

Franchise Connection

Volume 2009-1

A Newsletter for Franchisees, Prospective Franchisees, and Small Chain Owners

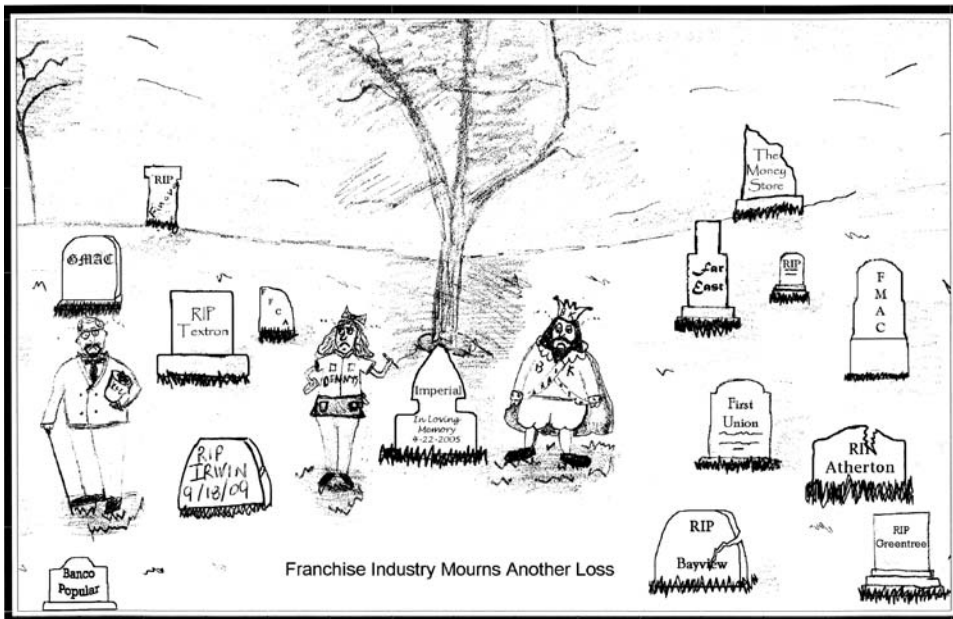
Alan F. Gallup

REGULATORS SHUT DOWN IRWIN BANKS

The franchise industry lost another lender Last Friday, when regulators shut down two Irwin Bank subsidiaries. On Monday, the parent holding company Irwin Financial filed for bankruptcy.

First Financial Bank has purchased the operations of Irwin Union Bank and Trust Company and Irwin Union Bank, through an agreement with the Federal Deposit Insurance Corporation.

Sources indicate that First Financial Bank will likely re-establish the franchise lending unit with much of Irwin's staff. Because First Financial Bank is a seven billion dollar bank, which is well rated, with good ratios, we could actually see an expanded credit criterion for franchise loans. It is likely to be a few weeks before these final decisions are made.



Over a dozen franchise lenders have ceased franchise lending since 1999.

Is Acquisition Financing Available?

In a word, yes. But it is not the same financing we have grown accustomed to over the past ten to twenty years. Acknowledging that most buyers can not meet today's tight credit criteria for **GE Franchise Finance**, the 800 pound gorilla of franchise lending, and that few acquisitions rise to meet the level of interest for **Wells Fargo** or **Citibank**, prospective buyers seeking debt financing need to look at today's alternatives: **SBA**, **Regional Banks**, and **Seller Financing**.



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While 2009 has been a difficult year due to declining sales and the restricted capital markets, National Franchise Sales has been successful by utilizing an adaptive strategy to meet the capital needs of the buyers, while accomplishing the goals of the sellers.



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Small Business Administration (SBA)

Many borrowers do not qualify for SBA lending because they exceed the gross sales cap of 6.5M in annual sales, or they need more than the 2M maximum loan. If a borrower can get past the onerous requirements of pledging one's home or other assets, SBA remains a viable source for many borrowers, *if they can find a bank actually willing to lend*. SBA lenders are out there, but none really on a national level, so it is a little like finding a needle in a haystack.

It is a difficult and time consuming task to find a bank that a) does not have regulatory restrictions, b) is not hoarding its capital to make their own acquisitions of weaker banks, and c) understands and is willing to make franchise loans. National Franchise Sales has dedicated significantly more time to sourcing banks for acquisitions that ever before.

Once a prospective bank is identified, then the bank's own loan criterion has to be considered. Elements such as borrower's credit score and history, historical financial performance of the business being acquired, borrower's business experience, etc., are all conventional expectations. Additionally, in the '09 lending environment, we find that two particular elements emerge as problematic; **declining sales trend and collateral**.

Declining sales and outside collateral remain the major impediments to SBA lending, even when the other strict 2009 credit criteria are met. Lenders will not loan on businesses with sales declines over 5%. They will not even loan 30% LTV.

Out of fear of relying on the businesses cash flow and cash flow projections, SBA lenders are requiring **50% to 100% outside collateral**.

Their formula for collateral is 80% of the appraised value of the personal residence, less the secured debt equals the available collateral. Hence a home worth 525k, with a mortgage of 350k, has an available collateral not of the 175k in equity, but 70k ($525k \times 80\% = 420k$. $420k - 350 = 70k$).

The SBA formula for income property starts at 75% of the appraised value!

Regional Banks

Regional Banks may well be the "*Acres of Diamonds*" for many franchisees and prospective franchisees. But identifying them and developing them as a resource can take years. Regional banks are just that, they are "regional". They usually restrict their lending to the region, where their bank branches are located.

Once a list of regional banks is created from anything as simple as the yellow pages, a bit of role reversal needs to be employed in that each bank's web site and published annual report, needs to be examined. From this material, one can generally determine the banks "menu" or types of lending and banking relationships they seek, and the actual financial health and liquidity of the bank can be assessed. The next step with this narrowed list of prospective banks is to contact a senior officer of the bank by phone to further explore their interest in your business. And learn if the bank has previously made franchise loans like the one being sought, and if they were happy with it. If this exchange goes well, then it

should be followed by a more in depth personal meeting, with the presentation of the borrower's Business Plan, Financial Information & Loan Application.

Once established, for franchisees looking to develop a long term banking relationship, this process should continue with several meetings a year to develop the relationship. Each possible acquisition or divestiture should be discussed with the banker. Established franchisees that follow this process have been able to find access to loans of 10M or more, but it is because they took the steps to build the relationship with a bank that was large enough and held the right philosophy about franchise lending.

Seller Financing

Many sellers are willing to carry the paper in order to sell. This may be strategic, or may be because they need to sell, or it may be because they want to improve their cash flow. Selling a business with old secured debt and large embedded equity can sometimes yield better cash flow than keeping the business. Since this approach qualifies as an installment sale, it can have many advantages to the seller. As such, with the difficulty in obtaining other acquisition financing, many sellers are willing to consider financing the sale to Qualified Buyers.

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