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## **VALUATIONS IN FRANCHISING**

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### **I. Introduction**

Determining the value of a closely held company can be a very difficult undertaking. With no open market for a company's shares, it is often impossible to find objective data points regarding a fair price for a particular business. Without objective data, determining a fair price at which to acquire or sell a company becomes an exercise in estimation, forecasting, calculation, and negotiation.

This paper will address the methodology for valuing closely held franchise companies (franchisors and franchisees). Being closely held, one encounters all of the issues above when it comes time to affix a value to the company. However, franchise companies come with their own subset of issues that affect valuation.

Franchises take advantage of customer's goodwill as expressed in brand value, but that goodwill may not be found on a balance sheet. Franchise agreements can contain onerous provisions that restrict a franchisee's ability to operate or transfer a company as they wish. Additional issues such as these complicate the already complex and nuanced analysis required to effectively value a closely held company.

This paper will examine the issues relating to the valuation of a closely held franchise company, and provide guidance as to how to manage them in a way that provides the most accurate estimation of value.

## **II. Reasons to Value a Franchise Company**

The valuation of franchise companies tends to be viewed simply as an exercise undertaken when a sale of the business is to take place. In reality there are a plethora of reasons to value a franchise company.

### **a. M&A Activity**

The most obvious reason to value a franchise company is to facilitate negotiation over the purchase and sale of the business. It is imperative on both the vendor's and purchaser's side to have an accurate valuation in order to facilitate constructive negotiation. Having an approximate value for a company ensures that no offers are made or accepted that would be unduly advantageous to the opposing side.

### **b. Going Public**

When a franchise company experiences exceptional success, its owners may wish to capitalize on that success by taking the company public and selling shares on an open market. This can be for the purposes of financing new initiatives or simply for an owner to cash out some or all of his or her stake in the company. Regardless of the reasoning, it is imperative that a sufficiently accurate valuation is performed beforehand, because offering shares in the open market is actually selling small pieces of the business, and the initial price at which the shares are offered will determine the total proceeds of the sale and the market capitalization of the company.

### **c. Going Private**

Once a franchise company has gone public, the pricing of its shares is no longer in the franchise company's control. Instead, the market decides what the share price is. If the franchise company feels that the market has undervalued those shares it may wish to buy them back and de-list the franchise company. In such event the corporation will have the most intimate knowledge of the business and will be in the best position to perform an accurate valuation. An accurate valuation indicating that the shares of a company are indeed undervalued can potentially reap large profits for the remaining owners of the business.

### **d. Litigation**

Litigation is another area that can necessitate the valuation of companies in situations where no sale of that business is contemplated. It may be that for one reason or another the courts need to affix a monetary value to a company in order to equitably resolve disputes. While the underlying dispute varies based on the type of action, the process for valuing companies in litigation remains generally the same with some differences in oppressed shareholder situations.

As this paper will show, valuation of a franchise company can be a subjective exercise, and so sometimes valuers will diverge widely in their approximations of value.

Small modifications to the assumptions underlying a valuation can provide one side or the other with a much more favourable approximation of value. As a result, both sides are likely to employ experts to provide them with favorable valuations. This has the effect of creating a credibility contest between expert valuers.

The function of the judge or jury is to weigh the evidence and consider the assumptions made by the experts. The judge or jury must then decide which side's position is more credible (or if neither is, to formulate some middle ground between the two). Typically, the courts reward litigants who make realistic assumptions and do not play with their numbers too much, as a judge is more likely to favour those who present the most objective evidence.

An interesting side note to the role of the judge and jury in weighing evidence is that they generally have no particular expertise in evaluating the assumptions of expert valuers. While judges are hoped to be experts in logic and evaluation, they are not especially versed in the mechanics of accounting or finance. This takes an exercise that already has a large subjective element to it and injects a whole second level of subjectivity. Regardless of the subjectivity inherent in valuations for litigation purposes, the more objective the valuation, the more likely it is to be accepted into evidence.

Discussed below are some of the types of litigation that might require valuations.

