YALE CASE MAY 23, 2023

Ten Essential Questions to Consider When Selecting a Franchise Brand for a Search Fund Journey

Picking a brand is a vital choice for franchise entrepreneurs

***Peter Mistretta*[1]**
***Michael Horowitz*[2]**
***Adam Wilver*[3]**
***A. J. Wasserstein*[4]**

In our recent case note, Exploring Franchisees as a Post-MBA Entrepreneurial Path, we investigated why MBA students might not consider being franchise entrepreneurs in a search fund project and provided compelling reasons for why they should at least consider the opportunity. In this follow-up case note, we examine 10 essential questions that a search fund entrepreneur must consider when identifying a franchisor partner in franchise entrepreneurship through the acquisition (ETA) pathway.

Once an entrepreneur decides to be a franchisee, which is a crucial decision point, the next most important choice is which franchise logo is right for them and why. *We cannot sufficiently emphasize the importance of selecting the right franchise partner*. It is challenging to envision a successful personal and financial outcome with an incompatible franchisor collaborator. With more than 300 different business format categories representing 805,436 projected franchise establishments in the United States for 2023, accounting for almost 3% of gross domestic product, this is a daunting task for any aspiring entrepreneur.[5] With options in automotive services, childcare and educational services, lodging services, fitness concepts, and ubiquitous quick-service and fast-casual restaurants, there are a dizzying number of alternatives. An entrepreneur's task is to select an initial franchisor partner with whom to launch a franchisee career. Although we are not in the business of picking or endorsing specific franchise systems, we deliver a series of questions that prospective ETA entrepreneurs should contemplate.

We have identified 10 essential questions (**Figure 1**) that will assist any entrepreneur in assessing which franchise logo is the best match for their enterprise. As interested as we are in franchises, being a franchise entrepreneur is not a panacea; entrepreneurs must still select the right industry and logo. We do not claim that our list of inquiries is comprehensive or perfectly accurate, but we believe it will directionally help identify potential appropriate franchise systems. We caution entrepreneurs considering these topics to resist the temptation to find a perfect partner. There are probably several that could fit and many that are definitely not suitable, but no franchise brand will present all the elements an entrepreneur might seek. Picking a franchise partner is akin to assessing a non-franchised industry and company in a search fund, and we reviewed what qualities might make a compelling industry and business in our case note On the Nature of Economic Characteristics, which would be another useful foundation and framework for contemplating franchise alternatives.

We encourage searchers to rigorously evaluate the 10 questions presented and use them as a screen to help narrow the myriad choices. Additionally, it might be helpful for entrepreneurs to assess what characteristics in their expedition are must-haves and what are nice-to-haves. Furthermore, searchers can attach weights to each trait to create an index representing a weighted score. Finally, we encourage entrepreneurs to approach these questions with a completely open mind, resisting the temptation to prejudge any brand before fully unpacking the opportunity through the lens of our questions. Ideally, entrepreneurs should mask the actual logo and laser in on the underpinning properties that drive the brand.

One unique and advantageous aspect of investing in franchises is that franchising is highly regulated state by state, and a plethora of information is publicly available in each brand's franchise disclosure document (FDD). Many FDDs are available for free on the State of Wisconsin Department of Financial Institutions website. The FDD is a treasure trove of juicy details and facts about the brand. Some of the legally reviewed data included are estimated initial investments (start-up costs) (Item 7), franchise location average performance (unit economics) (Item 19), and system-wide growth, transfers, and closures (Item 20). This provides a cost-effective and expedient way to assess brand and business quality.

For a handy database to help narrow potential franchisor brands, entrepreneurs can consult Krokit, a feature-rich platform for franchise entrepreneurs. The useful site allows users to query brands based on selection criteria, such as geography, size, and industry category. In addition, the results provide informative data points, such as investment range, average revenue per store, profit potential, and franchise fees. These dynamic statistics will assist potential franchisees in identifying logos that might fit their articulated selection criteria before drilling into a brand's FDD.

Figure 1: Ten questions to help discover the right franchise brand

- **01** **What does a successful outcome look like?**
- **02** **What is the right industry or category for the project?**
- **03** **What are the brand attributes and qualities being sought?**
- **04** **What are the franchisor's qualities and characteristics?**
- **05** **To what degree is there operational flexibility?**
- **06** **What are the demographics of the current franchisee base?**
- **07** **Is the system large or small, and what are the geographic dynamics?**
- **08** **What are the store-level economics and financial particulars?**
- **09** **What are the actionable entry points?**
- **10** **Do the entrepreneur's personal goals fit tightly with the system?**

We will now explore each of the 10 questions in detail.

