The whole business market has grown tremendously over the past six years with the amount outstanding expanding by five times to $27B by the end of 2019, which was also a record year of issuance. The market started in 2006 when Dunkin issued a $1.7B transaction, followed by Dominos in 2007. The market would take a pause during the credit crisis, but in the years thereafter, other restaurant franchisors would follow as whole business securitization allowed them to secure financing at a lower rate than what could be achieved in other debt markets. As the whole business market grew, companies outside of the restaurant space began to tap the securitization market and in 2019, an even broader array of franchise businesses, including fitness gyms, massage services, home restoration services, and childcare centers, entered the space. While the origins of whole business may have started in 2006, it has a connection to a past part of the securitization market that no longer exists today – the franchise loan market. Franchise loans had emerged in the 1990s and while the story of franchise loans is different from the whole business story of today, they share common elements and potential risks that are perhaps being overlooked today as they were in the past.

Beginnings of the Franchise Loan Market
The market for franchise loans began in the early 1990s. The cash flow based loans were originated directly to franchisees and were secured by one of three types of collateral – fee simple mortgages, ground leases, or enterprise loans (more on this below). Specialty finance companies began to emerge during this time period, taking over a niche space that had been served by commercial banks. Small banks had previously dominated the space in the 1980s and early 1990s, capitalizing on local knowledge and relationships, but as these small banks began to merge into larger entities, franchise loans became less important, opening the door for specialty finance companies to enter. The ability of these specialty finance companies to offer fixed rates and longer 15-20 year terms was also an appeal to franchisees who previously were limited to floating rate 7 year terms from commercial banks. New entrants continued to enter into the space, comfortable with the low level of historical defaults and viewing franchise loans as a higher yielding instrument with relatively low risks. Volume growth in the franchise loan market took off rapidly once securitization was introduced by a company called Franchise Mortgage Acceptance Corp (FMAC). The sector would have a 10yr run before collapsing in a classic case of a system with too much leverage.
A Link to the Past – Franchise Loans

**Pioneer**
FMAC was a Los Angeles based specialty finance company started by Wayne Knyal. Knyal originally had plans to become a Taco Bell franchisee and was looking to buy Taco Bell restaurants from John Martin, a golf friend and CEO of the Taco Bell unit owned by Pepsi at that time. While Martin was willing to sell Taco Bell restaurants to him, he suggested to Knyal that there may be better opportunities if he could find a way to lend to franchisees as banks were reluctant to finance restaurants. Knyal would take this suggestion and develop it further, formulating an idea to not only originate franchise loans to franchisees, who were having difficulty obtaining financing from banks, but to also securitize these loans much like the way Wall Street had been securitizing mortgage loans. Knyal would underwrite these loans based off cash flows or “business value” (also known as enterprise loans) which would allow the franchisees to borrow more money and for a longer term. With one part of the equation complete, Knyal would still need to sell the idea to Wall Street. He would be introduced to brokerage firm Dean Witter, which was initially skeptical about the idea as securitization was typically associated with more homogeneous products, such as mortgages. The idea, however, finally took form and Dean Witter was able to convince a client to buy the deal. The first deal, done in 1991, was a $64mm securitization of Taco Bell franchisees. It would take a few more years before the market would fully embrace franchise loan securitizations. Volume grew steadily from $175mm in 1995 to a peak of $3.3B in 1998.

**Franchise Loan Market**
Originations for franchise loans started with a limited number of franchisors in the traditional quick service restaurant (QSR) types, but would eventually expand to include more restaurant types, with many names still commonly known today (see below table). Franchise loans would also expand beyond restaurants to include convenience stores and gas stations (C&G), auto dealerships, video rentals, and others, but the bulk of securitization would remain with restaurants and C&G.
As mentioned above, franchise loans were collateralized by three types of collateral with enterprise loans proving to be the most problematic as there was no hard collateral backing the loan, which ultimately led to higher loss severities. Enterprise loans were based on the “value” of the business, predicated on the projection of cash flows and earnings generated by that business. This “value” was determined by models developed by third parties, such as Deloitte. Often times the values were determined without ever visiting the site or they inadequately accounted for the capital expenditures needed to run a business. The market grew rapidly for franchise loans as more specialty finance companies entered the space, buoyed by the strong performance of the loans and the low perceived risk of the business. Aside from FMAC, the other leading specialty lenders included Atherton, CNL Group, Franchise Finance Corp of America, Peachtree, and AMRESCO Commercial Lending, but the success of the sector would also draw in large conglomerates such as Citibank and Deutsche Bank.