## **1. Contract**

When a plaintiff sues in contract they are attempting to recover an amount that will compensate them for the harm done. Damages in contract are defined as an “amount sufficient to place the plaintiff in the same position in which he or she would have been had the contract been performed.”<sup>1</sup>

This definition of damages is important because it allows a plaintiff to recover not only the out-of-pocket expenditures they incurred in relation to the contract, but also any prospective profit they may have reaped from the performance of the contract.

## **2. Tort**

An action in tort refers to a cause of action occasioned by a civil wrong. While an action in tort also is based on the recovery of damages, the formula for determining those damages is sometimes different from the formula for contractual damages. In a tort action the measure of damages is the “amount necessary to place the plaintiff in

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<sup>1</sup> A. Swan, “Canadian Contract Law”, (2<sup>nd</sup> ed.), (LexisNexis: Markham, 2009) at para 6.11.

the financial position in which he or she would have been had the tort not occurred.”<sup>2</sup>

#### **e. Tax Assessment and Succession Planning**

Section 70(5) of the *Income Tax Act (Canada)* operates in such a way that it deems all property held by a taxpayer to be sold at its fair market value at the time immediately before their death. The effect of this provision is that it crystallizes any capital gains (increases in the value of property) and includes those gains in the taxpayer’s income for their terminal (last) tax return.

The definition of fair market value is “the highest price obtainable in an open market between informed, prudent parties acting at arm’s length and under no compulsion to transact, expressed in terms of money or money’s worth.”<sup>3</sup> To comply with section 70(5) the taxpayer’s estate must perform a valuation to determine the amount by which the shares have appreciated since they were acquired.

Hypothetically, each of the methodologies explored in this paper should yield approximately the same results. However, in practice, the choice of methodology can cause the final valuation to vary widely. While it is open to an estate to choose which valuation method to use, the Canada Revenue Agency can challenge that choice if they feel it does not properly reflect the value of the franchise company.

Related to the issue of taxation at death is succession planning. In order to reduce taxes at death and to facilitate a smooth transition from one generation of owners to the next, it is common for taxpayers to enter into “estate freeze” transactions. These transactions “freeze” the value of a taxpayer’s ownership stake in a company, and transfers the subsequent appreciation of that stake to a designated beneficiary. This tax deferral strategy requires a taxpayer to perform a valuation at the time of the transaction in order to fix the value of his or her shares.

#### **f. The 3 Ds**

There are other reasons to value a franchise company. These reasons generally focus more on provisions in the parties’ buy-sell agreements than in the franchise agreement. However, in the event of a franchisee’s death, often the franchise agreement requires new ownership within a time certain. Franchisees have to plan to avoid a distress sale in these situations. Shareholder or partnership agreements between franchise owners should address the following among other considerations:

##### **1. Death**

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<sup>2</sup> *Ibid* at para 6.188

<sup>3</sup> *Henderson Estate v. M.N.R.; Bank of New York v. M.N.R.*, [1973] F.C.J. No 800 (F.C.T.D.), *Affd.* [1975] F.C.J. No. 609 (FCA) at para. 21.

This contingency is most often addressed with life insurance. Generally an independent valuation or an acceptable buyout formula will become necessary and life insurance or some other form of funding process will have to be determined based on the amount required.

## **2. Disability**

Concerns regarding disability are generally dealt with in the same manner as those respecting death and the liabilities are often provided for with disability insurance.

## **3. Disaffection**

Disputes between the owners of a franchisee can have a negative effect on both the franchisee and the franchisor. Accordingly, it is often wise to set valuation formulae in the shareholder or partnership agreements and to update the formula and the data regularly to deal with buyouts in irreconcilable conflict situations.

## **g. A 4<sup>th</sup> D, Divorce**

The breakdown of a marriage can be one of the toughest circumstances a person faces in life. In Ontario, this experience is made all the more complex through provisions in the *Family Law Act*.<sup>4</sup> Section 5 of that act entitles a spouse to an equalization of “net family property”,<sup>5</sup> which is meant to be the aggregate value of the assets (or appreciation of assets) accumulated during the course of the marriage. Where one spouse (or both) holds shares of a closely held company, it will be necessary to perform a valuation.

