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Inspection and Evaluation Division

SBA's Experience With Defaulted Franchise Loans

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OFFICE OF INSPECTOR GENERAL

September 16, 2002

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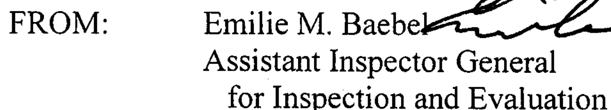
Assistant Inspector General
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SUBJECT: Inspection on ***SBA's Experience with Defaulted Franchise Loans***

We are pleased to submit our report on ***SBA's Experience with Defaulted Franchise Loans***. The Office of Inspector General examined the franchise loan portfolio's potential exposure, purchase rates, and specific lenders' performance.

Despite the popular view—publicly supported by SBA—that franchisees are much more successful than non-franchisees, SBA's experience with defaulted loans and some outside studies do not support this. The Office of Financial Assistance (OFA), in conjunction with the Office of Entrepreneurial Development, should ensure that the Agency's printed and electronic information on franchises no longer states this view.

SBA's loan databases inaccurately identify some loans to non-franchisees as franchise loans, thus hampering the monitoring of potential franchisor control over franchisees. Despite this, the databases may still be useful because the control issue could apply to *any* situation in which a large entity allows the use of its brand name. OFA should define what constitutes *either* a franchise loan *or* loans to small businesses that use a larger firm's brand name, communicate the definition(s), and recategorize its loan data.

Finally, of the large defaulted loans examined in depth, most exhibited early warning signs. However, any deficiencies in credit analysis cannot be attributed solely to lender bias in favor of loans involving a franchise system or its functional equivalent.

We appreciate the excellent cooperation received from your staff and the field offices.

Attachment

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TABLE OF CONTENTS

		Page
EXECUTIVE SUMMARY		iii
BACKGROUND		1
ISSUES		2
METHODOLOGY AND SCOPE		2
FINDINGS		3
RESULTS OF CASE STUDIES		6
APPENDICES		
A	Table 1: Guaranty Purchases – by Number of Loans	8
	Table 2: Franchise Loans Made by SBLCs v. All Other Lenders	9
	Table 3: Non-franchise Loans Made by SBLCs v. All Other Lenders	10
	Table 4: Guaranty Purchases – by Dollar Amount of Gross Originations	11
B	Table 5: Characteristics of the Lenders Used for Case Studies -- For SBA-Identified Franchise Loans	12
	Table 6: Characteristics of the Lenders Used for Case Studies -- For Non-franchise Loans	12
	Table 7: Sample of Defaulted Franchise Loans in Order of Initial Purchase Size	13
C	Office of Financial Assistance Comments	21
D	Contributors to this Report	23

ABBREVIATIONS

FTC	Federal Trade Commission
FY	Fiscal Year
OFA	Office of Financial Assistance
OIG	Office of Inspector General
PLP	Preferred Lenders Program
SBA	Small Business Administration
SBIC	Small Business Investment Company
SBLC	Small Business Lending Company
SOP	Standard Operating Procedure
UFOC	Uniform Franchise Offering Circular

EXECUTIVE SUMMARY

Background. Franchising accounts for over one-third of all retail sales. Although some have maintained that a franchise provides a franchisee a greater chance of success than would starting a completely independent business, not all studies support that conclusion.

The U.S. Small Business Administration (SBA) publicly supports the notion that franchise-based businesses are less failure-prone than independent businesses. If franchise-based businesses are indeed "safer," then Section 7(a) and Section 504 loans to franchisees—**hereafter called franchise loans**—should have significantly lower purchase rates for defaults than those of non-franchise loans.

Despite the notion of franchisee success, the Office of Inspector General (OIG) has identified potential origination problems in some purchased loans identified by SBA as franchise loans. Moreover, an SBA-funded study found that a *franchisor* must reach a minimum efficient scale to lower its costs. Thus, franchisors have an incentive to encourage as many prospective entrepreneurs as possible to become franchisees, including underqualified ones who may obtain—and default on—SBA guaranteed loans.

Issues. This inspection examined (1) the franchise loan portfolio's potential exposure, (2) whether Section 7(a) and Section 504 franchise loans have significantly lower purchase rates than non-franchise loans, (3) whether certain lenders have significant franchise loan purchases relative to the amounts they loan, and (4) whether there were actions such lenders could have taken during loan origination to prevent some purchases.

Methodology and Scope. The inspection team conducted database research on the 423,393 Section 7(a) and Section 504 loans made from Fiscal Year (FY) 1991 through FY 2000. Loans were also divided into recent originations and "seasoned" loans.

The team identified the two lenders that proportionately had the highest franchise (and non-franchise) loan purchases relative to disbursements. A judgmental sample of these lenders' largest purchased franchise loans was used to gain an in-depth *qualitative* look at potential weaknesses. The team analyzed district office and lender loan files to determine what factors lenders considered at origination and interviewed SBA officials.

Findings. Despite the popular view that franchisees are much more successful than non-franchisees, SBA's experience with defaulted loans does not support this. For example, the loans *identified by SBA as franchise loans* that originated from FY 1991 through FY 2000 actually performed slightly worse than non-franchise loans. In terms of dollars, *loans identified by SBA as franchise loans* performed only slightly better than non-franchise loans. Moreover, franchise loans made by Small Business Lending Companies (SBLCs) had significantly higher purchase rates than franchise loans made by other lenders. The two lenders mentioned previously are SBLCs.

