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KBP Foods and Barry Dubin

Programmatic acquisition can be a compelling growth strategy for a franchised business

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The lunchtime rush was just getting underway when Barry Dubin pulled his rental car into the parking lot of a KFC restaurant near Hartsfield-Jackson Atlanta International Airport. From a space at the far end of the lot, he watched SUVs line up in the drive-thru lane. Then, out of the corner of his eye, he saw a flash. It was a young girl, running back and forth on the sidewalk by the restaurant's front door. She swung about herself a red, white, and blue bucket of fried chicken, and her mother, clearly exasperated, struggled to corral her.

Dubin was the chief financial officer of KBP Foods, a KFC franchisee that owned and operated 64 stores in the Midwest and Florida. He had flown in from Kansas City late that morning in October 2011 to perform on-the-ground diligence of a portfolio of 53 KFC restaurants in the Atlanta metropolitan area that his company was considering for acquisition.

About six months earlier, Dubin had teamed up with Mike Kulp, an experienced quick-service restaurant (QSR) operator, to acquire KBP Foods as co-founders. The duo had sold their financial backers, a middle-market private equity firm, on the vision of growing KBP Foods through programmatic acquisition. Their business plan, put together earlier in the year, called for a gradual pace of acquisition activity, which would allow them to double their store count to 130 in five years. But one day in late October, Dubin received a call from a well-known broker in the QSR industry. The broker represented a long-time KFC franchisee in Atlanta. After building his business from zero to 53 stores over decades, this franchisee had recently decided that now was the time to sell.

Dubin had spent the first six months in his role as chief financial officer, building a pipeline of targets, but this opportunity did not look at all like the others. The 53-store portfolio dwarfed the assets in KBP Foods' desired size range, franchisees that owned between four and eight restaurants each. In addition, Atlanta was a market where KBP Foods had never operated before and one Dubin had not expected it to enter anytime soon. If KBP Foods went ahead with the deal, it would be a transformational, but highly risky, undertaking very early in the company's programmatic acquisition journey.

Despite these concerns, Dubin believed that the Atlanta portfolio might be an attractive acquisition. His review of the materials sent to him by the broker revealed that the Atlanta stores had meaningful upside potential if KBP Foods could improve their operations. There were also ways to create value through financial engineering. Fifteen of the 53 stores were real-estate-owned locations, so KBP Foods could help finance a deal with a sale-leaseback transaction. A purchase would also allow KBP Foods to reach a size, much more quickly than anticipated, at which it would reap the benefits of multiple arbitrage.

Sitting in his rental car in the KFC parking lot in Atlanta that late October day, Dubin thought these issues over once again. He wondered to himself, Should KBP Foods do this deal or not?

Barry Dubin's entry into QSR

After graduating from Indiana University Bloomington in the late 1990s, Dubin joined Arthur Andersen in Chicago. He spent four years there as a management consultant, while also earning the designation of Certified Public Accountant (CPA). He then moved to Merrill Lynch, where he sourced, analyzed, and managed middle-market private equity and debt investments. Following two years at Merrill Lynch, Dubin went back to school. He earned his MBA from Northwestern University's Kellogg School of Management in 2006. He then joined a building products manufacturer as its chief operating officer. After two years, Dubin decided to pivot into entrepreneurship. He partnered with a few private equity firms and bought a couple businesses in different industries.

It was from his work with the private equity funds that Dubin gained exposure to the QSR industry. As he learned more about the industry in an advisory capacity, he concluded that QSR franchising offered a compelling entrepreneurship opportunity. Depending on the particular franchise concept used, a well-run restaurant could generate a return on invested capital in the range of 20 to 50 percent per year.[3] Based on his review of franchise disclosure documents[*] from a range of franchisors, Dubin believed that building a new store in the franchise system of a solid national chain in a major category could reasonably generate a pre-tax unlevered return on invested capital (ROIC), measured by unlevered free cash flow as a percentage of cash invested, in the low teens. Dubin further thought that a pre-tax levered ROIC could range between the high 20s and the mid-30s, assuming three dollars of debt for every dollar of equity, (**Exhibit 1** and **supplemental ROIC spreadsheet**).

Dubin began to network aggressively within the QSR industry. He spent a considerable amount of time and effort building relationships with brokers, who facilitated sales of restaurants, as well as development officers at franchisors, who controlled admission into their respective franchise systems. Although Dubin connected with the right people and established credibility in their eyes with his professionalism, knowledge, and diligence, he realized that to take the plunge as a QSR franchisee he needed a business partner. Dubin had strong financial and strategic skills, honed from his experiences as a management consultant and a private equity professional. However, he lacked QSR operating experience, which was a prerequisite for gaining entry into a top-tier QSR franchise system. Dubin had to find someone with expertise as a QSR operator, and he ultimately did when a broker introduced him to Mike Kulp, a seasoned industry veteran. Dubin and Kulp were the perfect match, and they soon began to work together.

Franchising 101

Franchising, at its core, is just another method for producing, selling, and distributing goods or services. But what makes franchising unique is how it separates ownership of the business model, or franchise concept, from ownership of the operations. As a result, a franchise system has two pieces.

First, there is the franchisor. The franchisor develops and owns the franchise concept. The franchise concept includes a detailed and standardized playbook for operating a business as well as a brand under which that business is operated. In developing a franchise concept, a franchisor generally starts as an operating business. However, when deciding how to scale, a franchisor opts to rely on third parties, or franchisees, rather than growing the business entirely on its own.

[*] In the United States, a franchise disclosure document (FDD) is a legal document that a franchisor must provide to prospective franchisees during the pre-sale disclosure process. Pursuant to federal law, the document includes, among other things, information about the franchisor, the franchise system, and the estimated amount of investment capital that a franchisee would need to commence operations.

Franchisees are independent entrepreneurs. They own and operate their own businesses, but they do so according to the operating model developed by the franchisor and under the brand it has created. For the privilege, franchisees pay franchise fees, which typically are divided into two parts: royalties and marketing contributions. Royalties are the 'rent' that franchisees pay to a franchisor to use its business model and brand. These payments, usually four to six percent of a franchisee's gross sales, represent the main source of a franchisor's revenue. Besides royalties, franchisees contribute another three to five percent of their gross sales to cover marketing expenses that the franchisor incurs on their behalf to build the franchise concept's brand equity.

The dynamic outlined above has profound implications for the financial profiles of franchisors and franchisees. Franchises are capital-light, high-margin businesses. While a franchisor might own some physical assets, its primary assets are intangibles, specifically the business model and brand that serve as the foundation of its franchise concept. A franchisor's revenue, for the most part, derives from monetizing these intangibles through royalties, which a fairly lean cost structure can generate. On the other hand, franchisees conduct the lion's share of a franchise system's underlying operations. Doing so involves a much heavier investment in capital, cost of goods or services sold, and labor, resulting in a more asset-intensive, lower-margin financial profile.

