

OUTLOOK

Franchising: Always Be Closing

In the 1992 movie “Glengarry Glen Ross” starring Al Pacino, Jack Lemmon and Alec Baldwin, Baldwin plays a cocky real estate sales manager who reports to Mitch and Murray, the owners of a vacation lot sales business. Baldwin wears a Rolex, drives an \$80,000 BMW and claims to have made \$975,000 last year.

Baldwin announces during a memorable “motivational” speech to his sales staff (which includes Pacino and Lemmon) that all but the top two are to be fired at the completion of the sales contest. In a profanity-laced tirade about what it takes to be successful in sales, Baldwin tell his troops that only one thing counts in sales:

“Get them to sign on the line, which is dotted. A is for always, B is for be and C is for closing. Always be closing,” says Baldwin.

In “Glengarry Glen Ross,” the phrase “always be closing” was the fictional mantra of a second-rate Florida housing developer and a sales team that struggled to close deals. In the world of franchising, there have been plenty of Alec Baldwins pitching can’t-lose franchise deals. But unlike the movie, where the number and quality of leads was dreadful, franchise companies over the past decade have experienced an unparalleled boom in the number of prospective candidates who came willing and able to sign on the dotted line.

Now however, franchise sales have stalled for many restaurant concepts, and the quantity of “leads” has been significantly reduced. New strategies must be implemented by restaurant companies if they intend to sell franchises in the near term, especially with a financing market that has been uncooperative over the past year.

The Franchise Boom: 1998-2008

Franchising simply boomed during the past decade, especially for lower-investment franchises selling sandwiches, pizza, donuts and chicken wings. Subway added almost 10,000 domestic franchise locations between 1998 and 2008 according to Franchise Times Top 200 ranking, which equates to opening almost three restaurants per day. Quizno’s added almost 3,700 domestic locations during the same time period. Jimmy John’s increased the number of units by almost tenfold to 900 locations by the end of 2008. In donuts, **Dunkin**

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Financing and Deal-Making is in Vogue at November’s Restaurant Finance & Development Conference at the Bellagio

Despite the dreary financial results of the restaurant industry over the past year, we still expect a large turnout at this year’s **20th annual Restaurant Finance & Development Conference**, which is being held November 9-11, 2009 at the Bellagio Hotel in Las Vegas. Optimism has always been one of the finer attributes of restaurant owners and senior restaurant executives and we sense that most expect brighter days ahead. Based on our registrations to date, we expect approximately 1300-1400 attendees to this year’s finance fest, which would make this one of our larger turnouts.

We’d like to think that we are just good at putting on conferences. Or rather, we’ve assembled the industry’s top lenders and investors to exhibit this year and maybe that’s why attendance is running strong. Attendees will have the opportunity to zero in on the credit criteria of restaurant lenders, developers and brokers throughout the conference and specifically during our **Finance & Development Mall**. While financing has shown some signs of life in the past few months, we admit it still is tough to get deals done. We think it’s vital that you get in front of the finance sources before the market turns positive. Restaurateurs need every edge they can get. Solidify your contacts now!

We also have a great line up of general session speakers including **Stacy Perman**, author of the book about the iconic In-N-Out Burger, and **Paul Kasriel**, senior vice president and director of economic research for Northern Trust Company. In addition, **The Wall Street Journal’s** economic editor, **Stephen Moore**, takes on CNN’s **Paul Begala** in a debate over President Obama’s economic policies. And, don’t forget that popular comedian **Jim Gaffigan** headlines our Tuesday dealmakers luncheon.

Conference information is available on line at www.restfinance.com. **Las Vegas travel deals abound!** Register on line or call us at 800-528-3296.

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FINANCE SOURCES

GE Funds Jack in the Box Acquisition

GE Capital, Franchise Finance recently provided a \$4 million credit facility which enabled **Jack in the Box franchisee RDSL** to acquire and develop seven Jack in the Box franchise restaurants in greater Dallas. GE Capital only took two and a half weeks to approve and close the deal with RDSL.

Uniting four franchisees from across the country, the franchise ownership company, RDSL, was founded by **Rabi Viswanath, David Beshay, Sam Fong, and Lee Su**. RDSL currently owns and operates 19 Jack in the Box franchise units in the Dallas and Southern Oklahoma areas. "We're thrilled GE Capital provided certainty of close," says Rabi Viswanath, partner, RDSL.

GE Capital, Franchise Finance is a leading lender for the franchise finance market via direct sales and portfolio acquisition. With more than 30 years of experience and \$15 billion in served assets, the company serves more than 5,000 customers and more than 22,000 property locations. For more information, call 866-GET-GEFF (438-4333).

Auspex Represents Seller In Treadwell Deal

Metroplex Multifoods, Inc., owned and operated by long-time franchisee **Larry Durrett**, recently completed the sale of its Dallas/Fort Worth area Kentucky Fried Chicken business to **Treadwell Enterprises, Inc.** The transaction, which involved seven KFC restaurants, one of which was co-branded with Long John Silver's, also included the underlying real estate at six of the locations. **Auspex Capital** acted as the sell-side M&A advisor to Metroplex Multifoods for this transaction. Auspex Capital is a boutique investment banking and financial advisory firm specializing in the restaurant industry. Auspex's services include buy-side and sell-side M&A advisory, debt placement, asset valuation, institutional private equity and mezzanine placement, sale lease-back structuring and placement and financial restructuring.

For more information, contact **Chris Kelleher** at (562) 424-2455, or by e-mail at ckelleher@auspexcapital.com; **Shriram Chokshi** at (562) 424-5157 or schokshi@auspexcapital.com; or **Naveen Goyal** at (562) 424-5158 or ngoyal@auspexcapital.com.

MCC Appoints Mohr VP of Sales

Mercantile Capital Corporation recently appointed **Warren Mohr** as vice president of sales in the New York/Long Island region. Mohr formerly served as senior account executive with GE Capital and has more than 35 years of experience in lending and finance.

MCC provides SBA-guaranteed 504 loans to the franchise sector. For more information on Mercantile Capital Corporation, contact **Chris Hurn, CEO**, at 407-786-5040, or by e-mail at churn@mercantilecc.com.

