Franchisee Debt

A short Primer on debt and how to take it on and off.

Taking On Debt

Commercial financing is a viable option for franchisees that do not possess the necessary liquid capital or do not wish to tie up cash, liquidate assets, take on equity investors, or dilute ownership among shareholders. Despite the prevalence of franchisees that utilize leases and loans in the operation of their franchise businesses, and possibly due to the wide range of debt incurred up to 80% or more, financing costs are conspicuous by their absence from Franchise Disclosure Document Item 7. Estimated Initial Investment. Franchisees should therefore carefully consider the use of debt vs. equity to capitalize their franchised business and perform due diligence in the form of interviewing fellow franchisees and inquiring about their experience with debt.

All lenders require borrowers to service debt and repay loans without incident and without increased financial risk over the term. Small business owners and guarantors that apply for any form of commercial financing should expect to sign personal guarantees to service debt and repay loans. Lenders will scrutinize each borrower's and guarantor's personal background, current financial situation and credit history, applying conservative measures of risk assessment that generally do not accommodate bankruptcies. Such reviews tend to be more rigorous for first time franchise business owners and their guarantors.

Typical lender information and documentation requirements for borrowers holding ≥ 15% ownership:

►	Completed lease/finance application.
►	Completed personal financial statement form for each principal owner, borrower and guarantor.
►	Completed schedule of debts form for each principal and each guarantor.
►	Completed bank verified wire transfer instructions.
►	Current Driver's License for each principal owner, each Signor, and each Guarantor.
►	Current resume including relevant business experience for all active principals in business requesting finance.
►	Current business plan and (3) year financial proforma.
►	Prior (3) years Form W-2 and/or Form 1099 for each principal owner, borrower and guarantor.
►	Completed IRS Form 4506-T "Request for Copy of Tax Return" for each principal owner, borrower and guarantor.
►	Prior (3) years personal tax returns and all schedules, filed with IRS for each principal owner, borrower and guarantor.
►	Current signed and dated employment agreements and/or partnership agreements for each active principal owner, borrower and guarantor.
►	Current buy/sell agreements for businesses requesting financing.
►	All docs. in legal name of principal owner/borrowers evidencing sources and amounts of cash, cash equivalents and proof of ownership.
►	All franchisor required documents for businesses requesting finance.
►	Secretary of State Filings for businesses requesting finance.
►	Business financial statements including <90 days old interim business financial statements for businesses requesting finance.
►	Prior 2 – 3 years business tax returns and all schedules filed with IRS for businesses requesting finance.
►	Current signed and dated facility leases for businesses requesting finance.
►	Current signed and dated assignment of facility leases if not directly arranged between business requesting finance and landlord.
►	Signed and dated landlord addendums and/or waivers accommodating lender and franchisor required terms and conditions.
►	Current signed evidence of liability, property, and other business insurances naming lender as additional insured/loss payee.
►	Contractor leasehold improvement bids and/or contractor invoices reflecting total spend, or leasehold improvement budget.
►	Current lease/loan agreements, promissory notes, credit card statements, including balances, balloon payments and interest rates.
►	Any additional documents and information that each principal owner, each signor and each guarantor has knowledge of and which relate to such individual's business and/or personal finances, credit histories and/or the proposed finance transactions requested.

Lenders that collateralize loans with personal assets such as homes, properties or marketable securities typically securitize such loans in an amount greater than the loan itself. As a result, personally collateralized loans are normally easier to obtain than conventional business financing, especially for first time start up franchisees, or franchisees within networks that are relatively young or limited in unit distribution. Franchisee borrowers will typically pay more for collateralized financing in the form of higher interest rates and greater up front or closing fees and costs ranging up to several percent of the full loan value payable in advance. Lenders of personally collateralized loans may also prefer register UCC filings and place liens or other restrictions on borrower's personal assets and may also require term life insurance policies on active franchisee/owner/borrowers.

Franchisee Debt
A short Primer on debt and how to take it on and off.

Conventional business loans are commonly referred to as "*Cash-Flow*" financing. Lenders typically collateralize "*Cash-Flow*" loans exclusively with business assets, and employ selective criteria in the establishment of credit guidelines for franchise networks. "*Cash-Flow*" lenders determine franchise owner and guarantor total debt capacity without considering any revenue generated by a startup franchise businesses. Such lender position may appear overly restrictive due to the fact that most businesses generate revenues that are sufficient to cover at least a portion of post opening operating expenses prior to breakeven.

All lenders anticipate startup franchises to temporarily operate at a financial loss from a month to a year or more depending on business type, seasonality, competition, local and national economies, etc. In lieu of personal collateralization, "*Cash-Flow*" lenders mitigate risk by assuring that franchisee borrowers will maintain ongoing cash flows from sources other then the business being financed to cover working capital requirements and personal living expenses through breakeven. Cash flow sources may include spouses, partners and guarantors that maintain outside employment, or other businesses or investments. The goal is to avoid a situation whereby working capital reserves become depleted prior to achieving sustainable profitability.

Lenders and experienced business people recognize that undercapitalization is a leading cause of business challenges and failures. Cash shortfalls can result in owners feeling compelled to cut necessary investments in advertising and marketing, resort to high interest credit card debt, or risk even more undesirable options such as withholding payroll taxes, which may subject owners to criminal charges up to and including incarceration that ultimately prove difficult or impossible to reverse. The solution is to reasonably assure that franchisee borrowers' combined personal and business cash flows will not go negative at any time during the loan term.

