National Franchise Sales
M&A |Advisory Services

Franchise Connection

A Newsletter for Franchisees, Prospective Franchisees, and Restaurant Chain Owners

www.nationalfranchisesales.com

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Remodel Adjustment on Unit Valuations

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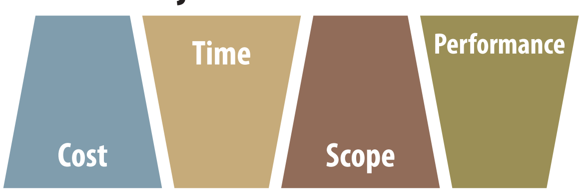
The Franchise restaurant business, having begun in the 1960s, is now a mature industry. One of the elements of a mature industry is the necessity of reinvestment into equipment and facilities. Franchise brands have recognized this, and in their effort to remain competitive, have nearly universally developed various remodel programs.

As we all know, the value of franchise restaurant businesses is primarily based upon the historical income production, adjusted for forward looking projections, combined with an assessment of the relative risk. This creates the traditional multiple of EBITDA.

Remodel Adjustment on Unit Valuations

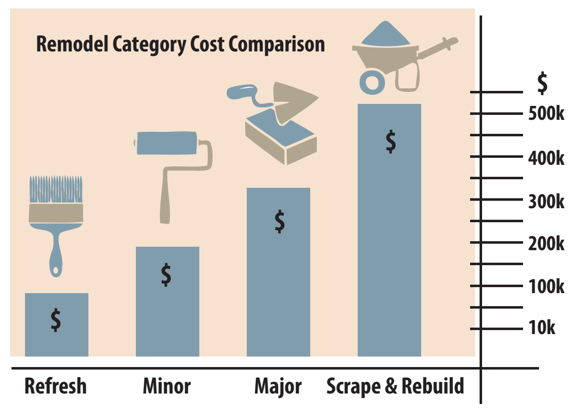


However, in addition to the multiple of EBITDA assessment, the marketplace considers Capital expenditures or remodel requirements into the valuation formula. These considerations can be broken down into four elements.

First, the overall cost of the remodel is considered. The cost of the remodel, often categorized and labeled, can range from an inexpensive **"Refresh",** to a **"Minor Remodel"**, to a **"Major Remodel"**, to **"Scrape and Rebuild"** (Exhib 1).

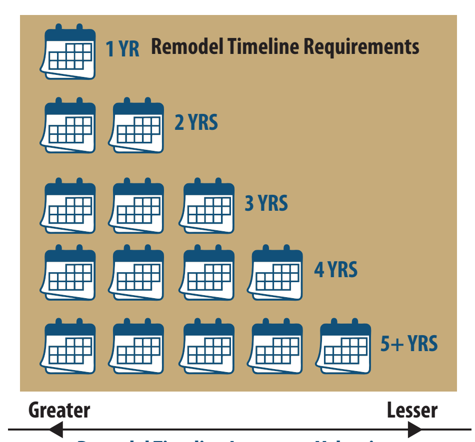
Although better defined within each brand, in general, a Refresh will cost in the range of $10,000 to something less than $100,000. A Minor remodel cost will be in the low $100,000s, and a Major remodel will be approaching $200,000 to as much as $500,000 or more. Generally speaking, the higher the brand AUV, the higher the cost of the remodel within the range of these levels.

Exhib 1



The second element considered is the timing of the remodel (Exhib 2). Although this cannot be measured as a simple time value equation, the marketplace will respond by adjusting the valuation impact of the Capital expenditure by looking at the timing of the required expenditure. How soon is the remodel due?