National Franchise Sales Completes Denny's Sale

National Franchise Sales recently completed its third multi-unit Denny's restaurant transaction for the year. Two of the buyer groups, **S&T Restaurants** of Pennsylvania and **Definitely Delicious Dinner** of Washington State are new to the Denny's system. The third group, **CMS Restaurant Partners LLC** of New York, includes both existing franchisees and stockholders that are new to the Denny's system.

While acquisition financing is particularly difficult in 2009, NFS was able to apply an adaptive strategy to each unique situation to meet the capital needs of the buyer, while accomplishing the goals of the seller.

"Each transaction took on its own personality, reflecting both the needs of the sellers and the capabilities of the buyers," said Alan Gallup, principal with National Franchise Sales. "We were able to obtain 75-percent loan-to-value bank financing with the use of a regional bank in one instance." One of the larger transactions was all cash from buyer, and two were financed by the sellers, with the seller carry ranging from 35 percent to 50 percent.

This blend of capital sources is indicative of what they are seeing on other transactions in nearly all brands across the country, he stated. But to carry out and complete transactions like these, NFS has to fully understand the needs of the seller and the goals of the buyer. "We are finding that the yields on notes to seller are valuable in today's marketplace," he added.

"Oftentimes the seller is paying off an older high interest rate commercial note, and finds that certain underperforming groups offer a better cash flow off the note than the after-debt cash flow of the current operation," stated Gallup. "Hence the decision to sell and carry paper. This can have the effect of improving a seller's coverage ratios, and often may be the difference of his being in overall compliance with his primary lender, and can even be the difference to his access to expansion or remodel capital."

National Franchise Sales has assisted franchisees and franchisors in the sale of their businesses since 1978, specializing in the resale of franchised businesses and small chains. For more information, contact **Alan Gallup** at 949-428-0480, ext. 103.

Jack in the Box's Second Largest Franchisee Files Chapter 11

Food Service Management Company, also known as Kobra Associates, filed for Chapter 11 bankruptcy in California on September 19th. The company was Jack in the Box's second largest franchisee and was ranked by the Monitor as the 43rd largest restaurant franchisee in the United States with 2008 revenues of approximately \$135 million. It operated 70 units in Northern California.

Verdad Real Estate Provides Capital for KFC Acquisition

Verdad Real Estate recently closed on the acquisition of a seven-store KFC package in and around Dallas/Fort Worth. The acquisition was assembled by Verdad and the restaurants were simultaneously leased to long-time KFC and Taco Bell franchisee **Treadwell Enterprises**, owned by **Mike Treadwell**. Treadwell owns and operates 49 KFCs and Taco Bell locations throughout the Northeast, Midwest and South. The transaction was structured and closed in 75 days to accommodate the seller's tight timeline.

Jason Keen, principal and founder of Verdad, said he and business partners **Jim Shindler** and **T.K. Keen** thought there were growth opportunities for KFC in the Dallas/Ft. Worth area, but for Treadwell, it didn't make sense for him to start building there. Keen said that they identified an operator who was willing to sell his KFCs, bought them, and leased them back to Treadwell, who will seed the area with new sites as well.

"Being a small and entrepreneurial company, one of our distinct advantages is there isn't a lot of red tape with us," said Keen. "We're a committee of two or three and can make decisions quickly."

Those decisions include working on a variety of projects for multi-unit, top-tier concept operators. Verdad is both a build-to-suit real estate developer and a capital provider to restaurant companies. They provide capital for acquisitions, recapitalizations, new construction, and sale/leasebacks.

Keen said they can offer 100 percent of the capital for a project, buying the land, constructing the building and financing the equipment. "The operator can grow without any out-of-pocket expense," he said. "In today's market that's an attractive vehicle for growth."

And during the building process, they are "100 percent transparent." Verdad contracts with the franchisee for a predetermined fee for development, and any cost savings during the process are passed back to the franchisee. The franchisee is able to see the construction contract, and if there are cost savings, Verdad will adjust the lease rate down.

"We have aligned interests in the effort to drive costs down," said Keen. It is to Verdad's advantage, and of course the franchisee's, to maintain a proper rent coverage ratio. "It helps ensure they will be profitable at the store level," he added. "We're an extra check and balance so they are not overleveraging themselves, particularly in a sale/leaseback arrangement."

The company has made investments in technology, and the franchisee can go online anytime, whether they are across town or across the country, to view the status of their project. As Keen says, if Verdad promises the walls will be up at a certain date, the franchisee can go online and see if it actually happened.

And, because of the current economy, Verdad is working to help various franchisees that are in technical or monetary default of their loan covenants. "We are very interested in acquiring that debt," said Keen. "Oftentimes when these franchisees are in breach of their covenants, it doesn't mean they are bad operators, or underperforming. It may mean they are overleveraged somewhere else. When you have that much pressure on your back, it is difficult to climb that hill every day."

Keen added this is an excellent time to develop. Land costs are down, cities have an incentive for development and so projects are getting approved and permitted faster, and construction costs are down 20 to 30 percent.

For more information on Verdad Real Estate, contact **Jason Keen**, principal, at 214-317-9700, or by e-mail at jkeen@verdadrealestate.com.

Trinity Capital LLC Provides Valuation Opinion for a Multi-Unit IHOP Franchisee

Trinity Capital LLC recently provided a formal opinion of valuation to a private equity firm that was changing the legal structure of one of its portfolio companies. The portfolio company was a multi-unit franchisee of IHOP, a national family dining restaurant concept.

Despite the lack of recent M&A activity involving franchisees in the family dining segment, Trinity was able to provide an opinion of value for the private equity firm that was used to satisfy tax requirements and facilitated a smooth transition to the new legal structure.

"Often we are required to perform an extensive reconstruction of a company's financial statements to reflect its actual, adjusted operating performance and its resultant true economic value," said **Kevin Burke**, managing director for Trinity. "While much of the valuation process is empirical, our opinion of value takes into consideration subjective influences as well."

Trinity is a boutique, middle-market investment banking firm providing financial advisory services including mergers and acquisitions, fairness and valuation opinions, private placements of debt and equity, distressed advisory and restructuring. Since its inception, Trinity has closed transactions in excess of \$10 billion. For more information on Trinity, contact Kevin Burke, managing director, at (310) 268-8330, or by e-mail at kburke@trinitycapitalllc.com.