Although many people associate franchising with fast-food chains, there is incredible diversity within the franchise universe. One useful framework for making sense of this heterogeneity divides franchises into two categories: business format and product distribution.[4]

A business format franchise is a franchise concept in which franchisees own and operate businesses that leverage the business model, operational playbook, and brand developed by the franchisor. Fast-food chains, such as McDonald's, Taco Bell, and Dunkin', fall into this bucket, but they are by no means alone. Service concepts, whether business-to-consumer or business-to-business, proliferate here as well. Prominent examples include The UPS Store (shipping and logistics), Kumon Math and Reading Centers (education), and Jiffy Lube (oil change and other car maintenance).[5]

On the other hand, a product distribution franchise is a sales relationship between a supplier and an independent dealer. Examples include automotive dealerships and soda bottling companies. This type of franchise generally has a lower profile than its business format counterpart, in part because it only accounts for 20 percent of franchising companies in the U.S. However, its economic importance is not to be underestimated, for product distribution franchises represent nearly 70 percent of all franchising revenues.

Franchising was big business in the early 2010s.[6] According to data from the U.S. Census Bureau, franchise businesses generated $1.3 trillion in annual revenue. Restaurants accounted for $165 billion, or 13 percent, of that $1.3 trillion. Quick-service restaurants (i.e., fast-food chains) contributed $129 billion, which was 78 percent of franchise restaurant sales and 10 percent of total franchising revenues.

Quick-Service Restaurants

Quick-service restaurants (QSR) have a long history in the United States. The oldest fast-food chain, White Castle, dates all the way back to the early 1920s,[7] but the industry expanded considerably and secured its place in American life following World War II.[8] With their low price points and fast service, QSR restaurants benefited from rising levels of disposable income, growing interest in dine-out options, and ever-increasing demands for convenience in a nation on the go.

By the early 2010s, quick-service restaurants represented a large portion of the overall U.S. restaurant industry.[9] U.S. Census Bureau data pegged the QSR segment at $185 billion, or 45 percent, of the $410 billion of industry-wide revenues. Within the QSR segment, franchises accounted for $129 billion, or 70 percent, of total sales and more than 122,000, or 54 percent, of total locations.

Segmentation in the QSR industry typically occurs along five dimensions: category, geography, store format, brand tier, and price point.

- Category: This refers to a QSR restaurant chain's primary menu offering. Sizable categories include hamburgers (e.g., McDonald's, Burger King, and Wendy's), sandwiches (e.g., Subway, Quiznos, and Jimmy John's), chicken (e.g., KFC, Popeyes, and Chick-fil-A), coffee (e.g., Starbucks,[†] Peet's, and The Coffee Bean & Tea Leaf), pizza (e.g., Domino's, Little Caesars, and Pizza Hut), and desserts (e.g., Baskin-Robbins, Dunkin', and Krispy Kreme).

- Geography: Some chains are national, operating in most, if not all, of the 50 states and the District of Columbia. Examples include McDonald's, Starbucks, and Domino's. On the other hand, some chains are regional, such as In-N-Out Burger[‡] (western U.S.) and Bojangles (southeastern U.S.).

- Store Format: Some QSR chains rely primarily on free-standing stores, complete with dining rooms and drive-thru lanes (e.g., Burger King). Others, especially those that derive most of their sales from takeout or delivery, have small-footprint storefronts (e.g., Papa John's). And then there are concepts generally found in shopping-mall food courts (e.g., Auntie Anne's).

- Tier: QSR concepts can be organized into tiers based on the strength of their brands. Top-tier concepts, which are the most prominent, include McDonald's, Taco Bell, and KFC. Among the mid-tier concepts are Wendy's, Dairy Queen, and Cinnabon. Finally, there are lower-tier concepts, such as Long John Silver's, A&W Restaurants, and Sbarro.

- Price Point: During the 2000s, price points within the QSR industry widened as new, higher-end chains emerged. Promising better quality and customer experience, these upstart concepts, such as Shake Shack,[§] Cold Stone Creamery, and Jersey Mike's, gained market share at the expense of incumbents among less price-sensitive customers and, in some cases, brought new restaurant goers into the QSR fold.

In a quick-service restaurant franchise, store-level economics drive revenues for both franchisees, who own and operate stores, and franchisors, who receive royalties that are a portion of a store's gross sales. Revenue per store, known in the industry as average unit volume (AUV), is a function of two main factors: order volume and check size. Order volume, or the number of orders placed by customers, depends on traffic (i.e., the number of customers) and frequency (i.e., the average number of orders per customer). Check size, or the average amount spent on each order, varies with order size (i.e., the average number of items per order), product mix (i.e., the product composition of the average order), and pricing (i.e., the prices set for each item on the menu).

There are two primary drivers of revenue growth for the overall franchise system: same-store sales growth and new store openings. The same-store sales growth rate captures the year-over-year percentage change in average unit volume at stores open for at least one year. Stores open for less than one year are excluded from this calculation because their revenues have not yet ramped up to a level consistent with a mature base of business. The second vector of system-wide revenue growth is new store openings. All else being equal, the more stores there are within the franchise system, the greater its overall revenues will be. However, if a

[†] Starbucks is a QSR chain in the coffee segment that does not utilize the franchise model.
[‡] In-N-Out Burger is a QSR chain in the hamburger segment that does not utilize the franchise model.
[§] Shake Shack is a QSR chain in the hamburger segment that does not utilize the franchise model.

franchise concept reaches market saturation or, worse still, overexpands, new store openings could actually reduce total system revenues by causing average unit volume to decline more than store count grows.

Although there is strong incentive alignment between franchisees and franchisors in increasing average unit volume, their economic interests are not identical. Ultimately, their divergent interests reflect a simple reality: Franchisees care most about restaurant *profitability*, whereas franchisors care most about restaurant *revenue*.

Kentucky Fried Chicken

By the time Barry Dubin became involved with KBP Foods in 2011, KFC had long been one of the most storied brands in American fast food. The KFC concept dates back to 1930, when Harland Sanders purchased a motel in Corbin, Kentucky, and started serving fried chicken to his guests. His fried chicken soon gained a local following, and in 1935, Sanders was commissioned as a Kentucky colonel by the state's governor. Four years later, Colonel Sanders perfected his recipe, which included a top-secret blend of 11 herbs and spices. In 1952, he decided that the best way to capitalize on the unique Kentucky-style fried chicken he had developed was to create a franchise concept around it. He found his first franchisees far from his native Kentucky in a suburb of Salt Lake City, Utah. The Utah franchise proved successful, and new franchisees joined the emerging system, which began to build a national brand through mass-media advertisements featuring the colonel himself, clad in his trademark white suit. Tremendous growth across the country encouraged Colonel Sanders, in the 1960s, to make the Kentucky Fried Chicken concept one of the first U.S. fast-food franchises to expand overseas. He sold the concept to an investor group in 1964 but remained the centerpiece of the chain's marketing campaigns until his death in 1980.[10]

Kentucky Fried Chicken continued to grow over the course of the next few decades and changed ownership multiple times along the way. In 1982, tobacco giant R.J. Reynolds bought it.[11] Four years later, the fried chicken concept was sold to PepsiCo, which added it to a stable of fast-food brands that included Pizza Hut and Taco Bell. PepsiCo rechristened Kentucky Fried Chicken as KFC in 1991 and, six years later, spun off its fast-food businesses, including KFC. The new entity, Tricon Global Restaurants, was the second-largest fast-food franchisor in the world after McDonald's. In 2002, Tricon Global Restaurants renamed itself Yum! Brands.[12]

