Small Business Lending Matrix and Analysis

The Impact of the Credit Crisis on the Franchise Sector

Prepared for the
International Franchise Association Educational Foundation

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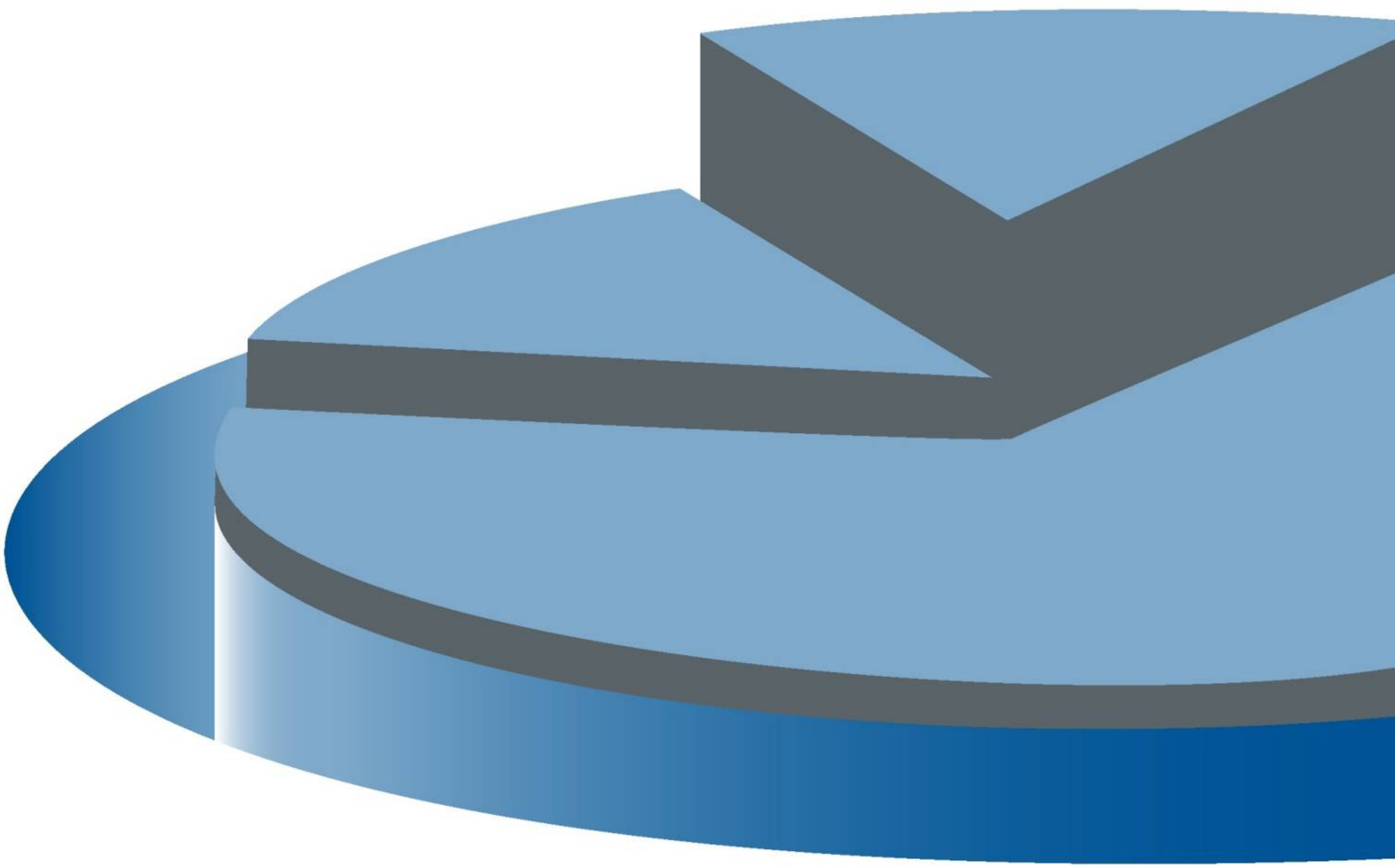

FRANdata

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Source Material

Information for this report is based on SBA data, the Franchise Business Economic Outlook for 2013, and additional third-party data such as government agencies. Additional information in this report was compiled from FDDs received and registered by state franchise examiners. Franchisors are required under state and federal laws to produce and deliver FDDs to prospective franchisees. As part of this disclosure process, certain state regulatory agencies require complete and updated FDDs to be filed and approved before a franchisor is permitted to sell franchising rights within their jurisdictions. These documents must be accurate by law.

More information concerning FDD disclosure guidelines is available at the North American Securities Administration Association (NASAA) website:

http://www.nasaa.org/Industry___Regulatory_Resources/Corporation_Finance/588.cfm

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FRANdata may be contacted at:

FRANdata
4300 Wilson Blvd, Suite 480
Arlington, VA 22203
703.740.4700

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EXECUTIVE SUMMARY

The franchise business climate is improving for the fourth consecutive year, supported by a higher demand for unit transactions, improved franchisor capacity for growth, greater bank willingness and ability to lend, and an economy that is slowly improving.

Demand from both new prospects and existing franchisees is expected to increase moderately in 2013. FRANdata projects a demand for more than 65,600 unit transactions this year, including new, transfer, and refranchised units. Collectively, this represents an adjusted 5.7 percent increase in demand over 2012 and an adjusted 16.9 percent increase over 2011. If achieved, these transactions will create more than 883,600 jobs for the U.S. economy. For more details about how the figures were adjusted for volume 5 of the Small Business Lending Matrix and Analysis, please refer to the introduction.

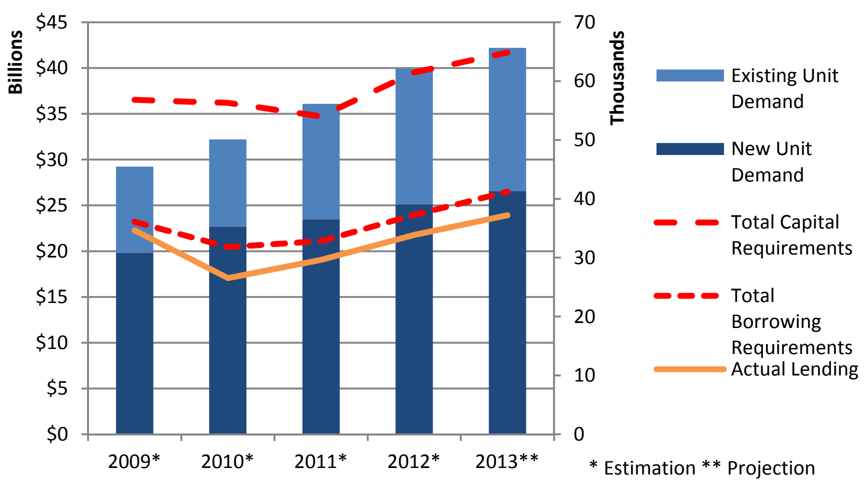
Multiple factors contribute to the increasing demand, including improved willingness and ability to invest. In addition, existing franchisor staff and resources will not limit investment or expansion ability in 2013, as was the case during the past couple years.

To satisfy demand completely, franchising will require $26.5 billion in lending. If capital is supplied at this level, the franchise businesses will generate or maintain a total of $117.4 billion in economic output and create 883,600 direct and indirect jobs.

Obtaining needed financing depends on bank willingness and ability to lend. Both factors are projected to improve in 2013 and the banks' willingness will be at its highest level since the recession. Nevertheless, banks will not fully meet franchise borrowing demand. FRANdata projects that of the $26.5 billion needed, banks will only make $23.9 billion available. This means a 9.7 percent shortfall in the supply of capital, which will result in 6,400 unit transactions not being financed.

A shortfall in lending has limited franchise growth since the start of the recession. The lending gap is slightly larger this year, up 62.1 basis points from the adjusted 9.1 percent shortfall in 2012 and the adjusted 9.7 percent in 2011. This is not to say that the financial institutions are less willing to lend. It is merely a reflection of franchise transaction demand outpacing the increase in funds being made available. In other words, financial institutions are not keeping up with the lending capital demanded by franchises. This year's gap between demand and the supply of capital will result in fewer unit transactions, more than 85,900 jobs not created and $11.4 billion in economic output lost.

Figure 1. Revised Small Business Lending Capital Needs



The Small Business Lending Matrix and Analysis, Volume 5 describes the reasons behind an increasing demand that is outpacing the supply of lending capital in detail by presenting and analyzing the following:

- Factors contributing to increased demand for unit transactions;
- Estimated capital requirements;
- Factors contributing to the lending shortfall; and
- The economic impact caused by the insufficient lending.
- Additionally, the analysis revisits estimates and projections made in previous volumes. The report provides a base lending scenario as well as scenarios that are more conservative or aggressive.

OVERVIEW

FRANdata projects that the franchise climate will improve again in 2013, in line with the positive trends since 2010. The main factors that shaped the franchise business environment in 2012 will to continue to take effect in 2013, including:

- Higher demand for franchise transactions
- Unconstrained franchisor capacity for growth
- Increased lending ability by banks to franchisees
- Increased willingness for both SBA and conventional lenders to finance franchisees
- Moderate pace of economic recovery through 2013

In 2013, franchise activity is projected to improve as a result of the continuous albeit slowly improving economy. However, capital access will remain a challenge. Despite the fact that lender willingness to provide financing is at the highest since the recession, FRANdata projects that banks will still not meet prospective and existing franchisees' borrowing requirements. Franchises will require $26.5 billion in new lending capital to fulfill 100 percent of the forecasted demand for new and existing units in 2013. However, banks are only projected to make $23.9 billion available, resulting in a shortfall of $2.6 billion.

With access to $23.9 billion in lending, close to 59,300 unit transactions will be financed. These new and existing units will create or maintain 797,700 jobs and generate $106 billion of annual economic output.

The adjusted gap in lending has been shrinking continuously, falling from an estimated 9.7 percent in 2011 to 9.1 percent in 2012. As both the demand for franchise unit transactions and the willingness to lend are trending upwards, FRANdata projects a faster growth in demand than in increased lending. In other words, the increase in demand will outgrow the rise in lending willingness, leading to a slightly larger gap of 9.7 percent in 2013 compared to 2012. As a result, the $2.6 billion shortfall will result in 6,400 transactions not financed in addition to more than 85,900 jobs not created or protected, and a loss of $11.4 billion in annual economic output that could otherwise take place in 2013.

The Small Business Lending Matrix and Analysis, Volume 5, provides a framework to estimate how the lending environment will impact the demand and supply of capital needed to finance franchise transactions, for both new and existing units. The report examines the main factors noted above and their inter-relationships.

The connection between sufficient capital for franchise transactions and its effect on job creation and sustained economic recovery is a critical one. Franchising as a business model has shown extraordinary resilience to economic downturns and has revived quickly even when the overall economy is still on its rocky recovery. In past recessionary and post-recessionary periods, franchise units have grown by 6 percent (between 1999 and 2006) and 5 percent (during the 1999 – 2002 Tech Bubble). Because franchising represents an opportunity for entrepreneurs to change careers or expand their business, it has helped spur the pace of economic growth and the recovery from the recession.

The potential pool of investors willing to start franchising has been sustained at high levels since the recession, partially due to the high unemployment rate. During the recession, however, banks have been left with limited funds after accounting for declines in their home mortgage loans. As a result, entrepreneurs' access to capital has been limited, constraining franchise growth and slowing the recovery. Therefore, lending has a direct effect on franchises, small businesses, job creation, economic output, and consequently, on the overall recovery.

Increased Demand for Franchises
FRANdata projects that the demand for franchise transactions will increase to 65,600 in 2013, a 5.7 percent increase from the adjusted demand of 62,100 transactions in 2012 and a 16.9 percent increase from 2011 adjusted estimate of 56,100.

With the overall economy improving, the demand for new unit transactions has started to surpass that for existing units. In 2013, demand for new units is projected to increase by 6 percent to 41,400 while that for existing ones will increase by 5 percent to 24,200. These transactions will require a total capital of nearly $41.7 billion, a 5.5 percent increase from the adjusted capital requirement in 2012. Of the total required capital in 2013, only $26.5 billion will need to be borrowed to sustain the full demand for transactions, representing an increase of 10.6 percent from the adjusted $24 billion needed in 2012.

Unconstrained Franchisor Capacity for Growth
Similar to 2012, franchisor capacity, including staff and resources to support franchisee recruitment efforts, will not be a restraining factor in 2013. During the recession, franchisors' capacity to grow was limited. The improving economic and business climate over the past couple years has helped franchisors to reinvest in their franchise development capabilities and strengthened their capacity to grow.

Lending Environment — Ability and Willingness
As they did in the previous three years, banks will continue to have sufficient funds available to meet the demand for franchise unit transactions in 2013. FRANdata projects that bank willingness to lend will improve for both SBA and conventional lenders. However, they will still not make sufficient funds available to meet overall lending demand. Economic growth, improvements in delinquency rates, more upbeat employment data, and positive trends in the commercial property market are projected to ease banks' lending standards and terms somewhat in 2013. FRANdata projects that banks' willingness to provide conventional loans will increase by 16.1 percent and by 20 percent for SBA-guaranteed loans. However, because of the sequestration and the reduced budget for SBA-guaranteed loans, SBA lenders' ability to provide capital will be reduced. As a result, the net willingness for SBA-guaranteed lending is projected to decline by 6.7 percent to reflect the total loan amount that SBA lenders are able to issue.

In fiscal year 2011, the SBA announced $30.5 billion in lending supporting over 60,000 small businesses, an all-time lending record in its 60-year history. The boost was driven by a combination of government-enforced provisions, such as the Recovery Act, the Small Business Jobs Act, raising the guarantee on SBA loans to 90 percent while eliminating or reducing fees, and the 2.5 times increase in the cap for SBA-guaranteed loans. With the slow recovery, despite the goal to boost private sector lending, the agency reduced its budget by 3.8 percent in fiscal year 2013. This will effectively reduce the total guaranteed lending by 8 percent from the 2012 level. The sequestration is likely to further reduce the budget for the SBA, lowering the guaranteed amount by another $902 million to just over $21 billion.

Even with the improved willingness, bank lending will not be adequate to meet all borrowing requirements to sustain franchise transactions. Financial institutions are still cautious about small business lending and are prepared to tighten their underwriting standards at any signs of economic distress. Evidently in the fourth quarter of 2012, 89.2 percent of senior loan officers reported that their lending standards remained unchanged while 1.5 percent reported somewhat tightened credit standards for small firms. At the same time, the net fraction of banks reporting increased capital demand from small firms rose to its highest level since 2005.

FRANdata estimates that between 20 and 25 percent of the SBA-guaranteed loans are provided to new and existing franchisees. Based on factors such as the overall economic growth, the decreased ability in SBA lending, and an improved willingness among conventional lenders, FRANdata projects that SBA-guaranteed lending will constitute a smaller portion of the overall financing to franchisees in 2013, down from the estimated 40 percent in 2012 to 24 percent.

Based on our assessment of SBA lending activities, business and economic trends, and the lending environment as a whole, FRANdata projects that lenders will have a pool of more than $34.8 billion available to finance franchise unit transactions in 2013. This represents a 13.4 percent increase from the adjusted $30.7 billion FRANdata estimated for 2012, reflecting economic growth and strengthened banks' balance sheets. At the same time, however, banks will only be willing to provide a total of $23.9 billion in lending to new and existing franchisees. Even though this represents a nearly 10 percent increase from the adjusted lending volume banks were willing to provide in 2012, it is still not sufficient to meet the borrowing needs of all transactions projected for 2013.

Competition for financing will remain tight in 2013, as lenders stay risk averse and credit standards have not changed significantly since 2009. Although the banks' willingness to lend has improved, this mostly applies to a certain group of borrowers. In other words, a large majority of lenders is competing for the same group of operators who are low risk and have a proven business record. Outside of the defined box, not much improvement can be observed. As a result, applicants who merely qualify will not be sufficient in the banks' view. Instead, lenders will assess creditworthiness by evaluating unit economics, system performance, and franchisor performance. Since 2008, entrepreneurs' access to capital has been limited, constraining franchise growth and slowing down the U.S. economic recovery.

Effect of Lending Shortfall in 2013

In 2013, FRANdata projects that banks will lend $5.6 billion through SBA-guaranteed loans and $18.3 billion through conventional loans, a total of $23.9 billion, to new and prospective franchisees. The difference between what is required to fund 100 percent of the demand and the capital that banks are willing to make available represents a shortfall of $2.6 billion, or 9.7 percent. This shortfall in lending will result in 6,400 transactions not being financed.