FINANCE SOURCES

Weichmann and King Form Consultancy

Craig Weichmann and **Bryce King** have joined forces to form **Brazos River Advisors, LLC**, a boutique advisory firm focused on multi-unit restaurant companies. The two met at financial advisory firm Mastodon Ventures a couple of years ago where both were restaurant company advisors. Both have the transactional, accounting and financial backgrounds and King has also operated restaurants, including Fuddruckers, of which he was CEO.

“Our main point of difference is the broad range of experience that we have gained over the years of taking 28 companies public and running Fuddruckers,” said Weichmann. “We bring that experience to the table as we understand far more than just the transaction—we understand the challenges of running the company and can balance that in selecting options for each client to consider.”

“It will allow us to go a step further with companies,” said Weichmann, who was a restaurant research analyst years ago for some well-known investment banking firms, including Morgan Keegan. “The step further is to do some strategic planning, managing people through the growth phase.” Adding managers and other labor, estimating how much the new changes cost, and deciding how to execute a new plan are all part of the process for building and growing a company. “But the process can be overwhelming, and we can provide the plan.”

Each advisory firm develops its own personality, and Weichmann says Brazos will be no exception. In fact, there aren't a lot of firms that work with emerging brands, and over the years that has become a focus for Weichmann.

“It's harder,” he said. “First, if you are a prospective investor, I have to explain what the concept is to you; you may not have heard of it. That's going to take longer.”

In the 1990s, you could be an emerging brand, he said, and go to market very early. That's not possible today. There's a demand for liquidity, and you have to be much larger.

“There are some very fine young brands out there that are healthy and have replicated,” he said. “They may be only 20 units. But lenders aren't taking that risk right now. This is a very tough cycle and it requires some new innovations to get through it.”

That may mean taking an operator, walking through the business with them, and making the necessary changes, he said. “Then, once that is done, we can come back and help them grow, because now his numbers are healthy. It requires someone who's been down the road before.”

For more information, contact Craig Weichmann, principal, at (903) 455-6004 or by e-mail at cweichmann@geusnet.com.

First Financial Bancorp Buys Irwin

First Financial Bancorporation, an Ohio-based bank holding company with approximately \$3.7 billion in assets has purchased the banking operations of **Irwin Union Bank and Trust Company** and **Irwin Union Bank, F.S.B.**, and subsidiaries of **Irwin Financial Corporation** through agreements with the Federal Deposit Insurance Corporation. The acquisition will be made through First Financial's wholly owned subsidiary, First Financial Bank, N.A.,

Irwin Union Bank and Trust Company, a commercial bank, and Irwin Union Bank, F.S.B., a federal savings bank, were shuttered last week by federal and state regulators for deficiencies in capital. The commercial banking business of Irwin had \$2.7 billion in assets and \$2.1 billion in deposits. The savings bank had \$493 million in assets and \$441 million in deposits.

Restaurant operators know Irwin through its commercial finance subsidiary, Irwin Commercial Finance Corporation, which makes restaurant loans as Irwin Franchise Capital Corporation. Irwin's franchise finance group had approximately \$587 million of franchise loans outstanding as of June 30, 2009. According to John Rinaldi, president of Irwin Franchise Capital Corporation, First Financial has acquired the assets of the franchise loan group and is expected to retain the franchise finance employees. Rinaldi pointed out that Claude Davis, the CEO of First Financial, is a former senior vice president of Irwin and was chairman of Irwin Union Bank and Trust. Davis is familiar with the franchise finance portfolio.

The holding company, Irwin Financial Corporation, has been restructuring over the past year due to financial problems brought on by the housing crisis and concentrations in Arizona and Nevada. Irwin had plans to reduce its operation to two segments, commercial banking and the franchise finance program, as it exits the mortgage banking and home equity lending markets.

Irwin's franchise finance portfolio has performed well given the problems in restaurants and commercial real estate. In an August 25th conference call to discuss the second quarter operating results, Irwin CFO Greg Ehlinger said that the franchise loan portfolio was stable.

“In a positive sign for our credit outlook, 30-day delinquencies for the franchise portfolio were unchanged from the first quarter in a relatively low 1.4 percent, said Ehlinger.

As more information becomes available about this transaction, check out our Web site at www.restfinance.com

The SBA Changes Goodwill Guidance and Other SBA Issues

The Small Business Administration recently revised its guidance on financing “goodwill,” the difference between the value of business and the value of the book assets in establishing a basis for a guarantee.

“The easiest way to explain it is that businesses are not sold on the basis of the assets,” **Ron Feldman, CEO of Siegel Capital** told the Monitor. For instance, the assets may be leasehold improvements such as POS systems, chairs and tables and equipment, which are used and don’t have much cash value.

The SBA had advised of capping the goodwill of a business at \$250,000 in March. “The SBA elected to hamper the business of resales in a recession,” he said. The seller had to finance the rest of the deal. “What motivates the seller to be the bank?” said Feldman.

In the beginning of September, the SBA changed its Standard Operating Procedure:

- Loans under \$500,000—no limitations on goodwill financing
- Loans over \$500,000—no limitations on financing provided that the equity injection is 25 percent or more of the purchase price.

“But if the owner has three restaurants that are cash flowing at \$250,000, they generally sell at three times cash flow, whereas the value of the assets may only be \$100,000,” Feldman explained.

“The fight we had with the SBA over the last six months was explaining to them that the point was to lend to businesses with high cash flow,” said Feldman. “The number-one priority for a lender is getting repaid, not to foreclose. Assets are not providing the cash flow to repay the debt.”

“Also, language forcing lenders to explore seller financing was stricken from the document,” he said. “Lenders now have the flexibility to determine if seller financing is appropriate on a transaction-by-transaction basis.”

Other SBA issues

At the Faegre & Benson Franchise Summit in August, Feldman told the audience that the secondary market for SBA loans “had healed itself,” but just for the amount of loans being made right now. “If we have more supply, would it be the same? We don’t know.”

Months ago, the SBA eliminated the borrower fee and raised the government guarantee to 90 percent, all in an effort to get banks interested in financing small businesses. An unintended consequence of this is that banks are refinancing conventional loans when they are up for renewal to take advantage of the guarantee.

