Chain Store Credit Review:
The State of the Art

Part 1 of 2

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This "lending to" is presented in two parts. Part 1 includes information on the business cycle, and use of a bottom-up approach and store-level statements. Part 2 (February 2001) begins with borrower analysis and moves to collateral value, enterprise loans, and secured loan structural considerations.

America is chained. From coast to coast, there are millions of chain retail establishments that address our every purchasing need. Many chains, such as McDonalds, have grown through franchising, which puts the operations of most stores into the hands of franchisees. As franchising has evolved, so have franchisees; indeed, many today operate hundreds of stores, sometimes under multiple brand names. Of course, many chains have grown without franchising. Most larger retail establishments, from grocery stores to hypermarkets to electronics stores, and a number of smaller retail establishments, including prominent restaurant chains, auto parts chains and convenience store companies, have chosen to develop and operate all of their stores corporately. To the uninformed observer, the tapestry of retail chains appears to be sewn with equivalent thread. But the engines of retail chain development are as diverse as the dynamics of each retail sector, each chain and each operator.

Properly done, chain store credit analysis entails a specialized and individualized approach. This article offers a general framework for chain store credit analysis that we have developed at Franchise Finance Corporation of America (FFCA). While this framework alone does not address all of the financing risks, it focuses on the most significant—borrower quality. Sound lending practices rest on the quality of the chain store operator and the stores that he or she operates.

The Business Cycle

Retail chains are predominantly cash businesses. Whether through cash or credit card sales, cash receipts are immediate. While the timing of cash receipts is generally immediate, the levels of inventory and related accounts payable can vary, depending on the retail sector and the chain. In most cases, the levels of accounts payable will equal or exceed inventory levels. In other words, the chain store operator can effectively sell the inventory one or more times over before paying for it. With little or no accounts receivable and payables that exceed inventory,

chain store operators typically maintain deficit working capital positions. There are several implications to a business cycle where cash is received from sales before any checks are cut to vendors. For lenders, this means that most chain store operators are not in need of working capital lines of credit unless they are used to bridge seasonal cash flow shortfalls. As a result, the lion's share of debt requirements from chain store companies will be in the form of term debt used to finance land, building and equipment. A second key implication of deficit working capital is that sales growth tends to throw off, rather than use, cash. As existing store sales grow or new stores are developed, actual cash flow will tend to exceed the sum of net income (excluding nonrecurring expenses[1]), depreciation, and amortization (or gross cash flow). Conversely, as stores are closed or sold and as sales decrease, actual cash flow will tend to be less than gross cash flow.

Gross cash flow is the most important benchmark for recurring cash flow and debt service capacity of a cash business. Companies cannot be relied on to open stores or increase same store sales from year to year, so measuring debt service capacity in such cases from the higher actual cash flow can be misleading. On the other hand, it must be remembered that chain store sales downturns generally exact a price. This is because corporate sales decreases often require the reduction of trade payables that far exceed the values of liquidated inventory. In the restaurant industry, for example, it is not uncommon for inventory to turn over four times before the first vendor bill is paid. So a reduction in inventory will likewise be accompanied by a fourfold reduction in payables. The penalty for lower sales, then, can be both a cash drain, as well as a decline in gross cash flow. No matter the retail sector or chain, it is important for the financial analyst to understand the operating cycle and its implication on corporate cash flows and the appearance of the balance sheet. This analysis should begin with gross cash flow as the basis for assessing corporate debt capacity.

A Bottom Up Approach

A chain store operator is not just a single business. It is a composite of many businesses. Those businesses are the individual stores within the company. From the vantage point of a lender, this notion is extremely important for two reasons. First, it means that term loans collateralized by the real estate or equipment of a single chain store operator have less effective individual credit exposure than at first blush. For example, a large loan to a single borrower and secured by a single asset would not be as diversified as a similar size loan to a chain store operator collateralized by the real estate and equipment at numerous profitable locations. The second reason emanates from the first: if loan proceeds are most often applied to finance land, building and equipment, then the primary source of each loan repayment is from the cash flow of the store itself. This notion is important because it means that chain store credit analysis, properly done, must begin at the store level. This may be thought of as a "bottom-up" approach to credit analysis.