01 What does a successful outcome look like?

When pursuing this journey, entrepreneurs should begin with a clear picture of what a successful outcome, both financially and personally, looks like. For example, aiming to operate a handful of stores in a tight geographical region will point entrepreneurs to one set of alternatives, but pining for hundreds of stores with a national footprint will direct them toward other options. Additionally, searchers need to define whether they intend to have a role that feels like an owner–operator or one that channels the chief executive officer (CEO) of a large enterprise with a fleshed-out executive team and deep infrastructure. Furthermore, entrepreneurs should scope the financial outcomes they are seeking in terms of their annual current income and the equity value created. Searchers hoping for a $200,000 annual salary with a few million dollars of equity value will pursue some specific types of brands, while others who long for millions of dollars of yearly compensation and tens of millions of dollars in equity will probably need to pursue others. Additionally, some brands can present the opportunity to earn several hundred thousand dollars with a single high-volume location, introducing less operational complexity. In comparison, other brands that typically have low six-figure revenue volumes might require many more sites with greater functional knottiness.

Part of the core success assessment should include the likely growth strategy. While all augmentation approaches can be comingled, entrepreneurs can focus on organic growth (opening new locations), acquired growth, or potentially convert existing locally branded operations into flagged franchise locations. Many pursue multiple growth avenues at once. It is common for franchisors to require franchisees that acquire existing locations to also develop new ones, which helps amplify franchisor revenue in such a way that acquisitions alone do not. The mix of new and existing units also impacts financing and duration decisions. The expansion strategy will help open up or constrain potential franchisor partners.

Searchers' plans to hold the business for decades compared to a quick three- to five-year flip will inform the eligibility of prospective franchisor partners. Shorter holding periods will likely eschew harvesting cash flows, instead choosing to use free cash to grow the business. Finally, searchers could consider whether they plan to pursue a growth strategy centered on a single brand or aspire to operate multiple brands in a franchisee conglomerate of sorts.

While a searcher is considering financial priorities, they must also balance personal preferences. For example, building a large organization will require more time to recruit executives, travel to multiple markets, design operational structures, and evaluate growth opportunities. On the other hand, an entrepreneur operating a smaller business with fewer locations may be able to spend more time closer to their product or service, customers, and front-line employees. In either case, over time, entrepreneurs may be able to design outcomes that allow them to be actively involved or to take a passive role and delegate to other operators.

Establishing a well-articulated image of a successful outcome will help entrepreneurs develop exactly what their goal is. This will not only help them define which franchise brands could deliver those objectives but will also prevent scope creep and drift in the search process.

02 What is the right industry or category for the project?

For an aspiring franchise entrepreneur, the industry selection process probably looks similar to what the industry selection process would look like for a more traditional ETA entrepreneur. The foundational questions relevant to ETA are also applicable in franchising. We think of this as a meta-analysis of what pond an entrepreneur will choose to fish in. Despite our curiosity and enthusiasm for franchises, laws of economic gravity still exist. A well-run franchise concept in an inferior industry will likely be an awful decision and produce disappointing outcomes.

A key decision an entrepreneur must contemplate in the franchise universe is whether or not to pursue a food service logo. Foodservice represents the largest category in franchising[*]and is often the first thing people think about when they hear the word franchise; however, franchising encompasses much more than just food concepts. Therefore, one basic assessment when considering the sector is whether to embrace or reject a food service logo.

Another element to evaluate is whether the franchise concept category is new and emerging or classic, with decades of history and proven performance. Of course, neither is correct or better, but both arcs have implications. For example, a new concept could provide a vast growth opportunity and the ability to engage early. This could present large economic rewards if the concept is tenable and gains traction. Alternatively, a classic category might have truncated organic growth prospects but might come with less risk and outcome variability and provide a programmatic acquisition opportunity.

Entrepreneurs must carefully evaluate whether an emerging concept is durable or fad. Some franchise concepts enjoy early and meteoric growth only to crater after the concept is no longer in vogue, as we have witnessed in categories such as food service (frozen yogurt) and fitness (cycling). Searchers should consider whether a product or service is enjoying popularity because of its novelty or because it is a better product or service offering in an established category. Some franchise brands may be early in commercializing an idea but prove unable to develop a competitive moat. We encourage searchers to seek franchise brands with enduring tenability and to eschew brands with mania characteristics. For example, a brand such as Pearle Vision, which was founded in 1961 and provides optical services for individuals, is not a trend—people will need eye exams, glasses, and contact lenses for years to come.

