Pulse of Franchise Lending

Q1 2020

Franchise Credit Begins to Tighten

As franchising enters a new decade, FRANdata reached out to franchise lenders to get a better understanding of the state of franchise lending.

The last decade was a period of unparalleled economic expansion and easy access to capital. There are now signs that economic expansion is ending.

If this expansion slows, or even stops, what will be the impact on franchise lending?

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Executive Summary

FRANdata's intelligence gathering with lenders revealed a number of challenges and concerns banks will be facing in the first six months of 2020. The bank's surveyed in this report represent average revenues of $315m and average total assets of over $8.5 billion.

The most consistent issues were:

- A plurality of lenders (40%) have a negative view of the lending environment in the first six months
  - ⇒ Credit officers have a more negative outlook than business development officers
- Lenders are beginning to experience a decrease in the credit quality of franchisee borrowers
  - ⇒ Some franchisors are approving new franchisees they would have rejected a few years ago due to credit or liquidity/net worth issues
- Underwriting requirements have begun to tighten for many of the respondents
  - ⇒ Many lenders expect this trend to continue throughout 2020
- The interest rate environment has been hugely important to attracting business, but lenders are also facing an increase in competition for borrowers from other banks
  - ⇒ SBA lenders noted that many transactions that would have been SBA loans a few years ago are now getting approved as conventional loans
- Lenders are generally positive about how their bank has positioned their portfolio, but have concerns that other lenders have overextended themselves
- Lenders are placing an increasing premium on working with the right brands that have strong performance metrics and who have not allowed their prospect screening standards to slide
  - ⇒ Nearly a quarter of respondents identified FRANdata's FUND report as a valuable tool in understanding the credit risk of brands

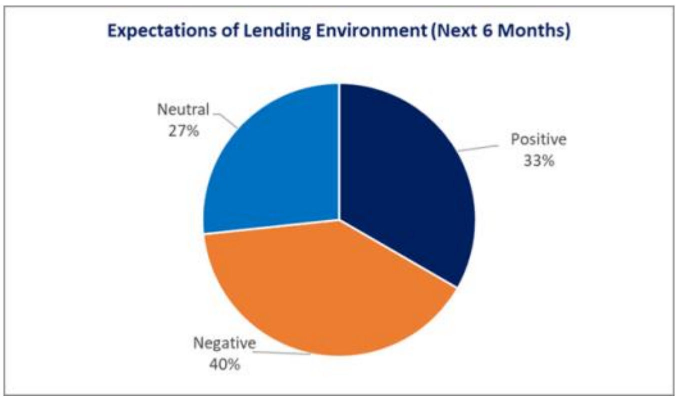
Methodology

To get an understanding of the state of franchise lending, FRANdata reached out to over 40 franchise lenders who on average have revenues of $315 million, and total assets of over $8.5 billion. Both business development and credit sides are represented in this study. They were asked a series of questions about what they had experienced recently and what they expected in the next six months. These questions were then scored to provide a numeric weighting for each respondent.

Results

FRANdata found that franchise lenders as a group have a slightly negative view of the landscape. Business development officers have an almost uniformly more positive outlook than underwriters, but both groups have concerns.

The biggest area of divergence between business development and credit is the current state of applicants, and what sort of applicants are expected to emerge in the next six months. Business development officers, as a set, are slightly positive on credit quality of applicants they've seen in the last six months, and they are, almost uniformly, positive on their expectations of credit quality in the next six months.



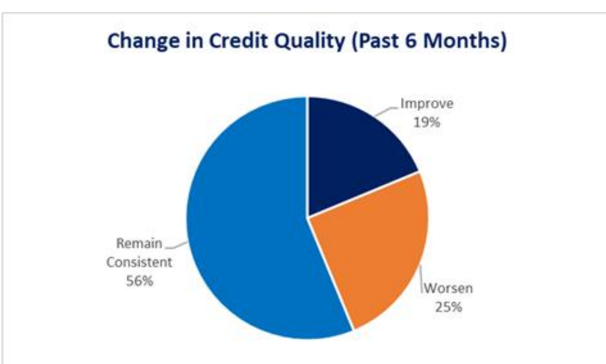
"It is feeling like 2007 all over again. Franchisors are digging deeper into their pipeline, signing up people they might not have otherwise."

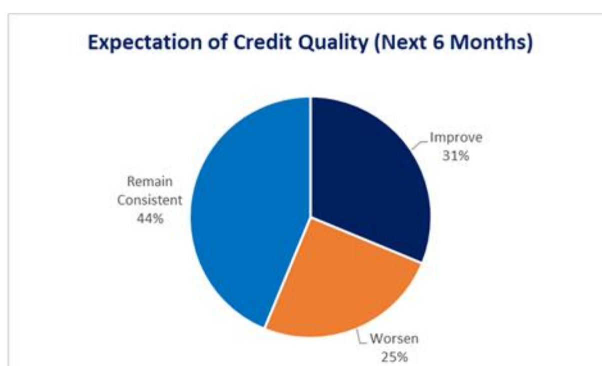
- Lender Respondent

On the other hand, credit officers are slightly negative on recent credit history, and expect the quality of applicants to deteriorate in the first six months of 2020.

