

Ways to Finance Your First Franchise Purchase

From WSJ.COM Start Up Journal - By JULIE BENNETT

"Money, money everywhere and not a cent for me," would have been the mantra for any prospective franchisee who attended the recent Restaurant Finance and Development Conference in Las Vegas, sponsored by the Restaurant Finance Monitor newsletter.

The annual event drew 1,100 people -- mostly men in suits -- to the Rio Hotel, where the nation's top lenders tossed around terms like "sale/leaseback" and "mezzanine financing" as casually as dealers threw cards in nearby casinos. Franchisers and multi-unit franchisees in the buttoned-down audience came close to cheering when a financial adviser announced that there are "droves of private-equity firms ready to invest \$20 million to \$400 million into expanding franchise companies." And when Andy Gunkler, vice president of franchise development for a restaurant chain called Quaker State & Lube in Sharon, Pa., announced he needed \$5 million in additional capital, he was mobbed by investment bankers.

But no one was there cheering on prospective franchisees, who need far less capital to simply get started. "Once you're established, lenders jump all over you," said conference panelist Brad Gilbert, national franchise manager for Comerica Bank in Austin, Texas. "But it's as difficult as ever to get start-up financing, and the hardest money of all to raise is in the under-\$100,000 range. Those loans take banks just as long to process as big ones, and there's no profit in them."

Of course, new franchises are opening every day, and that money has to come from somewhere. Since leaving Vegas (somewhat poorer), I've contacted conference speakers, pored through franchise publications and called franchise systems at random to investigate sources of start-up capital. And just like hitting triple sevens on a slot machine, it isn't easy.

Financing On Your Own

Most new franchisees raise capital by refinancing their homes or taking out home-equity loans. This is fine if the franchise you choose is so inexpensive that you can cover the franchise fee and total investment (rent, equipment, supplies, employee salaries, your own living expenses, advertising, etc.) yourself. But should you need to borrow money later, your lender will want you to put up collateral, and a fully mortgaged house doesn't qualify. Finance experts suggest you borrow only a portion of the available equity, and leave at least 25% of your home's value intact.

Downsized executives often use their severance packages or savings to get started. San Antonio residents Mike Robillard, 60, and his wife, Robin, 48, were looking for something to do after he retired from SBC Communications when an opportunity, Mr. Robillard says, "fell into my lap." Literally. He needed a haircut and found a coupon for Sport Clips, a guys-only hair salon that advertises as "no perms, colors or acrylic-nail smells." Just testosterone and big-screen TV's tuned in to sports. Mr. Robillard, who has a bachelor's degree in business and a master's in telecommunications management, loved the concept and used the funds in his Bell Systems savings plan to buy two stores from Sport Clips, which is based in Georgetown, Texas.

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Economic Strategies, Ltd.

752 Evelynton Loop; The Villages, FL 32162

Ph: 352 350-1517 Fax: 877-553-8073

Email: franchising@econstrategies.com Web: www.econstrategies.com

Retirees without separate savings can tap into their Individual Retirement Accounts or 401(k) plans without tax penalty through a vehicle called the Entrepreneur Rollover Stock Ownership Plan (ERSOP). As you can guess, the rules governing ERSOP's are really tricky, and they should not be attempted without play-by-play assistance from an accountant familiar with the workings of the Internal Revenue Service.

Financing Through a Loan

Prospective franchisees who qualify can borrow up to \$2 million in start-up capital through a loan guaranteed by the U.S. Small Business Administration. In the past decade, the SBA has become franchise-savvy, so much so that 47% of the loan guarantees processed through its Chicago office in 2003 were for franchises, says Stephen Konkle, an economic-development specialist there.

To streamline the process, the SBA contracted with FRANdata, a subsidiary of National Cooperative Bank in Washington, D.C., to review franchise documents and to list eligible systems on the Franchise Registry, at saving applicants weeks of processing time. Registration costs a franchiser \$2,500. So far, 286 are listed, with 12 more under review.