All else being equal, a growing category is more attractive than a stagnant or declining category. We think about growth in two dimensions. The first is the overall growth of the entire industry sector and then the growth of the exact franchise brand within the category. When examining why a certain logo is growing within a sector, we look for logic that points to a more consistent customer experience, pooled marketing and supply chains, loyalty programs, service packages that are usable in any geography, and a compelling value proposition. Growing verticals tend to benefit franchisees by delivering organic growth at a lower cost than stagnant or declining sectors. However, a franchise entrepreneur may consider brands in slow-growing, well-established categories with more reliable, abundant, and long-dated historical operating and financial data to be diligence. Prominent examples might include Wendy's, Arby's, Sonic, BK (formerly known as Burger King), and other heritage burger-focused quick-service restaurant (QSR) concepts.

The level of competition in a category must also be considered, but there is nuance beyond a binary competitive landscape assessment (i.e., "Yes, it is competitive" versus "No, it is not competitive") worth teasing out. Undoubtedly, a category loaded with fierce, similarly sized competitors offering undifferentiated products or services (think indoor cycling and spinning) is less attractive than a category with little competition dominated by one or two category leaders (think Pilates). However, examples abound of categories littered with competitors nibbling at a dominant player who was an early mover, has an outstanding brand, or offers a differentiated product that stands out from the pack, one being Orange Theory Fitness in the boutique fitness category.

[*] The International Franchise Association projected that in 2023 196,858 (24%) of the 805,436 franchise establishments would be QSR.

Franchise entrepreneurs should also consider the labor profile they will need to attract and manage. For example, an operator of a fast-food restaurant will have a large but highly competitive labor pool with a significant percentage of minors and other first-time entrants into the workforce. As a result, they will need to spend more time establishing basic expectations for on-the-job conduct but comparatively less time training the team on specific job responsibilities, as a crucial part of QSR operations is making the day-to-day tasks simple and easy to learn. By comparison, a massage or chiropractic clinic operator will be looking for specialized workers who may be harder to find but already have experience in their trade. As a result, such franchisees will spend more time training sales and marketing skills than massage techniques or chiropractic adjustments in their organizations. Disaster recovery businesses offer another contrast, requiring specialized training and certification for many tasks that are not widely held. A franchise owner here will have to develop procedures for training employees to perform specific duties while also building competencies in marketing, sales and project bidding, and inventory management. Recruiting, training, and retaining the best talent are universal differentiators among elite franchisees.

As in traditional ETA, revenue characteristics, revenue quality, and franchise operating format (store-based versus territory-based) matter enormously. Store versus territory is a critical nuance because store-based concepts often have ample scale to support a full-time manager. In contrast, territory-based concepts can feel like buying a job for some time before hitting stabilization. For young, first-time, and inexperienced entrepreneurs, contractually recurring revenue, or some repeat revenue, provides a cushion and greater future visibility on sales streams than purely transactional revenue. A territory-based franchise concept such as ServiceMaster might be significantly less capital-intensive to stand up but may be much more operationally intensive to execute well. On the other hand, a store-based concept such as Planet Fitness may be less operationally complex but may require significant capital investment and real estate development know-how to launch. We encourage readers to refer to our case note, On the Nature of Revenue, which discusses some considerations related to revenue characteristics.

Finally, a category with a large addressable end-user market is a desirable characteristic to seek in a franchise system. Franchises with a significant total addressable market probably have greater growth prospects than smaller niche-addressable markets. In addition to a broad scale, entrepreneurs should understand the opportunity to achieve scale and density in their specific geographic markets. Franchise groups that can build scale over a smaller geographic footprint enjoy more shared resources, operating leverage, and profit margins.

03 What are the brand attributes and qualities being sought?

Franchise entrepreneurs can roughly organize brands across three vectors (**Figure 2**): i) classic or emerging, ii) premium or moderate, and iii) in favor or out of favor. Decisions on each of these brand dimensions will quite literally determine a franchise entrepreneur's journey and return prospects. For example, in exchange for taking risks on an out-of-favor brand, a franchise entrepreneur may be able to quickly acquire a significant scale in that brand at attractive prices with favorable treatment from the franchisor (e.g., local marketing support, right of first refusal on acquisitions, royalty concessions, and more). However, what seems like a value-centric and compelling strategy may come at a cost, as swimming upstream as a franchisee in a brand that is not resonating with customers is exceptionally difficult for even the best operators.

Figure 2: Three brand attributes to consider

In other cases, a franchise entrepreneur committing to growing an emerging brand's network before the brand has demonstrable value may receive some of the above-mentioned concessions and exclusive access to highly sought-after markets for development. A downside of this strategy is that the entrepreneur is paying royalty and advertising fund payments to use a brand that is still so young that many customers do not recognize it. In this case, the entrepreneur must evaluate whether the growth of the network over time offers more opportunities than developing the same product or service under an independent brand.

