Lender Preferences

What types of financing does your franchise offering attract; why it matters to your franchisees, why it should matter to you, and how you can positively influence lender credit guidelines.

Business format franchising is all about franchisors offering proprietary brands, systems, training and support, in consideration of the efforts (and capital) of a network of franchisees. The fundamental purpose of franchisors however, is not to offer financial assistance. Franchise Disclosure Document Item 10. Financing, routinely reads; "*Neither we nor our affiliates offer direct or indirect* financing or guarantee your notes, leases or obligations*." Some franchisors further disclose; "*However, you may obtain financing from third parties and we may suggest funding sources to you.*" Franchisors accepted by the U.S. Small Business Administration ("SBA") as meeting eligibility requirements for its Franchise Registry program also disclose; "*Through the SBA Franchise Registry program www.franchiseregistry.com you may be eligible for expedited and streamlined SBA guaranteed loan processing through commercial lenders.*" A minority of franchisors disclose assistance with select fees and costs. Although such financing disclosures may conform to the FTC Franchise Rule, they fail to represent the influence franchisors and network performance have on attracting or discouraging lenders.

> *Note: The Federal Trade Commission ("FTC") defines franchisor indirect offers of financing to include; "*A written arrangement between a franchisor or its affiliate and a lender, for the lender to offer financing to a franchisee; an arrangement in which a franchisor or its affiliate receives a benefit from a lender in exchange for financing a franchise purchase; and a franchisor's guarantee of a note, lease, or other obligation of the franchisee.*"

Commercial financing is a viable option for franchisees that do not possess the necessary liquid capital, or do not wish to tie up cash, liquidate assets, take on equity investors, or dilute ownership among shareholders. Despite the prevalence of franchisees that utilize leases and loans in the operation of their franchise businesses, and possibly due to the wide range of debt incurred from none to 80% or more, financing costs are conspicuous by their absence from Franchise Disclosure Document Item 7. Estimated Initial Investment.

A short list of commercial franchisee finance options:

1. **Commercial Non-SBA loans.** (Collateralized exclusively by business assets.)
2. U.S. Small Business Administration ("SBA") government guaranteed loans.
3. Commercial Non-SBA loans. (Collateralized by personal and business assets.)
4. Home equity loans (An economical source of capital for franchisees with sufficient equity in their homes.)
5. IRS tax qualified employee benefit profit sharing plans. (Investment of franchisees' retirement plan rollover capital into loans to their franchised businesses.)
6. Credit Cards. (Not recommended or endorsed, but in wide use by franchisees.)

Franchise financing should be subject to a certain degree of negotiation, no matter what loan officers are programmed to say. The stronger the credit worthiness of franchisees, franchisors, networks, industries, and the economy, the greater borrowers' negotiating position will likely be. A complete absence of negotiation is an indication that something is amiss, and should be investigated and corrected before moving forward, if possible.

Franchisee financing is often available in a range of fixed or adjustable interest rates, with terms ranging up to 10 years. Terms are almost always negotiable, with the sweet spot usually occurring in the 60 month range. Interest rates may or may not be negotiable depending on a number of factors including, but not limited to; i) the types of loans available, ii) the prime interest rate charged by the Federal Reserve Bank, iii) borrower and guarantor credit histories, iv) current or anticipated local, state, regional, national and international economic conditions, v) borrowers' business type, vi) lender's cumulative risk experience within borrower's business segment or industry, vii) lenders' reservation of the option to resell loans within the financial marketplace after funding, and the topic of this article, viii) the influence of franchisors and their networks.

Lender Preferences

What types of financing does your franchise offering attract; why it matters to your franchisees, why it should matter to you, and how you can positively influence lender credit guidelines.

Finance application submission requirements are usually non-negotiable, at least until lenders have received and verified sufficient franchisee documentation and information to provide a qualified credit approval in writing. As lenders gain comfort and enjoy positive experience with franchisees, franchisors and their networks, they may relax certain compliance requirements, but only when requested to do so by solid performing business owners that present compelling reasons for any exceptions.