Quick formula for evaluating franchise owner financial capacity for conventional "*Cash-Flow*" based financing:

(+) Total monthly after tax personal income from sources other than the new franchise business seeking financing.
(+) Monthly EBITDA (Earnings Before Interest, Taxes, Dividends and Amortization) of pre-established profitable business(s) owned >2 years.
(–) Total personal and business related monthly debt service, including anticipated debt service for new financing being applied for.
(–) Total monthly personal living expenses that are not included in the monthly debt service amounts above.
(–) Total monthly post opening working capital required to operate new business e.g. rent, wages and taxes, and other expenses.
(=) Positive cash flow at all times without consideration of any revenues generated by the new business that may offset operating expenses.

Taking Off Debt

Franchise business owners that find themselves in a situation where monthly debt service, or the total dollar amount of personal and/or business debt has become financially and emotionally burdensome to the point of depriving the business of a profit or other measures of success, have a number of viable options to consider.

Guidelines for reducing or eliminating excessive debt:

►	Strive to view debt reduction in a positive light, for oneself, one's family, and for all other stakeholders involved in the business.
►	Full disclosure of the situation to the Franchisor and its support staff, as well as a CPA, for their assistance and recommendations.
►	Contact Franchisee Advisory Council members for names of fellow franchisees that persevered through similar situations, to inquire how they were able to capitalize and grow their franchise businesses and ultimately reduce to an acceptable level or completely retire debt.
►	Focus owners and all available employees on driving "*profitable sales*", expanding customer base, and reducing all non-essential expenses.
►	Refuse to take on any additional debt and pay down or off the highest interest loans first, which typically include credit card debt.
►	Establish detailed personal living expense budgets by deciding on temporary and long term cost cuts among all family members involved.
►	Temporarily reduce, suspend or eliminate salary and other forms of owner compensation and/or expense reimbursement from the business, and decide which owners and/or owner spouses should take on or maintain outside employment.
►	Liquidate all or a portion of available "*non-retirement*" plan cash savings or monetary investments such as stocks, bonds and mutual funds.
►	Refinance appreciating assets such as real estate to convert equity to cash. Home equity loans tend to offer low interest loans.
►	Sell fast depreciating or maintenance intensive assets such as 2nd or 3rd vehicles or trade newer/luxury models for less costly replacements.
►	Approach family or friends to become guarantors for existing business loans in order to re-negotiate an increased amount and/or longer term at favorable interest rates, or re-finance existing debt, possibly utilizing a more cost effective financial or collateral structure.
►	Sell equity in business to family, friends or others, i.e. sell shares of stock for cash with no immediate expectations for return on investment.
►	Take loans out on IRA or 401k retirement savings plans, or cash out all or a portion of the such investments.
►	Sell primary residence and purchase a home of lesser value, or temporarily relocate to an apartment, rental home, friend or relative's home.
►	Sell franchised or other pre-existing business(s) at a profit to break even, or if necessary consider a slight financial loss to retire debt.

Franchisee Debt

A short Primer on debt and how to take it on and off.

Debt is like body weight, easy to put on and challenging to take off. The old adage "*half of something is better than nothing at all*" aptly applies to highly leveraged franchise businesses, where an additional percentage of the profits commonly comes off the top line sales revenue in the form of franchisor royalties and advertising fund payments to the franchisor. The use of other people's capital can be appropriate when starting and/or growing franchised businesses, but rarely if ever should debt be taken for granted as the only choice available.

Two options that are always appropriate are to take on additional partners or guarantors that can bring cash to the deal, or hold off on the decision to purchase or expand a franchise. Waiting for a period of time necessary to save sufficient capital and avoid taking on debt beyond a franchisee's capacity to repay, and more importantly beyond their personal comfort level, may be the only safe course of action to preserve full ownership. There is no benefit to owning or growing a franchise business saddled with debt if it results in an unhappy existence for the owners and guarantors. The proper balance of debt to equity, confirmed by sound planning and supplemented with input from fellow franchisees that have gone before, will help franchise owners achieve the success they desire and enjoy their businesses along the way.

About the Author:

Bob Snelling is president and founder of Honor Capital Group, LLC a small business consultancy and finance intermediary, and the author of Tip Top Docs brand of professional business documents.

Bob's diverse business experience spans multiple industries dealing with products, services and people. Serving as an employee in various positions from warehouse to boardroom Bob has directly reported to no less than five extraordinarily different company presidents. As a business owner making decisions, setting budgets, and meeting payrolls for up to thousands of employees, Bob has known first hand what it is to maintain legal, operational and P & L responsibility. Performing in the roles of senior level executive, CEO, board director and major shareholder of Snelling and Snelling, Inc., a national, and for many years international company with hundreds of franchised and corporate units, Bob has by necessity perfected leadership skills that are tolerant and respectful of widely divergent perspectives.

A unique background with progressive levels of operational, managerial and financial responsibility has proved invaluable preparation for Bob's current role as business advisor and finance intermediary. Guided by ethical behavior, attention to detail, and a regimen of planning, collaboration and teamwork, Bob's innovative yet practical solutions consistently deliver return on investment and stand the test of time. Decades invested in the identification and implementation of sustainable best practices uniquely qualifies Bob to author relevant topics that today's franchised and independent business leaders can immediately benefit from and put into action.

Bob currently resides in Plano, Texas a suburb of Dallas with his wife and business partner Carol, their two children and a Border terrier. e-mail: bob@HonorCapitalGroup.com phone: (972) 735-0005