

A Study of Franchise Loan Performance in the SBA Loan Guaranty Programs

By Darrell Johnson and John Reynolds

Many franchise businesses take advantage of the loan guaranty programs offered by the U.S. Small Business Administration. This report, conducted by FRANdata on behalf of the IFA Educational Foundation, examines franchise loan performance compared to non-franchise businesses during the period 2001 to 2006.

The IFA Educational Foundation engaged FRANdata Corp., an Alexandria, Va. based research firm, to conduct a study on franchise loan performance in the U.S. Small Business Administration loan guaranty programs. The purpose of this study was to undertake a comprehensive review of SBA loan information, and combined with FRANdata's internal database, to compare franchise loan performance to non-franchise loan performance.

FRANdata determined that there may be significant under-reporting of SBA lending which could affect any comparison of franchise loan performance to non-franchise loan performance.

The SBA offers many loan programs to assist small businesses. It's important to note that SBA is primarily a guarantor of loans made by private and other institutions.

Two of the loan programs used most by franchisors and franchisees are the 7(a) loan program, named after the section of the Small Business Act which authorizes the SBA to provide loans to American businesses, and the 504 loan program. All 7(a) loans are only available on a

guaranty basis. These loans are provided by lenders who structure their loans by SBA's requirements and who in turn receive a guaranty from the agency for a portion of the loan. The guaranty is against payment default. The 504 loan program is a long-term financing tool for economic development within a community. It provides businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings.

Many franchisors and franchisees take advantage of the 7(a) and 504 programs. For the period 2001 to 2006, the SBA provided loan guaranties for more than 406,000 loan disbursements totaling more than \$82.7 billion. Of this total, at least 25,744 disbursements were made to franchise businesses, just over 6 percent of all disbursements. Franchise businesses received loans of \$7.9 billion, or 9.6 percent of the total loans.

FRANdata used SBA franchise data for selected years (fiscal years 2001 to 2006). In addition, the company obtained non-franchise SBA data for comparative purposes. Finally, FRANdata appended additional data per franchise system to

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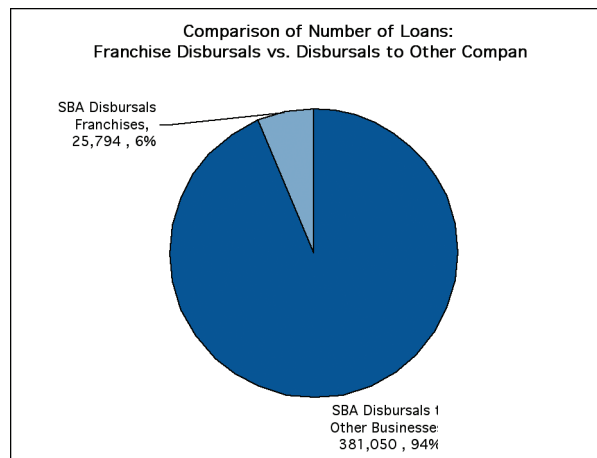


Chart 1

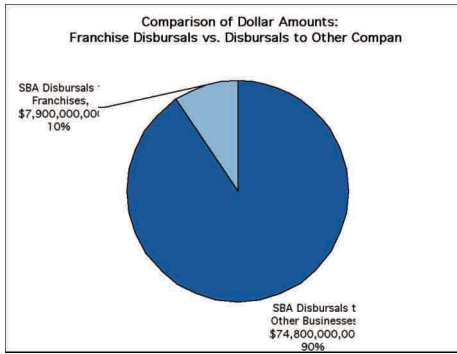


Chart 2

gain a more complete picture of results

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of any system. One important aspect of this study was to compare defaults and charge-off rates by franchise businesses to non-franchise businesses in comparable industries. (The charge-off rate equals dollars charged off divided by the total dollars disbursed. The failure rate equals the number of loans in liquidation plus the number of loans charged off divided by the total number of loans disbursed.)