In both of these theoretical examples, the franchise entrepreneur tolerates brand risk in exchange for higher expected value in the same way that traditional ETA entrepreneurs may overlook blemishes that arise in diligence if the purchase price is sufficiently low. Of course, every franchise entrepreneur would love to acquire scale in a classic, premium, and in-favor brand such as Taco Bell at a reasonable price that ensures equity value creation. However, similar to what traditional ETA entrepreneurs have to do to secure high-growth vertical software-as-a-service companies with $5 million plus recurring revenues, franchise entrepreneurs would have to pay up handsomely to secure an opportunity such as the hypothetical Taco Bell.

04 What are the franchisor's qualities and characteristics?

The main benefits of operating under a franchised brand include (**Figure 3**) i) lower customer acquisition costs than those of new independent four-wall operations, resulting from brand recognition, marketing sophistication, and marketing scale; ii) a standardized technology stack that is purpose-built and battle-tested for the operations of that brand; iii) a prenegotiated supply chain with economies from the scale of purchasing power of the entire franchised system; and iv) a playbook with operating routines and structures by which franchisees can manage their businesses. In exchange for these key benefits, franchisees, of course, pay a royalty fee—typically a mid-single-digit percentage of gross sales—and contribute to a national advertising fund to support the further development of the brand. Franchisees may also pay a mandatory fee on top of the royalty for using the franchisor's technology platform or may be required to purchase certain goods or services from the franchisor. Aspiring franchise entrepreneurs must be ruthless in evaluating whether a franchisor earns the fees it charges its franchisees or whether the fees are predominantly value leakage. An excellent way to assess franchisor value is to connect with existing franchisees to discuss how a franchisor behaves and what value they deliver. In addition, aspiring franchise entrepreneurs can make assumptions about new store buildout costs, ramp-up times to stabilization, and remodeling costs.

Figure 3: Main benefits of operating under a franchised brand

- i Lower customer acquisition costs
- ii A standardized technology stack that is purpose-built
- iii A prenegotiated supply chain with economies from the scale of the entire franchised system
- iv A playbook with operating routines and structures

In exploring this foundational point, we found existing franchisees to be the most valuable source of information. Existing franchisees can provide inquisitive entrepreneurs with critical information on the following six questions:

1. What is the franchisor's training and support like for new franchisees?
2. Do the technology tools provided by the franchisor facilitate franchisee operations or create friction?
3. Do the franchisor's marketing efforts directly drive volume to franchised stores?
4. Is the franchisor's leadership aligned with franchisees in its focus on improving franchisee unit economics, or is it more focused on driving franchisor revenue (which is sometimes at odds with franchisee profitability)?
5. Is the franchisor sophisticated in its pricing strategy?
6. Is the franchisor thoughtful in its menu-setting strategy?

We recognize that conducting loads of franchisee calls while evaluating multiple brands can be tedious and is probably not the most efficient use of an aspiring franchise entrepreneur's precious time. A filtering heuristic we suggest to get an early read on the above questions before undertaking franchisee calls is the ownership structure of the franchisor. Franchisors owned by blue-chip consumer private equity firms (e.g., Roark Capital Group) and franchisors with publicly listed equity (e.g., European Wax Center) tend to be on the more sophisticated and better side of the spectrum of these topics. Despite their sophistication and scale, however, institutional owners of franchised brands might focus on value extraction, which is more intense than founding entrepreneurial owners of franchise brands keen to grow and evangelize their concepts. Being part of a private equity-owned system could feel very different from being part of an entrepreneur-owned system.

Aspiring entrepreneurs should be aware that most franchise brands will require the guarantor of the franchise agreement (either a corporate entity or an individual) to backstop and make whole foregone royalties and fees for the franchise agreement term (most often 10 years) if the store closes. Well-established classic brands that enjoy the luxury of excess demand for system entry might require all meaningful investors to be guarantors (this can be problematic in the search fund model). However, some franchisors are open to a corporate guarantee versus a personal guarantee. Furthermore, some franchisors might be willing to negotiate to allow the closure of a store that is not performing without future royalty payment obligations. Failure could entail a double jeopardy: the opportunity cost of anticipated riches and a future commitment to a payment stream without corresponding income. An experienced franchise lawyer might be able to persuade the franchisor to yield on the royalty make-whole provision.

05 To what degree is there operational flexibility?

Developing data-driven pricing strategies, go-to-market approaches, product and service offerings, marketing efforts, and vendor selection processes, as well as professionalizing other operational routines, have been reliable value-creation levers for ETA entrepreneurs outside franchising. Franchisees, however, are often restricted in their operational decision-making latitude, even if they can make a compelling case to the franchisor supporting their decision. We introduced several franchisee constraints on operating policies in our recent case note, Exploring Franchisees as a Post-MBA Entrepreneurial Path, so we will not revisit them here.