“The positive is that they are using the program to mitigate their risk, said Feldman. “The negative is that it doesn’t do anything to start new businesses and create new jobs.”

He’s also concerned about “guarantee faith” of the banks. “The government has been declining some guarantee requests, so there is less faith in them from some banks,” Feldman said.

Let’s say there is a technical issue on the loan, said Feldman. Here’s one of his examples: He recently saw a loan default, where the bank didn’t get the proper collateral on the life insurance. Even though the borrower “was alive and kicking,” he said, the SBA denied the guarantee because of a collateral issue on the life insurance. The SBA is looking for ways to invalidate the guarantees.

And to Feldman’s point, this doesn’t help the banks’ comfort level when it comes to loaning to small businesses.

Long-time Finance Executive Fred Hoekstra Dies

GE Capital, Franchise Finance managing director **Fred Hoekstra** died in mid-September. Hoekstra was a long-time finance executive serving with Bank of America in the 1980s, and Sanwa Bank of California in the 1990s. He was well-known in franchise circles for first leading the franchise lending effort at CitiCapital and then subsequently, Merrill Lynch Capital before GE acquired Merrill last year. Fred led two teams at GE; one focused on alternative investments and the other focused on senior debt financing solutions for petroleum marketers.

“Fred was many things to many people—father, son, husband, brother, college professor, colleague and friend,” said Rick Thompson, senior vice president, GE Capital, Franchise Finance. “To me, he was ‘best friend.’ Throughout our 22 years together personally and professionally, he seldom had a bad day. He was a talented business leader that our team will greatly miss. We all are better people for having known him.”

“This is a very sad day for all of us who knew Fred,” said Darren Kowalske, president, GE Capital, Franchise Finance. “He was a tremendous individual, accomplished leader and valued friend. He will be greatly missed by all of us. It was a pleasure to have known and worked with him.”

The Monitor staff knew and worked with Hoekstra over the years, and learned during the course of our conversations that Hoekstra also taught finance at California State University, Fullerton. Hoekstra did this for the love of teaching, and it was his wish to make the subject of finance interesting for undergrads. Hoekstra is survived by his wife, Melody, two sons and a daughter.

FRANCHISING

The Evolution of Franchise/Company Ownership

San Diego-based **Jack in the Box** has been primarily a restaurant operator for most of its 58-year history. The company began franchising in the 1980s, but was still 80-percent company owned in 2003.

That's when the burger chain decided to make a change. It's been steadily unloading company-owned restaurants ever since, including an expected 150 this year. By 2013, Jack's company-owned percentage will be reversed: It will be 75-percent franchise operated.

Figures. When a company both franchises and operates its brand, there is a wide range of options as to the percentage of units it operates itself. But over the years, that franchise-to-company ratio for most restaurant companies has remained relatively constant: three franchisee-owned units for every company restaurant.

To be sure, there are some signs of a shift toward more franchisee control. Several large chains have sold off company units in recent years. And smaller, newer franchisors are more likely to avoid store ownership altogether, choosing to operate only a few units at most for testing purposes. Roughly a third of the largest restaurant franchisors operate 2 percent or fewer of overall system units.

Nevertheless, those chains that do own more than 2 percent of their system's units are 74-percent franchisee-owned, according to an analysis of data from the nation's largest franchise systems.

One theory as to why that ratio evolved, according to franchise consultant **Michael Seid**, is that investment bankers years ago wanted 25 to 30 percent company-owned stores to provide a system with brick-and-mortar assets—thus providing the lender with ever-so-important collateral. Those assets also give the franchisor a way to raise money should it run into trouble.

More likely, however, is that the ratio evolved because many systems felt it was a good strategy. A company can try new products, services or prices in its own restaurants before making the ideas a requirement of all stores.

"If you only have 5 percent (of the units), that's not a lot of data points on innovative products or services," said the franchise attorney and consultant **Jeffrey Kolton**. "With 20- to 25-percent company stores, you can implement a new idea quickly. See if it's going to work."

"Older companies," he added, "learned the hard way not to roll out programs on franchisees. The more testing they could do about new services, new products, proper pricing, the easier it was to roll out."

It's also a sign of faith in the system. Franchised chains like McDonald's and Famous Dave's have held to their company-owned ratios—despite some pressure to the contrary—because it gives them more credibility with their owners, showing that they have "skin in the game."

That's one reason why Jack in the Box will stop selling company units after it reached that 75-25 ratio, according to company spokesman **Brian Luscomb**. "We want to have a stake in the operations side," he said. "We've always been an operator in addition to being a franchisor. It gives us a better perspective on the business." And, he said, more credibility with franchisees.

Yet some companies clearly believe they can accomplish this goal with a smaller number of units—Yum! Brands, for instance, in late 2007 began selling off units with plans to cut in half, to 10 percent, the percentage of company-owned stores in its system.

Nicole Miller Regan, a senior research analyst with Piper Jaffray, said that 10 percent is the smallest percentage that a company can get the benefits of company-owned stores. "Corporate needs 10 percent so it can make changes," she said. "They have to control enough of the stores to be able to run programs or strategies."

Bankers have generally looked favorably upon franchising—even if they didn't always look so favorably upon some franchise-heavy sectors—because franchising revenue can be more profitable, and less risky. That risk is borne by the franchisees, who take the hit when food and labor costs rise, as they have in the past couple of years, and take the direct hit when sales fall.

Jack in the Box is reversing its ownership percentage in part because of economics. "It reduces exposure to volatility, the economic pressures on sales, shifting commodity and labor costs," Luscomb said, adding that it reduces G&A expenses, shifts ad costs and increases cash flow.

Investors tend to like franchising during difficult economic times, Regan said. Heavily franchised companies "are going to be considered more defensive. Corporate is not on the hook for food cost inflation, labor inflation. They get high-margin royalties." But that favor turns when the economy heads north—the company gets more of the benefits of a recovery and sales boost if it owns more units.

Indeed, it may be a sign of the strength of franchising as a business model that relatively few franchisors have gone bankrupt over the past year despite a brutal period for many restaurant chains. Not so franchisees and independents, which have had their share of problems.

The growth in international markets could ultimately shift chains toward more franchisee-owned units. Domestic restaurant chains are more likely to franchise international markets, at least through some partnership, because local companies have more knowledge of the unique markets. Several restaurant chains, like Dave & Buster's and California Pizza Kitchen, don't franchise at all in the U.S. but will franchise internationally.