In the first decade of the new millennium, KFC saw the fortunes of its international and domestic businesses diverge. The brand experienced incredible growth in Asia, particularly China.[13] However, the situation was not nearly so rosy at home in the U.S. After peaking at around 5,500 stores in 2004, the U.S. franchise system lost nearly 900 restaurants over the next seven years.[14] System-wide same-store sales declined in 12 of the 16 quarters between the first quarter of 2008 and the fourth quarter of 2011.[15] The main reason for KFC's struggles in the U.S. was intense competition, particularly from Chick-fil-A.[16] Between 2004 and 2011, KFC's share of the chicken segment of the U.S. QSR industry fell from 37 percent to 27 percent. During the same period, Chick-fil-A's share increased from 13 percent to 24 percent. Competitive dynamics were intensified by changes in consumer taste. Chicken sandwiches[**] became increasingly popular, which played to Chick-fil-A's strength within the broader chicken category. While KFC sold chicken sandwiches as well, its menu was much broader, and its business was built around its iconic bucket and meal offerings (**Exhibit 2**).[††]

[**] In the QSR industry, a chicken sandwich is a piece of fried chicken breast (i.e., boneless white meat) served on a hamburger bun. For the most part, customers could customize the sandwich's toppings and condiments to meet their preferences (e.g., hold the pickles, add cheese, no mayonnaise).

[††] KFC historically had focused on the bone-in segment of the chicken category. The bone-in segment encompassed traditional fried chicken offerings, such as legs (i.e., drumsticks), thighs, wings, and breasts (with the meat still

Programmatic Acquisition in the QSR Industry

Favorable Characteristics

As an industry, QSR franchising has six features that make it an attractive context in which to execute a programmatic acquisition strategy (PAS). These attributes are inherent in many QSR concepts, and they represent particularly powerful structural advantages for established brands like KFC.

First, QSR franchising allows an entrepreneur to start and grow a new venture while taking a relatively low business model risk. This is because the franchisee does not have to develop the business model from scratch. Instead, the franchisee pays the franchisor for the right to use the business model it has developed. In the case of mature franchises, the business model has proven to be a successful and durable method for creating economic value, often demonstrating decades of evidence from other franchisees. Perhaps most importantly, a franchisee in a mature concept creates its business under the flag of an established brand. This means that the franchisee can leverage considerable brand equity right out of the gate, which a franchisor of a mature concept has built over time through heavy investment in advertising.

Second, QSR franchising is, by design, repeatable. The franchisor creates a playbook and effectively licenses to franchisees the right to use it. In addition to various payments demanded of franchisees, franchise agreements stipulate the rules by which the franchisor expects franchisees to abide. These rules promote consistency of operations throughout the franchise system. Most visibly for customers, consistency manifests itself in the food they order. Franchisors develop the recipes and codify the menu. They also design workflows that, if implemented correctly by franchisees, generally ensure fast service and quality products for customers. When scaled across a large franchise system, the execution of a common playbook means that restaurants spread over a large geographic area are (at least in theory, and usually in practice) very similar to one another. A customer can walk into a restaurant in, say, New Haven, and the dining experience will be substantially the same as it would be if she had walked into a location in Los Angeles instead.

Third, for a programmatic acquirer, a QSR franchise system serves as a well-defined universe of acquisition opportunities. While many industries require a programmatic acquirer to invest significant time and resources in sizing the pool of potential targets, QSR franchising presents a considerably less daunting task. That is because the franchisor tightly controls the admission of franchisees into the system. The implications for a would-be programmatic acquirer in a franchise system are significant. Not only is it relatively straightforward to determine how many targets there are in the pool, but it is also much easier to learn who they are and figure out how to approach them.

Fourth, many, if not most, QSR franchise systems have a large number of multi-generational, family-run franchisees. As an example, consider the KFC system in the United States. In the early 2010s, it had approximately 4,600 stores. About 95 percent of those stores were owned by roughly 600 franchisees, implying that a very large portion of the franchisee base owned an average of about seven stores each. For a programmatic acquirer, this sort of fragmentation meant that there were enough acquisition targets of a digestible size to sustain growth through a steady pace of deals over time. In addition to their relatively small size, family-owned franchisees often present meaningful opportunities for a programmatic acquirer to create value by improving operations. This is because the owner-operators might not have the expertise, resources, and desire to optimize the profitability of their restaurants. Finally, family-run franchisees

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attached to the bone). KFC primarily sold bone-in chicken in family-sized portions, which were cardboard buckets that contained between eight and sixteen pieces of fried bone-in chicken. In many cases, customers opted to purchase a meal. A meal included a bucket of chicken as well as southern-style biscuits and a choice of side dishes that were commonly served alongside fried chicken in the U.S. (e.g., mashed potatoes, coleslaw, and corn).

usually pass the franchise down from one generation to the next. However, in some cases, when the older generation reaches retirement age, the younger generation might not be interested in continuing the family business of running restaurants. As a result, a generational transition often represents a natural catalyst for a family to exit franchising via a sale to a programmatic acquirer.

Fifth, QSR franchising has meaningful barriers to entry. For starters, not just anyone can become a franchisee. Franchisors typically undertake rigorous assessments of would-be franchisees and only accept those who meet strict criteria. Entrepreneurs have to demonstrate, among other qualifications, their financial capacity to own and operate a franchise. In addition, franchisors usually require that at least one of the owner-operators have previous restaurant experience, ideally in the QSR segment. Those entrepreneurs who make it through the evaluation process and gain entry into the system often benefit from terms in their franchise agreements that give them territorial exclusivity within a particular area. Such contractual provisions give the franchisee some protection against competition and reduce the risk that their restaurants' sales will be cannibalized by locations owned by other franchisees nearby.

Sixth, QSR franchising has attractive working capital dynamics. The main reason for this is that little, if any, cash is tied up in accounts receivable (A.R.). Customers either pay for orders in cash at the point of sale or they use credit or debit cards. In the former case, cash is received immediately, while in the latter case, cash comes in when card-based transactions settle, usually within a day or two. Ultimately, the negligible amount of A.R. reduces working capital investment, which, in turn, improves free cash flow conversion.

Less Favorable Characteristics

Despite the positive attributes outlined above, QSR franchising also possesses traits that, all else being equal, make it less attractive as an industry in which to execute a PAS.

For starters, there is intense competition for customers (i.e., diners). Diners have many options for where they eat their meals, face low switching costs, and tend to be highly price sensitive. If, for example, a parent wants to pick up a low-cost, kid-friendly dinner, such as fried chicken tenders, on the way home from work in a reasonably sized metropolitan area, they likely have several QSR chains to choose from. Some, such as KFC or Popeyes, will primarily be known for their chicken, whereas others, such as McDonald's or Carl's Jr./Hardee's, might offer chicken as part of a broader menu. And, if the metropolitan area is large enough, the parent might have multiple options within the same QSR concept (e.g., three KFC stores, each owned by a different franchisee, within driving distance of one another). Competition also extends beyond the franchised QSR industry. Local mom-and-pop restaurants are yet another alternative, as are national, full-service restaurant chains that offer takeout. In addition, in many markets, grocery stores have ready-to-go, hot-food counters that offer similar food at similarly low prices and with similar convenience. And, of course, there is always the option to skip takeout altogether and make dinner at home instead.