A recent example of the negative impacts this operational inflexibility can have on franchisees is the impact rising beef prices post-COVID had on franchisees of beef-centric QSR concepts. The cost of beef increased by nearly 25% between March 2020 and March 2023.[6] If the franchisors of QSR brands with a significant beef presence had not allowed franchisees to pass the cost of goods sold inflation on to customers by raising menu prices, franchisee profitability would have been decimated.

Some franchise brands embrace rigid compliance and uniformity in their operations and approaches. There is a single mantra of how things are done, and no deviation is tolerated. This results in a cohesive operating system across geographies; McDonald’s is an example of this approach. Other franchise brands tolerate more variations in local operations; ServiceMaster falls into this category. Entrepreneurs should be cognizant of what they need operationally and where they will perform best and thrive.

Franchisees of brands that are operationally restrictive must focus on other ways to create value, including through capital allocation, team building, and collaboration with the franchisor.

06 What are the demographics of the current franchisee base?

The demographics of the current franchisees in the system should inform a searcher’s strategy. We are particularly interested in ownership density, which we define as the average number of units an operator owns.

On the one hand, dense brands, those with pockets of large operators, might set the stage for large and influential franchisees to shape the franchisor on certain operating matters. This would be harder to do in a light-density system. On the other hand, a franchise brand with dense ownership might be challenging to execute a programmatic acquisition strategy since the brand has already partially experienced consolidation.

Although dense ownership is not universally bad, light-density brands might present a very desirable opportunity to scoop up single and handful of units at attractive prices in an acquisition play if there is an annual turnover in store ownership. DQ (formerly known as Dairy Queen) is a good example. DQ has over 4,000 franchise locations in the United States, and the largest franchisee owns around 250 restaurants. Most operators own fewer than 10 locations. Primrose Schools, an early childhood education concept, is a desirable light-density brand, but it has less than 1% annual ownership transfers, making it a thinly traded brand and potentially harder to be a serial buyer.

If a brand is older and the franchisee's ownership base has a high average age, this could signal that operators are ready and interested in selling. Younger owners might be less eager about exiting and more intent on scaling in the early stages of their careers. Similarly, it is instructive to understand owner tenure in a brand. Systems with many operators on the cusp of hitting their renewal dates, typically 10 or 15 years, might see renewal as an exit catalyst, paving the way for a programmatic acquisition play.

A brand with a large presence of private equity ownership at the franchisee level will have a different feel and tone than one with predominantly mom-and-pop owners. In a franchise system, the individual performance of each franchise location contributes to either building brand equity or diluting the power and image of the brand. This presence or absence of professionalization in the system impacts the entrepreneur's success and is worth investigating.

Finally, entrepreneurs should consider whether a franchise system has many, few, or no corporate-owned and operated units. A system with a majority of corporate-owned stores is different from a system with just a few corporate locations. Over the past decade, many franchisors have moved to asset-light business models. They sold most of their corporate sites to franchisees and now operate very few locations while focusing on collecting royalties. A franchisor with no exposure to its own operations might not fully understand the operational pain points franchisees are experiencing. The owner demographics in a franchise system will illuminate many things, including whether a programmatic acquisition strategy is likely and whether co-franchisees are helping or hurting the brand.

07 Is the system large or small, and what are the geographic dynamics?

The number of franchise locations in a system will set an upper limit on how large its franchisees can grow. Most franchisors do not want a single franchisee to become too large relative to the entire system, as it risks giving that franchisee too much power. A general rule of thumb is that franchisors prefer that no single franchisee owns more than 10% of the system.

An extensive system such as Popeyes, with over 2,900 franchised units, presents an opportunity for nearly limitless acquisition growth within the system. On the other hand, a smaller system such as Restore Hyper Wellness, with fewer than 200 franchised units, offers comparatively less opportunity. Still, it might be a compelling vehicle for growth through new developments in wide-open geographies. An operator intending to use acquisitions for growth needs an extensive system, but an entrepreneur yearning for organic growth in specified and desirable geographies might be better off in a smaller, emerging brand.

We encourage entrepreneurs considering the size of a brand system to think about how big they want to be in the system. Being the largest operator in a brand undeniably confers certain benefits and advantages, but being a top operator with 150 units in a 2,000-unit system feels different from operating 150 units in a 300-unit brand. Thus, an entrepreneur attempting to achieve a particular scale in a smaller system may find their growth plans rejected by the franchisor.