There is evidence to support the credit officer responses, as an analysis of recent SBA loan performance shows that franchise loan performance is slipping with an increase in charge-offs as compared to non-franchise loans.

Table 1 (following page) looks at franchise and non-franchise loan performance for the 2011 to 2015 SBA books as of Q3 2019. For the 2011, 2012, and 2013 books, loan performance for franchise and non-franchisee loans is nearly identical. In addition, each year has a lower charge-off rate than the year before during the same season.





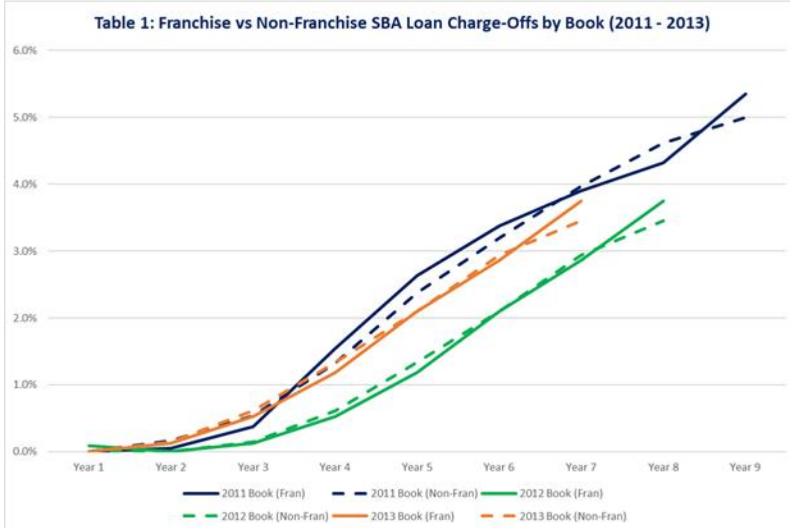
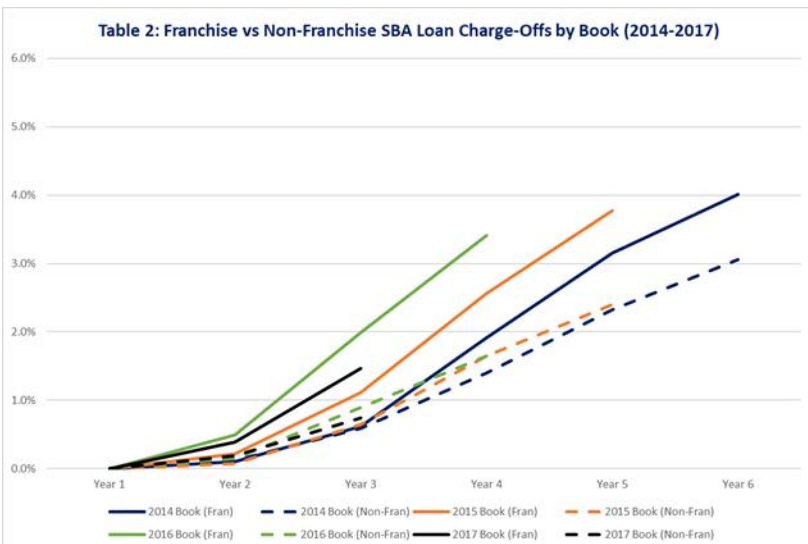


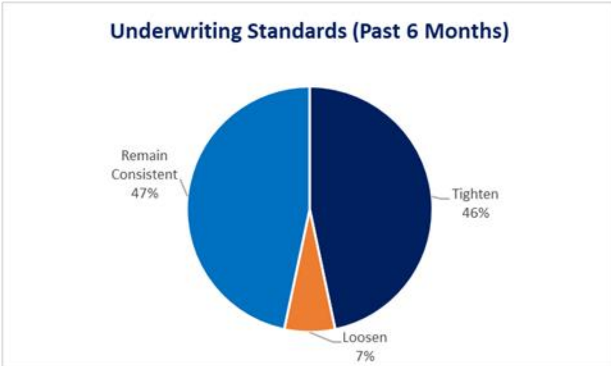
Table 2 examines the 2014 to 2017 books. In these books, we see that not only are franchise charge-offs increasing compared to non-franchise loans but each book, until 2017, has a steeper slope than the year before.

