



A Tale of Two QUIZNOS

BY FRED MINNICK

"We trusted in Quiznos. They promised us success, help, and everything else to get us to buy into the dream they were selling. They had a private secret ... to trap you and screw you, the franchisee!" Those words were from Bhupinder "Bob" Baber's suicide letter.

On November 27, inside a California Quiznos bathroom, the former operator shot himself in the chest three times with a pistol.

"Quiznos has killed me. Destroyed my life. Destroyed my family for the past seven years," wrote Baber, who was in the middle of litigation with the sandwich brand. His wife, Ratty Baber, gave

One story, the past, is about suicide, litigation, unhappy operators, and losses. The other story, the future, is filled with cost-cutting promises, amnesty on defaults, and something Quiznos operators haven't had in a long time—hope.

a deposition saying she found the suicide letter on their home computer. QSR magazine has confirmed three other Quiznos operators have committed suicide since 2004. Baber's death is the only one to receive national media attention, including coverage in the *New York Times* and *USA Today*. That's probably because the Toasted Subs

Franchisee Association (TFSA) posted Baber's suicide letter on its web site.

For publishing the letter, Quiznos terminated the TSFA board members' franchise agreements, claiming they broke "contractual obligations." In retaliation, the board members sued Quiznos, saying the letter was meant to be a memorial in Baber's honor. This dispute has not been resolved, but five of the eight plaintiff groups settled out of court for undisclosed terms.

No matter what happens in the TSFA suit, Quiznos' legal troubles are much deeper than the fate of three storeowners. According to federal court records, Quiznos had more than 30 open civil cases at press time. The 4,500-unit chain is facing class-action suits in Australia, California, Michigan, New Jersey (the suit was moved to Colorado, but consists of New Jersey plaintiffs), and Wisconsin.

Franchisees allege that Quiznos violated franchise, antitrust, and racketeering laws. They contend that the company forced them to buy food and supplies from Quiznos or its affiliates at inflated prices while setting low

retail prices for products, making the stores unprofitable. In addition, they allege that Quiznos misrepresented key facts about Quiznos' business operations in an effort to induce potential franchisees to buy.

The California and New Jersey suits both claim franchisees did not receive "assis-

"It's not good to have a growing closure rate. If there are failures in a concept, it doesn't make sense for [lenders] to keep making loans."

tance with site selection." In California, the suit consists of "sold not open" franchisees who paid \$25,000 in franchise fees seeking \$14.6 million. According to the lawsuit, California franchisees were misled by Quiznos area directors.

"They would make representations that they had researched these locations and that the locations would support profitable franchises, but our clients found they could not really make a profit," says Travis Jack, co-counsel for the California Quiznos franchisees.

Development Over Operations

According to its area director uniform franchise offering circular, as of December 31, 2005, Quiznos had 2,940 franchisees who had not opened their store within 12 months of signing the agreement. At the time, that represented 66 percent of the chain's franchise community.

"What happened was the company turned more into a development company," says Denny Cheng, a former vice president of development and operations for Quiznos.

Mark Maximovich, a former vice president of Quiznos, remembers when management made the switch.

"My first year and a half with the company were wonderful," Maximovich says. "We were growing at a good rate, and we were opening great stores, and they were doing

Greg Brenneman Q&A

New Quiznos CEO doesn't grant interviews to just anybody, especially when he's the newbie.



GREG BRENNEMAN RESUME

HOMETOWN:
Hesston, Kansas. Grew up Mennonite.

AGE:
45

EDUCATION:
BS-Washburn University,
Masters-Harvard Business School

EXPERIENCE:
Quiznos CEO
Burger King CEO
Continental Airlines President and COO
PricewaterhouseCoopers Consulting CEO
TurnWorks Inc. CEO

PERSONAL:
Likes marathon running.

QSR strives to tell both sides of the story. But that's not easy to do when one side won't talk.

For the past year, writer Fred Minnick has written several articles on Quiznos and not once did its executives give him an "on the record" comment. He'd be stuck with attributing press releases, internal Quiznos documents, or court records. The problem with that ink on paper doesn't tell the whole story.

Then, Greg Brenneman entered the picture. Within 48 hours of hearing QSR wanted an interview, the new Quiznos chief executive called.

