RISKY BUSINESS

Franchisees' High and Rising Risk of SBA Loan Failure
Background

Franchising and the SBA

Findings:

- The SBA 7(a) program
- One in six SBA franchise loans fail

The failure rate has increased over time

The number of franchise systems with high failure rates is increasing

Individual franchisees fare worse than those that are incorporated

Conclusion
The risk of failure for owners of franchised businesses who borrow through the largest government-backed small-business lending program is high and rising, according to an analysis by the Service Employees International Union of more than 60,000 loan records covering a 20-year period.

The analysis reveals a failure rate of 16.9 percent, more than one in six, for franchise loans made from 1991 to 2010 through the Small Business Administration’s 7(a) loan program. Even more concerning, the study shows that the franchisee loan failure rate is increasing over time, hitting 19.3 percent in the most recent period, or nearly one failure for every five loans. Furthermore, the analysis shows that among franchise systems that are significant users of SBA financing, the percentage with high failure rates has nearly tripled over the 20-year period to more than one in three in recent years. The failure rate is the proportion of loans that the SBA has written off after all the borrowers’ collateral, often including their home, has been liquidated. Such failed loans also involve the SBA making guarantee payments to the banks and other lenders that made the loans. Thus, loans that are charged off can represent a disaster for the borrower, who may have lost both business and personal assets, and a loss for taxpayers, since the SBA has written off the loan and may have made guarantee payments to the lender.
This report adds to a growing body of work by researchers, government agencies and journalists that reveals the significant financial risks and problems facing franchised business owners.

- A recent poll of U.S. franchisees by FranchiseGrade.com, commissioned by labor federation Change to Win, found most franchisees running at a loss or breaking even, with small salaries, substantial indebtedness and low satisfaction levels.³

- In September 2013, the Government Accountability Office found an overall default rate of 28 percent on SBA loans to franchised businesses made between fiscal years 2003 and 2012.⁶ The GAO report added to findings by the SBA Office of the Inspector General, which identified franchise systems with high SBA loan volumes that had default rates of at least 46 percent over the seven years from 2002 to 2009 while another undefined group of “similarly sized” franchises had average default rates of 26 percent.⁷ Defaults are a broader measure of problem loans than the loan failures analyzed in this report, as discussed below.

In the context of these indicators of substantial risks for franchisees, this report analyzes records of 64,191 SBA-guaranteed loans to franchised businesses made over the 20-year period: 1991 to 2010. The analysis looks at loan performance through October 2014 but does not include loans made after 2010 because, following the methodology of the SBA’s Inspector General, it is too soon to tell whether these more recent loans will fail or not.⁸

- A separate survey of McDonald’s franchisees found the burger giant’s owner-operators have both the most pessimistic business outlook and the worst assessment of their relationship with the franchisor in the survey’s 11-year history.⁴

- Recent reports in business publications have shown that for every 10 franchise units opened in the last three years, almost nine have closed.⁵ This is because there have been enough terminations of franchisees by their franchisors, franchisees going out of business and other closures to offset the vast majority of new franchised unit openings.

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FRANCHISING AND THE SBA

The SBA’s mission is to “maintain and strengthen the nation’s economy by enabling the establishment and vitality of small businesses.” However, SBA lending has also underwritten the growth of major franchisor corporations in the United States. For example, McDonald’s, Dairy Queen, Baskin Robbins and Aamco Transmissions were among the top 25 franchisors benefitting from SBA loans according to 1981 congressional testimony by the Government Accountability Office. More recently, sandwich giant Subway, the country’s largest franchise system by unit count, has the most SBA loans of any franchise system over the last 20 years.

However, individual franchisees, not franchisor corporations, take on the risk of hundreds of thousands of dollars in debt that often comes with buying into a franchise system. The average initial investment in a non-lodging franchise is $418,000. An SBA official advised potential franchisees to put down 20-30 percent of their franchise investment and “borrow the rest.” If franchisees take that advice, they will have borrowed, on average, some $300,000, and the SBA will require them (or other guarantors) to secure the loan with “all available assets (both business and personal).” The borrower’s home, certificates of deposit and stocks and bonds are examples of collateral listed on the SBA website that would be sold (“liquidated”) if “the cash generated by the small business is not sufficient to repay the loan.” Franchisors and their boosters appear to market to inexperienced investors, deemphasizing risk and emphasizing the support the franchise system provides. As one franchise consultant (and former franchisor executive) put it, franchising will “help you avoid much of the risk of starting a new business.” Or, as Stephen Caldeira, who heads the International Franchise Association, a franchisor-dominated trade group, stated, “For those Americans dealing with long-term unemployment or a lack of growth opportunities in their current jobs, franchise ownership offers a viable way to be in business for yourself, but not by yourself.”

