

Improvements in Restaurant Financial Reporting Needed

by: John A. Gordon, Principal

Via its sale of company units last month, Dine Equity (DIN) is now almost 100% franchised: 95% at Applebee's and nearly 100% at IHOP. Other chain restaurants are close: Domino's (DPZ) is very close, with about 95% franchised, worldwide. And more and more companies, especially in the QSR sector, are refranchising, increasing the number and scope of the franchising business. And all that franchisee business activity is off the books.

Other than the royalties and fees paid by the franchisees, and supply chain profits (in the case of Domino's and a few others with captive supply chains), none of the franchisee financial results is reported by the publicly traded companies. So the franchisee level health is not reported. Some analysts may ask but are always given general responses.

The company and franchisees are separate legal entities after all, and many but not all companies do report franchisee same store sales data: Brinker (EAT) started doing so this year, and Papa John's (PZZA) has such displays, for example. But not all do. And almost no one, save McDonald's (MCD) in one of its Investor Day presentations, directly proactively presents franchisee profit or cash flow. For most publicly traded restaurants, a spike in bad debt (unpaid royalties) or net opens/closes is about the only way to divine franchisee and overall system health.

We suggest this lack of visibility is unhealthy for investors, franchisors, franchisees, lenders and the markets, overall. Some lenders have already taken the industry to task for such unclear disclosure, and situations of imminent system or brand decline and collapse can be muted.

For example, the deteriorating state of the Arby's operation throughout 2009 to its being placed for sale in January 2011 could not be divined other than guesses via the number of closures or bad debt expense. Investors and the market would have been interested.

We propose a better way: once companies hit a tip point, such as 80% of units franchised, a voluntary minimum annual disclosure of franchisee average weekly net sales (not gross sales), and store level EBITDA, excluding franchisee G&A, dividends, debt service and other "below the store line" influences, be made. This could be via the annual investor's presentations almost all companies compose, or via the SEC 10K/10Q reporting cycle.

We are not proposing reporting franchisee personal shareholder returns or owner's salaries or any of that. Just the store level data.

It would provide for more visibility for investors, and demystify the process, for lenders and potential franchisees, at the very least.

PACIFIC MANAGEMENT CONSULTING GROUP

chain restaurant analysis and advisory

Every franchisor is vitally interested in getting its royalties paid, and the sales data and a mechanism to audit it, now exists. For companies audited, we bet that their auditors do a representative sample of franchisee sales, now.

Likewise, regarding store level EBITDA, every bank or lender is vitally interested in EBITDA, and franchisors have or should have visibility to that metric since (1) the franchise agreement may specify be reported (2) franchisors typically must approve sales and transfers, and thus have that visibility.

This could be reported in the management discussion and analysis section of the 10K (or, if it takes time to accumulate year end data, the Q1 10Q next quarter). With the last update of the SEC MD&A disclosure rules in 2003, unit sales and other statistical measurements can be reported simply.

SEC Rules: the 2003 update to SEC Regulation G made clear the basic standard that a reporting company shall not make public a non-GAAP measure, that taken with the information accompanying the measure, and any accompanying measure, contain an untrue statement of a material fact, or omits to state a fact necessary in order to make the presentation, not misleading. That is all controllable by the discloser.

We'd suggest the company present two single values, average weekly net sales (weekly gets us out of the 52 v. 53 week problem), and store level EBITDA (as a percentage of net sales), for current year and prior 2 years, and /or it could tier display the data in a simple quadrants (top fifth, second fifth, so forth) view (which we think might be more useful). If less than 100% of data was available, the percentage polled could be noted.

These two metrics are among the most fundamental indicators to restaurant economic vitality.

Other non-public 100% franchised companies like Dairy Queen (99% franchised) and Subway (100% franchised) can take the same clue.

This is a voluntary disclosure, a best practices proposal. While everything takes time and effort, it works to solve problems and give visibility to important data that the industry already has, or should have.

John A. Gordon
Pacific Management Consulting Group
chain restaurant analysis and advisory
www.pacificmanagementconsultinggroup.com