However, it can be argued that control, not competition, presents the biggest challenge to a QSR franchisee executing a PAS. Although franchisees own their own businesses, they cannot operate them however they please.[17] In order to remain in the franchise system, franchisees have to follow the rules set by the franchisor. While these rules, theoretically at least, are designed to create success for individual franchisees and the franchise system in general, a franchisor's incentives do not align perfectly with those of franchisees. Regional variations within a large franchise system also make it difficult, if not impossible, for a franchisor to set rules that work optimally for every franchisee in every situation.

The financial implications of ceding a considerable amount of operational control to a franchisor are profound, especially in the context of capital allocation. In the QSR industry, franchisors typically set a 10-year remodel cycle for stores. For a franchisee, this means that they have to invest their own capital to remodel the stores that they own on a schedule that they do not control and according to a new store design concept that they did not develop. The stakes are high because, in the QSR industry, store appearance has a very large impact on customer traffic and, in turn, sales volume. In addition, franchisors often require franchisees to open a minimum number of new stores. This requirement for 'new build' capital expenditures further reduces the amount of cash flow that a franchisee can freely allocate.

Finally, franchisees rely heavily on the franchisor to build brand equity and raise the profile of the franchise concept. A legacy franchisor (e.g., McDonald's and KFC) has to keep its concept fresh and relevant, while an emerging franchisor, whether completely new or making the leap from regional to national, has to differentiate its concept in an industry with many storied brands. In joining a franchise system, franchisees essentially bet that their franchisor will be a good steward of the brand under which they are building their businesses. They pay a meaningful amount for the right to use the brand, between six and ten percent of gross sales, in the form of royalties and marketing fees. And, since QSR industry revenues are highly correlated with brand strength, the fates of franchisees depend in large part on a franchisor's abilities as a brand builder.

KBP Foods

Since its founding in 1999, KBP Foods had slowly but surely executed a programmatic acquisition strategy in the QSR industry. The company started with a base business of five KFC stores in Colorado and then bought seven more in the Quad Cities region of Iowa in 2000. The following year, CEO Mike Kulp joined the company, and over the next decade, KBP Foods completed three more acquisitions. The first, in 2003, involved the purchase of 21 KFC stores in Kansas City, Missouri. The second, in 2006, added 13 KFC stores in Omaha, Nebraska, to the KBP Foods portfolio. The third, in 2009, brought 28 KFC stores in Tampa, Florida, into the fold. Along the way, the company also divested the original base business of five KFC stores in Colorado and closed five more (1 in Kansas City, 1 in Omaha, and 3 in Tampa). As a result, by early 2011, KBP Foods owned and operated 64 stores in four markets (7 in Quad Cities, Iowa; 20 in Kansas City, Missouri; 12 in Omaha, Nebraska; and 25 in Tampa, Florida). Collectively, these assets generated $70 million of revenue ($1.1 million per store, on average) and $9.1 million of 4-Wall EBITDA (implying a 13.0 percent 4-Wall EBITDA margin).[‡‡]

In the early 2010s, KBP Foods embarked on a new chapter in its history. Mike Kulp wanted to continue scaling the company, but he needed a business partner, someone with strong financial skills that would complement his expertise as a restaurant operator. Barry Dubin emerged to fill that role.

In April 2011, Dubin and Kulp, as co-founders, teamed up to purchase KBP Foods, with financing provided by a Florida-based, middle-market private equity firm. Kulp would lead the company as CEO, while Dubin would initially serve as chief financial officer. The business plan, as underwritten by their financial sponsor, was to double the number of KFC stores in KBP Foods' portfolio from 64 to 130 over the next five years via a programmatic acquisition strategy.

Dubin and Kulp believed that successful execution of a programmatic acquisition strategy depended on KBP Foods' ability to continuously improve its operations. Arguably, the most important determinant of success for a quick-service restaurant is the quality of its store manager. Store managers oversee the day-to-day operations from within the four walls of a restaurant, so they are in the best position of anyone within a QSR franchise unit to increase store-level performance. Dubin and Kulp recognized that traditional compensation methods for store managers were suboptimal from the perspectives of incentivizing the right

[‡‡] 4-Wall EBITDA refers to the earnings before interest, taxes, depreciation, and amortization generated by restaurant operations (i.e., within the four walls of a store). This earnings measure is distinct from Corporate EBITDA, which deducts corporate overhead from 4-Wall EBITDA.

behaviors and attracting and retaining the right people. The reason for this was that fixed compensation for the average QSR store manager was about 90 percent of their total compensation. Across the industry, total annual compensation for a store manager ranged from $40,000 for low performers to $50,000 for high performers. KBP Foods, on the other hand, weighted variable compensation much more heavily. A KBP Foods store manager earned a modest base salary but also received a share of store revenues and EBITDAR.[§§] This approach gave store managers a much stronger incentive to improve store-level performance. It also led to a much wider range in annual compensation for store managers, from $35,000 on the low end to $80,000 on the high end. In turn, high performers stuck around, low performers moved on to other opportunities, and folks who wanted to bet on themselves joined the KBP Foods team.

Besides getting the right store managers in place and incentivizing them effectively, KBP Foods created an equity compensation program for both senior leadership and upper-middle managers. This program was unique among QSR franchisees. For one thing, the program reached much lower down into the organization. Promising employees who were rising up through the ranks could receive shares in the company well before they reached the C-suite. In addition, the program was structured so that increases in KBP Foods' equity value accrued disproportionately to employees who owned relatively small stakes. Taken together, these tactics helped instill an ownership mentality at KBP Foods that extended well beyond the top layer of the company.

Store-level execution was the focus of a number of initiatives at KBP Foods. A well-defined integration playbook ensured that newly acquired stores would adopt best practices within just months after a deal closed. The company also employed area coaches. An area coach was a leadership position one level above store managers. Each area coach met regularly with the store managers in an assigned territory, helped them set priorities, and provided assistance in solving store-level problems as needed. Within the restaurants themselves, KBP Foods created processes to increase efficiency, especially around food and labor costs. Through better inventory management and optimized staffing levels, the company had been able to reduce Big Two Expenses[***] as a percentage of revenue from the low 60s to the high or mid-50s at the stores it acquired. KBP Foods also used analytics to improve up-selling and cross-selling when customers placed their orders. Driving incremental revenue is especially important in the QSR industry, for although profit margins are modest, operating leverage is significant. Finally, the company proactively invested in its physical plants. It kept its restaurants clean and well maintained and tended to complete remodels ahead of schedule. These tactics improved restaurant appearance, thereby increasing customer traffic and revenue per store.

KBP Foods also planned to create economic value through financial engineering. Part of the logic behind its programmatic acquisition strategy was multiple arbitrage. In the QSR industry, it was possible to buy small portfolios of assets where the restaurant operations[†††] commanded E.V./Corporate EBITDA multiples[‡‡‡] in the 4.5–6.0x range and sell larger portfolios of assets at E.V./Corporate EBITDA multiples

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[§§] EBITDAR is an acronym for earnings before interest, taxes, depreciation, amortization, and rent. Because EBITDAR adds back, or excludes, rent expense, the metric allows for apples-to-apples comparison of the operating performance of real-estate-owned stores to the operating performance of leased locations. This is different from EBITDA, which does not adjust for a franchisee's decisions around real estate (i.e., whether to own or lease). For the purposes of incentivizing a store manager, 4-Wall EBITDAR is a better choice than 4-Wall EBITDA. It measures restaurant performance within the confines of factors that a store manager can control, and real estate financing is not one of them.