There is also potentially more exposure per loan on franchise loans. In FY 2000, the average (mean) franchise loan origination size was 40% larger than that of the average

non-franchise loan. In FY 1991, the comparable figure was only 1%.

Based on literature presenting conflicting views and the above findings, franchisees are not necessarily significantly more successful than independent businesses. As a trusted information source, SBA has a responsibility to avoid inadvertently raising false expectations among prospective entrepreneurs and creating possible lender credit bias.

> **Recommendation 1 of 2:** ***To provide prospective entrepreneurs and lenders with accurate information, the Office of Financial Assistance (OFA), in conjunction with the Office of Entrepreneurial Development, should ensure that the Agency's printed and electronic information on franchises no longer states that franchise-based businesses are significantly more successful than independent businesses.***

SBA data on franchise loans is not clear. Agency officials have expressed concern as to what extent franchisors may control franchisees. Monitoring such a situation requires identifying the loans subject to such control issues. SBA's loan databases inaccurately identify some loans to non-franchisees as franchise loans. For example, loans associated with one major hotel chain are not franchise loans but are technically loans to members of a not-for-profit corporation. Such inconsistency results from the lack of a clear definition of what a franchise is, processing center dependence on the lender's decision as to whether a loan is a franchise loan, and the apparent similarities between franchisees and businesses operating under various types of licensing agreements.

The paradox is that, although SBA's loan databases are not technically accurate, they may be functionally useful. The concern over who controls small businesses could apply to *any* situation in which a large entity allows a small business to use its brand name.

To remedy its database situation, SBA has various options. Whatever method is chosen, the Agency needs definitional consistency that field offices and lenders can use.

> **Recommendation 2 of 2**: ***To enhance the accuracy and usefulness of its data, the Office of Financial Assistance should (1) clearly define what constitutes either a franchise loan or, in more general terms, loans to small businesses that use a larger firm's brand name, (2) communicate the definition(s) through an information notice to SBA offices and lenders, and (3) use the definition(s) to recategorize the data in the loan databases.***

Results of Case Studies. Most of the 12 defaulted loans examined in depth exhibited warning signs—such as a weak starting financial position, limited management experience or presence, and bad business locations—at the time of origination that should have raised concerns. Any deficiencies in credit analysis cannot be attributed solely to lender bias in favor of loans involving a franchise system or its functional equivalent.

SBA Comments. The Associate Administrator for Financial Assistance agreed with the report's findings and recommendations.

BACKGROUND

Franchising represents a major part of the U.S. economy, accounting for over one-third of all retail sales.[1] For years, franchisors, franchise lobbying groups, and the press have maintained that a franchise provides a franchisee a greater chance of success than would starting a completely independent business.[2] Some studies support that conclusion, such as a Frandata Inc. study showing a yearly failure rate of only 4.4% for the establishments of the 584 leading U.S. franchise systems. [3] In contrast, a study funded by the U.S. Small Business Administration (SBA) found franchisee failure rates to be greater than those of independent businesses.[4]

Further complicating the picture is the finding of another SBA-funded study that "approximately three-quarters of new franchise *systems* [emphasis added] cease to franchise within 12 years of beginning to franchise."[5] In other words, the branding, marketing, and training support that some franchisees rely on can disappear after a few years.

Despite these differences among studies, SBA publicly supports the widespread notion that franchise-based businesses are less failure-prone than independent businesses. SBA's web site states, "Although *the success rate for franchise-owned businesses is significantly better than the success rate for many independent businesses*, there is no formula to guarantee success."[6] (emphasis added) Lenders also appear to believe in the presumed safety of franchises. According to SBA field officials, lenders look more favorably on a borrower having a franchisor behind it. If franchise-based businesses are indeed "safer," then Section 7(a) and Section 504 loans to franchisees—**hereafter called franchise loans**—should perform better than non-franchise loans in terms of SBA having to purchase defaulted guaranteed loans. In other words, franchise loans should have significantly lower purchase rates than those of non-franchise loans.

Despite the notion of franchisee success, OIG audits and investigations have identified potential origination problems in some purchased loans identified by SBA as franchise loans. Moreover, a previously mentioned SBA-funded study found that a franchisor must

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[1] Shane, Scott, "Why New Franchisers Succeed," Small Business Research Summary, No. 178, August 1997, (U.S. Small Business Administration, Office of Advocacy), p. 1.

[2] A franchise is an agreement in which one company (the franchisor) grants to an individual or firm (the franchisee) the right to sell the franchisor's product or service under the franchisor's name in a specific location for a specified period. In return, the franchisee pays fees, royalties, and a contribution for advertising.

[3] Lafontaine, Francine, "Myths and Strengths of Franchising," Mastering Strategy, p. 3, http://www.bus.umich.edu/ft/lafontaine.html.

[4] Bates, Timothy, "Survival Patterns Among Franchisee and Nonfranchise Firms Started in 1986 and 1987," February 1996, (Wayne State University), p. 3.