Franchisees are by themselves, however, if their SBA-guaranteed loan fails. It is their homes and personal assets that can be sold off, not those of the franchisors.

Our analysis builds on previous work that has mainly focused on default rates by instead analyzing loan charge offs, the direst subset of defaulted loans where the SBA wrote a loss off its books after the lender could not recover the entire outstanding loan balance. This analysis also expands on previous studies by examining franchisees’ SBA debt problems over a longer time period — 20 years instead of the considerably shorter time spans in previous analyses — and by identifying the trend of rising franchise loan failure rates over time. Lastly, this analysis examines the performance of SBA loans made to less-sophisticated franchisees, identified as individual borrowers whose businesses are neither incorporated nor part of business partnerships, compared to the more sophisticated incorporated and partnership borrowers.
FINDINGS

This report analyzes data from the SBA’s largest lending vehicle, the 7(a) program, and finds that a high and rising proportion of 7(a) loans to franchised businesses end in failure.

THE SBA 7(A) PROGRAM

The 7(a) program guarantees loans to prospective and current business owners who lack sufficient financial resources or credit history to qualify for conventional financing.20 Private lenders actually originate and service the loans, which can be for starting or expanding a business, buying equipment or real estate, or constructing or renovating a building, among other purposes.21 The SBA guarantees that lenders will receive up to 85 percent of the loan amounts if borrowers do not pay in full.22

When a borrower defaults and the lender determines that the borrower will not be able to repay the debt, the lender can ask the SBA to honor its guarantee and “purchase” the guaranteed portion of the outstanding balance.23 The taxpayers are ultimately responsible for these guarantee payments.

Some but not all of these purchased loans end up being charged off the SBA’s books. Charge offs occur when the lender cannot collect a defaulting borrower’s outstanding balance, even after liquidating all the borrower’s collateral, possibly including their home and/or retirement savings.

The SBA then recognizes the unrecovered value of the loan as a loss and charges off that amount from its accounts.24 Such charged-off loans make up this report’s failure rate, defined as the number of charged-off loans as a percentage of all loans made.25

Defaulted loans that are not charged off include those where the lender works out a repayment plan that allows a borrower to exit default, or where liquidating the borrower’s collateral generates enough cash to pay off the outstanding balance.

ONE IN SIX SBA FRANCHISE LOANS FAIL

Between 1991 and 2010, the SBA guaranteed 64,191 loans to franchise businesses.26 As of October 2014, the SBA had charged off 10,879 of these loans, resulting in a failure rate over the 20-year period of 16.9 percent, or more than one in six.

<table>
<thead>
<tr>
<th>TABLE A: Summary of all SBA franchise loans originated 1991 to 2010.</th>
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<tbody>
<tr>
<td>Total number of loans</td>
</tr>
<tr>
<td>Number of charged off loans</td>
</tr>
<tr>
<td>Failure rate</td>
</tr>
</tbody>
</table>
An analysis of the performance of franchise SBA loans over the 20-year period shows that the failure rate has increased over time. To reduce the effect of annual volatility we divided the 20-year span into four five-year periods—1991 to 1995, 1996 to 2000, 2001 to 2005 and 2006 to 2010—and calculated failure rates for each period. In the earliest period, 1991 to 1995, the annual failure rate was 12.7 percent. The failure rate increased monotonically in each period. In the most recent period, 2006 to 2010, the failure rate reached 19.3 percent, nearly one failure of every five loans. This represents a 52 percent increase over the failure rate in the first period.

While the 2007-2009 recession sparked by the financial crisis may provide a partial explanation for the recent increase in the failure rate, we do not believe it explains the long-term increase. For example, the 1991 to 1995 period includes part of the 1990-1991 recession, but the failure rate for the period was only 12.7 percent, considerably lower than the rate of 16.9 percent for the entire study period.

