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Intellectual Property Securitization and Growth Capital in Retail Franchising

Tahir M. Nisar*

School of Management, University of Southampton, Highfield, Southampton SO17 1BJ, United Kingdom

Abstract

A retail franchisor needs growth capital so that the brand continues to grow and franchisor–franchisee relations remain strong. However, access to corporate liquidity to fund such franchise growth options is not unlimited. A method of raising finance particularly suited to retail franchisors is intellectual property (IP) securitization that allows companies to account for intangible assets such as intellectual property, royalty and brands and realize their full value. In recent years, a number of large restaurant franchisors have securitized their brands to raise funds, including Dunkin Brands and Domino’s Pizza (Domino’s). We use property rights approach to show that IP securitization provides mechanisms that explicitly define ownership of intangible assets within the securitization structure and thus enables a company to raise funds against these assets. Using a case study example of a retail franchise IP securitization transaction, we also provide evidence that these mechanisms are not overly restrictive and can be used more widely to help fund retail franchise growth and expansion.

Keywords: Retail franchising; Intellectual property securitization; Brands; Franchise growth

Introduction

Retail franchise growth is a critical parameter in a franchisor’s network stability. A franchisor may support its ambitions for rapid growth by improving its brand’s appeal as well as helping develop its franchised units. The low contractibility of the financial assets in the early phases of a franchise organizational life cycle points toward this critical role of a franchisor in assisting its franchisees (Windsperger and Dant 2006). Franchises of retail brands also need to provide an assurance that they are a stable business. This is important as many entrepreneurs embark on a franchising business because it offers the greatest potential financial rewards (Bradach 1998; Grünhagen and Dorsch 2003). Anyone looking to start their own business and capitalize on the opportunity offered by a franchise brand will be concerned with the long-term strength and viability of the franchise they are taking on. It is for these reasons that franchisors pay close attention to their own capital structure, in the manner they raise funds, in addition to their relationships with their franchisees.

The strength of a franchise business is also tested during a time when credit conditions are fragile. Due to large liquidity requirements, a credit crunch may hit the retail sector hard, resulting in an increased scrutiny for franchise loans, delayed construction and even some store closures due to lost business and difficulty in getting credit to see them through. Lenders may also increase their equity requirements for the new franchisees, severely jeopardizing the franchise growth efforts. Franchisors may then be expected to help their franchisees seeking growth capital. For example, Domino’s Pizza (Domino’s) offered up its own cash to its franchisees post-2007 credit crunch. It was short-term financial support, mainly in the form of small loans or payment deferrals for large operators who were looking to purchase additional locations.

Amid financial turmoil, franchisors can only step in to keep growth on track and ensure the stability of the franchise network, if they can boast of a viable capital structure. They need to have access to sufficient operating funds to be able to extend support to their franchisees and fill any gaps left by the reluctance of traditional lenders to fund franchise growth. Windsperger and Dant (2006) describe this issue in the following terms, “The franchisor may be quite constrained by the information asymmetry between the prospective conventional lenders (e.g., banks, venture capitalists) and himself concerning the profitability of investment project envisioned by the franchise concept. Due to their low salvage and/or liquidation value, the conventional lenders are likely to find it more difficult and risky to finance
investment projects if the investments are in intangible assets as compared to tangible assets such as plant and equipment” (p. 264; see also Caves and Murphy 1976; Combs and Ketchen 1999). Many retail franchise companies also lack high investment grade ratings because of their weak credit, and thus cannot raise funds on favorable terms. In recent years, a method of raising finance has gained prominence that enables companies to take loans on their intangible assets and make the necessary investments. The $1.7 billion Dunkin Brands IP transaction and the $1.8 billion KCD (Kenmore Craftsman DieHard, Sears’ special purpose vehicle) bonds, which came to the market in May 2006 showed how companies with weak credit can benefit from such a technology. Subsequently, Domino’s issued $1.85 billion in asset-backed securities in 2007, funded by its franchise operations. The deal was the largest IP securitization at that time. Both Dunkin Brands and Domino’s deals underscored the notion that a securitized debt structure is almost custom-built for large franchised operations, in particular the restaurant industry.