A principal tenet of credit analy-sis is that cash flow, not net income or asset sales, is the primary repayment source for corporate term borrowings. In reality, it's necessary to expand this cardinal credit rule to the store level. With respect to term borrowings, cash flow from financed stores is the primary source of their respective loan repayments. Cash flows from other stores operated by the borrower serve as secondary loan repayment sources. The disposition of loan collateral is the third source of loan repayment. In this way, credit risk is reviewed first from the bottom (financed store cash flows and anticipated collateral value), the bottom again (cash flows from the stores not financed by the lender, which serve as secondary loan repayment sources) and then the top (overall corporate credit strength, which is an aggregation of all stores operated by the borrower).

Without a bottom-up approach to credit analysis, chain store lending risk cannot be measured properly. This is especially so given a preponderant need for term financing. As lenders extend loans for more than a year or two, basic corporate credit review (what could be called a "top-down" look at corporate financial health) essentially becomes a credit-screening tool. Long-term lending risk cannot alone be supported by current corporate financial health. Corporate financial strength is transient. As a result, the long-term viability of chain store term loans lies more within credit criteria with greater long-term assurances. These include borrower management strength, store-level economics, collateral evaluation, loan structure and overall retail chain and sector health. Published statistical studies of

FFCA's collection data over the years bear this out. Going-in store-level fixed charge coverage ratios are better predictors of loan default and recovery than any similar corporate financial ratios.2 Other key quantitative variables include operator experience, the number of stores operated by the borrower (more is better), chain market share (measured on a local level), and collateral advance rate.

Starting with Store-Level Statements

Store level financial statements are the foundation of chain store credit review. As a rule, the lender should request multiple period financial statements for all of the stores operated by the borrower. A review of the store-level financial statements will immediately reveal both the expected store fixed charge coverage ratio (with any stores that are to be refinanced) as well as the degree of secondary repayment support from the free cash flows of the stores that are not financed. Free cash flow is the amount of cash flow remaining after fixed and administrative charges. Beyond this basic analysis, a review of store-level financial performance will illustrate six aspects of the business.

1. **Operating cash flow and free cash flow diversity.** Ideally, multi-unit chain store operators should have diversified cash flow streams. Seeing some stores that lose money is not an issue. What is an issue is if 80% of the cash flow comes from 20% of the locations. Store-level earnings concentrations represent increased risk.

2. **Operating profit margin consistency.** Operating profit margin is operating cash flow as a percent of store sales. As a general rule, stores having lower sales tend to have lower operating margins as a result of higher proportional fixed costs. FFCA maps out the economics of its chain store borrowers with regression models.3 A simple model that regresses operating cash flow to sales can be readily achieved with virtually any current spreadsheet or statistical software. The result is an equation that predicts operating cash flow given a level of store sales. The equation appears as a constant (representing fixed cost) and a coefficient (representing variable profit). To estimate operating cash flow for a given level of sales, one would take a sales estimate, multiply it by the coefficient and subtract the constant. Performing a regression analysis is key to estimating store operating profit margin consistency. The regression results illustrate margin consistency in several ways. The most significant of these is the correlation (or R^2) that estimates the degree to which operating cash flow is a function of sales. The lower the correlation , the less predic