[5] Shane, p. 1.

[6] U.S. Small Business Administration, "Is Franchising For Me? What Is Franchising?" http://www.sba.gov/gopher/Business-Development/Business-Initiatives-Education-Training/Franchise-Plan/fran2.txt.

reach a minimum efficient scale to lower its (as opposed to a franchisee's) costs.[7] Given this necessity plus the need to collect franchisee-paid fees, franchisors have an incentive to encourage as many prospective entrepreneurs as possible to become franchisees and find financing. Moreover, there is always a risk of some franchisors' overly optimistic financial projections enabling underqualified prospective franchisees to obtain—and default on—SBA guaranteed loans.

ISSUES

This inspection examined issues related to (1) the portfolio of defaulted guaranteed loans identified by SBA as franchise loans and (2) the quality of credit analysis on a judgmental sample of such loans. Specifically, the inspection sought to explore the following issues:

- The potential exposure to SBA in terms of the size of the franchise loan portfolio and the average size of individual franchise loans;
- Whether Section 7(a) and Section 504 franchise loans perform better than non-franchise loans in terms of having significantly lower purchase rates;
- Whether certain lenders have significant franchise loan purchases relative to the amounts they loan; and
- Whether there were actions that such lenders could have taken during loan origination that might have prevented some of the loan purchases.

METHODOLOGY AND SCOPE

The inspection team conducted database research to analyze characteristics of the loans that SBA identifies as franchise loans and to determine if such loans have a significantly higher purchase rate than non-franchise loans for the 423,393 Section 7(a) and Section 504 loans made from Fiscal Year (FY) 1991 through FY 2000 (excluding Small Business Investment Company loans and microloans). Of these, franchisees received 27,516 loans (6.5 percent of the universe). To further assess risk, franchise systems having more than $1 million in loan purchases and their lenders were identified.

Loans were further divided into recent originations (FY 1998 through FY 2000) and "seasoned" loans that originated during FY 1991 through 1997. Generally speaking, if a loan defaults during its first three to five years, the likely cause is a problem in origination. Conversely, older defaulted loans could have been subject to any number of non-origination-related causes, e.g., a loss of sales.

[7] Shane, p. 1.

Further research focused on which lenders' franchise loans were most likely to default. This required finding which lenders proportionately had the highest franchise loan purchases relative to disbursements over the 10-year period. To accomplish this, we divided each lender's dollar amount of franchise loan purchases by all lenders' total dollar franchise loan purchases to arrive at a percentage, repeated the process for disbursements, and compared the resulting two percentages. Thus, a lender with 15% of the total franchise loan purchases but only 5% of the franchise loan disbursements could be considered a potentially risky lender. For comparison purposes, we performed the same research for non-franchise loans.

In order to review specific conditions that had led to purchases for franchise loans originated during both the periods FY 1991-2000 and the more recent subset of FY 1998 through FY 2000, we identified the two lenders with the highest franchise (and non-franchise) loan purchases relative to disbursements. The team concentrated on the lenders instead of the franchise systems because two lenders accounted for 30.05% of the total dollar amount of franchise loan purchases for the 10-year period. See Appendix B, Tables 5, 6, and 7 for details.

The team used the case study approach to select a judgmental sample of the largest—and thus potentially most costly—purchased franchise loans from the lenders previously identified. Although results cannot be projected to the universe of purchased franchise loans, the case study approach offers an in-depth and targeted *qualitative* look at processes and potential weaknesses, especially if the same types of problems occur in different locations.

The team obtained and analyzed loan files from district offices and lenders to determine what factors the lenders considered at the time of origination, which problems were known at that time, and whether any are unique to franchise loans. The loans had originated from FY 1997 through FY 1999, with one turning out to be associated with an OIG investigative case. Interviews with SBA officials were also performed.

All work on this inspection was conducted in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

FINDINGS

Despite the popular view that franchisees are *much more successful* than non-franchisees, SBA's experience with defaulted loans does not support this.

- Loans *identified by SBA as franchise loans* that had originated from FY 1991 through FY 2000 actually performed slightly worse than non-franchise loans originating during the same period, with 7.01% of franchise loans being purchased as opposed to 6.32% of non-franchise loans. See Appendix A, Table 1.

- In terms of dollars for the same period, *loans identified by SBA as franchise loans* performed only slightly better than non-franchise loans. The percentage of the original gross amount of franchise loans that was purchased was 3.65% compared to 4.13% for non-franchise loans. The percentage of total disbursements that was subsequently purchased was 4.51% for franchise loans and 4.92% for non-franchise loans. See Appendix A, Tables 2 and 3.

- For "seasoned" loans that originated from FY 1991 through FY 1997, *loans SBA identified as franchise loans* performed slightly worse than non-franchise loans originated during the same period, with 9.75% having been purchased as opposed to 8.71% of non-franchise loans. See Appendix A, Table 1.

- For the same "seasoned" loans in terms of the origination dollar value, *loans SBA identified as franchise loans* performed only slightly better than non-franchise loans, with 5.27% having been purchased as opposed to 5.82% for non-franchise loans. See Appendix A, Table 4.