Royalty and intellectual-property-based securitizations allow companies to borrow against their brand strengths and future revenue streams (S&P 2002; Schwarcz and Ford 2003). Retail companies with weak credit can benefit from such an approach (S&P 2002). Asset-backed securitizations have been around for some while now; borrowing against a company’s assets, such as real estate holdings, equipment or computer lease receivables, were in vogue since the mid 1980s. IP securitization, on the other hand, makes possible for a company to use intellectual property assets as primary collateral and realize their full value. In contrast to mortgage-backed securities and other types of securitization deals, IP securitization aims to calibrate the risk and make it more transparent for investors. Early franchise transactions in the 1990s were based on a restaurant’s future sales, real estate and equipment, the traditional set of assets used in a securitization deal. The later IP-based securitizations, however, used the collateral against a brand’s trademark, systemwide royalty revenues and intellectual property to obtain high ratings. Many ‘household names’ in the fashion world packaged their royalty rights and trademarks into an off-balance sheet entity (Erol 1999; S&P 2002). The securities issued against these assets were rated by debt-rating agencies, enabling the fashion design businesses to borrow at much more favorable rates.

As intangible assets are the key driver of an IP securitization transaction, it inevitably raises the question of the distribution of ownership rights over these assets in a securitized structure. We draw upon property rights theory to examine these questions. The theory says that when contracts are incomplete, the best way to generate incentives for two parties to invest in non-contractible assets is to allocate residual rights of control to the party that will be most profitably affected by doing so (Demsetz 1966; Hart 1995; Hart and Moore 1990; Segal and Whinston forthcoming 2011). In the absence of such rights, contracting parties are likely to make suboptimal relationship-specific investments. Using a case study of an IP securitization transaction, we investigate how these residual rights of control underpin securitization structures and if these structures provide sufficient incentives for investment in intangible assets. Our investigation shows that the property rights framework explains in good measure the practice of IP securitization, and that it is a valid means of raising finance, especially when companies derive their significant value from intangible assets.

The article is divided into four sections. The first section discusses general issues involved in retail franchise growth, in particular the role of a franchisor as a capital provider. It is followed by our introduction to the IP securitization method. We then provide a case study of Domino’s securitization, including an early assessment of its performance. The final section concludes with suggestions for future work in this area.

Retail franchise growth

Watsona et al. (2005) suggest that a particular feature of retail organizations is asset intangibility, and therefore they use franchising to be a valuable means by which to develop their businesses, both domestically and abroad. Their empirical findings provide ample proof of the positive impact of franchising on the intellectual capital development and knowledge management for retail organizations. Franchisees typically are the engine of growth at many retail chains, in particular restaurants (Bradach 1998). Franchisees help develop retail markets by breaking into new territories and opening new units. Franchisees may also be instrumental in purchasing the franchisors’ underperforming stores earmarked for improvement. However, franchisees may need financial and transactional help when looking to open new stores or purchase underperforming stores (Grünhagen and Dorsch 2003; Kaufmann and Stanworth 1995). The re-purchase of underperforming units can be part of a franchisor’s strategy to turn around domestic results. This requires that the franchisors have sufficient resources available to finance and support such transactions. This is also the view of Norton (1995, 1988) who argues that franchising exists in order to reduce “operating and financial transactions costs.” This is against the capital constraint or the resource dependence hypothesis that suggests franchising provides capital for the franchisor at lower costs (Caves and Murphy 1976; Ozanne and Hunt 1971).

Norton’s view can be verified by casual evidence from the restaurant franchising industry. Restaurant franchisors implement specific programs that broaden their franchise bases as a means to grow business. In addition to implementing measures that grow same-store sales, they may also emphasize franchise recruitment as a way to expand their franchise operations. For example, in recruiting new franchise demographics, franchisors as diverse as Pizza Hut, KFC, Domino’s and Little Caesars Pizza have introduced special recruitment incentive programs for veterans, minorities and women. Domino’s offers veterans a $20,000 discount off the franchise fee. These programs are underpinned by the need for offering greater financial security and lower risk to the prospective franchisees. The programs may also translate into helping franchisees get financing, as well as more favorable lease and real estate terms. They thus provide an additional layer of support, over and above the backing a franchisor can offer to its franchisees with a well-known brand and assistance and network cooperation (Bradach 1998; Lafontaine and Shaw 1999). There is also an opportunity to demonstrate that the franchisor’s capital base is solid and can cope with any
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