Figure 1   Regression Line
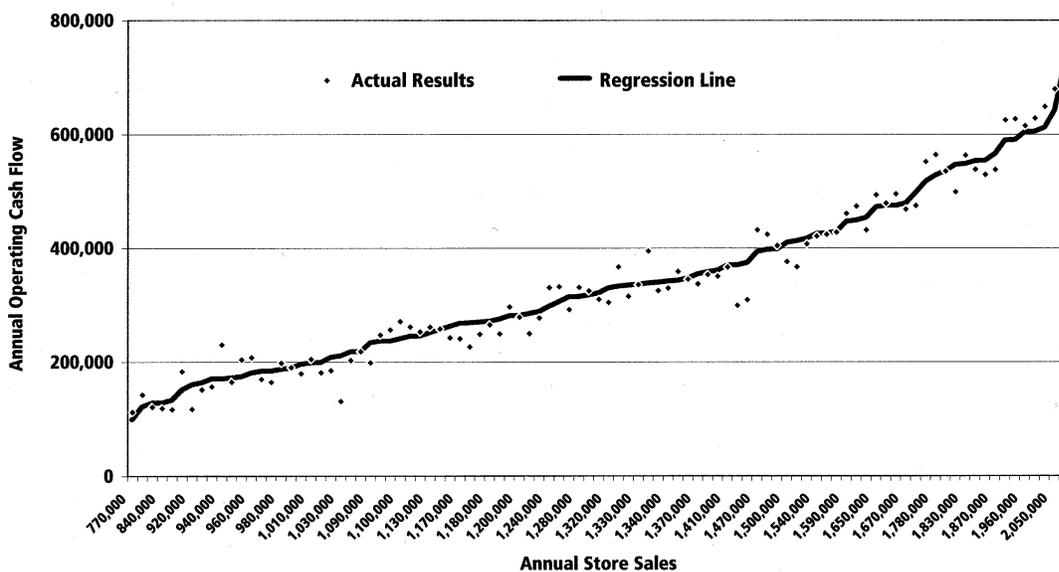
tive the model and the more inconsistent the results of the borrower's stores. A perfect correlation is 1, with most good models being at .8 or better (this means that 80% of changes in store operating cash flow are a function of sales). Models having lower correlations will tend to have high standard deviations of the constant, coefficient, or both. Inconsistent models having low R^2's and high standard deviations of the variables mean that there is little ability to predict store operating cash flows for given levels of sales. The lack of predictive ability implies higher lending risk. Poor predictive models suggest store-level management or margin inconsistencies. The regression line example seen in Figure 1 is for a family dining chain and provides a typical illustration of a chain regression model having good predictive characteristics.

The formula for the regression line in Figure 1 is Operating Cash Flow = Sales x 42.37% - $227,182. This regression formula is before the company's indirect overhead of 5% of sales. So, including the overhead would reduce the coefficient to 37.37%. The R^2 is .962, suggesting a high predictive level.

3. Expected new store performance. Chain retail sectors tend to be mature, which means that there is little new store development relative to the base of existing stores. However, loan requests for new store development can be well assessed though a review of existing store-level income statements. Given a predicted level of sales, operating cash flows can be readily estimated through regression analysis and equations as noted earlier. Breakeven sales results for new and existing stores can also be estimated through

the regression equation shown as:

Breakeven Store Sales = (Store Debt Service + Regression Constant) / Regression **x** Variable Profit Coefficient

In the case of the family dining chain illustrated earlier, annual store debt service of $150,000 would result in breakeven sales of $1,009,317 (assuming a coefficient of 37.37%).

4. Store performance volatility. Statistics like "average unit sales" and "same store sales" tend to mask true volatility. In any given year, some stores are likely to have sales increases, while others will have sales reductions. High standard deviations of individual store sales percentage changes suggest high sales volatility. Again, volatility equates to lending risk. In this case, the risk tends to be from competitive or managerial difficulties. Both point to corporate vulnerability.

5. Chain expansion potential. The creation of chain-specific regression models, coupled with knowledge of the cost of new store development, will provide the analyst with an understanding of chain expansion potential. The ability of any chain to expand is driven by unit-level economics and an ability to generate acceptable returns on shareholder investment. There exist many chain retailers for whom new store development is no longer viable. While this fact does not preclude financing existing stores, it may suggest a vulnerability to new competition and lost market share. The V Formula[sm] is a good tool to estimate current pre-tax rates of return on shareholder equity.[4] A reasonable assumption is that targeted pre-tax rates of return on new stores should exceed 30% annually. The V Formula can be readily deter-

mined through a regression model and from other variables familiar to the lender. The basic V Formula computation is as follows:

The V Formula[sm]
(Sales/Investment x Operating Profit Margin - Portion Financed x Interest Rate - Annual Capital Investment/Investment) / Portion of Equity (which equals 1-Portion Financed) = Current Pre-Tax ROE

6. Secondary payment sources. As noted earlier, free cash flows from stores that a lender does not finance can serve as a secondary repayment source for unprofitable stores that a lender does finance. An analysis of store-level operating results should reveal the breadth and amount of store cash flows that represent potential secondary loan repayment sources.

A bottom-up credit analysis that begins with store-level operating results will point clearly to borrower and chain strengths and weaknesses. The success and prudent capitalization of any chain store business, viewed from the bottom up, says a great deal about its owners and managers. As lenders, we should seek to finance well-run businesses, and overall financial health and stability are key indicators of management quality. Observations that can be made from the bottom up transcend more transient top-down credit issues and are key to making long-term credit decisions.

