Case

Quick Lube Franchise Corporation (QLFC)

Preparation Questions

1. What grounds might QLFC have for filing a lawsuit against Huston?
2. Why do you think Huston has asked for a meeting with Herget?
3. What advice would you give Herget as he considers Huston's request for a meeting with QLFC?
4. As part of that advice, how much is QLFC worth?
5. Does your answer to Question 4 depend on how QLFC is harvested?

It had been a year since Huston, a major oil company, had bought 80 percent of Super Lube, Inc., the number one franchisor of quick lubrication and oil-change service centers in the United States with 1,000 outlets. As a result of that takeover, Super Lube's largest franchisee, Quick Lube Franchise Corporation (QLFC) found itself in the position where its principal supplier, lead financing vehicle, and franchisor were the same entity. Was this an opportunity or a disaster? In April 1991, Frank Herget, founder, chairman, and CEO of QLFC was faced with one of the most important decisions of his life.

Historical Background

Super Lube was the innovator of the quick lube concept, servicing the lube, motor oil, and filter needs of motorists in a specialized building with highly refined procedures. It was founded in March 1979 by Jeff Martin. Frank Herget was one of the four founding members of Martin's team. After a few years, Herget became frustrated with life at the franchisor's headquarters in Dallas. He believed that the future of Super Lube was in operating service centers. That put him at odds with founder, Chairman, and CEO Jeff Martin who was passionately committed to franchising service centers as fast as possible. Martin and Herget had known each other for a long time so they sought a mutually acceptable way to resolve their differences. Their discussions quickly resulted in the decision that Herget would buy a company-owned service center in northern California by swapping his Super Lube founder's stock valued at $64,000, which he had purchased originally for $13,000. Quick Lube Franchise Corporation was founded.

Early Success and Growth

Success in his first service center inspired growth. Eventually, QLFC controlled service center development and operating rights to a geographic area covering parts of California and Washington with the potential for over 90 service centers. Herget's long-term goal was to build QLFC into a big chain of Super Lube service centers that would have a public stock offering or merge with a larger company (*Exhibits A* and *B*).

Herget financed QLFC's growth with both equity and debt (*Exhibits C* and *D*). Most of the additional equity came from former Super Lube employees who left the franchisor to join QLFC in senior management positions. They purchased stock in QLFC with cash realized by selling their stock in Super Lube. A key member of Herget's team was Mark Roberts, who had been Super Lube's CFO until 1986. He brought much needed financial sophistication to QLFC.

The primary debt requirement was for financing new service centers. In 1991, the average cost of land acquisition and construction had risen to $750,000 per service center from about $350,000 10 years earlier.

Growth was originally achieved through off-balance-sheet real estate partnerships. An Oregon bank lent about $4 million and a Texas bank lent almost $3 million. However, rapid growth wasn't possible until QLFC struck a deal with Huston Oil for $6.5 million of subordinated debt. The Huston debt was 8 percent interest—only for 5 years and then amortized on a straight line basis in years 6 through 10. The real estate developed with the Huston financing was kept in the company. QLFC was contractually committed to purchasing Huston products.

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EXHIBIT A

QLFC Growth

	82	83	84	85	86	87	88	89	90	91
Service Centers	2	3	4	7	16	25	34	44	46	47
Sales ($ million)	.5	1.6	2.1	3.8	8.5	15.5	19	27	28	30

