. Mr. Goodman has been a Director or Board observer for over 35 portfolio companies during his investment career. A speaker at numerous industry conferences and events, Mr. Goodman received his A.B., J.D., and M.B.A. degrees from Harvard University and is a member of the State Bar of California. (jgoodman@gemini-investors.com)

Andrew Loewinger is a partner at Nixon Peabody LLP in Washington D.C. He concentrates his practice on domestic and international franchising, and corporate, intellectual property, regulatory, and transactional issues. He is a key member of the international franchising practice, which represents world leaders in franchising and retail distribution. Andrew has handled several hundred in-bound and out-bound franchise transactions and joint ventures in more than 85 countries. He is the co-author and co-editor of International Franchise Sales Laws, published by the American Bar Association on franchise sales laws around the world. (aloewinger@nixonpeabody.com)

Gilles Menguy is managing partner at Gast & Menguy in Paris. He is qualified as a Paris Bar Avocat and Solicitor of England & Wales. The firm has a niche 10 man strong team of highly trained franchise lawyers. The firm has advised hundreds of French and international franchise systems over the years, in contract, litigation, M&A and competition law. Mr Menguy focuses currently on assisting first league franchisors in their international development and engineering contractual frameworks to help in the financing of franchisors. (gilles.menguy@gastmenguyavocats.com)

Ted P. Pearce has been involved in the practice of franchise law for over 30 years. He is Special Counsel with the law firm Nexsen Pruet PLLC in Charlotte, North Carolina, USA. His practice focuses on all aspects of franchising working with both franchisors and franchisees on transactional matters. Prior to joining Nexsen Pruet Mr. Pearce was vice president and General Counsel for Driven Brands, Inc., which owns and operates 5 franchise systems including Meineke Car Care Centers, Inc. and MAACO Collision and Auto Painting. He is the co-author of "Mergers and Acquisitions of Franchise Systems" appearing in the ABA Franchise Law Compliance Manual. Mr. Pearce is a graduate of the University of Virginia where he received his BA, and the Syracuse University College of Law where he received his JD. (TPearce@nexsenpruet.com)

Carolyn J. Vardi is a partner in the M&A Practice Group at White & Case in New York. She represents buyers and sellers in domestic and international public and private mergers and acquisitions and advises domestic and international corporate clients in a broad range of industries, private equity funds and commercial banks. Ms. Vardi's practice is particularly focused on representing private equity firms with respect to their acquisitions and disposals of portfolio companies. (cvardi@whitecase.com)