- Franchise loans made by Small Business Lending Companies (SBLCs) from FY 1991 through FY 2000 had significantly higher purchase rates than franchise loans made by other lenders for the same period, both in terms of the percentage of their original loan amounts (5.49% vs. 2.86%) and the percentage of their disbursed loan amounts (6.68% vs. 3.56%). See Appendix A, Table 2. The two lenders identified as having the highest franchise and non-franchise loan purchases relative to disbursements are SBLCs.

In addition to the performance previously stated, loans identified by SBA as franchise loans had other notable characteristics.

- There is potentially more exposure per loan on franchise loans than on non-franchise loans. In FY 2000, the average (mean) franchise loan origination size was 40% larger than that of the average non-franchise loan, i.e., $347,209 vs. $248,434. According to an SBA official, the size difference can be attributed to franchise loans to hotels and for restaurant structures tending to be large dollar amounts. In contrast, in FY 1991 the average franchise loan was only 1% larger, $237,754 vs. $235,775.

- Franchise loans represent a gradually increasing percentage of loan originations, having increased from approximately six percent of gross dollar originations in FY 1991 to nearly ten percent in FY 2000.

- Although purchased franchise loans often mean major monetary losses, there are exceptions. For example, despite the fact that several of the loans selected involved bankruptcy and/or minimal recovery, two of the loans were recovered in full.

Based on the literature that presents conflicting views on franchisees' overall success and the above findings, franchisees are not necessarily significantly more successful than independent businesses. Moreover, because a franchise system is supposed to provide a

proven formula for success, prospective entrepreneurs can easily overestimate the benefits of franchising, while underestimating the risks, such as being unable to sell the business without franchisor approval.

As a trusted source of public information, SBA has a responsibility to avoid inadvertently raising false expectations among prospective entrepreneurs and creating possible bias among lenders in their credit analyses. This is especially important as SBA increasingly uses the Internet to inform and instruct an ever-wider small business audience.

Recommendation 1 of 2: To provide prospective entrepreneurs and lenders with accurate information, the Office of Financial Assistance (OFA), in conjunction with the Office of Entrepreneurial Development, should ensure that the Agency's printed and electronic information on franchises no longer states that franchise-based businesses are significantly more successful than independent businesses.

SBA data on franchise loans is not clear.

Loan data should enable Agency managers to monitor their programs, accurately report on program performance, and readily address any concerns. SBA officials' major concern about the loans the Agency identifies as franchise loans is to what extent franchisors might use franchise agreements to control franchisees. According to Standard Operating Procedure (SOP) 50-10(4)(D), a franchisee should have the right to profit from its efforts and to risk loss. Monitoring such a situation first requires identifying which loans are subject to such control issues.

SBA's loan databases inaccurately identify some loans to non-franchisees as franchise loans. For example, loans associated with one major hotel chain are not loans to franchisees but are technically loans to members of a not-for-profit corporation. Nonetheless, because of the chain's famous brand name and its franchise-like appearance, a lender had mistaken it for a franchise system when originating the loan. Moreover, the chain appears as a franchise system throughout SBA's loan database. Of the 12 loans we examined in detail, three were misclassified as franchise loans. Two of the loans were the lender's mistake, and one appears to have been SBA's mistake. To deal effectively with the control issues mentioned previously, SBA needs to clarify how it wants loans categorized, i.e., by actual franchise loans versus non-franchise loans or by some other arrangement.

There are several reasons for the inconsistency in categorizing franchise loans. The most basic is that SBA has no clear definition of what a franchise is. According to one Agency official, there is also no legal definition dependent on a franchisor using a Uniform Franchise Offering Circular (UFOC) because the UFOC is required only in approximately a dozen states. Even the Federal Trade Commission's (FTC) definition periodically changes.

Thus, although SBA loan processing centers and field offices are responsible for inputting loans into the databases as franchise or non-franchise loans, the criteria for defining franchise loans are not firm. For Preferred Lenders Program (PLP) loans, it is the lender who states whether a loan is being made to a franchisee when the lender provides information to the PLP processing center. Complicating matters further are the apparent similarities between franchisees and businesses operating under various types of licensing agreements.

The problem of categorizing loans in which a small business uses a larger entity's brand name is not new. Approximately twenty years ago, SBA made a policy decision deeming car dealerships eligible for SBA loans but not tracking those loans as franchise loans.

The paradox of the above is that, although SBA's loan databases are not technically accurate, they may be functionally useful. The concern over who controls small businesses could apply to any situation in which a large entity allows a small business to use its brand name, whether through a franchise agreement, licensing agreement, distributorship, or some functional equivalent. Although SBA officials believe there is a slim chance of control issues when, say, a licensing agreement is involved, there are no guarantees this will be the case in the future.

To remedy its database situation, SBA has various options. At one extreme, the Agency could narrowly define each type of loan in its database as a franchise loan, a licensing agreement loan, or some other specific type. This would likely require major adjustments to the databases. An easier option would be for SBA simply to broadly redefine what it now calls franchise loans in terms of a broader category of loans to small businesses that use corporate branding. The Agency would likely need to make only a few adjustments to its databases. SBA could also redefine loans using a combination of methods. Whatever method is chosen, the Agency needs definitional consistency that field offices and lenders can use.