In the mid to late 1990s, franchisors were looking to sell their company-owned stores, driven by a desire to focus more on managing their brand and to become less capital intensive. Taco Bell, for example, was able to sell 1,135 company-operated stores in a span of three years, generating $730mm in return. With the availability of capital, both from an increasing number of specialty lenders and from the securitization market, conditions were ripe for existing franchisees to acquire more stores or for new franchisees who lacked the financial means to enter. Analysts and pundits began talking about the potential size and growth of this market as the franchise concept was pervasive across many different types of businesses outside of restaurants. By extension, they were promoting the need for a large and deep franchise loan market. Indeed, the market for franchise loans was hot and the competition for loans equally competitive, so much so that lenders had to compete on total loan proceeds, as borrowers would routinely shop lenders to see who would provide the highest loan amount. The aggressive pursuit of borrowers saw some lenders advancing proceeds equaling 100% of the enterprise value and as high as 200% of the appraised real estate value. Some franchisees took advantage of this, cashing out the equity in their business and there was even a case where one franchisee used the loan to buy a private plane. While the private plane purchase was a one-off, extreme example, it highlighted the lack of oversight of lenders in a fast growing market. Lenders weren’t the only ones looking to expand their business as there were many small franchisees who were looking to quickly expand the number of restaurants they owned. Competition among franchisees to acquire restaurants led to bidding wars which drove up the valuations of the restaurants being acquired from the franchisors. For instance, franchisees drove up the valuation of Taco Bell restaurants, allowing the company to sell those units at 6x operating income, compared to the more typical 4.5x for QSRs at that time. With financing readily available, franchisee operators were able to acquire these restaurants with very little to no money down and it would also allow them to acquire blocks of restaurants at a time. Small operators who didn’t have the expertise to handle a large scale business would also prove to be problematic down the line.

The 1990s was a time period that saw a rapid expansion of the franchise loan market and the entrance of the specialty lenders that originated them. Securitization provided the avenue for the market to scale further in size and to grow more rapidly. Underwriting standards were pushed aside or perhaps didn’t exist, as a fiercely competitive market saw no reasons to have concerns. Problems, however, began to reveal themselves in 2000, the beginning of the cracks in the franchise loan market.
Downfall

The credit performance of the franchise loan market performed well throughout the 1990s with average monthly defaults registering less than 25 basis points (bps) during the late 1990s. However, a confluence of problems – excess leverage, inflated valuations, declining sales, recession and inexperiencer operators – would ultimately lead to the sector’s demise.

Trouble began to brew in January 2000, when an entity named Olajuwon Holdings Inc (OHI) filed for bankruptcy. OHI was a franchisee operator of Denny’s restaurants and accounted for nearly 15% of the collateral in a franchise securitization from Global Alliance Finance, an affiliate of Deutsche Bank. In 1998 OHI had acquired 63 Denny’s restaurants valued at $42mm by Deloitte’s model. The purchase, along with the 23 restaurants already owned, made OHI the second largest Denny’s franchisee. Based on the valuation provided by Deloitte, the company would use $29mm in financing to acquire these restaurants. However, OHI’s lawyer, after filing for bankruptcy, would claim that over a dozen of these restaurants were in poor and inoperable condition, requiring significant capital to replace roofs, stoves, and booth seats held together with duct tape. One restaurant was even reportedly boarded up with weeds growing in the parking lot. The model valued each restaurant at $670,000 on average, but OHI’s lawyer claimed some of these restaurants needed as much as $500,000 in capital expenditure, a factor not accounted for in the model. The company would claim $7mm in losses and in the bankruptcy sale, Denny’s would buy back these restaurants for $4.5mm in cash and $10.3mm in liabilities, leading to minimal recoveries to the securitization.