Figure 1. Effect of Lending Shortfall 2013

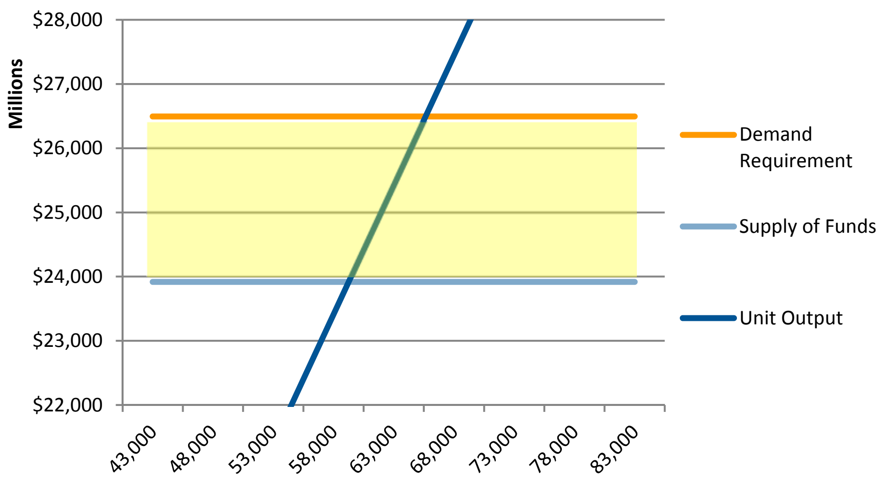


Figure 1 presents the effect of the projected lending shortfall on the number of transactions. The yellow area defines the shortfall in lending due to the difference between bank willingness to lend, presented by the Supply of Funds, and franchise borrowing requirements, presented by the Demand Requirement.

New Units

FRANdata projects that in 2013, the 41,400 possible new unit transactions would create 858,500 direct and indirect jobs and add $114.1 billion in annual economic output. This also means that the shortfall in lending will cost the economy 4,000 new units, 83,500 jobs not created, and $11.1 billion less in annual economic output.

Table 1. Base Scenario, Effect of Lending Shortfall on New Units

Base Scenario (New)	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing
Maximum Level	41,401	858,467	$114,086,804,423
Effect of Shortfall	(4,025)	(83,466)	($11,092,348,716)
Projected Actual	37,376	775,001	$102,994,455,707

Existing Units

The lending shortfall has a similar but more muted effect on transactions of existing units, which include both transfer and refranchised units. FRANdata assumes that if a unit that needs to transfer or refranchise is unable to get funding, 95 percent of the time it will continue to operate for the following year. As a result, 5 percent of the existing units would be unsustainable. This means that a demand for 24,200 existing units would maintain 25,100 direct and indirect jobs and $3.3 billion in annual economic output. However, due to the shortfall in lending, FRANdata projects 2,400 existing unit will close. Consequently, 2,400 jobs and $324.8 million in economic output will not be protected.

Table 2. Base Scenario, Effect of Lending Shortfall on Existing Units

Base Scenario (Existing)	Existing Units Transaction	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing*
Maximum Level	24,244	25,136	$3,340,475,294
Effect of Shortfall	(2,357)	(2,444)	($324,785,299)
Projected Actual	21,887	22,692	$3,015,689,995

*The number of jobs maintained was calculated by taking the 24,244 demanded transactions for existing units and multiplying them by the estimated 21 (direct and indirect) jobs. The product is multiplied by 5 percent to calculate the number of jobs not protected by the units that will close without financing. The same methodology was applied to estimate the economic output.

Total Transactions – New and Existing Units

In 2013, the 65,600 total unit transactions seeking capital could create or maintain 883,600 total direct and indirect jobs and create or maintain $117.4 billion in total direct and indirect economic output. However, due to banks' unwillingness to lend, 6,400 unit transactions will not take place. As a result, 85,900 direct and indirect jobs will not be created or maintained and more than $11.4 billion in economic output will be lost.

Table 3. Base Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Base Scenario (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing
Maximum Level	65,645	883,603	$117,427,279,717
Effect of Shortfall	(6,383)	(85,910)	($11,417,134,015)
Projected Actual	59,263	797,693	$106,010,145,702

More Aggressive Lending Scenario

The above projections are based on FRANdata's analysis of a combination of factors that would affect small business lending. In addition to the base case scenario, it is worth examining a more aggressive and a more conservative approach to lending and their effects on the economy than the one discussed above.

Under an aggressive lending scenario, banks will increase their lending to $25.6 billion (from $23.9 billion under the base scenario). This could occur if the positive signs of growth and stabilization continue at an accelerated pace throughout 2013 and SBA-guaranteed lending will not be constrained by budget reductions. More than 56,100 jobs and $7.5 billion more economic output will be maintained compared to the base approach. This represents a 7 percent increase from the base scenario in both jobs and economic output created or maintained.

Table 4. Aggressive Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Aggressive (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	883,603	$117,427,279,717	100%
Effect of Shortfall	(2,214)	(29,807)	($3,961,222,669)	3%
Projected Actual	63,431	853,796	$113,466,057,048	97%

More Conservative Lending Scenario

On the other hand, banks may take a more conservative approach to lending than projected. This could happen if banks tighten their lending again in case of global economic distress and political uncertainties. Under the conservative scenario, total available lending will be reduced to $22 billion. This shortfall will result in an additional 4,800 unit transactions over the ones under the base scenario unable to take place. Consequently, an additional 65,200 direct and indirect jobs and an additional $8.7 billion in economic output will not be created or maintained. The total number of jobs and economic output that are unable to be created or maintained will be more than 151,100 and $20.1 billion, respectively.

Table 5. Conservative Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Conservative (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	883,603	$117,427,279,717	100%
Effect of Shortfall	(11,225)	(151,091)	($20,079,324,183)	17%
Projected Actual	54,420	732,513	$97,347,955,534	83%

INTRODUCTION

This is the fifth volume of the Small Business Lending Matrix and Analysis, a report series designed to estimate how the current lending environment will impact the demand and supply of capital to franchising in the year ahead. The combined unit transactions (defined as an investment in a new unit or an existing unit) have a huge impact on the U.S. economy. Each franchised unit creates an estimated average of 21 direct and indirect jobs and generates $2.8 million in direct and indirect annual economic output. The ability to create and protect jobs is paramount as the U.S. economy slowly regains its footing. Franchising plays an important role in this process by ensuring the continued recovery after the worst recession since the 1930s.

Since 2009, FRANdata's Small Business Lending Matrix and Analyses have projected lending capital requirements for franchise systems across all industries based on the following factors:

1. Average initial investment for a unit transaction
2. The number of unit transactions, defined as both new and existing units
3. Distinction between new prospective franchisee and experienced operator, and their willingness and ability to start new units or acquire existing units
4. Banks' willingness and ability to lend
5. Bank loan terms

For the third consecutive year, the U.S. economy has enjoyed an uninterrupted recovery and falling unemployment since the end of the recession. Compared to earlier recoveries, however, this is also the weakest rebound so far. As a result of the defense spending reduction and the aftermath from Hurricane Sandy, the economy took a hit in the last quarter of 2012, remaining flat. Many economists believe this was a temporary development and that the year 2013 is well positioned for a rebound.

Following the sluggish holiday season, in January 2013, retail sales reached $417 billion, representing only two tenths of a percent increase from the previous month. However, the sales data in February came as a surprise with a 1.1 percent jump to an estimated $421.4 billion, exceeding all projections. Experts had anticipated reduced spending even further in 2013 in light of the payroll tax increases, rising gas prices, and the political turmoil in Washington.[1] The new sales data, however, show that improved job prospects are helping consumers and the economy to overcome these hurdles. Market uncertainties and the much covered sequestration may have scared consumers into keeping their wallets shut for the near future. However, the outlook in the mid- and longer- term may not be all that depressing.

The economy continued to grow throughout 2012. Personal income increased 3.5 percent in 2012 to a total of $13.9 billion in December. This growth rate is below the 5.1 percent gained in 2011. Much of this was driven by the rebound of the stock market and 2012 was a much better year for investors than 2011. The NASDAQ rose nearly 16 percent for the year, followed by S&P 500's 13.4 percent gain. Small cap stocks also did well with 14.7 percent in returns. The equity markets' overall performance was rather impressive amid uncertainties around the U.S. elections, fear over the fiscal policy, and ongoing sovereign debt problems in Europe.

At the end of 2012, the average 401(k) balance reached a record high of $77,300, up 12 percent from one year ago.[2] According to AARP, workers who are over the age of 50 did even better. The housing market has been stabilizing over the past few years and has picked up somewhat in 2012. While buyer

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[1] MasterCard Advisors. http://www.mastercardadvisors.com/spendingpulse.html

[2] Fidelity Average 401(k) Balance Climbs to Record High at the End of 2012, Fidelity, February, 2013. http://www.fidelity.com/inside-fidelity/employer-services/fidelity-analysis-finds-record-high-average-401k-balance

traffic continues to rise, seller traffic is holding steady. In January 2013, the total housing inventory declined 4.9 percent from the previous month to 1.7 million, down 25.3 percent from the same time last year. At the current sales pace, the level of housing inventory is only sufficient for four months of supply. A supply shortage of homes for sale is also putting upward pressure on prices.

The unemployment rate declined gradually in 2012 to 7.8 percent, down 50 basis points from the beginning of the year. The 7.7 percent reported in February 2013 caught most people by surprise. However, experts are skeptical as the sequestration could affect 750,000 jobs. The improved unemployment rate over the recent months may signal a better economic environment. This is consistent with other economic indicators. As consumer confidence slowly recovers, new and prospective franchisees will gradually regain their ability to take on additional franchising activities.

With the stimulus programs in place, the SBA-guaranteed loans took on a significant role in lending during the recovery. In fiscal year 2013, the agency requested $948 million in total budget. This will provide guarantees to $23.2 billion in loans. Although still strong, the total SBA-guaranteed lending is down 8 percent from the $24 billion in 2012.[3] Furthermore, the $85.4 billion federal spending cut is likely to reduce the SBA loan subsidy by $16.7 million. As a result, loan guarantees will drop by $902 million, from $22 billion to just over $21 billion.[4] However, the third round of quantitative easing is effectively increasing the monetary base. As a result of the previous two rounds of expansionary monetary policy, total domestic deposits at all insured institutions are up 22.7 percent since 2009. The Federal Reserve is prepared to continue its bond buying effort at its present pace.

Financial institutions were directly affected by the economic downturn. Since the onset of the financial crisis in 2008, a total of 478 banks have failed with a total estimated loss of $86.8 billion. The number of failed institutions skyrocketed in 2009 and 2010. Since then, the financial industry started to recover and the number of failed institutions has dropped significantly to 51 in 2012, half of what was recorded in 2011. Only three have failed in the first two months of 2013.[5] Even though some banks remain fragile, their position has improved over the previous years. In 2011, net income for the surviving institutions surpassed $100 billion for the first time since 2006. Full-year earnings continued their upward trend in 2012 to reach $141.3 billion, a 19.3 percent increase from the previous year. In the last quarter of 2012, insured institutions reduced their loan loss provisions by $4.9 billion from a year ago to $15.1 billion, representing the smallest fourth quarter provision that banks have had to set aside since 2006. In addition, business and consumer loan delinquency rates are also improving, down 40 basis points to 4.7 percent.

Small business loan approval rates also improved in January 2013 from a year ago, as both large and small banks are stepping up small business lending. The loan approval rate at large banks was up 520 basis points to 14.9 percent, while that for small banks only picked up 270 basis points to 49.8 percent. While banks are lending more in absolute terms, the ratio of total lending to the flood of deposits decreased. Between 2009 and 2012, total domestic deposits at all insured institutions grew at a 7.1 percent annual rate. Loans issued, on the other hand, only increased marginally at a 1.8 percent annual rate. The Senior Loan Officer Survey finds that the vast majority of banks left standards unchanged for loan approvals to smaller firms. A fraction of lenders also stated a somewhat tightened credit environment, which was not the case in the first half of 2012 or 2011. Nevertheless, a significant

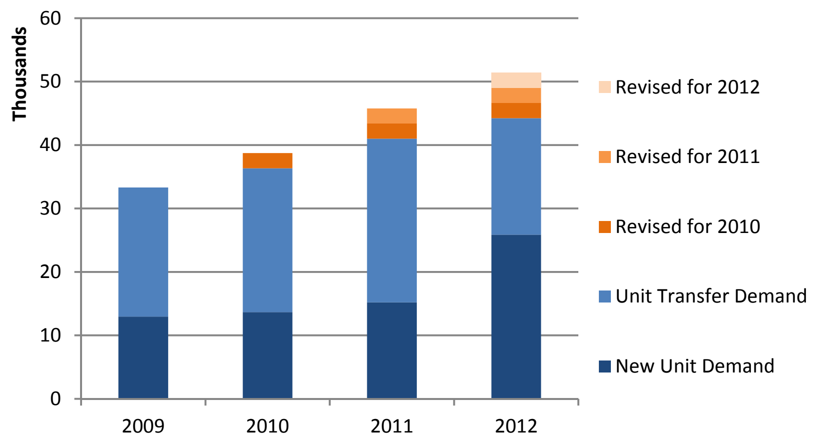
[3] FY 2013 Congressional Budget Justification and FY 2011 Annual Performance Report, U.S. Small Business Administration, March, 2013. http://www.sba.gov/sites/default/files/files/1-508%20Compliant%20FY%202013%20CBJ%20FY%202011%20APR(1).pdf
[4] U.S. Small Business Administration
[5] Failed Banks, FDIC, March, 2013. http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30

number of domestic institutions maintain an optimistic outlook for 2013, expecting reductions in delinquency and charge off rates for all types of firms and overall improvements in asset quality.[6]

The economic recovery has been choppy and world events as well as domestic policies have also created uncertainties. Taking into account major factors and external forces such as the ones discussed above, FRANdata forecasts that new and prospective franchisees' willingness and ability to invest in franchise transactions will continue to rise in 2013. Banks' willingness to lend will also see remarkable improvements from their 2012 levels. This increase in demand for unit transactions will effectively raise the demand for capital. As in the previous years, the projected supply of funds will not be adequate to support the entire demand. In fact, there will be an enlarged lending gap of 9.7 percent between the demanded funds and the capital lenders are willing to make available. This points to a demand growth being stronger than the improvement in lending.

For the 2013 projections, FRANdata used the same methodology as in its previous studies, but made adjustments to the past estimations and changed some underlying assumptions. The most significant ones include the following:

Figure 1. Effect of Revised Base Year Unit Demand



- In preparation of this year's matrix, FRANdata revisited the unit demand estimations from the previous analyses. Franchise activities have seen significant improvements since the end of the recession. Unit transactions are taking place at a faster pace than what the previous studies have estimated. For volume 5 of the lending matrix, FRANdata revised the base year unit demand for 2012 and retrospectively to account for the additional transactions. They comprised between 4.9 percent and 6.6 percent of what was previously projected. Effectively, the total number of unit demand has been revised from 36,300 to 38,700 for 2010, from 41,000 to 45,800 for 2011, and from 44,200 to 51,400 for 2012. Figure 1 presents the effect of this adjustment.

- In the previous lending matrices, unit transactions requiring less than $50,000 in initial investment were excluded from the projections. This was based on the assumption that such low investment levels are financed through non-institutional sources or need no debt to start the business. Although each loan volume is small, the total number of loan transactions is still significant. After analyzing small business loan data, we came to the conclusion that a significant number of units with low investment levels still obtained financing through institutional sources. The inclusion of unit transactions that require less than $50,000 in initial investment adds an average of 4,900 transactions each year to the unit demand. The demand estimates have been adjusted for 2012 and previous years.

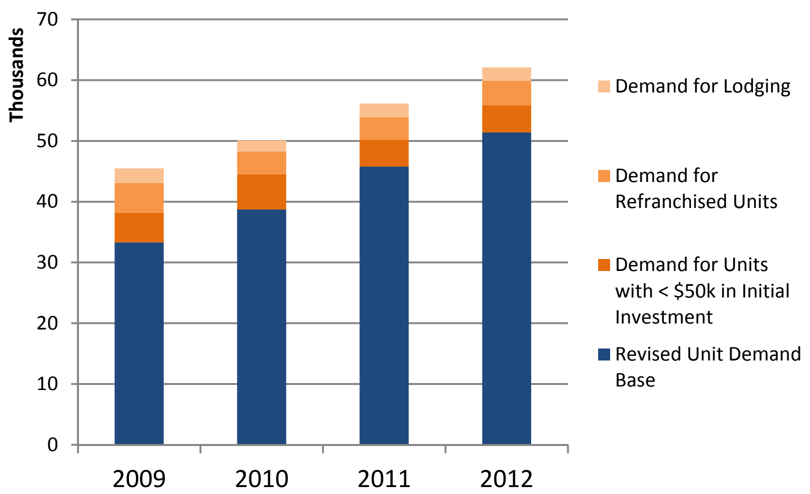
- Refranchised unit transactions, defined as franchisor company-owned units sold to franchisees, had historically not been reported under the old UFOC filing requirements. In 2007, the FTC made it a requirement to report refranchised transactions. With adequate data and dependable

[6] Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve Board, February, 2013. http://www.federalreserve.gov/boarddocs/snloansurvey/201302/fullreport.pdf

trends, FRANdata is now able to make reliable projections. Volume 5 of the lending matrix adds refranchised unit transactions to the projected transaction demand. The inclusion of refranchised transactions adds an average of 4,100 transactions each year to the unit demand, which has also been adjusted for 2012 and retrospectively. Throughout the report, existing unit is consistently used to refer to the sum of transfer and refranchised units. The two types of transactions are treated the same in terms of survival rate and initial investment requirement.

- Previously, the lodging industry was excluded from the analysis as an outlier. The underlying assumption was that it is a capital intensive industry and is financed primarily through capital market activities, which are typically unavailable to other franchise segments. While this assumption still holds, available loan information revealed that lodging unit transactions with less than $6 million in average investment still rely on conventional methods to obtain financing. Although the portion of the capital being financed is relatively small compared to other franchise industries, the sheer volume of total disbursement makes up a material part of all loans made available to franchises.