The *Family Law Act* calls for an equalization of the “value” of property. Generally, The appropriate methodology for valuation of corporate holdings under this regime will differ depending upon the circumstances of each case.<sup>6</sup> Ontario courts have recognized that “fair market value”, as defined above, may not always produce an equitable result, and so they have endorsed the concept of “fair value”.<sup>7</sup> As it pertains to companies, fair value differs from market value in that it takes the circumstances of the parties into account, as opposed to considering the sale of the company to an arm’s length third party.<sup>8</sup>

For example, take the situation where a person holds a franchise company jointly with two family members. While a buyer on the open market would request a minority discount (discussed below), Ontario courts might not apply this discount

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<sup>4</sup> *Family Law Act*, R.S.O. 1990, c F.3.

<sup>5</sup> *Ibid* at s. 5.

<sup>6</sup> *Rawluk v. Rawluk*, 29 D.L.R. (4th) 754, 55 O.R. (2d) 704, (Ont. H.C. ) at para. 25.

<sup>7</sup> *Menage v. Hedges*, [1987] O.J. No. 1512, 8 R.F.L. (3d) 225 (Ont. U.F.C.)

<sup>8</sup> *Balcerzak v. Balcerzak*, [1998] O.J. No. 3860, 41 R.F.L. (4th) 13 (Ont. Gen Div.) at para. 28.

(or would lower its amount) where the current owner acts in concert with the other shareholders as a single bloc.<sup>9</sup>

Generally, the fair market value will very closely approximate the fair value of a company. However, the courts' willingness to take the complexities of a situation into account when considering a valuation makes it important to examine the unique circumstances of a business and its owners when undertaking a valuation in the context of divorce.

### **III. Modern Valuation Principles in Franchising**

The business of valuations received its primary impetus as a mandated exercise from statutory changes and court recognition of its precepts over the past decades. Placing a value on any asset generally requires converting a unique property into a monetary equivalent. The theory of appraisal rests on three basic principles:

1. The principle of substitution—the economic value of a thing tends to be determined by the cost of acquiring an equally desirable substitute;
2. The principle of future benefits—all values are anticipations of the future; and
3. The principle of alternatives—each party in a buy/sell transaction has alternatives to consummating the particular transaction.

The use of business valuation experts has grown, driven by litigation, a hot mergers and acquisitions marketplace, the tax laws, and court decisions. The formulae used in valuations are many and varied. There are P/Es and other market multiples, Dividend Discount Models, Capital Asset Pricing Models, debt free approaches to valuation, discounted cash flow approaches, and option pricing models; and most pricing models also account for control premiums and minority discounts.

### **IV. Terminology**

The specialized vocabulary of appraisals and valuations is stultifying and filled with technical terms many of which mean the same thing. Also some legal and accounting definitions tend to overlap the appraisers' usage while others do not.

For example, in fixing the “value” of a business, a practitioner must deal with a whole host of confusing names and bizarre ratios such as discounted cash flows and modified discounted cash flows; price-to-earnings ratios and price-to-sales ratios; “cap” rates and growth rates; and disputes over whether one business is “comparable” to another.

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<sup>9</sup> *Ibid* at para. 29.

There are three (and really only three) general methods that are acceptable for determining business value. These are—in legal terms—book value, capitalization of earnings, and comparable sales.

Book value is the net worth of a company determined by either its balance sheet assets or the replacement cost of its balance sheet assets—minus liabilities.

The capitalization of earnings method assumes either that the earnings of a business constitute an annual percentage return on the value of the business or, more accurately, that the present discounted value of all of the business's earnings into the future is the current business value.

Once the discount rate and the earnings are determined, a value is computed. Thus, a 5% capitalization (also called discount) rate applied to \$100,000 of earnings would yield a business value of two million dollars (\$100,000 divided by .05 = \$2,000,000). This is the same result as a 20:1 price/earnings ratio.