Later in 2000, other deals began to experience trouble as well. One FMAC transaction saw losses in its deal due to the bankruptcy of a franchisee operator of Perkins restaurants, where the bankruptcy sale resulted in less than $1mm in proceeds on loan balances of approximately $9.5mm. The trust recovered nothing after payments were made for servicing advances and to the special servicer. Another FMAC transaction saw losses due to the bankruptcy of Midland Food, a company that began in 1995 and quickly grew to become one of the largest Pizza Hut franchisees. In total, $200mm in collateral defaulted that year, which was only the beginning of troubles for the franchise loan market. Lenders would also begin to exit as losses mounted.

One of the lenders that exited was FMAC, the pioneering company that started the market for franchise loan securitization. In 1999, FMAC was acquired by Bay View Bank for $309mm, but just one year later, in September 2000, Bay View Bank would shut down the franchise lending business after writing off $235mm in losses in the three months preceding its decision to close the business. Bay View Capital, the parent company of Bay View Bank, would see its stock price drop by over 50% from the previous year due to the losses. With over $700mm remaining in its portfolio of franchise loans, Bay View Capital decided to put itself up for sale after regulators ordered the company to develop a plan to maintain sufficient capital. After rejecting bids from Wells Fargo and Golden State Bancorp, Bay View Capital decided to liquidate itself and would eventually wind down in two years, selling various parts of its businesses to other banks; thus closing the chapter on FMAC.

Defaults continued into 2001 and the recession that began in March of that year, only exacerbating problems. Many franchisees began to feel the weight of the excess leverage they had accumulated over the years and combined with weak sales, more began to default. The collapse had begun. What began as weakness in a few struggling restaurant concepts, would spread to other restaurants and then to the C&G sector and the impact would be felt across the franchise loan market as nearly all issuers experienced collateral degradation. Defaults continued to spiral out of control and by the end of 2001, more than $1B in franchise loan collateral defaulted, representing about 10% of securitized collateral. Some 41% of the defaults were in QSRs and of those, Taco Bell franchisees accounted for 42%. The losses caused all but the largest issuers to exit the business in 2001, which would also mark the year that securitization for franchise loans would essentially end.

Many restaurant franchise concepts struggled, acute among them were Taco Bell and Burger King. According to street estimates, approximately 25% of the 4,000 Taco Bell franchised restaurants defaulted as same store sales declined by 5% overall in 2000 and with a reported 9% decline in the last quarter of that year. Declining sales, combined with excess leverage, left many franchisees vulnerable with one restructuring lawyer estimating that seven of the top twelve Taco Bell franchisees were in default. Taco Bell would eventually step in and help franchisees and their lenders restructure deals in nearly 1,800 of its restaurants and spend around $150mm to buy back restaurants, purchase land and buildings and spend on capital expenditures. The company also set up a $15mm loan program to assist franchisees that ultimately helped approximately 1,500 restaurants.
A Link to the Past – Franchise Loans

Burger King, embroiled in a price war with McDonald’s and battling a slumping economy, would also experience a considerable number of franchisee defaults. Ameriking, Burger King’s second largest franchisee with 379 restaurants, filed for bankruptcy and would later liquidate. The franchisee started in 1994 with just 25 units, but quickly expanded via debt and in a time span of two years grew to operate 200 units. The company succumbed in 2002, saddled with too much debt and suffering income losses from 2000-2002. The failure of franchisee Ameriking also impacted Diageo, the parent company of Burger King, which at the time was trying to sell the Burger King business to a consortium of investors led by TPG. Diageo eventually sold Burger King to the TPG led group for $1.5B, after the group slashed down the original offer price of $2.26B. After the sale, the new CEO would also set up a program that helped some 20% of franchisees, including the four largest, restructure debt.

In 2002, another $1B in franchise loan collateral defaulted as trouble shifted to the convenience and gas sector, which accounted for 53% of the defaults. Volatile gas prices, along with competition from large retailers, such as Wal-Mart and Costco, entering the gasoline space and driving down gasoline margins, caused over-levered companies that were heavily reliant on gasoline sales to file for bankruptcy. Two notable bankruptcies in the C&G space came from Swifty Serve and Clark Retail Enterprises, which combined to account for over half of the defaults in C&G that year. Swifty Serve was the nation’s second largest privately-owned convenience store chain with 547 stores. The chain, which was just five years old, would file for a full chapter 7 liquidation. Clark Retail Enterprises, largely owned by Apollo Management, was a C&G operator with more than 1,300 units and $2.5B in annual sales. Apollo had acquired the company in 1999 when it operated over 800 stores. Clark then went on an expansion spree, acquiring eight different chains totaling 500 stores in a span of two years. Clark’s plan had been to continue to expand aggressively with Apollo claiming it could get the chain to 3,000 or 4,000 units within the next few years. However, saddled with too much debt and declining gasoline margins, the company would quietly file for chapter 11 without ever having missed a payment. They became the sixth chain with 170 or more stores to file for bankruptcy between 2001 and 2002, a period that saw the C&G sector default close to $1B. By the end of 2002, cumulative defaults totaled $2.5B, representing over 27% of franchise loan collateral.