Up front fees, charges and related costs are typically negotiable with lenders, and may include loan origination and guarantee fees that can total up to several percent of the loan amount, as well as term life insurance policies on franchisee principals.

Personal asset collateralization may also be negotiated with lenders. The difference between personal and business asset collateralization can be material for franchisees, especially when lenders request personal asset coverage in excess of 100% of the loan value. Franchisees universally prefer not to pledge personal assets and be encumbered by lender restrictions on the purchase or sale of their homes and marketable securities.

The one exception to negotiation, at least for new, "*start up*" franchises, are personal guarantees of the principle franchisees and guarantors that lenders request for virtually all small business financing. Typically, only the most well established and fiscally sound companies are able to secure commercial financing with corporate guarantees based solely on an officer's signature, and without any personal guarantees.

One type of financing worth highlighting is the **Commercial Non-SBA loan, collateralized exclusively by business assets, with no pledge of personal assets**. These loans are frequently referred to as "*Conventional Business*", "*Credit*", or "*Cash Flow*" financing, and are the preferred financing option for businesses with established track records and proven financial performance. When such loans are offered to franchisees, especially new "*start- up*" franchisees, they are typically available only through experienced franchise friendly lenders that maintain in house expertise capable of performing sophisticated analysis of Franchisor Disclosure Documents and comprehensive evaluations of franchisors and their networks. Despite franchises being individually owned and operated, lenders offering this financing factor in the viability of franchisors and the historic performance of their franchise networks, as they establish basic credit guidelines for franchisees. The benefits to franchisors, whose franchise networks have been pre-approved for this type of financing, are manyfold. Franchisors are not required to directly or indirectly assist with any resulting franchisee loans, although that is an option some franchisors offer. Interest rates are usually competitive and fixed for the loan term, which can range from 24 to 72 months or longer. Up front fees are minimal, normally requiring only a modest security deposit, inconsequential processing fees, and the first month's payment at time of funding.

Once credit guidelines have been established for "*conventional business*" financing, lenders investigate the credit worthiness of principle franchisees and any guarantors that apply. Lenders will analyze borrowers' personal cash flows in combination with anticipated franchise business cash flows including debt service on the new loan. "C*onventional business*" financing requires that combined personal and business cash flows remain comfortably positive throughout the loan term. Given the fact that startup franchised businesses require working capital infusions for months to a year or longer, the lender requirement to maintain net positive cash flows will, more often than not, involve ongoing income from sources such as spouses, partners or guarantors that maintain outside employment through the point when the businesses reach sustainable profitability.

"*Conventional business*" loans, while not for everyone, are often one of the most overlooked, yet desirable and cost effective sources of debt financing available to both "*start up*" and existing franchisees who qualify. Not unexpectedly, the performance and reputation of franchisors and their networks to positively (or negatively) influence experienced franchise lenders offering such conventional financing is equally overlooked.

Lender Preferences

What types of financing does your franchise offering attract; why it matters to your franchisees, why it should matter to you, and how you can positively influence lender credit guidelines.

Franchisors, without offering direct or indirect financing assistance to their franchisees, can influence the types of loans lenders are willing to offer franchisees in other ways as well. To attract lenders of SBA guaranteed financing, franchisors can apply to the SBA and meet the eligibility requirements for its FRANCHISE REGISTRY program at *www.franchiseregistry.com*. In addition, the SBA website, www.sba.gov contains a gold mine of information about franchise and small business financing that all franchisors should avail themselves to, including long term studies of franchising from various perspectives. To attract other types of commercial financing, and set the stage for franchisees to be able to negotiate the most competitive leases and loans, franchisors are well served by calling on finance intermediaries and brokers, as well as the presidents of several local, regional, and national banks that market franchisee financing, to inquire about lender preferences related to franchisors and their networks.