Here are the key findings —

- For the period 2001 to 2006, data show an average charge-off rate of 5.9 percent for all SBA loans in comparable industries and a slightly higher average charge-off rate of 6.5 percent for loans identified as franchise related.
- Franchise charge-off percentages were higher than SBA total charge-off percentages in four years and were lower in two years.
- Out of a total of 520 North American Industry Classification System industries which had both franchise and non-franchise data, SBA franchise loans had a lower charge-off rate in 376 industries (72 percent), and had a higher charge-off rate in 114 industries (22 percent). These data suggest that loan performance varies greatly by type of business for both franchises and non-franchise businesses.
- Some of the industries which had higher charge-off rates for franchises than for total SBA charge-off rates

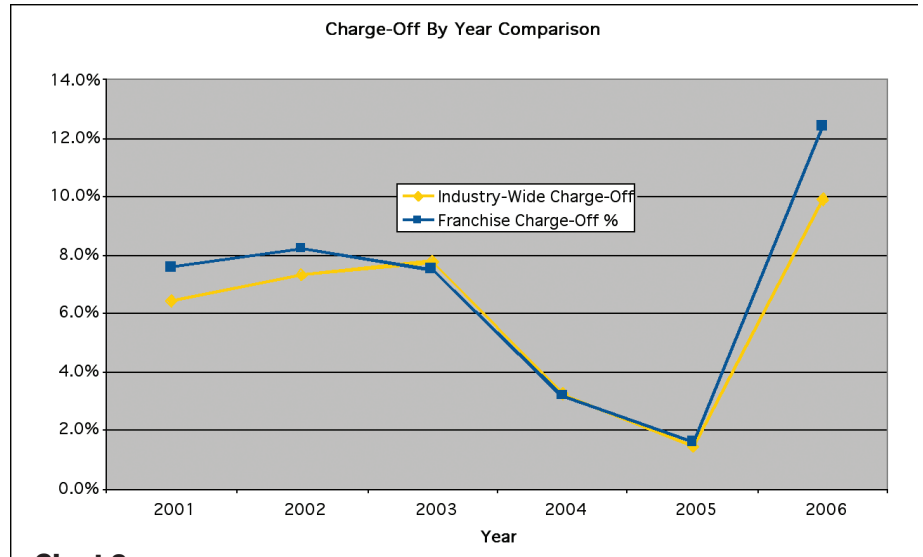


Chart 3

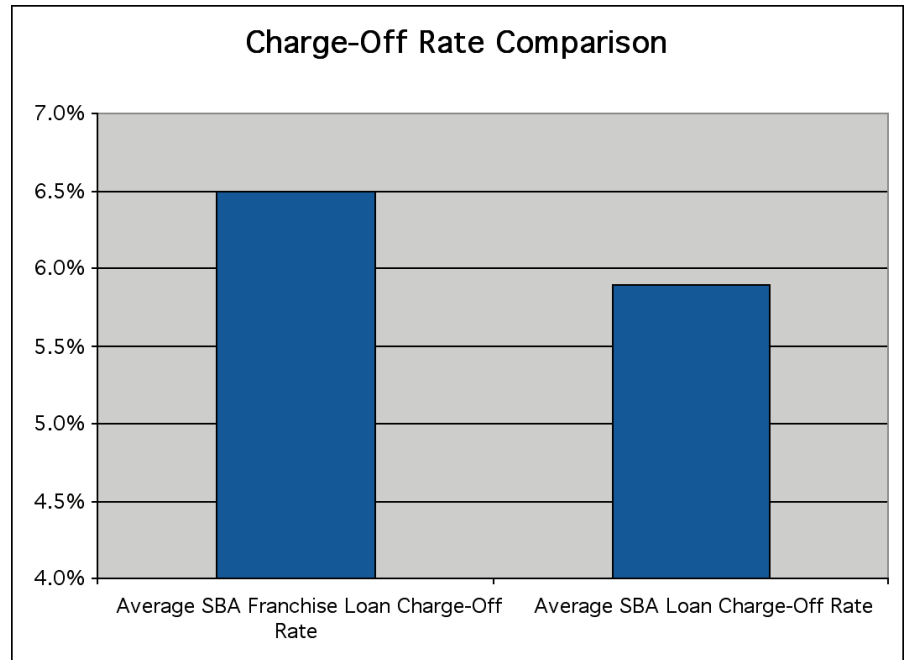


Chart 4

included gift/novelty, sporting goods, automobile related, and hobby/toy segments (Note: These industries were singled out only if they had a minimum of \$10 million in franchise disbursals). • After examining the charge-off rate of franchise loans to SBA total loans in the same industries, we have noted that although the data show a difference of 6.5 percent to 5.9 percent respectively, the difference is attributable to a relatively small number of industries. Further study indicates that these are industries with a larger scope of operation and investment size, which would explain

why a relatively small number of disbursals could affect the overall average. For example, by excluding 10 industries for which the most SBA franchise loan dollars were charged off, the franchise charge-off rate shrinks to 3.5 percent, compared to 3.2 percent for non-franchises.