Recommendation 2 of 2: To enhance the accuracy and usefulness of its data, the Office of Financial Assistance should (1) clearly define what constitutes *either* a franchise loan *or*, in more general terms, loans to small businesses that use a larger firm's brand name, (2) communicate the definition(s) through an information notice to SBA offices and lenders, and (3) use the definition(s) to recategorize the data in the loan databases.

RESULTS OF CASE STUDIES

Most of the 12 defaulted loans examined in depth exhibited warning signs at the time of origination that should have raised concerns to the two lenders about the entrepreneur or the business. See Appendix B, Table 7. The warning signs generally fell into three categories:

- A weak starting financial position, as evidenced by borrower discretionary income or assets insufficient to cover unexpected expenses, inadequate cash injection, or irregularities in financial reporting, such as projections that omitted wages to be paid.

- Limited management experience or absentee management.

- Bad business location relative to the competition or to customer access.

The lenders appeared to have relied heavily on *franchisor* financial projections in three of 12 cases. Two of these cases involved startup businesses. Moreover, documents associated with another case showed that the lender was eager to do business with the franchise system. It is unclear to what extent these situations may have biased lenders in their credit analysis.

The overall lack of reliance on franchisor projections likely resulted from the fact that only five of the 12 loans went to startup firms. When a borrower was buying an existing business, historical data was generally used.

In short, any deficiencies in credit analysis cannot be attributed solely to lender bias in favor of loans involving a franchise system or its functional equivalent. There were simply other warning signs—regardless of franchise status—that should have caused the lenders to hesitate before making the loans.

Appendix A, Table 1

Guaranty Purchases - by Number of Loans

Non-Franchise v. Franchise Data

FY 1991 – 2000 7(a) & 504 Loan Data

	Non-Franchise			Franchise			Number of Loans			
Fiscal Year	**# Loans with Purchases**	**As a % of the Total # of Loans to Non-franchises Only**	**As a % of the Total Number of Loans with Purchases**	**# Loans with Purchases**	**As a % of the Total # of Loans to Franchises Only**	**As a % of the Total Number of Loans with Purchases**	**Number of Non-Franchise Loans**	**Number of Franchise Loans**	**Total # of Loans**	**Total Number of Loans with Purchases**
1991	2,562	13.20%	93.85%	168	14.05%	6.15%	19,413	1,196	20,609	2,730
1992	2,452	9.83%	95.22%	123	8.52%	4.78%	24,939	1,443	26,382	2,575
1993	2,212	8.02%	93.69%	149	8.38%	6.31%	27,586	1,777	29,363	2,361
1994	3,345	8.81%	93.57%	230	9.71%	6.43%	37,985	2,368	40,353	3,575
1995	5,599	9.90%	92.88%	429	12.02%	7.12%	56,530	3,570	60,100	6,028
1996	3,886	7.93%	91.50%	361	9.72%	8.50%	49,022	3,713	52,735	4,247
1997	2,683	5.87%	90.73%	274	7.37%	9.27%	45,703	3,716	49,419	2,957
Total or Avg. (91-97): *	**22,739**	**8.71%**	**92.91%**	**1,734**	**9.75%**	**7.09%**	**261,178**	**17,783**	**278,961**	**24,473**
1998	1,648	3.73%	92.32%	137	4.53%	7.68%	44,178	3,022	47,200	1,785
1999	596	1.31%	91.83%	53	1.62%	8.17%	45,655	3,264	48,919	649
2000	51	0.11%	92.73%	4	0.12%	7.27%	44,866	3,447	48,313	55
Total or Avg. (91-00): *	**25,034**	**6.32%**	**92.85%**	**1,928**	**7.01%**	**7.15%**	**395,877**	**27,516**	**423,393**	**26,962**

* Totals refer to numbers. Average figures refer to percentages.
Note: Section 7(a) data does not include Small Business Investment Company (SBIC) loans and microloans.

Appendix A, Table 2

Franchise Loans Made by SBLCs v. All Other Lenders

Data Set: FY 1991 - FY 2000 Section 7(a) & 504 Loans by All Lenders to Franchisees Only

(Data excludes SBIC loans & Microloans)

	Disbursed Amount Gross	Original Amount Gross	Guarantee Purchase Gross Principal	% Purch / OAG	% Purch / DAG		# Loans Approved	# Loans with Purch	% Loans with Purch
SBLC TOTAL	$1,964,834,711	$2,388,669,876	$131,201,840	5.49%	6.68%		5,487	535	9.75%
All Other Lenders	$4,486,011,681	$5,582,048,100	$159,536,420	2.86%	3.56%		22,029	1,393	6.32%
Grand Total (SBLC + AOL)	$6,450,846,392	$7,970,717,976	$290,738,260	3.65%	4.51%		27,516	1,928	7.01%

Appendix A, Table 3

Non-franchise Loans Made by SBLCs v. All Other Lenders

Data Set: FY 1991 - 2000 Section 7(a) & 504 Loans by All Lenders to Non-Franchisees Only

(Data excludes SBIC loans & Microloans)

