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VALOREM PRINCIPIA

The Principles of Value

Volume 14 Issue 1 February 2006

FRANCHISORS AND FRANCHISEES: UNIQUE PARTNERS, UNIQUE VALUES

By: Barry Kurtz, Esq. and Nevin Sanli, ASA

In the broad spectrum of business enterprises, franchise operations – meaning both franchisors and franchisees – are a breed unto themselves, requiring unique valuation approaches.

Chief among the reasons for this is the fact that the relationship between franchisor and franchisee creates a hybrid partnership. The franchisor owns and manages certain items of intellectual property but does not deliver goods or services to the consumer. That job belongs to the franchisee, which as a rule owns only certain hard assets used in carrying out this task.

Looked at from this standpoint, the valuation consists more of discovering to what degree each asset contributes to the success of the business enterprise – a task more easily said than done.

Under common provisions of state law, a franchise relationship exists when:

The franchisee engages in offering, selling or distributing goods or services under a marketing plan or system "prescribed in substantial part" by the franchisor;

The franchisee's business is "substantially associated" with the franchisor; and

The franchisee pays a fee to the franchisor in order to engage in business.

Taking these one by one, the franchisee operates under a plan or system "prescribed in substantial part" by the franchisor when the latter provides the franchisee with advice and training, retains significant control over the conduct of the franchisee's business, grants the franchisee exclusive rights to operate in a given territory, or requires the franchisee to purchase or sell a specified quantity of the franchisor's goods or services.

Similarly, the franchisee's business is "substantially associated" with the franchisor if the former uses the latter's trademark and advertising slogans to identify its business.

As for fees, they may include franchise fees, royalties on sales, and payments for training and assistance or for inventory and supplies.

Mergers and acquisitions involving franchise operations are commonly asset sales, not stock sales, so franchisors and franchisees alike can organize their companies under the legal structure that best suits their respective tax needs, largely without regard to valuation.

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SARBANES-OXLEY: NOT JUST FOR PUBLIC COMPANIES

By: Richard S. Grant, Attorney at Law

Overview

In the wake of the highly publicized corporate scandals of 2000 and 2001, Congress passed the Sarbanes-Oxley Act to promote better corporate governance and disclosure by public companies. The law – known as "SOX" in the legal world – was signed by the President in July 2002, and has received much attention in the press since then. The law regulates publicly held companies, so naturally much of the talk has been on the impact it has had on those companies. Because of the publicity the law has gotten, in our practice as corporate counsel to emerging growth and mid-sized privately owned companies, we are often asked if private companies need to concern themselves with the law. And the answer we frequently find ourselves giving is a firm yes.

On its face, Sarbanes-Oxley is specifically designed to regulate public, not private, companies. Among its many provisions, Sarbanes-Oxley imposes stringent financial oversight obligations on public companies. One of the most significant requirements is that these companies' senior officers certify the financial statements they file with the SEC and certify that they have developed and implemented internal controls over the company's financial reporting. Companies must also disclose whether they have adopted codes of ethics for their senior financial officers.

So if Sarbanes-Oxley regulates only public companies, how are private companies affected? The answer lies in how public companies interact with privately-held companies, particularly private companies that are acquisition candidates for public companies. The general effect of Sarbanes-Oxley has been to create a heightened sensitivity within public companies over financial reporting and financial housekeeping. As a result, public company buyers have become more proactive in how they think about financial disclosure issues when evaluating a transaction with a private seller. Public companies considering an acquisition of a private business are now paying much closer attention to the private company's financial record keeping and are carefully thinking about how the private company's financial affairs will impact the buyer's obligations under Sarbanes-Oxley. Not only are public buyers demanding more detailed representations and warranties and stronger indemnities dealing with financial matters in the transaction documents, but public companies are more closely scrutinizing the buyer's financial affairs during the due diligence process. Public company buyers now carefully review whether the potential seller has financial "housekeeping" problems that may impact the buyer's ability to comply with Sarbanes-Oxley after the acquisition.

It is not surprising why public companies have been so acutely sensitive over the law: Not only has the law received much attention, but the penalties for failing to comply can be severe. Under certain circumstances, for example, violations of the law may require officers to forfeit bonuses and other compensation if the company is required to make an accounting restatement due to its non-compliance with the law.

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"Progress is impossible without change: and those who cannot change their minds cannot change anything."
– George Bernard Shaw

Franchisors and Franchisees Continued from Page 1

Different Businesses and Different Assets

Whatever the legal structure of their companies, franchisors and franchisees own different assets. In general, the franchisor owns intangible assets including goodwill, logos, brands, trademarks, advertising slogans, and business systems and processes – for example, recipes in the case of the fast-food franchisor. The franchisee gains the right to use these assets in the conduct of its business but as a rule owns only some or all of the tangible assets it needs to conduct business, including equipment, inventory and supplies. Sometimes the franchisor owns or leases real estate and equipment and leases or subleases them to the franchisee. Sometimes the franchisee owns or leases these items directly.