In addition, the growth in fast-casual concepts could also shift system control to local owners. Casual dining chains, like Chili's and Ruby Tuesday, generally operate more of their own units. Fast-casual chains, like McAlister's Deli, Moe's Southwest Grill and Five Guys Burgers, tend to operate fewer.

The economy, however, could ultimately shift the domestic market back toward more company-owned restaurants. Companies could take over struggling franchisee-owned units, often at a discounted price. And with the credit crunch keeping franchisee expansion at a minimum, chains with cash and little debt are simply deciding to expand themselves. "I think there's going to be a shift," Kolton said. "There will be some converting to company owned operations for franchisors that have the infrastructure to do it."

"You'd rather keep the units alive. Take over operation. Get ready to run it yourself if you have the infrastructure, and then sell it back to a franchisee."

— Jonathan Maze

Faegre Summit Sheds Light on Franchise Financing Market

At franchise law firm **Faegre & Benson's Franchise Summit**, held on August 26 in Minneapolis, one of the topics of the day was exploring the "new normal" in franchise finance.

The only thing normal about the financing markets, say participants, is that nothing is normal.

Even in 2011 and 2012, said **Darrell Johnson**, president of franchise information firm FRANdata, the actual lending will not meet the demand. "Franchisors will be in the position of having franchisees waiting for loans," he said. The "preferred lender" model, where franchisors have a list of pre-approved lenders wanting to lend to their franchisees, is a 20th-century concept, he added. "Lenders are cherry picking who they want to lend to."

And while we're all waiting for 2010 for financing to loosen up, Johnson said that the next two to four years will be choppy and the recovery slow.

Ron Feldman, CEO of Siegel Capital, a financial broker that focuses on the franchise sector, added that capital is expensive for franchisees today. For existing franchisees, 10 to 14 percent rates for conventional financing is the norm, and this is for selective, strong franchise concepts. Leasing companies "are getting creative," he said, and rates range from 9 to 20 percent depending on credit.

"Some start-ups are accessing an 18-percent interest rate over five years, some higher" said Feldman. "You have to question whether or not a franchisee can succeed at that rate."

Ken Switzer, CFO of Marco's Pizza, talked about his company's captive leasing program. Marco's works with the bank to offer a 10-percent interest rate, but the franchisor stands behind the lease. Thus, the franchisee has a lower debt rate.

It's important that the bank has some recourse "beyond the SBA," said Feldman.

According to Feldman, there are other "new normals:"

- More than ever, banks are looking at the managerial experience and financial acumen of the franchisee.
- A FICO score of 650 is a must.
- Home equity cannot be used without other income to fund a franchise.
- Banks now require a cash injection of 20 percent for the big brands and 30 percent "for everyone else."
- A borrower must have the cash equivalent of three to six months personal expenses.
- There's a moratorium on the food sector.
- Most lenders have a minimum loan greater than \$200,000.
- Lenders are wary of geographical areas with large residential/housing issues.

Feldman suggested franchisors should "get active with lender relations," and work to provide alternative financing solutions such as direct financing to franchisees, limited or full guarantees, or a first loss reserve pool. Landlord financing is also an option, such as tenant improvement allowances.

Marco's is getting creative, said Switzer, forming Marco's Assurance, LLC, which includes a captive first dollar loss guarantee entity for the lenders. "The most important benefit of this may be psychological," he said. It sets Marco's franchise apart and gives the lender a certain comfort level with the concept.

Marco's Capital, LLC, on the other hand, did a private placement to raise investment funds, where the company can take a minority interest in the franchisee. It can bridge the gap on the down payment, and the franchisee buys out the minority interest in six years.

For more information on Siegel Capital, contact Ron Feldman, CEO of Siegel Capital at (610) 668-9780 or rfeldman@siegelfg.com.

For more information on Marco's Pizza, contact Ken Switzer, CFO of Marco's at (419) 829-0903 or kswitzer@marcos.com.

Will the Equity Markets Ever Return?

For private equity groups that invested in restaurants a few years ago, then saw one likely exit strategy blocked by an almost non-existent IPO market, here's some good news: There are signs that a warming may be just beyond the horizon.

A broad-based equity rally since spring, coupled with the expectation of an increase in consumer spending next year, is providing hope for a more robust public market. That could satisfy pent-up demand for investors eager to put money into publicly traded, high-growth restaurant companies.

Indeed, investors appear to be clamoring for new blood in the public space. "We still get a lot of inbound calls from investors looking to invest in the sector," said **Damon Chandik**, who heads the restaurant group at Piper Jaffray. "But they're not totally comfortable with the current outlook."

The IPO market fell off a cliff two years ago as the country fell into a recession. The number of initial public offerings fell from 272 in 2007 to 43 last year, according to the IPO research firm Renaissance Capital. And this year, the IPO market isn't even meeting those not-so-lofty standards—only 21 companies have gone public.

But there are signs that it may be improving. IPO filings have picked up this summer—there have been 34 since July, after only 19 filings were made the previous nine months. An improved stock market and a rosier economic outlook may be the reasons. Economists expect the stimulus-boosted economy to grow in the second half, followed by gradual, albeit sluggish, growth next year.

While unemployment is expected to increase into the middle of next year—it currently sits at 9.7 percent—that increase is already showing signs of slowing. Retail sales typically follow improved GDP by a couple of quarters, said **Michael Phalen** managing director of Wells Fargo Securities.

Improved restaurant sales, however, have been slow to appear, and a brighter industry outlook is a key element in any potential comeback of the public market in the restaurant space. Quick-service chains have begun to feel the consumer pullback this summer—sales growth at McDonald's has slowed, for instance, and Burger King's once admirable sales figures hit a wall this spring.

And casual dining sales continue to fall. August comparable-store sales fell 5.4 percent at casual diners, according to Knapp Track, which tracks monthly same-store sales numbers at 30 casual dining chains. Traffic was down 4.6 percent. The numbers extended a lengthy string of sales declines for the sector, but **Malcolm Knapp**, the consultant behind the tracking service, said that the declines may have bottomed out with July's 8.4-percent sales decrease. He also speculated that sales may begin to turn positive later this year, particularly December, as they will be compared against a brutal period of a year ago.

