

Chain Store Credit Review: The State of the Art

Part 2 of 2

by Christopher H. Volk

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

Borrower Analysis

The vast majority of chain store operators are privately held. For the analyst, this means that there is often no simple corporate financial statement analysis; there is borrower analysis. A borrower is any group of companies or entities that combine in unison to operate chain retail establishments. As illustrated earlier, it is the operations of these chain retail establishments that are generally the primary and secondary sources of loan repayment. Many borrowers will house their operations in multiple companies. Some companies may operate stores. Other entities may house land, building, and equipment that are leased to the operating companies. Still others may house man-

agement and general and administrative activities. To make matters more complex, it is not unusual to see divergent share ownership of the various entities that comprise a borrower. The analyst should take care to consolidate, or at the very least to combine, the entities that together constitute the borrower.

The private ownership structure of the majority of chain retailers means that most will elect to employ single-level tax structures, such as Subchapter S or Limited Liability Corporations. Some will even occasionally employ partnerships or proprietorships, especially for the ownership of real estate used in the business. Regardless of business structure, the analyst should take steps to make borrowers com-

parable. Following are a few tips on how this can be accomplished.

Shareholder dividends.

Shareholder compensation in closely held, single-level tax structures is often taken out in the form of dividends or partnership distributions. As noted earlier, such distributions should be subtracted from operating cash flow when computing corporate fixed charge coverage ratios. This adjustment renders single-level tax paying vehicles comparable to C Corporations, where the compensation of company management is typically embedded within overall corporate general and administrative expenses.

Excess rents. Many private borrowers will derive shareholder compensation through excess rents

© 2001 by RMA. Volk is president and COO of Franchise Finance Corporation of America (FFCA), a publicly traded NYSE company that provides financing to chain store operators. Founded in 1980, FFCA financed over \$4 billion representing nearly 6,000 locations as of September 30, 2000.

charged on the real estate owned and leased to operating companies. To make companies comparable, the analyst should endeavor to consolidate entities, categorizing excess rents as officer compensation in the process.

Minority interest. It is common to see divergent shareholder ownership of companies within a borrower group. This is frequently a means to incent senior management or employees by giving them a piece of the pie. However, when looking to compute borrower free cash flow, that portion of income allocable to minority shareholders should be expensed as "minority interest." Often, this allocation of income will not be available to support borrower obligations.

Income Statement Ratio Analysis

Income statement ratios are one of the best tools to review chain store companies. The fixed charge coverage ratio is very important and was discussed in Part 1 of this article. There are additional income statement ratios that merit brief discussion.

Inventory turnover. This ratio is most important for chain retailers that sell durable goods. Those companies that sell consumable goods will generally have a rapid turnover with little volatility from year to year.

Receivables turnover. Most chain retailers do not carry trade receivables, rendering this ratio of little value. The lack of trade receivables and rapid inventory turnover are the major contributors to the deficit working capital positions of chain retailers.

Payables turnover. If a company has a cash flow shortfall, there

are only four basic ways to sustain operations:

1. Raise added shareholder equity.
2. Borrow money.
3. Sell assets.
4. Stretch out payments to suppliers.

This fact makes the payables turnover ratio important. The analyst should look for little volatility and payment within trade terms. In this regard, trade purveyor credit checks are also highly important.

Cash turnover. This ratio is a better measure of chain store operator liquidity than the quick or current ratios. Many chain store operators maintain only a few days' sales in cash supply. A large portion of this amount resides in store cash registers. This ratio measures the number of days' sales in cash. The more cash sales, the better the liquidity.

Debt/EBITDA. This ratio is among the more important leverage ratios for chain retailers. The benchmark to look for is a function of real estate ownership. This is because real estate is the asset that can be financed over the longest timeframe. For borrowers that own all of the real estate underlying their locations, a Debt/EBITDA ratio of 5:1 might not be unreasonable. For those that lease all of their locations, this ratio should be considerably lower.