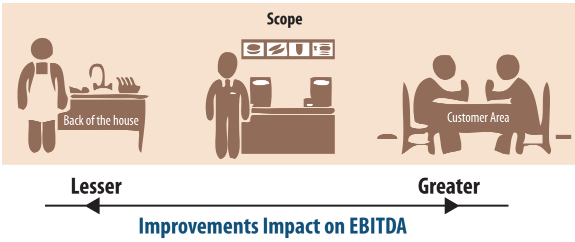
Exhib 2



Remodel Timeline Impact on Valuation

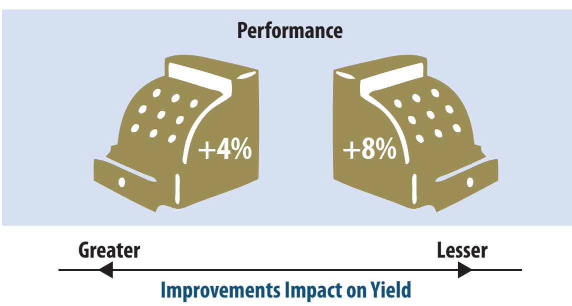
Remodel Adjustment on Unit Valuations (cont.)

Exhib 3



The third element used to assess the Capital expenditure impact on the business value, is the nature or scope of the expenditure (Exhib 3). Since all of these are used in the context of forward looking projections of future income production, those remodel elements more likely to improve future income by driving sales and net income, weigh less heavily against the multiple of EBITDA. In other words, customer area improvements, which should drive sales, do not count against multiple of EBITDA as much as back of the house improvements that have little impact on either sales or margins.

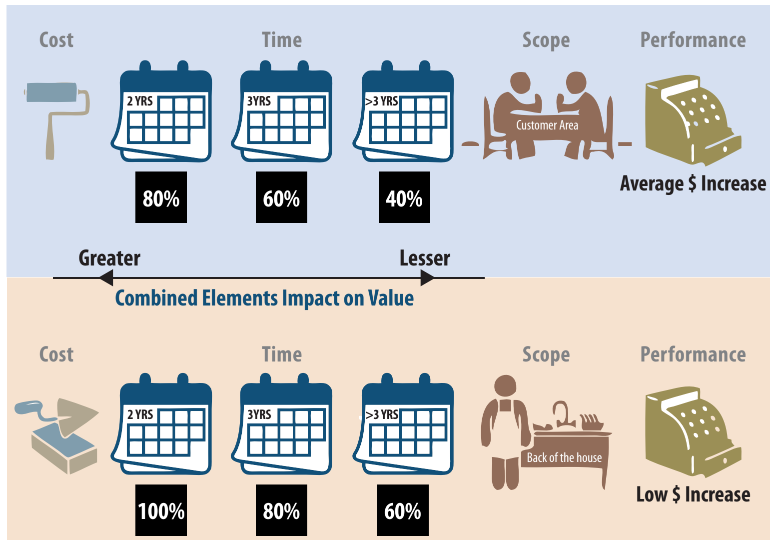
Exhib 4



Finally, each of these elements are influenced by the actual averages of sales and margin impacts or performance, as can be measured by in-brand remodels already completed. Essentially, this is simply an eye on the opinion of the "bang for the buck" notion (Exhib 4). One brand may have a remodel program with a cost of $200,000 and an average sales impact of plus 8%, and another brand may also be requiring $200,000 in remodeling, but only yielding an average sales comp of 4%. So it stands to reason, that the latter brand, with its average sales increase of 4% will find the marketplace more harshly impacting values for this required expenditure.

As these elements of **cost**, **time**, **scope**, and **performance** combine into an understanding of averages (Exhib 5), the remodels containing pure customer area remodels, with average performances, tend to be counted against the business valuations by a factor of 80% if required in year one, 60% in year two, 40% in year three, and seem to have little impact if more than three years out.

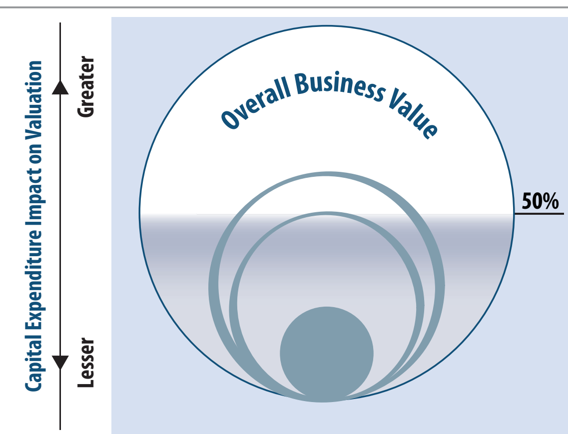
Exhib 5



If the remodels are entirely, or that portion of them that are back of the house not known to change sales or margins, anything required within the first two years carries nearly a dollar for dollar reduction in business value. If more than two years out, up to about five years, there is a gradual decline in this value impact.