As these considerations make clear, in many ways franchisors and franchisees are in different businesses. Franchisors do not earn profits directly from the sale of products or services at all. Instead, they are repositories of intellectual property, and their value derives in great measure from their skill in managing both that property and their relationships with franchisees.

Impact on Value

The impact of this skill on value can be substantial. Assume, for example, two operations generating equal revenues and profits, one a pure franchisor owning none of its outlets and the other a non-franchisor selling the same product – say, fast food – through a chain of wholly owned outlets. The franchisor might command a multiple of six to eight times earnings before interest, taxes, depreciation and amortization (EBITDA), or cash flow, and the non-franchisor a multiple of four to five. This results in part from the fact that the non-franchisor faces more operating risk in its day-to-day operations compared to the franchisor, who has shifted some of that risk to its franchisees.

Where the franchisor sells a brand-name product, the steps involved in deriving value begin with determining what premium the brand-name product commands over generic products and then, through a series of calculations, isolating values for every other item in the franchisor's "inventory" of intellectual property.

The next step is to gauge the franchisor's growth prospects – and here consumer demand is paramount. How many more buyers of the franchisor's products or services are there? Where are they? How many more territories might the franchisor establish over the next five years to reach these buyers? Over the next ten years? What will this effort cost?

The terms governing what franchisors can do when renewing agreements with their franchisees are also important in valuation. For one thing, these terms may permit a franchisor to increase royalties, fees or rents. For another, they may require franchisees to remodel their premises, upgrade equipment, etc. Taken all in all, the more these terms favor franchisors, the more value they generate for the franchisor.

The same holds true for the franchisor as lessor of real estate or equipment. In general, the more of these assets the franchisor has, the better, since they give the franchisor rental income in addition to royalties and fees, along with possibly regular and predictable increases. The management of such assets, however, can become a business in itself, possibly distracting the franchisor from its primary mission, with negative impact on valuation.

A good deal of data is available on royalty rates, making it relatively easy to judge their impact on the value of franchisor and franchisee operations. Overall, royalties reflect the marketplace value of the intellectual property created by the franchisor and made use of by the franchisee. But because competition is extensive in many areas of franchising, royalties are also more or less predictable, depending of course on the product or service in question. In the fast food industry, for example, royalty rates range from 3 to 8 percent, with most franchisors charging 6 percent or less.

Upfront franchise fees reflect the same factors, with some top-tier franchisors charging as much as $1 million per store, sometimes more. Here, too, the impact on valuation is obvious.

In the case of the individual franchisee, the key is to gauge the value of its hard assets – plant, equipment, inventory, etc. – in generating the franchisee's profits. But there are additional factors to consider as well: How much value does the franchisee derive from being part of the franchisor's system? To what degree does the franchisee gain or lose value because of economic and social conditions in its territory? Because of capacity? Because of its hours of operation? Does the franchisee have first right of refusal to expand into new territories?

When valuing a master franchisee, other questions arise: assuming that state law permits the practice, does the master franchisee bargain over royalties, fees, territories, and other factors? If so, what value does the master franchisee derive from this power? Does the master franchisee achieve economies of scale by operating its own training program, by wringing costs from the supply chain, by negotiating special real estate leasing terms?

The right to sell products and services through catalogs or over the internet can become a point of contention between franchisor and franchisee. If the franchisor retains the right to sell to catalog or internet customers residing within the exclusive territory of the franchisee, this can diminish the value of the territory. If, on the other hand, the franchisee has the right to sell to catalog or internet customers irrespective of its own territory, this diminishes the value of the franchisor's business, not to mention the businesses of other franchisees.

To avoid this, many franchisors, recognizing that they are in the intellectual property business, not the business of delivering goods or services, retain control of catalog and internet sales but funnel orders through franchisees in whose territories the orders originate. From the standpoint of valuation, such franchisors, by striving to increase the commerce of their franchisees, enhance their own value.

Franchise Agreements

Most franchise agreements attempt to make these matters explicit, but gray areas persist and give rise to much litigation, with significant impact on valuation. Goodwill, for example, is the property of the franchisor, but the franchisee may create goodwill specific to its

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Regina J. Schroder, shareholder of Bullivant Houser Bailey PC, was selected by her peers for inclusion in The Best Lawyers in America ® 2006 in the area of tax law. A shareholder in Bullivant's Sacramento office, Regina focuses her practice in all aspects of corporate finance, securities, general business counseling and tax issues. A past chair of the California State Bar Tax Section, Regina devotes a significant portion of her practice to business tax counseling on federal, state and local levels, including tax consequences associated with the purchase and sale of business entities. Regina's clients include both publicly traded and privately held domestic and international companies. Regina joined Bullivant in October 2005, as a result of the merger with Bartel Eng & Schroder, where she was a partner for 15 years. Regina has been practicing for nearly 25 years.