EXHIBIT B

Quick Lube Franchise Corp.: FY 1991 Budget Worksheet*

	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Total
Sales	2,424,718	2,444,629	2,756,829	2,816,765	2,872,074	2,358,273	2,619,415	2,435,022	2,494,696	2,733,469	2,464,172	2,795,804	**31,215,866**
Cost of sales	544,689	549,348	613,728	626,809	639,126	529,542	588,628	547,137	573,063	627,574	565,836	642,144	**7,047,624**
Variable expenses†	805,251	826,956	894,782	914,080	943,260	790,276	893,236	819,709	844,626	911,313	826,811	949,576	**10,419,876**
Fixed expenses	358,640	349,858	351,828	363,917	371,498	366,260	371,988	391,686	378,485	388,381	399,375	393,974	**4,485,890**
Real estate cost	320,377	337,372	340,652	341,353	352,053	352,053	372,030	372,030	392,337	392,452	392,452	410,552	**4,375,713**
Store operating income	395,761	381,095	555,839	570,606	566,137	320,142	393,533	304,460	306,185	413,749	279,698	399,558	**4,886,763**
Overhead	255,515	261,573	245,083	241,089	263,458	278,333	258,655	274,724	277,974	269,551	279,819	275,440	**3,181,214**
Operating income	140,246	119,522	310,756	329,517	302,679	41,809	134,878	29,736	28,211	144,198	(121)	124,118	**1,705,549**
Other income	7,392	7,392	7,392	7,392	7,392	7,392	7,392	7,392	7,392	7,392	7,392	7,392	**88,704**
Dropped site expense	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	**(99,996)**
Minority interest	686	613	(2,610)	(3,254)	(3,145)	2,065	511	4,529	4,346	1,290	6,564	2,459	**14,054**
Interest expense	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	(5,495)	**(65,940)**
Taxable income	134,496	113,699	301,710	319,827	293,098	37,438	128,953	27,829	26,121	139,052	7	120,141	**1,642,371**
Income tax expense	54,921	47,253	119,971	126,613	115,680	17,885	53,211	17,790	16,727	58,652	6,880	51,779	**687,362**
Net income	79,575	66,446	181,739	193,214	177,418	19,553	75,742	10,039	9,394	80,400	(6,873)	68,362	**955,009**

* Budget revised March 21, 1990.

† Royalties to the franchisor equal 7% of gross sales.

EXHIBIT C

Quick Lube Franchise Corp.: Consolidated Balance Sheets

	Year Ended March 31	
	1991	**1990**
Assets		
Current Assets		
Cash	$ 740,551	$ 665,106
Accounts receivable, net doubtful accounts of $61,000 in 1991 and $44,000 in 1990	518,116	309,427
Construction advances receivable	508,168	137,412
Due from government agency		407,678
Inventory	1,093,241	1,074,513
Prepaid expenses other	407,578	401,562
Total Current Assets	3,267,654	2,995,698
Property and Equipment		
Land	351,772	351,772
Buildings	3,171,950	2,519,845
Furniture, fixtures and equipment	2,988,073	2,644,801
Leasehold improvements	242,434	183,635
Property under capital leases	703,778	703,778
Construction in progress	68,138	531,594
	7,526,145	6,935,425
Less accumulated deprec and amort	(1,290,565)	(854,473)
	6,235,580	6,080,952
Other Assets		
Area development and license agreements, net of accumulated amortization	923,970	988,314
Other intangibles, net accumulated amort	273,737	316,960
Other	151,604	208,898
	$10,852,545	$10,590,822
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable & accrued expenses	$ 3,085,318	$ 3,198,694
Income taxes payable	37,224	256,293
Note payable		250,000
Current portion - LTD	203,629	174,134
Current portion of capital lease	19,655	17,178
Total Current Liabilities	3,345,826	3,896,299
Long-Term Debt, less current	2,848,573	3,052,597
Capital Lease Obligations, less current	628,199	648,552
Other Long-Term Liabilities	731,783	483,534
Minority Interest	2,602	13,821
Total Long-Term Liabilities	4,211,157	4,198,504
Shareholders' Equity		
Common stock, par value $.01/share authorized 10,000,000 shares; issued 1,080,000 shares	10,800	10,800
Additional paid-in capital	1,041,170	774,267
Retained earnings	2,243,592	1,710,952
	3,295,562	2,496,019
	$10,852,545	$10,590,822