Brenneman doesn't normally grant interviews so early in his tenure. He went nine months at Burger King before talking to the press. But as he explained to Minnick: "We're not in the business of not talking to people."

And so, after hundreds of unreturned phone calls, emails, two faxes, and one snail-mail letter, QSR is pleased to bring you Quiznos's side of the story.

How have your first couple months on the job been? It's been fun to dive into Quiznos. I bought a piece of the company and agreed to come in and really take a look at this. And that is pretty much my style—I'm a Kansas farm boy by background, and I grew up Mennonite. I learned a couple things early on: an incredible work ethic and treat everyone with dignity and respect.

I did it with the Continental employees and the employees at P.W.C., and the employees and franchisees at Burger King. We're doing the same thing here. We're just solely focused on increasing the profitability at the restaurant level, and I'm taking a look at all the revenue items and all the cost items to pull that off.

What do you think about the tumultuous mood in the franchise community? Clearly, in the past, there wasn't a great feeling. We've tried very hard to turn that around in six or so short weeks. Just like any big company, you make a decision on one day and a few months later, it happens. But we're going as fast as we possibly can and making our way through it.

Have you been to some of the stores? I'm in stores every week.

Recently, I spent almost the whole day with (50 franchisees) in Denver, and we went through literally everything from couponing to commodity costs.

All the new franchise owners are required now to come in to Denver to go through a discovery day about what it means to be a franchise owner. So I'm seeing all the new folks who come in.

Many people say Quiznos grew too quickly. What are your development plans? We've actually slowed development dramatically. We'll still develop and we're still growing, but not nearly at the rate that we were historically.

When I think about growth, I think in terms of new units, which is historically how Quiznos thought about

growth, and growing our existing franchise owners—that's more important to me than how many new units we build.

"I learned a couple things early on: an incredible work ethic and treat everyone with dignity and respect."

great volume. There were no issues. And then kind of all of a sudden, there were quotas on how many stores we had to sell.”

That mentality sounds familiar to David Lopez, a single-unit operator in Philadelphia, who felt pressured to buy. After turning down two locations, Lopez purchased his store from another franchise owner, but he never met the man.

“Supposedly, the owner’s wife became pregnant, couldn’t take care of the store anymore, and literally just walked out of the store,” Lopez says. Quiznos told Lopez: “We can flip this store to you for a lot cheaper than you opening a new store.”

In 2005, there were 27 flips in the Philadelphia market. Not counting transfers, there’s a 6.3-percent closure rate systemwide, says Wally Butkis, partner of Restaurant Research, LLC. “It’s not good to have a growing closure rate,” Butkis says. “If there are failures in a concept, it doesn’t make sense for [lenders] to keep making loans.”

Many Quiznos operators receive capital through the Small Business Administration loan program and most of these lenders “are

not financing any more,” says Rita Atikian, a former two-store franchisee in Michigan. “My loan company told my partner that banks are pulling out because so many [Quiznos operators] are defaulting on their loans and filing bankruptcy.”

Neither the SBA nor Atikian’s lender would comment for this story.

Atikian says she lost more than \$300,000 because of high food costs, lack of local-store marketing, and a flawed rebate system, which is based off of an operator’s inspection score. Lopez says he lost 10 points during an inspection, when an employee didn’t have his shirt tucked in.

“If a light bulb was out, they take points off,” says Lopez, whose weekly volume is under \$4,000.

But not all franchisees are blaming Quiznos for negative store sales. In fact, according to internal reports, February 2007 systemwide same-store sales and average-unit volumes exceeded 5 percent.

Jim Brady, a five-store operator in Arizona, says his weekly AUVs are in the \$11,000 range. Brady says the failed fran-

chisees have nobody to blame but themselves.

“I market my own areas. I get out myself and pass out coupons,” Brady says. “These other people, they’re waiting for Quiznos to market for them.”

Nonetheless, franchisees are pumping money into the system, and Lopez contends there’s no way to track it. “I couldn’t tell you if they bought a Leer Jet with our advertising money, because they won’t send a detailed listing of how they spend our money,” Lopez says. “We have absolutely zero power over any advertising monies nationally, locally, or anything.”

According to a Quiznos UFOC, franchisees pay seven percent royalties of gross sales; three to four percent of gross sales for a regional advertising fee; one percent of gross sales for marketing and promotion; and three percent of gross sales for local advertising. In addition, franchisees are subject to \$100 per default payment and two percent interest per month on any late payment. That’s one sided, says international franchisee attorney Mario Herman.

