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KAHALA BRANDS™

How Canada's Serruya Family Made Some $300 Million Off A Bunch Of Faded Food-Service Brands

Michael and Aaron Serruya made a fortune in Canada with Yogen Früz, starting in the mid-1980s, when frozen yogurt was booming. Now, after 30 years of dealmaking in frozen desserts, they've done it again, with the sale of closely-held Kahala Brands, an under-the-radar franchisor of faded food-service brands, including Cold Stone Creamery and Blimpie, to a publicly traded Canadian firm, MTY Group, for around $320 million in cash and stock.

Michael Serruya, 51, and his younger brother Aaron, 49, and their parents indirectly own 92% of Kahala, so that represents a roughly $300 million take for the Canadian yogurt kings. And it raises questions: Why are 18 food brands, some of which have been shrinking for years, worth such a hefty price? And what does the deal say about the possibilities for bringing back aging brands – and profiting off those that have lost their luster?

"We have always been value acquirers," Michael Serruya told Forbes in a recent telephone interview. "And we hope that we see values or opportunities that others overlook. Typically it is those type of assets that have the greatest upside."

Serruya, whose family immigrated to Canada from Morocco in the 1960s, got into yogurt in the mid-1980s when TCBY and I Can't Believe It's Yogurt had created a boom in the United States. Seeing the lack of such frozen desserts in Canada, the brothers – then 20 and 18 – flew down to TCBY's Little Rock, Ark., headquarters to see if they could become that brand's Canadian franchisee. A few days later, TCBY told them no; it simply wasn't ready to move to Canada. "My brother and I were devastated for the first two or three hours," Serruya recalls. Then they realized that they could develop their own concept from scratch, setting up a frozen yogurt business in Canada before anyone else did. So they came up with the name Yogen Früz – like Häagen-Dazs, a made-up name with an umlaut – and opened the first location in a suburban Toronto mall.

By the time TCBY did enter Canada, Serruya recalls, Yogen Früz already had around 100 stores and had staked out many key locations. And it kept expanding. In 1995, it raised $30 million in a public offering on the Toronto Stock Exchange, allowing it to do a flurry of acquisitions, including I Can't Believe It's Yogurt and Golden Swirl. Three years later, it merged with Integrated Brands, an American marketer of frozen treats, to create CoolBrands International. At its peak, CoolBrands was one of North America's largest ice cream makers, with brands like Eskimo Pie and Chipwich. But its fortunes ultimately unraveled, the company's assets were sold off and the publicly traded shell that remained was merged with Wayne Huizenga's Swisher International in 2010.

For years, Serruya had eyed Scottsdale, Ariz.-based Kahala, so when it went to auction in 2013, the family jumped. Founded in 1981 as a smoothie-and-juice bar, Kahala had its own long and rocky history. Over the years, the business had expanded rapidly, especially after Robert Peterson, the late publishing magnate (Hot Rod, Guns & Ammo, Motor Trend) invested in it in 1999. In 2006, for example, Kahala bought Blimpie, the struggling sub chain, adding nearly 1,600 restaurants to the fold and increasing systemwide sales to more than $600 million. A year later, Kahala merged with Cold Stone Creamery, then a popular ice cream chain with 1,400 locations run by Doug Ducey, now the Republican governor of Arizona. The new entity was large and unwieldy, with more than 4,600 locations and more than $1.1 billion in systemwide sales. Cold Stone was Kahala's largest brand then, and it continues to be so today.

Trudy Grabenauer, 63, who has been a Cold Stone franchisee in Sonoma County, Calif., for 15 years and now runs four locations that bring in about $400,000 apiece in revenues, says that things changed at Cold Stone after the 2007 sale to Kahala. The organization became more corporate, and franchisees were often kept in the dark, she says. Making matters worse, store owners felt squeezed as the country plunged into recession in the wake of the 2008 financial crisis. "The recession really hit the ice cream business hard," she says. "I barely made it through that."

It didn't help that ice cream stores like Cold Stone struggled with new competition from Pinkberry, founded in 2005, and a renewed frozen yogurt craze. The chain had grown quickly, and many franchisees faced costs that were too high for any downturn in sales. In 2012, franchising trade publication Blue MauMau named both Cold Stone Creamery and Blimpie to its list of worst franchises to buy. Default rates on its franchisees' SBA loans soared, landing it near the top of the worst-defaulters for the decade ended in 2013, according to an analysis of SBA data by the *Wall Street Journal.* And litigation with franchisees piled up, with dozens of court cases and arbitration proceedings detailed in Cold Stone Creamery's recent franchise disclosure document. One suit involved a group of franchise owners who accused the ice cream chain of failing to provide detailed information about money they believed should have been set aside for their benefit in a marketing fund. (Serruya says that most of the Cold Stone litigation has been resolved.)

By the time the Serruyas acquired Kahala in 2013, for an undisclosed sum, it had shrunk dramatically. Its 14 brands accounted for systemwide revenues of $760 million, some 45% lower than at the time of the Kahala-Cold Stone merger. Serruya, who'd never shied away from beaten-down brands – he'd invested in American Apparel when it was on the brink in 2011 and even once made a play for the parent of adultery website Ashley Madison – saw value. He believed that Kahala offered something unusual in the world of franchising: A rollup of numerous food-service brands, which allowed it to plug in new acquisitions to grow.