Finally, the sheer magnitude of the Capital expenditure as a ratio of the overall business value trumps all other assessments (Exhib 6). Meaning, that once the Capital expenditure required is greater than half of what the business is worth, under any formula, it tends to consume the value at a greater and greater rate, often exceeding the actual cost of the program.

Exhib 6



Select Recently Completed Transactions (Samples)

SOLD
Denny's

4 Units | California

Buyer: Seaside Dining Grp
Seller: Den 107, LP

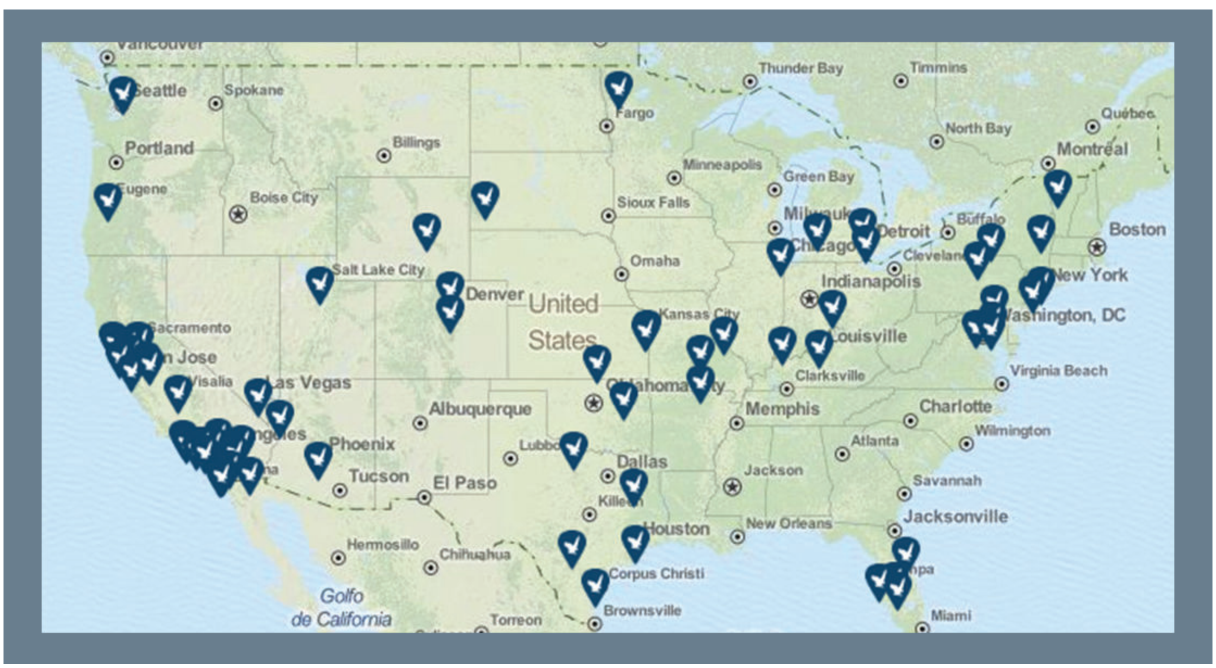
NFS is proud to have introduced the buyer group, Seaside Dining, Inc., to the Denny's system. Half of the business required significant lease modifications with the assignment process. NFS was able to accomplish this by applying creative solutions that met the buyer's needs, and completed these during the time the buyer was engaged in the franchisor's training program.

SOLD
WING·STOP
DINE-IN OR CARRY-OUT

1 Unit | Texas

Buyer: Varughese Kuruvilla
Seller: Devphoy Enterprises

Due to the brand expertise of the NFS Advisor, this transaction was completed in less than 90 days from listing. The NFS database of buyers produced an existing franchisee buyer, and the financial materials were retrieved by the absentee operator from the Brand approved Accounting System.



Snapshot of Current Resale Opportunities Available and in Sales Process*

*Pins reflect number of single & multi-unit opportunities - location count considerably higher