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What Franchising Trends Mean for Mid-Market M&A

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Steady revenue streams from franchisee-paid royalties, a replicable business model and relatively limited capital investment make franchising companies lucrative from an investor's standpoint. Here's why:

There is plenty of uncertainty surrounding continued inflation, supply chain shortages, a fluctuating labor market and conflict overseas, what's in store for franchise brands in 2023, particularly as it relates to mid-market M&A?

The macro environment fueled by inflation will slow the mid-market and cause deals to become harder to structure and close. However, factors like inflation, supply chain disruptions and the impact of the Russia-Ukraine conflict will start to subside as the Fed rate hikes slow down the economy.

Franchisors across all categories are being advised to take steps to circumvent some of these concerns by updating their systems, processes and focus. From operations to marketing, financials to human capital, franchisors – especially those who plan on selling – must act proactively to increase their purchasing appeal and valuation for M&A deals.

Setting the Stage for Strong Financial Performance

Private equity firms are looking at today's franchisor landscape relative to the 2008 recession. Many investors will be looking at some of the brands and industries that performed well back then, on the notion that history will repeat itself.

Investors will cautiously take a deeper dive into a company's performance and operations to provide the assurance they're seeking for a reliable "recession-proof" investment. Along with profit & loss statements, one of the key metrics they'll look at is a company's free cash flow conversion, especially in companies and industries with high annual CapEx demands.

Cutting costs is one of the obvious first steps many franchises have already taken to prepare for the upcoming recession. While the labor shortage is making things difficult for companies that need employees, several companies are enacting major layoffs to soften some of the blow they're expecting in 2023.

They're also locking in pricing with suppliers and ordering inventory ahead of time for better rates. Still, they'll need to continue to raise prices for consumers as inflation prevails.

Capital expenditures can tell a PE firm a lot about the future of a company, especially when it comes to valuation. It often signals those companies at the forefront of innovation, and for those companies who have invested and seen results, this kind of data can help "seal the deal" in an M&A transaction.

Booming Activity in Certain Sectors

Though the potential for an upcoming recession will present roadblocks for several firms, others will continue to thrive. Essential business services, including software and technology companies, will become more critical than ever.

Patrick Galleher, Boxwood Partners

Not only do these services help businesses operate smoothly with fewer employees and at lower costs, but they also see an increase in demand due to the customer experience becoming such an important competitive factor.

According to software firm **CGS**, 30 percent of customers are willing to pay more for excellent service – even during periods of inflation. Because of this, brands that can offer consumers one-of-a-kind, convenient experiences will come out on top, and mobile apps, contactless models and artificial intelligence will continue to play a key role.

Of course, essential B2C services will still drive more interest and better Ebitda multiples as they did during the pandemic.

Scaling Back on International Operations

One of the most potent transitions since the beginning of the pandemic has been bringing supply chains closer to home.

Traditionally, many franchisors would produce their goods internationally to save on labor and materials. For those who had not already started moving their supply chain when the pandemic-related shutdowns and economic effects began, increased geopolitical risk, like the conflict in Russia and Ukraine, led them to explore production options closer to U.S. shores.

For those who have not yet moved their supply chain to the U.S., they've at least begun moving it closer, such as countries like Mexico, and this trend will continue through the new year.

An Increased Investment in Human Capital

In 2023, there is one asset of all that will rise to the top of a company's agenda: people. According to **BRINK News**, "the three top drivers that business leaders believe deliver deal success are leadership alignment, culture alignment and talent identification/retention."

Though the labor shortage will subside later in the year and companies will be able to stabilize labor costs, their skills and expertise play an integral role in a company's projections. This is not only true for employees, but also for highly-trained franchisees.

Some PE firms are putting people at the forefront of their buying strategy, purchasing companies with skilled workers through M&A transactions, not only negating the labor shortage but setting themselves up for continued success.

Green Consumerism on the Rise

According to **IBM**, sustainability is one of the top factors on the minds of today's consumers – especially the two largest groups: Millennials and Gen Z. Brands focusing on eco-friendly systems and processes will do more than help the environment – they'll also gain a major competitive edge.

Franchises will continue to invest in their green initiatives by updating their packaging, selling eco-friendly alternatives and products made from recycled materials, providing incentives for most customers to go green, including sustainability in their marketing efforts, and building more eco-friendly supply chains.

While this may not provide tangible assets in an M&A deal, the competitive edge or Unique Selling Proposition it offers may be considered in valuing a company.

How a Potential Recession Will Affect Deal Structures & Terms

While lenders may benefit from higher interest rates, it does not necessarily mean borrowers are losing out. Once inflation settles, many of the deals will balance out, as borrowers pay off their debt at a time when each dollar has returned to its normal value.

Because franchising offers benefits like brand recognition, an experienced support team and a proven model, it's less risky than many other investments. That's why back in 2008, many laid-off white-collar employees saw franchising as an opportunity to become their own boss and control their own destinies. As a result, franchise brands experienced significant growth as "corporate refugees" flocked to their systems wanting to own their franchise locations.

All things considered, mid-market M&A will remain active – just at slightly lower levels. Those brands that have the working capital to invest in people and systems and that can improve their processes and customer experience will be set up to succeed in 2023 throughout all the disruptions – whether that means growth or being in a solid position for a sale.

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