	Disbursed Amount Gross	Original Amount Gross	Guarantee Purchase Gross Principal	% Purch / OAG	% Purch / DAG		# Loans Ap-proved	# Loans with Purch	% Loans with Purch
SBLC TOTAL	$10,462,809,518	$12,424,415,690	$756,892,971	6.09%	7.23%		28,911	2,384	8.25%
All Other Lenders	$62,451,580,741	$74,396,698,135	$2,830,362,681	3.80%	4.53%		366,966	22,650	6.17%
Grand Total (SBLC + AOL)	$72,914,390,259	$86,821,113,825	$3,587,255,652	4.13%	4.92%		395,877	25,034	6.32%

Appendix A, Table 4

Guaranty Purchases – by Dollar Amount of Gross Originations

Non-Franchise v. Franchise Data

FY 1991 - 2000 Section 7(a) & 504 Loan Data

	Non-Franchise			Franchise			Loans by Gross Originations			
Fiscal Year	Guarantee Purchase Gross Principal	GP as a % of gross loan orig. to non-franch. only	GP as a % of total $$ purch.	Guarantee Purchase Gross Principal	GP as a % of gross loan orig. to franch. only	GP as a % of total $$ purch.	Non-Franchises	Franchises	Total	Total - Guarantee Purchase Gross Principal
1991	$542,628,983	11.86%	94.60%	$30,948,571	10.88%	5.40%	$4,577,108,517	$284,354,206	$4,861,462,723	$573,577,554
1992	$492,856,937	7.97%	95.90%	$21,059,926	5.13%	4.10%	$6,185,202,462	$410,679,627	$6,595,882,089	$513,916,863
1993	$412,058,373	5.84%	92.96%	$31,206,382	5.88%	7.04%	$7,059,983,615	$530,790,263	$7,590,773,878	$443,264,755
1994	$451,624,940	5.10%	91.77%	$40,510,910	5.96%	8.23%	$8,847,395,991	$679,545,166	$9,526,941,157	$492,135,850
1995	$497,354,428	5.48%	92.67%	$39,311,142	5.10%	7.33%	$9,080,493,526	$770,644,363	$9,851,137,889	$536,665,570
1996	$427,754,933	4.64%	90.02%	$47,438,374	4.88%	9.98%	$9,209,064,339	$971,440,819	$10,180,505,158	$475,193,307
1997	$363,692,454	3.71%	90.16%	$39,706,166	3.62%	9.84%	$9,806,873,291	$1,096,936,504	$10,903,809,795	$403,398,620
Total or Avg. (91-97) *	**$3,187,971,048**	**5.82%**	**92.72%**	**$250,181,471**	**5.27%**	**7.28%**	**$54,766,121,741**	**$4,744,390,948**	**$59,510,512,689**	**$3,438,152,519**
1998	$271,933,340	2.76%	91.40%	$25,572,177	2.72%	8.60%	$9,856,867,199	$938,614,415	$10,795,481,614	$297,505,517
1999	$113,989,418	1.03%	89.70%	$13,082,334	1.20%	10.30%	$11,051,886,158	$1,090,884,903	$12,142,771,061	$127,071,752
2000	$13,361,846	0.12%	87.54%	$1,902,278	0.16%	12.46%	$11,146,238,727	$1,196,827,710	$12,343,066,437	$15,264,124
Total or Avg. (91-00) *	**$3,587,255,652**	**4.13%**	**92.50%**	**$290,738,260**	**3.65%**	**7.50%**	**$86,821,113,825**	**$7,970,717,976**	**$94,791,831,801**	**$3,877,993,912**

* Totals refer to numbers. Average figures refer to percentages.
Note: Section 7(a) data does not include SBIC loans and microloans.

Characteristics of the Lenders Used for Case Studies

As noted earlier, the team identified the lenders with the highest franchise loan purchases relative to disbursements over ten-year and recent three-year periods. Using previously described methodology, a lender with, say, 15% of the total purchases but only 5% of total disbursements could be considered a potentially risky lender. The tables below show that both lenders ranked as potentially risky lenders. Moreover, both are SBLCs.

For SBA-Identified Franchise Loans

Table 5

Lender	Lender's Percentage of All Lenders' Dollar Purchases in Terms of Gross Principal	Lender's Percentage of All Lenders' Gross Disbursements for Loans
Lender X (FY 1991- FY 2000)	12.03%	7.12%
Lender X (FY 1998 – FY 2000)	20.71%	9.74%
Lender Y (FY 1991 – FY 2000)	18.02%	8.16%
Lender Y (FY 1998 – FY 2000)	15.43%	5.49%

For Non-franchise Loans

Table 6

Lender	Lender's Percentage of All Lenders' Dollar Purchases in Terms of Gross Principal	Lender's Percentage of All Lenders' Gross Disbursements for Loans
Lender X (FY 1991- FY 2000)	3.67%	1.95%
Lender X (FY 1998 – FY 2000)	9.75%	3.12%
Lender Y (FY 1991 – FY 2000)	8.54%	4.61%
Lender Y (FY 1998 – FY 2000)	12.28%	3.37%

