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The Franchise Valuations Reporter

Franchise Technology Risk Management

Franchisee Profits

Our lead story on this elusive topic comes from **John A. Gordon**, principal of **Pacific Management Consulting Group**, a chain restaurant and advisory firm. John and I have a common interest in the economics of restaurant operations and have worked together to provide litigation support in franchise disputes.

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Franchisee Store Level Economics

Disparities in Reporting Not Easy to Overcome

by John A. Gordon

Several recent news items have reconfirmed the confusion in reporting and tabulating franchisee store level economics. Because franchisor financial reporting is so poor--and almost universally sparse--both franchisors and franchisees can get in trouble quickly if the right definitions aren't considered.

In February 2012 a survey of average McDonald's (MCD) franchisee income statements by Janney Capital Markets revealed about a 9.2% or $248,000 per store franchisee store EBITDA margin. This conflicts with McDonald's corporate reported results of $338,000.

See the following 2011-2012 MCD franchisee profitability comparison:

Measurement	Janney US MCD sample	MCD Reported US Co. Stores	MCD WW Franchisees	Arcos Dorados (So. America)
AUV (annual sales)	$2.7M	$2.856	Not Disclosed	$2.0M
EBITDA $	$248,000	$320,000	$338,000	$284,000
EBITDA %, AUV	9.2%	20.6%	Not Disclosed	14.2%
Adjusted EBITDA $ less royalties/rents		$250,000 (8.8%)		

Sources: Janney Capital Markets, 2012 MCD and ARCO SEC 10K and S-1 filings.

The difference is probably due to the worldwide mix of franchisees that MCD reported since sales and profits are much higher in Europe, for example, and because the US reported sample may exclude nontraditional units, such as airport units. The rent/royalty factor that franchisees pay has been normalized in the Janney and McDonald's company store numbers. Additionally, Arcos Dorados owns over 500 of their 1800 stores and does not state company margins the same way as does MCD and is therefore not comparable.

Reasons Why Reporting and Definition Problems Abound

1. Corporate earnings calls give very little information on

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franchisees. Analysts don't ask enough questions about franchisee economics except in very broad terms. Assumptions are gained by store opening/closures and by franchisor bad debt expense.

2. Franchise Disclosure Document (FDD) Item 19 "earnings disclosure" is voluntary. The FTC does not check or validate the numbers.

3. A simple income statement may exclude many additional charges that must be covered by store level profit, for example:

- Franchisee general and administrative expense;
- Debt service, both principal repayment and interest;
- Maintenance capital spending on smaller ticket rehabs, e.g. painting, carpets, etc that isn't expensed to the P&L
- ;
- Major CAPEX-equipment, build out costs, remodels just to renew the existing store;
- Brand and business mandated upgrades;
- Future new store openings.

Some franchisors don't have reliable franchisee financial results or say they don't. Franchisees use different charts of account and handle G&A differently. And franchisors with shaky store level economics won't say. When pressed, franchisors talk store level margins -- earnings before interest taxes, depreciation and amortization (EBITDA) -- but as we saw above, many other costs and expenses must be covered.

What Are Some Solutions?

- **Improve Reporting -** Franchisor reporting on store level economics can be improved in the FDD. Annual net sales (not gross) store level should be reported, arrayed by volume, into quartiles. Every franchisor in the US has these numbers to power their royalty collections. And store level EBITDA, excluding franchisee overhead, can be reported. Every bank or lending institution in the world wants these numbers.
- **Improve Publicly Traded Company Earnings Analysis** - Many chain restaurants are almost 100% franchised, yet many publicly traded companies reveal no franchisee sales trends and none reveal profitability. We suggest the same data as above be revealed in the 10Q reports, once annually, on a lagged basis, to get the data collected, after year end.

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Economic Nexus for Income Tax Since KFC v. Iowa: Bad Advice and Our Advice

Another Round of Legal Articles Is Claiming This Is a New Issue - That Is So Not True!

There's been a recent flurry of commentary and articles on economic nexus since the SCOTUS denied certiorari in *KFC v Iowa*.[1] Most of the commentators claim this is a new issue. We don't think that anyone, particularly from the IFA, can say that with a straight face and we don't think that recommending to any franchisor that they treat the issue that way is good advice.

The issue most assuredly is not new; the IFA has been aware of it and fighting it since 1979. As I have pointed out in previous issues of this newsletter, economic nexus as the basis for income taxation has been upheld consistently in practically every court that considered it for almost 20 years.

Arguments are also made that economic nexus has never been applied to franchising before - that too is totally untrue! North Carolina's Assistant Attorney General, Kay Miller Hobart, cited cases against franchising in a paper for the IFA Legal Symposium in 2006 at a session at which she was a speaker and which I chaired.

