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What Lenders Want When Making Franchise Loans

By Dennis L. Monroe

There is no doubt significant credit is available for the franchise community. This credit comes from different sources —large traditional lenders; sale/leaseback providers; smaller, niche lenders; unisource lenders; small or regional banks; private equity funds; individuals, and other sources. These lenders can be divided into four groups. This month's column will discuss what each of these groups is interested in when it considers providing funding to the franchise community. My partner, Ryan Palmer, recently moderated a panel discussion on this topic with various lender representatives and me at the Franchise Finance & Growth Conference, held last month in Las Vegas. Here are some take-away points from our panel and my general observations. Let's now look at the five lender groups and what they want:

Group 1: National Senior Lenders

- These lenders have been in the business for a number of years, have significant resources and have loaned billions of dollars to the franchise community.
- They look for larger franchisees in a first- or second-tier franchise system with a national following. The systems must have few closures or default issues and strong unit economics, have endured the downturn and are on a growth path.
- They expect franchisors to provide credit enhancements either through intercreditor agreements or remarketing agreements.
- They target multi-unit franchisees who have been in business for a significant period, typically with more than five stores, and a 4-to-1 EBITDA-to-debt ratio.
- Most of these lenders will require personal guaranties from the franchisee's principals, but in some cases they may be willing to limit the guaranty by amount or time, or both.

Group 2: Specialty Finance Companies

- Group 2 lenders don't compete with Group 1 lenders because their pricing and interest rates are higher. They look at stable third-, fourth- or fifth-tier concepts that do not have all of the characteristics of franchisees targeted by Group 1 lenders.
- These lenders focus more on the operator, under the theory that a strong operator has shown his or her ability to perform well regardless of what the franchise system does.
- They will often want the franchisor to provide some credit enhancements.
- They prefer systems with lower capital investment requirements, and may not be as real estate intensive as Group 1 lenders. They also require personal guarantees from the franchisee's principals.
- More franchisees will qualify for loans made by these lenders than will qualify with Group 1 lenders. Group 2 lenders are more expensive that Group 1 lenders, but Group 2 lenders have a significant presence and market share in franchise lending and offer flexibility and quick decisions.

Group 3: Local and Regional Banks

- Group 3 lenders have some interest in franchise lending and lend within their geographical footprint.
- These lenders are interested in a stable franchisor, but are underwriting the borrower more than the franchise system. Normally the borrowers are smaller franchisees who are in an early stage, are not overly leveraged, have good credit and strong personal financial statements.
- They require personal guaranties from the franchisee's principals.
- This group may consider lending to a franchisee that is part of a regional franchise system. These lenders may be one of the best sources of financing franchise systems with a presence in the bank's trade area. Many systems have developed unique relationships with such lenders.

Group 4: Specialty Lenders

- Group 4 lenders make small, specific loans, such as equipment or remodeling loans, cash advances or personal guaranty loans.
- The rates are comparatively high and the amortization period is short.
- Personal guaranties are required.
- Knowledge of the franchisor is important, particularly if they are lending for remodeling programs, point-of-sale upgrades or other types of specific activities or equipment mandated by a franchisor.
- For these lenders, the key is the operator and the operator's credit.

Group 5: Unisource Financing

- Group 5 lenders provide equity, debt and mezzanine financing, as appropriate.
- This group concentrates on operators over franchise systems or brands. They look for someone they can partner with rather than just being a lender. They finance new store development and acquisitions.
- This hybrid financing is relatively new to franchising.

The rates are high, particularly compared to senior debt.

- These lenders take a more active role in monitoring the activities of the borrower by increased financial reporting. They may require some control over major decisions, including one or more board seats.

Other options

- Sale-leasebacks. This remains an important option for real-estate-intensive concepts. With cap rates low, it's a great time to consider one.
- SBA financing. We cannot forget SBA-guaranteed loans, which is and will always be a major source of financing. Most lenders in Groups 1, 2 and 3 have SBA capabilities.

Much of this information we already knew, but the recent Franchise Times Franchise Finance & Growth Conference confirmed it. Let's hope the robust lending continues, but will not be unjustifiably exuberant.

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