Restaurant Research Think Piece – March 2009

How Are Franchise Loans Holding Up?

There is precious little data available to size-up franchise loan performance because lenders tend to hold this information very close to chest. All-the-same, it is obviously a critical issue given today's economic environment… Do we explain the general lack of financing for franchisees today as a function of higher defaults or does the lack of liquidity merely reflect the lenders' own lack of liquidity? Perhaps both explanations are true to some extent?

To answer this question, we set-out to interview various in the know clients in order to develop at least an anecdotal understanding of the big picture. Unfortunately, unless you have access to GE Finance's massive franchise portfolio, this may be the best anyone can do. For our reader's information, our discussions spanned the gamut to include a major sector lender, a sector leading appraisal firm and one of the leading legal players in franchise finance.

Here is what we found out. The general condition of franchise loans is less bad than one would imagine. This primarily reflects that underwriting standards have improved dramatically since the days of securitizing lending when the traditional practice included "add-backs" to overhead in order to create a "normalized" expense number for the credit models. This means that more recent franchise loan underwriting would not add-back things like the cost of an operator's private aircraft on the assumption that, if push came to shove, the plane would be eliminated to benefit the borrower's cost structure. Resultantly, today's loans are issued off of lower advance rates.

Also on the plus side – current franchise loans generally have a 10% sales cushion built in. This means that an operator can suffer a 10% cumulative sales decline over the course of their loan before their covenants start to raise red flags. Further, assuming the borrower can continue to service their loan after a 10% sales drop (which is often the case), lenders will typically keep from pulling the plug – that is if a regulator of some sort is not breathing down their back! A quick look at same-store-sales performance over the recent past will show which concepts are the most likely to be pushing up or past the 10% sales decline rule. Fortunately, with the exception of some glaring problems in casual, not many chains are approaching this benchmark. Further, with energy prices down and government stimulus forthcoming things don't look too bad from a top-line perspective in our opinion.

Another plus for our asset class – commodity costs have come down dramatically. Resultantly, unit level margins have far more breathing room than they did this time last year – and just in time! Interestingly, it is no secret that chains far and wide took pricing over the last several years to cover these inflated food costs - which have since deflated along with the rest of the economy. However, it seems to us that restaurant operators have behaved very much like your traditional gas station operator – i.e. quick to raise prices, but slow to lower them. Seems to us that now may be the time for restaurant operators to test the theory of price elasticity in the food business by giving back some of their cost savings at a time when their consumers are counting every penny. Sorry for the diversion, but we couldn't resist.

Finally, we should note that franchise loan asset class performance numbers that we can analyze (things like comps and closure rates) must be considered from a geographical perspective. So while it is our opinion that restaurant sector numbers generally look to be holding-up, they would look even

better if you back out the "sands" states (i.e. Florida, California, Nevada and Arizona). That is not to say that loans made to operators in the sands states will not go bad (or that there are not a material number of loans to units in the sands states), just that we should be careful not to paint the entire industry with the same broad brush.

OK, now for some unsavory points to consider. Our sense is that leverage levels for recent franchise loans have been kept to reasonable levels as we discussed – at least in terms of advance rates. However, it is also important to consider collateral values as expressed by unit level EBITDA multiples and real estate cap rates. In other words, while a lender may only have advanced 75% of estimated collateral value (vs. say 110% in the days of old), multiples may have been too high (or cap rates too low) to begin with as the debt bubble inflated asset prices in the restaurant finance space similar to residential/commercial real estate. So a 75% advance rate may seem conservative until collateral values decline by 25% - and then things no longer look so comfortable for the lenders.

Another downside to consider has to do with the same 10% sales cushion that we previously mentioned. Today's lenders are optimists by nature – otherwise, how else could they justify 5 or 10 year loans? However, prospects of a prolonged economic recession could change the confidence of lenders in this asset class (as well as all other asset classes for that matter). In this case, today's lenders could decide that a 10% sales cushion will no longer due – in that case, pick a downside number for the underwriters to incorporate into their models and we begin to see more downward pressure in collateral values (only because of the lack of all cash buyers!).

So we can see that the risks to this asset class are mostly forward in nature. Notably, we are just coming into the compliance season for sector borrowers' 4Q08 unit level performance evaluation. An uptick in technical defaults even among current borrowers could present problems as loans come due. With tighter underwriting standards, it may be difficult to rollover existing debt. This is an important consideration as every year 10% of total franchise loans come due for repayment/refinancing (if you assume 10 year terms) or 20% assuming 5 year terms. In any case, it is easy to see how this problem could be alleviated by greater liquidity to the franchise finance sector.

No matter what, it is our firmly held belief that our asset class of restaurant loans will ultimately prove to be very resilient. This reflects our confidence in both the strength of the sector's brands (with their proven ability to quickly adapt) along with the strength and skills of the franchisee operators that make-up many of these same systems. Sure, we expect that economic circumstance will ultimately lead to a healthy weeding-out process of the weakest and most irrelevant brands and operators – but we do not expect this will resemble the "blood bath" - which is how one client characterized the implosion of the franchise bonds of old caused by imprudent underwriting. As an aside, this is one reason why historical franchise loan performance can not necessarily be used to project our current prospects.

So we continue to stand by the conclusion of our last think piece: Who Will Capitalize on the Franchise Finance Opportunity? "With national franchise lenders having dwindled down to just a few remaining players, there seems to be an excellent opportunity for some new, forward thinking lenders to step-into what could be a golden opportunity. This reflects our opinion that new entrants would enjoy an even better time of franchise lending than the exiting players not just because of better demand/supply dynamics but also because of the benefit of tougher underwriting standards and better lending rates (driven by a reduced supply of capital to the chain restaurant industry)."

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