"The business model of Kahala was to acquire franchise brands that got stuck. They had these weak brands," says John Gordon, principal at Pacific Management Consulting Group. Adds Darren Tristano, president of food-industry consulting firm Technomic: "There are very few stories of brands recovering."

Since Serruya took over as CEO, he has returned the business to its core fast-food operations. He sold off extraneous assets like hotels, unloaded the company-owned stores to refocus on franchising, and pruned back the number of units to increase profitability and same-store sales, a key metric of financial health. The number of U.S. Cold Stone Creamery outlets shrank 7% to 1,035 in 2015 from 1,111 in 2013, while the number of U.S. Blimpie stores dropped 36% to 357 from 560 in the same period. “I think most of the pruning took place on or about 2013, and to a smaller degree in 2014,” Serruya says. “We are net-net opening more stores than we’re closing. But no question that pruning needed to take place.”

Mohit Mehrotra, 38, who once owned three Cold Stone stores in Massachusetts and Rhode Island with his father, sold two of his locations and is now in the process of closing his last one. The triple-whammy of high real estate costs, high labor costs and ice cream being a tough sell in the winter in the Northeast squeezed his business, Mehrotra says, and he’s been losing more than $30,000 on the store a year to stay open. “I love the Cold Stone brand, but we’re burnt out,” he says. Brian White, 38, a restaurant owner and Cold Stone franchisee who once had nine stores and a development deal to open many more, similarly, has whittled down his holdings to just two stores, one in Albany, and the other in Springfield, Mass., since first buying into the system in 2004. “I am fearful about the brand, but I know how to market my own stores,” he says, noting that his two remaining stores bring in about $1.5 million in combined sales. “I don’t think I could make a profit under $400,000.”

Serruya points to rising same-store sales at Cold Stone as an indication that his strategy since buying Kahala is working. Cold Stone Creamery’s same-store sales rose 7.6% in 2015, and then climbed 6.4% in the first quarter of this year – strong numbers for a fast-food operator. Kahala’s overall results are equally impressive: While its revenues of $121 million in 2015 were 7% lower than in 2014, its pre-tax income of $22 million was 35% higher in the same period, according to Kahala’s audited financial statements. Serruya attributes the revenue decline largely to a selloff of corporate-owned stores. “We are very big believers in the asset-lite model, which is a system that is predominantly franchised, so when you see a small shrinkage on the top line, it has not been a shrinkage on the bottom line, which has grown exponentially over the years,” he says.

Today, the company has no debt, not even a line of credit. Meanwhile, Serruya has acquired additional brands, including Planet Smoothie, Tasti D-Lite and, most notably, Pinkberry, the once-trendy frozen dessert chain, with 155 U.S. outlets and systemwide sales of $138 million in 2015. “This is a space where my family and I feel very comfortable operating,” Serruya says. “We understand it, we love it, and we think we can add value to the brands.”

Yet less than three years after buying Kahala, in late-May, the Serruyas agreed to sell it to MTY Group, which like Kahala is a rollup of food-service brands that do well in food courts, creating a franchise conglomerate with some $1.6 billion in systemwide sales and $70 million of Ebitda (earnings before interest, taxes, depreciation and amortization) from 58 brands in more than 5,600 locations worldwide. Investors in MTY appeared pleased: Since the deal was announced, they’ve bid up MTY shares 24% to a recent $44.

Serruya says that he had sought the deal with MTY’s founder and CEO Stanley Ma, who he had known for more than a decade and who is a Canadian franchisee for Kahala’s TacoTime brand, and the two had been in discussion for a year and a-half. The deal will allow Ma, who the Canadian press dubbed the food-court king and who built MTY through a series of acquisitions to a company with 40 brands like Vanellis, Mr. Sub and Kim Chi Korean Delight that few Americans would know, to expand to the United States. (Ma declined to speak for this story.)

Franchisees don't seem to know much about the deal yet. Grabenauer, the Sonoma County franchisee, says she received a short email. Kyle Turner, 24, who started at Cold Stone out of high school in Amelia Island, Fla., and last summer bought the store with a partner, says he wasn't even aware that Kahala had agreed to sell – though he couldn't be happier as a new franchisee. "It doesn't really affect our day-to-day operations. It just shows that we're in such different worlds," Grabenauer says.

Serruya believes that the deal will not only help MTY in its desired expansion to the United States, but will also yield operational efficiencies by putting numerous franchised operations together under one roof. He points to MTY's Mr. Sub brand in Canada, which mirrors Kahala's Blimpie brand here. The strategies of the two companies to acquire fast-food brands (QSR, in the restaurant lingo) that do well in food courts, shopping malls and the like are "identical," Serruya says. "The only difference is that we operate in different geographic areas. That is why this [deal] makes so much sense."

As for Serruya himself, after the deal closes he'll be a major shareholder of MTY and continue to work with the combined entity on acquisitions, looking for fast-food brands that can round out MTY's food-court offerings, as well as potentially expanding into other sectors. "We expect to be very aggressive on the M&A side," he says. "That's part of what I enjoy doing."