EXHIBIT D

Quick Lube Franchise Corp.: Consolidated Cash Flow

	Year Ended March 31		
Operating Activities	**1991**	**1990**	**1989**
Net Income	$ 532,640	$ 764,794	$ 524,211
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and Amortization	612,063	526,750	414,971
Provision for losses on accounts receivable	16,615	30,510	5,559
Provision for deferred income taxes	(15,045)	12,519	50,388
Minority interest in losses of subsidiaries	(11,217)	(129,589)	(83,726)
Loss (gain) on disposition of property and equipment	33,301	(420)	N/A
Changes in operating assets and liabilities:			
Accounts Receivable	(225,304)	(58,700)	(135,585)
Inventory	(18,728)	(273,559)	(286,037)
Prepaid expenses and other	(6,016)	(102,117)	(34,334)
Accounts payable and accrued expenses	(113,376)	559,456	1,409,042
Income taxes payable	(219,069)	404,068	(620,434)
Due from shareholders and affiliates	N/A	N/A	(43,742)
Other long-term liabilities	263,294	167,501	84,697
Net Cash Provided by Operating Activities	849,158	1,901,213	1,285,010
Investing Activities			
Purchases of property and equipment	(599,327)	(1,922,892)	(1,922,852)
Proceeds from sale of property and equipment	374,592	8,523	782,519
Acquisition of license agreements	(44,000)	(127,000)	(117,000)
Acquisition of other intangibles	(2,615)	(327,549)	(2,500)
Change in construction advance receivable	(370,756)	593,017	(601,525)
Change in other assets	43,894	(138,816)	11,908
Net Cash Used in Investing Activities	(598,212)	(1,914,717)	(1,849,450)
Financing Activities			
Proceeds from long-term borrowings and revolving line of credit	4,940,000	4,026,441	2,448,071
Proceeds from borrowings from related parties	N/A	N/A	19,600
Principal payments on long-term borrowings	(5,364,529)	(3,463,693)	(2,658,534)
Principal payments on borrowings from related parties		(19,600)	(7,216)
Principal payments on capital lease obligations	(17,876)	(38,048)	N/A
Proceeds from sale of Common Stock and capital contributions	266,903	97,201	19,600
Net Cash Provided by (Used in) Financing Activities	(175,502)	602,301	(178,479)
Increase (Decrease) in Cash	75,444	588,797	(742,919)
Cash at beginning of year	665,106	76,309	819,228

Super Lube's Relationship with Its Franchisees

Despite bridge financing of $10 million at the end of 1985 followed by a successful initial public offering, Super Lube's growth continued to outpace its ability to finance it. At the end of the 1980s, Super Lube was in technical default to its debt holders. Huston struck a deal to acquire 80 percent of the company in a debt restructuring scheme. However, during the time of Super Lube's mounting financial problems and the subsequent Huston deal, franchisees grew increasingly discontented.

A franchise relationship is governed by a contract called a license agreement. As a "business format" franchise, a franchisor offers a franchisee the rights to engage in a business system by using the franchisor's trade name, trademark, service marks, know-how, and method of doing business. The franchisee is contractually bound to a system of operation and to pay the franchisor a royalty in the form of a percentage of top-line sales.

The Super Lube license agreement called for the franchisor to perform product development and quality assurance tasks. Super Lube had made a strategic decision early in its existence to sell franchises on the basis of area development agreements. These franchisees had grown to become a group of sophisticated, fully integrated companies. As the franchisees grew with multiple outlets and became increasingly self-reliant, the royalty became difficult to justify. When the franchisor failed to perform its contractually obligated tasks as its financial problems grew more and more burdensome toward the end of the 1980s, a franchisee revolt began to surface.

The Huston Era Begins

The new owners, Huston Oil, quickly moved to replace virtually the entire management team at Super Lube. The new CEO was previously a long-term employee of a Kmart subsidiary. He took a hard-line position on how the franchise system would operate and that Huston motor oil would be an important part of it. The first national convention after the Huston takeover was a disaster. The franchisees, already frustrated, were dismayed by the focus of the franchisor on motor oil sales instead of service center-level profitability.

Herget decided to make a thorough analysis of the historical relationship between Quick Lube Franchise Corporation and Super Lube. Three months of research and documentation led to Quick Lube Franchise Corporation calling for a meeting with Huston to review the findings and address concerns.

The meeting was held at the franchisor's offices with Herget and the franchisor's CEO and executive vice president. Herget described the meeting:

> The session amounted to a three-hour monologue by me followed by Super Lube's rejection of the past as relevant to the relationship. I was politely asked to trust that the future performance of the franchisor would be better and to treat the past as sunk cost. In response to my concern that Huston might have a conflict of interest in selling me product as well as being the franchisor and having an obligation to promote service center profitability, they answered that Huston bailed Super Lube out of a mess and the franchisees should be grateful, not combative.

Litigation

The QLFC board of directors received Herget's report and told him to select a law firm and to pursue litigation against Huston. QLFC's three-months of research was supplied to the law firm. A suit against Huston was filed three months after the failed QLFC/Huston "summit."

Huston denied the charges and filed a countersuit. Document search, depositions, and general legal maneuvering had been going on for about three months when QLFC's attorneys received a call from Huston requesting a meeting. Herget immediately called a board meeting, and prepared to make a recommendation for QLFC's strategic plan.