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Don't know how to get the capital you need to build or expand? Here are some ideas for navigating the new lending environment.

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Financing matrix

How to play the financing game

Financing is certainly a different game than it used to be. Here are some unique ideas.

Financing for real-estate assets

Multi-tenant facilities

Let's look at the variety of ideas for sourcing the funding for leasehold improvements. Most franchise businesses utilize strip centers, malls or multi-tenant buildings vs. stand alone facilities. It is important in today's world to maximize landlord/tenant improvement allowances and minimize the repayment. In many cases franchise businesses are the anchor in a multi-tenant facility. This gives added bargaining power to the franchise because its occupancy of the facility will greatly enhance the ability to lease out the remainder of the facility.

When looking at the tenant improvements (TI's) the landlord will provide, get as close as possible to your full buildout costs. These costs are difficult to finance through traditional sources. Please consider the following when the landlord is looking at potential repayment:

Keep the interest factor low (in the 2% to 3% range) if the TI's are amortized.

Do not pay TI's for the life of the lease. Make sure the repayment of the TI allowances burn off over a reasonably short period of time.

Build a significant level of TI's into the basic rent factor.

Try to convince the landlord to include some of the furniture, fixture and equipment amounts in the TI allowance (this would traditionally be financed through senior debt or equipment leasing).

Be careful about having leases that contain built-in increases ("Steps"). Steps may seem a logical approach, but we cannot be certain as to the future amount of inflation. Also, the utilization of Steps creates a problem under GAAP accounting and can lower the value of your business when applying a multiple of EBITDA. The calculation for GAAP rent takes the rent for the period of the lease and then divides by the number of years under the lease which then provides the average lease payment for each year. If there are Steps in the lease, your up-front lease cost (on a GAAP basis) is higher than in later years and, as said before, this approach will lower the value of the company. Instead, consider creative percentage rent approaches which do not increase GAAP rent vs. cash rent. By using percentage rent at a fairly low rate, you may be able to achieve what the landlord needs (i.e., a hedge against inflation) but not have the problem with the punitive aspects of GAAP rent.

When looking at leasehold interest and protection, confirm there are buyout rights for the lease prior to the end of the lease so that if the franchise business is not working, you can walk away and possibly pay off the unamortized portions of the leaseholds, creating an effective and flexible financing vehicle.

Stand alone facilities

If you own your real estate and plan to do a sale/leaseback, look at a bifurcated allocation where a significant amount of the value of the real estate is allocated to the land and a small portion is allocated to the building itself. You can actually use two different leases: a ground lease and a building lease. The ground lease has a more attractive value than a building lease. By having an aggressive land valuation and land lease, you can save yourself money in the long term on the sale/leaseback rent and then minimize the higher rents you will pay on the building. For example, if you have a $2 million real estate project and you allocate $1.5 million to land and you can sell the ground lease for an 8 cap (which will give you lease payments of $120,000 per year) and then you sell the building for $500,000 at a 12 cap, that gives you a payment of $60,000 a year for a total of $180,000. If you were going to take the property on the open market, you probably would be around a 10 cap overall which means your rent would be $200,000 vs. $180,000. This is a good approach to consider and take advantage of current market cap rates.

Business assets

While the national lenders are not as active as they used to be in financing franchise business assets (such as leasehold furniture, fixtures and equipment), there are still lenders such as community and regional banks that fill the void. Additionally, the SBA remains a powerful force in the franchise world.

One selling point to a community or regional bank is to look at ways you can enhance your banking relationship. The community and regional banks are always looking for deposit relationships. In many cases the deposits from your business will help improve the bank's liquidity position. You may also remind the smaller banks as to the benefit of job creation that the loan will provide to their community and possibly help the bank with their community re-investment requirements.

When you meet with various lenders, you need to provide compelling reasons for the lender to lend you the money. Make sure you have all of your bases covered and that you present the following information:

- Current and historic financial information
- Consistent and conservative pro-forma financials
- Detailed information about your concept and the franchisor
- Clear statement of sources and uses
- A detailed analysis of two sources of repayment, which would be repayment through the business and possibly repayment through other businesses or guarantees.

Global solutions

A new and clever entrant into the franchise finance world is what I will call "global solutions." These global solutions are usually a private equity fund that provides senior debt, equity and what we call a strip of high-yield debt (or mezzanine). Private equity groups recognize that there are good operators worth funding. Then, if you combine this with lower market valuations, the private equity groups feel comfortable in providing the totality of funding. While this is a costly type of financing, it does get the job done. This type of financing also allows for servicing of these obligations through cash flow. It further creates alignment because the lender/investor is fully engaged in your business. This arrangement is a particular fit for the superior owner/operator who has limited capital resources.

Franchisors

Other forms of financing in today's world are provided by franchisors. We are seeing an unprecedented approach by franchisors in the franchise finance world including:

- Private placements to create outside funds that provide funding for their franchisees
- Creative intercreditor and remarketing agreements to lenders, landlords and investors
- Joint ventures or putting money into key franchisees
- Developing corporate stores for refranchising purposes
- Direct loan programs
- Credit enhancements for existing loan programs
- Pro-forma term sheets so their franchise communities are getting market terms
- Creating business plan templates which provide uniformity in presenting a concept to a financing source
- Meeting with lenders, trying to encourage them to loan to their franchise community

Misc. financing deals

There are always a number of ideas for financing. Here are a few:

Equipment leasing is still available. Tax incentive leases can be attractive in terms of minimizing cash outlay. Be careful as to the residual amount you will owe at the end of the lease.

Most franchise sales involve seller paper. Seller paper can be a way to finance transactions and be beneficial for the seller in terms of a reinvestment and tax deferral.

The work load is slow for many contractors so they may have the ability to do some financing.

Suppliers and vendors are always good sources for financing.

While vendors are concerned about your accounts payable being at high levels, they also are more concerned about not getting paid. If you can assure your vendors they will get paid, they may allow you, for example, to go from 45 to 90 days terms (which can greatly help your cash flow and create monies for start up costs and other items in your expansion plan).

There may be an ability to use outside guarantors to guaranty debt or leases for a robust fee.

We've seen the purchase of distressed debt as a way of paying for assets of the selling companies.

Various new government programs and funding may be available for the franchise business community.

In general, there is a lot of "outside the box" thinking in the franchise finance world. That's why new cracks are always appearing. FT