In addition, the contrast between the failure rates for the first and last periods is particularly startling considering that loans that originated in the 1991 to 1995 period have had up to 24 years to fail, while loans made in the 2006 to 2010 period have had at most eight years to fail. In the coming years, the SBA will continue to charge off loans that originated between 2006 and 2010, which will push the failure rate for loans made in that period even higher.
THE NUMBER OF FRANCHISE SYSTEMS WITH HIGH FAILURE RATES IS INCREASING

Another way to examine failure rates over time is to analyze the number of franchise systems with failure rates above a given benchmark in each period. We limited this analysis to franchise systems whose franchisees took out a significant number of loans across the period. In particular, the analysis only included systems whose franchisees had taken out at least 50 loans between 1991 and 2010, with at least one loan in each of the four five-year periods. A total of 198 franchise systems and 37,923 loans met these criteria. Those loans made up 59 percent of all franchise loans and 65 percent of the value of all franchise loans made in the 20-year period.

The number of systems with high failure rates – defined as over 20 percent – almost tripled over the 20-year period. For loans with origination dates in the 1991 to 1995 period, 13.6 percent of systems had failure rates in excess of 20 percent, nearly one in seven systems. For loans originating in the 2006 to 2010 period, 35.9 percent of systems, or more than one in three, exceeded this benchmark. Figure 2 illustrates this increasing number of systems with high failure rates.

Table B lists the top 20 systems by unit count with loan failure rates of at least 20 percent. It includes not only franchisors whose financial troubles are well known, such as Quiznos and Cold Stone Creamery, but also muffler chain Meineke, printing franchise Minute-Man Press and pet store chain Petland. These 20 systems had failure rates ranging from 20.8 percent to 49.6 percent. These findings are consistent with a September 2014 Wall Street Journal analysis of SBA loans to franchised businesses between 2004 and 2013, which found that failure rates for the worst-performing systems ranged between 18 and 41 percent.28
Another indicator of worsening financial distress for franchisees is that the aggregate failure rate for the franchise systems listed in Table B has increased over time. It was 20.7 percent in the 1991-1995 period, rose to the 25-27 percent range in the two periods from 1996-2005 and jumped to 36.8 percent in the most recent five-year period. Systems with significant increases from the first to the last five-year period include frozen yogurt chain TCBY, whose failure rate more than doubled from 11.9 percent in 1991-1995 to 27.3 percent in the most recent period; Quiznos, which jumped from 26.1 percent to 40.8 percent; and printer Post Net, which vaulted from 17.9 percent to 40.9 percent.

### TABLE B:
Top 20 franchise systems with SBA loan failure rates over 20 percent, by number of loans originated, 1991 to 2010.

<table>
<thead>
<tr>
<th>Franchise system</th>
<th>Number of loans 1991 - 2010</th>
<th>Failure rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quiznos</td>
<td>2,503</td>
<td>25.0%</td>
</tr>
<tr>
<td>Cold Stone Creamery</td>
<td>906</td>
<td>24.5%</td>
</tr>
<tr>
<td>Matco Tools</td>
<td>728</td>
<td>33.4%</td>
</tr>
<tr>
<td>Blimpie</td>
<td>571</td>
<td>29.1%</td>
</tr>
<tr>
<td>Meineke</td>
<td>392</td>
<td>22.2%</td>
</tr>
<tr>
<td>Minuteman Press</td>
<td>361</td>
<td>21.1%</td>
</tr>
<tr>
<td>Aamco Transmissions</td>
<td>328</td>
<td>23.8%</td>
</tr>
<tr>
<td>All Tune and Lube</td>
<td>320</td>
<td>41.6%</td>
</tr>
<tr>
<td>Cottman Transmission</td>
<td>268</td>
<td>36.6%</td>
</tr>
<tr>
<td>Alphagraphics</td>
<td>248</td>
<td>25.8%</td>
</tr>
<tr>
<td>Post Net</td>
<td>232</td>
<td>21.6%</td>
</tr>
<tr>
<td>Marble Slab Creamery</td>
<td>222</td>
<td>26.1%</td>
</tr>
<tr>
<td>TCBY</td>
<td>188</td>
<td>23.4%</td>
</tr>
<tr>
<td>Huntington Learning Center</td>
<td>182</td>
<td>30.8%</td>
</tr>
<tr>
<td>Petland</td>
<td>164</td>
<td>37.8%</td>
</tr>
<tr>
<td>Mr. Goodcents Subs and Pasta</td>
<td>159</td>
<td>20.8%</td>
</tr>
<tr>
<td>Precision Tune</td>
<td>146</td>
<td>23.3%</td>
</tr>
<tr>
<td>Computer Renaissance</td>
<td>142</td>
<td>24.6%</td>
</tr>
<tr>
<td>Fox's Pizza Den</td>
<td>140</td>
<td>25.0%</td>
</tr>
<tr>
<td>Golf Etc.</td>
<td>135</td>
<td>49.6%</td>
</tr>
</tbody>
</table>