[***] Big Two Expenses is the name QSR industry participants use to refer to the sum of food and labor costs.

[†††] In the case where a portfolio of assets included real estate, the valuation of the portfolio was established by valuing the restaurant operations separately from the real estate and then adding the two valuations together.

[‡‡‡] For the purposes of valuation, when a portfolio had both leased stores and real-estate-owned locations, Corporate EBITDA included implied incremental rent expense for the real-estate-owned locations. That way, restaurant operations could be valued separately from any real estate.

in the 6.5–7.5x range.[§§§] KBP Foods also optimized its capital structure. When it acquired assets, it generally funded the deals with three dollars of debt for every dollar of equity. Finally, the company had considerable experience with sale-leaseback transactions. By selling off real estate that came with restaurants it purchased, KBP Foods could tap an additional source of financing, which allowed it to reduce the amount of equity it needed to use to complete acquisitions.

The final piece of KBP Foods' programmatic acquisition strategy was to create and maintain a strong reputation in the QSR industry. Dubin and Kulp planned to further nurture their relationships with important brokers in order to generate consistent deal flow. In addition, they sought to build on the credibility they had gained in the eyes of the franchisor. After all, the franchisor approved all franchisee transactions, and the franchisor might decide to sell some of its company-owned stores to existing franchisees that it believed were skillful operators. Dubin and Kulp also wanted to grow their own direct sourcing capability over time, so they decided to participate as actively as they could within the franchisee community and on system-wide committees established by the franchisor.

The Atlanta Opportunity

By October 2011, when Dubin visited Atlanta, six months had passed since Kulp and Dubin had completed their purchase of KBP Foods. Kulp had drawn upon his operational expertise and focused on improving the base business of 64 KFC stores. Dubin had leveraged his financial skillset and deal-making experience to build a pipeline of acquisition targets. As summer turned to fall, he was evaluating a number of opportunities. In most cases, the potential seller was a mom-and-pop franchisee with between four and eight KFC stores in one of KBP Foods' existing markets in the Midwest and Florida. Such deals would allow KBP Foods to grow its market share where it already operated. Meanwhile, there were a few other assets for sale that presented an opportunity for geographic expansion. If KBP Foods were to consummate one such transaction, it would add a modest portfolio of KFC stores in a new territory not far from its current footprint. Examples included a seven-store franchisee in Des Moines, Iowa (roughly equidistant between Quad Cities, Iowa, and Omaha, Nebraska) and a five-store franchisee in Orlando, Florida (a one-and-a-half-hour drive from Tampa, Florida).

Then, shortly before Halloween, a broker with whom Dubin had built a strong relationship informed him that there was a franchisee looking to sell a portfolio of 53 KFC stores in Atlanta, Georgia (**Exhibit 3**). Collectively, the stores generated $58.3 million of revenue ($1.1 million per store, on average), $9.6 million of EBITDAR (16.5% margin), and roughly $6.3 million of 4-Wall EBITDA (10.8% margin across the entire portfolio, which contained 15 real-estate-owned stores and 38 leased locations).[****] Real-estate-owned stores, which paid zero rent, contributed $2.7 million of 4-Wall EBITDA ($181,500 per store, or 16.5% margin), while leased locations earned $3.6 million of 4-Wall EBITDA ($93,500, 8.5% margin). The seller had built the business over several decades, but having recently turned 70, he wanted to retire. Since his children had no interest in taking over the business, he decided that an exit, not a generational transfer, was the best option. The broker believed that the 53-store portfolio could be an interesting opportunity for Dubin and Kulp, two young entrepreneurs with the backing of a middle-market private equity firm. After a quick phone call, the broker sent Dubin a packet of information on the assets.

Dubin began to review the materials from the broker and soon discovered that the Atlanta portfolio had several positive attributes. For starters, Atlanta was a large and attractive market (**Exhibit 4**). In addition,

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[§§§] An EV/EBITDA multiple is calculated by dividing a firm's enterprise value by its annual EBITDA.
[****] 4-Wall EBITDA measures the earnings generated by restaurant operations and does not include a charge for Corporate G&A (i.e., shared services overhead). In the QSR industry, Corporate G&A was approximately three percent of gross sales (e.g., for a portfolio of QSR restaurants with a roughly 11-percent 4-Wall EBITDA margin, the Corporate EBITDA margin for that portfolio would be around eight percent).

there appeared to be considerable room for improving operations across the 53-store portfolio. The average Atlanta store generated $1.1 million in revenue and earned a 10.8-percent 4-Wall EBITDA margin (blended across the real-estate-owned stores and leased locations). While revenue was in line with the average for KBP Foods' existing operations, the 4-Wall EBITDA margin across the portfolio was more than two percentage points lower (10.8% versus 13.0%). When Dubin divided the Atlanta assets into five categories to better understand the composition of the portfolio, he thought there was a good mix of stores, including many where KBP Foods could drive better results (**Exhibit 5**). Best of Breed stores were extremely well run and generated high levels of revenue and profitability. Solid Performers were assets that performed reasonably well already yet still had some upside potential. Underachievers were restaurants that struggled under existing ownership but offered a highly skilled operator the chance to drive profitability substantially higher. High Renters were leased locations with reasonably good operations but above-market rent. And Troublemakers were stores that did not generate sufficient revenues to be profitable.

In addition, there appeared to be ways to create value through financial engineering. Fifteen of the 53 stores in the portfolio were real-estate-owned locations, meaning that KBP Foods could help finance an acquisition with a sale-leaseback transaction (**Exhibit 6**). Selling off the portfolio's real estate and leasing it back would take advantage of the fact that real estate cash flows (i.e., rent payments) were less risky than cash flows produced by an operating business (e.g., a quick-service restaurant). The difference in risk profiles meant that real estate cash flows commanded higher valuations than operating cash flows. A sale-leaseback transaction would reduce operating cash flows by the amount of incremental rent expense paid to a third-party landlord. Lower operating cash flows, in turn, would decrease the value of the portfolio's restaurant operations. However, due to the valuation spread, this decrease would be more than offset by the value created by selling off the real estate that would generate that incremental rent expense. In sum, paying rent to a third-party landlord was worth more to KBP Foods than paying no rent at all at its real-estate-owned locations.

According to Dubin's preliminary calculations, the incremental rent expense would be $1,320,000, assuming a rent factor of eight percent of gross sales (which was typical in the QSR industry). Adjusting the profit and loss statement for incremental rent expense would result in the 4-Wall EBITDA margin declining from 10.8 percent to 8.5 percent (**Exhibit 7**). Using a capitalization rate[††††] of seven percent, Dubin computed that the Atlanta real estate was worth roughly $19 million (**Exhibit 8**).

Dubin further estimated that, based on valuations paid for similar assets that had traded recently in the market, a fair price for the restaurant operations was about $19 million, an enterprise value that was 6.0x Corporate EBITDA of $3.2 million (**Exhibit 8**). A sale-leaseback transaction would reduce the cash required for the acquisition of the 53-store portfolio from roughly $38 million to approximately $19 million. If KBP Foods could finance a deal with three dollars of debt for every dollar of equity, it would need just $4.8 million of equity, as opposed to $9.5 million without a sale-leaseback transaction (**Exhibit 9**). In effect, by completing a sale-leaseback, KBP Food would invest less equity capital overall and, in the process, would concentrate its investment in operating activities that generated higher returns than owning real estate.