And then there is the "floodgates" argument: that all the states will suddenly get on the economic nexus bandwagon (as if they have not been on it for decades) and that payment of such tax levies will be the end of franchising as we know it - another preposterous assertion! Let us remember the late Lou Rudnick's article (then one of the deans of the franchise bar) about the **1993** *Geoffrey* case claiming just that. Mr. Rudnick (RIP) described the original decision upholding economic nexus as jeopardizing the license revenues of Walt Disney, Mickey Mouse, and Michael Jordan. See Minear and Rudnick, "South Carolina Extends the Reach of State Income Taxes to Franchisors". It was not true then; it's not true now.

And states asserting income tax nexus are not being rapacious. In fact, as we have shown in this newsletter, if the franchisors pay the income taxes the state gets no more (and generally a little less) tax revenue than if a simple mom-and-pop operation paid income taxes without paying **and deducting** royalties. The arithmetic shows it is no windfall to the states.

But most importantly, non-filing franchisors can be liable for all their years of operation with interest and penalties - as was held against KFC in Iowa. That can TRIPLE the liability. And such a result is anything but absurd as some commentators seem to imply . Many commentators and certainly the state taxing authorities would argue it is just tax fairness or as the Iowa court in KFC explained, it is merely the price franchisors pay for the right to be safe to have their marks and business systems protected and earn monies in their jurisdiction.

[1] See e.g. Gary R. Batenhorst & Adam W. Barney, "The Quagmire of the State Income Tax Nexus in the Wake of KFC v. Iowa Dept of Revenue" *Franchise Law Journal* Vol. 31 Number 3 (Winter 2012); and Scott M. Susko and Meghan J. Schbmehl, "Dealing with a Changing State Tax Landscape" *Franchising World* (March 2012)

CCH's Franchise Regulation and Damages

The Unknown Treatise

As noted above, there's been a whole flurry of commentary and articles recently in reference to the KFC "nexus" case. But very few in the franchise bar know that the CCH treatise, *Franchise Regulation and Damages*, which I co-wrote and which I update 3 times a year, has a very extensive chapter on the issue, covering the Constitutional arguments in great depth and including sales tax nexus and income tax nexus tables for all 50 states, as it applies to franchisors, dealers and distributorships.

Additionally, the most recent issue of the *Franchise Law Journal* has an article on the issue of Lost Future Royalties.[1]

In *Franchise Regulation and Damages*, which was very favorably reviewed, I also write on that issue. The chapter is long and comprehensive including a review of the difference between termination and abandonment, the "hotel" cases and the other lost future royalties issues and cases. It also includes a discussion of the recent case of *Days Inn Worldwide vs. Investment Properties of Brooklyn*[2] which again raised the issue of hotel franchisors' rights to lost future royalties. In *Days Inn,* the franchisee defaulted three years into a 15 year term by selling the property after failing quality inspections and not paying royalties for the last several months of his hotel operation.

The franchisor sued, won a default and then claimed the remaining twelve years of royalties, discounted to present value, as their damages. The judge disagreed, specifically referencing other case law holding that hotel franchisors were allowed to collect an amount equal to only the royalties forsaken during the period it would take them to re-franchise the area. Those cases generally provided franchisors with damages equal to only 2 years of royalties.

[1] Douglas R. Hafer and Logan W. Simmons, "Lost Future Royalties: Lessons from Recent Decisions", *Franchise Law Journal*, Vol. 31 No. 3 (Winter 2012)]
[2] (DC MN) August 26, 2011, CCH Business Franchise Guide ¶14,756

Awuah: The Continuing Saga - Franchisee or Employee

Federal Court Awards Treble Damages Since December 12, 2006

The *Awuah* saga continues. Most recently Federal District Judge William G. Young, in *Awuah v. Coverall North America*, ruled on March 15, 2012, that Massachusetts Coverall franchisees are employees for labor law purposes and imposed treble damages going back six years, holding "the contractual limitation period, two years, does not govern the Wage Act claims." Coverall's motion for leave to take discovery and file an expert report was denied.

As we have previously noted, the issue also resonates in other areas of law. In one recent case sounding in vicarious liability,[1] a Mississippi federal district court held that there was a genuine issue of material fact under Mississippi law as to whether the relationship between a janitorial business franchisee and a franchisor was an employer-employee relationship or whether the franchisee was an independent contractor because conflicting factors in the agreement between the parties supported the existence of both arrangements. Thus, the question was one for a jury to decide and the franchisor's motion for summary judgment on the issue was denied.

And more recently an interlocutory appeal to the Ninth Circuit was allowed by a Northern California District Court to determine whether the issue of a "right to control" was the same for employment classification claims as it was in the franchise context.[2]

[1]*Hayes v. Enmon Enterprises*,CCH Business Franchise Guide ¶14,647 (S.D. Miss. June 22, 2011)
[2] *Juarez v. Jani-King of California*, CCH Business Franchise Guide ¶14,787. (N.D. California February 16, 2012)