Bullivant Houser Bailey PC is a multi-service, West Coast law firm with nearly 200 attorneys in four states. A nationally recognized trial firm, Bullivant is among the 250 largest law firms in the U.S. In addition to litigation services, the firm offers a wide range of domestic and international business transaction assistance to businesses of all sizes. Effective October 2005, the firm merged with Sacramento-based Bartel Eng & Schroder. Bullivant has six West Coast offices, with locations in Portland, Oregon; Seattle and Vancouver, Washington; Sacramento and San Francisco, California; and Las Vegas, Nevada.
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SP&H's 2005 Fall Charity Gala… The Event of the Year!

With over three hundred guests in attendance, our annual Fall Charity Gala was held on Friday, November 4th, 2005 from 7:00pm until 1:00am at Twentieth Century Fox Studios in Century City. We raised over $20k for "Theatre of Hearts, Inc./Youth First" our 2005 adopted beneficiary charity who presented Nevin Sanli, Thomas E. Pastore and Carl Terzian with a "Youth First" community award.

The evening's festivities included a children's theatre performance, silent auction, casino style gaming, buffet dinner, dancing, live band, sweet station, outdoor cigar lounge with a jazz guitarist and a progressive live painting. Throughout the evening we raffled gift baskets, certificates for shopping, dining, spa treatments and more!

We auctioned everything from youth artwork to Muhammad Ali's signed boxing glove to a Rolling Stones autographed guitar to "Dinner Around The World".

Upon departure, each guest received a gift bag filled with items from our Sponsors and Donors including dining and spa certificates.

"I can honestly say Sanli Pastore and Hill is not a company that just stimulates the community by self-testimony and business genius but you are a company that believes in the strength of community. Your generosity and support has given so many more youngsters the opportunity to realize their dreams and gain a true sense of self-confidence by honoring them and their art".
–Sheila Scott Wilkinson, Founder of Theatre Of Hearts/"Youth First"

"On behalf of the City of Los Angeles, I commend Sanli Pastore & Hill's dedicated team for their efforts to improve the quality of life for our City's children and for continuing to make this important charity event possible. For years now, this event has brought the community together in support of non-profit organizations throughout Los Angeles that are working to ensure that young people have bright and prosperous future".
– Mayor Antonio Villaraigosa

On behalf of SP&H, a very heartfelt thank you to our Sponsors, Donors and Guests for your generous support and contribution to a successful evening.

For more information on how you can be involved and for advance Sponsorship and Donor opportunities, please contact Soroya Crystal Imam, Director of Business Development & Events. (310) 571-3400 simam@sphvalue.com / specialevents@sphvalue.com.

In each edition of Valorem Principia, SP&H features a different dining hotspot, providing highlights, reviews, and insights to our clients and friends across the state. If there is a restaurant that you feel should be showcased in future editions, please contact Soroya Imam at 310-571-3400, ext 233 or simam@sphvalue.com. We look forward to hearing from you. Until then, Bon Appetit!

Dining Spotlight

Amalfi Ristorante, Bar & Room 5 Lounge

143 North La Brea Avenue
Los Angeles, California 90036
(323) 938-2504
Cuisine: Rustic Italian

For this issue of our Dining Spotlight, we decided to give you a "dining review." We surveyed our SP&H staff, below you will find their survey results!

Located on the LaBrea Restaurant Row, Amalfi recently played host to our employee Holiday Party. Upstairs we dined and danced to live music in the private area known as the *Room 5 Lounge.*

Attentive staff greeted us with an array of notable wine selections and spirits to compliment the creative tray passed appetizers. Some of our favorites included the Aranchini, crispy saffron and tomato risotto bites stuffed with a ragu of meat, mozzarella and peas, the Crostini al Tonno Tartare, taro root chips topped with marinated raw Ahi tuna and organic rainbow greens and the Porcini Puffs, delicately puffed pastries filled with porcini mousse, truffle oil and pine nuts. And this was just the beginning.

Our plated three-course dinner tempted us with salad selections. Followed by Entree selections of Roasted Atlantic Salmon with red bell peppers and sage in a white wine reduction presented on a bed of garlic spinach and mashed potatoes, oven roasted Cornish hen with roasted garlic and country style herbs accompanied by Italian style potatoes and fresh vegetables, shiitake, porcini and champignons in light cream and truffle oil and grilled New York Strip with Italian herbs and Barolo wine sauce on a bed of arugula and roasted potatoes. And who can forget the individual dessert plates, each containing bitter chocolate cake and ricotta pumpkin cheesecake with homemade whipped cream.

