



Selling the Sizzle

Positioning Your Retail, Food or Hospitality Business For Sale

By Lou Katz, Esq.

A profitable company with growing sales is essential to selling a retail, food and hospitality (“RF&H”) business. However, the realization of the value for a RF&H business does not begin and end with average store unit sales. Rather, careful planning of your business during operation often leads to an increase in the enterprise value of the company upon the sale of the business.

Location, Location, Location

Selecting good sites appropriate for the products being sold and negotiating good leases at each location is essential to the value of the RF&H business. The key lease components which affect the company’s enterprise value are as follows:

- Length of term – A lease with a modest fixed term (i.e., five years) and many extension options should be the goal of any lease negotiation. Flexibility in the period of occupancy, with opportunities to remain at the premises for a great length of time if the location is successful, is essential to success. Unlike other businesses, a successful RF&H business cannot easily move locations. On the other hand, the ability to shed a non-performing location may also result in less of a purchase price penalty as the buyer will not have to assume a long-term underperforming unit.
- Option terms at fair market value are usually not good for the tenant – A lease which allows the tenant to only exercise its option at “fair market value” at the time of election will result in turning a tenant’s extension option into a landlord’s “put” right. Usually, the landlord controls most of the process in determining fair market value, the tenant is required to exercise this option when the rent is still unknown and the tenant also loses control of the predictability of its rent for purposes of projections required for operating and ultimately selling its business.
- Assignment clause and landlord recapture provisions – Care should also be taken when negotiating assignment clauses in RF&H leases. A provision which gives the landlord full discretion or too much control in approving an assignee may result in many otherwise qualified potential buyers being eliminated. By limiting the pool of buyers, the landlord impacts the seller’s valuation as competitive bidding will be stifled or eliminated.

Additionally, a right of the landlord to recapture a tenant’s space upon the sale of the business, can be outright deadly to the seller’s valuation. Many buyers will not bid if they know the landlord can cancel their bid by recapturing the space. Even if bidding is achieved, the landlord can wipe out the entire bid by exercising its right to recapture the premises. Accordingly, these provisions, in any form, including recapture provisions upon landlord’s major renovations of its shopping center or other building, should be eliminated at all costs.

What a Tangled Web We Weave ...

The temptation still exists for many RF&H businesses to underreport income in a fool-hearted attempt to reduce income taxes. Unfortunately, you cannot have it both ways. Revenues you report to the Internal Revenue Service are the same revenues your buyer is going to look at. As many companies are sold on a multiple of earnings or revenues basis, underreporting income will result in lower amounts paid for the company being sold. Often times, the loss in enterprise value exceeds the tax gain generated by the underreported income.

Many sellers are naive in thinking that they can explain away the underreported income. However, imagine the suspicion of the conservative buyer who you are expecting will trust you when you try to explain to him or her your questionable tax practices. Also, many sellers do not realize that the mere discussion of the underreported income may disqualify the company's accountant or investment banker from being involved in the due diligence process essential to the sale of the company. In fact, the information disclosed on a so-called "confidential basis" will result in repeated disclosure of the underreported sales as the same must be explained to the buyer's lenders, investors and other interested parties. Before too long, the seller's little secret may become common knowledge, including the knowledge of people not necessarily friendly to the seller, including the IRS.

Protect the Intangibles

In the crowded field of RF&H businesses, trade names, logos and marks are essential to differentiating your business from your competitors. A fanciful, unique name or logo properly registered and protected is essential to the value of the RF&H company. The time to research and register a tradename or logo, is before opening the first location, not after the RF&H business is successful. If the name is not available, find another name rather than opening the business and becoming successful only to have a senior name user make you change the name or pay an unreasonable royalty or license fee for the use of the name.

A common trap for the unwary is to think that a prior registrant of a name will not affect your company's use of a name or similar name because you are in a different geographic location. A buyer of a business with a broader geographic scope will want unbridled use of the name in every territory. As the buyer looks to expand the RF&H concept into other markets, the chance of likelihood of confusion with the senior name holder increases. Any costs associated with acquiring the name from the senior user will ultimately be paid from a decrease in the seller's purchase price or a lost opportunity for sale if the senior user digs in its heels and won't sell or license use of the name.

It's the Employees ...

The value of an RF&H company is also often impacted by its relationship with its employees. Knowledgeable business buyers do not want to inherit companies with substantial employee morale problems, long-term employment commitments or substantial unfunded employment benefits. Most employees (other than very essential senior management) should be employee's at will which allows both the buyer and the employee to terminate the employment relationship at any time. To the extent that employees have long-term contractual relations and are not employees at will, a buyer will look to reduce the value of the seller enterprise or require the seller to pay any projected severance obligations which the buyer may inherit from the existing employment arrangements.

Many RF&H businesses are also dependent upon a handful of key non-owner senior management employees. Obviously, the more diversified and interchangeable the management group, the less dependent is the organization and its value on the continued employment of any individual with an acquirer. The key employees should also be subject to standard confidentiality, non-solicitation, and in some cases, non-compete agreements which are assignable to a buyer of the business. As a general rule, these restrictive covenant agreements must be executed upon the initial employment of the key employee and will not be enforceable if required of a non-owner employee on the eve of an acquisition.

Don't Let Your Financing Control Your Sale

Both debt and equity financing arrangements may have a significant impact on the net value received by a selling RF&H company. The most obvious example is in a loan arrangement which requires the borrower to pay prepayment interest, penalties and fees if the loan is repaid early. As many RF&H acquisitions are structured as asset sales, free and clear of any liens and encumbrances, the seller is required to pay off its bank debt as a condition of closing. The sale then triggers the prepayment by the seller to its lender of prepayment fees which are rarely waived by a bank about to lose a good borrower. The time to negotiate the elimination or reduction of prepayment penalties is at the inception of the loan not at the expiration of the relationship.

The effect of equity financing on a company's net enterprise value is often more subtle, but much more impactful. Mandatory sales provisions (also known as "drag-along clauses") in private equity or venture capital financing arrangements can really impact a company's value by forcing a business to be sold in a down market or at another inappropriate time. The RF&H company and its private equity or venture capital partners need to have a meeting of the minds going into the investment on the eventual timing of the sale of the business. If the business operators and equity providers have a different vision of the appropriate conditions and timeframes for selling the business, the result for everyone will generally be a disappointing enterprise value upon a premature sale of the company.

Another provision to try to avoid in negotiating a private equity deal is a mandatory buyout clause running to the benefit of the equity capital provider. This provision can also affect the timing of the sale of the RF&H business as the only option which the operating owners may have is to sell the business to fund the mandatory buyout obligation. In a tight capital market, replacement financing may not be available and the company may need to be sold. Usually when capital is scarce, business valuations are likewise low and the selling company will suffer the consequence of having to sell in such a market. Accordingly, a mandatory buyout provision and other similar terms which penalize the operating owners if the capital providers do not have their interest liquidated by a certain date should be carefully negotiated at the inception of the equity investment.

Conclusion

It's never too early to plan the sale of an RF&H business. Unlike technology start-up companies of the late 1990s which started discussing exit strategies before a dollar of sales were generated, RF&H business owners are often late in planning their business for sale. Careful planning of the key components of a successful RF&H company, including leased and owned locations, revenue reporting, brands, names and logos, employee relationships and financing arrangements, will lead to a higher value for the enterprise when the company is ultimately sold in the open market.

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