

# When Drive-thru Won't Do: Due Diligence for Quick-service Restaurant Operations

By Adam R. Haberman, CPA

The continuing merger and acquisition activity in the middle market stems in part from private equity and strategic investors' targeting larger quick-service restaurant (QSR) franchisees. These operations, which often comprise many individual stores, pose particular challenges to performing due diligence. Author Adam Haberman provides an overview of effective financial due diligence for transactions involving QSR franchisees.

The National Restaurant Association predicts that sales at QSRs – generally defined as locations where the primary function is to provide full meals without table service – will hit \$156.8 billion in 2008, a gain of 4.4 percent over 2007.<sup>1</sup> With national QSR chains enjoying soaring profits,<sup>2</sup> QSR franchisee operations are attracting the potential interest of private equity and strategic investors within the middle market.

As in any acquisition, due diligence is crucial. Valuations in franchisee acquisitions are often based on projected earnings before interest, taxes, depreciation, and amortization (EBITDA) as well as expected levels of working capital and capital expenditure. Rigorous financial due diligence is necessary to assess the seller's projections of these financial measures. Due diligence is also valuable for identifying other potential risks that might affect the investor's ultimate assessment of value.

## The Role of Individual Stores

Due diligence for QSR franchisee operations should reflect the critical role played by the individual stores in determining the overall profitability of the franchise. A single, highly profitable store undergoing an unexpected change can dramatically affect valuation.

Same-store analysis is a key element of analyzing QSR franchisees historically, especially in periods of significant growth. Investors must determine the extent of growth from existing stores relative to



growth derived from the addition of new stores. Key questions regarding the role of the individual stores include:

1. Which stores are the most and least profitable? Why?
2. What factors are driving revenue trends (for example, location, individual store management, advertising)?
3. Is each store maintaining its gross profits, or are increasing revenues and growth the result of lowering prices or adding stores that are not profitable or only marginally profitable?

Where a store experiences significant revenue growth or decline, potential investors would be wise to understand the contributing factors and the potential implications. Nearby road repairs might

cause a temporary decline; construction of a bypass around the main thoroughfare that is home to the store could result in a more permanent decline. The opening of a new shopping center or big-box retailer in the area could have favorable long-term implications, while the launch of a competing QSR across the street might permanently impair revenues.

## Location, Location, Location

A QSR's performance depends largely on its location. It is impossible to account for all of the attributes and potential dynamics of each location – a competitor can move in after the deal closes, for example, thus undermining that store's business. Effective due diligence can, and should, assess the

general sustainability of individual franchise revenues, based on known risks and opportunities at the time the investment is contemplated.

Due diligence must determine whether existing risks could force a store out of business or into relocation, such as a landlord unwilling to extend the lease on an extremely profitable store. If the revenues are closely tied to its location, the same store at a different location might not sustain the same revenues and EBITDA. Due diligence should therefore include an examination of franchise agreements and lease expiration dates to determine the potential risk of losing locations, especially those stores that are in the top quartile of the franchisee's stores in terms of profitability.

### General Profitability Factors

QSR franchisees are not typically valued at high multiples of EBITDA; however, these operations are generally considered to have predictable cash flows. With QSRs hawking hamburgers, tacos, or submarine sandwiches to price-sensitive customers, franchisees are generally precluded from aggressive pricing. Accordingly, the profitability of a franchise operation depends in large part on scale and size as well as locations.

Although a new owner might find fewer opportunities to effect dramatic changes, increase revenues, or cut costs than would, for instance, a new owner of a manufacturer, generating additional profitability from QSRs is quite possible. If the seller has grown attached to a certain store and finds closing it difficult even when the store proves to be unprofitable, for example, a new buyer will be focused on maximizing investment returns and unlikely to have such difficulty. Our experience has been that potential investors often make closing unprofitable stores a prerequisite of the purchase agreement.

Due diligence for QSR franchisee operations should consider all the factors that affect EBITDA and non-EBITDA items. These include the selling, general, and administrative expenses, particularly salaries and benefits, rents, advertising, and travel expenses. Is management operating the stores at sustainable levels of personnel? Are any unusual factors present, such as related-party ownership of a company-owned store that artificially

reduces rent expense? The answers might require analysis to assess normalized EBITDA on a prospective basis.

### Franchise Agreements and Profitability

Franchise agreements can greatly affect profitability, especially with large national chains that impose numerous operational restrictions. Investors should pay close attention to provisions related to franchise fees, advertising fees, royalties, and other payments; qualitative requirements; and renewals. Corporate-level overhead (nonstore costs) can also prove to be critical if the buyer is carving out the stores rather than acquiring the corporate group, or if the corporate group operates multiple entities.

Provisions addressing required capital expenditures and maintenance merit close scrutiny in due diligence as well. QSR valuations are often initially based simply on comparative multiples of EBITDA, a practice that ignores the timing and magnitude of necessary or required capital expenditures. Capital expenditure requirements can add up, though. A store's building might have a long life, and any necessary remodeling or upgrades incur a capital cost. If many of the stores in a franchisee operation are nearing the end of their buildings' useful life spans, capital costs could increase considerably in a few years. With QSRs' tight margins, these costs can have a significant impact on short- and long-term cash flows. Due diligence should also focus on whether the sellers are deferring significant capital expenditures and maintenance in an attempt to push this cost to the seller.

### Cash Management and Fraud Prevention

QSRs tend to be cash-based businesses, making theft and fraud major concerns. An employee skimming a mere \$10 from the cash register every day can make a difference in the bottom line. A 2006 study of fraud in the workplace determined that the median fraud loss for general service organizations, including restaurants, was \$163,000, and skimming was the most common form of asset misappropriation.<sup>3</sup>

Fraud-related losses vary from store to store, but certain procedures can minimize the risk across locations. For

example, integrating point-of-sale terminals with centralized reporting functionality provides more effective cash and credit monitoring than segregated systems do. Due diligence should determine the design and operational effectiveness of internal controls for deterring and detecting management and employee fraud. A lack of effective internal controls could indicate that additional investments in systems and process controls are required.

Inventory management is another area of concern with QSRs. How is inventory recorded and tracked? Does the individual location have procedures to minimize inventory waste? Most QSRs use frequent physical counts rather than perpetual inventory systems, so it is important that the operation has strong controls related to inventory management.

### A Data-intensive Endeavor

Due diligence for the acquisition of a QSR involves specific issues and risks not commonly encountered in other types of acquisitions. With a typical acquisition, due diligence might analyze the target company's historical financial results over a three-year period, whereas acquisition of a franchisee operation with 250 stores calls for the equivalent of 750 separate analyses. To adequately assess the investment value and potential returns of a franchise, prospective buyers must understand and plan for the level of effort that is required to perform appropriate financial and operational due diligence.

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<sup>1</sup> "Restaurant Industry to Continue to Be Major Driver in Nation's Economy Through Sales, Employment Growth in 2008," National Restaurant Association, Dec. 12, 2007.

<sup>2</sup> "Burger King's Earnings Up 23 Percent," The Miami Herald, Nov. 6, 2007; "McDonald's Sees 3rd-Quarter Profit Above Expectations," Reuters, Oct. 12, 2007.

<sup>3</sup> 2006 Report to the Nation on Occupational Fraud & Abuse ([www.acfe.com/documents/2006-rttn.pdf](http://www.acfe.com/documents/2006-rttn.pdf)).

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