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Special points of interest

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On the Web

El Pollo Loco:
elpollolocorestaurants.com

International House of Pancakes:
ihop.com

Kentucky Fried Chicken:
kentuckyfriedchicken.com

Carls Jr.:
www.ckr.com

Bennigans:
www.bennigans.com

The Financing Menu

In most cases, sellers are seeking all cash on the sale of their business. Thus the term “cashed out.” Consequently, a truly qualified buyer, must not only have the management know how and be financially qualified, but must also have the ability to obtain financing to cash out the seller.

Until the last few years, financial institutions, and especially banks, were frequently reluctant to finance franchise businesses. This was in part due to the bankers’ lack of familiarity with the nature of the various franchises.

This has changed with the lender’s investment into the franchise arena, in many cases with the creation of specific franchise lending programs, and even the establishment franchise lending divisions. Fortunately, in today’s market, there are many lenders willing and able to loan money on franchised businesses and small chains.

However, it can still be a frustrating process trying to locate the

right lender for your situation. **Each lender has certain programs on their menu, and required ingredients for their buyers.** However, unlike a restaurant, they don’t publish their menu and don’t list the required ingredients. Lenders like to keep both somewhat of a secret, in part due to the competitive nature of the business, and in part because their menus change often.

For this reason a valuable financial advisor or business broker will stay in touch with these financial institutions to ensure that buyers have the very best options available.

Lenders can be categorized into three main categories including, securitized, portfolio, and SBA (Small Business Administration). Each category of lender has advantages and disadvantages.

Securitized Advantages:

Interest rates are typically lower than other loan options.

May finance a larger portion

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An Exit Strategy

When considering the purchase of a business, buyers often look at sales, rent, personal appeal, income, safety, security of future earnings, cost of acquisition, and reinvestment required in the future. But a buyer should also consider “What if?” What if the buyer doesn’t like the business, what if the buyer needs to sell for family or health reasons? Answer: Never buy something you can’t sell.

What is my business worth?

No matter what the conversation is leading up to, the question "What is my business worth?" is ultimately the question every principal wants answered on the first call. And for good reason. Few answers can have a greater impact on the decision to sell.

Valuation Methodology:

There are a number of factors that affect the value of a Franchise. The primary factor is the income generated by the Franchise, also known as the "Principle of Production of Income."

The "Principle of Production of Income" asserts that the furniture, fixtures, equipment, and leasehold improvements are as valuable as the income that can be derived from them. Therefore we concern ourselves with an estimate of market value relative to the production of income as opposed to cost, book value, or replacement value. In this way, the Franchise is looked upon as a tool acquired with the intention of, and for the purpose of, creating income.

When assessing the Production of Income of a Franchise for the purpose of determining market value, the income must be viewed in the eyes of the buyer. The three primary methods of income production assessment are **EBITDA**, **Recast Earnings**, and **Owner Operator Recast Earnings**.

- ◆ **EBITDA** depicts the earnings before interest, income taxes, depreciation and amortization.

EBITDA is most commonly utilized in larger multi-unit transactions, and generally yields the lowest valuation of the three methods.

- ◆ **Recast Earnings** utilizes the historical sales and costs of the subject Franchise, combined with various adjustments to reflect regional norms for the brand, and the elimination of unusual or non recurring expenses. Depreciation, amortization, income taxes and debt service are also eliminated.

The Recast Earnings is effective for small multi-unit transactions, as it recognizes the changes new management will bring about.

- ◆ **Owner Operator Recast Earnings** is similar to the Recast Earnings, but combines various adjustments to reflect the methods of operation of an owner operator.

The Owner Operator Recast Earnings is an effective method of valuation when the units are to be sold individually as it typically yields the highest



valuation for under performing units.

Once the method of income production assessment has been established, then the intangible factors of market conditions must be considered. Although there are far too many to list here, the most significant conditions impacting value are:

- **Sales level**
- **Term of Lease**
- **Rental rate relative to earning potential**
- **Sales trend**
- **Sales relative to chain average**
- **Potential for competitive intrusion**
- **Condition of neighborhood**
- **Condition of facility**
- **Popularity of geographical area (supply vs. demand)**
- **Franchisor/franchisee relationship**
- **Impending governmental or franchisor facility upgrade requirements**
- **Attractiveness of facility**

These conditions are then factored into the income production assessment to arrive at a market valuation.

The Internal Revenue Service defines fair market value as, "The amount at which property would exchange between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having a reasonable knowledge of relevant facts."