“Comparable” sales are recent sales of similarly situated businesses. Because those prices are not estimates but actualities, the comparable sales method is generally preferred as the most realistic proof of fair market value.

In accounting terms, these methods are known as (1) cost (book value), (2) income (capitalization of earnings), and (3) market (comparable sales), respectively. Calculations using other methods or comparisons should be treated with great caution.

## **V. Authorities**

The basic definition of “Fair Market Value” in Canada is found in the Federal Court (Trial Division) case, *Henderson Estate v. M.N.R.*:

“the highest price obtainable in an open market between informed, prudent parties acting at arm’s length and under no compulsion to transact, expressed in terms of money or money’s worth.”<sup>10</sup>

The hypothetical buyer and seller are assumed to be able, as well as willing, to trade. For the most part, the methods used to calculate the value of distributorships or business format franchises are the same as those used for closely held entities in general.

The factors to be considered in determining a valuation are:

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<sup>10</sup> *Henderson Estate v. M.N.R.*; *Bank of New York v. M.N.R.*, [1973] F.C.J. No 800 (F.C.T.D.), Affd. [1975] F.C.J. No. 609 (FCA) at para. 21.

- a. The nature and history of the business;
- b. The economic outlook in general and the outlook for the specific industry in particular;
- c. The book value of the interests held and the financial condition of the business;
- d. The earning capacity of the business;
- e. The dividend paying capacity of the business.
- f. The existence, or nonexistence, of goodwill or other intangibles;
- g. Past sales of the interests held and the size of the block to be valued; and
- h. The market price of previously traded interests of comparable companies engaged in the same or a similar line of business.

While these factors are generally applicable to all businesses, franchises and dealerships present many other unique valuation problems. For example, because trademarks are involved, the scope of the license granted and whether it is exclusive or non-exclusive must be considered. Also, the risk of non-renewal, the restrictions on transfer, rights of first refusal, and/or rights of approval of proposed transferees must be taken into account in determining value. After the franchise-specific valuation issues are addressed, the general rules of valuation must be followed.

## **VI. Acceptable Methods of Valuation**

As referenced above, there are generally only three valuation approaches—cost, income, and market—which are acceptable in determining “fair value” and a valuation specialist is required to consider *all* three approaches. If one or more is not used, the valuation specialist must usually explain why an approach was not used.

It is also important to note that while generally accepted accounting principles may not mandate which of the methods is to be used for measuring the fair value of an item, there is nonetheless a clear preference for the use of observable “market” prices to make the determination. In the absence of observable market prices, fair value should be based on the best information available in the circumstances.

When observable market prices are not available, a company often engages an expert to determine the fair value and the valuation methods used by the expert should incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. If information about market assumptions is not available, a company may use its own

assumptions as long as there are no contrary data points indicating that marketplace participants would use different assumptions.

However, a valuation expert is not required to use comparable “market multiplier” methods, usually multiples of EBITDA, if, for example, in the expert’s opinion, another method such as the Discounted Cash Flow method is more appropriate.

## **VII. Other Measures of Value**

An appraisal or valuation has been defined as a judgment of the worth of something, or a *supportable opinion* as to the value of something. However, there are different kinds of value: there is religious value, social value, moral value, philosophical value, ethical value, and sentimental value. Then there is economic value. Within economic value, there are the above-referenced “fair value” and “fair market value.”

However, in the real world of business, things don't always work according to business appraisal theory. For example, going through the exercise of three methods of valuation to determine the price that a buyer could be expected to accept rarely applies in the real world. Real world buyers and sellers of mid-size and smaller businesses usually don't apply either sophisticated financial theory or business appraisal methodology when deciding what price to offer or accept. Instead most will judge the value of the business by simple criteria, such as price in relation to:

- revenues
- earnings
- cash flow
- "pay back" period
- other rules of thumb (or rumors thereof)
- bad advice

Additionally, there is strategic value and synergistic value. However, these are buyer-specific value adjustments and by definition do not conform to the definition of “fair market value,” which supposes a hypothetical willing buyer and willing seller, neither under any compulsion to buy or sell. The fact that the buyer and seller are “hypothetical” precludes giving them the specific characteristics necessary to determine strategic value and synergistic value. But in the real world of M&A, obviously strategy and synergies most definitely do come into the mix.