Figure 2. Effect of Changing Assumptions on Unit Demand



With the real estate market strengthening and the cost of capital at historical lows, the lodging industry is presented with an opportunity to revive and to expand. For these reasons, lodging demand is included to formulate the total demand estimation for 2012 and retrospectively. As a result, two main factors affect the lending matrix:

1. The inclusion of the lodging industry will affect the initial investment calculation, as the average will be positively skewed due to the industry's high capital requirement. To minimize the effect, FRANdata took the weighted average approach to account for the percentage of transactions that are projected to take place. The initial investment for the lodging industry and other industries is weighted by the number of transactions for each. As a result, the average investment needed for each unit transaction rises to $601,500 from the estimated $401,600 in 2012.
2. The total capital made available will also need to be adjusted to account for loans disbursed to the lodging industry and to systems that require less than $50,000 in the initial investment. FRANdata estimates that instead of the $3.8 billion SBA-guaranteed lending previously projected for 2012, a total lending of $6.1 billion is applied to account for the change in assumptions. Similarly, conventional lending is adjusted upwards from the estimated $5.7 billion to $15.7 billion to account for the changes.

Figure 2 reflects all revised assumptions discussed above. Effectively, unit demand for 2012 is adjusted to 62,100 from 51,400, an increase of 20.8 percent.

As in the previous studies, potential new owners were divided into two groups, first time owners and experienced franchisees. FRANdata examines the ability and willingness to invest in a unit transaction for each group separately.

In 2013, operators' willingness and ability to invest in franchise transactions are projected to improve further from their 2012 levels. New franchisees' ability to invest will continue to strengthen, mostly encouraged by their improved financial position, the rebound of the stock market, the reviving housing market, and a higher 401(k) balance. These factors reinforce operators' confidence while boosting their ability to take on transactions. Existing operators' ability to invest is also projected to increase, supported by the overall improving economic conditions.

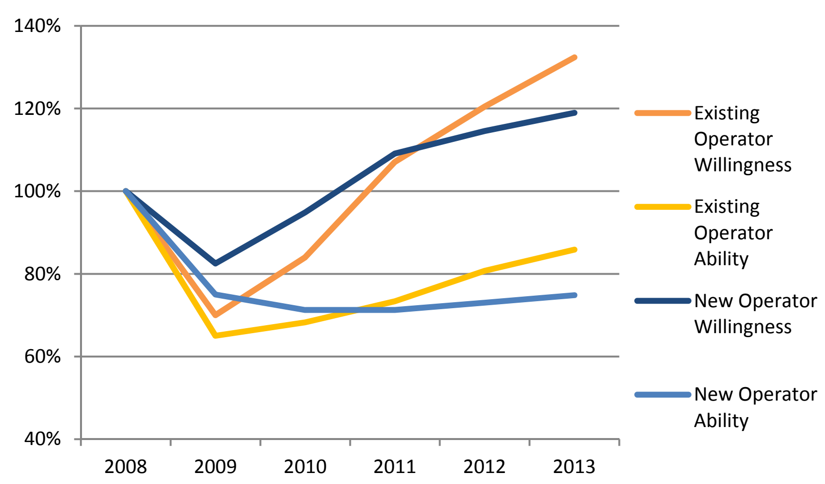
Table 1. Estimated and Projected Operator Willingness and Ability

Operator Willingness and Ability	Estimated				Projected
	2009	2010	2011	2012	2013
Existing Operator Willingness	-30%	20%	28%	13%	10%
Existing Operator Ability	-35%	5%	8%	10%	6%
New Operator Willingness	-18%	15%	15%	5%	4%
New Operator Ability	-25%	-5%	0%	3%	3%

Although improving, willingness and ability for operators alike will increase at a lower rate than in 2012. This reflects the overall slow recovery throughout the year and the fact that this year's increases are from a relatively higher base than in 2012. In 2013, FRANdata projects existing operator willingness and ability to increase by an average of 8 percent, compared to an estimated average of 11 percent in 2012. For new franchisees, FRANdata projects an average increase of 3 percent as opposed to an average of 4 percent in 2012. Table 1 presents the changes in willingness and ability since 2009.

Figure 3 provides a visual presentation on the changes in willingness and ability normalized to 100 percent for 2008. Willingness and ability for both groups of operators have grown since their initial drop in 2009. Willingness rose faster than ability as optimism improved quicker than capacity at the first signs of a growing economy. Also, existing franchisees' ability to invest fell significantly in 2009 because they incurred higher losses when the economy stalled.

Figure 3. New and Existing Operator Willingness and Ability



Based on these assumptions, FRANdata projects a total demand of 65,600 unit transactions for 2013. This represents a 5.7 percent increase from the adjusted demand in 2012 and a 16.9 percent increase from 2011.

As with the previous studies, FRANdata relied on actual data, sample data, industry knowledge, franchisor interviews, and discussions with lenders to assess lender willingness and ability. FRANdata forecasts that 5 percent of the existing units will unable to continue operations due to lack of financing. The effect is captured in the total jobs and economic output not protected.

Table 2 shows the different scenarios FRANdata projects for 2013, based on the above considerations.

- The Maximum Level presents the total demand for unit transactions, the number of jobs created or protected, and total economic output created or protected. In other words, the Maximum Level outputs are only constrained by the operators' willingness and ability to invest into a unit transaction but not by the lending environment.
- The Base Scenario presents the outcomes that FRANdata considers most likely to occur based on the current economic situation. It shows a 9.7 percent gap from the maximum possible level of outputs.

- The Aggressive Scenario could occur if the economy strengthened and banks eased their lending standards considerably from the current expectations. This would reduce the output gap from 9.7 percent to 3.4 percent.
- The Conservative Scenario could occur if the economy worsened and banks tightened their lending standards in 2013. Under these circumstances, there would be a 17.1 percent gap.

Table 2. Scenarios Comparison

Scenario	New Units	Existing Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	24,244	883,603	$117,427,279,717	100%
Based Scenario	37,376	21,887	797,693	$106,010,145,702	90%
Aggressive	40,004	23,427	853,796	$113,466,057,048	97%
Conservative	34,322	20,099	732,513	$97,347,955,534	83%

The jobs created or maintained through financing include the jobs created by opening a new unit and the jobs maintained through financing an existing unit that would have closed without sufficient funds. FRANdata estimates that 5 percent of the transactions for existing units that do not receive financing will close in 2013. FRANdata estimates 21 (indirect and direct) jobs per unit to calculate the number of jobs that would be created or maintained based on financing availability. Every new unit transaction that does not occur because of financing constraints results in 21 of these jobs not created. Conversely, only 5 percent of existing unit transactions without financing will result in 21 jobs not protected. The same methodology was applied to estimate the economic output.

The projected demand of 65,600 franchise transactions reflects a 9.6 percent compound annual growth rate (CAGR) from the adjusted 2009 level of 45,500. Over the same period, demand for capital increased at a CAGR of 3.4 percent from an adjusted $36.5 billion in 2009 to $41.7 billion in 2013. The total borrowing required will also increase at a similar CAGR of 3.4 percent from an adjusted $23.2 billion to $26.5 billion. Actual lending is projected to improve steadily at a CAGR of 1.8 percent, from an adjusted $22.3 billion to $23.9 billion.

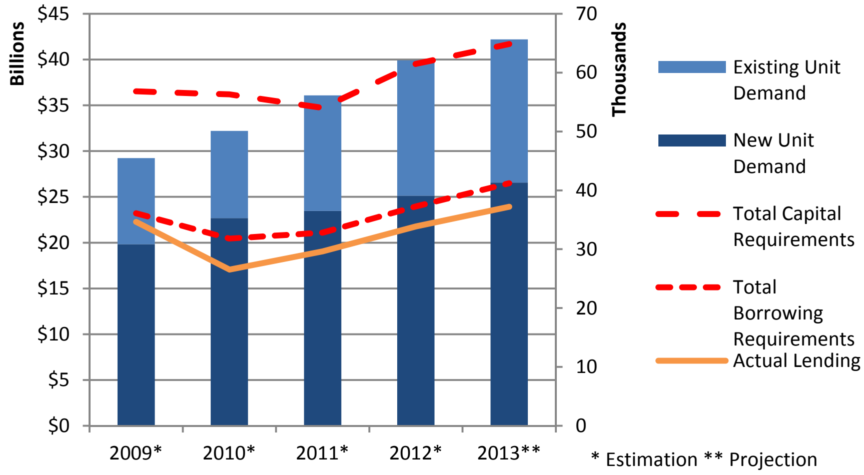
Over the examined period, the gap between the demand and supply of funds was the largest in 2010. FRANdata projects the lending gap to be slightly larger 2013, at 9.7 percent from the 9.1 percent shortfall in 2012. This is a reflection of the demand for franchise transactions outgrowing the amount of funds made available. In other words, financial institutions are not keeping up with capital demanded by franchises. Table 3 summarizes FRANdata's estimates and projections for the lending environment from 2009 to 2013.

Table 3. Small Business Lending Capital Needs 2009 - 2013

Lending Capital Needs $ in Millions	Estimated				Projected
	2009	2010	2011	2012	2013
Total Capital Requirements	$36,518	$36,194	$34,724	$39,529	$41,696
Total Borrowing Requirements	$23,213	$20,448	$21,089	$23,965	$26,494
New Unit Demand	30,850	35,291	36,499	39,094	41,331
Existing Unit Demand	14,639	14,814	19,646	22,998	24,314
Actual Lending	$22,271	$17,050	$19,044	$21,783	$23,918
Lending Gap	4.1%	16.6%	9.7%	9.1%	9.7%

Figure 4 summarizes the estimated and projected developments of the franchise lending environment from 2009 to 2013.

Figure 4. Revised Small Business Lending Capital Needs



Under FRANdata's base scenario projection for 2013, a lending gap of $2.6 billion will occur. Due to this shortfall, a total of 6,400 unit transactions will not take place, resulting in a total of 85,900 direct and indirect jobs not created or maintained and more than $11.4 billion in direct and indirect economic output not generated or maintained.

PROJECTED TRANSACTIONS FOR 2013

As in previous years, FRANdata calculated the projected demand for franchise transactions by using the prior year's estimate as a baseline. Demand projections are based on assumptions about franchisor and franchisee willingness and ability to either develop new units or invest in an existing unit, such as a transfer or a franchised unit. The main factors impacting the likelihood for a unit transaction to take place include franchisor capacity, operator willingness, and operator ability to open or purchase a unit.

Economic indicators, such as GDP growth, confidence levels, standard of living perceptions, the housing market, personal financial position, the equity market, and the unemployment rate have improved since the end of the recession. The outlook is getting better compared to twelve or six months ago, even though at a slower pace compared to a year ago.

The economy unexpectedly stalled in the final quarter of 2012 as a result of the defense spending cut and the aftermath from Hurricane Sandy. Broader economic indices point to a more optimistic outlook: real GDP is expected to reach 2 percent in annualized growth in the first quarter and will possibly exceed 2.1 percent in 2013; February's retail sales data were up 1.1 percent from the previous month, exceeding all expectations; the rally in the stock market also continued in 2013 with the S&P 500 just shy of its all-time record and the Dow breaking through the 14,198 record set in October 2007. In addition, the unemployment rate dropped to 7.7 percent in February, although some experts are skeptical as the sequestration threatens to affect 750,000 jobs.

However, many challenges and obstacles still lie ahead of a full recovery. There are concerns about the effect of the sequestration, potential tax hikes, consistently high gasoline prices, possible tightening of lending conditions, potential aggravations of the financial crisis in Europe, and healthcare legislation-related issues. These factors will continue to influence franchisors' capacity to grow, as well as investor ability and willingness to invest in unit transactions throughout 2013.

Franchisor Capacity

In light of the recession, franchisors limited their resources to develop and support franchise transactions. As the U.S. economy slowly recovered in 2010 and 2011, franchisors started to rebuild their growth capacity as they maintained and strengthened the training and development staff needed for a successful expansion. Franchisor capacity was not a constraining factor to franchise development in those years.

Despite a stalled recovery in 2012, many franchisors resumed hiring personnel in development, training, and support departments throughout the year anticipating a strengthened and expanded system. Economic uncertainty, including the financial cliff, caused executive optimism to cool down in the last quarter of 2012, according to CEO satisfaction surveys. As a result, planned hiring is expected to fall in 2013 compared to the beginning of 2012. Businesses are cutting down on capital spending owing to a less optimistic view on revenue and profit growth in the coming months.[7] Franchise leaders have a similar pessimistic view on employment plans in 2013 compared to 2012, according to the Franchise Business Leader Survey. More franchisors are planning to decrease the number of jobs than those that plan to add staff, compared to a year ago. However, franchisors remain rather optimistic about expansion in 2013, with 81.3 percent of surveyed franchisor executives intending to increase their unit counts.[8] The overall sentiments in the franchising community fare better than what the market suggests.

[7] CEO Confidence Index, Vistage, January, 2013. http://www.vistage.com/media-center/Infographic-Q412.aspx
[8] Business Leaders Give 2013 Outlook Mixed Reviews, Franchising World, January 2013. http://www.franchise.org/IFA_NEWS/Business_Leaders_Give_2013_Outlook_Mixed_Reviews/

Franchise companies are prepared to work under current conditions to drive results.[9] For this reason, FRANdata expects franchisors to continue a cautious hiring pace in 2013. Given that franchisor capacity for growth depends primarily on employing an adequate workforce rather than capital investment, FRANdata believes that, as in 2012, franchisor growth capacity will not be a limiting factor for franchise growth in 2013.

Operator Willingness and Ability

Besides franchisor capacity, the two main factors affecting the demand for unit transactions are operator ability and willingness to develop new or to acquire existing units. Operator ability is determined by their access to capital and personal financial position. However, in addition to the availability of capital, the demand for a unit transaction will be affected by the operators' willingness to invest, which is based on intangible factors, such as perception of the economy, forecasts, risk aversion, and other individual emotional and psychological factors.

Demand for unit transactions is also influenced by the type of prospective operator. FRANdata distinguishes between new owners and experienced franchisees with existing franchise operation(s). The ability and willingness to invest may differ for these two types.

Table 1. Changes in Willingness and Ability for Existing Operator and New Franchisee

Franchisee Type	Changes in Willingness and Ability	
	New Units	Existing Units
Existing Operator Willingness	10%	10%
Existing Operator Ability	6%	6%
New Franchisee Willingness	5%	3%
New Franchisee Ability	3%	3%

The matrix in table 1 assesses the change in operator willingness and ability for unit transactions in 2013. The change in willingness and ability is used to determine the demand for new and existing units assuming no constraining market factors, such as that of franchisor growth capacity.

Willingness

In 2012, FRANdata projected that existing operator willingness to invest in new and existing units would increase by 15 percent and 10 percent, respectively. New franchisee willingness to open new units was also projected to increase, although to a smaller extent, at 10 percent. Their willingness to engage in existing unit transactions was unchanged. These projections were supported by optimistic economic indicators, such as rising consumer and business confidence and growth in retail and same-store sales. In 2013, FRANdata expects that new and existing franchisees' willingness will grow further from their 2012 levels. However, the improvement is slightly lower than the increase in the previous year.

FRANdata projects that, in 2013, existing operator willingness to develop both new and existing units will improve by 10 percent. The demand for new units is more susceptible to the overall market conditions than the demand for existing locations. When the economy underperforms, the development of new units slows considerably, while that of existing units remains less affected. This is driven by the lower risk of existing units because of the availability of their performance history. However, as the economy starts to improve and optimism picks up, new units become a more attractive option while the demand for existing locations still remains relatively stable. While the improving economy will lead the demand for both new and existing units to increase in 2013, the demand for new units will be growing faster.

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[9] Want to Grow Your Franchise System in 2013? Pay Attention to These Changes in the Industry. Franchise Performance Group, February, 2013. http://www.franchiseperformancegroup.com/top-franchise-industry-trends-and-takeaways-from-the-2013-ifa-conference/?utm_source=Important+Trends+and+Takeaways+From+the+2013+IFA+Conference&utm_campaign=IFA+2013+Email&utm_medium=email

New franchisee willingness to invest in a new unit will increase modestly by 5 percent over its 2012 level. Their willingness to invest in existing units will improve by 3 percent. New operators' willingness will pick up slowly due to their lack of franchise business experience. Based on interviews with prospective new franchisees, their willingness to take on an existing unit is lower than to open a new one. New prospective franchisees consider existing units that are in good shape to be more expensive to purchase while the more affordable ones would not be an attractive deal due to their challenges to survive prolonged and difficult economic conditions. Existing franchisees, on the other hand, do not consider existing units' potential issues to be challenging because of their experience operating similar businesses. For this reason, they are no less willing to take over an existing unit.

The main business and economic factors affecting franchisee willingness to develop new and existing units are discussed below. For more details, please refer to the Appendix.

For the third consecutive year, the U.S. economy has enjoyed an uninterrupted recovery and falling unemployment since the end of the recession. However, this is also the weakest rebound so far with real economic growth averaging only 0.8 percent since 2009. In addition, the unemployment rate is still overwhelmingly high compared to previous recoveries. Several economic indicators initially pointed to a relatively strong recovery in 2012 with an unexpected stall in the last quarter. Other factors, including rising gasoline prices, higher taxes, and the European crisis challenge the economy to rebound.

