COLEMAN REPORT

The SBA Lender's Industry Information Source

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How Do Franchise Systems Attract Lenders?

Relationships & the Role of the Zor the Most Important Factors

How much more important is the franchisor today than five years ago?

"Much more important," Tommi Homoth, Business Development Senior Vice President at American Business Lending, answered during a breakout session of the Franchise Times Restaurant Franchise Development Conference.

"Back in the nineties, I was doing SBA lending and one year we did $32 million. We were doing things like decorating and t-shirts, franchise concepts that aren't around now, but all we looked at was the borrower. We didn't even look at the UFOC for a concept, which is what they called FDD's back then. But now we're looking at the strength of the franchisor. We've had concepts that we've looked at and said no, we cannot finance your franchisees on the basis of the strength of the franchisor."

The evolution of lenders like Homoth has sped up exponentially since the Recession, and Homoth isn't the only one who is approaching franchise lending more carefully.

"It's absolutely the most important thing, especially when we're talking about new operators opening up and new location," Mark Challis, President of Equity, Inc. added.

"I'll tell you what, it is very important that we go back and take a look at the failure rate from a historical perspective and really that is the first checkmark we look into. Just to give you a benchmark, what we're really looking for is if you have a failure rate in excess of about 15%, that's a red flag for our sources. You'll find others that actually have a much lower percentage, but in the market in which we work, it's really that 15% that we look for."

The main topic of the breakout session discussion was how do franchisors attract banks and other lenders to their franchise systems? Joining Homoth and Challis on the panel were: John Kimball, Vice President, Park Midway Bank; Lex Lane, National Sales Manager, Main Street Bank; and Trey Grim, Business Development Manager, United Capital Business Lending.

Lane added his experience on the change that has occurred as well, "We did lean heavier on the borrower in the past and on the franchisors. Over the past two or three years, it's been around 50/50 in the underwriting process, in which we're underwriting the franchisor alongside the franchisee; so it has definitely increased.

"I think as much as it is important for us to understand the FDD, read through and look at the failure numbers, it's important to establish dialogue with the franchisors, so that we really understand what's behind the numbers. And I think that's probably become more important than anything in the last two years."

Opportunity for Community Banks

Main Street Bank is a national bank whose footprint includes "all 56". But, the national franchised lender is not the same today. The powerhouses of even two years ago have either disbanded their SBA loan divisions or extremely cut back.

CIT ranks at 28th, still doing loans but no longer at the rate they used to. Bank of America is not a 7(a) lender, choosing to do a limited amount of 504 loans, and Banco Popular, who in the past was one of the largest national lenders, is no longer doing them. But, fifty percent of all restaurant loans are still being done with a guaranty. The national lender concept today is vastly different, but community banks view it as an opportunity for them to fill the void.

"It's what I like to call the 'under $5 million' category," Lane said, "There's obviously a bunch of areas for the larger loan lenders to work with the $5 million that everybody is familiar with, but I think that when you're looking for franchisors, you're looking for growth with new or existing franchisees where the deal sizes are a lot smaller. And I think to some extent, there are some opportunities."

"I absolutely agree," Grim concurred, "When we're working franchises, especially concepts that maybe aren't quite as mature, we're going to see that the typical loans we make may not meet the standards of a lot of the national or larger banks. As a result, we see tremendous opportunity there, and that's pretty much our sweet spot, the 'under $5 million' category."

Most community banks have relatively small footprints, and look for the most out of the loans they make. Park Midway Bank is a fair representation of most community banks nationwide, and vice president John Kimball attributes their success to having an understanding of what they look for in a franchisor.

"The franchise concept is the heart of the uniformity that helps us understand the risk, and we are in the risk, in the words of risk mitigation. I wouldn't necessarily say that for us the maturity of the concept is as important as the extent at which that franchisee is developing in our area and showing attraction in the marketplace," Kimball said.

"Community banks are lending. We are lending and dramatically growing on lending, but we understand the frustration because we all know that there are community banks out there that are having difficulties. There are a significant number of community banks though that are doing well, so as franchisors, one of the things that you need to do to help your franchisee is help them do the bank selection process."

Kimball lists three steps to the bank selection process: Make sure you're working with an SBA lender, make sure that the SBA department is experienced and dedicated, and make sure you look at the quality of the bank.