*Note: The table draws from the 198 systems that had at least 50 loans between 1991 and 2010 and at least one loan in each of the four five-year periods.*
INDIVIDUAL FRANCHISEES FARE WORSE THAN THOSE THAT ARE INCORPORATED

Despite franchisors’ claims that buying a franchise business affords inexperienced individuals the support to succeed in business, loans to individual franchisees failed at a higher rate than loans made to franchisees that were either incorporated or part of a partnership. Borrowers that are incorporated businesses or partnerships typically fall into one of two categories: (1) They are new franchisees who had enough sophistication and resources before they invested in their franchise to establish the corporation or partnership;29 (2) Or they are longer-term business owners who may have started out unincorporated and un-partnered but have grown and evolved to take advantage of these risk-reducing legal forms. In any case, the franchisee who is the sole individual borrower lacks the protection of the corporate form or partnership should the loan fail.

During each five year period over the 20-year period of analysis, the failure rate for individual franchisees has been consistently above that of corporate/partnership franchisees. In the most recent period, individual franchisee loans failed 21.5 percent of the time, well above the 19.1 percent failure rate for corporate/partnership franchisees. Figure 3 below shows this consistent pattern of significantly higher failure rates for individual franchisees.

*FIGURE 3: Failure rate of SBA franchise loans, by franchisee business form and period, 1991 to 2010.*

<table>
<thead>
<tr>
<th>Period</th>
<th>Individual Failure Rate</th>
<th>Corporate/Partnership Failure Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 - 2010</td>
<td>19.1%</td>
<td>21.5%</td>
</tr>
<tr>
<td>2001 - 2005</td>
<td>17.2%</td>
<td>18.3%</td>
</tr>
<tr>
<td>1996 - 2000</td>
<td>16.2%</td>
<td>18.3%</td>
</tr>
<tr>
<td>1991 - 1995</td>
<td>14.0%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

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CONCLUSION

Over the past 20 years, one of six SBA loans has ended in failure. Moreover, franchise loan performance has worsened, with loans that originated in the most recent five-year period facing an almost one in five chance of failure. And the number of franchise systems with a high rate of failure – over 20 percent – is also on the rise. Further, franchisees without the knowledge or resources to incorporate or form partnerships – presumably the least-sophisticated franchisees – fare the worst.

This analysis, added to recent research by the GAO, the SBA Inspector General and others on the risks of franchise lending, calls into question some of the supposed benefits of franchising. Franchise boosters assert that “the SBA really likes to back franchisees” and that “buying into a franchise is one of the quickest and easiest ways to jump into the business world - especially for potential entrepreneurs that may not have the skills or creativity to develop their own business concept.” This study demonstrates, however, that franchising is an increasingly risky form of entrepreneurship that has resulted in failed loans and losses for taxpayers and for thousands of franchisees.

METHODOLOGY

This analysis is based on a dataset covering all SBA 7(a) loans made between October 1989 and October 2014, which corresponds to the SBA’s 1990 to 2014 fiscal years. The dataset, obtained through a Freedom of Information Act request, contains information on the borrowers’ names and addresses, lending banks, loan amounts, loan statuses, charge-off amounts, franchisor names and corresponding codes, NAICS industry codes, and type of business (corporate, partnership or individual). Participating lenders submit monthly reports with the current payment status of all loans, but the SBA only releases to the public status data on loans whose status is: (a) paid-in-full, (b) charged off, or (c) canceled.

The payment statuses of all other loans, including current loans that are in good standing as well as loans that are delinquent and may be in the liquidation process, are not included in the publicly available data; the SBA lists the status for these loans in its publicly available data as “exempt.” The failure rate is defined as the number of charged-off loans divided by the total number of loans made. The total number of loans made includes all loans in the data provided by SBA except canceled loans.

Loans that originated after 2010 are excluded from the analysis to avoid the inclusion of unseasoned loans - loans that have been outstanding for less than four years and likely have not been on the books long enough to fail. This exclusion is consistent with the methodology of the SBA’s Inspector General.