For example, when a franchisor reacquires a franchise, it, uniquely, reaps the additional benefit of becoming the complete owner of all the trademark rights in the granted territory. Any other buyer would be merely a licensee subject to restrictions. It is generally conceded that the ownership of all rights in a trademark in a given territory is worth more than the sum of the value of the licensor’s interest plus the licensee’s interest for the same territory before the merger of their interests.

## VIII. Valuation of Trademarks and Intangibles

Intangible assets, also referred to as intellectual properties (“IP”), have become the most valuable assets of the 21st century. In the past, hard assets, such as factories and equipment, were the embodiment of wealth. Today, in many companies intangibles often account for more than 70% of the total enterprise value. In some cases, the value placed on the intangibles by companies with a long history of acquisitions is greater than the entire net worth of the corporation itself. Interbrand, an appraisal company, valued the Coca-Cola brand or trademark at \$71.8 billion in 2011, and included it in its compilation of “The World’s 100 Most Valuable Brands”. Other food franchise companies that were on the list were Pizza Hut with a brand value of \$4.0 billion, KFC with a brand value of \$5.9 billion, and McDonald’s with a brand value of \$35.6 billion. For franchise companies the trademarks, “franchise operating system”, goodwill and know-how are generally the most valuable assets owned.

Occasionally, the issue of the situs of intangibles comes up in litigation, but more frequently the issue that arises is the valuing of intangibles generally, as a damages problem in many types of litigation, but also whenever there are mergers, acquisitions, or asset sales. Yet, valuation is often problematic because, among other things, self-created IP practically never appears on the balance sheet. Creation costs—including legal fees, search fees, artwork, and design and creative service fees—are expensed, not capitalized, under generally accepted accounting principles.

Generally, the law recognizes four basic types of intellectual property: patents, trademarks, copyrights, and trade secrets. Any economic analysis of “franchise rights” shows that a key element of value is the trademark license and the goodwill attached thereto. There are several accepted methods for valuing trademarks. These are: the profit split method, the selling price differential method, the econometric method, and the relief from royalty method. These methods are defined as follows:

1. Profit Split Method—this is based on the division of the after-tax operating margin that a licensee would be willing to pay, after taxes, to a hypothetical licensor for the use of a trademark or trade name.
2. Selling-Price-Differential Method—this calculates the value of trademarks and trade names by determining the incremental price differential attributable to trademarks and trade names over unbranded products or services and then splits the premium portion of the price between the hypothetical licensor and the hypothetical licensee.
3. Econometric Method—this method purports to derive implied economic values for trademarks expressed as a percentage of sales. Several cases have recognized the validity of somewhat similar regression analyses.

4. license agreements to determine an appropriate royalty rate. Once such comparable royalty is determined, three steps follow: (1) determining the projected excess earnings for the branded product or service, (2) selecting an appropriate royalty rate for the license, and (3) computing the present value of the royalty payments using a discounted cash flow method.

But trademarks are not the only IP commonly found in franchise endeavors, and the identification and listing of IP properties (and their status as protected or not protected), coupled with a valuation of such properties for book value purposes (if purchased) or for impairment measurement, is something that should—or must—be done by most franchise companies.

## **IX. Valuation Discounts and Premiums**

The owner of a controlling interest in an enterprise has valuable benefits that the owner of a minority interest does not. Consequently, control—or the lack of it—is often a factor taken into account in determining the value of an interest. Discounts or premiums are amounts, usually expressed as a percentage, that are applied to tentative valuation estimates to compensate for circumstances or situations not otherwise taken into account by the valuation method.