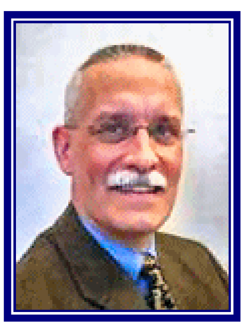
Franchisors' positive contribution to franchisee financing is as much about becoming knowledgable of, and delivering on, the right things, as it is about avoiding the wrong. The sad fact, and a primary reason why businesses, franchised and independent, small and large, public and private, fail to thrive, is inadequate capitalization, which can occur at any time in the business life cycle.

The "*Guidelines for attracting franchise friendly lenders*" included with this article represent a comprehensive starting point for franchisors to perform a self evaluation. Generally, the more lender preferences franchisors meet, the more competitive and favorable loan rates, terms and credit guidelines will be, the greater the access to the most cost effective loans, and the stronger the negotiating position of credit worthy franchisees.

If your franchisees are not enjoying access to, and negotiation of, the most cost effective financing, or are cannibalizing retirement savings plans, or are resorting to the temptation of credit cards to augment working capital needs, now is the time to perform an evaluation and begin a rigorous program of corporate and network enhancement to help your franchisees access the financing they deserve and achieve the success they desire.

About the Author:

Bob Snelling is president and founder of Honor Capital Group, LLC a small business consultancy and finance intermediary, and the author of Tip Top Docs brand of professional business documents.



Bob's diverse business experience spans multiple industries dealing with products, services and people. Serving as an employee in various positions from warehouse to boardroom Bob has directly reported to no less than five extraordinarily different company presidents. As a business owner making decisions, setting budgets, and meeting payrolls for up to thousands of employees, Bob has known first hand what it is to maintain legal, operational and P & L responsibility. Performing in the roles of senior level executive, CEO, board director and major shareholder of Snelling and Snelling, Inc., a national, and for many years international company with hundreds of franchised and corporate units, Bob has by necessity perfected leadership skills that are tolerant and respectful of widely divergent perspectives.

A unique background with progressive levels of operational, managerial and financial responsibility has proved invaluable preparation for Bob's current role as business advisor and finance intermediary. Guided by ethical behavior, attention to detail, and a regimen of planning, collaboration and teamwork, Bob's innovative yet practical solutions consistently deliver return on investment and stand the test of time. Decades invested in the identification and implementation of sustainable best practices uniquely qualifies Bob to author relevant topics that today's franchised and independent business leaders can immediately benefit from and put into action.

Bob currently resides in Plano, Texas a suburb of Dallas with his wife and business partner Carol, their two children and a Border terrier.

e-mail: bob@HonorCapitalGroup.com phone: (972) 735-0005

Lender Preferences

What types of financing does your franchise offering attract; why it matters to your franchisees, why it should matter to you, and how you can positively influence lender credit guidelines.

Guidelines for attracting franchise friendly lenders:

1. Franchise Offering

- ☐ Proven concept successfully operated by multiple companies as company owned and/or franchised divisions with broad geographic distribution.
- ☐ Emerging market not yet saturated according to Franchise Disclosures, as well as industry and government statistics.
- ☐ Relatively recession resistant.
- ☐ Minimal or limited seasonality.