Appendix B, Table 7

SAMPLE OF DEFAULTED FRANCHISE LOANS IN ORDER OF INITIAL PURCHASE SIZE

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Restaurant. (Startup, with most loan proceeds for new construction and equipment.) WEST COAST	Y	$1,988,963 37.5%	Lender used proforma balance sheet for a similar restaurant as the starting balance sheet. Projections were based on franchisor's Uniform Franchise Offering Circular (UFOC), which has an earnings section based on the actual experience of the franchisor and franchisee stores that have operated at least six months. Thus, a combination of localized and franchisor data was used to evaluate this startup location.	Lack of name recognition; competitor different from the one existing at the time of loan origination moved into same shopping center; new construction hindered customer access; onsite management problems.	1. Lien position discrepancies involving large prior liens. 2. Credit analysis discounted competition. A key competitor was 200 yards from the site where the borrower's restaurant was to be built. Competition was thought to have an inferior location. 3. Lender originally declined other loans associated with the borrower because of questionable repayment ability and inadequate debt to worth ratio.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Hotel. SOUTH	X	$1,558,556 46.6%	Lender report showed the purpose of the loan was to purchase a hotel and convert it to a famous brand name hotel. It showed "established franchise concept" as one of the deal's 13 strengths. However, hotel chain is not a franchise system.	Increased competition and the delay in opening a nearby expo center. Appraiser believed that hotel's inability to gain the use of the famous brand name hurt its profit potential.	No evidence that business received or was about to receive the famous brand name designation.
Hotel. NORTHEAST	Y	$1,302,056 57.208%	No indication that lender relied too much on the franchisor in its initial credit analysis. Lender memo indicates that the projections were those of the borrower.	SBA contends that lender failed to analyze the business risks prior to approval.	1. Hotel was in a bad location, with limited visibility from the highway. 2. Borrower had difficulty with people. Against the lender's wishes, the borrower had started construction before the lender could record the loan documents. Borrower disagreements with a contractor resulted in mechanic's liens. 3. An internal lender memo cast doubt on borrower's character.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Photocopy and document processing business. NORTHEAST	Y	$1,248,548 60%	This was a sale of an ongoing business. Lender used historical data of the business, not the franchisor. Loan is over $1 million without 50% allocated for commercial real estate purchase. Mitigated by borrower's previous ownership of this franchise concept.	Borrower claimed amount of business transacted annually was not what the previous owner stated when selling the business. Lender official stated that borrower contends that the seller overvalued the business.	1. Lender noted concern over borrower's minority ownership in the real estate holding co. that would own this property. 2. A consulting firm associated with the borrower received a $23,000 brokerage commission, although it is not clear if this was an affiliate of the borrower. 3. Borrower was not responsive in submitting required documents promptly. 4. Borrower had little discretionary income after expenses. 5. Eighty percent of the cash injection for the purchase of commercial real estate in a separate transaction was to have come from another lender. This would have hurt borrower's repayment ability on this loan.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Gas station and convenience store. NORTHWEST	Y	$1,205,116 59.571%	Per lender's credit memorandum, borrower developed first year revenue and expense forecast based on business' historical operating results and his own research. No franchisor projections appear to have been used.	Per the liquidation plan, lender was unaware of the cause of business breakdown, stating only that an attorney had said the business did not receive enough volume.	High loan to value ratio, which lender felt was mitigated by borrower's experience, the franchise name and business location, and the business' previous success.
Gas station and convenience store. (a startup) MIDWEST	X	$1,060,000 70.75%	SBA branch counsel believed that this was not a franchise arrangement. A major corporation supplied the gasoline but without a franchise agreement. Although the SBA branch office never logged the loan as a franchise loan, SBA's database shows this as a franchise loan. Borrower made projections based on the local gas supplier's assistance.	Increased building costs resulting in a shortage of working capital, lack of bookkeeping experience, and lack of experience in a *corporate* business.	Loan was done as a loan requiring prior SBA approval. Lender recognized this as a "high risk venture in a competitive business" but believed the borrower's experience and projected cash flow offset the negatives. SBA branch rejected the deal, convinced that borrower's injection was insufficient and high leverage would hamper repayment ability. An SBA district overruled the branch and approved the loan.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Fast food restaurants. SOUTHWEST	X	$ 856,898 51.072%	No major reliance on franchisor data.	Fraud involving business brokers and borrower in attempt to buy six fast food restaurants. A major OIG investigation resulted.	1. High broker fees. 2. High loan to value ratio. 3. Equipment given too high a collateral value. 4. Lender income statement for borrower showed *no projected wages to be paid*, thus overstating projected profits.
Restaurant. (a startup) WEST COAST	Y	$ 841,837 75%	Because this was a startup, there was no historical info, per original credit memo. Per the business plan, an average sales estimate for freestanding restaurants with this brand name was used, i.e., not localized data.	Per lender site visit report: the opening of similar competing restaurants hurt business. Borrower contended he received little support from the franchise system. He closed this start-up business and walked away.	1. High loan to value ratio. 2. Borrower had limited recent industry experience. A review of lender files confirmed the original conclusion that the limited experience was a clear vulnerability, especially for a startup, that the lender discounted. 3. Per Internet search: in 1995 a franchisee in another state sued the franchisor for failure to live up to its agreement.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Five leased restaurants that had been in operation less than 18 months. MIDWEST	X	$ 829,570 65%	Projections appear to be those of the franchisor. However, localized demographic data was also used.	Mismanagement resulting from borrower's absence from daily operations.	Filings showed borrower as an out-of-state resident. Absentee ownership appeared likely. Lender appears not to have analyzed how an absentee owner would manage the restaurants.
Fast food restaurant. (a startup) MOUNTAIN STATES	Y	$ 754,978 75%	No historical information because business was a startup. Lender may have been biased by the franchisor's business concept, per a lender memo showing a desire for more franchisee deals with that franchisor. The only available historical data was on the parents' firm that operated multiple fast food restaurants of a *different* brand name.	Inadequate sales due to restaurant not being located on a major thoroughfare and not having adequate traffic. It was hard to locate, *despite analysis at the time of origination claiming that location was a high growth area with good access to the subject business.* A memo from an appraisal service after the default called it an "inferior location."	1. High debt to worth ratio. 2. Borrower's questionable personal finances, including a personal budget that left little discretionary income and little margin for error. 3. An income statement improperly showed as "other income" a one-time $85,000 gain on the sale of a family fast food restaurant. This overstated projected income. 4. Inferior location. See adjacent box.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Gas and convenience store. MIDWEST	X	$ 742,400 75%	Not at all. SBA field office considered this to be a distributorship, and not a franchise, relationship. Lender also appeared *not* to consider the borrower a franchisee. It is unclear whether an SBA processing center categorized the large corporation involved as a franchisor. Debt coverage was based on borrower's projections.	Borrower claimed to have paid too much for the business. Lender said business cash flow was insufficient to make loan payments and believed having the two sons operating the business was the cause of the problem.	1. Borrower had no relevant experience, although his sons did. 2. Appraised value of the property was far lower than loan value. 3. Seller of the business, *after little time as the owner*, was returning to his country of origin. Lender documents show it was aware of weak historical financial information. 4. Sons' personal guarantees were of questionable value, given their lack of assets.