Investors may be betting on an improvement in the restaurant space. Since March, restaurant stocks are up 130 percent, according to Wells Fargo's internal restaurant stock index.

Potential IPO Candidates?

If the public market for restaurants warms in the next year, a handful of restaurant companies could be potential candidates for an initial public offering. Here are a few companies that restaurant insiders feel have the best chance at going public.

Noodles & Company: Interesting concept with a well-regarded management team.

Yardhouse: Could satisfy investors' demands for a differentiated restaurant concept, even if it is upscale-casual.

Jimmy John's Gourmet Sandwiches: But at 98-percent franchisee-owned, does it need the capital?

Dunkin' Donuts: "Blue-collar Starbucks" has long been rumored to be eyeing an IPO.

Corner Bakery: Popular bakery seems to be a strong candidate for the public market.

Logan's Roadhouse: Highly regarded and unique concept.

Cheddar's: Strong value proposition.

Potbelly: Recent management change may make it less of a candidate right now.

First Watch: Strong unit economics and popular among customers.

Phalen said he believes investors may be betting that sales will begin turning upward next year. "It's reasonable to presume that the equity markets are looking ahead and assuming a recovery in consumer spending in 2010," he said.

Chandik isn't so sure. He believes the stock rebound was a simple correction of an overselling of stock. "That was driving off a situation where a lot of investors were selling anything and everything," he said.

A restaurant has not gone public since Carroll's Restaurant Group made a stock offering in December 2006—which followed the more heralded offering of Chipotle Mexican Grill. Most of the restaurant chains in the public sphere are well established or have limited growth prospects. "There's a paucity of truly high-growth restaurant companies in the public domain," Phalen said. The most likely candidates for a public offering may be companies in the limited-service space, especially fast-casual chains, which have more easily withstood the onslaught of the economy. While there are plenty of casual-dining chains that would make good options for the public market, there remains a deep concern about the sector's overall performance, as well as its capacity.

"The key is growth," Chandik said. "A lot of these chains aren't showing the growth. Or they're showing negative growth. (To go public), they have to be differentiated concepts, with high growth potential and strong unit economics."

— Jonathan Maze

ANALYST REPORTS

Sonic Corp.
SONC-Nasdaq
(Sell)

Recent price: \$11.51



Founded in 1959, Oklahoma-based **Sonic Corp.** operates and franchises a chain of quick-service, drive-in restaurants. The company operates 3,475 Sonic Drive-Ins, including 684 partner drive-ins and 2,791 franchisee-owned drive-ins.

Steven Kron, Goldman Sachs analyst, added **Sonic** shares to its "Conviction Sell" list, saying that today's strength is a "compelling exit point for what we see as a NT relative underperformer." He noted that same-store sales will remain weak as the company struggles to improve its value proposition with discounted offers in the competitive QSR category. 2010 margin improvement "is well-known and expectations likely include promotional offsets to declining commodity costs." In addition, valuation is expensive, "given its limited unit growth profile," and Sonic shares trades at the high end of Goldman's QSR coverage.

Burger King Corp.
BKC-NYSE
(Overweight)

Recent price: \$17.90



Burger King operates the world's second-largest hamburger chain. The Florida-based company owns or franchises 11,925 restaurants in more than 70 countries and in all 50 U.S. states. Founded in 1954, the Florida-based company is known for its flame-broiled burgers, fries and other sandwiches.

Piper Jaffray analyst **Nicole Miller Regan** sees improvement in Burger King, suggesting that its difficult run may be over. She notes that many U.S. regions have seen stabilizing sales, while some markets are improving. Broadly, U.S. comp trends have been improving every month since May. "We expect continued improvement based on value-focused, product-based promotions and easing comparisons." She believes the company's earnings projections for the first quarter of 2010 are achievable, and expects earnings to remain flat, year-over-year, at \$0.38 per share. In addition, she believes that store remodels, new products and a provocative media campaigns, combined with extended hours, puts Burger King in a more offensive position. "We believe the worst is over for BK. As results improve, our price target multiple assumption may prove conservative."

Cracker Barrel
CBRL-NYSE
(Market Perform)

Recent price: \$34.85



Tennessee-based **Cracker Barrel** operates a restaurant and retail concept in the U.S., under the name of Cracker Barrel Old Country Store. Restaurants offer breakfast, lunch and dinner menus featuring home-style comfort foods. Retail stores offer various decorative and functional items, including apparel, music, cookware, ceramics, figurines and rocking chairs. The company operates 579 full-service restaurant and gift shops.

Raymond James analyst **Bryan Elliott** is "encouraged" that **Cracker Barrel's** comp-sales trends appear to be stabilizing and, though negative, outpacing the broader casual-dining sector. Nevertheless, he said, "We believe that CBRL shares are fairly valued versus peers at current levels." Management provided initial fiscal-year 2010 EPS guidance of \$2.85-\$3.10 on generally flat comp-sales assumptions and slightly lower operating margins. "The overall revenue and EBITDA outlook for the company is static until a meaningful recovery in consumer spending occurs." He added, "At current valuations, we view the stock as neither cheap nor dear—P/E multiple levels are at the lower end of the peer group but EV/EBITDA multiples are near the upper end."

OUTLOOK

Donuts added 2,800 locations to its domestic totals while Cinnabon added 400 units. **Papa Murphy's**, a take and bake pizza operation, doubled in size between 1998 and 2008, growing to more than 600 units.

Even companies that were barely a blip on the business radar screen in 1998 grew rapidly through franchising during the decade. **Five Guys Burgers and Fries**, which had fewer than six locations by the end of 1998, just opened its 400th location last month. **Wingstop**, a 1500 square-foot chicken wing concept that had just 14 locations in 1998, added 400 units during the decade.

An accommodative monetary and lending policy espoused by Alan Greenspan and an ownership society advocated by George W. Bush fired up the masses for small business growth. There were tax benefits, low interest rates and rising investment values which played into the boom. A legion of franchisee candidates arrived on the scene with swelling home values and fat 401(k) balances ready to make downpayments on the so-called "American Dream." Banks and other financial institutions stepped over each other to become the lender of choice to all kinds of franchise systems from sandwiches to pizza.

