SMALL BUSINESS
BIG RISKS

SBA franchise loan failures in California

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EXECUTIVE SUMMARY

Three in ten Small Business Administration loans to California franchisees in recent years have failed, according to a new analysis by the Service Employees International Union. The study also finds that more than 40 percent of franchise systems that have been significant users of SBA loans in California in the most recent five-year period analyzed have failure rates above 20 percent.

This report follows up on SEIU's analysis of national trends in SBA franchise lending, released in May 2015, which found a high and rising risk of loan failure for franchised businesses that borrow through the SBA's 7(a) Loan Program, the agency's largest loan program.[1] This report analyzes records for 7,165 loans to franchisees in California over a 20-year period, 1991 to 2010, representing a subset of the more than 60,000 SBA franchisee loan records analyzed in the national report.

> "...IN CALIFORNIA THE FAILURE RATE IN RECENT YEARS FOR FRANCHISE LOANS HAS INCREASED MUCH MORE RAPIDLY THAN THE NATIONAL RATE."

The California and national failure rates for the 20-year period are similar, about one in six, and both California and national failure rates are highest in the most recent period analyzed. However, in California the failure rate in recent years for franchise loans has increased much more rapidly than the national rate.

The failure rate for loans to California franchisees made between 2006 and 2010 increased to 29.5 percent, more than double the 12.3 percent failure rate of loans originated between 2001 and 2005. In comparison, the national failure rate increased from 17.4 percent to 19.3 percent over the same period. The analysis also reveals that the percentage of systems with high failure rates — defined as above 20 percent — in California has increased to 42 percent in recent years among franchise systems that are significant users of SBA financing. This is more than double earlier periods' shares of systems with high failure rates.

The analysis in this report is based on loan failure rates, which is the percentage of the loans charged off by the SBA after a borrower defaults on a loan and the lender liquidates all of the borrowers' collateral, which can include their home or other personal assets.[2] Loans that are charged off represent a financial disaster for the borrower, who may have lost both business and personal assets, and a loss for taxpayers, since the SBA has to write off the uncollected value of the loan.[3]

BACKGROUND

This analysis of SBA loans to California franchisees builds on SEIU's national report, ***Risky Business: Franchisees' High and Rising Risk of SBA Loan Failure***, and adds to the growing body of work by researchers,[4] government agencies[5] and journalists[6] that reveals the financial risks and problems facing franchised business owners.

This report analyzes the records of 7,165 loans made to California franchisees over a 20-year period: 1991 to 2010. It 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.[7]

THE SBA 7(A) PROGRAM

This report analyzes data from the SBA's largest lending vehicle, the 7(a) program, which guarantees loans to prospective and current business owners who otherwise could not qualify for credit.[8] Private lenders originate and service the loans, which can be used to start or expand a business, buy equipment or real estate, or construct or renovate a building, among other purposes.[9] The SBA guarantees that, depending on the size of the loan, it will pay lenders up to 85 percent of the loan amount if the borrower does not pay in full.[10]

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.[11] 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.[12] 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.[13]

Defaulted loans that are not included in the failure rate 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. By contrast failed or charged off loans 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.[14]

FRANCHISING IN CALIFORNIA

California is the birthplace of the pioneer franchise system, McDonald's. In 1948, the McDonald brothers, Dick and Mack, developed a fast and efficient restaurant system for their San Bernardino drive-in based on a limited menu and self-service. They began franchising their "Speedee Service System," ultimately partnering with milkshake equipment salesman Ray Kroc, who would take the franchised fast food concept national and ultimately global.[15] They also inspired a host of imitators in their home state so that by 1954 "the California market had become the cradle of a fledgling fast- food business."[16] The SBA underwrote the rapid growth of franchised fast food chains: McDonald's, Dairy Queen, A&W and Baskin-Robbins, along with franchisors in other industries, such as AAMCO Transmission and Radio Shack, were among the top users of SBA loans, according to 1981 congressional testimony by the Government Accountability Office.[17]

California is second only to Texas as the largest market for SBA 7(a) franchise loans. Of the more than 60,000 loans to franchised businesses in the U.S. from 1991 to 2010, 11.1 percent of loans went to California franchisees.