But, sadly, the SBA doesn't make loans, only guarantees up to 85% of a start-up business loan once it's been processed. You have to secure the funds through a bank or other lending institution, and too many lenders don't know much about franchising. Mr. Konkle says, "Every time I hold a banker-training seminar, I have to spend an hour and a half of it explaining franchise financing."

Some franchisers have done an end run around such confusion, by educating bankers about their concepts.

Ron Ericksen, vice president of market development for USA Baby in Elmhurst, Ill., for instance, invites area bankers to visit company headquarters, or, if they're not in Chicago, to tour local stores. (The strategy had an unexpected payoff when a lender in California was so impressed that he bought a franchise himself, Mr. Ericksen says.)

Once a bank has had good luck with a franchise loan, it tends to loan money to more franchisees from the same concept. Allied Houston Bank, for example, has financed 40 of the 142 Sports Clips franchises, including the two additional stores the Robillards opened this year.

Begin your financing search, Mr. Gilbert says, by talking to your potential franchiser about banking relationships and asking existing franchisees about where they obtained financing.

But if the system you choose has no strong lender ties, you'll have to "build a personal relationship with a local lender" -- a phrase heard again and again at the Finance Conference.

I didn't fully understand it until I talked to Kelly Reed, 41, of Haysville, Kan. Mr. Reed, who has a degree in computer-information systems, had been laid off from his job in February and was collecting unemployment when he discovered Computer Troubleshooters USA of Atlanta on the Internet. The Australia-based tech-support company has a franchise fee of \$11,000 and total investment of less than \$20,000. But, Mr. Reed says, "we didn't have any money to invest. My wife was working just to make ends meet."

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When Chip Reaves, Computer Troubleshooters' national director, asked Mr. Reed if he had a relationship with a local banker, he thought of Brad Rucker, vice president of Home Bank & Trust Co. of Wichita.

"Brad had played on my brother's basketball team," he said, "and he'd approved the loan I took out a few years ago to buy a motorcycle." As a precaution, Mr. Reed's dad, a retired schoolteacher, moved some of his savings into Brad's bank.

"I asked for \$50,000, so we'd have something to live on while the business got rolling," Mr. Reed says, "and Brad told me to come back with a business plan." Like many franchisers today, Computer Troubleshooters provides business-plan templates to prospective franchisees but it still took Mr. Reed and his wife, Shelli, 40, three weeks to finish theirs.

Mr. Rucker, 32, was impressed. "They covered all the basics -- why they wanted to start the business, what the competition is, and why they'll be successful. We don't make a lot of start-up business loans, and I've done only four SBA loans this year. But we have to take care of our customers." The SBA asked the Reeds to put up their house and the Harley as collateral, and Home Bank loaned them \$45,000 in September. The Reeds still have \$30,000 of that money left, by the way, and believe that by 2006 their franchise will be bringing in \$100,000 a year, or twice as much as Mr. Reed earned before.

Friends and Family

If you have spotty credit, are dealing with a new franchise company with no earnings history, or don't own a house or even a Harley, it's unlikely a bank will loan you money, no matter how many pick-up games your brother plays with the institution's vice president. The last stop on your financing hunt is Mom, Dad, Uncle Dan and Jim, that high-school loser who make a killing in tech stocks.

Jeff Rosenfeld, founder of Kessev Finance in Minneapolis, who specializes in financing franchises, warns: "I've seen friendships and families torn apart over such transactions." To keep your relationships intact, he offers the following advice.

- Put together a business plan, including a two-year monthly forecast of your sales and expenses. Include what you're asking of your investors, what they'll get in return, and when they'll get their equity back -- probably not until you sell, qualify for a conventional loan, or attract the attention of one of those multimillion-dollar private-equity firms.
- Don't build up their expectations; explain all the risks and never take money from a relative or friend who can't afford to lose the entire sum.
- Have an attorney who understands securities draw up a formal contract. Then if something goes wrong, it won't come as a big shock -- and you can still sit down together at holiday meals.

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