Chain store borrower financial statements are a composite of store-level results. This means that income statement ratios will often be distorted for one key reason: Not all of the stores have been operated for the same number of months as the period covered by the borrower financial statements. A 12-month statement for a borrower will include many

stores open for the full period as well as stores open for a fraction of the period. So borrower income statements (including full-year statements) must be annualized to arrive at meaningful financial statement ratios. The most accurate means of achieving this is to annualize the individual results of all of the locations operated by the borrower. A second common means of annualizing income statement ratios is to assume a midyear convention and similar profit contribution levels for all stores in the following computation:

Annualized income statement ratio computation $\frac{\text{Ratio} \times \text{Ending number of units}}{\text{Beginning number of units} + \text{Ending number of units}}$

Balance Sheet Ratio Analysis

Balance sheet ratios are the least helpful of all ratios when it comes to the analysis of chain retailers. This is so for three reasons.

1. Chain store operators are generally engaged in a cash business. Given this fact and the resulting deficit working capital, income statement ratios are paramount.
2. The single greatest difference between the balance sheets of chain store operators is the degree of real estate ownership. One operator may own stores, while another may elect to lease stores. Both may have similar Free Cash Flows, yet their balance sheet ratios will be markedly different. This scenario is played out frequently among chain store operators and underscores the limited value of balance sheet ratio analysis.

3. A related issue is that real estate ownership depresses borrower earnings by virtue of the depreciation expenditures. In general, accounting depreciation tends to exceed functional obsolescence. The result can be that companies in business for many years can and often do have depressed net worths that arise from their decision to own, rather than rent, their real estate.

The best way to evaluate and compare borrower balance sheet ratios is to capitalize off-balance sheet lease obligations. To do this, some lenders will go through the trouble of calculating a present value of future lease payments. It may be preferable, however, to capitalize the lease payments using a global capitalization rate (rent capitalization rate). This is because leases are invariably renewed, which means that their technical maturity dates are less significant than their intended maturity dates. In this sense, companies must be analyzed as going concerns and not based on the technical present value of future obligations. Using a global capitalization rate also helps to estimate the value of the assets effectively controlled by the company. For example, if real estate lease rates tend to be in the 10% range, a \$70,000 annual payment implies an asset valued at approximately \$700,000. If there are just five years left on the lease, the value of the asset is not diminished. In fact, the cost to renew the lease at the end of the lease term may be even greater, another issue that bears importance to the analyst. In any event, capitalizing the lease payments will generally do the best job of incorporating

both operational intent as well as the values of assets controlled by the borrower.

In addition to capitalizing off-balance sheet debt, it makes sense to add accumulated depreciation to equity and to fixed assets. This adjustment makes sense for two reasons.

1. Chain retail establishments must be well maintained to attract a finicky buying public. As a result, the effective remaining lifespan of the fixed assets of many chain store operators should not be materially different from the anticipated lifespans of new assets. If this is not done, then newer companies and chains will generally have better equity ratios by virtue of the fact that they are newcomers.
2. Older companies with significant accumulated depreciation will be at a comparative ratio disadvantage, even though they may have assets of equal quality and even though they may have purchased those assets for far fewer years earlier. In this way, older, more established chain retailers will tend to show higher debt/ equity ratios, while not getting any credit for property condition or unrealized asset appreciation.

What follows is a brief example of balance ratios, with formulas included where appropriate to incorporate the preceding discussion:

Sales/fixed assets. This ratio denotes sales efficiency. The higher the ratio, the better.

$$\frac{\text{Sales}}{\text{Gross fixed assets}} \times \frac{1}{(\text{Lease payments} \div \text{Lease capitalization rate})}$$

Debt/equity. This ratio denotes

the degree of financial leverage. The lower the better.

$$\frac{(\text{Debt} \div (\text{Lease payments} \div \text{Lease capitalization rate}))}{(\text{Equity} \div \text{Accumulated depreciation})}$$

Debt/assets. This ratio denotes the degree of financial leverage. The lower the better.

$$\frac{(\text{Debt} \div (\text{Lease payments} \div \text{Lease capitalization rate}))}{\text{Assets} \div \text{Accumulated depreciation}}$$

Quick and current ratios. By virtue of their operating cycles, chain retailers tend to have deficit working capital positions. The cash nature of the business makes the relationship of current assets to current liabilities relatively unimportant. After all, it is gross cash flow, not the liquidation of current assets, that supports current liability levels. As a result, it is commonplace to see current and quick ratios of 0.5:1 or 0.25:1, respectively.