Premiums are applied to valuations for things such as below-market leaseholds, appreciation of assets (*e.g.* improved real estate) and the ability of a business to obtain below-market financing.

Discounts are applied, *inter alia*, for minority interests, for lack of marketability, for restrictions on transfer, and for rights of first refusal. There can also be multiple discounts for assets owned through layered entities. Ready marketability adds to the value of an asset because the market pays a premium for liquidity.

## **X. Right of First Refusal**

Another discount factor which must be considered in the context of franchises, dealerships and distributorships is the Right of First Refusal (“ROFR”), which can be a serious impediment to marketability.

When a franchisor holds a ROFR, a potential buyer from a franchisee is concerned because then the franchisor is always a potential bidder. It is also true that, because it is the franchisor, such a holder of a ROFR knows more about an available franchise than any potential outside bidder. As a result, any outside bidder would have to expend a great deal of effort and money to approach the franchisor's knowledge of the available franchise. Without that knowledge, the outside bidder may offer too little and risk losing out to the franchisor, or too much and risk making a bad deal.

Also, because the franchisor may have a special interest in expanding its position, it might have a tendency to drive up the price beyond what a potential buyer would be

willing to pay based solely upon the present value of anticipated cash flows. Accordingly, both of these factors act as a significant deterrence to would-be bidders for available franchises subject to ROFRs, and, therefore, they reduce the value of the available franchises.

In rebutting such claimed discounts, though, it can be argued that a normal franchise, distributorship, or dealership is not such a complex organization that the costs of analyzing it for bidding purposes would be prohibitively high. It is argued that such concerns regarding a ROFR are more appropriately applied to complex high-tech companies where the hidden value of intellectual property can make accurate analysis difficult and expensive, especially for an outsider. All agree, however, that some discount is warranted for a ROFR.

Moreover, anecdotal evidence supports the argument that the right to approve a transaction has had a dampening effect on the resale of franchises. Franchise transfers (re-sales) have been denied approval because the franchisor contended the price was too high, meaning that the franchisor was concerned that the prospect would be unable to pay off the purchase price and pay royalties.

## **XI. Valuation Factors for Franchises and the Front End Franchise Fee**

Franchisors look to balance their own profitability with the profitability of their franchisees in order to maintain healthy and stable franchise systems. If franchisees were not able to make money, the system would collapse. That being said, franchisors are constantly looking for more ways to provide value to franchisees in order to expand the revenue pool and grow their profits (or failing that, to justify taking a larger portion of the revenue pool).

One way franchisors earn revenue is through up-front payments made by franchisees upon buying the franchise. This front end fee is generally payable before operations commence and represents an additional capital expenditure on top of all the normal costs of opening a business. Although in most successful franchise companies the up-front franchise fee is not a profit source and is only intended to cover the costs of establishing the franchise (i.e. training the franchisee), in international franchising most successful franchise systems are able to charge a substantial front end franchise fee because the amount of the fee is directly tied to the overall value of the franchise in a particular country. Franchisees generally purchase franchises only where the size of the initial capital investment is more than offset by expected future returns. Franchisees therefore must perform a valuation to decide if a front end fee is acceptable.

Franchise companies have many unique attributes that affect the ultimate valuation (and therefore affect the size of the front end fee a franchisor can charge). Some of the factors often considered in determining the value of franchise companies and the front end fees they can charge are:

- a. Goodwill and other Intellectual Property
- b. Demographics of a Territory
- c. The Terms of the Franchise Agreement
  - i. Revenue Sharing
  - ii. Forced Sourcing
  - iv. Renewal/Expiry Provisions
  - iii. Performance Criteria

## **XII. Conclusion**

Performing valuations in franchising is as much an art as it is a science. Projections and assumptions must be made using data of varying reliability.

As valuation is not an exact science, performing a valuation will not attach a value to a franchise that is accurate to the cent. However, a valuation of a franchise provides an objective point of reference with which to plan, evaluate and negotiate, which facilitates the effective formulation, implementation and maintenance of business strategies.

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