2. Franchisor General

- ☐ Actively franchising ≥ the initial franchise agreement term, well beyond start-up and into the franchisee renewal phase.
- ☐ Established franchisee pre-qualification criteria for experience, net worth, liquidity and working capital, commensurate with franchise offering.
- ☐ Provides assistance/guidance with target market demographics, unit site selection, lease negotiation, design and build out.
- ☐ Brand name recognition sufficient to help generate sales in addition to franchisees sales ability.
- ☐ Resale valuation formula for franchise units approximates industry norms.
- ☐ Franchise agreement term exceeds length of typical finance terms, normally >5 years.
- ☐ Licensed to sell franchises and conduct lines of business provided, in all states where franchisee borrower businesses are to be operated.
- ☐ Member in good standing and active participation in one or more franchise and industry specific trade associations.
- ☐ Minimal environmental risks, such as on premises storage, use and/or release of chemicals, dust, fumes, etc.
- ☐ Minimal legal disclosures. No negative pattern of franchisee disputes, litigation, judgments and settlements. No state or federal injunctions for fraud, violation of franchise law or unfair or deceptive trade practices laws.
- ☐ No corporate bankruptcies without detailed explanation, and years of successful post bankruptcy operation.
- ☐ High standards for franchisees' systems, employees, facilities, quality, cleanliness, and purchase/use of goods and services.
- ☐ Provides options for franchisees to purchase goods and services from multiple sources at competitive prices.
- ☐ Reasonable but not excessive control over franchisees' businesses.
- ☐ Reasonable franchise renewal terms and conditions.
- ☐ Use of incentives and sanctions to enhance franchisee value and encourage compliance, resorting to legal enforcement for only the most material and chronic franchisee breaches/defaults of the franchise agreement.
- ☐ Provides continual support to franchise network to drive franchisees top line revenues and bottom line profitability.
- ☐ Willingness and ability to support and train, and in certain circumstances, extend financing to struggling franchisees.
- ☐ Willingness and/or contractual ability to maintain franchise units in continual operation without permanent closure in event of franchisee default or termination, with franchisor option to assume position as landlord or sub landlord, or via direct unit ownership.
- ☐ Willingness to waive 1st lien positions on franchisee furniture, fixtures, equipment and inventory in favor of lender.

3. Franchisor principals

- ☐ Prior experience at company, within the industry and/or franchising.
- ☐ No felony convictions for fraud, violation of franchise law or unfair or deceptive trade practices laws.
- ☐ No commercial bankruptcies and explanations for any prior personal bankruptcies within past 7 years.

4. Franchisor financials

- ☐ Broken out by franchise system, with parent, subsidiaries or other entities and/or activities individually reported.
- ☐ Majority of income derived from franchise fees and royalties as opposed to company owned units or product, equipment and service sales.
- ☐ Demonstrate profitability, increasing retained earnings, and consistent shareholder equity.
- ☐ ≈$2MM min. gross revenues. ≈$1MM min. total assets. ≈$500K min tangible net worth (commensurate with franchisor unit count).
- ☐ Increasing gross revenues, total assets and tangible net worth from year to year, unless satisfactory explanation for any decreases.

5. Franchisees

- ☐ Reasonably sized and protected sales and/or unit territories, or full franchisor disclosure of no granted territories.
- ☐ Reasonable direct/indirect local competition, with minimal or no competition from franchisor and fellow franchisees.
- ☐ Capable of funding >20% of initial franchise investment and up to 100% of ongoing working capital requirements through breakeven.
- ☐ Total initial investment to open and reach sustainable profitability is reasonably within range of franchisor's investment disclosure
- ☐ Loan term requests < current franchise agreement term length.
- ☐ Facility lease term or lease renewal term options that cumulatively equal franchise agreement term length.

6. Unit counts, growth and turnover

- ☐ >50 units in operation each >1 year old.
- ☐ Franchise unit count > company owned unit count.
- ☐ Franchise unit counts for multi-unit franchisees ≥ single unit franchisees.
- ☐ Year to year net franchise unit count growth, with adequate explanation for any declines in Franchise Disclosure Document.
- ☐ Franchise unit openings closely match franchisee commitments to open units as disclosed in prior year Franchise Disclosure Documents.
- ☐ <10% total annual franchise unit turnover without acceptable franchisor written explanation in Franchise Disclosure Document.

7. Fees and costs

- ☐ Reasonable initial franchise fees for type of business or industry and comparable to competitor offerings.
- ☐ <10% of the equivalent of gross sales revenues for total ongoing fees for royalties, advertising/marketing funds, etc.