The Health Barometer
In a cash business with a predominant need for term borrowings, one barometer of health stands out from all others: the fixed charge coverage ratio. This ratio measures the ability of a company to pay its debt service obligations from its operating cash flow. Operating cash

flow is gross cash flow before interest and lease payments, less dividends paid (it's good to subtract dividends if the company is a single-level tax structure). Operating cash flow backs out both interest and lease payments to make companies more comparable. In businesses where the largest balance sheet differences lie in how much real estate is owned or leased, both interest and lease payments must be included in fixed charges. The final fixed charge is the amount of current debt maturities. Putting this all together, the corporate fixed charge coverage ratio looks like this:

Corporate Fixed Charge Coverage Ratio = Operating Cash Flow / (Interest Expense + Current Debt Maturities+**1** Lease Payments)

While the corporate fixed charge coverage ratio provides the most meaningful single measure of borrower financial health, it excludes the health of the assets financed. Not surprisingly, the single most important measure of the health and debt service capacity of the stores is also a fixed charge coverage ratio, but at the store level. The store-level fixed charge coverage ratio looks like this:

Store-Level Fixed Charge Coverage Ratio = (Store Operating Cash Flow[5]) / (Interest Expense + Current Debt Maturities + Lease Payments)

Both corporate and store-level fixed charge coverage ratios exclude one key item from the numerator: replacement capital expenditures (CapEx), otherwise known as functional depreciation. Functional depreciation takes two forms. The first of these is normal wear and tear. Roofs, carpeting, furniture, equipment and various other capital items periodically wear out and need to be replaced. The second item of

functional depreciation pertains to less frequent asset remodeling or reconfiguration. With many chain retailers, stores undergo major remodeling every few years in order to remain competitive in the ever-changing retail environment. The amount of replacement CapEx used in the numerator is generally a function of the retail sector and chain and can often be estimated as a percent of initial store investment. For example, if replacement CapEx is estimated to be $20,000 annually, with the original cost of the land, building and equipment of $1 million, then the annual functional depreciation amounts to 2% of original capital investment. To effectively compare chain store operators within the same chain or retail sector, the analyst should take care to use the same functional depreciation estimate methodology.

Many analysts do not include replacement CapEx in their fixed charge coverage ratios. Providing loan terms are matched with expected collateral lifespans, this may be excused. If this is properly done, borrowers may reasonably anticipate an ability to continually finance new equipment as they replace old, worn out equipment. This strategy limits store-level fixed charge coverage ratio from declining (because the functional obsolescence can be largely financed). Still, companies that pay for functional obsolescence out of store cash flow build greater equity cushions over time and are more conservatively operated. ☐

NOTES

1 Nonrecurring expenses, as used here, is a financial rather than an accounting convention. Nonrecurring expenses typically includes gains or losses from the sales of properties, and other similar readily quantifiable expenses or income not anticipated to recur. Otherwise, gross cash flow is fully loaded for how the borrower actually operates, not how he could theoretically operate. As such, non-recurring items should not include adjustments for store pre-opening costs, new store development overhead, estimated shareholder excess compensation or other similar arbitrary expense estimates.

2 See "Models of Default and Recovery for Chain Restaurant Loans" published by Merrill Lynch, Pierce, Fenner & Smith Incorporated, January 1997. See also "Franchise Loan Default Model" published by Morgan Stanley Dean Witter & Co, April 2000.

3 See "Tenant Business Fundamentals—A Foundation for Value" by the author, which appeared in the May/June 1992 issue of *The Journal of Property Management*.

4 See "The V Formula Framework, A Tool to Evaluate Corporate Capitalization and Shareholder Value" by the author, which appeared in the October 1999 issue of Strategic Finance, published by the Institute of Management Accountants .

5 Store Operating Cash Flow does not encompass dividends, but must include an allowance for indirect general and administrative (G&A) costs, which are typically not allocated to store-level profit and loss statements. The amount of G&A costs applied should ideally be equal to the G&A percentage of the company as a whole. Indirect G&A costs include home office expenses such as marketing, accounting and executive compensation, as well as regional management costs. Borrowers will sometimes make the case that new stores can be acquired or constructed with just nominal marginal G&A costs. While true, the analyst should still load a store with its fully allocated compliment of G&A costs. The reason is that any replacement operator will likely incur G&A costs at a more representative level.