Effective debt/operating cash flow. While this ratio is an income statement ratio, it is included here as an example to illustrate the benefits of capitalizing off-balance sheet debt. This ratio is similar to Debt/EBITDA, but incorporates leased assets, making it more meaningful. For purposes of this illustration, this ratio is also annualized.

$$\frac{[(\text{Debt} \div (\text{Lease payments} \div \text{Lease capitalization rate})) \div \text{Operating cash flow}] \times \frac{1}{\text{Ending number of units}}}{(0.5 \times \frac{1}{\text{Beginning number of stores}}) \div \frac{1}{\text{Ending number of stores}})}$$

Collateral Value

An often-debated topic among lenders is how much money can be advanced against collateral. Real estate, given its relative value, is by far the most dominant issue. Chain

store real estate is most often a free-standing, single-tenant location, which necessitates a different type of analysis from most other commercial real estate.¹ The difference lies in the fact that stores are built specifically to house the operations of retail chains (in real estate parlance, this is called “build to suit”). So if the real estate is leased, rents tend to be a function of the cost to build the location and the required rate of return to the landlord. Unlike most real estate, tenants of free-standing chain store locations generally do not compute their lease rates on a per-square-foot basis. Neither do landlords. Each is simply looking for returns on their respective equity investments. As collateral, the implication of this fact is clear: Chain store locations are seldom, if ever, worth more to a chain store operator than their replacement cost. If a chain store operator is asked to pay more for a location than a new store would cost to build (presuming the same sales and operating profitability), he or she will generally choose to build.

While real estate replacement cost is typically the most a lender could expect from real estate collateral, chain stores frequently trade for values that are well below this amount. Store-level economics are the reason. Many retail chains simply do not generate sufficient operating cash flows at the store level to justify new store development. At the same time, such chains may have many existing locations that can be readily financed for amounts that are less than replacement value. The conclusion: Replacement cost is generally the most that a lender should advance against chain store real estate. Often, lenders will

advance less. But in all cases, the amount advanced should have debt service that can be supported by store-level operating cash flow as illustrated earlier.

The way loans are most likely to be treated in bankruptcy serves to delineate lending risk. As a general rule, loans to finance real estate and equipment are more likely to be upheld in bankruptcy if they are:

1. Extended for amounts equal to or less than collateral replacement cost.
2. Collateralized by stores that have sufficient cash flows to cover the debt service.²

Any loan that is extended to finance chain store real estate or equipment that does not meet these criteria is not effectively secured. Such a loan is in danger of having some or all of its proceeds characterized as a corporate senior loan that cannot look to the performance of the chain store collateral as a primary repayment source. Corporate senior loans are often referred to as “enterprise” loans.

There is no rule of thumb for determining liquidation values of chain store collateral. In an abstract sense, a loan to finance a chain retail store is not a real estate loan, because the real estate is not the primary source of repayment. Instead, it is a business loan that is collateralized by real estate. This is an important distinction, because it means that the liquidation value of the collateral is a function of its value to similar businesses. In turn, that value is variable, depending upon the anticipated store-level economics of the users. Indeed, free-standing single-tenant retail properties have a hierarchy of uses that are a function of store-level economics.

As noted earlier, real estate replacement cost will tend to present a ceiling for real estate loan recovery. After that, what is recovered is generally a function of the buyer’s store-level economics, the amount of conversion costs required (less is better), and the type of financing available.

In addition to fee real estate and equipment financing, lenders are occasionally asked to provide financing for leased chain store locations. Leased locations generally take two forms: those that are subject to ground leases and those that are subject to long-term land and building leases. Financing any leased location is riskier than being collateralized by a first lien on fee real estate because collateral control entails the payment of rents. Such payment of rents has the real potential of diminishing, and possibly eliminating, loan recoveries in the event of a monetary default. While the technical collateral instruments are different for ground leases (a building mortgage) and land and building leases (a leasehold mortgage), the philosophic issue is the same: The underlying rents should be below market for the collateral to have value. In the case of ground leases, the presumption is generally that this is the case; for the assumption of a ground lease payment, the lender can control the value of both land and building. However, no lender should take this for granted. If leases tend to be made based upon the cost to construct a property, the lender should estimate the degree to which a lease may be below market as follows:

Market Value Lease Spread Computation

Property Replacement Cost 3
 Prevaling Lease Rate 2
 Current Lease Payment 5
 Positive Lease Spread