“Quiznos believes that they’re entitled to

In one of your weekly voicemails, you talked about knocking food costs from 30 percent to about the 25 to 26 range. What are the challenges of bringing down the food costs so dramatically? I wish I could say I think it’s going to be difficult. But I really don’t.

We’ve been in a mode where there wasn’t a lot of testing in our system. More was always better.

Will the operators get more power over their local marketing monies? About 65 percent of the markets have actually elected to put regional marketing dollars in. That’s new just in the last month. And the returns on that money have been incredible. I had a franchise owner from San Diego e-mail me and say that his sales were up 21 percent.

What about couponing? We’ve been pretty coupon dependent. Our net 2s, which is our sales before coupons, is up. But our net 3s, which is sales after discounts, is up even more. And that’s a key ratio for us as we go through the year.

We did about 16 FSIs last year. We’re going to be down to seven this year.

Many franchisees say Quiznos’s rebate system is unfair, and they are penalized for ridiculous mistakes. Any plans to change the current rebate system? I honestly don’t know yet. I’m looking at all that.

Coming from the Burger King business, it was the same thing. There’s always a vocal minority of franchise owners who hate anything you do. Some of them will say ‘We just hate the rebate system...just give it to us at price.’ And others will say ‘We understand the rebate system. We count on that for our cash flow.’ I’m going through it right now and sorting out what’s going on....One thing I am going to do is declare amnesty on all default notices, just like the Italians do about every five years on taxes.

Are there any particular products or programs you plan to cut? We’re doing top-to-top meetings with all of our vendors, which hadn’t been done for a long time. There’s just dollars falling out of that process.

I was able to take the pricing on cleaning products down 19 percent start-

ing March 1. Just off the negotiations with vendors, I think there’s a lot of money sitting here.

There’s also a lot on the revenue side. If you look at how we merchandise cookies, for example. We had these strips that looked like they had come out of a Mobil gas station and we’re merchandising our cookies at knee height in packaging that looks like it was created in 1942.

We have pretty good cookies. If we’d put them in baskets next to the counter in a little bit more attractive packaging and put heat on them, I think we’d sell about twice as many.

There’s a lot of low-hanging fruit here for the franchise owners to benefit from.

The Toasted Subs Franchisee Association has been very critical of Quiznos, calling for “whistle blowers” in the franchise group. How do you

feel about the association? I have nothing against people expressing their opinions and being thoughtful about it.

If you go on the [TSFA] web site, there’s trial attorneys advertising. It’s hard for me coming into the system to say that’s an independent, objective group. It’s certainly not representative of the system. I don’t think it’s either destructive or productive. If they want that forum to talk, they can. I ignore most of that stuff and do what I think is best to drive profitability for franchise owners.

Has that style worked? In any industry, if you focus on what matters to employees or to franchise owners and you focus on the economics, all the rest comes around. So that’s why I set up the weekly communications and that’s why I answer every e-mail sent to me. I really do believe that people are people, and you need to deal with them individually.

I’ve already had five or six franchise owners e-mail me and say ‘Greg, we were going to sell our store, but we really like what’s going on now and we’ve pulled it off the market.’

—FRED MINNICK

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future royalties under section 21.3 of the franchise agreement,” Herman says. “What happens if you don’t have any net profits? You’re apparently not entitled to anything ... Let’s say you’re in a 15-year agreement and you’re three years in and say, ‘I can’t take this anymore. I’m losing \$4,000 a month.’ So, you terminate the agreement. They file a claim for simple breach of contract under 21.3. You say ‘I was defrauded’ but you signed the agreement and are forced to pay.”

A New Beginning

How do you attempt to mend the relationships between disgruntled franchisees and Quiznos? You hire a turnaround specialist like Greg Brenneman, Quiznos new CEO and the former COO of Burger King and president and COO of Continental Airlines.

Raised a Mennonite in tiny Hesston, Kansas, and a graduate of Harvard Business School, Brenneman made peace with Burger King franchisees, improved its profits, and prepared the company for its initial public offering.

“[Brenneman] brings an excellent track record working with franchise owners to improve their unit economics and the ability to spearhead revenue growth through innovative new products, concepts, and opportunities,” stated Rick Schaden, in a January press release. Schaden stepped down as Quiznos CEO at that time but remains chairman.

