Major Changes In The Franchise Sector, Thanks To Remodels

In the spring of 2010, McDonald's quietly began pushing more franchisees to remodel units, providing them with additional incentives to accelerate the chain's effort to rebuild each of its locations. It was a bold move at the time, particularly given its already massive lead over its fast-food competitors.

The QSR sector has been falling all over itself to keep up ever since. Burger King is so eager to remodel its store base quickly that it sold nearly 300 company restaurants to Carrols Restaurant Group at a steep discount to prod its largest franchisee to remodel 450 units. Wendy's is about to ignite its remodel program. For a while KFC was willing to terminate franchisees and shut their stores down if they didn't remodel substandard locations. Arby's, badly in need of a new look, is about to reveal its new look to franchisees.

They join casual diners like TGI Friday's and Applebee's, and others, in the rush to fix up aging locations. All of them see the Golden Arches as the Gold Standard.

McDonald's "put pressure on the whole industry," said Nick Cole, executive vice president and group head of restaurant finance for Wells Fargo. "They came out of this recession and announced a huge remodeling project, not because they do it well, but because McDonald's is a well-run company, a step ahead of their competition. And they have such control in their system, they can move more nimbly on projects like that."

Yet this rush to remodel may well change the franchise sector in the process. Remodels cost money. And while many operators can afford to pay for the new look, smaller, older operators can't. There's already evidence that the remodel push is forcing older franchisees to sell stores because they simply can't afford to pay the cost after years of weak sales. "It does drive more exits," said David Epstein, principal with the Chicago-based investment-banking firm J.H. Chapman.

Brokers we spoke with agree. Patrick Silvia of Advanced Restaurant Sales said that remodel concerns are a key reason (along with health care reform) that this may be the biggest year for franchisee mergers and acquisitions in 10 years.

This affects the sale price that franchisees will get—the cost of the remodel is subtracted from the price the franchisee receives. But unless the operator has cash or lending, they may have no choice, lest they face a shutdown. "Many franchisors will shut you down, if they can, if you don't do your remodels," said Joe Thissen, an agent out of Minneapolis with National Franchise Sales. "So either they sell now for less or they get shut down and get nothing."

This is driving further consolidation in the franchise sector, which has seen plenty of it the past couple of years. With debt cheap and readily available for larger borrowers—and many in systems that simply aren't expanding—bigger franchisees are eagerly snapping up many of these restaurants.

Periodic remodels are an important part of the restaurant business—young people in particular will avoid older, outdated restaurants, after all. Burger King, Wendy's, Arby's, Applebee's, TGI Friday's and KFC are all older concepts that need to remain relevant. "Operators consider it a cost of doing business," said Wally Butkus, partner at the industry research firm Restaurant Research. "Every so many years you're going to have to reinvest in your stores, paint them, clean them up. If you don't do it, you lose business to your competitors. It's a necessity."

Still, the major renovations many of these chains need, including scrape-and-rebuilds, cost hundreds of thousands of dollars, and the chains' sales losses in recent years has made the investment questionable.

Operators have been quick to question sales projections. We asked lenders whether they require numbers that show remodels generate a sales lift, and none of them said they do—franchisees do that for them. "They want to make darn sure they're getting more return," said Dan Holland, executive vice president at Atlanta-based Cadence Bank. "They're businessmen. They're more skeptical than we are."

The extent to which operators can expect a sales lift from a remodel depends heavily on a number of factors. In general, the bigger the cost of the remodel, the bigger the sales lift. Scrape-and-rebuilds can have a dramatic impact, with an average sales lift of 24.2 percent, according to Butkus.

But there is a substantial drop after that. Major remodeling jobs average a 6.6 percent sales lift. And that's when it becomes questionable whether a remodel job can earn a return.

John Gordon, a restaurant consultant out of San Diego, analyzed a hypothetical, $400,000 remodel of a restaurant making $1.5 million a year in sales. A 7-percent sales lift in that remodel only broke even. "On a traditional scale, a 7-percent AUV gain doesn't work," he said. "It's marginal at best."

Burger King's remodel costs $250,000—the cost was cut in half under 3G Capital, which along with financing and $100,000 in incentives has led many franchisees to start remodeling. Still, Gordon questions whether the remodel will be able to generate the 15-percent sales lift the company says it can. "I very much doubt they can get 15 percent," Gordon said. "I can see single digits."

Wendy's plans cost more. Earlier this month, the Ohio-based chain said it would have three options for a remodel. The top option would cost $650,000 to $700,000, a high cost for a remodel. But they would generate an estimated 25-percent sales lift, or about $350,000 a store in added sales. "Clearly," Gordon said, "that's going to be a winner."

But operators also have lower-tier options that cost $500,000 or $300,000. The company said those options would be expected to generate a sales lift. It just didn't say how much.

— Jonathan Maze