While the California franchise market is large, most California franchisees are truly small-business people: About 66 percent of franchisees in the state own only one unit/store of their franchise, according to a recent survey.[18] That poll also indicated that many of California's franchisees are struggling to get by and face significant risks of losing their personal assets if their businesses fail. The survey revealed that:

- Seventy-one percent of California franchisees surveyed operate at a loss or are just breaking even. Moreover, 79 percent of franchisees polled reported a personal salary or draw of less than $50,000 in the last year.[19]

- Of the 74 percent of California respondents who borrowed to finance their franchised business, one third used SBA-guaranteed loans.[20]

- About 49 percent of California franchisees who financed their franchise pledged their primary home as collateral, while 18 percent pledged their 401K savings, and 11 percent used other retirement savings.[21]

FINDINGS

ONE IN SIX SBA FRANCHISE LOANS FAIL

The SBA 7(a) program guaranteed 7,165 loans made to California franchisees between 1991 and 2010. As of October 2014, the SBA had charged off 1,183 loans, resulting in a failure rate of 16.5 percent, or about one in six loans. The California failure rate for franchise loans is on par with the national failure rate of 16.9 percent for loans that originated in the same period.

TABLE 1 . Summary of all SBA franchise loans originated 1991 to 2010.

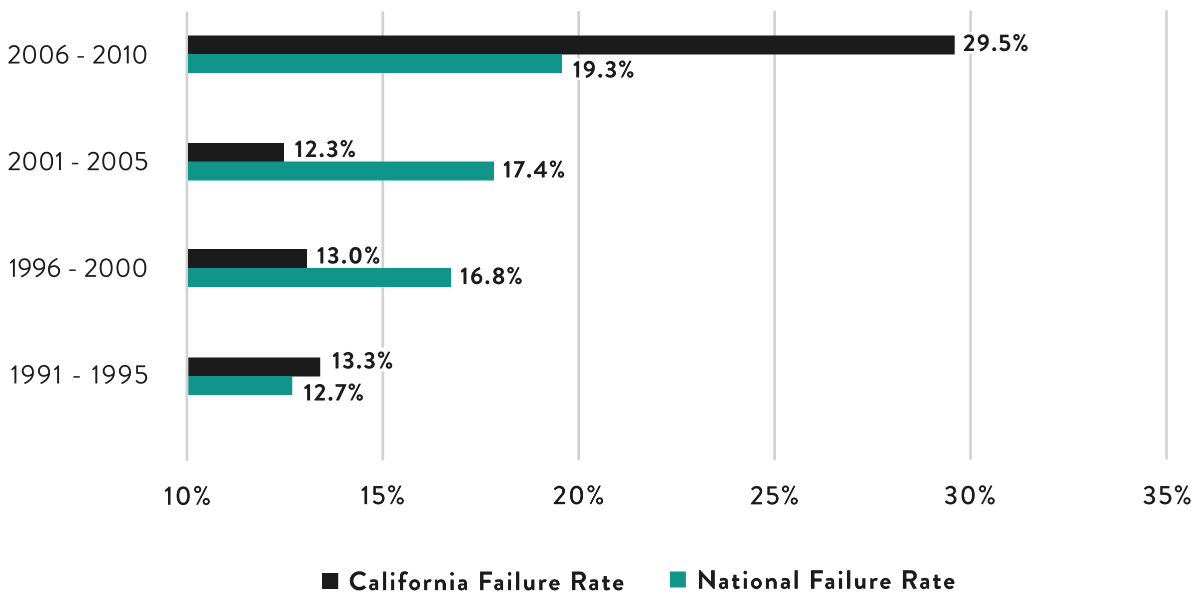
	California	National
Total number of loans	7,165	64,191
Charged off loans	1,183	10,879
Failure rate	16.5%	**16.9%**

THREE IN TEN CALIFORNIA LOANS HAVE FAILED IN RECENT YEARS

In the 20-year period from 1991 to 2010, the failure rate has more than doubled in recent years to three failures for every 10 loans made. To reduce the effect of annual fluctuations, 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 loans made in each period. In the most recent period, 2006 to 2010, the failure rate reached 29.5 percent, or three in 10 loans. In 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. In contrast to this recent surge, from 1991 to 2005, the failure rate remained relatively flat, fluctuating between 12.3 percent and 13.3 percent.

The recent explosion in the failure rate is particularly troubling because, before 2006, the California SBA franchise loan failure rate had been lower than the national rate. As Figure 1 shows, the surge in the California failure rate from 2006 to 2010 means that the 29.5 percent risk of SBA loan failure for California franchisees during that period is over one and one half times the overall national 19.3 percent SBA franchise loan failure rate.

FIGURE 1. Failure rate for all franchise loans, fiscal years 1991 to 2010.



THE NUMBER OF FRANCHISE SYSTEMS WITH HIGH FAILURE RATES IN CALIFORNIA IS INCREASING

Another way to examine failure rates over time is to analyze the number of franchise systems with high SBA loan failure rates. In the most recent period analyzed, over 40 percent of franchise systems that are significant users of SBA loans had California franchisee failure rates above 20 percent.

In order to analyze the number of systems with high SBA failure rates in California, we reviewed franchise systems whose franchisees had least 20 loans between 1991 and 2010 and at least one loan in each five-year period. A total of 59 franchise systems and 3,051 loans met these criteria, which account for 42.6 percent of all franchise loans and 49.1 percent of the value of the loans made to California franchisees over the 20-year period.