The franchising sales machine was also able to tap into the corporate angst of the franchisee candidates, caused by large tech layoffs in 2000, and economic uncertainty brought on by 9/11. Tired of working for the big corporation, America's mid-level manager was anxious to trade in his/her corporate office badge for a logoed apron. It didn't matter if the franchise opportunity was 30 years old or 30 days old, the corporate exiles were itching to start making money for themselves in a variety of concepts.

All of the economic indicators and the psychology of the buyers were on overdrive. It was the Internet though, that changed the momentum for franchisors and delivered the big numbers during the past decade.

Franchise sales had always been a big business but the way franchises were sold changed in the late 1990s. Boatloads of random franchise inquiries started pouring in to franchisors via the Internet. Hundreds of newly created, independent franchise Web portals popped up to guide the flood of prospective franchisees seeking information about franchise concepts. These franchise portals advertised heavily on the Internet to find leads for their franchise advertisers who were interested in the volume of potential candidates.

Franchising was packaged and marketed by the portals as a way to reach the American dream of business ownership. Unfortunately, the marketing used by many of the franchise Web portals utilized some of the same hucksterism that was used to sell sub-prime mortgages. To attract candidates, the Web portals carried flashy names like Red Hot Franchises, The World's Hottest Franchises and America's Best Franchises.

Franchise Gator, a popular franchise sales portal, was so successful in finding franchise leads and selling them to franchisors that it sold itself to aQuantive, a digital media

company, for \$21.5 million in 2006, and was later sold to Microsoft in 2007.

How effective were the franchise Web portals? Franchise sales experts estimate that almost half of the new franchises sold during the past decade came from Internet lead sources.

In addition to the franchise Web portals, hundreds of franchise brokers took to the streets to handle the surge in the number of Internet-generated candidates. In a broker deal, a prospective franchisee candidate was shown a variety of franchises and selected one based upon their interests and financial ability. Assuming the candidate signed on the dotted line, the broker was paid a fee by the franchisor for the matchmaking exercise. The fee was substantial, usually approximating one-half of the total franchise fee. Some brokers even convinced franchisors to raise their franchise fees, so that their share of the fee would be worth their sales effort.

The result of electronic franchise sales, expanding broker networks, friendly lenders and a roaring economy created a boom in the number of franchisors seeking to sell franchises and also the number of franchisee candidates seeking to open their first franchise outlets.

The Recession Has Changed the Franchise Sales Game

The Great Recession, as you can imagine, has changed the way restaurant franchises are being sold—or not being sold—in the United States. No longer are prospective candidates flush with ready cash and an inflated net worth to tap. Since 2007, the median U.S. home has declined by 22 percent, according to the National Association of Realtors. Although stock market averages have improved somewhat in 2009, Fidelity Investments estimates that the value of 401(k) declined by 27 percent in 2008.

Much of the equity and downpayment for small format franchisors came from home equity and retirement savings sources. The balance of the franchise investment package was financed by a lender, usually one with Small Business Administration (SBA) backing. That too is now slowed, despite the efforts of the Obama administration. Lending has been curbed to only the best borrowers, and many franchise systems are finding it a tough go with lenders. Some lenders, most notably the largest SBA franchise lender, Wells Fargo SBA, now require that a prospective restaurant franchisee have specific industry experience before they will approve a loan.

The lack of readily available funds and the risk-averse nature of Americans in 2009 has reduced the number of franchise candidates substantially.

Internet leads are down and that is impacting the Web portals, brokers and ultimately franchise companies themselves, who struggle to find qualified leads. Kim Ellis, vice president of corporate development for Process Peak, a company that works with franchisors on their development plans, estimates that franchise portals have declined across the board by more than 60 percent from the peak period of a few years ago. Ellis estimates that franchisors were advertising on as many seven

to 10 Web portal sites, but now have cut back significantly, and many have given up on the sites altogether because the quality of leads is so poor.

The number of portals has also consolidated as franchisors have cut back on their advertising. As portal sales have declined, one company, Landmark Interactive, has consolidated a number of franchise Web portals including Franchise Gator, Franchise Advantage, Franchise Solutions and franchise.com and now operates about 10 franchise portals. A number of lesser-known franchise portals have gone out of business due to lack of advertising.

The negative publicity at some high-profile franchises may also be responsible for some decline in the number of new franchise candidates. Store closings and franchisee bankruptcies at Krispy Kreme and Quiznos went beyond the trade press and moved into the main-stream media. Prospective franchisees see closed restaurants and it scares them off until business conditions improve.

Brokers that once relied on the steady leads generated by the portals have also been impacted. No longer can they depend on a steady stream of Internet leads who want franchises. Brokers now must resort to networking the old-fashioned way to find franchisee candidates—in local chambers of commerce, rotary clubs and outplacement offices.

Franchisors have also had to adjust their franchise recruitment strategies. Joe Matthews, the author of “Street Smart Franchising” and a consultant, sees franchisors putting less money into portals and more money into search engine optimization, sponsored links, public relations and other forms of lead generation.

Matthews sees the future of social media impacting franchising whereby potential franchisees will be able to share more information about a particular brand. He forecasts a shift in investment interest away from the franchisors who sell the most franchises, to ones that consistently produce the greatest results for their franchisees.

Darrell Johnson, CEO of FRANdata, goes further with that notion and believes potential franchisees and more importantly, their lenders will demand better and more detailed information about operating results. This will include more companies providing earnings claims, especially the ones that can tout above-average performance.

“Underperformance will be punished,” said Johnson.

What’s Next for Franchising?

When I first started following franchise companies in the early 1980s, I found that most restaurant companies would just as soon build out a company market for themselves rather than franchise it to someone else. Company store development was considered very important at the time. If an existing franchise operation came up for sale, the franchisor was often involved in the bidding process to reacquire the territory for itself. When a franchisee ran into financial trouble, the company

often bought the franchise at a discount and turned around the operation. The franchisor then kept it for itself or sold it to another franchisee for a profit. Now, the development emphasis over the past decade has clearly skewed towards franchising.

Franchising changed in the early 1990s according to Tom MacIntosh, a veteran franchise attorney now practicing with Krass & Monroe in Minneapolis. MacIntosh thinks that Subway founder **Fred DeLuca** proved that a franchise company could be more profitable by selling franchises rather than actually running its own company stores, especially ones with lower volumes. DeLuca began charging a higher royalty than was typical of most franchisors at the time.

