New Considerations

Growing optimism has lenders warming to first-time franchisees

By Jonathan Maze

A Christmas present changed Lauren Mobley's life. Mobley was working in the fashion business in Philadelphia, just more than a year ago, when Santa Claus left a bird feeder under the Christmas tree. She went online, to the bird retailer Wild Birds Unlimited, and found that it was a franchise. "It just sort-of snowballed from there," she said.

"Snowballed," as in she bought a franchise, got it financed, moved her family from Philadelphia to Rock Hill, South Carolina, where as of press time, she was opening her first unit. "I left my job with a steady paycheck in the industry I knew, moved from the city I lived in, sold my house and everything to come down here and sell bird stuff," Mobley said.

Interestingly, if Mobley received that bird feeder just one or two years earlier, it might not have happened, thanks to the complex financing markets. Mobley needed a loan to come up with the $100,000 startup cost. That's typically smaller than most lenders are willing to loan. She also shifted industries, one more thing that lenders frown upon. And she was a first-time franchisee—perhaps the biggest of the three strikes against her.

And yet Mobley got financed quickly. She used the online lending site BoeFly, and from there received several loan inquiries. She ultimately chose a local South Carolina bank for the financing.

That Mobley was financed as easily as she was is a good sign of the state of the financing markets. Lenders are more active. And they're warming to groups they otherwise would have avoided. A whopping 88 percent of lenders in a recent BoeFly survey said they would consider loans to first-time franchisees. In the years after the credit crisis, first-unit financing was almost impossible to find.

According to a recent Federal Reserve survey of senior loan officers, demand for loans increased in the last three months of 2011 and the cost of loans is getting cheaper. Loan officers reported spreads have eased, along with the cost of credit lines.

A small-business lending index published monthly by the online lending site Biz2Credit, found that small banks and alternative lenders increased approvals for small-business loans in December 2011 more than any other month. Loan applications rose by 30 percent, suggesting optimism heading into the new year.

▲ **It's still** a rare breed of lender, but more are seeing franchisees as a good investment.

That optimism also was evident in the BoeFly survey, in which 83 percent of lenders said they expect to originate more franchise loans in 2012 than they did in 2011. At the same time, 84 percent of franchisors said they expected more growth in the coming year. The upshot: Franchisors expect to expand, and lenders expect to finance those efforts.

While surveys on expectations can be volatile, the fact that both franchisors and lenders are on the same page can only be viewed as a good thing. "That, to me, was a healthy thing to see," said Mike Rozman, BoeFly's chief strategy officer and co-president. "Everyone is

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thinking growth is coming. It's some legitimate optimism."

A changed market

All of that said, lending is different, and more stringent. And there's plenty to suggest the changes that came in the aftermath of the 2008 financial crisis have been made permanent. Consider the Fed survey: Senior loan officers almost unanimously said their lending standards hadn't changed. This suggests they're not budging their demands for loan covenants, equity and capital requirements.

Some franchises have decided to avoid financing altogether. The Denver-based burger chain Smashburger, which has an initial investment up to $770,000, requires franchisees to pay for their first unit in cash, and sometimes their second. The high-demand franchise can afford such a requirement because it's luring some well-heeled operators. But it's unusual for a restaurant concept with that level of investment to require all-cash initial build-out.

To be sure, there are a few chains out there like Smashburger that have no problem getting operators to build and lenders to lend—Jimmy John's, Five Guys, Firehouse Subs, to name a few, seem to have little problem expanding. Yet demand for loans remains cool among franchisees in middle-tier systems that have had modest- or no-sales growth, but are not struggling, said Lex Lane, vice president of business development for United Capital Business Lending.

He said uncertainty in the economy is still keeping many franchisees from diving back into the development game again. "Everybody feels like it's not settled yet," Lane said. "They don't feel like the volatility is so significant that it would keep them from growing. They have a little hope. But they're not sold yet."

One significant change in franchise financing is through the Small Business Administration. The post-crisis aftermath left banks leery of risk. That drove many lenders to the SBA, which backs up to 75 percent of small-business loans. Congress also stepped in to improve the market amid concerns of bad loans and limits that didn't quite meet the demand. Business owners are now eligible for up to $5 million in SBA-backed loans. SBA loans skyrocketed, hitting a record number during the federal government's last fiscal year.