As Table 2 shows, the number of systems with failure rates over 20 percent in California has been increasing since the 1996 to 2000 period when 16.9 percent of systems had such high failure rates. In the latest five-year period, 42 percent of the 59 franchise systems that used SBA loans significantly over the last 20 years had failure rates of over 20 percent.

Franchisor success and name recognition do not necessarily protect California franchisees from loan failure, as Table 3, which lists franchise systems with SBA franchise loan failure rates over 20 percent, illustrates. For example, loans to California franchisees of leading pizza chain Domino's have failed more than 20 percent of the time in the last 20 years, as have loans to franchisees of other well-known franchise systems, including AAMCO Transmissions and frozen yogurt chain TCBY.

TABLE 2. Percentage of franchise systems with SBA loan failure rates over 20 percent for California franchisees, by period, 1991 to 2010.

Five-year period	Percentage of systems
1991 - 1995	**25.4%**
1996 - 2000	**16.9%**
2001 - 2005	**18.6%**
2006 - 2010	**42.4%**

Note: *The table draws on the 59 systems that had at least 20 loans between 1991 and 2010 and at least one loan in each of the four five-year periods.*

TABLE 3. Franchise systems with California SBA loan failure rates over 20 percent, by number of loans originated, 1991 to 2010.

Franchise system	Number of loans	Number of loan failures	Failure rate
AAMCO Transmissions	54	13	**24.1%**
Blimpie	46	15	**32.6%**
Submarina Sandwiches	46	11	**23.9%**
All Tune and Lube	41	21	**51.2%**
Econo Lube N' Tune	41	9	**22.0%**
Matco Tools	39	12	**30.8%**
Domino's Pizza	37	8	**21.6%**
AlphaGrafics	36	11	**30.6%**
AIM Mail Center	29	7	**24.1%**
Kelly's Coffee & Fudge Factory	28	8	**28.6%**
Rocky Mountain Chocolate Factory	28	6	**21.4%**
Sizzler	27	9	**33.3%**
TCBY	24	5	**20.8%**
Precision Tune	22	5	**22.7%**
Gold's Gym	21	6	**28.6%**
Jimboy's Tacos	20	6	**30.0%**

Note: *The table draws from the 59 systems that had at least 20 loans between 1991 and 2010 and at least one loan in each of the four five-year periods.*

CONCLUSION

The SBA is a key source of financing that has enabled thousands of individuals to achieve their dreams of business ownership. However, for almost one-third of California franchisees who took out SBA loans in the most recent period, that dream became the nightmare of loan failure. Almost 30 percent of SBA guaranteed loans to California franchisees from 2006 to 2010 failed, which is more than double the failure rate of prior periods analyzed. It is also one and a half times the 19.3 percent national SBA franchise loan failure rate for the most recent period.

The risk to franchisees is highlighted by the large and rising proportion of franchise systems with high failure rates.

These are not a few “bad apples”: Over 40 percent of the franchise systems whose California franchisees have been significant SBA borrowers have failure rates over 20 percent in the most recent period.

Owning a franchise in the Golden State can often be a risky proposition for franchisees. Franchise legislation currently before the California General Assembly would reform current law governing the franchisee-franchisor relationship and add protections and rights for franchisee small business owners. As this report demonstrates, franchisees often put their savings and personal assets at risk. We believe the legislation would enhance the stability of the franchise business sector in California. ■

METHODOLOGY

This analysis is based on a dataset covering all SBA 7(a) loans made to California borrowers 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 borrower’s names and addresses, lending banks, loan amounts, loan status, 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.[22]

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.[23] The franchise system name identification process increased the franchise loan sample from 54,759 to 64,191 for the national sample, and from 5,963 to 7,165 for the California sample.

ENDNOTES

1 United States Small Business Administration. Loan Program Performance, Table 2 - Gross Approval Amount by Program. March 31, 2015. https://www.sba.gov/sites/default/files/files/WDS_Table2_GrossApproval_Report.pdf

2 United States Small Business Administration, “SBA Charge Off Procedures Summary and Suggested Wrap-Up Report.” https://www.sba.gov/sites/default/files/forms/bank_wrapup_report.pdf
See also: SBA, “Helpful Hints for Navigating the National Guaranty Purchase Center, Liquidation Expectation and Standards, p. 2. https://www.sba.gov/sites/default/files/files/Helpful_Hints_Guide_20120504.pdf

3 SBA’s 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 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/files/Helpful_Hints_Guide_20120504.pdf