As a result of the defense spending reduction and the aftermath from Hurricane Sandy, the economy unexpectedly shrank in the last quarter of 2012, remaining flat in real GDP, the weakest performance since the second quarter of 2009. Many economists believe this was temporary and the year 2013 is well positioned for a rebound. GDP is expected to reach 2 percent in annualized growth in the first quarter and possibly exceeding 2.1 percent in 2013.[10] Standard of living perceptions showed positive signs in 2012. Correspondingly, CEOs' assessment of current economic conditions has grown slightly more favorable in the fourth quarter, after some of the more pessimistic sentiments that arose in the third quarter.

Nevertheless, optimism about living standard perceptions and a positive executive outlook do not compensate for the effects of economic and political uncertainties. The consumer confidence index declined in December 2012 to 66.7, despite an improved final quarter, and sharply again in January 2013 to 58.6, erasing all of the gains made in 2012. Factors such as personal financial situation, increase in the payroll tax, and uncertainty about the job market have undoubtedly dampened consumers' spirits.[11] Similarly, even though small business confidence ticked up in the last month of 2012, it is still one of the lowest in history. An optimistic outlook will boost operators' willingness to participate in small business transactions. However, economic uncertainty in areas such as the impending health care law, limited credit access, and taxes are affecting the confidence of business owners.

Growth in retail sales, an indicator of higher potential profitability, also has a strong positive effect on existing and new franchisees' willingness to develop franchise units. In 2012, monthly retail and food services sales (seasonally adjusted) grew by an average of 5 percent over the previous year's sales, but remained below the 8 percent average growth achieved in 2011. Attributed partially to sales declines in the Northeast, holiday sales in 2012 may have been one of the worst since the onset of the financial crisis. Following the sluggish holiday season, in January 2013, sales reached $417 billion,

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[10] R-Word for U.S. Economy in 2013 is Rebound Not Recession, Bloomberg, January, 2013. http://www.bloomberg.com/news/2013-01-31/r-word-for-u-s-economy-in-2013-is-rebound-not-recession.html

[11] The Conference Board Consumer Confidence Index Declines, The Conference Board, February, 2013. http://www.conference-board.org/data/consumerconfidence.cfm

representing only two tenths of a percent increase from the previous month. However, January 2013 saw a larger increase in sales at 6.2 percent from the previous year. The sales data in February came as a surprise with a 1.1 percent jump to an advanced estimate of $421.4 billion, exceeding all projections. Experts had anticipated reduced spending even further in 2013 in light of the payroll tax increases, rising gas prices, and the political turmoil in Washington.[12] The new sales data, however, show that the improved job prospects are helping consumers and the economy to overcome these hurdles.

However, the auto industry's continuous recovery and strong vehicle sales may signal a healthier economy. In February, seasonally adjusted annualized rate for new retail light vehicle remained above 12.1 million units. Although a decline from the robust 13.1 million in January, this growth is still stronger than the 11.7 million achieved a year ago.

Still a less than robust retail sales trend and a lowered confidence level, coupled with an improved automobile industry leave business owners perplexed and divided on where the economy is heading. At the same time, the slowly improving economy has brought hope to small and medium sized businesses Therefore, FRANdata projects an improved willingness among prospective and existing franchisees.

Ability

In 2012, FRANdata estimated that existing operators' ability to acquire new and existing units would improve by the same 10 percent. New franchisee ability to invest in new units was estimated to improve by 5 percent and remained unchanged for existing units. These projections were based on a suppressed economic growth rate in 2011, personal investment portfolios, concerns over domestic outlook and developments in Europe, and increased home sales.

With a strengthened economy, existing and new franchisees' ability to develop new and existing units has improved further from the 2012 levels. FRANdata forecasts that, in 2013, existing operators' ability to develop new and existing units will rise by 6 percent over last year's. New franchisees' ability is projected to improve by 3 percent for both types of transactions. This also marks the first time since the recession that new operators see an improved ability in investing in existing unit transactions. However, the projected rise in ability in 2013 will be somewhat subdued in comparison to the forecast for 2012, due to the suppressed growth rate of economic recovery we saw last year.

Limited access to capital continued to be a restraining factor hampering operators' ability to invest in unit transactions. In addition, new and existing operators' ability to develop franchised units is affected by multiple factors, such as the performance of the equity market, personal investment portfolio, the housing market, etc. These factors are expected to persist throughout the year.

Personal income, a direct indicator for operators' ability to engage in franchise transactions, increased 3.5 percent in 2012 to a total of $13.9 billion in December. This growth rate is below the 5.1 percent gained in 2011. Most of this gain took place in the last two months with December posting the highest growth of 2.6 percent in eight years.[13] Effectively, an average household is in a much better financial shape. Wealth increased by $1.72 trillion to $64.8 trillion in the third quarter of 2012, in part due to the rising financial assets owned by American households. This household wealth level is only $2.5 trillion short of its $67.3 trillion peak recorded in the third quarter of 2007. At the same time, household debt

[12] MasterCard Advisors. http://www.mastercardadvisors.com/spendingpulse.html
[13] Bureau of Economic Analysis, February, 2013. http://www.bea.gov/national/index.htm#personal

fell by $65.5 billion to $12.87 trillion.[14] The change in the average household financial position points to a strengthened investment ability among current and prospective franchisees.

The rebound of the stock market drives most of the increases in household wealth. It is also an indicator of operators' investment capability in franchise transactions. Overall, 2012 was a much better year for investors than 2011. The NASDAQ rose nearly 16 percent for the year, followed by S&P 500's 13.4 percent gain. Small cap stocks also did well with 14.7 percent in returns. The rally in the stock market powered ahead in 2013 with the S&P 500 just shy of its 1,565 all-time record and the Dow breaking through the 14,198 record of October 2007. Moreover, increased corporate merger and acquisition activities also help investors to regain confidence and provide a boost to the market. Increases in the stock markets will positively impact operators' ability to investment in franchise transactions. If the signs of economic recovery remain stable, they will further support the market.

Aside from obtaining a business loan, many first time operators draw on their retirement savings as a source of investment capital or borrowing collateral. At the end of 2012, the average 401(k) balance reached a record high of $77,300, up 12 percent from one year ago.[15] According to AARP, workers who are over the age of 50 did even better. It is encouraging for potential operators to see that the retirement balances have bounced back from where they were during the recession. Housing recoveries have led general economic recoveries throughout recent history. Home equity has also been a traditional alternative to fund investments for prospective franchisees. Existing home sales remained steady in January at 4.92 million, up 9.1 percent from a year ago. The shortage of supply puts upward pressure on prices. After two years of continuous declines, the S&P/Case-Shiller Home Price Index of U.S. home prices, showed a reversal of this trend in 2012 and ended the year with strong gains. The improvement in the housing market will have a positive impact on prospective franchisees' ability to invest in unit transactions because it provides the potential to use property as collateral for business loans.

The unemployment rate declined gradually in 2012 to 7.8 percent, down 50 basis points from the beginning of the year. The 7.7 percent reported in February 2013 caught most people by surprise. However, experts are skeptical as the sequestration threatens to affect 750,000 jobs. The subdued economic growth will further limit businesses' need to hire additional workers, causing the unemployment rate to remain above 7.5 percent and stay near 8 percent throughout 2013. As consumer confidence slowly recovers, new and prospective franchisees will gradually regain their ability to take on additional franchising activities.

Based on these factors, several seemingly contrarian trends impact investor ability and willingness. FRANdata projects that new and existing franchisees' ability to invest in franchised units in 2013 will improve moderately from 2012 levels. The economic recovery will continue to be vulnerable. Concerns over both domestic policies and developments in Europe threaten to slow down the pace of business investments.

For more details on the factors affecting investor ability to invest in franchise unit transactions, please refer to the Appendix.

[14] U.S. Household Wealth Rises to near 2007 High, Reuters, December, 2013.
http://www.reuters.com/article/2012/12/06/us-usa-economy-households-idUSBRE8B50ZV20121206
[15] Fidelity Average 401(k) Balance Climbs to Record High at the End of 2012, Fidelity, February, 2013.
http://www.fidelity.com/inside-fidelity/employer-services/fidelity-analysis-finds-record-high-average-401k-balance

Projected Franchised Unit Transactions

Based on the economic factors discussed in the previous two sections, FRANdata projects that, despite certain economic gains in 2012, the ability to purchase a new or existing unit will continue to be a more limiting factor for both types of operators. Along with the improvement of the economy, the demand of new units is projected to grow faster than that for existing locations. Based on FRANdata's database, in 2012, transactions for existing units represented an estimated 37 percent of total adjusted demand, or 23,000, while new unit transactions represented 63 percent, or 39,100.

FRANdata projects that the demand for new units will continue to be higher than that of existing units in 2013. Demand for new unit transactions is projected to increase by 6 percent to 41,400, while the demand for existing ones will increase by 5 percent to 24,200.

This increase will lead to demand for a total of 65,600 unit transactions in 2013, up 5.7 percent from the adjusted demand for 62,100 transaction in 2012. In other words, a total of 65,600 new and existing unit transactions are projected to seek financing in 2013.

ESTIMATED CAPITAL REQUIREMENTS

Estimated Average Initial Investment

In order to estimate the capital requirements for the projected demand for 65,600 unit transactions in 2013, FRANdata examined the average initial investment per new and existing unit. The estimated average initial investment for 2013 is $635,200.

In 2011, an increased availability of existing units for investment temporarily depressed the average price for transfer or refranchised units. Suppressed revenues and business valuations made many small business owners feel more open to selling their units when the economy started to pick up during that year. In 2012, the backlog of existing units started to clear out as the economy continued to improve and the price of an existing unit was back up to the level of initial investment for a new unit. Although still short of its full potential, FRANdata believes that the price of an existing unit is no longer suppressed in 2013 and existing locations should be selling at a premium because of the availability of performance history. Since transactions for existing units account for a smaller portion, roughly 37 percent, of the overall transactions, and the actual sales multiples differ largely by sector and are difficult of measure, FRANdata continues to calculate the average initial investment under the assumption that the price for an existing unit is equal to the initial cost of a new unit.

The inclusion of the lodging industry will affect the initial investment calculation, as the average will be positively skewed due to the industry's intensive capital requirement. To minimize the effect, FRANdata took the weighted average approach to account for the percentage of transactions that is projected to take place. FRANdata calculated separately the average for a set of 70 lodging brands and for 1,400 other franchise brands, applying the assumptions discussed previously. The initial investment for the lodging industry and other industries is weighted by the number of transactions for each. As a result, in 2012, the average investment needed for each unit transaction increases to $601,500 from the originally estimated $401,600.

The $635,200 weighted average initial investment for 2013 is 5.6 percent higher than the adjusted investment of $601,500 in 2012, and 9.1 percent above the $582,000 in 2011. In 2011 and 2012, many franchisors lowered their IFF requirements and sought other ways to reduce the investment requirement in order to make their brands more appealing while the credit market was tight and operators had very little free cash on hand to invest. Increasingly in 2012, many franchisors reverted back to the pre-recession investment levels. FRANdata expects this trend to continue in 2013 with the investment level slowly matching its 2010 level. For this reason, FRANdata adjusted the investment up by 5.6 percent over 2012, arriving at the projected $635,200 for new and existing units in 2013.

Using the projected average initial investment of $635,200 for new and existing units, FRANdata projects that investors will require $26.3 billion of capital for new and nearly $15.4 billion for existing units. This leads to a total of nearly $41.7 billion in capital for the projected demand for 65,600 unit transactions in 2013. This represents a 5.5 percent increase from the adjusted $39.5 billion estimated for 2012.

Loan to Cost Ratio

Only a part of the calculated $41.7 billion in required capital will come from lenders. Lenders require borrowers to make an equity contribution at the time of applying for a loan. The loan to cost ratio banks expect on franchise transactions varies by type. Since SBA loans have a government guarantee of up to 90 percent of the principal, protecting the bank from loan charge-offs, such transactions often offer a higher loan to cost ratio than conventional loans. This means that a smaller equity contribution would qualify franchisees for an SBA loan.

In 2013, based on lender and franchisor feedback, as well as some marginal easing of lending standards reported throughout 2012, FRANdata projects the upper range of the loan to cost ratio to be 80 percent for SBA and 70 percent for conventional loans. On average, however, this ratio will remain largely unchanged from its 2012 and 2011 levels of 65 percent to 75 percent for SBA and 50 percent to 60 percent for conventional lending.

The Federal Reserve Survey on Senior Bank Loan Officers showed a minor easing in lending standards throughout 2012. However, this applied mostly to large and middle market firms (i.e. with annual revenues of $50 million or more), which excludes most franchised businesses. In the final quarter of 2012, a fraction of lenders also stated a somewhat tightened credit environment, which was not the case the first half of 2012 and 2011. The majority of respondents who reported eased standards and terms cited increased competition from other banks and nonbank lenders as the most important reasons for the easing. Some also pointed to a more favorable or less uncertain economic outlook and an increased tolerance for risk.[16]

At the beginning of 2012, FRANdata projected that SBA-guaranteed loans would account for 40 percent of the total financing available to franchises. Following two record years of SBA-guaranteed lending in 2011 and 2012, the agency reduced its budget by 3.8 percent in fiscal year 2013 with an aim to boost private sector lending. The budget reduction will effectively lower the total guaranteed lending by 8 percent from the 2012 level. The sequestration is likely to further reduce the SBA budget, lowering the guaranteed amount by another $902 million to just over $21 billion. Based on the budget information, an improved willingness to lending among conventional lenders, and lender and franchisor feedback, FRANdata projects that in 2013, SBA-guaranteed lending to franchisees will constitute a smaller portion of the overall financing to franchises, accounting for approximately 23.6 percent.

FRANdata projects that total borrowings of $26.5 billion is required to meet 100 percent of transaction demand in 2013, up 10.6 percent from the adjusted $24 billion in 2012 and by 25.6 percent from the adjusted $21.1 billion in 2011. The significant increase in borrowing requirements in 2013 is driven by two main factors: first, an increase in demand for unit transactions, due to an improving economy, and second, as described above, an increase in the initial investment levels.

The Lending Environment

The lending environment is impacted by the amount of funds that banks have available to lend, and banks' willingness to put this capital to use. The following section examines both the banks' ability and willingness to lend.

Ability to Lend

FRANdata projects that banking ability to lend will continue to surpass the capital needed to satisfy the projected demand for unit transactions in 2013. This is a continuation of trends observed since 2010.

Based on the assessment of SBA franchise activity sources, FRANdata estimates that between 20 and 25 percent of SBA loans are made to franchises, and about 23.6 percent of franchisees' funding will come from SBA-guaranteed loans. The agency also reports that SBA loan levels are back to pre-recession levels, even without the special provisions that helped fill the gap over the past few years. Because of the sequestration and the reduced budget for SBA-guaranteed loans, the lending ability for

[16] Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve Board, February, 2013. http://www.federalreserve.gov/boarddocs/snloansurvey/201302/fullreport.pdf

SBA lenders is projected to contract as a result. With the economic growth and the overall lending environment, conventional lending is likely to improve from its 2012 level. The third round of quantitative easing is effectively increasing the monetary base and banks' ability to lend and to spend. According to the FDIC, total domestic deposits at all insured institutions are up 22.7 percent since 2009. With trillions of dollars on the sideline, banks are pressured to start making money again.

Based on these assumptions, FRANdata projects a pool of over $34.8 billion in funds to be available to support franchise lending in 2013. About $8 billion, or 23.6 percent, will be available through SBA-guaranteed lending with the rest coming from conventional lending. Thus, the estimated bank lending ability will be well above the total borrowing requirements of $26.5 billion to fulfill the projected demand of 65,600 transactions in 2013. As in the last three years, banks should have the ability to meet 100 percent of demand for funds. This means that 2013 is the fourth year in a row where banks' lending ability surpasses small business loan demand.

In 2008 and 2009, lending to small business was limited by the overall shaken state of the banking industry. Many banks did not have the ability to lend even if they wanted to. Responding to the economic crisis, the government implemented a number of stimulus measures to protect the banking industry and to increase lending. The Recovery Act from 2010 set aside a $375 million funding pool to temporarily eliminate fees for SBA loans. The Small Business Jobs Act has also provided resources to help small businesses.

With the stimulus programs in place, the SBA-guaranteed loans took on a significant role in lending during the recovery. In fiscal year 2013, the agency requested $948 million in total budget. This will provide guarantees to $23.2 billion in loans. Although still strong, the total guaranteed lending is down 8 percent from the $24 billion in 2012.[17] Furthermore, the $85.4 billion federal spending cut is likely to reduce the SBA loan subsidy by $16.7 million. As a result, loan guarantees will drop by $902 million, from $22 billion to just over $21 billion.[18] Despite the drop in these funds, the third round of quantitative easing is effectively increasing the monetary base and banks' ability to lend and to spend. As a result of the previous two rounds of expansionary monetary policy, total domestic deposits at all insured institutions are up 22.7 percent since 2009. This practice will put downward pressure on interest rates and an influx of capital will continue be added to banks' balance sheet, increasing institutions' ability to lend.