SBA lending has cooled off to a more normalized pace—the number of loans fell by nearly 50 percent in the last three months of 2011 from the same period of a year earlier, when thousands of loans were being made before the expiration of higher federal loan guarantees. Yet loan brokers say it's easier to find banks willing to make loans, even to startups.

"It's very positive," said Reg Byrd, president of Direct Connect Ventures, which mostly helps startup franchisees. He said lenders are starting to come off some of their more stringent requirements. For instance, his company recently helped a former technology worker secure a loan to open a coffee shop in Austin, Texas, by using the borrower's experience working at a McDonald's in college to satisfy the bank's experience requirement. "Things are loosening up. We are getting deals done," Byrd said. Still, SBA borrowers should be prepared to have 30-percent equity, good credit, secondary income and be prepared to use collateral.

Innovation

Tight financing markets have generated innovative financing efforts. Use of retirement funds has become more common and accepted. Services like BoeFly and Biz2Credit also have emerged since the recession, simplifying the loan search process using the Internet. BoeFly saw a 300-percent increase in January, which Rozman attributes partly to the warming market. Yet it's also a sign of his company's stratospheric growth—it's only two years old, after all.

Another company looking to make a splash in the franchise finance market is Merchant Cash and Capital. The 7-year-old company offers cash advances against anticipated credit card receipts. It's a more expensive piece of financing. The loans cost 21 percent if the borrower goes directly through Merchant, or 30 percent if the borrower goes through a third-party broker.

A borrower qualifies for as much as two times the monthly credit-card sales (so $20,000 a month would make the operator eligible for up to a $40,000 loan). Merchant takes a percentage of the credit-card receipts, and it usually gets repaid in eight to 12 months. Higher sales yield a faster repayment.

The company was started in 2005, and loans were typically made for working capital during the worst of the recession. These days, the loans are more likely to be used for remodeling efforts or even to fund the purchase of additional units. They're more likely to be used by franchisees—Subway, Meineke, Jiffy Lube and Midas franchisees have been among Merchant's users. It's become so popular that the company has started its own franchise division. Franchisees "are getting turned down by traditional lending sources," said Seth Broman, vice president of business development and head of the franchise division. "They're coming to us."

Franchisor financing

The lending shortfall has led many franchisors to take more significant steps to ensure their franchisees get financed. Several have started lending programs through Franchise America Finance, which preapproves franchisors and provides access for their franchisees to a predetermined pool of SBA financing. While the franchisor goes through an often-lengthy preapproval process, it doesn't guarantee any part of the loan.

Massage Envy, the fast-growing massage franchise, recently was approved for an additional $15 million in loans through the program. Other systems that have started lending programs through Franchise America Finance include Maaco and Togo's. "Without a program, deals are still getting done, but there's no reliable source and loans are made on a case-by-case basis," said Todd Peterson, vice president of franchise sales for Togo's. He said the Franchise America Finance program streamlines the approval process and makes it more efficient.

A few franchisors guarantee some of the loan. Denny's recently announced a $100 million financing program, in which the franchisor guarantees a small part of the loan, for franchisees build in certain markets. Other chains, such as Marco's Pizza and Johnny Rockets, have taken it a step further by lending directly to franchisees.

While such efforts are more common now, it's still relatively rare to see franchisors actually guaranteeing loans. "It's happening, but to a very small degree," Lane said. "Franchisors just don't want to open the door. Once you do it, the precedent is set."

But, for all the improvement in the markets recently, franchisors do have to be more aggressive in securing financing. Paul Pickett, vice president of franchise development for Wild Birds, said he has to begin talking about the financing issue from the moment a prospective franchisee expresses interest in opening a new unit—something he didn't have to do five years ago.

"The days of a franchisee walking in and getting financing are over," said Greg Esgar, chief financial officer at Massage Envy. "You, as a franchisor, have to roll up your sleeves. If you care about your franchisees, you have to do whatever it takes to get them financing." FT