2001 and 2002 would serve as the peak years for defaults and while defaults would continue in the following years, the amount of defaults would gradually decline. The story remained much the same – franchisees facing declining sales were unable to service the large amount of debt they had acquired over the previous years. By the end of 2006, cumulative defaults reached $3.7B, representing 39% of all collateral in the securitized franchise loan market rated by Fitch. The C&G sector led the way with 40% of the defaults, followed by QSR at 36%. The top five QSRs that defaulted included: Taco Bell, Burger King, Hardees, Pizza Hut and Arby’s.

New Defaults
Securitization
Franchise loan securitizations were structured with senior and subordinate classes and included an IO tranche. Subordinate classes included multiple tranches rated from AA to B, while seniors were rated AAA. Below is an example structure from FMAC’s 1998-C transaction:

<table>
<thead>
<tr>
<th>Class</th>
<th>Balance</th>
<th>Rating</th>
<th>Interest</th>
<th>CE</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>96,160,000</td>
<td>AAA</td>
<td>5.99%</td>
<td>24.50%</td>
</tr>
<tr>
<td>A2</td>
<td>174,020,000</td>
<td>AAA</td>
<td>6.66%</td>
<td>24.50%</td>
</tr>
<tr>
<td>A3</td>
<td>12,200,000</td>
<td>AAA</td>
<td>6.99%</td>
<td>24.50%</td>
</tr>
<tr>
<td>AX (IO)</td>
<td>374,015,423</td>
<td>AAA</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>20,570,000</td>
<td>AA</td>
<td>7.05%</td>
<td>19.00%</td>
</tr>
<tr>
<td>C</td>
<td>20,570,000</td>
<td>A</td>
<td>7.41%</td>
<td>13.50%</td>
</tr>
<tr>
<td>D</td>
<td>13,090,000</td>
<td>BBB</td>
<td>7.66%</td>
<td>10.00%</td>
</tr>
<tr>
<td>E</td>
<td>13,090,000</td>
<td>BB</td>
<td>8.66%</td>
<td>6.50%</td>
</tr>
<tr>
<td>F</td>
<td>5,610,000</td>
<td>B</td>
<td>8.66%</td>
<td>5.00%</td>
</tr>
</tbody>
</table>

Source: Moody’s

In the aftermath of the collapse of the franchise loan market, losses in securitization would vary depending on the issuer as each issuer had different levels of concentration in QSR, C&G, and casual dining. Severities would also vary with C&G experiencing the worst at 68% on average, while QSR averaged 49%, both significantly higher than what any had projected. FMAC, for example, would have losses reach up to as high as the AAA rated tranche on a couple of deals.
franchisee level could leave these deals more vulnerable than what many are anticipating. As important as perhaps it should be. With franchisors already operating with high leverage, any underlying leverage trouble at the whole business market, it appears franchisee leverage is once again not a part of an investor's lexicon or at the very least, it is not considered the leverage picture of the franchisees and underestimating the impact of leverage proved perilous for investors. In today's environment that was overlooked back then is being overlooked today – namely that of leverage. Whole business securitization is chasing that same goal, there was little thought in the risk of excess leverage.