Commercial real estate (CRE) values are important indicators for bank lending ability. An improvement of CRE values is likely to increase large banks' ability and willingness to lend. The sales volume for CRE has been rising steadily since 2008, and reached a record high of $64 billion in 2012.[19] Property prices, as tracked by both CoStar's Commercial Repeat-Sale Index and the Moody's/RCA Commercial Property Price Indices, showed an 8.1 percent improvement in 2012. Distress sales as a percentage of total sales continued to decline from a peak of 35.4 percent in March 2011, only accounting for 11.5 percent in December.

Financial institutions were directly affected by the economic downturn. Since the onset of the financial crisis in 2008, a total of 478 banks have failed with a total estimated loss of $86.8 billion. Since then, the financial industry started to recover and the number of failed institutions has dropped significantly to

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[17] FY 2013 Congressional Budget Justification and FY 2011 Annual Performance Report, U.S. Small Business Administration, March, 2013. http://www.sba.gov/sites/default/files/files/1-508%20Compliant%20FY%202013%20CBJ%20FY%202011%20APR(1).pdf

[18] U.S. Small Business Administration

[19] CoStar Commercial Repeat-Sale Indices, February, 2013. http://www.costar.com/uploadedFiles/About_Costar/CCRSI/articles/pdfs/CCRSI-February2013.pdf

51 in 2012, half of what was recorded in 2011. Only three have failed in the first two months of 2013.[20] Even though some banks remain fragile, their position has improved over the previous years. Full-year earnings continued their upward trend in 2012 to reach $141.3 billion, a 19.3 percent increase from the previous year. Other measurements of financial soundness of these institutions, such as return on assets, return on equity, and the core capital ratio, all showed different degrees of improvements in 2012.[21] These trends and developments point to a healthier and more stable financial environment, which will further facilitate banks' improved ability to lend in 2013.

In the last quarter of 2012, insured institutions reduced their loan loss provisions by $4.9 billion from a year ago to $15.1 billion, representing the smallest fourth quarter provision that banks have had to set aside since 2006. In addition, business and consumer loan delinquency rates are improving, down 40 basis points to 4.7 percent. This represents an 80 basis points improvement from a year ago and the lowest rate since the fourth quarter of 2008.[22]

The financial industry is in better health and stronger position to make funding available in order to fully revive the economy. All the trends and developments have pointed to a healthier and more stable financial environment. This will further facilitate banks' improved ability to lend in 2013.

Willingness to Lend

While banks are able to meet 100 percent of the capital needed for franchise development, the limiting factor in 2013 will still be their willingness to do so. FRANdata projects that the overall improving economic and business climate will positively affect banks' willingness to lend. For the second consecutive year, the willingness to provide conventional loans is projected to continue to improve.

FRANdata projects that in 2013, conventional lending will increase by up to 16.1 percent, pressured by trillions of dollars on the sideline. Simultaneously, lenders' willingness to provide SBA-guaranteed lending is projected to improve by 20 percent. However, SBA related lending will be constrained by the reduced budget and therefore diminish lending ability. To reflect the amount of SBA-guaranteed loans lenders are able to issue, FRANdata estimates a net 6.7 percent reduction in willingness for SBA-guaranteed lending, even though such willingness has actually improved.

These projections are based on factors such as pressure to lend based on a prolonged period of suppressed lending, an improved loan approval rate, and loan officer opinion surveys. Additionally, the improving economic and business conditions will provide a further boost to banks' willingness. Upbeat data on employment, manufacturing and overall growth are likely to have a positive effect in the lending environment.

After another difficult year for small businesses, the Thomson Reuters/PayNet Small Business Lending Index (SBLI) shows that lending has strengthened during the latter part of 2012. Small business loan approval rates also saw improvements in January 2013 from a year ago, as both large and small banks are stepping up small business lending. The loan approval rate at large banks was up 520 basis points to 14.9 percent, while that for small banks only picked up 270 basis points to 49.8 percent. Credit unions and institutions that offer alternative lending continue to slide, even though they still lead the industry with the highest small business loan approval rate at 47.6 percent and 63.8 percent, respectively.[23]

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[20] Failed Banks, FDIC, March, 2013. http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30

[21] Quarterly Banking Profile, FDIC, December, 2013. http://www2.fdic.gov/qbp/2012dec/qbp.pdf

[22] Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, Board of Governors of the Federal Reserve System, March, 2013. http://www.federalreserve.gov/releases/chargeoff/delallsa.htm

[23] Biz2Credit Small Business Lending Index, Biz2Credit, December, 2012. http://www.biz2credit.com/pressroom/small-business-lending-index-december-2012.html

While banks are lending more in absolute terms, the ratio of total lending to the flood of deposits decreased. Between 2009 and 2012, total domestic deposits at all insured institutions grew at a 7.1 percent annual rate. Loans issued, on the other hand, only increased marginally at a 1.8 percent annual rate. The loan to deposit ratio is at a historical low at 84 percent for the 8 largest commercial banks. This ratio was at 101 percent in 2007 when the banking industry was the most willing and enthusiastic about lending. The severely imbalanced deposit to loan ratio indicates the economy is currently in a transition when pressure on banks moves from not losing money to starting to make money. Although it is unclear exactly when the economy will move onto the next phase when lenders start to move out on the lending risk curve, the financial industry is certainly well prepared to make the move.

Most banks are not lending because the credit standards have not changed much since the beginning of the recovery. The Senior Loan Officer Survey echoes the same finding. Less than 10 percent of banks said standards have eased somewhat on C&I loans. A fraction of lenders also stated a somewhat tightened credit environment, which was not the case in the first half of 2012 and 2011. Nevertheless, a significant number of domestic institutions maintain an optimistic outlook for 2013, expecting improvements in delinquency and charge off rates for all types of firms and overall improvements in asset quality.[24]

With trillions of dollars on the sideline, banks are pressured to start making money again. Lenders begin to respond to that pressure by initiating very conservative lending to proven operators. Although banks' willingness to lend has somewhat improved, this is limited to a certain group of borrowers. In other words, a large majority of the lenders are competing for the same group of operators who are low risk and have a proven business record. When going outside of the defined box, not much improvement can be observed.

While banks are eager to make new loans and put idle capital to use, finding qualified borrowers still seems to be the biggest challenge. Franchised businesses have an advantage over independent small businesses in that franchises have the ability to statistically and quantitatively measure a brand's performance history. This provides franchisees with a competitive advantage when securing financing as the creditworthiness of the system is addressed, in addition to the borrower's qualification. There are three areas that lenders want to assess in addressing system creditworthiness: unit economics, system performance, and franchisor performance. Lender willingness to extend a loan declines as a system's credit risk becomes less transparent. As a result, applicants who merely qualify will not be sufficient in the banks' view.

[24] Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve Board, February, 2013. http://www.federalreserve.gov/boarddocs/snloansurvey/201302/fullreport.pdf

ECONOMIC IMPACT AND LENDING SHORTFALL

Franchise Economic Impact

Based on the Economic Impact of Franchised Business Study, an average franchise unit provides approximately 11 direct jobs and 10 indirect jobs and creates $1.1 million of direct economic output and $1.7 million in indirect economic output.[25] This section examines the economic impact of franchising in 2013 if borrowing capital requirements were met by lenders.

Table 1. Franchise Direct and Indirect Jobs and Economic Output per NAICS Code

Industry	# Jobs per Unit		Economic Output per Unit	
	Direct	Indirect	Direct	Indirect
Automotive	6	5	$1,252,375	$2,003,800
Business Services	10	9	$1,590,921	$2,545,474
Commercial & Residential Services	6	5	$861,835	$1,378,936
Lodging	27	25	$3,078,229	$4,925,167
Personal Services	6	5	$805,838	$1,289,341
QSR	20	18	$1,345,934	$2,153,495
Real Estate	3	3	$564,720	$903,551
Retail Food	8	7	$631,550	$1,010,480
Retail Products & Services	5	5	$407,469	$651,951
Table/Full Service Restaurants	29	26	$1,644,802	$2,631,683
Average	11	10	$1,059,870	$1,695,792

The projected 41,400 new unit transactions for 2013 would create 451,800 new direct jobs and 406,600 indirect jobs, a total of 858,500 jobs. The new unit transactions projected for 2013 would translate into $43.9 billion in direct annual economic output and $70.2 billion in indirect economic output, for a total of $114.1 billion annual economic output.[26]

Transactions for existing unit do not generate new jobs or additional economic output, but sustain the existing number of jobs and level of output. However, some units that are looking to transfer or refranchise might not find a buyer. Although some franchisors may re-acquire some transfer units, others will be closed. FRANdata assumes that 5 percent of the existing units will be closed in 2013 because of lack of funding for the necessary transactions. Therefore, the 24,200 transactions of existing units that could occur without the limitation of lending would sustain 13,200 direct jobs and 11,900 indirect jobs, a total of 25,100 jobs. These existing units would also maintain $1.3 billion of direct annual economic output and $2.1 billion in indirect economic output, totaling $3.3 billion.

In total, FRANdata projects that the full demand for unit transactions seeking capital in 2013 will account for 883,600 total direct and indirect jobs either created or protected and over $117.4 billion in total direct and indirect annual economic output either created or protected.

Shortfall in Lending

The improvement in willingness will not be sufficient to meet new and existing franchisees' demand for funds in 2013. FRANdata estimates a shortfall of $2.6 billion, or 9.7 percent, in lending to franchise businesses this year. Banks are forecasted to lend $23.9 billion to franchises in 2013 versus the $26.5 billion that would meet the 100 percent of the demand.

[25] Franchise Business Economic Outlook for 2013, International Franchise Association Educational Foundation

[26] Jobs are defined as positions filled by part-time and full-time employees or by self-employed individuals. Economic output is defined as the gross value of the goods and service it produces.

The 9.7 percent gap in lending represents a 62.1 basis point increase from the 9.1 percent in 2012. That year, FRANdata forecast that banks would be willing to lend an adjusted $21.8 billion to franchises, $2.2 billion less than the estimated demand to meet 100 percent of unit transactions.

Figure 1. Effect of Lending Shortfall 2013

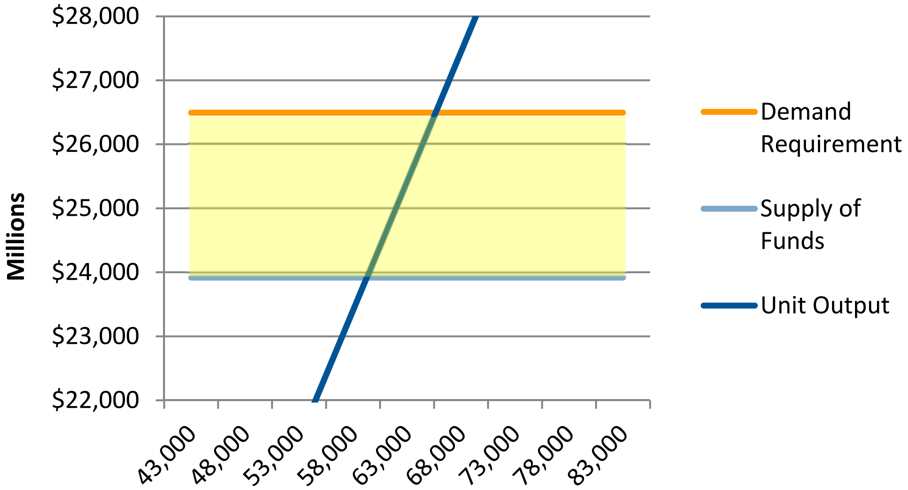


Figure 1 presents the effect the projected lending shortfall has on the number of franchise unit transactions, including new and existing ones. The yellow area defines the shortfall in lending as the difference between bank willingness to lend, presented by the Supply of Funds, and franchise capital borrowing requirements, presented by the Demand Requirement.

Economic Impact due to Shortfall in Lending in 2013

FRANdata projects that franchises will require $26.5 billion in new lending capital to fulfill 100 percent of the projected demand for unit transactions in 2013. At the same time, FRANdata forecasts that banks will only make available $23.9 billion to franchises. The estimated 9.7 percent shortfall in lending will result in 6,400 unit transactions that will not be funded. The following section examines the negative impact on economic output caused by the shortfall in lending capital.

Each franchise unit is estimated to employ nearly 21 people (11 directly and 10 indirectly) and to create $2.8 million in total annual economic output. With this assumption, the 41,400 new unit transactions in 2013 would create 858,500 total jobs and add $114.1 billion in annual economic output. This also means that the shortfall in lending would cost the economy 4,000 new units, 83,500 jobs not created, and $11.1 billion in annual economic output.

Table 2. Base Scenario, Effect of Lending Shortfall on New Units

Base Scenario (New)	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing	Percent of Maximum Level
Maximum Level	41,401	858,467	$114,086,804,423	100%
Effect of Shortfall	(4,025)	(83,466)	($11,092,348,716)	10%
Projected Actual	37,376	775,001	$102,994,455,707	90%

From a lender's perspective, transactions for existing units involve less risk than new unit transactions. This is due to the availability of historical performance data. However, it is not possible to project the exact way in which the shortfall in lending will affect existing vs. new unit transactions because it depends on the banks' individual underwriting considerations. For simplicity purposes, FRANdata assumes that an equal percentage of new and existing unit transactions out of the respective projected units will not be developed due to the shortfall in lending. This means that 10 percent of loan applications for both new and existing unit will not receive financing.

The lending shortfall has a similar but more muted effect on existing unit transactions. FRANdata assumes that if these units are unable to get funding, 95 percent of the time the unit will continue to operate for the following year. The 24,200 transactions for existing units would maintain 25,100 jobs and $3.3 billion in annual economic output if funding were received.[27]

However, due to the shortfall in lending, FRANdata estimates that 2,400 transactions of exiting units will not occur. The cost to the economy will be 2,400 total jobs and $324.8 million in annual economic output not maintained.

Table 3. Base Scenario, Effect of Lending Shortfall on Existing Units

Base Scenario (Existing)	Existing Units Transaction	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing*	Percent of Maximum Level
Maximum Level	24,244	25,136	$3,340,475,294	100%
Effect of Shortfall	(2,357)	(2,444)	($324,785,299)	10%
Projected Actual	21,887	22,692	$3,015,689,995	90%

The number of jobs maintained was calculated by taking the 24,200 demanded transactions for existing units and multiplying them by the estimated 21 (direct and indirect) jobs. The product is multiplied by 5 percent to calculate the number of jobs protected. The same methodology was applied to estimate the economic output.

To summarize, the shortfall of $2.6 billion in capital will result in 6,400 transactions unable to take place. This will cost the economy 85,900 total jobs and $11.4 billion in annual economic output not created or maintained.

Table 4. Base Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Base Scenario (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	883,603	$117,427,279,717	100%
Effect of Shortfall	(6,383)	(85,910)	($11,417,134,015)	10%
Projected Actual	59,263	797,693	$106,010,145,702	90%

[27] The projected 24,200 transactions of existing units would result in 25,100 total direct and indirect jobs. Approximately 95 percent of these transactions would continue to operate even if funding was unavailable. The remaining 5 percent, or 2,400 jobs would be lost if funding were not available. The number of jobs maintained was calculated by taking the 24,200 total demanded transactions for existing units and multiplying them by the estimated 21 (direct and indirect) jobs. The product is then multiplied by 5 percent to get to the number of jobs lost from the units that would have to close. The same methodology was applied to estimate the effect on economic output.

BANK LENDING SCENARIOS ANALYSIS

FRANdata projects that the constraints in bank lending throughout 2013 will result in 85,900 jobs and annual economic output of $11.4 billion not created or maintained. These estimates are based on FRANdata's expected net effect of a combination of issues that could affect bank lending to small businesses. In addition to the expected net 6.7 percent decline in SBA-guaranteed lending and 16.1 percent increases in conventional loans, it is worth examining the effects on the economy if banks took a more aggressive or, conversely, a more conservative approach to lending than the base scenario discussed previously.

Aggressive Scenario

Under an aggressive lending scenario, FRANdata assumes that in 2013, SBA-guaranteed lending to franchises will not be constrained by the budget reduction. Even though the total amount of loans guaranteed by the agency is reduced, this approach assumes that a larger portion of the SBA lending will gravitate towards franchising. Simultaneously, the willingness for conventional lenders will also increase from their 2012 levels by 23.8 percent. The aggressive approach represents the upper limit of an optimistic but reasonable case.

This scenario can take place if the current level of growth and stabilization continues at an accelerated pace in 2013. Loan delinquencies have improved considerably in 2012 and are expected to continue this trend. At the same time, the economy has moved further away from the recession and is growing. In addition, the stock market is reaching record highs again along with a strengthened household net worth. The unemployment rate is also on the right path. In 2012, credit standards and terms did not change much from the prior year. However, a significant number of domestic institutions maintain an optimistic outlook for 2013, expecting improvements in delinquency and charge-off rates for all types of firms. If these positive signs continue to take effect in a more systematic manner, banks are likely to extend funding with more confidence in 2013.

Based on the projected increases in lending, banks would be willing to provide $25.6 billion, an increase of 7 percent over the base case scenario. This will reduce the number of transactions not financed by 65 percent from 6,400 under the base scenario to 2,200 under the aggressive scenario. The additional unit transactions under this approach will result in 56,100 more jobs and over $7.5 billion more in economic output. This represents a 7 percent increase from the base scenario in both outputs.