Lenders who deem themselves adequately secured by a leasehold interest value should seek to have their loan payments equal to or less than the positive lease spread. In addition, the term of the loans should not exceed the term of the underlying leases (it is all right for a lender to include lease renewal options in this calculation). As a rule of thumb, a lender should generally seek to have the underlying lease term exceed the loan term by at least five years; the longer the lease term, the more potentially valuable the leasehold collateral. Given the inherently higher risks of lending against leasehold collateral, leasehold loans should ideally be for shorter terms than loans secured by first liens on real estate. Lastly, the positive lease spread has value only if it is supportable by the operating income of the associated chain store. In light of the higher degree of risk associated with ground lease or leasehold loans, the store-level fixed charge coverage ratios should ideally be higher than for fee simple properties.

Enterprise Loans

Real estate and equipment loans constitute the majority of term credit needs for chain store operators. However, the maturation of many chain store retail sectors has led to significant merger and acquisition activity. In turn, this activity has brought about a need for loan proceeds that often exceed amounts that could be prudently financed against a company's hard assets, as already outlined. A loan request in excess of this amount is often called senior or,

as mentioned earlier, an enterprise loan.

Enterprise loans generally have little in the way of meaningful collateral. Most lenders in the business of making such loans seek collateral ranging from unencumbered equipment packages to leasehold mortgages to franchise agreement assignments to trademarks to company stock. The limited security for enterprise loans generally mandates shorter loan terms, higher loan interest rates, and stronger corporate loan covenants. Such loan covenants may impose a floor on the corporate fixed charge coverage ratio, restrict dividend payments, limit debt incurrence, or have other restrictions designed to closely monitor corporate activities. Such covenants are crucial to enterprise lending to provide lenders with advance warning mechanisms and resulting options to minimize losses in the event of downturns in corporate credit performance. Unlike secured loans described earlier, bankruptcy is a far less hospitable venue for enterprise lenders. As a result, advance-warning mechanisms may serve to stave off bankruptcy and potentially realize enhanced value from asset dispositions or recapitalization.

The limited available collateral for enterprise loans results in substantially elevated lending risks. The most immediate is an enhanced risk of monetary default. Insolvency compels borrowers to assess cash flow allocation priorities. Enterprise loan payments take a back seat. This is analogous to consumers who will pay their home mortgage before credit card bills. Beyond the immediate heightened risk of monetary default, there is another meaningful enterprise lending risk—the risk of

limited loan recovery in the event of a default. Because enterprise loans have limited collateral, they depend on the ongoing corporate creditworthiness and borrower value. Should this become challenged, the recoverability of the outstanding loan proceeds is challenged as well. The limited collateral means that, unlike more secured loans, no equity cushion is ever built up. So the proportional loan loss can be as great in seven years as it is in three years. Greater risks of loan default and limited recovery equate to greater risks to enterprise lenders of eventual loan losses. For this reason enterprise lending mandates higher interest rates and greater servicing discipline.

Secured Loan Structural Considerations

It is important that chain store loan extensions accompany structural elements designed to maintain credit quality. This is the role of loan structural enhancements and loan covenants. Among the many enhancements and covenants employed, personal guarantees as well as remote borrowers and select covenants bear special consideration.

Personal guarantees. The majority of chain store operators are private, closely held concerns. Operators seek business structures that serve to enhance their after-tax earnings. Single-level tax structures are one means to achieve this end. Likewise, those that operate as traditional C Corporations will seek to limit taxable corporate earnings by maximizing shareholder compensation. All of this is fully understandable, but it often results in low corporate fixed charge coverage ratios, with limited cash flow retained in

the business. For a lender, this activity speaks to the need for a personal guaranty. Credit analysts often view the support of a guaranty in terms of secondary payment monetary support. However, many principals of closely held companies possess relatively little in the way of net worth outside of their businesses. The point of obtaining a guaranty does not generally lie in enhanced credit support, but rather in forging an alignment of interest that promotes greater default resolution speed. Guarantors are generally highly motivated to work with lenders to maximize the timely recovery of their loans. Without such motivation, bankruptcy or foreclosure proceedings can drag on for a year or more, permanently depriving a lender of lost interest income.³ In a review of the history of FFCA's loan losses between 1981 and 1998, FFCA found that the presence of personal guarantees reduced losses on monetary loan defaults by an average of 10%.⁴ Enhanced default resolution speed is the primary reason.

