5 Questions to Consider Before Asking for a Franchise Loan

By: Alicia Chandler

The 5 Cs of Credit

When lenders evaluate potential borrowers, they are assessing these five areas.

Conditions are the specifics of the loan and factors that may influence it.

Character points to the applicant's credit history.

Collateral pertains to the assets a borrower pledges to secure the loan.

Capacity refers to the debt load a company can sustain.

Capital refers to how much equity the company has available.

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A few years ago, franchisee Mike McDermott wrote a great piece for The Voice on retirement and how older franchisees leaving the business create opportunities for young entrepreneurs to break into ownership. He described many of the factors that go into qualifying for a loan to finance a purchase, and those same considerations apply to loans for expansion, improvements, or succession planning. Here, I'll expand on those points and look at the objective and intangible elements that go into a lender's decision.

What are lenders looking for?
At the heart of every lending decision is the question: "Can the borrower repay the debt?" Nobody wins if loans can't be repaid, so a lender needs evidence that the borrower is a good credit risk. Here's a list of documents lenders routinely require to assess credit risk:

• Financial statements for the past three years;
• Company tax returns for the past two years;
•Franchise agreement(s);
• Lease agreement(s);
• Pro-forma financials that forecast expected future revenue; and
• Personal financial statements that establish the financial character of stakeholders.

Lenders need to understand how the cash will be used. Will you be setting up a new location, expanding your space, or upgrading your equipment?

They'll also want to know if the current management team will be involved for the whole length of the loan period. Lenders may hesitate to extend credit if you or other company principals intend to retire or sell the business before the repayment period ends; they may require a formal succession plan before considering the loan application.

How much do I need as a down payment?
Lenders usually expect borrowers to provide 10% to 20% of the total purchase price as a down payment. If a franchisee wants to buy the real estate in which their restaurant operates, a lender will likely provide financing up to 85% of the appraised value of the property or the purchase price of the property, whichever is lower.

Do I need collateral?
Lenders want to see that borrowers have the resources to pay back the loan, so most require that the loan(s) be secured by all of the borrowers' business assets (i.e., collateral)

What intangible factors do lenders consider?
Lenders base a significant part of their decision on the character of the person making the request and other principals in the business. They are looking for factors that support the loan being repaid. Here are some of the elements lenders consider:

• **Credit score** – Your credit score and those of any principals in the company give the lender a picture of your overall credit worthiness and management of your personal finances.

• **Experience owning or managing similar businesses** – Lack of experience is one of the more common reasons lenders deny loan applications for new businesses. Demonstrating the

combined experience of the principals and management team shows the lender the business is in good hands.

• **Level of involvement** – Lenders want to know how closely involved the principals will be with the day-to-day running of the business. If the principals will be more hands-off, the lender will want to know more about the tenure and experience of the management team.

• **Business plan** – A well-written business plan anticipates many questions that lenders might have and provides financial projections demonstrating how the company will be able to manage debt repayment.

How to choose a lender?
Franchise loans are a specialized area within lending. Conventional lenders who specialize in the franchise space can provide creative solutions that may not be possible through SBA loans. For example, a conventional franchise lender can facilitate earnout arrangements in which the seller holds a portion of the debt and the buyer makes payments based on future performance of the business.

Remember, although basic requirements are similar, no two lenders are the same. An initial conversation with a lending professional to discuss the questions outlined above should lead to guidance about next steps to support your growth.

Alicia Chandler is president of Indianapolis-based First Franchise Capital Corporation ("FFCC"), a First Financial Bank company, which provides customized financial solutions for multi-unit quick serve restaurant franchisees of best-in-class concepts nationwide. The materials presented here are for informational purposes only. They are not offered as and do not constitute an offer for a loan, or legal or tax advice from FFCC.

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