Last but not least, portfolios of more than 100 restaurants that had changed hands over the past year had commanded multiples of 7.0x Corporate EBITDA. By purchasing the Atlanta assets, KBP Foods would, in

[††††] Capitalization rate (or cap rate for short) is commonly used in real estate and refers to the rate of return on a property based on the net operating income (NOI) that the property generates. In other words, capitalization rate is a return metric that is used to determine the potential return on investment or payback of capital. The formula for cap rate is equal to net operating income (NOI) divided by the current market value of the asset. For example, if a real estate property has a NOI of $100,000 and is valued at $800,000 the cap rate is 12.5 percent. See Capitalization Rate - Overview, Example, How to Calculate Cap Rate (corporatefinanceinstitute.com).

one fell swoop, reach the scale necessary to take advantage of a sizable multiple arbitrage opportunity much sooner than had been expected in the original business plan.

There was a lot to like about the Atlanta opportunity, but Dubin had some concerns as well. First, he and Kulp had purchased KBP Foods itself a little more than six months before. The duo was still getting their legs under them and had not expected to complete any deal so soon. Second, Dubin and Kulp had sold their private equity backers on the vision of a steady pace of modestly sized acquisitions that would take KBP Foods' store count from 64 to 130 over five years. Yet now they found themselves contemplating a transformational deal that would get them most of the way there less than a year into their programmatic acquisition journey.

Third, there was the issue of geography. Dubin was open to geographic expansion, but he had planned to focus on targets that would allow KBP Foods to get an initial foothold in new markets not far from its existing business. The company would then add to its store base as it became comfortable operating. The Atlanta deal clearly did not fit the bill in that regard. The city itself was approximately 450 miles from Tampa, Florida, and nearly 800 miles from KBP Foods' nearest restaurants in the Midwest (**Exhibit 10**). In addition, 53 stores hardly qualified as an initial foothold. The entire Atlanta market had 93 KFC locations, so if it moved ahead with the deal, KBP Foods would immediately take control of more than half of the total store count in a territory in which it had never operated before.

Fourth, Dubin was unsure how capital expenditures would impact KBP Foods' expected return. The Atlanta stores were in reasonably good shape, but all 53 of them would have to be remodeled between Years 3 and 5. It cost $350,000 to remodel a store at the time, and cost inflation was running at two percent per year. Taken together, this meant that KBP Foods would have to invest a considerable amount of capital into the acquired store base in the not-too-distant future. Dubin was not sure whether he should think about remodeling costs as a capital expenditure, operating expense, or deferred purchase price.

To collect his thoughts and better understand the drivers of economic value, Dubin built a financial model for the Atlanta opportunity (**Exhibit 11** and **spreadsheet supplement**). In his financial model, he assumed that KBP Foods would engage in a sale-leaseback transaction of the portfolio's real estate immediately after the acquisition closed. In addition, he constructed the spreadsheet in such a way that he could estimate the sensitivity of expected return to different assumptions around deal financing, growth, profitability improvement, capital expenditures, and exit multiple. But this effort was no mere intellectual exercise. Other franchisees were putting together rival bids for the Atlanta portfolio, so Dubin had to perform his analysis and reach a conclusion quickly. KBP Foods could always pass on the deal and instead pursue its initial strategy. For his part, Dubin believed that he could source five promising targets in the four- to eight-store range per year for each of the next five years and that KBP Foods had ample capacity to complete and integrate one such acquisition annually. But he also knew that an opportunity like the Atlanta portfolio was unique and might be worth pursuing, even though it did not conform to his and Kulp's original business plan for the company.

Conclusion

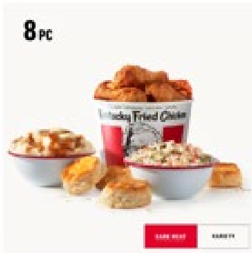
Back in the KFC parking lot near the airport in Atlanta, Barry Dubin sat in his rental car. He reached for his briefcase on the floor in front of the passenger's seat and took out a file folder. He began to thumb through some new documents about the 53-store portfolio that the broker had sent him early that morning. He came upon a page describing the restaurant that stood before him now. He looked up from the photograph on the sheet and at the store now before him, in all its glory. His mind once again ran through all the positives and negatives about this potential acquisition. The time to make a decision was rapidly approaching. Should KBP Foods go ahead with the transformational Atlanta deal, or should it take a more gradual approach to programmatic acquisition, as it had originally intended?

Exhibit 1: Illustrative Return-on-Investment-Capital (ROIC) Analysis for a QSR Restaurant

	Low	High
Real Property	$0.87M	$0.99M
Building & Site Costs	$0.74M	$0.84M
Equipment, Signage, Décor, etc.	$0.38M	$0.43M
Other	$0.21M	$0.24M
Total Expenditure	$2.20M	$2.50M
Revenue	$1.20M	$1.20M
Rent Factor	8.0%	8.0%
Implied Rent	$0.10M	$0.10M
Cap Rate	7.0%	7.0%
Value of Real Estate	$1.37M	$1.37M
Total Expenditure	$2.20M	$2.50M
Less: Value of Real Estate	-$1.37M	-$1.37M
Cash Investment	$0.83M	$1.13M
4-Wall EBITDA Margin	13.5%	13.5%
4-Wall EBITDA	$0.16M	$0.16M
Corporate Overhead as % of Revenue	3.0%	3.0%
Corporate Overhead	$0.04M	$0.04M
Corporate EBITDA	$0.13M	$0.13M
Unlevered FCF Conversion	85%	85%
Unlevered FCF (pre-tax)	$0.11M	$0.11M
Corporate EBITDA/Cash Investment (pre-tax)	19.6%	14.4%
Unlevered FCF/Cash Investment (pre-tax)	**12.9%**	**9.5%**
Payback (EBITDA)	5.1 yrs	7.0 yrs
Payback (FCF)	7.7 yrs	10.5 yrs
Debt/Capital Ratio	75%	75%
Equity/Capital Ratio	25%	25%
Debt	$0.62M	$0.85M
Equity	$0.21M	$0.28M
Cash Investment	$0.83M	$1.13M
Interest Rate	5.0%	5.0%
Interest Expense	$0.03M	$0.04M
Unlevered FCF (pre-tax)	$0.11M	$0.11M
Less: Interest Expense	$0.03M	$0.04M
Levered FCF (pre-tax)	$0.08M	$0.06M
Levered ROIC (pre-tax)	**36.7%**	**23.0%**

Source: QSR Franchise Disclosure Documents, case authors' analysis

Exhibit 2: Sample Items from the KFC Menu



8 pc. Meal

10 Piece Feast

12 pc. Meal

12 pc. Meal

12 pc. Chicken Bucket

12 pc. Chicken Bucket

KFC Chicken Sandwich Combo

KFC Chicken Sandwich Box

KFC Chicken Sandwich

3 pc. Tenders Fill Up

3 pc. Tenders Combo

4 pc. Tenders Combo

Mashed Potatoes & Gravy

Mac & Cheese

Cole Slaw

Source: KFC

Exhibit 3: Financial Summary of the 53-Store Atlanta Portfolio

Store Count	
Leased Locations	38
Real-Estate-Owned (REO) Locations	15
Total Stores	53