Remote borrowers. It is not breaking news that borrower bankruptcy can be unkind to lenders. Among the greatest risks faced by lenders is the likelihood that they will receive little or no meaningful loan payments for the duration of a bankruptcy proceeding. For enterprise loans, there is no effective means of defraying this risk. However, real estate lenders can minimize this risk by setting up remote borrowers (see Figure 1). The most basic means is to have a borrower take title to the real estate, which is then leased to the operating company. The lender's recourse to the operating company comes

through a collateral assignment of the lease stream, combined with a first mortgage on the real estate. In turn, the lease payment made by the operating company must be equal to or greater than the loan payment by the owner/borrower. The idea is to synthetically convert a loan into a lease at the operating company level. Within bankruptcy, leases are treated as executory contracts, meaning that the operating company does not have the option to indefinitely occupy and operate leased stores while not making payments. For lenders, the significance is a more rapid resolution for relinquished properties and the uninterrupted receipt of payments on retained stores.

There are two clear risk benefits to a lender of remote borrowers—default risk dispersion and recovery enhancement.

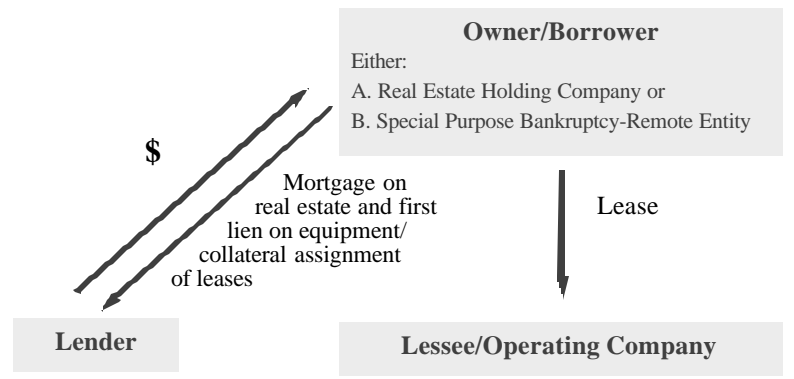
Default risk dispersion. When a lender finances multiple stores for a chain store operator, a borrower bankruptcy will imply a simultaneous monetary default on all of the loans. However, when remote borrowers are used, the bankruptcy of the operating company may not result in the default of any loans at all, because the lessee/operating company will retain profitable

leased locations. In the event that some of the locations financed are unprofitable, the lessee/operating company may elect to relinquish those properties to the owner/borrower, while still retaining and paying for other profitable locations. As was noted earlier, a large loan to a single borrower and secured by a single asset is not as diversified as a similar size loan to a chain store operator collateralized by the real estate and equipment at many profitable locations. By setting up remote borrowers, the notion of this diversity is structurally asserted.

Recovery enhancement. Remote borrowers can serve to speed up the recovery process by allowing lenders the rapid repossession of relinquished properties. In addition, a lender always has the option of modifying leases on unprofitable locations so that they will be acceptable to the lessee/operating company. Such a result can also expedite loan recovery.

When it comes to remote borrowers, there are further structural features that can enhance a lender's security position and promote a stronger alignment of interest between the borrower and the lender. Two of the most frequently

Figure 1



seen enhancements are bankruptcy-remote borrowers and master leases.

Bankruptcy-remote borrowers. Ideally, remote borrowers should be bankruptcy remote. Such borrowers have directorial mandates that are designed to prohibit bankruptcy filing. A prohibition from bankruptcy filing further structurally asserts default risk dispersion and recovery enhancement. The borrower's board of directors has a fiduciary obligation not to file for bankruptcy and the lessee/ operating company has a business incentive to retain and pay for profitable stores. The result is default risk dispersion and greater certainty of more rapid collateral repossession.

Master leases. The real estate leases between the owner/ borrower and the lessee/ operating company can be either individual leases assigned to specific properties or in the form of a master lease that covers multiple properties. A master lease is preferable because it is designed to deny the lessee/ operating company the ability in bankruptcy to affirm or reject specific properties. With an inability to "cherry pick" properties, the lessee/ operating company must rely on the lender for any concessions. As a result, a master lease offers lenders a heightened level of control over the ultimate disposition of their collateral.