4 See, e.g., FranchiseGrade.com, National Survey of Franchisees 2015 – Results for California. http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015-California.pdf and FranchiseGrade.com, National Survey of Franchisees 2015. http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015.pdf

5 See, e.g. 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. http://www.gao.gov/assets/660/657723.pdf and United States Small Business Administration, Office of Inspector General. “The SBA’s Portfolio Risk Management Program Can be Strengthened.” July 2, 2013. https://www.sba.gov/sites/default/files/oig/Audit%20Evaluation%20Report%2013-17%20The%20SBA's%20Portfolio%20Risk%20Management%20Program%20Can%20Be%20Strengthened.pdf

6 See, e.g., Kate Taylor, “Does the Franchise Industry Have a Turnover Problem?” Entrepreneur, October 17, 2014. http://www.entrepreneur.com/article/238653 and Erik Sherman, “Here’s The New Bad News About Franchises,” October 15, 2014. http://www.inc.com/erik-sherman/here-s-the-new-bad-news-about-franchises.html

7 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. Our analysis shows that the average age for loans at their time of charge off was 4.8 years. United States Small Business Administration, Office of Inspector General. “The SBA’s Portfolio Risk Management Program Can be strengthened.” July 2, 2013. p. 13. https://www.sba.gov/sites/default/files/oig/Audit%20Evaluation%20Report%2013-17%20The%20SBA's%20Portfolio%20Risk%20Management%20Program%20Can%20Be%20Strengthened.pdf

8 According to bank regulator the Office of the Comptroller of the Currency, the SBA’s loan guarantee “offsets some of the risk lenders face when lending to borrowers who may not meet conventional underwriting terms. The SBA guarantees loans to borrowers who otherwise could not qualify for credit.” Office of the Comptroller of Currency. SBA 7(a) Guaranteed Loan Program Fact Sheet. December 2013. http://web.archive.org/web/20150317150601/http://occ.gov/top ics/community-affairs/publications/fact-sheets/-fact-sheet-sba-7a-guaranteed-loan.pdf. Conventional underwriting standards for small business loans include “Overall creditworthiness of the borrower”; in addition, “Many small business borrowers also rely on their personal wealth and resources to support loan requests.” See: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, “Underwriting Standards For Small Business Loans Originated Under The Small Business Lending Fund Program,” December 2010, pp. 2-3. http://www.federalreserve.gov/boarddocs/srletters/2010/sr1017a1.pdf

9 United States Small Business Administration. “Use of 7(a) Loan Proceeds.” https://www.sba.gov/content/use-7a-loan-proceeds

10 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

11 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, “Time 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.”

12 United States Small Business Administration, “SBA Charge Off Procedures Summary and Suggested Wrap-Up Report.” p. 1. https://www.sba.gov/sites/default/files/forms/bank_wrapup_report.pdf

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

14 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/files/Helpful_Hints_Guide_20120504.pdf

15 John Love, McDonald’s: Behind the Arches” (revised edition) New York, Bantam, 1995, pp. 9-25; pp. 39-44.

16 John Love, McDonald’s: Behind the Arches” (revised edition) New York, Bantam, 1995, p. 25.

17 Henry Eschwege, GAO, testimony before the House Subcommittee on Commerce, Consumer and Monetary Affairs, Committee on Government Operations, May 19, 1981. p. 14. http://www.gao.gov/assets/100/99769.pdf

18 The survey was conducted by FranchiseGrade.com, a leading market research and analysis firm for the franchising industry and commissioned by Change to Win, a labor federation that includes SEIU. See: FranchiseGrade.com. “National Survey of Franchisees, Results for California 2015.” May 2015. Accessed May 2015. p. 6. http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015-California.pdf

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20 FranchiseGrade.com. “National Survey of Franchisees, Results for California 2015.” May 2015. Accessed May 2015. p. 15. http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015-California.pdf

21 FranchiseGrade.com. “National Survey of Franchisees, Results for California 2015.” May 2015. Accessed May 2015. p. 16. http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015-California.pdf

22 In its 2013 evaluation of the franchise loans, the OIG excluded loans that originated after May 2009 in order to avoid counting unseasoned loans. Our analysis shows that the average age for loans at thier time of charge off was 4.8 years. United States Small Business Administration, Office of Inspector General. “The SBA’s Portfolio Risk Management Program Can be strengthened.” July 2, 2013. p. 13. https://www.sba.gov/sites/default/files/oig/Audit%20Evaluation%20Report%2013-17%20The%20SBA's%20Portfolio%20Risk%20Management%20Program%20Can%20Be%20Strengthened.pdf

23 United States Small Business Administration, Office of Inspector General. “Banco Popular did not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans.” Report Number: 11-16. July 13, 2011. p. 6-7. http://www.sba.gov/sites/default/files/Audit%20Report%2011-16_0.pdf