Under the aggressive scenario, 40,000 new franchise transactions will be funded, resulting in 829,500 new jobs and $110.2 billion economic output.

Table 1. Aggressive Scenario, Effect of Lending Shortfall on New Units.

Aggressive (New)	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing	Percent of Maximum Level
Maximum Level	41,401	858,467	$114,086,804,423	100%
Effect of Shortfall	(1,397)	(28,959)	($3,848,537,044)	3%
Projected Actual	40,004	829,508	$110,238,267,380	97%

Under the aggressive scenario, 23,400 transactions for existing units will be funded, resulting in 24,300 jobs and $3.2 billion economic output maintained.

Table 2. Aggressive Scenario, Effect of Lending Shortfall on Existing Units

Aggressive (Existing)	Existing Units Transaction	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing*	Percent of Maximum Level
Maximum Level	24,244	25,136	$3,340,475,294	100%
Effect of Shortfall	(818)	(848)	($112,685,625)	3%
Projected Actual	23,427	24,288	$3,227,789,668	97%

The number of jobs maintained was calculated by taking the 24,200 demanded transactions of existing units and multiplying them by the estimated 21 (direct and indirect) jobs. The product is multiplied by 5 percent to calculate the number of jobs protected. The same methodology was applied to estimate the economic output.

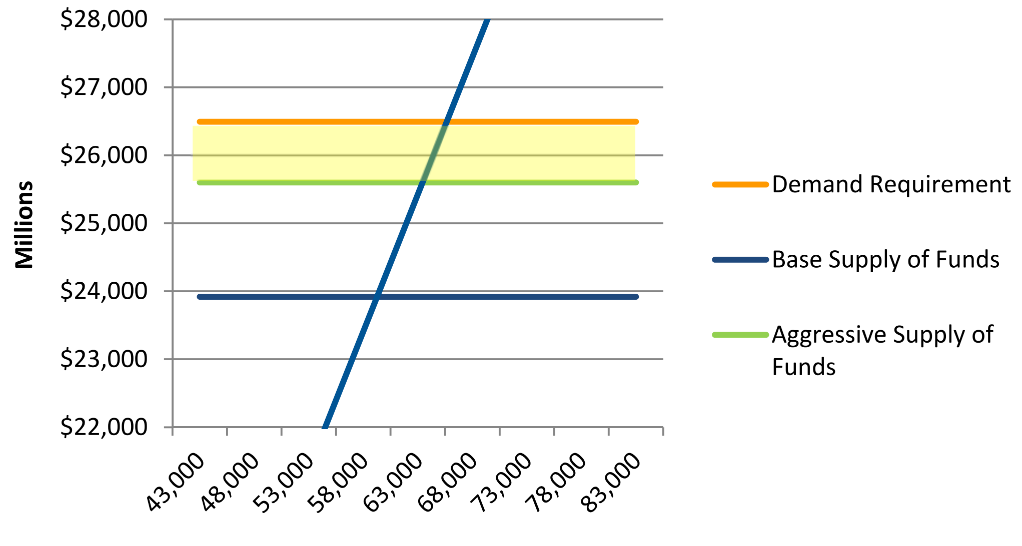
In total, provided that banks increase their lending to franchisees aggressively, 853,800 total jobs and $113.5 billion total economic output will be either created or maintained in 2013. This represents 96.6 percent of the maximum level of output that could have been generated or maintained if the entire demand for capital is met.

Table 3. Aggressive Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Aggressive (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	883,603	$117,427,279,717	100%
Effect of Shortfall	(2,214)	(29,807)	($3,961,222,669)	3%
Projected Actual	63,431	853,796	$113,466,057,048	97%

The shortfall under the aggressive lending scenario is presented by the yellow area as shown in figure 1.

Figure 1. Effect of Lending Shortfall, Aggressive Scenario



Conservative Scenario

Under a conservative scenario, FRANdata assumes that bank willingness to lend will remain stagnant. Moreover, SBA-guaranteed lending will also be affected by the reduced budget. Under this scenario, willingness for SBA-guaranteed lending will improve by 10 percent, resulting in a net 14.4 percent reduction due to the budget cut. Willingness for conventional loans will only improve by 6.7 percent from the 2012 levels. This scenario represents the lower limit of a pessimistic but reasonable case.

This scenario will take place if the U.S. economic growth slows down even further. The U.S. economy is still battling the outcomes from the crisis of 2008 to 2009. Uncertainty about the fiscal debt, higher fuel costs and higher payroll taxes will continue to impact the sluggish recovery. However, with mostly positive economic data in the first quarter of 2013, such a conservative scenario is less likely to happen.

Under this scenario, banks will be willing to lend only $22 billion, 8.2 percent below the base scenario and 0.8 percent above the estimated funds for 2012. Under the conservative scenario, 7,100 new transactions will not be funded. Effectively, a total of 146,800 jobs and $19.5 billion in output would not be created or maintained in 2013.

Under the conservative scenario, 34,300 new franchise units will take place, adding 711,700 jobs and $94.6 billion output to the economy.

Table 4. Conservative Scenario, Effect of Lending Shortfall on New Units

Conservative (New)	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing	Percent of Maximum Level
Maximum Level	41,401	858,467	$114,086,804,423	100%
Effect of Shortfall	(7,079)	(146,793)	($19,508,123,977)	17%
Projected Actual	34,322	711,675	$94,578,680,446	83%

Under the conservative scenario, 20,100 transactions for existing units will be funded, maintaining 20,800 jobs and $2.8 billion in economic output.

Table 5. Conservative Scenario, Effect of Lending Shortfall on Existing Units

Conservative (Existing)	Existing Units Transaction	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing*	Percent of Maximum Level
Maximum Level	24,244	25,136	$3,340,475,294	100%
Effect of Shortfall	(4,146)	(4,298)	($571,200,206)	17%
Projected Actual	20,099	20,838	$2,769,275,088	83%

The number of jobs maintained was calculated by taking the 24,200 demanded transactions of existing units and multiplying them by the estimated 21 (direct and indirect) jobs. The product is multiplied by 5 percent to calculate the number of jobs protected. The same methodology was applied to estimate the economic output.

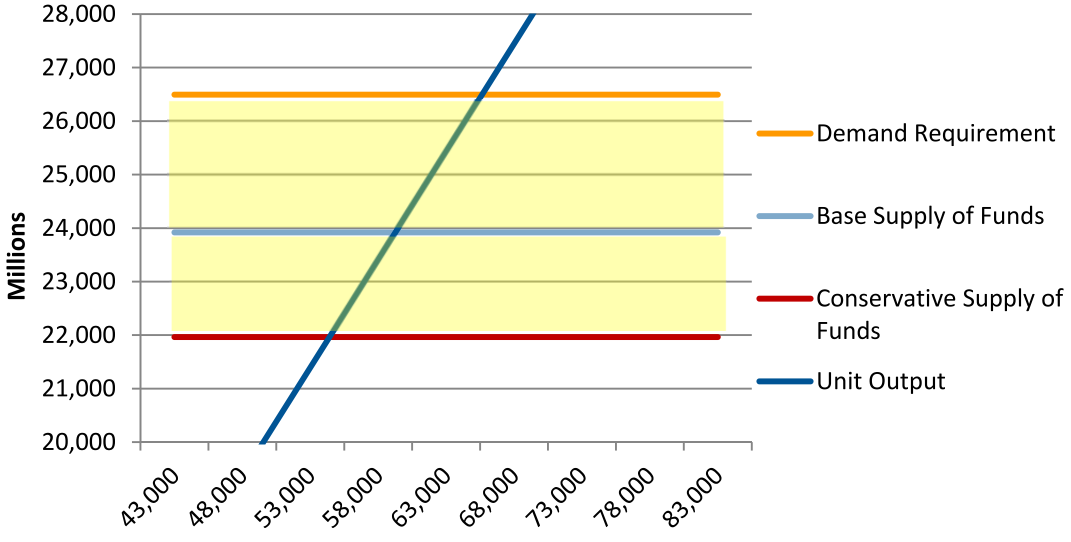
In total under the conservative approach, 732,500 jobs and $97.3 billion output will be created or maintained in 2013. This represents a 17.1 percent shortfall from the maximum level of output that could have been generated or maintained if the entire demand for capital is met.

Table 6. Conservative Scenario, Effect of Lending Shortfall on New and Existing Units Combined

Conservative (New and Existing)	Total Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	65,645	883,603	$117,427,279,717	100%
Effect of Shortfall	(11,225)	(151,091)	($20,079,324,183)	17%
Projected Actual	54,420	732,513	$97,347,955,534	83%

The shortfall under the conservative lending scenario is presented by the yellow shaded area.

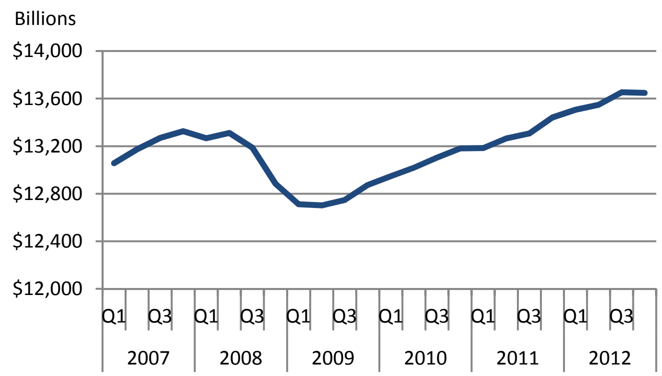
Figure 2. Effect of Lending Shortfall, Conservative Scenario



Operator Willingness

For the third consecutive year, the U.S. economy has enjoyed an uninterrupted recovery and falling unemployment since the end of the recession. Compared to earlier recoveries, however, this is also the weakest rebound so far. Real economic growth averaged only 0.8 percent and the unemployment rate remains high at 7.7 percent. As the economy continues its slow recovery, franchisees' willingness to invest in franchise unit transactions is expected to improve moderately from 2012. Several economic indicators pointed to a relatively strong recovery in 2012 with an unexpected stall in the last quarter. Other factors, including rising gasoline prices, higher taxes, the sequestration and the European crisis will provide challenges for the economy to rebound.

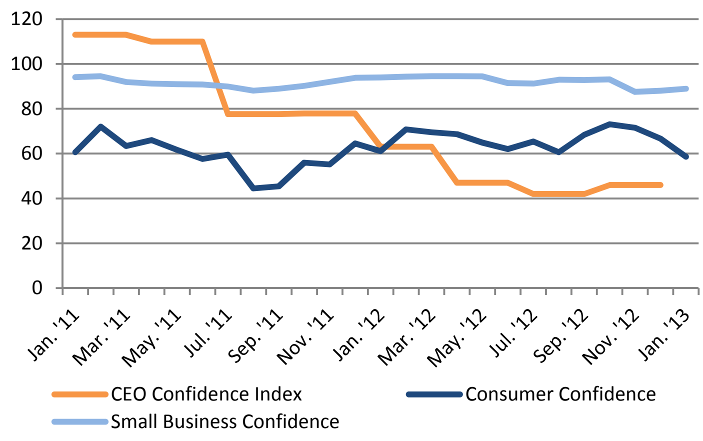
Figure 1. Quarterly Seasonally Adjusted Real GDP



Economic Outlook

As a result of the defense spending reduction and the aftermath from Hurricane Sandy, the economy took a hit in the last quarter of 2012, remaining flat. Many economists believe this was a temporary development and that the year 2013 is well positioned for a rebound. GDP is expected to reach 2 percent in annualized growth in the first quarter and possibly exceeding 2.1 percent in 2013.[28] However, the sequestration could lower the GDP by 0.5 percent and raise the unemployment rate to 9.1 percent by the end of 2013.[29]

Figure 2. Consumer and CEO Confidence



Standard of living perceptions, as measured by Gallup, showed positive signs in 2012. On average, more than 50 percent of Americans said their standard of living is getting better, up from an average of 46.7 percent in 2011. Just over 31 percent perceived the standard of living as getting worse, also down from almost 35 percent a year ago. In February 2013, the reading reached its highest level at 57 percent since 2008. These developments are a positive sign that the overall faith in the economy is improving.[30] This also impacts how business owners and potential investors perceive the economy.

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[28] R-Word for U.S. Economy in 2013 is Rebound Not Recession, Bloomberg, January, 2013. http://www.bloomberg.com/news/2013-01-31/r-word-for-u-s-economy-in-2013-is-rebound-not-recession.html

[29] Economic Effects of Policies Contributing to Fiscal Tightening in 2013, Congressional Budget Office, November, 2012. http://www.cbo.gov/publication/43694

[30] In U.S., Standard-of-Living Optimism at Five-Year High, Gallup Wellbeing, February, 2013. http://www.gallup.com/poll/160340/standard-living-optimism-five-year-high.aspx

Correspondingly, the CEOs' assessment of current economic conditions has slightly improved in the fourth quarter, after some of the more pessimistic sentiments that arose in the third quarter of 2012. The CEO Confidence Index ended the year with a read of 46, up from 42 in the third quarter, but still below where the index started the year.[31] Going into 2013, most executives remain wary about business conditions and anticipate a continued slowdown in the pace of economic growth, contrary to the economists' previous projections.

Nevertheless, optimism about living standard perceptions and continuously positive executive outlook do not compensate for the effects of economic and political uncertainties. These can be observed in the consumer and small business outlook trends. The confidence index declined in to 66.7, despite an improved final quarter, and continued to drop sharply again in January 2013 to 58.6, erasing all of the gains made in 2012. Factors such as personal financial situation, the increase in the payroll tax, and uncertainty about the job market have undoubtedly dampened consumers' spirits.[32] Similarly, even though small business confidence ticked up in December 2012, it is still at one of the lowest levels in history. It remained low for the beginning of 2013 as small businesses struggle to turn a profit.

Unlike in 2012, franchisees and franchisors have mixed views about the direction of the economy in 2013, according to the Franchise Business Leader Survey. In fact, franchisees have become more pessimistic than franchisors. Among the franchisors, 29.4 percent, up from 21.4 percent from last year, believe the economy will take a turn for the worse. Franchisees are even more pessimistic, with 36.2 percent taking the same stand, up from 22.2 percent last year. At the same time, the number of franchisors expecting the economy to improve jumped to 33.9 percent from 21.4 percent one year ago. On the other hand, only 24.6 percent of franchisees have a positive outlook of the economy, although this is up from 22.2 percent a year ago.[33] An optimistic outlook will boost operators' willingness to invest in small business transactions. However, economic uncertainty in areas such as the impending health care law, limited access to credit, and taxes are negatively affecting the confidence of business owners.

Figure 3. Franchisor View on the Economy

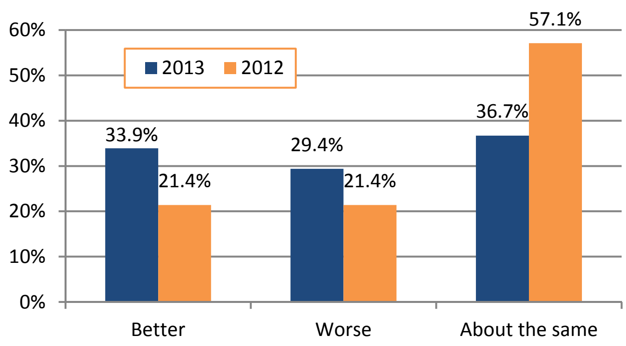
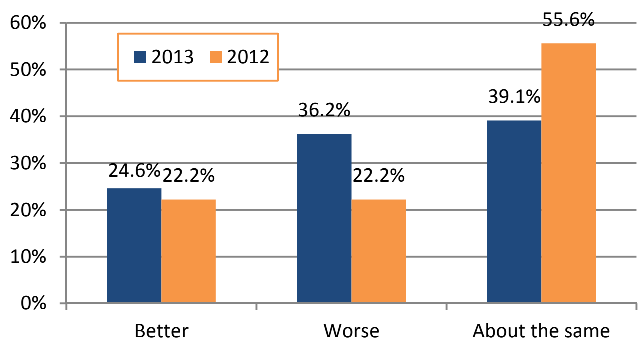


Figure 4. Franchisee View on the Economy



The overall sentiment in the market points only to a marginally improved willingness at the beginning of 2013. Prospective and existing franchisees are divided regarding business conditions, although the willingness to invest in new or existing units remains. The view of consumers and businesses is best summarized by unexpected ambivalence of the underlying economic trends.

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[31] CEO Confidence Increases, The Conference Board, January, 2013. http://www.conference-board.org/data/ceoconfidence.cfm

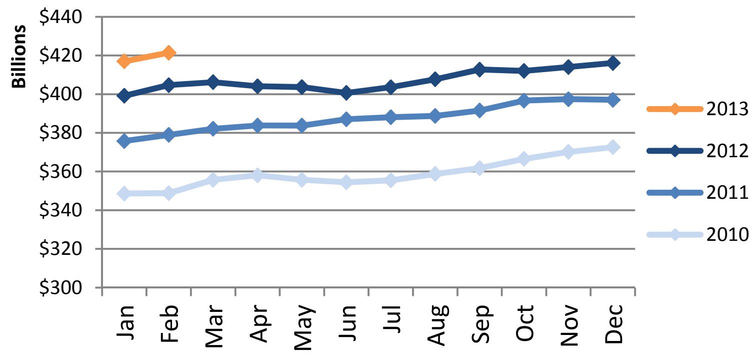
[32] The Conference Board Consumer Confidence Index Declines, The Conference Board, February, 2013. http://www.conference-board.org/data/consumerconfidence.cfm

[33] Business Leaders Give 2013 Outlook Mixed Reviews, Franchising World, January 2013. http://www.franchise.org/IFA_NEWS/Business_Leaders_Give_2013_Outlook_Mixed_Reviews/

Retail Sales

Growth in retail sales, an indicator of higher potential profitability, also has a strong positive effect on existing and new franchisees' willingness to develop franchise units. In 2012, monthly retail and food services sales (seasonally adjusted) grew by an average of 5 percent over the previous year's sales, but remained below the 8 percent average growth achieved in 2011.