The Subway franchise model and the use of area-developer agreements has been employed by countless franchise companies as they try to emulate Subway’s success.

Things have changed dramatically over the past decade. The enormous capital costs of building new restaurants have been prohibitive for many newer restaurant companies to raise the capital necessary to build a large number of company stores. Many companies have to rely on franchising to grow their brands. But how will franchise development work in this economy when the lending environment is so poor?

Ellis predicts that we will start to see what she calls the “WalMart Effect,” or rolling back prices of royalties and franchise fees to attract new franchisees. Some franchise systems are already waiving franchise fees and offering reduced royalties to attract franchisees. Papa Johns is offering no franchise fees and no royalty during the first year if a franchisee signs up for a development territory by December 27th. 7-Eleven Inc., the nation’s largest convenience store chain, recently launched a program that discounts its franchise fee for retired or inactive U.S. military veterans who were honorably discharged. Others are offering discounts to military personnel, too.

Red Mango, a yogurt chain founded in Korea and now expanding in the U.S., says it will repurchase the franchisee’s store for up to \$275,000 if the franchisee is not satisfied with the store for any reason within the first six months of opening. The program lowered the initial \$35,000 franchise fee by \$10,000 for franchisees who sign new franchise agreements in 2009 and contributes an additional \$10,000 to the franchised location for local store marketing.

Franchisors may find themselves in bidding wars for qualified franchisee candidates in the coming years. The perfect franchisee who has equity and can find financing to develop stores may not want to pay the big franchise fee or royalty unless it really warrants the investment.

Franchisors who can’t demonstrate positive franchisee performance might have to resort back to the Mitch and Murray sales job. I expect that for franchisors who won’t adapt, it will be a bit tougher to “always be closing” in the coming decade.

—John Hamburger

Twenty Years of the Restaurant Finance & Development Conference

Twenty years ago I came up with the idea of a restaurant financial conference where restaurant CFOs and controllers could meet and network with restaurant lenders and investors. I had been the chief financial officer of a small restaurant franchisee in Minnesota from 1980 to 1987 and I wondered why all the restaurant meetings and conferences dealt only with kitchen equipment and food products.

I found that it was difficult to meet restaurant lenders unless you belonged to a big franchise company and could attract them to your franchisee convention. Commercial finance was changing in the early 90s and I could see the growth of sale-leaseback and non-bank lenders. I also saw that restaurant companies were embracing the multi-unit operating format. I thought restaurant companies would be anxious to meet with lenders and investment bankers. It turned out I was right.

Little did I know 20 years ago that our conference would become responsible for facilitating billions of dollars of restaurant financing and investment deals over the years. I wish I could still get a commission on those deals.

Our first conference was held at the Radisson Hotel in downtown Minneapolis in November, 1990. **Mary Jo Larson**, now our Franchise Times publisher, joined me that morning as we stapled the attendee manuals that I had picked up at 5:30 a.m. that morning at Kinko's. Attendees expecting to find cold November temperatures in Minnesota were greeted with summer-like 70-degree temperatures. We had about 50 attendees at our first conference.

Some of the first-year attendees would go on to do great things in the restaurant business. **Don Harty**, a three-unit Burger King franchisee at the time, attended the first event. Don now runs ADF Companies, a 300-plus unit franchisee of Pizza Hut and Panera Bread. **Gene Baldwin**, CFO of a Pizza Hut and Long John Silver's franchise, was also there. Gene has since become a top workout advisor to restaurant companies and lending institutions. **Michael Grisanti**, owner of a chain of restaurants in his name and also the former president of the National Restaurant Association was also there. **Mike Dimond** of Cardinal Development was there looking for financing for his development customers. Mike has never missed a conference since. **George Keith**, investigating the conference for GE Capital, also attended. George went on to a long career with a variety of franchise finance companies including Finova, CIT and Heller. George is now a Golden Corral franchisee in Tennessee.

Dennis Monroe attended our first conference and has spoken at every one since then. I didn't know Dennis at the time but he had called me a few weeks before the conference and requested to be a speaker. I went out to meet him at his office, liked him and signed him up. Dennis, of course, is now synonymous with restaurant finance and has become a great friend. **Allan Hickok** was also at the first conference. Allan was the newly appointed restaurant analyst at **Piper Jaffray & Co.** and later went on to become a top Wall Street analyst and investment advisor. Allan has also become a good friend.

As I mentioned, Mary Jo Larson was at our first conference. I had hired Mary Jo only a few weeks before to help edit the Restaurant Finance Monitor. At the time, Mary Jo didn't know anything about the restaurant business or franchising, but now has become a national expert in both. **Gayle Strawn**, who runs our conferences, started with us in 1993 and has been with us ever since. We couldn't put on the conferences today without Mary Jo and Gayle's help.

We didn't have a luncheon speaker that first year but started in 1991 with **Richard Pillsbury**, the author of "From Boarding House to Bistro, the American Restaurant Then and Now." Over the years we've had some wonderful speakers at our conferences. I've had the opportunity to meet some neat keynote speakers and really nice people such as Monty Python's **John Cleese**, comedian **Dennis Miller** and actor/economist **Ben Stein**.

Although I consider myself a conservative when it comes to politics, I'm disappointed to say that two of the biggest jerks we've had speak at our conference were conservatives—**Bill O'Reilly** and **John Stossel**. O'Reilly was such an egomaniac that no one at our luncheon table could even talk with him. In fact, when he was giving his speech, O'Reilly's cell phone kept ringing and he made no effort to turn it off. Stossel, whose bits I usually enjoy watching on television, was also a pill. **Jesse Ventura** (I don't know what political party he is from) showed up looking like he hadn't slept or taken a bath in a month. **Al Franken** and **George Stephanopoulos**, on the other hand, whom I usually disagree with politically, were really nice guys. Go figure.

I hope to see you all at the Bellagio this November for our twentieth! I'm just as excited as I was for our first one back in 1990.

—John Hamburger

RESTAURANT FINANCE MONITOR

2808 Anthony Lane South, Minneapolis, Minnesota 55418

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Subscription Rate: \$295.00 per year. \$550.00 for two years.

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