Our experience in franchise business brokerage, our skill in providing both buyer and seller with a knowledge of the relevant facts, and our extensive client base of both buyers and sellers uniquely qualify National Franchise Sales to answer the question, "What is my business worth?"

- Alan Gallup



The Financing Menu *continued from page 1*

of the project cost allowing for a lower down payment.

Disadvantages:

Potentially large prepayment penalties.

Typically not available for buyers with limited retail experience.

Portfolio

Advantages:

Less red tape in loan process.

Greater flexibility with refinancing allowing for future growth or divesting of specific franchise units.

Disadvantages:

Loan programs and availability of programs change regularly.

Less accessible to less experienced buyers.

SBA

Advantages:

No prepayment penalties.

Allows first time buyers an access to capital.

Disadvantages:

High loan origination fees.

Rates typically higher than other options.

If you are thinking about buying or selling a business, it's a good idea to work with a financial advisor and/or a business broker to determine the types of lending programs available. As a seller, you need this information to form a proper expectation and avoid surprises. This information does the same thing for a buyer, and it empowers your broker to represent you as a qualified buyer.

- Alan Gallup & Michael Ingram of NFS

Acquisitions & Divestitures

National Franchise Sales has been known for over 20 years as "the Franchise Resale Specialists". This involves the resale of franchise locations one or more at a time.

But another area of our business involves the acquisition/divestiture of small chains. Over the years, NFS has discretely and professionally managed transactions for a variety of companies. Some examples include a 30+ coffee franchisor, a small chain of 10 casual restaurants (HI), and several small Mexican food chains.

By their nature, these transactions were held

to the highest levels of confidentiality and involved all the pre-requisites of quality the buyer, due diligence, and financing, in order to successfully complete the transaction.

Due diligence and financing transactions involving small franchisors or small chains present unique challenges. The professionals at National Franchise Sales and their associates are proven and experienced. If you are considering such an acquisition or divestiture, and would like a confidential appointment, give us a call.

Understanding Elements of Risk/Reward

One of the factors affecting the value of a business is the relationship of the commitment to the annual earnings of the business. As a business approaches rental com- a one to one ratio of earnings to income, it becomes less desirable due to the greater risk to earnings loss imposed by the rent, and thus less valuable. If two businesses each have a net earnings of \$200,000 per year, but one has a rental of \$60,000 and the other a rental of \$150,000, the business with the lower rent will have a higher value, even if the other has higher sales. This is an element of the risk/reward ratio.



Worth Reading...

12 Secrets to Cashing Out *by Robert L. Bergeth*



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*Specializing in the resale of franchise
businesses and small chains.*

Disabilities Act

IFA has submitted comments to Congress in favor of a bill that provides commercial facilities with 90 days notice before a lawsuit can be filed against them for alleged violations of the Americans with Disabilities Act (ADA). The measure would allow businesses, during that time, to make any necessary corrections without incurring the expenses involved in protracted litigation.

The bill, HR 3590, introduced by Rep. **Mark Foley** (R-Fla.), received a hearing from a House Judiciary Subcommittee on May 18. Rep. Foley introduced the bill in reaction to instances across the country where trial attorneys have been aggressively pursuing actions against small firms.

Citing examples from his district, Foley said "in none of the cases have any of these businesses been given advance notice or warning in order to correct the problems before a lawsuit was filed. And in most if not all of these cases, the businesses have remedied the problem, or agreed to, only to face bills from these attorneys of reportedly up to \$5000."

More than 50 disabled individuals attended the hearing in opposition to the bill. Those testifying in opposition expressed the opinion that the threat of a lawsuit is the only way to get businesses to comply with the ADA and that the disabled should not have to wait for any period of

time to exercise their right to sue.

IFA contends in its comments that the interests of the disabled are best served in a system that allows business owners to address verified violations in the workplace, rather than wasting time and money in court. IFA members are urged to contact their House and Senate members to encourage them to co-sponsor Foley's legislation. For information regarding this bill, contact IFA Dir. of Government Relations **Brendan Flanagan** at brendan@franchise.org or 202-662-0792.

Did you know...

...The concept of replicating retail outlets through the business format franchise structure was pioneered by Martha Matilda Harper, in 1891 when she opened her second Harper Hair-dressing Parlor and located it in Buffalo, New York.

...At the close of 1999, 102 minority franchisees, collectively, owned 321 Denny's restaurants, representing 37 percent of all Denny's franchise restaurants.

...System sales for the Applebee's concept reached \$2.35 billion in 1999, an increase of 14 percent over the prior year.

...Wienerschnitzel is the largest hot dog fast food chain in the World with over 300 restaurants, selling over 70 million hot dogs per year.