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Off Balance

Seven ways for franchisors to lend a financial hand

By Dennis L. Monroe

Even though the credit markets have loosened to give the franchise community more credit, that does not mean money is plentiful (particularly for emerging concepts and non-national brands). Proactive franchisors should continue to look at creative ways to provide financing for their franchise communities. This financing, in many cases, creates an incentive for the franchisees to expand and develop aggressively.

Recently I have seen more creativity in franchisor-assisted or -sponsored financing. Below are seven different structures franchisors may consider in providing financing to their franchisees. All of this is based on the premise that many franchisors do not want to use their balance sheets to provide financing for the franchisees, particularly if the franchisees primarily use SBA lending or are served by a large commercial finance company.

1 **Royalty Pool**. A franchisor should consider motivating a lender to provide funding to its franchise community by creating a royalty pool (the non-advertising royalty payments to the franchisor) whereby those franchisees (who are borrowers from a particular financing source) have a portion of the royalties they would pay (for example, 50 percent) put into a collateral pool for the benefit of the lender and released to the franchisor as the franchisee pays down its loan. Here's an example of this structure: the franchisor receives royalty payments of $40,000 per year from the franchisee, deposits a portion of it into an enhancement or escrow account during the first four years of a term loan (that would be $20,000 for four years, or $80,000). As soon as the franchisee has performed for four years, the franchisor gets back one year of royalties beginning in the fifth year and continuing in the following years. The beauty of this structure is that the risk to the lender is normally in the early stages of a loan. If, for instance, the franchisee has borrowed $400,000 to develop a new store, that $80,000 would represent a 20 percent enhancement.

2 **Personal Guarantee Insurance.** Personal guarantee insurance has recently entered the franchise world. Most franchise businesses still require personal guarantees; however, they are seldom collected upon. Normally personal guarantees are entered into to create the appropriate incentives for individuals to see that their company performs. The effective use of this insurance may be a way to enhance the creditworthiness of a franchisee loan and mitigate the risk. The insurance premium is payable annually, and may burn off if the loan has worked its way through 50 percent of its term.

3 **Last Loss.** If the franchisor was a guarantor on a franchisee's loan (even if it was a limited guarantee), the financing source can unilaterally go after the franchisor even before the actual loss is determined. A better approach may be what is known as a last-loss guarantee. If the provisions of the last-loss guarantee are well drafted and tight, the franchisor is only liable after the lender has taken all necessary actions to collect from all potential sources and dispose of the assets. During this process the franchisor will be actively involved in the liquidation, sale or closure, which helps limit the risk for the franchisor. From an accounting standpoint, the liability that may need to be booked is limited because of the mitigating circumstances. Franchisors should use a last-loss provision to help facilitate the flow of money into their system.

4 **Buy-Back Pool.** This also is an enhancement approach to the lender for franchise loans. The buy-back pool approach specifies for the lender the price at which the franchisor will agree under certain circumstances to buy back and operate franchise assets in the case of default. This price is fully defined and is limited in nature and scope. It is not the full amount the lender is owed, but it is an amount for which the franchisor feels it can get the franchise assets back and make a reasonable return. For instance, the buy-back price may be 50 percent of the loan amount; a multiple of EBITDA, earnings before interest, taxes, deductions and amortization; or a minimum liquidation price for the actual assets. The franchisor can also reduce its risk with the lender by providing for a limited number of units it will buy back in a given year. This approach makes a lot of business sense. It provides enhancement to the lender and also gives

the franchisor control of troubled assets.

5 Private Equity Pool. Many non-public franchisors are owned by private equity groups. These groups are constantly looking for reasonable returns on their invested capital. One technique I like to see used by private equity owners is to provide a pool of funds that can be loaned to the franchise community. Normally this type of loan is in the form of subordinated debt with a higher yield, but should bridge the gap between the equity the franchisee is required to put in and the available senior debt. This, of course, assumes the available senior debt will not provide enough funding, even with a reasonable equity contribution, to allow the franchisee to develop effectively. The benefit of this approach is that the private equity holder gets an above-average return, along with the opportunity for further development, which would increase the royalties and income on the private equity owner's investment side—so it is the ultimate double dip.

6 Let Me Help You. Under this arrangement, the franchisor negotiates with three or four lenders and develops term sheets. After the term sheets are developed, the franchisor assists to a significant degree in the due diligence of the franchisee and also provides historical data (very similar to earnings claims) to the lender as to certain performance matrices. In this case, the franchisor is controlling the quality of the loan and assurance of repayment, which benefits both the franchisor and the lender.

7 Franchisors' Line of Credit. In many cases, franchisors have lines of credit for their own development. In my mind, there is nothing wrong with the franchisor using this line of credit to make reasonable investments or loans to the franchisee on a select basis. The franchisor certainly understands the collateral of the franchisee borrowers, and this collateral is similar to what the bank has for the line of credit. I acknowledge the concern regarding some of the variable entity rules and consolidation, but I do believe these can be reasonably limited so long as the appropriate type of control is in place and the ultimate risk does not fall upon the franchisor.

Of course, there are other ideas in today's creative financing world, but these examples should give franchisors new ideas on how to assist their franchisee communities. FT

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