- By comparing specific franchise system unit levels to SBA data for the same systems, FRANData determined that there may be significant under-reporting of SBA lending which could affect any comparison of franchise
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**Charge-Off Comparison By Industries:
(Out of a Total of 520 Comparable Industries)**

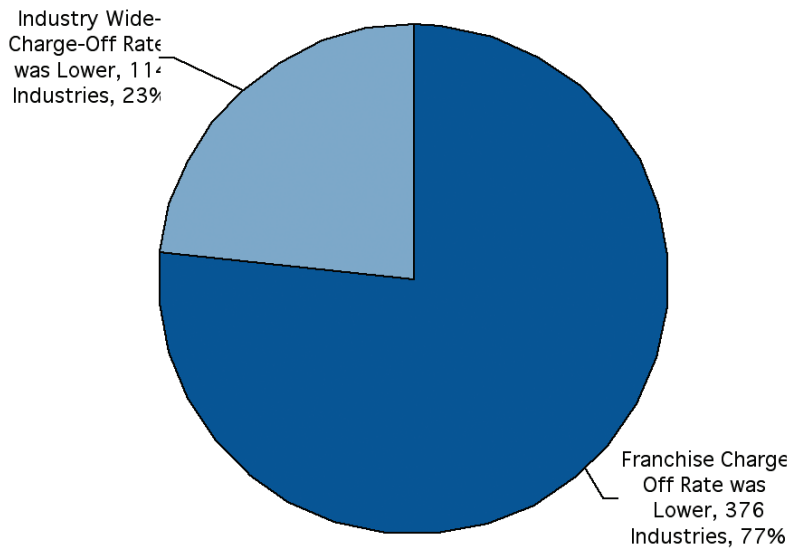


Chart 5

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loan performance to non-franchise loan performance. The SBA determines if a loan is a franchise loan when the business applying for an SBA loan or the lender identifies the borrower as a franchise in the loan documentation. Because some businesses and some lenders do not properly identify borrowers as franchises, the number of franchise

loans may be under-reported. (FRANdata is working with the SBA to address the under-reporting issue.)

METHODOLOGY

FRANdata sought out the largest sample size possible. The company used all available SBA franchise system lending activity over six years from 2001 to 2006, which totaled 1,710 franchise systems. FRANdata currently tracks information

on more than 3,000 active systems. In this study it used all loan data identified by the SBA as being associated with franchise systems by industry. This provided a more complete SBA franchise data set than previously available. In addition, we were able to expand the date range to include disbursements after 2005 for comparative purposes.

Based on the expanded data, we were able to compare, by industry, franchise loan loss compared to SBA total loan loss. In addition, in order to better pinpoint reasons for distinctions in the data sets, we examined year-by-year differences between franchise loan losses and SBA total loan losses. The report also examined those industries in which the franchise loan loss compared to the total SBA loan loss was the greatest. ■

For additional information, contact IFA Educational Foundation Pres. John Reynolds at 202-662-0764 or jreynolds@franchise.org or FRANdata Pres. Darrell Johnson at 703-740-4700 or djohnson@frandata.com.

Expanded Report Sample

DisbFY	Naics	NAICS_Description	# Loans	DisbGross
2001	722110	Full-Service Restaurants	2,230	\$473,379,97
2001	722211	Limited-Service Restaurants	972	\$196,451,70
2001	811111	General Automotive Repair	742	\$139,904,33
2001	721110	Hotels (except Casino Hotels) and Motels	707	\$553,968,80
2001	447110	Gasoline Stations with Convenience Stores	653	\$340,353,87
2001	624410	Child Day Care Services	610	\$166,198,66
2001	621210	Offices of Dentists	529	\$152,000,99
2001	812112	Beauty Salons	508	\$49,636,13
2001	621310	Offices of Chiropractors	497	\$61,011,50
2001	621111	Offices of Physicians (except Mental Health Specialists)	412	\$96,024,20
2001	812320	Drycleaning and Laundry Services (except Coin-Operated)	407	\$109,670,24
2001	561730	Landscaping Services	399	\$53,757,45
2001	445310	Beer, Wine, and Liquor Stores	386	\$86,139,48
2001	445110	Supermarkets and Other Grocery (except Convenience) Stores	377	\$106,464,26
2001	235110	Plumbing, Heating, and Air Conditioning Contractors	366	\$71,752,08
2001	811121	Automotive Body, Paint, and Interior Repair and Maintenance	363	\$93,465,26
2001	445120	Convenience Stores	339	\$80,750,73
2001	713940	Fitness and Recreational Sports Centers	334	\$77,414,82
2001	235990	All Other Special Trade Contractors	334	\$69,011,77