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As the economic crisis plays out, franchises should brace for the upcoming year. By Laura Tutor

A crisis of credit has become a crisis of confidence in the U.S. economy, and it’s enough to bring a decade-long boom in franchise sales and growth skidding to a halt.

Indeed, most experts are saying it will be at least 2010 until the market for franchise sales and financing stabilizes itself. In the meantime, franchisors are advised to close out the deals they have in the works and hang tight, focusing on operations improvement until the economy improves. For franchisees still interested in expanding, and who might look to take over faltering operations, alternative sources of financing are becoming more popular.

“Make sure what you’ve got is doing well,” says Craig Slavin, who monitors lead flow with the Franchise Navigator. “Close what deals you’ve got. Take care of your existing franchisees.”

The message is grim, but it’s one that many in franchising expected to hear. The reluctance, or in some cases the inability, of banks to extend credit has stymied prospects for franchisees who’ll need financing to buy into a brand. According to Slavin, it’s been particularly harsh on mid-level or emerging concepts.

“For a lot of the larger investment franchisors, it’s diminishing some, but it’s still pretty substantial,” Slavin says. Mid-tier franchises, however, tend to draw franchisees who are looking to build wealth, who must rely on such things as home equity or real estate as leverage for getting a loan. Those people are being affected. In recent years, their investments in mid-tier and emerging concepts fueled much of the franchise boom.

Home equity cash-out value dropped some $40 billion between the third quarter of 2006 and the second quarter of 2008, according to FRANdata. That plummet in real estate equity brings a new factor into the old franchising equation that said rising unemployment increased interest in franchising as a new career.

It was last October that the Dow Jones closed at a record high of 14,164. Since then, however, frozen credit, record number of foreclosures, and a slew of job losses have seized the market.

Fixes, such as the $700 billion bailout Congress extended to Wall Street, will take time to show any ripples in the economy. According to On Deck Capital Founder and CEO Mitch Jacobs, once improvement starts to show, it will take months longer for market forces to stabilize and consumer and investor confidence to return.

“We reward someone who has a continuous trend of good business history, but couldn’t get a traditional bank loan,” Jacobs says, explaining that his company looks at data like customer base and consistent cash flow rather than focusing most on the business owner’s personal credit. “We built a performance-based model.”

The company also offers what Jacobs calls a micro-payment system, which allows business owners to set up a repayment plan that allows them to pay back a small amount every day. That amount is fixed, Jacobs says, and it allows small business owners to avoid cash flow crunches that can come with one lump monthly payment.

“We really had the lender in mind when we started this,” he says, adding that many didn’t have options for small businesses. “Small business owners, however, like the consistency, and they like repaying a little bit every day.”

WD Partners’ Dennis Lombardi, a longtime restaurant industry analyst, says franchisees looking to borrow amounts near or below $200,000 will likely be able to find such a deal at a local or regional bank. He says larger operators, those looking to finance programs in the millions, will likely be out of luck for the foreseeable future.

“It will never be as easy as it was before,” Lombardi says. “Banks will be under much more pressure to make sure they don’t over-leverage the recipient of the loan.”

Among other predictions is that more successful, financially stable franchisees will be in a position to buy out struggling operators. That will increase the percentage of units that are consolid ated under fewer numbers of franchisees. However, experts caution that brands selling chunks of new stores to multiunit developers look hard at how many restaurants franchisees have in various stages of completion. In other words, projections might need to be revised to fit the current economic climate as well as what’s to come.

FRANdata reports that the Small Business Administration (sba) will continue to be one of the bright spots for lending and that banks will turn more of their customers toward their SBA lending departments.

Slavin says the current conditions mean franchisors will need to take a closer look at their franchisee prospects and will have to get more involved with franchisee funding and financing once the conditions are ripe for growth again.

That means franchisors should prepare to provide detailed and historical risk analyses for the brands. The bottom line is franchisors will also have to see that their franchisee screening material matches up with what banks will require of them when they seek financing.

Slavin says that, in addition to the credit crunch, franchising will be affected by declining revenue. That means operators will be focused more in 2009 on the cost-driven side of running a franchise. He says it will be the second quarter of 2009 before the economic ship starts to right itself.

“The earth is moving underneath us, and it doesn’t feel good,” Slavin says. “Hunker down.”

According to him, franchisors are, by nature, an optimistic bunch. History has shown the industry is an incredible part of the country’s economic engine and that 2009-10 will simply mean franchisees and franchisors have to hone their operations.

“Franchisors may take more risk; they may have a larger role,” he says. “It’s not ever going to return to what it was in the past.”

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