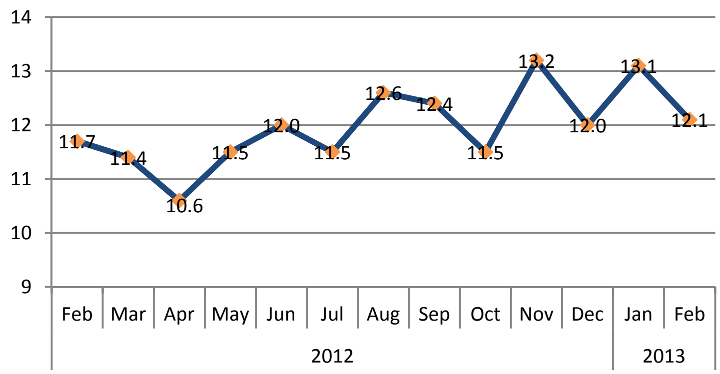
Figure 5. Retail and Food Services Sales



Attributed partially to sales declines in the Northeast, holiday sales in 2012 may have been one of the worst since the onset of the financial crisis. Retail sales grew only 0.7 percent during the holiday season, compared to the 2 percent growth in the same period a year ago.[34] Retail consulting firm Customer Growth Partners reported a similar result, with sales only up 2 percent during the holiday season after a 5.8 jump in 2011.[35] Online shopping, which posted double-digit growth over the past few years, only gained between 8.4 and 15.2 percent.[36] While the number of transactions was up 24.3 percent compared to a year ago, the average ticket price, on the other hand, continued its decline at 7.3 percent.

The changing online shopping behavior and the disappointing retail sales trends over the holidays may hurt existing and new franchisees' willingness to develop franchise units. Following the sluggish holiday season, in January 2013, retail sales reached $417 billion, representing only two tenths of a percent increase from the previous month, but a 4.4 percent jump in sales over the same period last year. However, January 2013 saw a larger increase in sales at 6.2 percent from the previous year. The sales data in February came as a surprise with a 1.1 percent jump to an estimated $421.4 billion, exceeding all projections. Of the $421.4 billion in sales, 18.6 percent were generated by motor vehicles and parts dealers. Food service and beverage stores, general merchandise, and gas station sales accounted for 23.5 percent, 12.4 percent, and 11.3 percent of the sales, respectively.[37] Expert had anticipated reduced spending even further in 2013 in light of the payroll tax increases, rising gas prices, and the political turmoil in Washington.[38] The new sales data,

Figure 6. U.S. Retail Light Vehicle Sales SAAR



[34] SpendingPulse 2012 Holiday Full-Season Holiday Report: Key Holiday Categories in Slight Year-Over-Year Gain: 0.7%, MasterCard Advisors SpendingPaulse, December, 2012. http://www.mastercardadvisors.com/modules/news/130109_1_pr_spendingpulse.html

[35] The firm's estimates are based on government data, information from retails, and observations from researchers in stores, malls, and on the internet. Early Data Show Weak Holiday Sales, Wall Street Journal, December, 2012. http://online.wsj.com/article/SB10001424127887323291704578201703984825458.html

[36] A Fresh Perspective on Holiday Shopping Trends, Chase HolidayPulse, December, 2012. http://pulse.chasepaymentech.com/index.html

[37] U.S. Census, February, 2013. http://www.census.gov/retail/marts/www/marts_current.pdf

[38] MasterCard Advisors. http://www.mastercardadvisors.com/spendingpulse.html

however, show that improved job prospects are helping consumers and the economy to overcome these hurdles.

Market uncertainties and the much covered sequestration may have scared consumers into keeping their wallets shut for the near future. However, the outlook for the mid- and longer term may not be all that depressing. The auto industry's continuous recovery and strong vehicle sales may signal a healthier economy. In February, seasonally adjusted annualized rate for new retail light vehicle remained above 12.1 million units. Although a decline from the robust 13.1 million in January, this growth is still stronger than the 11.7 million achieved a year ago.[39] Total light vehicle sales are expected to have reached 1.2 million in February, representing a 7 percent increase from last year. Rising demand and car sales are an indicator for future economic recovery. In addition, the industry is also experiencing higher transaction prices, stable incentives, and a healthy lease level. The newly redesigned models are also making an impact on the marketplace, according to J.D. Power and Associates.

A less than robust retail sales trend and a lowered confidence level, coupled with an improved automobile industry leave business owners perplexed and divided on where the economy is heading. At the same time, the slowly improving economy has brought hope to small and medium sized businesses. Therefore, FRANdata projects an improved willingness among prospective and existing franchisees.

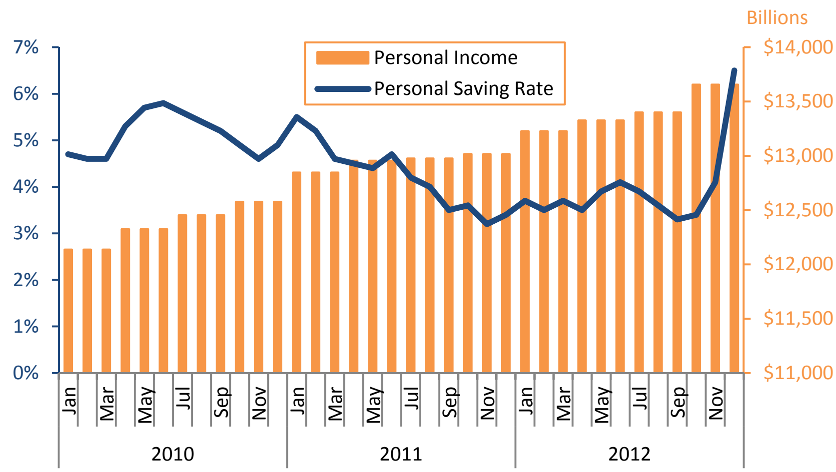
Operator Ability

Limited access to capital continues to be a restraining factor hampering operators' ability to invest in unit transactions. In addition, new and existing operators' ability is affected by multiple factors, such as their personal investment portfolio, equity market performance, the housing market, etc. The factors that will affect new and existing franchisees' ability to invest are expected to persist.

Personal Financial Position

Personal income, a direct indicator of operators' ability to engage in franchise unit transactions, increased 3.5 percent in 2012 to a total of $13.9 billion in December. This growth rate is below the 5.1 percent gained in 2011. Most of this gain took place in the last two months with December posting the highest growth of 2.6 percent in eight years.[40] However, much of this increase was driven by a jump in personal dividend income, which increased 34.3 percent that month and is expected to reverse in January.

Figure 7. Personal Saving Rate and Personal Income



Effectively, an average household is in a much better financial shape with wealth having increased by $1.72 trillion to $64.8 trillion in the third quarter of 2012. This is in part due to the financial assets owned by American households which increased in value. As of February

[39] February 2013 Automotive Retail Forecast, J.D. Power and Associates, February, 2013. http://www.jdpower.com/content/press-release/zTaMAmO/february-2013-automotive-retail-forecast.htm

[40] Bureau of Economic Analysis, February, 2013. http://www.bea.gov/national/index.htm#personal

2013, household wealth is only $2.5 trillion short of its $67.3 trillion peak recorded in the third quarter of 2007. At the same time, household debt fell by $65.5 billion to $12.87 trillion.[41] A combination of improved wealth and less debt increases consumers' buying power. As a result, the average personal savings rate continued to decline for the second year to 3.9 percent, down from 5.1 percent in 2010 as Americans get back to spending. The change in the average household financial position points to a strengthened investment ability among current and prospective franchisees.

The Equity Market

The rebound of the stock market drives most of the increases in household wealth. It is also an indicator of operators' investment capability in franchise transactions. Overall, 2012 was a much better year for investors than 2011. The NASDAQ rose nearly 16 percent for the year, followed by S&P 500's 13.4 percent gain. Small cap stocks also did well with 14.7 percent in returns. The equity markets' overall performance was rather impressive amid uncertainties around the U.S. elections, fear over the fiscal policy, and ongoing sovereign debt problems in Europe.

With the prospect in Europe slightly improved and China growing stronger, investors seem optimistic that the rally will march on through 2013. U.S. stocks powered ahead in the New Year with the S&P 500 just shy of its 1,565 all-time record and the Dow breaking through the 14,198 record of October 2007.

Moreover, increased corporate merger and acquisition activities also help investors to regain confidence and provide a boost to the market. In 2012, a total of 128 companies went public, the second-highest IPO total since 2007.[42] As a result, the amount of money raised through public debt and equity is also up 22 percent.[43]

Increases in the stock markets will positively impact operators' ability to investment in franchises. If the continuing signs of economic recovery remain stable, they will further support the market.

Traditional Sources of Financing

Aside from obtaining a business loan, many first time operators draw on their retirement savings as a source of investment capital or borrowing collateral. At the end of 2012, the average 401(k) balance reached a record high of $77,300, up 12 percent from one year ago.[44] According to AARP, workers who are over the age of 50 did even better. Those who are between the age of 50 and 54 averaged $111,900 in their account and those between the age of 65 and 69 averaged $136,800.[45] While two thirds of the increase was attributed to a thriving market, one third was due to participant contributions. It is encouraging for potential operators to see that the retirement balances have bounced back from where they were during the recession.

Housing recoveries have led general economic recoveries throughout recent history. Home equity has also been a traditional alternative to fund investments for prospective franchisees. Therefore, it has a direct impact on the ability to invest. The housing market has been stabilizing over the past few years

[41] U.S. Household Wealth Rises to near 2007 High, Reuters, December, 2013.
http://www.reuters.com/article/2012/12/06/us-usa-economy-households-idUSBRE8B50ZV20121206

[42] IPOs Have Good, But Not Great, 2012, USA Today, January, 2013.
http://www.usatoday.com/story/money/business/2012/12/31/ipos-2012-facebook-invest/1799967/

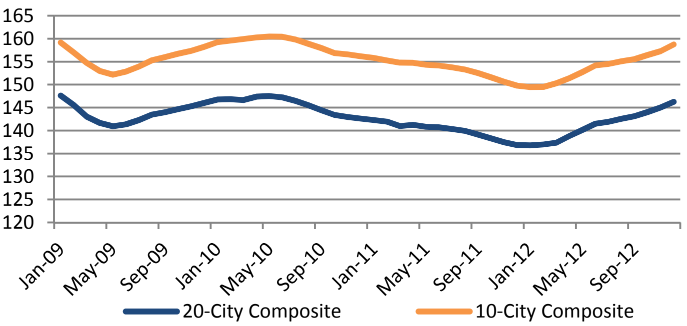
[43] Money Raised in Public Markets on the Rise—U.S. SEC Chairman, Reuters, February, 2013.
http://www.reuters.com/article/2013/02/22/sec-investors-idUSL1N0BM22420130222

[44] Fidelity Average 401(k) Balance Climbs to Record High at the End of 2012, Fidelity, February, 2013.
http://www.fidelity.com/inside-fidelity/employer-services/fidelity-analysis-finds-record-high-average-401k-balance

[45] 401(k) Balance Hit Record High--$111,900 for Ages 50-54, AARP, February, 2013. http://blog.aarp.org/2013/02/15/401k-balances-climb-to-record-high/

and has picked up somewhat in 2012. Existing home sales remained steady in January 2013 at 4.92 million, up 9.1 percent from a year ago. Sales rose in every region but the West, the region that is most constrained by limited inventory. While buyer traffic continues to rise, seller traffic is holding steady. The same month, total housing inventory declined 4.9 percent from the previous month to 1.7 million, down 25.3 percent from the same time last year. At the current sales pace, the level of housing inventory is only sufficient for four months of supply. This is the lowest housing supply since April 2005.[46]

Figure 8. S&P/Case-Shiller Home Price Index



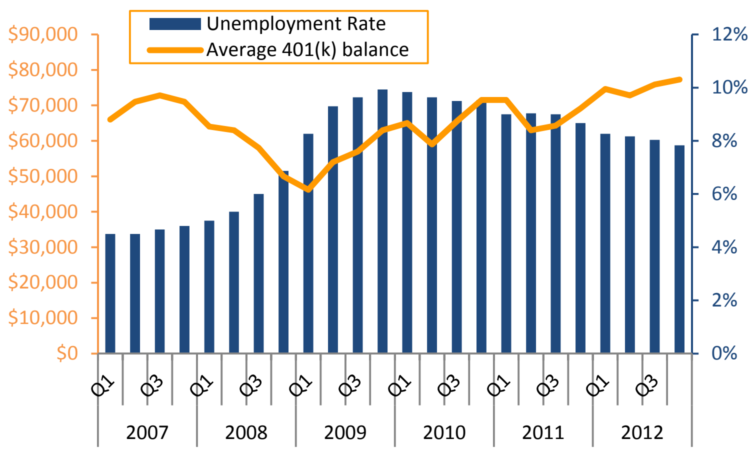
The shortage of supply puts upward pressure on housing prices. After two years of continuous declines, the S&P/Case-Shiller Home Price Index of U.S. house prices, showed a reversal of this trend in 2012 and ended the year with strong gains. The 10- and 20-City Composites posted 5.9 percent and 6.8 percent in annual return, respectively.[47] In addition, the pending home sales index, a forward looking indictor on the housing market, rose 4.5 percent in January. This could also point to a rise in home sales and a stronger price growth driven by inventory shortages. Experts expect total sales to be lower than in 2012, while home prices are projected to rise more strongly.[48] The improvement in the housing market will have a positive impact on prospective franchisees' ability to invest in new or existing units because it provides the potential to use property as collateral for business loans.

Unemployment

The unemployment rate declined gradually in 2012 to 7.8 percent, down 50 basis points from the beginning of the year. This number rose slightly in January to 7.9 percent and has been hovering around this range since September. The 7.7 percent reported in February 2013 caught most people by surprise. However, experts are skeptical as the sequestration threatens to affect 750,000 jobs.

Many believe the resulting subdued economic growth will further limit businesses' need to hire additional workers, causing the unemployment rate to remain above 7.5 percent and stay

Figure 9. Unemployment Rate and 401(k) Balance



[46] January Existing-Home Sales Hold with Steady Price Gains, Seller's Market Developing, National Association of Realtors, February, 2013. http://www.realtor.org/news-releases/2013/02/january-existing-home-sales-hold-with-steady-price-gains-seller-s-market-developing

[47] S&P/Case-Shiller Home Price Indices, S&P Dow Jones Indices, March, 2013. http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----

[48] January Pending Home Sales Up in All Regions, National Association of Realtors, February, 2013. http://www.realtor.org/news-releases/2013/02/january-pending-home-sales-up-in-all-regions

near 8 percent throughout 2013. By the end of 2017, the unemployment rate is expected to fall to 5.5 percent and further down to 5.2 percent by 2023.[49] Known as the lagging indicator, the unemployment rate is an important measure of the economy's growth rate. The improved unemployment rate over the recent months may signal a better economic environment. This is consistent with other economic indicators. As consumer confidence slowly recovers, new and prospective franchisees will gradually regain their ability to take on additional franchising activities.

Based on these factors, several seemingly contrarian trends impact investor ability and willingness. FRANdata projects that new and existing franchisees' ability to invest in franchised units in 2013 will improve moderately from 2012 levels. The economic recovery will continue to be vulnerable. Concerns over both domestic policies and developments in Europe threaten to slow down the pace of business investments.

Bank Ability to Lend

FRANdata estimates banks will continue to have sufficient funds to finance the projected demand in 2013, continuing the trend since 2010. With the overall economic recovery, conventional lending is also likely to improve from its 2012 level. The ability to lend is influenced by three factors, stimulus measures implemented by the government, commercial real estate values, and the condition of financial institutions.

Stimulus Measures and Monetary Policy

In 2008 and 2009, lending to small business was limited by the overall shaken state of the banking industry. Many banks did not have the ability to lend even if they wanted to, hampered by concerns about the collapse of the housing market and uncertainty related to the valuation of bank assets. The liquidation of Lehman Brothers in 2008 and CIT's bankruptcy in 2009 were some of the most prominent bank failures. In 2009, total lending by U.S. banks fell 7.4 percent, the steepest drop since 1942.

