

Private equity's untapped opportunity in Canadian franchising

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Private equity firms are showing an increased interest in acquiring Canadian franchise systems.

Many factors make franchise systems particularly enticing targets for investment: successful systems provide predictable, long-term revenue streams with relatively low operational costs, established brand recognition and market penetration, and opportunities for synergies with other businesses owned by PE firms.

The franchise business model is used in virtually all industries across the nation and represents a growing and important sector of the Canadian economy, so there are many potential deal opportunities.

With a huge potential upside, of course, come significant traps for the unwary.

Franchising is highly regulated in Canada and investing in or acquiring a franchise system requires specialized knowledge. Set out below are some key issues that PE firms should consider when evaluating an investment opportunity in a franchise system.

We also outline some key considerations when structuring an acquisition to help ensure the PE firm gets the deal it bargained for and to help avoid any obstacles to future exit strategies when it comes time to sell the system.

Due diligence & determining a franchise system's value

Investing in a franchise system requires specialized due diligence in addition to the standard diligence done in a typical M&A transaction.

Franchise-specific due diligence is used to assess the system, evaluate whether the deal makes sense, identify risks related to non-compliance with franchise legislation and/or the franchisor's relationships with its franchisees, and allocate these risks between the parties.

The need for this franchise-specific due diligence is in part due to the nature of the assets of the business being purchased, as well as the unique regulatory environment in Canada and the related legal risks if the target franchisor has not operated the system in compliance with these laws.

Franchising is regulated in six of the 10 Canadian provinces (Alberta, British Columbia, Manitoba, New Brunswick, Ontario and Prince Edward Island). The primary obligation for a franchisor is the requirement to prepare and deliver to prospective franchisees (which includes renewing and resale franchisees, unless an exemption exists) a prospectus-style

disclosure document before the franchisee enters into the franchise agreement or pays any consideration. If a franchisor fails to comply with this requirement, the franchisee has a right to rescind the agreement and seek considerable compensation from the franchisor.

The legislation also grants franchisees a statutory right of action for misrepresentation if a franchisor fails to comply with this disclosure obligation. Under the legislation, both parties to a franchise owe each other a duty of good faith and fair dealing.

Things to consider include:

- The franchisor's compliance with these franchise-specific laws, including whether there are any material deficiencies with the target's franchise disclosure document, including identifying whether any franchisees have a rescission remedy available under provincial legislation. Case law in Canada has considerably expanded the scope of disclosure from what is prescribed in the legislation. Be aware that, in reviewing a disclosure document, simply comparing it to the disclosure regulation would not reveal deficiencies identified by this case law;
- The franchisor's disclosure processes and record-keeping (delivering a perfect disclosure document is worthless if the franchisor cannot prove it has done so);
- The health of franchisee relationships, including whether franchisees have been noted in default, the existence of a franchisee advisory council and/or association;
- Franchisees' performance and economics;
- The registration and protection of intellectual property rights, and;
- The nature of any exclusivity granted to franchisees that may impact future growth potential or that may restrict the firm from owning competing businesses.

Focused due diligence can help confirm, qualify, or undermine the potential benefits of purchasing the franchise system or the value of the business, and also provide a sense of whether the PE firm will be able to meet its post-closing goals for the successful operation, growth and ultimate sale of the system down the road.

Of course, conducting franchise-specific due diligence on each franchisee is simply cost prohibitive in all but the smallest franchise systems. Experienced franchise counsel can help customize a due diligence process tailored for the target system, which balances legal cost with identifying material risks.

Structuring the transaction to allocate risk

The results of franchise-specific due diligence will help a PE firm structure the transaction to properly allocate risk. For example, if franchise-specific due diligence has revealed that some franchisees have a two-year rescission remedy the PE firm should consider the pros and cons of structuring the deal as an asset-based transaction versus a share-based transaction.

In addition, regardless of whether the deal is structured as a share deal or an asset deal, the existence of potential franchise-related liabilities may warrant:

- A reduction in the purchase price;
- An increased holdback;

- The inclusion of franchise-specific representations, warranties and indemnities, including from the seller's parent or key shareholders, and possibly longer indemnities than would typically be negotiated; and/or;
- Representation and warranty insurance.

Pay particular attention to the duration of holdbacks, representations, warranties and indemnities to ensure they align with the statutory limitations periods under franchise-specific legislation and standard statutory limitations periods.

Understanding rights & limitations on system change

In acquiring a franchise system many (if not most) PE firms have plans to make changes to the system post-closing.

It is essential for PE firms to review the relevant franchise agreements to understand the contractual rights and limitations to implement such system change. In addition, even where the PE firm may have the contractual right to make desired changes post-closing, it will be important to understand the impact of, and potential limitations arising from, the common law and statutory duty of good faith and fair dealing on franchise system change.

It will also be critical for the PE firm to understand the importance of the franchisor and franchisee relationship and the benefits of having franchisee buy-in when introducing system changes.

Planning for an exit

The life cycle of many PE franchise investments includes plans for an eventual exit and sale of the franchise system.

With this goal in mind, PE firms must conduct targeted due diligence to ensure any obstacles are identified prior to acquiring the franchise system, and corrected as soon as possible post-closing so that the full value of the system can be realized.

In particular, firms should focus on:

- Reviewing the terms of the franchise agreements to ensure the franchisor has a clear contractual right to assign agreements without the consent of franchisees;
- Identifying and understanding any existing franchise statutory liabilities that may impact the value of the system both pre- and post-closing, and;
- Taking steps post-closing to revise any legal documents (i.e., the franchise agreements and disclosure documents) and to correct any disclosure processes that gave rise to any pre-closing statutory liabilities.

Final thoughts

The predictable long-term revenue streams, established market penetration and opportunities for growth and synergies will likely continue to make franchise systems an attractive investment for private equity firms.

However, the highly regulated and relatively litigious environment of franchising in Canada,

combined with the unique characteristics of the franchisor and franchisee relationship, means that PE firms should proceed with caution and ensure that they are working with a deal team that is supported by experienced franchise lawyers so they are well advised on specific issues that may impact value, risk allocation and future plans for the business.

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