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How Financing Feeds Growth of Food-based Franchises

You expect a few things when you visit your favorite fast-dining chain: cleanliness, prompt service, and consistency. The multi-location, same-flavor experience that defines food-based franchises has helped propel the industry to an estimated $340 billion in annual economic output, according to a 2015 report.

For prospective operators who want a slice of the industry, there are expectations that go beyond menu items and counter service. Securing the right type of funding and managing capital as the business grows are responsibilities as critical as the quality of the food.

“Whether they’re operating one restaurant or dozens, franchisees need a financing structure that helps them grow and adapt to an unpredictable environment,” says Doug McKenzie, commercial leader at CIT Franchise Finance, a division of CIT Bank. “Franchisees rightfully put a lot of focus on operations, but they can limit their opportunities if they don’t give the same attention to financing.”

The Stages of Financing

The restaurant industry is a notoriously tough business, with some 60 percent of establishments failing within the first three years, according to University of Denver Professor H.G. Parsa, an expert on food trends. Franchises hold appeal in part because of brand recognition and a proven formula that keeps customers returning. For first-time franchisees, assembling the cash to establish and operate the business can be a hard-to-fill order.

For some would-be operators, tapping into the resources of their franchisors is the easiest approach to getting started. Many franchisors have relationships with lenders that can help to shorten the approval process. There is also the DIY route, utilizing retirement funds, lines of credit, home equity loans, and even bringing in business partners or investors. Federally backed SBA loans are also an option, and with the passage of the American Recovery and Reinvestment Act, the SBA now guarantees as much as 90 percent of the loan. However, as franchisees begin to expand their businesses; their financing needs may shift to more complex legal structures comprising discrete entities taking on debt from multiple sources.

“For borrowers seeking funds at this second stage, local banks are typical sources of financing. Loan officers have built relationships with franchisees, who might use their personal assets as collateral for loans”, says McKenzie.

Once a franchisee takes on a larger portfolio, it may be necessary to seek more structured franchise financing. By working with a specialized partner, franchisees can assess their current and future business needs, arrive at credit ratios that complement the company’s current performance, and develop an arrangement that supports growth plans.

“This type of financing is going to be tied to the anticipated life cycle of the business, to their growth intentions,” McKenzie says.

According to McKenzie, franchise restaurant underwriting is typically based on several factors including consolidated historic financial statements, capex requirements/growth plans, ownership and legal structures, lease and franchise agreement tenures, operating experience as well as other considerations.

Financial Structures for Multiple Business Motives

Across the U.S., franchise businesses have outpaced growth in the wider economy for the past five years. These enterprises support nearly 5 million jobs, firmly establishing food-based franchises as one of the core drivers of the American economy.

Borrowers with multiple locations might be seeking help to finance an acquisition, fund a new building project, or consolidate existing loans. "We're looking for someone who's got a lot of projects, an established portfolio of stores, and a history of growth," McKenzie says of the profile of typical clients.

"Sometimes, it's not growth but rather a brand transformation that requires financing. That's the case for a national chain looking to transition from in-line or mall locations to a new generation standalone format to meet the evolving needs of consumers. Transactions such as this work best when lenders understand the long-term, strategic implications for such transformative initiatives both for borrowers and the franchisors who grant the rights to open such businesses", McKenzie says.

"Lenders have to understand the direction of the system, the people involved, and the insight into why the franchisee is better for such an arrangement," McKenzie says. "It's necessary to know what's happening on the back end, so if there are any problems, you can deal with the franchisor and try to find the right solution together."

Improving your Capital Structure

When considering an expansion, the addition of a knowledgeable franchise finance partner can help franchisees to bring their balance sheets into order and consolidate existing debts to potentially lower their payments. A partner can also help position a company for acquisitions or leverage existing equity in their business for growth.

For growth-oriented franchisees, there are best practices to keep in mind. The businesses should be producing consolidated financial statements, ensure their premises lease agreements have extension options, understand their capex requirements, and not be over-levered. "Over-complicated organizational structures can create financing challenges in terms of reporting, securitization, and flexibility" McKenzie says.

Avoiding Surprises in Fine Print

"Prospective borrowers should make sure they spend the right amount of time on due diligence before entering into financial agreements. It's critically important to understand the details in the loan documents, such as the terms of default", McKenzie says. There are both positive and negative covenants, varying reporting requirements, cross-default provisions with lease and/or franchise agreements, prepayment rights and so on that should stimulate close inspection. . In other cases, there may be prohibitions on the transfer of property rights or shares, as well as prohibitions on other types of financing that would conflict with other loans.

"Many borrowers don't spend enough time looking at these documents," McKenzie says. "They need to understand them. At a minimum, they should absolutely have their lawyer or accountant (preferably both) look at the documentation to make sure they know what they are agreeing to."

As franchisees add locations and expand operations, they may find that the ingredients that worked in the past fall short as they grow a business. Operations may be overextended, and in extreme circumstances, intervention may be needed. Creating a healthy capital structure is as critical as keeping the kitchen clean—maintaining order keeps trouble away and helps prevent surprises down the line.