Source: Restaurant Finance Monitor

There's No 'Too Big' for the Best Operators

By Nicholas Upton

In 1999, the Wall Street Journal explored the growth of "mega franchisees" in the restaurant business. Back then, the term meant a 50-unit operator expanding into a second brand.

That phrasing seems comical now with three operators (Flynn, NPC International and Dhanani Group) reporting well over $1 billion in revenue among thousands of restaurants. And several others could break the billion-dollar mark in 2017.

That's good news for the private jet industry, but what keeps these giant franchisee organizations from getting too big? It's the same thing that separates the great single-unit operator from a bad one: a culture of operational excellence.

"That's where the challenge lies: How do you maintain operating discipline that is critically important to the small and midsize franchisee—how do you avoid losing that culture to a bureaucratic monster that you need to run 600 stores," said Chris Kelleher, managing director at Auspex Capital. "Try to shrink it up and keep it like it was in the old days. Running it on a local basis?"

It's not an easy task. It requires a balance of focus on building and maintaining that culture and allowing those within it to push it. Kelleher said one of his clients—a large operator in Wendy's and Taco Bell—found maintaining an operations culture required constant attention from an executive at the top of each brand dedicated to "building up that structure."

One of those franchisee giants, GPS Hospitality, has set a goal of $1 billion in sales. CEO Tom Garrett said hiring good people and a growth mindset can tame the bureaucratic monster.

"If all you're doing is stretching your current people and spreading them thinner and thinner, you're going to reach a point of diminishing returns," said Garrett.

The key to a culture is keeping it like it was when it was small, but with systems. To get larger, huge franchise systems need to maintain an owner-operator mentality in each unit.

"Our approach has been to push decision-making as far down as you can. Make sure you have a culture that rewards decisionmaking and leadership," said Garrett. "If you don't have a good system or good people and then you try to centralize everything, all you do is get farther and farther away from the business and farther and farther way from the customer."

Operators like Garrett have all but proven that the model scales for brands and investors. This year, the top 200 added 7.2% in total units but added 8.4% in revenue, showing yet again that with the right system, efficiencies emerge.

Brands and investors are happy to see metrics like that as the trend continues. It means less general and administrative costs for support. And franchisors spend nothing running the actual restaurants. Above all, the franchisor is no longer responsible for the tricky task of building and maintaining a great culture.

"I don't care how big they get, honestly, as long as the culture is being replicated as best as possible," said restaurant investor and analyst Roger Lipton, of Lipton Financial Services. "They've got to guard against the same malaise that their franchisor guards against."

Burger King, Wendy's and DineEquity were all able to slash G&A expenses by undertaking large refranchising efforts. Each sold stores to large operators which need less handholding and have the capital to remodel, but still enjoy a few points of margin from efficient operations.

Each of those concepts, however, has had stumbles as franchisees grew to a massive scale. Done right, asset-light means higher EBITDA and more stable returns. But brands need to treat franchise operating partners as such or a large part of the system could break down.

"These operating partners capture all kinds of data and can bring up tough conversations that brands need to have. The highly efficient firms can spot trends before and give feedback better than smaller counterparts that are focused on executing," said Lipton. "You can learn a lot from your good franchisees."

The larger the operator, however, the better the relationship has to be. Large operators won't be as willing to go with the flow as will many small franchise operators, and they won't stay silent if they think the franchisor is gouging franchisees.

The franchisors "need to remember they're your partners and you can't milk it. What can happen: The franchisor gets more mature and they look for more ways to get paid," said Lipton.

If vendor rebates get out of hand, software charges rise or the supply chain is squeezed, mega franchisees won't trudge on. As Wendy's saw in a dispute with DavCo over remodels and a mandatory POS upgrade, when a large operator doesn't fall in line, it's not pretty. For Wendy's, it was a three-year legal

battle with it's fourth-largest franchisee, which only ended when DavCo agreed to sell the restaurants back to Wendy's, which later sold them to NPC.

That raises another question about large operators: Is it the responsibility of the new mega franchisees to keep brands in check? Without a powerful and organized franchise association, large operators may be the only groups that have influence.

If franchisees acquiesce to every brand request because they want to keep the M&A gatekeeper happy, they could enable real damage to the brand and the industry down the road. In the past, it's been a question of profits and losses, but should big operators ponder their role in bigger questions, like oversupply?

"The big issue I'm concerned about is how franchisors are focused almost exclusively on pushing the franchisee system to add store count; everyone has massive goals," said Kelleher. "The banks have played along and provided the gasoline for the fire. If you go through all the public announcements, they all want hundreds and hundreds of restaurants. That's a big part of the reason you're seeing consumer spending weakness, and that's a dangerous place we're headed."

To guard against outsized influence that would put those big promises in peril, some brands are limiting how large an operation can get. Taco Bell has capped the number of units at 250 and Pizza Hut has slowed the flow of units to NPC—hence the massive Wendy's diversification.

"Between 25 and 250, that's the sweet spot, at that point you've got brand resistance," said Kelleher. "I think they [franchisors] don't want to have too much, it's like everything else, you want to diversify. If you have a very large operator who has a heart attack and dies, you're in trouble."

What does this mean for the entrepreneurial spirit that franchising evokes? There probably will always be brands where entrepreneurs or corporate refugees can buy a job, even a great job, but Kelleher said it's going to be tough to find a comfortable spot between a few restaurants and a large operation.

"The people who are really going to go extinct are the middle tier, the five to 25—those guys have a hard time," said Kelleher. "You can't run it out of a garage and you can't afford the overhead of a strong staff. That group, I don't

think, has a future. They need professional management, but they don't have the scale to absorb the overhead."

—Nicholas Upton