Type of Business and Geographic Region	Which Lender (X/Y)	Guarantee Purchase Gross Principal and SBA's % Share of It	Extent that lender relied on the viability of the franchise concept and/or the franchisor's projections in its initial credit analysis	Reasons Given for Default	Warning Signs Present at Time of Loan Origination
Auto exhaust repair shop. (a startup) SOUTHEAST	X	$ 542,895 75%	Borrower originally intended to be with another franchise system, which the lender considered a "strong franchise concept." Lender also knew about the class action lawsuit by franchisees against that franchisor. Lawsuit caused borrower to switch to a less-known franchisor. Lender appeared not to be dependent on either franchise system's projections, relying instead on handwritten numbers that appear to be the borrower's.	None. Borrower never stated that he was having problems. Lender's attempts to contact borrower were unsuccessful.	1. Questionable handling of personal finances contrasted with a thorough business plan. 2. Risky credit score contrasts with lender's favorable assessment of borrower's experience and initial business cash position. In short, lender overemphasized borrower's management experience and underemphasized risks.

Appendix C

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: August 23 2002

TO: Emilie M. Baebel
Assistant Inspector General
for Inspection and Evaluation

FROM: James E. Rivera
Associate Administrator for Financial Assistance

SUBJECT: Final Draft Inspection Report
SBA's Experience with Defaulted Franchise Loans

I have reviewed your memorandum dated August 14, 2002 and the above-noted Final Draft Inspection Report, and have the following responses:

Findings: (1) Despite the popular view that franchisees are much more successful than non-franchisees, SBA's experience with defaulted loans does not support this. (2) The second finding was that SBA data on franchise loans is not clear.

Recommendation 1 of 2: To provide prospective entrepreneurs and lenders with accurate information, the Office of Financial Assistance (OFA), in conjunction with the Office of Entrepreneurial Development, should ensure that the Agency's printed and electronic information on franchises no longer states that franchise-based businesses are significantly more successful than independent businesses.

Recommendation 2 of 2: To enhance the accuracy and usefulness of its data, the Office of Financial Assistance should (1) clearly define what constitutes either a franchise loan or, in more general terms, loans to small businesses that use a larger firm's brand name, (2) communicate the definition(s) through an information notice to SBA offices and lenders, and (3) use the definition(s) to recategorize the data in the loan databases.

OFA Response:

A member of my staff conducted a similar study and analysis of the SBA loan data base for the same period under inspection and came to the same conclusion supported by your finding related to the relative success of franchise verses non-franchise loans. We also agree that the data base can include a description of other entities allowing a small business to use its brand name, whether through a franchise agreement, licensing agreement, distributorship, or some functional equivalent.

My conclusion is to agree with the findings and recommendations of the Final Draft Inspection Report

(1) OFA will review the content of franchise related printed and internet documents and make changes as appropriate. OFA will work with the Office of Entrepreneurial Development at their request.

(2) OFA will (1) clearly expand on the definition of what constitutes a franchise loan to include loans to small businesses that use a larger firm's brand name, whether through a franchise agreement, licensing agreement, distributorship, or some functional equivalent (2) communicate that expanded definition through an information notice to SBA offices and lenders, and (3) use the expanded definition to recategorize the data in the loan databases, causing the franchise database to be more inclusive of a generic category of small businesses and be more useful to the field and lenders as a resource and simplify data entry.

Feel free to contact me with any further questions or comments regarding this matter.

CONTRIBUTORS TO THIS REPORT

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