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In search of equity

Finding available lending sources

We need equity, and we need it now. Tight credit is hurting franchising, but there is hope—and financing—from several potential sources.

No debt and little equity have made it difficult for franchise systems to plan for the future. But do not lose hope. Here are some tools to assist you.

First, equity is most effective when there is debt at some level. Debt is tight, but moderate leverage is available. Consider the SBA, local and regional banks, leasing companies and some of the traditional lenders at a much lower leverage.

As for equity, there are some analogous situations. Whole Foods and Times Co. both did private placements in the form of convertible debt or preferred equity. We can learn something from this. Also, while the price/earnings ratios seem to have come down (particularly for the S&P 500), this is really not accurate because the market has already anticipated lower earnings. Therefore, the price/earnings ratios may still be at a moderate level.

All this means the returns expected are still reasonable; and we in the franchise world do not have to look at fire sales or low valuation for equity deals.

So what is truly available?

Vulture funds:

Private individual investments, particularly in the real estate area, are starting to surface. This is particularly true in the hotel area and triple net lease properties. These funds can help a good operator secure funds for acquiring troubled assets that can be turned around. The low pricing can create some opportunities. Groups such as DJM Realty and Hilco Real Estate may be a good source of information in this area.

Franchisor enhancement:

Recently, franchisors have been looking at ways to provide an enhancement to lenders and equity sources to provide the needed funds to their franchise system. With stock values dropping precipitously, most public franchisors are now less concerned about their present market cap versus trying to plan for the future and search for ways to enhance the value of their franchise system. These franchisors are now more willing to lend their balance sheets to enhance or actually provide equity to the franchise system. Here are some possible approaches:

- Franchisors establish a seed equity investment to a newly created fund with a hopeful investment and look at friends of the company to invest in the fund. The fund then provides either preferred or mezzanine type investments to capital- and debt-challenged franchisees.
- Franchisors directly fund a joint venture or a store development plan with good operators.
- Franchisors raise money in a new entity for use exclusively for new store development.

Private placement:

Private equity money may be tight, especially on the franchisee side. The private placement market to individuals still has some limited viability. A carefully structured preferred stock offering with a moderate preferred return (4 to 6 percent) and a significant part of the upside (20 to 25 percent) may be a good alternative for certain moderately wealthy people. The key is strong unit or corporate economics with minimally volatile cash flow.

A new brand of private equity:

A new kind of private equity group is emerging. It focuses on micro investments with strong operators and

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ties their returns to current available cash flow. Some are mezzanine funds and preferred stock funds. An example of this new fund is CapitalSpring.

Landlords:

I know this has been discussed in numerous articles, but look at getting a direct loan from your landlord. Make this loan a self-liquidating loan where, for example, 10 percent is forgiven each year for 10 years.

Suppliers:

Carve off your overdue vendor payables and ask the vendors to reduce their pricing, thus increasing profitability. Use the price reduction to reduce the overdue payables to the vendor. This found money has a neutral effect on cash flow and improves your balance sheet.

Troubled Asset Relief Program (TARP) funds:

Why not? Consumer spending represents 70 percent of the economy. Franchise businesses represent a good share of this spending. If we really want to create jobs and spur the economy, put some money in the form of soft loans (Goldman Sachs got 5 percent money) to be administrated by me (just kidding). All of these funds could be used to pay off tough loans or new capital expenditures or working capital to hire or rehire workers.

Plan your needs. Look at what returns you can offer; franchisors/franchisees work together and then come up with a well-designed plan. Once designed, look at every legal permissible way to market and be patient. FT