Responding to the economic crisis, the government implemented a number of stimulus measures to protect the banking industry and to increase lending. The Recovery Act from 2010 set aside a $375 million funding pool to temporarily eliminate fees for SBA loans and to increase the government guarantee of loans to up to 90 percent. The Small Business Jobs Act, also signed in 2010, provided resources to help small businesses by extending the SBA enhanced loan provisions while offering billions more in lending support, tax cuts, and other opportunities for entrepreneurs and small business owners.[50]

With the stimulus programs in place, the SBA-guaranteed loans took on a significant role in lending during the recovery. In fiscal year 2013, the agency requested $948 million in total budget. This will provide guarantees to $23.2 billion loans, of which $16 billion will support financing through the 7(a) program and $6 billion through the 504 program. Although still strong, the total guaranteed lending is down 8 percent from the $24 billion in 2012.[51] Furthermore, small businesses will feel the heat from the sequestration. The $85.4 billion federal spending cut is likely to reduce the SBA loan subsidy by $16.7 million. As a result, loan guarantees will drop by $902 million, from $22 billion to just over $21 billion.[52]

[49] The Budget and Economic Outlook: Fiscal Years 2013 to 2023, Congressional Budget Office, February, 2013. http://www.cbo.gov/publication/43907

[50] Small Business Jobs Act of 2010, U.S. Small Business Administration, October, 2010, http://www.sba.gov/content/small-business-jobs-act-2010

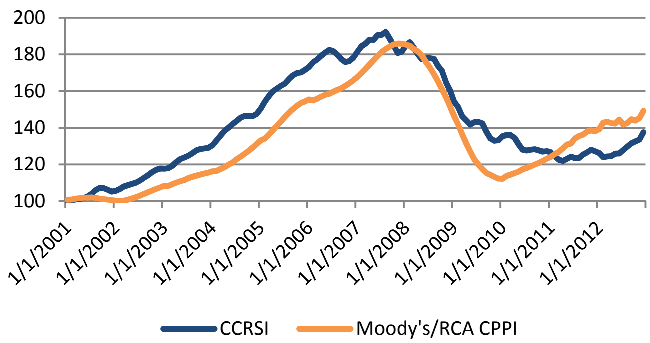
[51] FY 2013 Congressional Budget Justification and FY 2011 Annual Performance Report, U.S. Small Business Administration, March, 2013. http://www.sba.gov/sites/default/files/files/1-508%20Compliant%20FY%202013%20CBJ%20FY%202011%20APR(1).pdf

[52] U.S. Small Business Administration

In addition to these funds, the third round of quantitative easing is effectively increasing the monetary base and banks' ability to lend and to spend. In September, 2012, the Federal Reserve announced plans to unleash more stimuli into the market by buying $85 billion in mortgage-backed securities each month. As a result of the previous two rounds of expansionary monetary policy, total domestic deposits at all insured institutions are up 22.7 percent since 2009. The Federal Reserve is prepared to continue its bond buying effort at its present pace until the economy meets the inflation and unemployment targets. This practice will put downward pressure on interest rates and an influx of capital will continue be added to banks' balance sheet, increasing institutions' ability to lend.

Commercial Real Estate Value

Figure 10. U.S. Commercial Property Prices Index

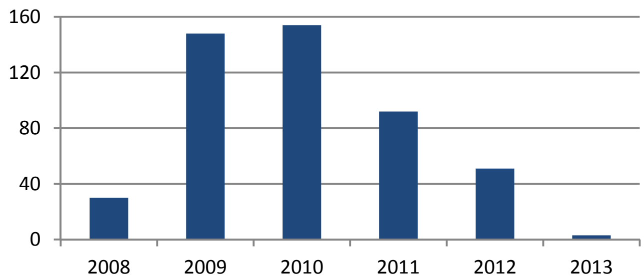


Commercial real estate (CRE) values are important indicators for bank ability to lend. Larger banks have traditionally had more CRE exposure than small community banks. An improvement in CRE values is likely to increase large banks' ability and willingness to lend. The sales volume for CRE has been rising steadily since 2008, and reached a record high of $64 billion in 2012.[53] Property prices, as tracked by both CoStar's Commercial Repeat-Sale Index and the Moody's/RCA Commercial Property Price Indices, showed an 8.1 percent improvement in 2012. This compared to a 0.1 percent price decline and a 12.1 percent improvement from a year ago as measured by each of the indices. Distress sales as a percentage of total sales continued to decline from a peak of 35.4 percent in March 2011, only accounting for 11.5 percent in December, the lowest level since the end of 2008. In the last quarter of 2012, demand for CRE loans also strengthened moderately, while the credit standards remained basically unchanged, only easing marginally, according to the senior loan officer opinion survey.

Condition of Financial Institutions

Financial institutions were directly affected by the economic downturn. Since the onset of the financial crisis in 2008, a total of 478 banks have failed with a total estimated loss of $86.8 billion. The number of failed institutions skyrocketed in 2009 and 2010 to a historical high of 148 and 154 failures, respectively. The total amount of estimated loss reached $34.6 billion in 2009 alone. Since then, the financial industry started to strengthen and the number of failed institutions has dropped significantly to 51 in 2012, half of what was recorded in 2011. Only three have failed in the first two months of 2013.[54]

Figure 11. Number of Banks Failed per Year



With the slow recovery, the banking system is still expected to shrink, although at a much slower rate. These trends changed the industry. For instance, the number of large and financially sound institutions, those with more than $10 billion in assets, has remained virtually unchanged during the recession. On the other hand, smaller institutions

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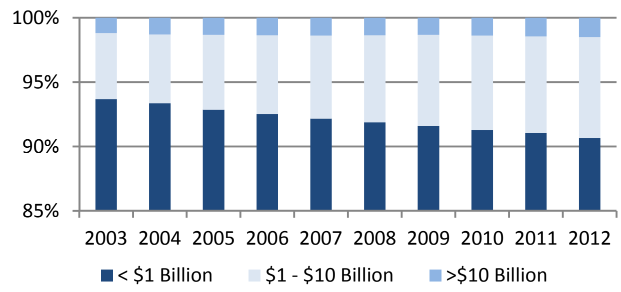
[53] CoStar Commercial Repeat-Sale Indices, February, 2013. http://www.costar.com/uploadedFiles/About_Costar/CCRSI/articles/pdfs/CCRSI-February2013.pdf

[54] Failed Banks, FDIC, March, 2013. http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30

with less than $1 billion in assets have declined at a 4.2 percent annual rate since the beginning of the crisis, accounting for less than 91 percent of the banking industry for the first time.

Even though some banks remain fragile, their position has improved over the previous years. In 2011, net income for the surviving institutions surpassed $100 billion for the first time since 2006. Full-year earnings continued their upward trend in 2012 to reach $141.3 billion, a 19.3 percent increase from the previous year. This is the second highest annual net income ever reported by the industry. Other measurements of financial soundness of these institutions, such as return on assets, return on equity, and the core capital ratio, all showed different degrees of improvements in 2012.[55] These trends and developments point to a healthier and more stable financial environment, which will further facilitate banks' improved ability to lend in 2013.

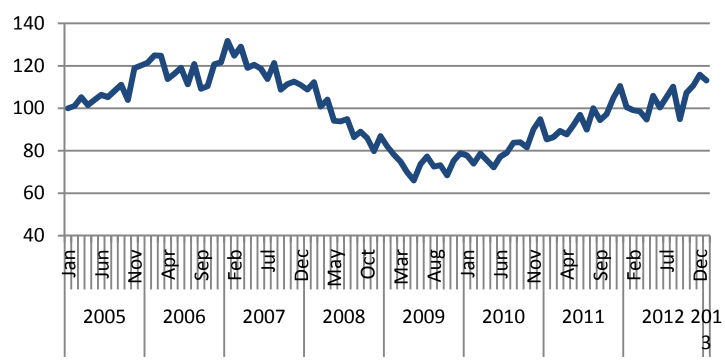
Figure 12. Number of Institutions by Asset Size



In the last quarter of 2012, insured institutions reduced their loan loss provisions by $4.9 billion from a year ago to $15.1 billion, representing the smallest fourth quarter provision that banks have had to set aside since 2006. In addition, business and consumer loan delinquency rates are improving, down 40 basis points to 4.7 percent. This represents an 80 basis points improvement from a year ago and the lowest rate since the fourth quarter of 2008.[56] A similar trend is also observed among all FDIC insured institutions. Net charge-offs totaled $18.6 billion in the fourth quarter, down 27.4 percent from a year ago. This drop also represents the tenth consecutive quarter in which charge-offs have declined, an indicator of improved asset quality.

The financial industry is in the ever better health and position to make funding available in order to fully revive the economy. These trends and developments point to a healthier and more stable financial environment. This will further facilitate banks' improved ability to lend in 2013.

Figure 13. Thomson Reuters/PayNet SBLI



Bank Willingness to Lend

While banks are projected to be able to meet 100 percent of the capital needed for franchise development, the limiting factor in 2013 will still be their willingness to do so. Banks' willingness to provide conventional lending tightened drastically during the recession and not much has improved since.

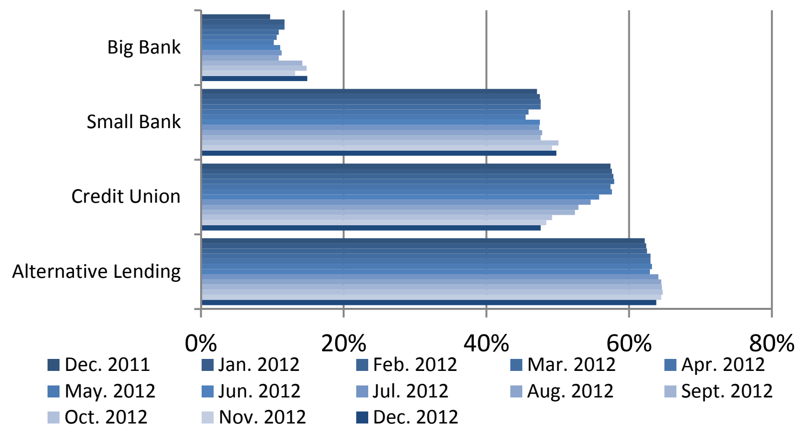
After another difficult year for small businesses, the Thomson Reuters/PayNet Small Business Lending Index (SBLI) shows that lending has strengthened during the latter part of 2012. The index settled at 113.1 in January, after adding 12.5 percent from a year ago. However, this jump is still below the 17.7 percent improvement observed at the same time in 2012 and the 20.4 percent from 2011.

55 Quarterly Banking Profile, FDIC, December, 2013. http://www2.fdic.gov/qbp/2012dec/qbp.pdf

56 Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, Board of Governors of the Federal Reserve System, March, 2013. http://www.federalreserve.gov/releases/chargeoff/delallsa.htm

Small business loan approval rates also improved in January 2013 from a year ago, as both large and small banks are stepping up small business lending. The loan approval rate at large banks was up 520 basis points to 14.9 percent, while that for small banks rose slowly by 270 basis points to 49.8 percent. Credit unions and institutions that offer alternative lending continue to slide, even though they still lead the industry with the highest small business loan approval rate at 47.6 percent and 63.8 percent, respectively.[57]

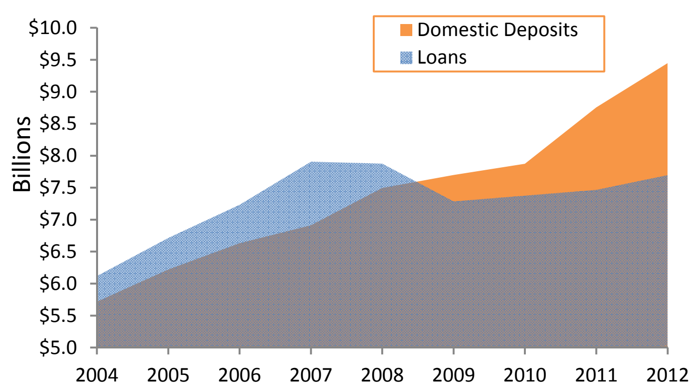
Figure 14. Approval Rate by Institutions



Unlike national banks that are still testing the water on large portfolios in new markets, local banks that typically do not have the exposure to the broader market have helped small businesses through the last few years. Local banks, limited by their resources, make loans to local businesses that they know. Another big trend in small business lending is mostly spotted among alternative lenders such as community development financial institutions, accounts receivable financers, merchant cash advance, micro lenders, and others.

2011 marked a record year for the SBA with over $30.5 billion in guaranteed loans to 60,000 small businesses. At $30.3 billion, the agency supported a similar level of loans to small businesses in 2012, the second largest total. That year, the SBA approved $15.2 billion through the 7(a) program and $15.1 billion through the 504 program. This compared to the $30.5 billion and $22.6 billion made available in 2011 and 2010, respectively.[58] The willingness for SBA-guaranteed lending is likely to continue to increase with the improving economy and as a result of the SBA-implemented provisions in support of small business lending.

Figure 15. Bank Deposits vs. Loans



While banks are lending more in absolute terms, the ratio of total lending to the flood of deposits decreased. Between 2009 and 2012, total domestic deposits at all insured institutions grew at a 7.1 percent annual rate. Loans issued, on the other hand, only increased marginally at a 1.8 percent annual rate. The average loan to deposit ratio fell 300 basis points in the fourth quarter to 84 percent for the 8 largest commercial banks.[59] This ratio was at 101 percent in 2007 when the banking industry was the most willing and enthusiastic about lending. As of the end of 2012, the loan to deposit ratio is at historical low, and

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[57] Biz2Credit Small Business Lending Index, Biz2Credit, December, 2012. http://www.biz2credit.com/pressroom/small-business-lending-index-december-2012.html

[58] SBA Loan Dollars in FY 2012 Reach Second Largest Total Ever; $30.25 Billion Second Only to FY 2011, SBA, October, 2012. http://www.sba.gov/about-sba-services/7367/329571

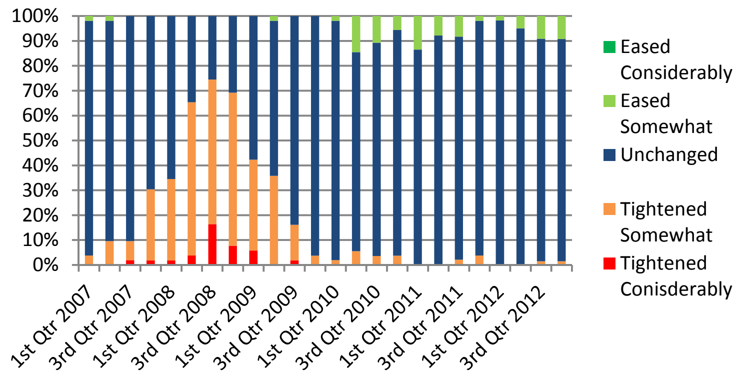
[59] JPMorgan Leads U.S. Banks Lending Least Deposits in 5 Years, Bloomberg, February, 2013. http://www.bloomberg.com/news/2013-02-20/jpmorgan-leads-u-s-banks-lending-least-of-deposits-in-5-years.html

banks are sitting on an ever larger amount of excess cash, totaling $1.8 trillion.[60]

The severely imbalanced deposit to loan ratio indicates the economy is currently in a transition when pressure on banks moves from not losing money to starting to make money. Although it is unclear exactly when the economy will move into the next phase when lenders start to move out on the lending risk curve, the financial industry is certainly in a position to make the move.

Most banks are not lending because the credit standards have not changed much since the beginning of the recovery. The Senior Loan Officer Survey finds that the vast majority of banks left standards unchanged for loan approvals to smaller firms. Less than 10 percent of banks said standards on C&I loans have eased somewhat. The most commonly cited reason for having eased standards or terms was increased competition from other lenders or nonbank lenders, a less uncertain economic outlook, and an increased tolerance for risk. A fraction of lenders stated a somewhat tightened credit environment, which was not observed in the first half of 2012. A significant number of domestic institutions maintain an optimistic outlook for 2013, expecting improvements in delinquency and charge off rates to all sizes of firms and overall improvements in asset quality.[61]

Figure 16. Senior Loan Officer Opinion Survey on Bank Lending Practices for Small Firms



With trillions of dollars on the sideline, banks are pressured to start making money again. Lenders begin to respond to that pressure by initiating very conservative lending to proven operators. Although banks' willingness to lend has somewhat improved, this is limited to a certain group of borrowers. In other words, a large majority of the lenders are competing for the same group of operators who are low risk and have a proven business record. When going outside of the defined box, not much improvement can be observed.

While banks are ready to make new loans and put idle capital to use, finding qualified borrowers still seems to be the biggest challenge. Franchised businesses have an advantage over independent small businesses in that franchises have the ability to statistically and quantitatively measure a brand's performance history. This provides franchisees with a competitive advantage when securing financing as the creditworthiness of the system is addressed, in addition to the borrower's qualification. There are three areas that lenders want to assess in addressing system creditworthiness: unit economics, system performance, and franchisor performance. Lender willingness to extend a loan declines as a system's credit risk becomes less transparent. Franchise systems with a proven track record have the best access to the credit market, compared to other franchise systems and independent businesses that are competing for the same loan.

The key to lender willingness in this environment centers on information. Lenders have created tighter credit qualification boxes after the recession. The situation has not improved much and lenders will not apply more liberal terms quickly. As banks are only slowly changing from a mindset of not losing money

[60] Federal Deposit Insurance Corporation, March, 2013. http://www.fdic.gov/bank/statistical/stats/index.html
[61] Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve Board, February, 2013. http://www.federalreserve.gov/boarddocs/snloansurvey/201302/fullreport.pdf

to positioning to competition, greater underwriting due diligence remains. As anyone who has applied for a home mortgage in the past three years can attest, much more analysis and paperwork is required.

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