

Health Monitor

How to gather key info from franchisees and then evaluate it



By Dennis L. Monroe

In these volatile economic times, the challenge every franchisor faces is effectively monitoring the

financial health of a franchise system. This type of monitoring is not just a luxury, but a necessity.

Prior to a prospective franchisee entering a franchise system there is always a detailed analysis of the financial position of both the proposed operating entity and the individual owners who will serve as guarantors. The initial information is reflective of the opening financial position of the franchisee. Unfortunately, this financial position can quickly change as the franchisee develops and operates its stores. The real concern is how the franchisee initially finances the acquisition of franchise rights and the development of franchise units.

The key element is leverage; or how much debt the franchisee has incurred. There are two key questions that reflect why financial information from all franchisees is important:

- Does the capital structure and debt level of the franchisee create a sustainable and viable franchisee in the long term?
- Does the leverage and available equity create a structure for the future that allows the franchisee to fulfill its development obligations?

Once we have established that a key component of every franchise system is franchisee sustainability, then it is important to look at how the franchisor effectively monitors the sustainability (that is, the financial health) of each of its franchisees.

The first issue in monitoring the financial health of the franchise system and individual franchisees is how the franchisor gathers the appropriate information.

Four ways to gather financial information:

1. Contractual rights. Franchisors need to make sure the franchise agreement and other applicable agreements (and the amendments, as appropriate) provide a contractual obligation for the franchisees to supply profit and loss statements, balance sheets, lender documents, and lease documents for the franchisee entity and all related and affiliated entities. Many franchise agreements have a provision regarding the franchisee's obligation to provide detailed financial information but most franchise agreements do not require that the franchisee must supply financial information of related or affiliated entities. Many times individual franchisees develop concepts in different entities and those entities may end up using multiple assets to cross-collateralize loans and different types of debt. Using multiple assets to cross-collateralize can create a big problem for the franchisor if the related entities (which may be operating different concepts) have financial problems that may impose significant constraints on the franchisee entity. In

summary, a franchisor needs to make sure its franchise documents provide that the franchisee supply a wide variety of financial information, including financial information and supporting documents for related and affiliated entities.

2. Confidential information. One of the ways to create an environment where the franchisee is willing to provide the appropriate financial information is for the franchisor to make sure its franchisees understand that all information provided is confidential and that lending sources, landlords and investors will not be contacted. Also, there needs to be assurance to the franchisee that this information will not be used except as it relates to providing assistance to the franchisee related to its financial position. Franchisees are always concerned that financial information may be used to declare defaults or create leverage against the franchisee. Franchisees have an inherent distrust of providing too much information to the franchisor; thus, a well-drafted confidentiality agreement may help allay some of the concerns of the franchisee.

3. Unique situations. There are crucial times in the life of the relationship between a franchisor and its franchisee where the franchisor may have leverage to secure appropriate financial information if the franchise documents are inadequate. This can occur when a franchisee requests new development rights, an extension of development rights, consent for an acquisition, a default waiver as it relates to late payments, a modification in certain agreements, or a request for a store closure. All

of these situations give rise to an opportunity for the franchisor to secure appropriate financial information in a very straightforward manner.

4. Third-party sources. Another way to secure some financial information is to have open discussions with third party financial sources. These discussions, in most cases, simply supply anecdotal information. Some of the groups to be contacted would be key suppliers, lenders, multi-property landlords, sale/leaseback sources, equipment suppliers, equipment leasing companies and any other key players who may be providing financial support to the franchise system. Again, most of these sources will not provide confidential information but they may give some significant indication of financial problems.

Once the franchisor has gathered information, the information needs to be evaluated in two ways:

- Determining the health of the franchise system, including the franchise system's ability to develop; and
- What are the significant current issues that need to be dealt with to limit financial stress in the system?

To determine the health of the franchise system, including the franchise system's ability to develop, a franchisor can use the following list of questions and issues to help analyze the data:

1. Overall leverage measured by debt to cash flow (3 times is acceptable).
2. Cash cushion—how much liquidity is available?
3. Fixed charge coverage, cash flow to all fixed charges (1.3+ is acceptable)
4. Rent to sales—this percentage varies by concept, but excessive rent is very problematic.
5. Cross collateralization—does a lender tie up multiple assets?
6. Are the general administrative expenses excessive?
7. Are there balloons coming due for debt or leases?

There are many more questions to ask; these are only a sample. The answers to these questions will dictate not only the financial health of a franchisee but a willingness to develop new stores. Many franchisors use this information to develop a numerical rating system for both financial health and ability to develop.

Below are questions a franchisor can ask to determine the current significant issues regarding financial stress in the system and troubled franchisee situations:

1. Have there been late payments for either leases or loans?
2. Have there been covenant defaults?
3. What is the payment history for royalties and advertising?
4. What has been heard from system suppliers?
5. Have there been UCC or credit searches on suspected troubled franchisees?
6. Is there awareness or notice of lawsuits or potential lawsuits regarding a franchisee?
7. Have capital improvements, repairs and maintenance been neglected?

Again, these are only some sample questions. Once a franchisor has concluded there is a troubled situation, the key starting point is a face-to-face meeting with the franchisee. The franchisor needs to have a frank conversation whereby it can develop a detailed, non-adversarial plan that meets the specific needs of the franchisee. Then a decision as to the franchisor's direct involvement needs to be made. Also, it is critical that the outside professionals utilized understand franchisee workouts and the franchise system.

Finally, in planning for an ongoing

healthy franchise system, there are questions a franchisor should ask itself:

Have we been proactive in dealing with balance sheet issues? Have we talked to key landlords? Have we talked to senior lenders? What is our approach with bankruptcy filings? Have we provided business models for our franchisees? Are there clear capitalization thresholds? Have we been proactive with suppliers? What is our position on deferring royalties and development obligations? How aggressive should we be in dealing with troubled situations?

The process of determining the financial health of the system is a series of questions that each franchisor has to ask itself. Be in tune with what the franchisees are looking for. Our firm has developed very good questionnaires that we would love to send to any franchisor that would like to approach its franchise community in a systematic manner. **FT**

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