P&L	Leased	REO	Total	With Extra Rent	% Margin
Revenue	**$41,800,000**	**$16,500,000**	**$58,300,000**	**$58,300,000**	**100.0%**
Food	-$13,167,000	-$5,197,500	-$18,364,500	-$18,364,500	-31.5%
Labor	-$11,704,000	-$4,620,000	-$16,324,000	-$16,324,000	-28.0%
"Big Two" Expenses	-$24,871,000	-$9,817,500	-$34,688,500	-$34,688,500	-59.5%
Gross Profit	**$16,929,000**	**$6,682,500**	**$23,611,500**	**$23,611,500**	**40.5%**
Variable Opex	-$5,852,000	-$2,310,000	-$8,162,000	-$8,162,000	-14.0%
Fixed Opex	-$4,180,000	-$1,650,000	-$5,830,000	-$5,830,000	-10.0%
4-Wall EBITDAR	**$6,897,000**	**$2,722,500**	**$9,619,500**	**$9,619,500**	**16.5%**
Rent	-$3,344,000	$0	-$3,344,000	-$4,664,000	-8.0%
4-Wall EBITDA	**$3,553,000**	**$2,722,500**	**$6,275,500**	**$4,955,500**	**8.5%**

Average Store	Leased	REO	Total	With Extra Rent
Revenue/AUV	$1,100,000	$1,100,000	$1,100,000	$1,100,000
Food	-$346,500	-$346,500	-$346,500	-$346,500
Labor	-$308,000	-$308,000	-$308,000	-$308,000
"Big Two" Expenses	-$654,500	-$654,500	-$654,500	-$654,500
Gross Profit	$445,500	$445,500	$445,500	$445,500
Variable Opex	-$154,000	-$154,000	-$154,000	-$154,000
Fixed Opex	-$110,000	-$110,000	-$110,000	-$110,000
EBITDAR	$181,500	$181,500	$181,500	$181,500
Rent	-$88,000	$0	-$63,094	-$88,000
4-Wall EBITDA	$93,500	$181,500	$118,406	$93,500

Note: "With Extra Rent" includes implied incremental rent for the 15 real-estate-owned (REO) locations.

Source: Case authors' analysis

Exhibit 4: Demographic Snapshot of Atlanta

Population	
Atlanta, GA	420K
Metro Atlanta	5.3M
National Population Ranking	
Atlanta, GA	#38
Metro Atlanta	#9
Population Growth: Trailing 10-Year CAGR	
Atlanta, GA	0.1%
Metro Atlanta	2.2%
Median Household Income	
Atlanta, GA	$62K
Georgia	$55K
United States	$59K
Racial Mix (Atlanta, GA)	
Black	54%
Non-Hispanic White	33%
Hispanic or Latino	5%
Asian	3%
Other	4%
Age (Atlanta, GA)	
Median Age	32.9 Yrs
% of Population Under 18	19%
% of Population Between 20 and 39	38%
% of Population Over 65	10%
Household Mix (Atlanta, GA)	
With Children Under 18	23%
Without Children Under 18	20%
Family	43%
Non-Family	57%

Source: US Census Bureau

Exhibit 5: Unit Economics of Atlanta Stores by Category

	Best of Breed	Solid Performers	Underachievers	High Renters	Troublemakers	Average Store
P&L ($/Store)						
Revenue/AUV	$1,350,000	$1,150,000	$1,050,000	$1,150,000	$950,000	$1,100,000
Food	-$405,000	-$356,500	-$336,000	-$356,500	-$332,500	-$346,500
Labor	-$351,000	-$316,250	-$315,000	-$316,250	-$313,500	-$308,000
"Big Two" Expenses	-$756,000	-$672,750	-$651,000	-$672,750	-$646,000	-$654,500
Gross Profit	$594,000	$477,250	$399,000	$477,250	$304,000	$445,500
Variable Opex	-$168,750	-$161,000	-$168,000	-$161,000	-$218,500	-$154,000
Fixed Opex	-$135,000	-$115,000	-$105,000	-$115,000	-$95,000	-$110,000
4-Wall EBITDAR	$290,250	$201,250	$126,000	$201,250	-$9,500	$181,500
Rent	-$90,000	-$85,000	-$85,000	-$105,000	-$80,000	-$88,000
4-Wall EBITDA	$200,250	$116,250	$41,000	$96,250	-$89,500	$93,500
% Margin						
Food	30.0%	31.0%	32.0%	31.0%	35.0%	31.5%
Labor	26.0%	27.5%	30.0%	27.5%	33.0%	28.0%
"Big Two" Expenses	56.0%	58.5%	62.0%	58.5%	68.0%	59.5%
Gross Profit	**44.0%**	**41.5%**	**38.0%**	**41.5%**	**32.0%**	**40.5%**
Variable Opex	12.5%	14.0%	16.0%	14.0%	23.0%	14.0%
Fixed Opex	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
4-Wall EBITDAR	**21.5%**	**17.5%**	**12.0%**	**17.5%**	**-1.0%**	**16.5%**
Rent	6.7%	7.4%	8.1%	9.1%	8.4%	8.0%
4-Wall EBITDA	**14.8%**	**10.1%**	**3.9%**	**8.4%**	**-9.4%**	**8.5%**

Notes:

"Best of Breed": Extremely well-run stores
"Solid Performers": Stores with decent performance but some room for improvement
"Underachievers": Stores with significant potential to improve profitability
"High Renters": Stores with decent operations but an unfavorable lease
"Trouble-makers": Stores that aren't generating sufficient revenue to be profitable
"Average Store": Average store among the 53 stores for sale in Atlanta (after adjusting for implied incremental rent at REO locations)
AUV: Average unit volume (the industry term for revenue per store)
"Big Two" Expenses: The industry term for the sum of food and labor costs (i.e., Cost of Goods Sold)
Variable Opex: Operating overhead (e.g., utilities, cleaning and waste removal, bathroom supplies, etc.)
Fixed Opex: The amount of store revenues shared with the franchisor (the sum of royalties and market contributions)
4-Wall EBITDAR: Store-level earnings before interest, taxes, depreciation, amortization, and rent
4-Wall EBITDA: Store-level earnings before interest, taxes, depreciation, and amortization

Source: Case authors' analysis

Exhibit 6: Sale-Leaseback Transaction Analysis

Sale-Leaseback Transaction Summary	
# of Real-Estate-Owned (REO) Locations	15
Revenue Per Store	$1,100,000
Total Sales at REO Locations	$16,500,000
Rent Factor as % of Sales	8.0%
Implied Rent Expense	$1,320,000
Cap Rate	7.0%
Total Value of Real Estate	$18,857,143

Source: Case authors' analysis

Exhibit 7: P&L Impact of Sale-Leaseback Transaction

	53 Stores Without SLB			53 Stores With SLB	
	$	**% Margin**		**$**	**% Margin**
Revenue	$58,300,000	100.0%		$58,300,000	100.0%
4-Wall EBITDAR	$9,619,500	16.5%		$9,619,500	16.5%
Rent Expense	**-$3,344,000**	**-5.7%**	→	**-$4,664,000**	**-8.0%**
4-Wall EBITDA	**$6,275,500**	**10.8%**		**$4,955,500**	**8.5%**
Store Count					
Leased Locations	38			53	
Real-Estate-Owned Locations	**15**			**0**	
Total Stores	53			53	

