Spilled Milk

Franchise Valuations: When Character Isn't Enough

by Bruce S. Schaeffer, J.D., LL.M. (in Taxation)

A lesson learned in Asia is that character doesn't always work as a sole factor on which to base a loan. However, that lesson is learned in the U.S. as well, as this true, but sad, tale relates. Another lesson learned is that lending on franchises is not the same as lending on other assets.

Once upon a time there was a successful franchisee, Reggie McKenzie, who had a wonderful relationship with Bank 33. Reggie had started out small but with the bank's help and loans he had come to own four Super Grease Instant Lube franchises in the Atlanta area. It had been a good loan and a profitable piece of business for the bank.

About four years later, Reggie was presented with an opportunity to acquire 100 Inaudible Muffler shops located in four states throughout the Southeast. Reggie presented Bank 33 with a business proposal filled with optimistic growth projections. The bank was happy with its past relations with McKenzie, and was familiar with the goodwill associated with Inaudible Mufflers. They submitted Reggie's application package to the loan committee.

John Dean was the new head of franchise lending for the bank. He knew that there are more than 550,000 franchised businesses in the U.S., generating more than $800 billion in sales. He had read that the International Franchise Association estimates that a new franchise business opens somewhere in the U.S. every eight minutes during each business day. And he had heard that franchising will account for 50 cents out of every retail dollar in the U.S. by the year 2000.

Dean was no fool. He knew a growth area when he saw one. At the first meeting of the loan committee, he was tasked with doing a complete analysis of the application. McKenzie was asking for a $20 million loan so that he could bid $22 million to acquire the 100 Inaudible Muffler shops, which had been company owned.

Dean noticed that the projections provided in the borrower's business plan showed an anticipated increase in gross revenues over a period of five years from 3-9% per year. He did some research about the automotive aftermarket in the trade magazines and found that the market was not growing anywhere near that fast and that, in the Southeast, the market was actually declining. He pointed this out in a memo to the lending committee but they thanked him and expressed their respect for McKenzie's proven ability to run a business.

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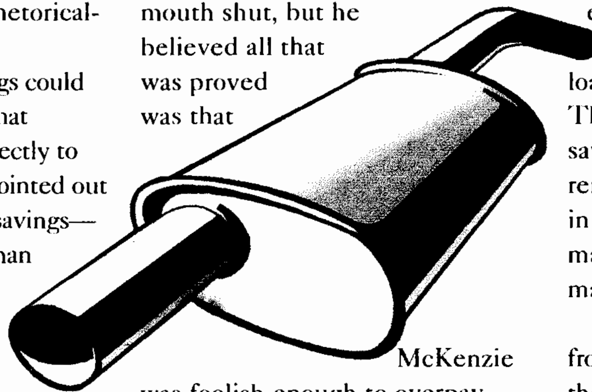
Dean had another concern. The borrower's projections showed an estimated decrease in top line costs for promotions and allowances from approximately 10% of gross down to approximately 3% of gross. Dean prepared another memo to the lending committee. He made two points:

1. These were company-owned shops. Who would better know the amount that should be spent on promotions and allowances than the franchisor themself, he asked rhetorically in his memo.
2. If these top-line savings could be accomplished, all that money would flow directly to the bottom line. He pointed out that such anticipated savings—solely—would more than fund the entire debt service on the borrowed $20 million. Dean wrote, if it's too good to be true, perhaps it's too good to be true.

Again the lending committee thanked John Dean but continued to emphasize their respect for McKenzie's proven ability to run a business.

The lending committee felt Dean was a pessimist. They tried to ease his concerns by pointing out that McKenzie was an innovator—a real creative guy who could continually come up with new schemes and concepts. By this time, Dean was fearful of additional rebuke; therefore, even though he felt that franchise operators should be able to follow exactly the franchisor's business plan rather than be independent and creative, he kept it to himself. Uniformity, not innovation, is at the heart of successful franchising, he muttered.

The lending committee approved the loan. There were seven bidders for the 100 Inaudible Muffler shops. McKenzie outbid them all. The $20 million loan was closed and there was a small party. In a very condescending way, the senior members of the lending committee pointed out to Dean that he had been wrong about McKenzie. Dean had learned to keep his mouth shut, but he believed all that was proved was that McKenzie was foolish enough to overpay—more than any other knowledgeable bidder.



Sales at McKenzie's Inaudible Muffler shops promptly plummeted 20%. Two months after the loan closed, McKenzie told the bank the loan would have to be restructured. At the same time, he notified the franchisor that he would not be able to pay the contracted amount of royalties. The bank gave McKenzie a concession to pay interest only for the first year. The franchisor agreed to waive royalties for the same period.

The lending committee was very unhappy. They didn't appear as smug to Dean anymore. Then, two months later, McKenzie notified the bank and the franchisor that even with their accommodations he could not service the interest portion of his debt or pay his creditors in a timely fashion. McKenzie also found out he could not reduce his costs for promotions and allowances at all.

From that day on, every meeting McKenzie had with the bank also had three lawyers in attendance. Furthermore, McKenzie made it clear that, as far as he was concerned, it was all the fault of Dean who, he claimed, had infected his franchises with this cancer. He demanded that Dean be taken off his loan. The committee agreed. They didn't want anyone around saying, "I told you so." They removed Dean from his position in charge of franchise lending and made him an assistant branch manager in rural Alabama.

It was at that time, when confronted with a possible visit from the bank examiners, that Bank 33 called in a franchise valuation expert. The expert reviewed all the lending committee papers and asked what had happened to Dean. They told him that Dean had developed an aversion to large-scale lending and moved to the country.

The franchise valuation expert immediately expressed concern over the franchisee's dramatic growth: It's an incredible jump from running four shops in Atlanta—all of which can be visited in person within less than an hour—to 100 shops in four states, he told the lending committee. He also told them that, believe it or not, it's quite a change to go from lube shops to muffler shops, even though both are in the automotive aftermarket.

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The franchise valuation expert pointed out another aspect the bank missed in its lending analysis. In a $22 million acquisition, the balance sheet of the franchisee after the acquisition listed the acquired asset "franchise rights" as $11 million. But the valuation expert noted that the bank's lending analysis was based strictly on projected cash flow. A book value analysis, the valuation expert told the lending committee, immediately reveals that if 50% of the value is denominated franchise rights, then that means 50% of the value rests in an intangible contract right subject to termination provisions, subject to nonrenewal, and subject to coming to an end at the defined end of the term of the contract. It's just not the kind of asset that can be sold at auction.

The valuation expert was a cynical guy. He showed the lending committee what he considered to be another warning sign: Beware franchisors selling company-owned stores—not unlike "Beware Greeks bearing gifts." The ultimate result was that, sadly, within the first year, the bank had to write off more than 40% of the value of the loan.

Moral of the Story

Lending on franchises is not the same as lending on other assets. Although they are ubiquitous, franchises are not freely assignable or alienable. All of the goodwill that inures from the operation does so to the benefit of the franchisor; but the bank's borrower is the franchisee. The best advice is to get an expert valuation before the loan is made rather than after it goes into default. And in this area, frankly, qualified experts are hard to find. ❒