That is to say, they don't consider the impact of leverage on the franchisee. As can be seen from the 1990s, many didn't adequately take multiple consecutive years of 10% sales decline without considering that such sales decline may cause that unit to shut down. The franchise loan securitization market of the past is different than the whole business market of today, but perhaps a similar dynamic that was overlooked back then is being overlooked today – namely that of leverage. Whole business securitization is financing at the franchisor level where the collateral is a royalty stream on the sales generated by all the underlying franchisees. The franchise loan securitization market only exists as a notation in history. The rise and fall of the franchise loan market resembled what had been seen before. A sector that rose quickly in an environment that saw overly optimistic valuations provided by third party models; models that offered speedy decisions to lenders despite inherent valuation flaws that underestimated the levels of capital expenditures required by individual franchisees and that failed to account for any significant sales declines. It was also an environment that saw lenders eager to lend to a concept – enterprise loans – that perhaps they overestimated in its ability to hold value. And of course, it was an environment that was enabled by the securitization market, providing lenders and franchisees with a way to expand their businesses. Naturally, with financing easy to obtain, franchisees took the opportunity to expand as quickly as they could, fueling their growth with debt. Small operators, who would normally take years to grow as they reinvested profits into the business to expand, suddenly found themselves with the ability to grow in multiples in a single transaction. Not only did they have the ability to grow, they had many lenders competing with each other to finance their growth. Lenders were lax in their oversight as they were more interested in capturing as much market share as possible. In the end, the fundamentals and profitability of a business still mattered and when losses mounted, all the factors that enabled quick expansion were exposed as being flawed. Perhaps this statement from Mr. Knyal, founder of FMAC, best summarizes the mindset of many participants in the franchise loan market at that time and how the market got so out of place: “I've gone from being broke to being rich.” Indeed, and while others were furiously chasing that same goal, there was little thought in the risk of excess leverage.

The franchise loan securitization market of the past is different than the whole business market of today, but perhaps a similar dynamic that was overlooked back then is being overlooked today – namely that of leverage. Whole business securitization is financing at the franchisor level where the collateral is a royalty stream on the sales generated by all the underlying franchisees. The franchisors who have whole business securitization operate with high leverage, generally in the 6-7x range with some operating at significantly higher levels. While these conditions are seemingly acceptable to investors in this current environment, the one area that is not well understood or paid attention to is the leverage level of the underlying franchisees. Disclosure of financial information on underlying franchisees in securitization deals does not exist and obtaining outside information on the hundreds of individual franchisees is very limited at best. While crucial to forming a fuller picture of the franchisor, the financial health of the underlying franchisee seems to be an afterthought for the market. Even rating agencies, in their stress analysis take the view that franchisees can take multiple consecutive years of 10% sales decline without considering that such sales decline may cause that unit to shut down. That is to say, they don't consider the impact of leverage on the franchisee. As can be seen from the 1990s, many didn't adequately consider the leverage picture of the franchisees and underestimating the impact of leverage proved perilous for investors. In today's whole business market, it appears franchisee leverage is once again not a part of an investor's lexicon or at the very least, it is not as important as perhaps it should be. With franchisors already operating with high leverage, any underlying leverage trouble at the franchisee level could leave these deals more vulnerable than what many are anticipating.

Conclusion

Today the franchise loan securitization market only exists as a notation in history. The rise and fall of the franchise loan market resembled what had been seen before. A sector that rose quickly in an environment that saw overly optimistic valuations provided by third party models; models that offered speedy decisions to lenders despite inherent valuation flaws that underestimated the levels of capital expenditures required by individual franchisees and that failed to account for any significant sales declines. It was also an environment that saw lenders eager to lend to a concept – enterprise loans – that perhaps they overestimated in its ability to hold value. And of course, it was an environment that was enabled by the securitization market, providing lenders and franchisees with a way to expand their businesses. Naturally, with financing easy to obtain, franchisees took the opportunity to expand as quickly as they could, fueling their growth with debt. Small operators, who would normally take years to grow as they reinvested profits into the business to expand, suddenly found themselves with the ability to grow in multiples in a single transaction. Not only did they have the ability to grow, they had many lenders competing with each other to finance their growth. Lenders were lax in their oversight as they were more interested in capturing as much market share as possible. In the end, the fundamentals and profitability of a business still mattered and when losses mounted, all the factors that enabled quick expansion were exposed as being flawed. Perhaps this statement from Mr. Knyal, founder of FMAC, best summarizes the mindset of many participants in the franchise loan market at that time and how the market got so out of place: “I've gone from being broke to being rich.” Indeed, and while others were furiously chasing that same goal, there was little thought in the risk of excess leverage.

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