The size of a franchise system will typically also inform its geographic scope. Smaller systems tend to be more locally or regionally centric, while high-unit brands lean toward coast-to-coast national coverage. If an entrepreneur must be in a specific geographic area, smaller systems might not fit the bill, while larger systems with greater breadth could have openings.

Finally, the size of a system will likely have implications for financing and exit opportunities. For example, smaller systems with fewer data points could be more challenging to finance with both debt and equity. Additionally, undersized systems with fewer in-system operators and less brand awareness might trade at lower exit multiples and have less liquidity than larger, better-known logos.

08 What are the store-level economics and financial particulars?

We cannot emphasize enough just how important it is to fully inspect store-level economics and all the financial dynamics in a franchise system (this can also be considered territory- or equipment-level economics for service brands). This is fundamentally what an entrepreneur buys into, and there should be clear visibility and consistency in unit economics in a franchise system. Entrepreneurs might be willing to endure a lot of unpleasant friction with the franchisor and burdensome entry into the system for the right economics. We advocate approaching this with a return on invested capital (ROIC) mindset. We want to comprehend the annual SLEBITDA (store-level EBITDA[†]) for a brand in relation to the necessary investment capital to stand up a single unit. We acknowledge that SLEBITDA does not account for capital expenditures (maintenance and growth) or dilution from corporate shared services functions, but unit-level ROIC is the fundamental investment thesis in a brand. For example, it typically costs around $300,000 to launch a new clinic for the Joint Chiropractic brand. This includes all franchise license fees, capital investments, tenant improvements, and working capital associated with funding the cash flow burn pre-opening until the clinic ramps to break even. It does not retain real estate ownership and assumes that the franchisee is a tenant paying rent. The average clinic in the Joint Chiropractic system does around $125,000 of SLEBITDA, implying a pre-tax unlevered ROIC of 40%.

When considering store-level economics for new locations, we first focus on the amount of capital necessary to launch a new unit. Some brands, such as Crunch Fitness, require millions of dollars to open a new store, while others, such as Jackson Hewitt Tax Service, can be opened with a few hundred thousand dollars. How much capital is required for each new location will determine how many units an entrepreneur can develop and at what rate.

We also consider expectations of absolute cash flow from a single location to be an important financial characteristic, as it has meaningful implications for management complexity and, therefore, the quantity of general and administrative (G&A) costs required to oversee the locations. For example, a 10-unit portfolio of the Joint Chiropractic would have an expected SLEBITDA of $1.25 million but might require only a few employees at the corporate level to oversee and support the individual locations. By comparison, with average unit revenue volumes estimated at $450,000, it may take 20–30 Subway locations to generate the same SLEBITDA while requiring many more corporate employees to oversee the larger footprint and employee count.

Another factor to consider is the average EBITDA purchase multiple for small unit portfolios in a brand. We are particularly excited about systems with bountiful and actionable opportunities to purchase locations

[†] Earnings before interest, taxes, depreciation, and amortization.

costing in the low-to-mid single-digit (3x to 5x) multiples of EBITDA. This dynamic presents another attractive method for growing and creating equity value at very reasonable entry valuations.

Additionally, we encourage entrepreneurs to evaluate capital availability in franchise systems when considering unit economics and acquisitions. For example, some brands are more financeable than others because they have preapproved relationships with partner banks, and some brands are not as financeable or have higher debt and equity pricing due to higher perceived risk.

Finally, SLEBITDA is *not* net free cash flow, and as attractive as SLEBITDA can be in some brands, entrepreneurs should *never* disregard other important expenses for running a franchise business: G&A expenses, capital expenditures for maintenance, capital expenditures for franchisor-mandated improvements, equipment, remodeling, and changes in working capital (especially in non-point of sale concepts). While SLEBITDA is a compelling metric to consider, the conversion rate to cash flow is not 100%, and material dilution is likely.