Given the importance of identifying loans to franchisees and since lenders are not required to report franchise system data, we identified additional franchisee borrowers not identified in the dataset as franchisees following a methodology modeled on that in an SBA Inspector General report. The franchise system name identification process increased the franchise loan sample from 54,759 to 64,191.
ENDNOTES


2. An SBA description of the loan purchase and liquidation process states the lender requests payment of the loan guarantee (a “purchase”) and then later after all liquidation is complete the SBA charges off the loan. This makes it clear that in at least some cases there is both a guarantee payment and a charge off. See SBA, “Helpful Hints for Navigating the National Guaranty Purchase Center.” Liquidation Expectation and Standards, pp. 3-4. https://www.sba.gov/sites/default/files/Helpful_Hints_Guide_20120504.pdf


6. United States Government Accountability Office, “Small Business Administration: Review of 7(a) Guaranteed Loans to Select Franchisees,” Report Code: GAO-13-759, September 10, 2013, first page (unnumbered). http://www.gao.gov/products/GAO-13-759. The GAO indicates that the SBA made guarantee payments on 28% of franchise loans guaranteed by the SBA. The GAO does not explicitly call this figure a default rate. However, it is clear from the report that default rate refers to loans on which SBA has made guarantee payments. For example, referring to one set of franchise loans, the report states, “Of the total population of 170 loans, we identified 74 defaulted loans … SBA made guarantee payments of around $11 million on the defaulted loans” (p. 8). Similarly, the SBA Inspector General uses the term default rate to refer to loans that have defaulted and for which the SBA has had to honor loan guarantees. Specifically, the Inspector General writes, “Upon loan default, the lender generally requests payment of the guarantee from the SBA. The SBA reviews the lender’s actions on the loan to determine whether it is appropriate to pay the lender the guaranty, which the SBA refers to as a guaranty ‘purchase.’” See SBA, Office of Inspector General. “The SBA’s Portfolio Risk Management Program Can be Strengthened.” July 2, 2013, p. 5. https://www.sba.gov/sites/default/files/oig/Audit%20Evaluation%20Report%202013-17%20The%20SBA’s%20Portfolio%20Risk%20Management%20Program%20Can%20Be%20Strengthened.pdf


8. In its 2013 evaluation of the franchise loans, the SBA Office of Inspector General excluded loans that originated after May 2009 in order to avoid counting unseasoned loans – loans that likely have not been on the books long enough to fail. Our analysis shows that the average age for loans at time of their charge off was 4.8 years.


14 $300,000 is 71.7 percent of the average initial investment of $418,000.

15 United States Small Business Administration. “7(a) Loan Repayment Terms.” https://www.sba.gov/content/7a-loan-repayment-terms


21 United States Small Business Administration. “Use of 7(a) Loan Proceeds.” https://www.sba.gov/content/use-7a-loan-proceeds
The guarantee percentage is 85 percent for loans up to $150,000 and 75 percent for loans larger than $150,000, United States Small Business Administration. “7(a) Loan Amounts, Fees & Interest Rates.” https://www.sba.gov/content/7a-loan-amounts-fees-interest-rates

According to the SBA website, “A lender first may request payment on the SBA guaranty for loans made under most SBA loan programs following a 60-day uncured delinquency.” SBA, “When to Request Purchase.” https://www.sba.gov/offices/headquarters/oca/resources/5086 See also: SBA, SOP 50 57 – 7(a) Loan Servicing and Liquidation. Chapter 23, Section C. Pg. 146. https://www.sba.gov/sites/default/files/sops/SOP_50_57-7%28a%29_Loan_Servicing_and_Liquidation_-_FINAL_1.pdf, which states that one requirement before SBA will make a guarantee payment is “Uncured Loan Default-The Borrower must be in default on a payment due the Note for more than 60 calendar days unless SBA agreed in writing otherwise.”


Loans in the SBA dataset listed as “canceled,” which SBA staff state are loans approved but never disbursed, are excluded from the analysis.

We obtained these data through a Freedom of Information Act request – see Methodology section. All references to years in this report are to the SBA’s fiscal year, which begins on October 1.


Sole proprietorships – unincorporated and non-partnership businesses – are considered both the easiest and least expensive type of business organization to create, but they expose the proprietor to personal liability for the business’s possible losses. See Kristie Lorette, “What Three Ways Is a Franchise Business Organized?” Houston Chronicle online (no date) http://smallbusiness.chron.com/three-ways-franchise-business-organized-4470.html

