D|A|DAVIDSON
INVESTMENT BANKING

FRANCHISE INDUSTRY TAKEAWAYS

Sharing noteworthy takeaways from our market observations and some of the biggest franchise events to start the year.

Private equity continues its middle market M&A retreat into the franchise industry. Franchise brands remain equally excited to explore additive partnerships that can accelerate growth within their systems. The communal energy has convention halls still buzzing with energy as the industry remains in rarified air, being a priority sector for investors in an otherwise still uncertain M&A environment. But all that buzz isn't without some ringing left in the ears.

Changes in SBA leaving some with not much to say.

Rule changes in SBA funding now require 100% U.S. citizen ownership. Foreign investment can comprise a meaningful portion of the prospective franchisee pool for franchisors. Remains to be seen how much of a chilling effect this will have on the overall franchise development pipeline in the near-term, though the impact is likely to be disproportionate depending upon each franchisor's own development strategy.

Cloudier skies developing for franchisor umbrellas.

Historically private equity has emphasized building multi-brand franchise systems ("umbrellas"), which can leverage a single infrastructure to scale and support multiple franchise brands. It's a strategy with a nice finance sheen, though in practice, that cross-sell sparkle hasn't quite held its luster. Similar to evaluating network performance in a single franchise system, a bell curve emerges where some brands have difficulty graduating from the subscale class or otherwise have overweighted headwinds to navigate, dragging down the shine of their peer brands in the platform. In a platform with mixed results, the valuation implications feel increasingly negative. Seems first institutional capital investors are putting the umbrellas away and basking in the sun of targeting single brand investments, where sheer whitespace alone can underwrite the investment opportunity. As for the umbrella strategy... for the first institutional investors, seems that's a storm not worth bracing for until after the next port of call (i.e. a problem for the next investor buyout).

AI is siphoning leads from franchise broker funnels.

Franchisors are seeing more organic franchisee leads coming from "self-educated" prospects who are leveraging AI to shop franchise opportunities. The volume of brands AI can process has allowed some franchisors to get a "free" namedrop at the broker party they otherwise weren't invited to. It's a boon to candidate lead flow for franchisors, but like an obsession over effective SEO strategy for digitally native brands, franchisors are scrambling to learn how to control the AI narrative. What's a tool for franchisee prospects though is also a tool for franchise development teams and brokers. At minimum, franchise development teams have found a new sparring partner to train their sales pitch on. For brokers, the emphasis on having differentiated perspective on each franchisor's story, and the offering of a human partnership in navigating a complex sales process, feels more vital than ever before.

Some investors still blanking on their first franchisor investment.

There are not enough scaled franchisors to go around, and some investors in the circuit have been dating many franchisors over the years, but still can't find one that will say "yes!" So, they've opened their aperture to pursue targets in the broader franchise ecosystem, especially multi-unit franchisees. The strategy has provided investors a backdoor opportunity to participate in franchise concepts they find compelling but would otherwise not have the ability to participate in. It's not hard to see why for many eager franchise investors, they'll need to add one more "e" to finally earn their seat at the industry table.