Survey Results (scale of 1-10, 10 being Excellent)

Appetizer & Salad: 7.7	Beverage: 8.0	Entrée: 8.0
Ambiance: 7.0	Dessert: 7.0	

Need we say more?…see you at Amalfi's!

Franchisors and Franchisees Continued from Page 2

own operations and become entitled to compensation in the event that a local governing body condemns the business under eminent domain. This specific goodwill can become an item of community property in divorce proceedings as well.

With respect to both franchisors and franchisees, certain terms in the franchise agreement also affect valuation – for example, terms permitting franchisors to terminate agreements with undesirable franchisees. These, too, can give rise to litigation, making it necessary to step carefully when judging the efficacy of the terms in any particular franchising agreement.

Not surprisingly, the impact of many such terms is not the same on franchisors as on franchisees. An agreement giving the franchisor ample leeway in terminating undesirable franchisees will tend to enhance the valuation of the franchisor and depress that of the individual franchisee. Conversely, a solid, locked-in territory favors the franchisee but may depress the valuation of the franchisor. Either way, the key to the result, whether favorable or unfavorable to the one party or the other, lies in the strength and clarity of the terms of the franchise agreement – or the lack thereof.

One final factor, liability, can affect valuation. Most franchise agreements specify that franchisors are not liable for the debts or torts of franchisees, and vice versa. Even so, litigants commonly try to involve franchisors in any liability action against franchisees on the theory that the franchisor is likely to have the deeper pockets. The courts may side with litigants in cases where the franchisor exercises such control over the actions of the franchisee as to trigger vicarious liability – as, for example, when a franchisor requires the franchisee to follow an employee manual produced by the franchisor. Hence here, too, it is necessary to step carefully when deriving valuation.

Barry Kurtz, a specialist in franchise law, is of counsel to the Encino, Calif., law firm Greenberg & Bass. He may be reached at (818) 728-9979 or bkurtz@greenbass.com. Nevin Sanli is president and co-founder of Sanli Pastore & Hill. He may be reached at (310) 571-3400 or nsanli@sphvalue.com.

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Transactions With Public Companies: What To Expect

Private companies that are negotiating acquisitions with public buyers can expect those buyers to increase their financial due diligence of the target company and to make decisions based on what is disclosed in the diligence. In the past, public buyers often were willing to overlook imperfect financial practices as long as the target company was otherwise a sound acquisition; the prevailing view was that many of the seller's financial problems could be fixed after the closing. Sarbanes-Oxley has dramatically changed that view. With the threat of severe penalties looming, public companies now look closely at a target company's finances and internal controls and carefully consider what impact those practices and controls will have on the buyer after the closing. Public companies may pass on an acquisition of a company that has irregular or problematic financial practices or may consider the company less valuable and reduce the purchase price.

Clean House Now

Private companies can avoid problems with a public buyer if they prepare now. By adopting practices that will ensure that they have a "clean house" if an acquisition occurs, private companies will be prepared to respond to stringent due diligence requests and address Sarbanes-Oxley issues that the buyer may raise. Indeed, considering the heightened sensitivity to these issues, a private company with clean finances may project a better overall image and, therefore, be a more attractive acquisition candidate.

To do this, we recommend:

Keep financial records well-organized and maintain them in an orderly fashion. The acquiring company will have an easier time reviewing the records and preparing audited financial statements.

Prepare financial statements and other financial reports in a consistent manner.

Remember that your financial records will come under close scrutiny in an acquisition, so in the course of operating your business maintain them accordingly.

Hire and rely on competent accountants who understand your business and are well-versed in the concerns a public company buyer may have under Sarbanes-Oxley.

Under certain circumstances, loans that a private company makes to its officers and directors may be prohibited after the acquisition. Be prepared to discharge these loans in an acquisition by a public company.

Private companies may even want to consider implementing their own internal financial oversight and control programs that are modeled after Sarbanes-Oxley programs. Not only would this prepare these companies for acquisitions with private companies, but it may make them a stronger company overall. For example, lenders may view these companies as better credit risks and, therefore, be more willing to extend them credit on favorable terms.

* * *

Sarbanes-Oxley has increased the scrutiny that public companies give to the financial practices of private companies that they are looking to acquire. Private companies that understand this and are proactive in addressing financial matters will be viewed as more attractive acquisition partners. If you are considering an acquisition by a public company, your counsel should understand Sarbanes-Oxley so he or she can respond to any "SOX" concerns the buyer may raise.

Richard Grant is a partner in the Corporate and Tax Department of Van Etten Suzumoto & Becket LLP, a 50 lawyer, full-service law firm in Santa Monica (www.vsblaw.com). His practice focuses on representing privately held companies in many different transactions, including mergers and acquisitions, corporate finance, structuring of ventures, and general corporate counseling.

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