With Quiznos, Brenneman has an extra incentive to fix the company—TurnWorks Inc., Brenneman’s private equity firm, has taken an equity position.

Since taking Schaden’s spot, Brenneman has sent out a weekly voicemail to franchise operators and fields 50 to 75 franchisee emails a day.

“There was very little communication coming out of Quiznos corporate historically,” Brenneman says. “I think we’re working through it ... There’s a little bit of excitement and hope in the system right now.”

And for good reason. On March 2, Brenneman declared amnesty for all defaults.

“[This] is a new process, where we treat felonies like felonies. If you have food safety issues, that’s a felony and we’re going to fix it,” Brenneman says. There will be no more default notices for “minor things, like you didn’t button your top button on your shirt.”

Brenneman is also finding ways to cut cost. He has implemented a 20-percent

cost reduction on kids’ meals and a 19-percent drop in cleaning chemicals.

“[For] our kid’s meals, we actually gave a sandwich, Cheetos, a cookie, and a fruit roll up,” Brenneman says. “For what competitors were doing for kids, we had twice as much food as anybody else.”

Brenneman plans to bring food cost down from slightly more than 30 percent to the 25- to 26-percent range. One strategy is to cut back on the extra meat.

“If we said we wanted to do extra meat sandwiches, that automatically became double meat. You can’t even close the sandwich

Brenneman plans to bring food cost down from just more than 30 percent to the 25- to 26-percent range.

practically,” he says. “If you go from [double meat] to 175 percent or 150 percent meat and you look at them side by side, you can’t even tell the difference. There’s still meat spilling out everywhere, and yet the food cost of that is dramatically different.”

Quiznos is also removing 27 percent of its SKUs by reducing the number of sandwiches, chips, salads, and bottled drinks by at least 25 percent. Product specification changes are being made to move to 2, 4, and 6 ounces on all subs with 3, 6, and 9 ounces on the extra meat subs. New bacon is being brought into the system at 25 percent of the cost of the current bacon.

“[These changes] I don’t think the customer will notice at all,” Brenneman says. “But it has a dramatic effect on food costs.”

As for marketing, Quiznos loves television and is sticking to its spots. But there will be a reduction in couponing.

Operations Over Development

With the company-wide goal of increasing restaurant profitability by \$15,000 per store, Brenneman wants to focus less on development and more on operations.

“We need to be great operators,” he says. “Any franchise system, to be healthy, needs to be a great operating system. Growing our existing franchise owners—that’s more important to me than how many new units we build.”

He wants to grow at a rate of 400 to 600 stores per year. But he’d like to see that development come from profitable franchisees instead of new store owners.

Moving toward that goal, the company plans to launch a new web site, myQuiznos.com, a franchise-owner portal. It will provide training, online equipment, food ordering, and many other tools to help owners. Quiznos is also testing appliances and service components that will significantly increase profitability, Brenneman says.

But even with the promises of dropped costs and higher profits and more concentration on their needs, some operators are skeptical.

“Right now, from franchisees’ perspective, it is business as usual, as it has been for years, and that’s not good,” says Chris Bray, president of the TSFA. “Greg is planning to make some changes ... We wait with baited breath.”

Greg Schaefer, a two-store operator in Kentucky, thinks differently. He’s done the math, and says, “I can make a profit in 2007,” with all the reduction in costs.

“There’s no doubt corporate is starting to make some good changes,” Schaefer says.

Brenneman says six franchisees, who planned to sell, have already told him that because of tomorrow’s promise, they’re staying in the system.

“There’s no magic to this,” Brenneman says. “We’re just solely focused on increasing the profitability at the restaurant level, and I’m taking a look at all the revenue items and all the cost items to pull that off.”

He believes that once everybody starts making profits, the lawsuits and the negative mood will go away. The company is even willing to let bygones be bygones with franchisees suing them.

“If they want to come back in good graces and work through the processes, we’ll certainly welcome them back,” Brennan says. “But the best thing I can do is put them in a position that’s attractive, whether they’ve been sold a franchise that isn’t open or they’re an operating franchisee. Three months from now, it’s going to be a lot easier for these guys.”

For now, “I want franchisees to feel like there’s some hope in the system,” Brenneman says.

So do they.



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