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Fast-Food Franchisees Bulking Up

Article

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Weaker sales following the recession are prompting many big fast-food chains to adopt leaner business models by unloading company-owned outlets to franchisees.

The latest example is Burger King Holdings Inc., which is in the midst of a turnaround and counting on a bigger appetite for restaurant ownership among people like Vince Eupierre of Corona, Calif.

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Associated Press

Burger King restaurants, such as this one in Miami, have revamped their menu as part of the company's turnaround effort. The chain is unloading many company-owned outlets to franchisees.

Mr. Eupierre, a 71-year-old immigrant from Cuba, bought his first Burger King franchise in the late 1970s, after working nights as a Burger King assistant store manager. Today, he owns 34 Burger King franchises in Southern California employing 2,500 workers, including part-timers.

His sales are down by about 25% from three years ago, and he recently spent $1.3 million to comply with the chain's revamped menu, on items like smoothie stations and new freezers.

"If you ask me, 'Will you buy another store today?' I'd say, let's wait a little bit and see what happens in the next 60 to 90 days," he says.

In the industry, it is known as refranchising, and the strategy is based on the idea that franchisees will tend to run a tighter ship than a company-owned operation.

Since 2007, McDonald's has reduced its share of company-run restaurants to 19% from 23%, today operating 6,435 of its 33,510 restaurants world-wide, according to company data.

"It's making the company more profitable," says Richard Adams, a former McDonald's Corp. executive who runs a San Diego-based consulting company for McDonald's franchisees.

"The franchisee has more skin in the game," says William Ackman, a hedge-fund founder who is soon to be one of Burger King's newest investors through his fund's interest in Justice Holdings Ltd., a U.K.-listed investment vehicle. "He's going to put his heart and soul into it."

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But Robert Zarco, a Miami-based franchise attorney, says unloading most or all company-owned locations to franchisees could signal that the franchiser lacks "confidence in its own brand."

Roughly 92% of Burger King's units already are franchised, a figure that takes into account one large refranchising deal completed last month. The Miami-based fast-food company slipped to third place last year in U.S. sales among burger giants, behind No. 1 McDonald's and second-place Wendy's Co.

Now, Burger King plans to have almost all of its 7,200 units in the U.S., and more than 12,500 units globally, franchised by early 2013.

"Refranchising has been a highly successful strategy for us," says Virginia Ferguson, a spokeswoman for Yum! Brands Inc., Louisville, Ky., which currently operates less than a quarter of all its restaurants world-wide. The parent to more than 37,000 Pizza Hut, KFC and Taco Bell restaurants last year sold 404 of its company-operated locations in the U.S., including 264 KFC, 74 Taco Bell and 66 Pizza Hut outlets, company data show.

In doing so, it reduced its ownership of U.S. restaurants to 13% from 15% in 2010. It plans to further shed its ownership of KFC and Pizza Hut outlets to just 5% by the end of the year, and Taco Bell to 16% within two years, she said.

Between 2009 and 2011, Jamba Inc., owner of Jamba Juice Co., sold 174 stores to existing or new Jamba franchisees. About 40% of its 769 stores are company-owned today, down from 70% before the refranchising.

"We wanted to expand the brand presence quicker and de-risk the business model," says Karen Luey, chief financial officer of the Emeryville, Calif.-based beverage chain. "We wouldn't be able to do that with company-owned stores because it's a capital-intensive process."

Jack in the Box Inc., a San Diego company that owns Qdoba and Jack in the Box brands, is actively looking for franchisees to buy 17 corporate-run stores in Indianapolis, Kansas City, Oklahoma City and Tulsa, according to company spokesman Brian Luscomb.

All the locations are relatively new, he adds, and are part of the company's broader strategy of testing markets with company-owned restaurants and then selling to franchisees.

Today, 72% of the company's 2,221 locations are franchised, up from only 22% of its 2,006 restaurants in 2004. It hopes to sell another 80 to 120 by the end of this year, he adds.

"Wall Street security analysts think dollar-to-dollar royalty cash flows are more valuable than restaurant operating cash flows," says Kevin T. Burke, managing director of Trinity Capital LLC in Los Angeles.

Burger King was taken private in 2010 by 3G Capital, a New York-based investment firm, and will soon become publicly traded through a merger with a shell company.

John Gordon, a restaurant analyst in San Diego, believes that the company-owned Burger King restaurants expected to go on sale in the coming months are likely to be poor investments.

"The problem is that the unit economics are so bad," he says. "Because of bad store management over the past 40 or 50 years, you got all these beat-up stores."

Mr. Ackman, the hedge-fund founder, disagrees with that assessment. "Yes, there are stores that need to be upgraded. But it's a good investment," he says.

Last month, Burger King announced that Carrols Restaurant Group Inc. of Syracuse, N.Y., will acquire 278 of its company-owned restaurants for approximately $15.8 million, or about $56,800 per unit. The deal—which will make Carrols the system's largest franchisee world-wide with a total of 575 locations—includes a commitment by Carrols to renovate 450 of the stores over the next 3½ years. Burger King agreed to purchase a 28.9% equity stake in Carrols.

Steve Wiborg, president for Burger King's North America operations, says the Carrols deal isn't representative of the typical transaction. He declined to comment on prices for the remaining company-owned Burger King restaurants up for sale.

According to Mr. Gordon, the cost of a single Burger King restaurant generally ranges from $600,000 to $800,000.

Mr. Wiborg said forthcoming sales of company-owned Burger King restaurants will likely include transactions involving just two or three units and that some may require remodeling. He added that the cost of remodeling a Burger King restaurant to current standards ranges from $275,000 to $375,000, depending on the size.

—Emily Maltby contributed to this article.

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