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PORT OF CALL

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CURT HUDSON

Kathleen Edwards hopes to open a spa in this Delran, N.J., outlet in the fall.

In a slow year, franchisors cut deals to keep growing

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With business loans still hard to come by, franchisors unwilling to sacrifice growth are making their systems more affordable to new owners by reducing franchise fees, offering incentives, providing in-house financing or scrutinizing their business model for savings that can be shared throughout the system.

Hand & Stone, a Hamilton, N.J.-based spa concept with eight locations in the Philadelphia area, saves each franchisee tens of thousands of dollars on average by negotiating favorable rent and cashback from the landlord for tenant improvements.

"A lot of landlords have got a lot more vacancy than they used to," said Bob McQuillan, vice president for franchise development. "There's not a lease that we've done that we haven't received money back from the landlord."

Recently, Hand & Stone negotiated a 20 percent reduction in rent and a significant tenant improvement allowance on behalf of Kathleen and Bill Edwards, who are buying a franchise that they plan to open in Delran, N.J., this fall.

"At the low end we've gotten back \$40,000 [in tenant improvement money] and we've gotten back as much as \$150,000; the Edwards' number was in between," said McQuillan.

The tenant improvement money "will be our working capital," said Kathleen Edwards, who said she and her husband had had to put up more collateral than they'd expected for their Small Business Administration loan.

Franchisors interviewed say the tougher lending requirements threaten growth.

"Two years ago it was a lot easier," said Marty Ferrill, vice president of operations for the Philly Pretzel Factory, a soft pretzel franchise that began in 1998 in Philadelphia. "You basically needed 20 percent eq-

uity of your own into the loan. Now banks are pushing for 30 or 40 percent."

A lending analysis by research company FRANData in Arlington, Va., on behalf of the International Franchise Association (IFA) estimated a \$3.4 billion shortfall between franchisee demand for loans and what banks are willing to lend this year.

Ferrill said he has been getting about 40 to 50 calls a week from would-be franchisees, more interest than ever before. Despite that, the franchisor expects to open only 10 stores this year, down from 16 last year and 34 in 2008.

"Enthusiasm is still there for franchising and people want to get involved, but franchisees get dampened once they go out and try to get financing to invest in a business," said Ferrill.

After almost zero growth last year, the number of franchise establishments is forecast to grow 2 percent in 2010, according to the IFA.

By comparison, in the years following the last recession, between 2001 and 2005, the number of franchised businesses grew by 4.3 percent per year.

Franchises are generally a better credit risk than an independent business, but banks are reluctant to loan to them because they're uncollateralized loans, says Ron Feldman, CEO of Siegel Financial Group in Bala Cynwyd. "If you're opening a franchise unit most of the time there's no real estate involved, you're going into a strip center or it's a service business and there's no real collateral behind the loan."

Default rates for SBA franchise loans average 6 percent. That's about the same as for conventional businesses, and experts say that rates for franchises are actually lower. The SBA's data isn't reliable because banks do not necessarily report all the new franchise loans they write, though they do report all the loans that go bad.

"All the bad loans are there, but not all

FRANCHISORS

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the good loans," explained Feldman.

Last year, the number of loans that went bad more than doubled according to preliminary data, said Darrell Johnson, president and CEO of FRANData. However, he said the SBA won't know how many of those defaults were franchise versus non-franchise loans until more analysis is done.

Franchisors are doing what they can to keep expanding their systems.

Last year the Pita Pit — a fast-food restaurant concept founded in Coeur D'Alene, Idaho, with one store so far in Philadelphia — began giving new franchisees a 20 percent reduction off the initial franchise fee, which is \$25,000, and a 40 percent reduction for existing franchisees opening additional locations.

The Pita Pit discounts the 6 percent royalty fee in the first two years. To fuel growth in its core demographic, the franchisor is offering an extra \$10,000 incentive to open locations in college towns.

The Maid Brigade, an Atlanta-based franchise that does home cleaning services in 34 states and Philadelphia, held a contest open to veterans. The first prize was an entire franchise, worth \$45,000.

"Activities like that have allowed us to continue to grow our system and attract quality people ... [otherwise] results might have been somewhat different," said President Bart Puett, noting that franchises grew 5 percent in 2009 and he expects the same in 2010.

The Lawn Doctor of Holmdel, N.J., and Wireless Zone of Middletown, Conn., both with operations in the Philadelphia area, provide in-house financing for up to 50 percent of their franchise fees.

Some franchisors have refused to cut deals.

"Our company didn't panic last year," said Jeff Travitz, director of franchise sales for King of Prussia-based the Goddard School, a long-established childhood education franchise. "There's value in a brand and when you start cutting fees and making deals that isn't good for anyone and for people who are already open it lowers the value of their franchise."

When banks got stricter on loans, Goddard responded by getting stricter on pre-qualifying candidates financially.

"We're not trying to figure out how to get people into business who can't afford to be in business," Travitz said. ■