



Private Equity in Franchising

Private equity (“PE”) involvement in the franchising world has increased in recent years. Though historically PE firms have focused primarily on investment in franchisors, PE firms have in recent years increased their focus on franchisee-side investment. Understanding the franchisor’s perspective on PE investment into its franchisee community can help PE firms more effectively negotiate their relationship with the franchisor.

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Categories:

[Blogs](#)

[Private Equity Industry](#)

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Franchisors may be open to PE firms joining the franchisee community because PE investment can efficiently and aggressively grow a franchise system in a way that smaller franchisees cannot. PE firms typically have long-standing relationships with large lenders that can fund aggressive, multi-unit development.

Franchisors also appreciate PE firms’ focus on driving revenue and profit to produce returns for PE firm investors because that focus coincides with increased gross sales and therefore greater royalties for the franchisor. Franchisors also value the professionalism and sophistication that PE firms can introduce to the franchise system.

On the other hand, franchisors are often cautious of PE investment. PE-backed franchisees often make formidable adversaries when disputes arise within the franchise community. Large PE-backed franchisees have more leverage to push back on a franchisor’s new system mandates and fees, potentially causing discontent in the wider franchisee community. Franchisors may also be uncomfortable with a PE firm’s relatively short investment timeframe. Some PE-backed franchisees are ineffective operators when compared to smaller franchisees that view their investment in the brand as a life-long commitment or are second-generation franchisees. PE-backed franchisees sometimes have a tense relationship with smaller franchisees that feel they are being “crowded out” of the system or that too much of the franchisor’s focus is on the needs and concerns of the larger PE-backed franchisees. PE investment in a franchisee community can introduce cultural shifts and tensions that represent a fundamental change in a franchise system.

Franchisors that are receptive to and see the advantages of PE investment in the franchise community are typically willing to negotiate certain of the standard franchise agreement terms and

related requirements that have historically been non-negotiable. For example, franchisors may waive training requirements, particularly if the PE investment is in an existing franchisee that will continue to be managed day-to-day by the founding franchisee. Franchisors frequently waive requirements that franchisee owners personally guaranty the obligations of the franchisee entity, understanding that PE firms may be unwilling or unable (under governing or lending documents) to provide guaranties. Franchisors are often willing to forgo their right to control and approve franchisee financing arrangements when a sophisticated PE firm is involved. However, the franchisor may insist on a “relationship” agreement establishing certain ground rules for the relationship, such as requirements that the PE firm remain invested in the franchise for a certain period, that the PE firm (and the franchisee) will not go public, or requiring the PE-backed franchisee to maintain PCI and other technology compliance (if using its own IT infrastructure).

The members of Frost Brown Todd’s (FBT) Franchise and Hospitality Industry Team have significant experience guiding our clients through the legal and relationship issues of PE investments in franchise systems. Working closely with our FBT PE Industry Team colleagues, our Franchise and Hospitality Industry Team can help you navigate the legal complexities of investing in a franchise brand.

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