09 What are the actionable entry points?

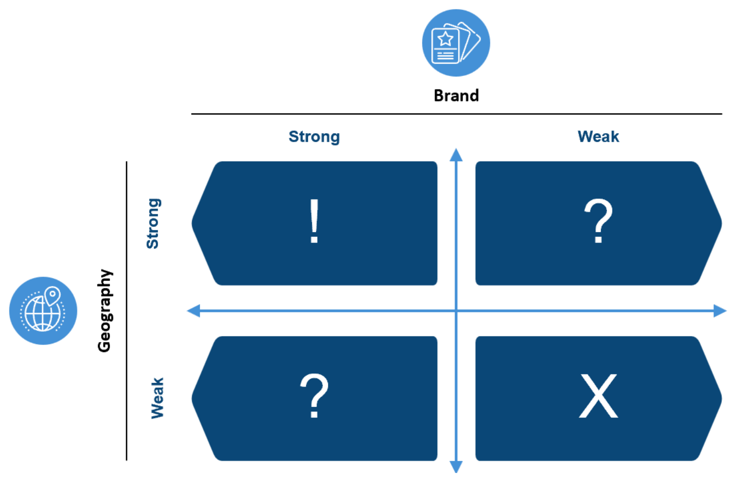
Entering a franchise system can be arduous and akin to applying for membership in an exclusive club. With some desirable brands' proven economics and high probabilities of success, many entrepreneurs clamor for access and admission. This leads to the vexing problem of successfully identifying an alluring franchise brand but being unable to win approval to enter the system. Domino's pizza is a common example of a system that is highly in demand from prospective franchisees but admits very few of them; instead, it chooses to offer franchising opportunities to entrepreneurs from the pool of successful Domino's restaurant employees. Franchisors typically have a rigorous evaluation process for prospective rookie operators. Acceptance often includes a liquid net worth requirement, in-person interviews, and previous operating experience (sometimes in the specific brand). This vetting procedure is understandable. Franchisors invest in and cultivate their brands and want to ensure that their operators support the logo and add value to the system as a whole. A rogue or underperforming franchisee is nothing but a headache for the franchisor. Furthermore, since franchisor economics are a derivative of franchisee revenue performance, franchisors act like investors in some ways and allocate locations and flags to franchisee partners with the best potential to perform well.

While ETA entrepreneurs have pedigreed resumes, they often lack meaningful operating experience and might be perceived as unappealing franchisee candidates. Chick-fil-A is another franchisor that, like Domino's, requires operating experience in their system before they grant a new franchisee a location. This results in the conundrum of discovering whether there are actionable entry points into a system. If an ETA entrepreneur can pass the franchisor requirements, they can launch a new location in an agreed-upon geography or commit to opening a series of locations over a specified timeframe. However, this approach is only tenable if the entrepreneur is willing to launch the program by standing up virgin stores. This point cannot be understated. The franchisor gets less value from someone entering a system and just buying existing stores. Committing to a development plan is essential to getting into favor with the brand and is more operationally complex than many ETA paths, given that the starting point for the business is from scratch (albeit with a robust playbook).

Alternatively, a searcher can identify acquisition candidates in the targeted brand. This track presents a double hurdle. A deal encompassing valuation and diligence obstacles must be struck with the seller. The franchisor will still need to access and approve the entrepreneur purchasing the legacy franchisee location, and a seller may be biased against selling to a not-yet-approved franchisee due to the risks of securing franchisor approval. We strongly encourage entrepreneurs to engage with their target franchise brands early in the process to ensure they understand the requirements and the franchisor's amenability to approve them before spending significant time and money evaluating deals.

Entrepreneurs should also remember that not all geographies are created equally, even in the best franchise brands. A high-performing brand in an undesirable territory can be a poor choice in the same way that the best geography will not save a struggling brand. **Figure 4** depicts the nuanced relationship between brand and geography, which must be considered when evaluating the applicable gateways to a system. Being granted a franchise is not a guarantee of success; a poor franchise operator can still struggle to succeed with a flourishing brand in a terrific location.

Figure 4: Likely potential outcomes when franchise entrepreneurs select a brand and geographic market



Entry into a desirable franchise system is not a given and will require demonstrating financial capability, operating experience and potential, and a dose of serendipity. We encourage aspiring entrepreneurs to network vigorously once they have identified their chosen brand, work to connect with current franchisee operators, and try to access the franchisor executives, especially the franchise development professionals—they are ultimately the guardians of the system. When interacting with franchisor executives, entrepreneurs need to sell their exuberance for the brand, their commitment to the system, and their ability to scale a professionalized business. To ensure that the franchise entrepreneur is casting a wide enough net for success in their search, they may consider identifying several franchised systems in which to search.

10 Do the entrepreneur's personal goals fit tightly with the system?

We understand that a franchise brand with ideal economic characteristics may still not be a match for a prospective entrepreneur. At the beginning of this note, we encouraged entrepreneurs to temporarily forget about the actual brand logo and actively evaluate it without any preconceived notions about what the business does. This is an attempt to take emotion out of the decision-making process and make a fact-based verdict. At some point, however, the entrepreneur will need to unmask the logo and ascertain whether there is a genuine fit. For example, a model with compelling financial attributes in an auto services concept might make all the sense in the world for some searchers but could be met with flagging energy for others who just cannot see themselves building a career underneath the hood of a car. Similarly, some people categorically reject QSRs as a pathway regardless of economic opportunity.