Source: Case authors' analysis

Exhibit 8: Valuation Analysis for the 53-Store Portfolio

Assumed Deal Math		Notes
Revenue	$58,300,000	- $1.1M of revenue/store for 53 stores
4-Wall EBITDAR	$9,619,500	-16.5% 4-Wall EBITDAR margin
Rent Expense (38 Leased Stores)	-$3,344,000	- $88K per leased store
Incremental Rent Expense (15 Owned Stores)	-$1,320,000	- Assumes 8.0% rent factor
Adjusted Rent Expense	-$4,664,000	- Normalized for 15 owned stores
4-Wall EBITDA	$4,955,500	- Also known as Store-Level EBITDA
Corporate G&A	-$1,749,000	- Assumes Corporate G&A margin of 3.0%
Corporate EBITDA	$3,206,500	
Corporate EBITDA	$3,206,500	
EV/Corporate EBITDA	6.0x	
Enterprise Value of Restaurant Operations	**$19,239,000**	
Incremental Rent Expense (15 Owned Stores)	$1,320,000	
Cap Rate	7.0%	
Value of Real Estate	**$18,857,143**	
Enterprise Value of Restaurant Operations	$19,239,000	
Value of Real Estate	$18,857,143	
Valuation of the 53-Store Portfolio	**$38,096,143**	

Source: Case authors' analysis

Exhibit 9: Transaction Financing Analysis

	Without SLB	With SLB	Delta	Notes
Valuation of the 53-Store Portfolio	$38,096,143	$38,096,143	$0	
Less: Proceeds from Sale-Leaseback	$0	-$18,857,143	-$18,857,143	
Cash Required	**$38,096,143**	**$19,239,000**	**-$18,857,143**	**- SLB reduces cash required**
% of Cash Required Financed with Debt	75%	75%	0%	- Assume same leverage
Cash Required	$38,096,143	$19,239,000	-$18,857,143	
Less: Debt	-$28,572,107	-$14,429,250	$14,142,857	- Less debt used
Equity	**$9,524,036**	**$4,809,750**	**-$4,714,286**	**- Less equity used**

Source: Case authors' analysis

Exhibit 10: Map of KBP Foods' Operating Footprint

Source: Case authors' analysis

Exhibit 11: Returns Model

Assumption Key:				Output Key:	
"Base" Business EBITDA (Inclusive of Incremental Rent)	$3,206,500	Minimum Cash Balance	$0	Year 10 IRR	
"Base" Purchase Multiple	6.0x	Normalized Same Store Sales % Growth	1.5%	Year 10 Equity	
Enterprise Value of Restaurant Operations	$19,239,000	1-Year Revenue Lift from Remodeling	10.0%	Year 10 MOIC	
Value of Real Estate / Proceeds from Sale-Leaseback	$18,857,143	Free Cash Flow % (before Interest)	75%		
Valuation of Atlanta Portfolio	$38,096,143	Remodeling Capex Per Store	$350,000		
Cash Required After SLB	$19,239,000	Maintenance Capex Per Store	$25,000		
Acquisition Debt/Capital Ratio	75%	Capex Cost Inflation	2.0%		
Starting Gross Debt	$14,429,250	Target Food Margin	30.0%		
Initial Equity Invested	$4,809,750	Target Labor Margin	27.0%		
Rent Factor	8.0%	Target Variable Opex Margin	12.0%		
Cap Rate	7.0%	Target Fixed Opex Margin	10.0%		
Exit Multiple	7.0x	Total Rent Margin	8.0%		
Interest %	5.0%	Corporate G&A Margin	3.0%		

Year	0	1	2	3	4	5	6	7	8	9	10
BOP EBITDA		$3,206,500	$3,813,403	$4,437,398	$5,078,862	$5,832,819	$6,694,200	$7,034,164	$7,280,298	$7,477,074	$7,648,356
EBITDA Growth		$606,903	$623,995	$641,463	$753,958	$861,380	$339,965	$246,134	$196,776	$171,282	$158,597
Acquired EBITDA	$3,206,500	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
EOP EBITDA	$3,206,500	$3,813,403	$4,437,398	$5,078,862	$5,832,819	$6,694,200	$7,034,164	$7,280,298	$7,477,074	$7,648,356	$7,806,953
Free Cash Flow Before Interest		$2,860,052	$3,328,049	$3,809,146	$4,374,614	$5,020,650	$5,275,623	$5,460,223	$5,607,806	$5,736,267	$5,855,214
BOP Gross Debt		$14,429,250	$14,429,250	$14,429,250	$14,429,250	$14,429,250	$14,983,610	$14,983,610	$14,983,610	$14,983,610	$14,983,610
Debt Increase/(Decrease)		$0	$0	$0	$0	$554,360	$0	$0	$0	$0	$0
EOP Gross Debt	$14,429,250	$14,429,250	$14,429,250	$14,429,250	$14,429,250	$14,983,610	$14,983,610	$14,983,610	$14,983,610	$14,983,610	$14,983,610
BOP Cash		$0	$828,516	$2,164,812	$921,066	$114,932	$0	$3,193,976	$6,718,959	$10,552,774	$14,690,908
Cash Inflow from Debt Issuance		$0	$0	$0	$0	$554,360	$0	$0	$0	$0	$0
Free Cash Flow Before Interest		$2,860,052	$3,328,049	$3,809,146	$4,374,614	$5,020,650	$5,275,623	$5,460,223	$5,607,806	$5,736,267	$5,855,214
Less Remodeling Capex		$0	$0	($2,971,382)	($3,030,810)	($3,477,855)	$0	$0	$0	$0	$0
Less Maintenance Capex		($1,351,500)	($1,378,530)	($1,406,101)	($1,434,223)	($1,462,907)	($1,492,165)	($1,522,009)	($1,552,449)	($1,583,498)	($1,615,168)
Less Interest		($680,037)	($613,222)	($675,409)	($715,716)	($749,181)	($589,482)	($413,233)	($221,542)	($14,635)	$0
EOP Cash	$0	$828,516	$2,164,812	$921,066	$114,932	$0	$3,193,976	$6,718,959	$10,552,774	$14,690,908	$18,930,954
BOP Net Debt/(Cash)		$14,429,250	$13,600,734	$12,264,438	$13,508,184	$14,314,318	$14,983,610	$11,789,634	$8,264,652	$4,430,837	$292,703
EOP Net Debt/(Cash)	$14,429,250	$13,600,734	$12,264,438	$13,508,184	$14,314,318	$14,983,610	$11,789,634	$8,264,652	$4,430,837	$292,703	($3,947,344)
Net Debt : EBITDA	4.5x	3.6x	2.8x	2.7x	2.5x	2.2x	1.7x	1.1x	0.6x	0.0x	NA
FCF : Interest		4.2x	5.4x	5.6x	6.1x	6.7x	8.9x	13.2x	25.3x	392.0x	NA
Exit Multiple											7.0x
Valuation of Atlanta Portfolio	$38,096,143										$54,648,669
Less: SLB Proceeds	($18,857,143)										$0
Enterprise Value of Restaurant Operations	$19,239,000										$54,648,669
Less EOP Net Debt	($14,429,250)										$3,947,344
Equity Value	$4,809,750										$58,596,013

Note: This analysis collapses the acquisition of the 53-store portfolio and the sale-leaseback of 15 real-estate-owned stores into a single transaction completed in Period 0.

Source: Case authors' analysis

Endnotes

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