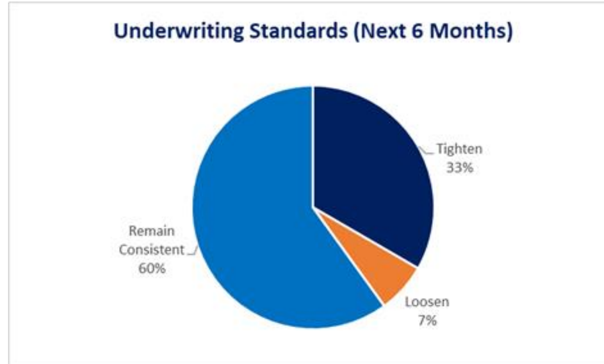


"Applicants have gotten worse; Less experienced, no management experience, no P&L experience, lots of illiquid, people with too much debt. People that would not have gotten signed a few years ago."

- Lender Respondent

These trends highlight the concerns credit officers raised regarding the overall quality of franchise applicants. It also suggests lenders will be tightening credit standards, something that appears to already have begun.





Both business development officers and credit officers report that underwriting requirements began to tighten in 2019, and both groups expect that trend to continue in 2020.

> *"Because of portfolio issues we had to tighten underwriting standards. We've put more emphasis on the franchisee's management experience."*
> *- Lender Respondent*

Another common theme mentioned by the respondents was increased competition. Many lenders noted that they are seeing more banks going after the same deals. There has also been a trend of increased competition from conventional lenders approving deals that a few years ago would have been SBA transactions.

Some SBA lenders felt an economic downturn or increase in rates might actually benefit their business. One lender said, "If a recession decreases competition from conventional lenders, SBA lending opportunities might actually improve."

> **"I think the best brands will be okay. If competition for consumers increased, the bad brands will be pushed out."**

Another SBA concern mentioned by a few lenders is the ROBS program. There are concerns that if the SBA changes the requirements for the program, ROBS loans will no longer be profitable for banks to pursue, which would limit potential capital sources for franchisees.

Another recurring theme FRANdata identified in the responses was the importance of working with the right brands, in the right sectors. Most of the lenders are positive about franchising but feel that bad brands will likely get pushed out of the market in the next recession. This creates a huge premium of ensuring they are working with the best possible brands and fully understand all the risks associated with the brand and their sectors. One lender said, "I think the best brands will be okay. If competition for consumers increased the bad brands will be pushed out."

> **"Recently, it seems like anyone with a rowing machine in their basement has opened a gym."**

Lenders also mentioned concerns about three sectors: restaurants, boutique fitness, and hotels. Lenders attached red flags to these three sectors because of concerns about future performance. A number of lenders mentioned seeing difficulties in restaurant portfolios that are keeping them out of that space. Nearly 30% of the respondents mentioned boutique fitness as a potential bubble with too much growth and too many new brands. One lender said, "Recently, it seems like anyone with a rowing machine in their basement has opened a gym."

Approximately, 25% of the respondents specifically identified FRANdata's FUND reports as an important tool for understanding and evaluating the potential risk a brand might create for their franchisees.

Internal analysis of our FUND score highlights the predictive ability of the FUND score to understand potential loan losses. We tested this relationship and found that it had a .61 correlation. One lender described the FUND score as an invaluable tool for their underwriting team.

FUND Score	Updated Expected Loan Performance	Prior Expected Loan Performance
>800	>98.4%	>97.2%
700-800	91.0%-98.4%	92.1%-97.2%
600-700	87.4%-91.0%	86.9%-92.1%
500-600	76.5%-87.4%	81.9%-86.9%
<500	<76.5%	<81.9%

The change in loan performance by FUND score, since the FUND score's inception to now, also highlights what the surveyed lenders are saying about the importance of good brands and ties in the trends observed in the SBA charge-off data. **Brands with high FUND scores have seen their loan performance rate improve, while brands that are really struggling have begun to perform worse.**

A final point that lenders highlighted, was that most banks feel good about their portfolio's position while still feeling generally negative about the economy and lending as a whole. Almost every lender felt their institution is well prepared for a downturn and that, while they expect loan losses to increase, their portfolio of brands would be stable.

"The FUND score has been an invaluable tool in improving our underwriting standards."

About FRANdata

FRANdata is a leader in the strategic analysis, forecasting and measuring of franchise performance. Our deep industry expertise and breadth of historical and predictive capabilities allows us to effectively measure risk while enabling sustainable portfolio growth. FRANdata harnesses facts and figures into targeted business development strategies and actionable solutions that transform mediocre outcomes into highly successful business results.

FRANdata also runs the Franchise Registry (www.franchiseregistry.com) where some 9000+ lender members, representing more than 3000 lending institutions obtain credit risk information that helps them get to “yes” quickly, structure franchise loans properly, and document their loan files fully. Used by some of the most active franchise lenders in the industry, the Franchise Registry is dedicated to supporting a lenders’ franchise financing needs ranging from business development, franchise underwriting to analyzing franchise portfolio strength.

FRANdata is headquartered in Arlington, Va., and is often cited as franchise experts in media publications such as The New York Times, The Wall Street Journal, Forbes Magazine, the Franchise Times, and Nation’s Restaurant News. For more information go to www.frandata.com.