The notion of remote borrowers is complex and a complete analysis of the merits of remote borrowers is beyond the scope of this article. However, their use is widespread and FFCA's experience supports their desirability.

Loan covenants. Chain store

loans that are secured by real estate and equipment generally have little in the way of corporate covenants.

This is because corporate covenants for secured real estate loans can often be at odds with other financing needs, including enterprise loans, general-purpose loans, or lines of credit. Covenants should be designed to ensure loan quality maintenance, while avoiding unneeded financial constraints.

Among covenants, the most important is a store-level fixed charge coverage ratio covenant. Presuming that loans to finance multiple chain store locations are cross collateralized and cross defaulted, such fixed charge coverage ratio covenants can be made at an aggregate store level. This makes sense, because typical chain store operators can lose money in 10-20% of their locations. Requiring each store to perform individually can be excessively burdensome. Moreover, when making loans to finance existing chain store locations, the proceeds allocated to money-losing locations can often be limited. By having an aggregate fixed charge coverage ratio test, the lender can monitor the health of the primary source of loan repayment—the stores securing the loan. In the event that the aggregate store-level fixed charge coverage ratio falls below the covenant, the lender has the option of requiring loan repayment, loan reduction, or collateral substitution. Provided the borrower is healthy, it may have the financial flexibility to accommodate such a request and assure loan quality maintenance. Cash flows from stores that a lender does not have as collateral represent a secondary repayment source but not one that can be prudently relied upon for the

long term. Therefore, store-level fixed charge ratio covenants are designed to offer a lender the opportunity to proactively avert potential loan deterioration.

Apart from store-level fixed charge coverage covenants, various other loan covenants are occasionally necessary. One common desirable covenant for secured loans pertains to a minimum borrower net worth. This is especially true in the event a remote borrower is used. Here, the covenant must reside in the lease between the borrower and the lessee/operating company. The value of this covenant arises in the event of the bankruptcy of the lessee/operating company. Where the net worth falls below the covenant, the lessee may be prevented from accepting the leases, thereby placing the lender in a stronger position to negotiate an optimal loan recovery resolution. Another covenant is a prohibition from changes in corporate control. This covenant is commonly shared by all loans.

There's More

A general framework for chain store credit analysis cannot alone ensure loan portfolio performance. There are other important issues for lenders that transcend this general framework, including retail sector and individual chain dynamics. In addition, good loans are not just made; they are properly documented and serviced. Proper documentation holds the key to enforcing lenders rights. Regarding servicing, close borrower performance and covenant compliance monitoring are essential to maximizing long-term loan portfolio quality. This is especially true given the term loan nature of the majority of chain store

borrowing needs. With the transience of corporate credit quality, lenders must also stay abreast of sector and chain operational fundamentals. The final key is that lenders must be ready to take on the role of special servicer, which is to say that they must be capable of dealing with monetary defaults and chain store repossessions. Optimizing value in the event of a monetary default requires knowledge of chain store participants and alternate potential users. It also entails a general knowledge of how losses can be minimized in the bankruptcy landscape. But all of this must begin with a basic credit review framework. The essential underwriting standards represented within this article are the current state of this art.

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Notes

1 See "Single Tenant Retail Real Estate Valuation and Financing: An Enterprise Approach" by the author published in the Spring 1997 issue of *The Real Estate Finance Journal*, a Warren, Gorham and Lamont publication.

2 See "Franchise Loan Default Model" published by Morgan Stanley Dean Witter & Co, April 2000. This study of FFCA's loan loss history confirms that loans that are high rela-

tive to collateral replacement cost have a higher incidence of default and a lower level of loss recovery.

3 In recent years, some lenders have taken to watering down guarantees by limiting their enforcement to so-called "bad boy" activities, which include acts of fraud and borrower voluntary bankruptcy filings. To be effective, the author believes that personal guarantees must be unlimited in their scope. Otherwise, lenders are faced with having to first prove "bad boy" actions prior to seeking to enforce the guarantees themselves. The time taken in this endeavor contradicts the principal value of a personal guaranty: increasing the speed of loan recovery.

4 See "Franchise Loan Default Model" published by Morgan Stanley Dean Witter & Co, April 2000.