"You're working with an SBA lender, they should be a preferred lender under the SBA's preferred program," Kimball explained.

"That is a program that designates the bank to make decisions on behalf of the SBA. Also be sure they are dedicated; we have probably ten banks in the state of Minnesota that are very strong lenders that have specialized departments with people who just do SBA lending. The last part is sometimes the most difficult thing you have to do, which is you have to take a look at the quality of the bank and the financial underpinnings of the bank.

"I tell borrowers that now the reality is you have to underwrite your bank also, and there's a great tool for doing that. FDIC.gov will line up all of the community banks, and you can take a look at their profitability by quarter. And while you may not be an expert at evaluating the financials of a bank, at least it's going to give you a really good indication as to number one, the extent at which that bank is wanting to lend, and number two, the extent at which the bank is going to be able to keep a customer.

"One of the issues that we have in the banking industry is when a customer starts to show difficulties, your standing with your regulators will often give you more or less room in terms of how you work with that borrower."

> You've got to sell yourself – you're selling yourself to the franchisee and the bank, and I absolutely think every franchisor should have somebody on staff to help with this.
>
> *Lex Lane*
> *National Sales Manager*
> *Main Street Bank*

What Are Banks Looking for From the Zor?

A general question from the session, was what banks are looking for from the Zor in terms of helping the Zee?

"I think that the franchisor can play an integral role in helping prospective franchisees or existing franchisees within their system prepare credit," Grim answered, "Frankly, I think in a lot of cases lenders struggle with newer franchisees because they're not equipped with a package that is saleable, so I think a franchisor can help their franchisee base by helping to facilitate that package."

"You've got to sell yourself," Lane added, "you're selling yourself to the franchisee and I absolutely think every franchisor should have somebody on staff to help with this."

But, what can a Zor do to show the bank that their system has what it takes to receive funding?

"As a lender, it's hard to get much; you're either going to get some sort of guarantee or you're going to get promises," Lane said.

"We're going to be there for you and we're going to put a lot of stock on that. And not that I think that somebody isn't going to tell the truth, but they're going to get a loan today that may not have a problem for four years when they may not be there. So, what's on paper is really what matters. I've seen some folks, and this is small in comparison to some type of guarantee or great comfort level, talk to the franchise system and talk with existing franchisees to see what their interaction is with the franchisor."

> It used to be when we evaluated the credit or score of the principal owners, that if we saw something on there that was clearly to us causing the score to be lower or below our threshold, we could explain it away; that doesn't work anymore.
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> *John Kimball*
> *Vice President*
> *Park Midway Bank*

For Challis and Equity Inc., it all goes back to the failure rate.

"We've done a number of different things and we sit in a little different position than the balance of this panel in that we in essence are the third party financing piece in really a sort of broker capacity.

"What we do is put together that 'bank-ready' package; we understand what the financial matrix is that the banks are looking for, so we do an awful lot of research and understand who we're going to be presenting the loan opportunities to. So, we really try to prepare that franchisee or perspective franchisee before we put together that package."

When Challis and Equity Inc. look at a franchise system, they look for whether the system actually works, whether their Zees are financially healthy and happy, and whether the system will actually follow some of the guidelines that Equity may put out there.

"In other words," Challis explained, "we want to make sure that they're not interested in just selling a franchise, but rather they're willing and looking to support a franchisee. We do a number of different things so that when we get a candidate that comes to us, it's actually someone who truly is financeable and they're not just trying to run people through the system and see what sticks."

Coleman's Takeaway

The Franchise Times Restaurant Franchise Development Conference overall was a huge success. Breakout sessions like this one created a wealth of knowledge for both franchise systems and lenders alike. The theme throughout though, was that so much has changed in the past few years, and every business has been forced to change. The national lender concept has evolved, the importance of the Zor has increased, and franchise systems are continuing to make the necessary changes they need to in order to get their Zees funded.

In today's lending, relationships and trust matter more than ever. Banks are looking for Zors that will council their Zees and help them not only in the lending process, but throughout the loan. It is a willingness to return the basics, that even two years ago still wasn't there, that is helping the lending industry and small businesses recover from our economic situation and be successful in the current business world.