We encourage entrepreneurs to reflect on some questions, such as whether they can see themselves working in a prospective industry and logo, whether they can envision managing and leading the employee base, whether the business will be emotionally and intellectually fulfilling, and whether they can be passionate about the brand's core service.

Additionally, entrepreneurs need to see themselves in the system and be comfortable telling family and friends about their professional careers. Can they envision being an operator and interacting with the franchisor and co-franchisees? Some searchers might feel more comfortable with the franchisors owned by professional investors, while others might prefer interacting with the entrepreneur who built the franchise brand. There needs to be a personal cultural match.

Conclusion

We continue to be curious and energetic about franchisee entrepreneurship for ETA entrepreneurs. Although we do not consider this an appropriate pathway or a fit for all post-MBA searchers, we genuinely believe it offers many compelling attributes for *some* aspiring ETA entrepreneurs. Once a searcher commits to the franchisee track, a crucial step will be scrutinizing and picking a single franchise brand or group to focus on. Despite our zeal for franchises, an entrepreneur who selects the wrong logo will likely fail. Our 10 essential questions to consider when choosing a franchise brand for a search fund journey will help aspiring entrepreneurs find the right franchisor partner for their goals and projects. We encourage entrepreneurs to consider deeply and evaluate our series of inquiries to help tilt the probability of finding the best partner in their favor.

We wish you success and good luck finding the right franchise system for your ETA odyssey. Additionally, we hope you build a thriving franchise business that is fun, economically rewarding, intellectually challenging, and personally fulfilling!

Exhibit 1: Additional resources

- A Consumer's Guide to Buying a Franchise. Federal Trade Commission. September 2020. 591a_buying_a_franchise_sept_2020.pdf (ftc.gov)
- Bascaro, Aicha. *The Franchise Fix*. Morgan James Publishing, 6 Mar. 2018.
- Bisio, Rick and Mike Kohler. The Educated Franchisee: Find the Perfect Franchise for You. Editorial: Minneapolis, Mn, Tasora Books, 2017.
- Busker, David. *Franchise Vision: Transform Your Future through Franchise Ownership*. Saint Louis, Mo, Fourth Wave Publishing, LLC, 2019.
- Camras, Marc, and Melissa Hart Woods. *Secrets of Franchise Success*. 2015.
- Delk, Christy Wilson. *Adventures in Franchise Ownership*. Morgan James Publishing, 3 July 2018.
- Greenberg, Scott. *The Wealthy Franchisee*. Entrepreneur Press, 17 Nov. 2020.
- Kamal, Faizun. The Right Franchise for You: Escape the 9 to 5, Generate Wealth, & Live Life on Your Terms. New York, Morgan James Publishing, 2020.
- Leonard, Mark C. 7 Steps Every First Time Franchise Buyer Should Follow. CreateSpace, 18 Jan. 2014.
- Libava, Joel. *Become a Franchise Owner!* John Wiley & Sons, 3 Nov. 2011.
- Maillet, Wayne. *Franchising Demystified*. Friesen Press, 20 Oct. 2014.
- Schroeter, Britt, and Rick Bisio. *The Franchisee Playbook*. 21 Jan. 2020.
- Siebert, Mark. The Franchisee Handbook : Everything You Need to Know about Buying a Franchise. Irvine, CA, Entrepreneur Press, 2019.

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies.

Copyright 2023 © Yale University. All rights reserved. To order copies of this material or to receive permission to reprint part or all of this document, please contact the Yale SOM Case Study Research Team: email case.access@yale.edu.

Endnotes

[1] Peter Mistretta is the founder and CEO of Knight Franchise Holdings and the owner and operator of franchised locations of category-leading consumer brands. He is a graduate of the Stanford Graduate School of Business.

[2] Michael Horowitz is the CEO of Buckeye Restaurant Group, a large franchisee of Wingstop restaurants that was established via the ETA path in 2018. He graduated from Harvard Business School.

[3] Adam Wilver serves as the co-owner, president, and CEO of a multiunit B2B services franchise, which he acquired while pursuing his MBA at MIT Sloan School of Management (Class of 2022).

[4] A. J. Wasserstein is the Eugene F. Williams, Jr. Lecturer in the Practice of Management at the Yale School of Management.

[5] International Franchise Association's 2023 Franchising Economic Outlook. 2023 Franchising Economic Outlook | International Franchise Association

[6] U.S. Bureau of Labor Statistics. "Average Price: Ground Beef, 100% Beef (Cost per Pound/453.6 Grams) in U.S. City Average." FRED, Federal Reserve Bank of St. Louis, 1 Jan. 1984 to 1 Mar. 2023. fred.stlouisfed.org/series/APU0000703112.