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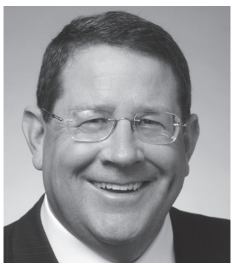
Working Out

How to prevent or work through financially troubled franchisees



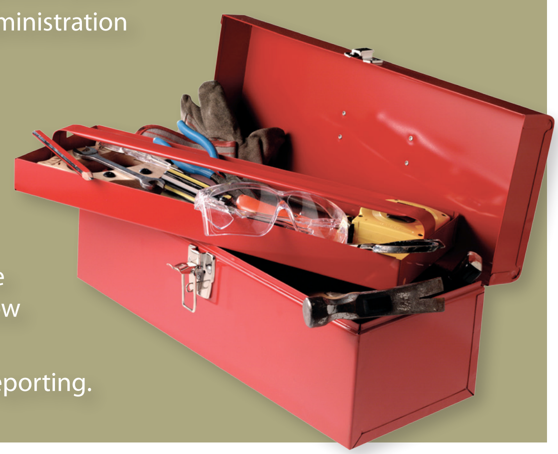
By Dennis L. Monroe

A franchise system is defined by the strength of its franchisees. But franchisees within a system are seldom uniformly strong, because they vary in their operational, developmental and financial capabilities. In light of this diversity, let's look at a model way to deal with franchisees' financial issues and to successfully steer a troubled franchisee toward becoming a successful and financially viable member of the system.

Tips to avoid trouble

Franchisors can change the impression, and the distrust associated with it , that they are playing a behind-the-scenes Big Brother role in their systems. Here are some steps to take:

1. Have different reporting systems in place.
2. Involve the Small Business Administration if it is used.
3. Maintain open, constant dialogue with key lenders.
4. Use uniform accounting systems and charts of accounts.
5. Deploy updated and effective point-of-sale systems that allow for daily polling.
6. Develop effective overstore reporting.



The initial evaluation

All franchise systems have some basic financial requirements, but I would suggest the franchisor look at four financial matrices to evaluate a franchisee:

1. Liquidity. It is not just present liquidity but available liquidity. If the franchisor requires $300,000 of liquidity, and if all of it goes into the opening of stores, there may not be any backup liquidity. Perhaps the franchisee should secure a line of credit or have other resources available. In most cases the liquidity needs should be double of what most franchisors require.

2. Financing. Franchisors often miss the scope of a franchisee's financing. It is important to use a balance-sheet approach. Look at initial leverage in light of the equity contributed into the franchisee's company. Answer the following questions: Is the financing amortization reasonable? What is the pro forma fixed-charge coverage ratio? What collateral is being used for the loan? Is it cross-collateralized with other assets of the franchisee? Does the franchisee run more than one concept?

One of the biggest issues I have seen in multi-unit franchisees is that everything is cross-collateralized. If one concept is not doing well but another concept is, cross-collateralization can bring everything down. It is very difficult to untangle this type of arrangement.

3. Real estate. Look at how the real estate is owned and handled to ensure franchisees will be successful. Consider the following points in a lease: The rental rate should be a reasonable percentage of sales; rents should not have overly aggressive inflators or percentage rent provisions; and the lease should not be used as a financing vehicle for personal property. This can be costly and cause the franchisee, even in normal times, to pay excessive fixed charges.

4. Franchisee expectations. What are the expectations regarding taking money out of the company? If the franchise is a job replacement, the franchisee obviously has to be able to make a living. If it is an investor-type franchise, the franchisor needs to make sure the investor's expectation about cash flow that comes out of the business is appropriate.

I often encounter unrealistic expectations, with franchisees believing they are going to be able to take cash out of the business from day one. Cash may need to be accumulated, so any pressure to make distributions may have an adverse effect on the operation.

Monitoring

Next a franchisor needs to effectively monitor its franchisees. Most franchise documents allow the franchisor to get the financial statements. I am often amazed that franchisors do not request balance sheets. They are aware of the P&Ls and gross sales (by collecting royalties), but they are seldom apprised of the appropriate positions of the balance sheet, particularly since debt funding is readily available and can be easily refinanced. It is important to review the franchisee's balance sheet every year (or every quarter, if possible) to review the leverage, the lenders, the type of collateralization and lease modifications.

Even if the franchisor has an ongoing monitoring process, there are situations when the franchisee can get in financial trouble. It is important to find this out early. The first warning sign is a tight fixed-charge coverage ratio (FCCR, the necessary available cash flow to pay debt and fixed charges). Do not wait for the franchisee to fail to pay royalties or rent.

If there is no financial cushion, the franchisor knows it is only a matter of time until the franchisee has to put more money into the company, begin running up trade payables or get behind on rent, royalties and debt service. If the franchisee has an FCCR of 1.2 or lower (particularly if they are in the 1.1 range), the franchisor needs to work with the franchisee, discuss additional equity and develop a plan to get the fixed-charge coverage up to where it should be.

If the franchisor realizes the franchisee is really in trouble, the franchisor needs to actively engage in discussions with the lenders, equipment leasing companies and landlords. There needs to be a realistic determination. First, should rent be adjusted to a level that can be sustained as a percentage of sales? As to debt, is it over-leveraged, and is there a need for a writedown or reamortization? Equipment leases, which can be costly, should be reviewed and possibly renegotiated.

The franchisor has to be active. The franchise development and financial people have to be involved in this process.

If the franchisee seems to be heading toward bankruptcy (which, while granting a franchisor substantial rights, imposes considerable limits in terms of disclosure, closed stores and other issues), the franchisor needs to look at ways to either buy out the franchisee—turning the stores into corporate stores or flipping them to a different franchisee—or work with the lender to possibly look at closures or a reconcepting of the stores.

There is a plethora of possible solutions. One of the most successful options is transferring the stores to a new franchisee who is financially strong and good at turnarounds. Though franchisors are always reluctant to pay to get rid of a franchisee, doing so, working with the lenders and helping someone else come onboard (either in a joint venture or as an operator until things can be stabilized) can be the best approach.

If the situation is not salvageable, the franchisor may choose to forgo pursuing personal guarantees or other collection activity (unless the circumstances warrant it) and work with the franchisee to close the store without penalty and get out of the system.

Good, effective partnership and involvement by all interested parties is key. Careful franchisee evaluation and selection, monitoring and a proactive role in addressing potential problems can go a long way toward preventing or reducing the damage a financially troubled operation can cause to a system. FT

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