



THE CYPRESS GROUP

"Results through Focused Expertise"

Investment Bankers
Exclusively Serving the
Restaurant Industry

Changing Trends & Solutions in the New Financing Landscape

The Cypress Group provides a full range of Investment Banking and Strategic Advisory Services to the Restaurant Industry

Services Include:

- Mergers, Acquisitions & Divestitures
- Restructuring, Turnaround Situations & Bankruptcy
- Capital Formations: Debt & Equity
- Strategic Advisory Services
- Valuations & Fairness Opinion
- Litigation Support

The consolidation of franchise industry finance companies, local and regional banks as well as other financial institutions that has taken place prior to and during the current recession has led to only a handful of major institutions providing debt capital to franchise and independent restaurant companies in this environment. These groups are well known to most in the restaurant industry. These institutions have dramatically decreased leverage multiples while increasing interest rates and are tightly preserving capital until general economic conditions and restaurant sales show signs of stability. As these lenders constrain the flow of debt capital to our industry (or shut off lending completely), there are some trends that all franchise owners should take into consideration to ensure their financing needs are met during this recession. This article provides an update on the current macroeconomic outlook, capital market conditions and emerging financing trends that may help franchise companies navigate the challenges posed by the current environment.

Where are we on the Recessional Curve?

The answer to this question is far from rhetorical and nearly impossible to answer. However, there are applicable economic observations of late that help us understand where restaurant companies can identify viable financing options in the current environment. First, numerous economic indicators have emerged over the last few weeks that were not as bad as many investors anticipated. Consumer confidence, housing sales, corporate earnings (particularly in the financial sector) and related stock prices have provided some buoyancy to the longer term economic outlook. In addition, the recent government financial stress tests, while exposing continued weakness in the banking sector, were more positive than most anticipated. Many economists are now predicting that we may have already reached bottom while also warning that the economy will be slow to emerge from such a deep and widespread downturn.

The second observation is that a rebound in the debt capital markets is likely to lag behind a recovery in the broader economy. Historically, the financial sector has been the first to contract and the last to expand once an economic rebound begins. More specifically and directly applicable to the current environment, the delay in new lending is driven by a couple of factors. First, the large banks that typically keep loans on their balance sheets (versus selling them to outside investors) have serious issues within existing portfolios and are fearful of making additional mistakes. These concerns center around future write-downs, balance sheet contractions and the refinancing risk associated with loans maturing in the next two to three years. Another major factor is that many of the institutions (pension funds, private debt funds, hedge funds, etc.) who historically have purchased new loans from the banks or finance companies originating them have closed their doors, curtailed investments or allocated capital in other areas perceived to offer better risk/reward parameters.

While none of us knows exactly when economic stability will return or exactly how this recessionary cycle will come to an end, we do believe that franchise and restaurant companies who are creative and well informed as to current market conditions will benefit substantially in a recovery. Given the challenges that many of the larger lending institutions are dealing with, we offer the following advice to restaurant companies to best position themselves in a recovery.

Start Developing Relationships with Local and Regional Banks

While many local lenders may not have been as competitive as their larger counterparts in the last few years, many of these banks successfully avoided the pitfalls that now plague our industry's larger financial institutions. With a level playing field where the advance rates have decreased across almost every industry, a local lender may provide competitive financing where old relationships cannot. These groups can provide a solution for a company in need of a refinancing or new unit development / acquisition capital. While the government is injecting funds across the nation, regional communities are focused on boot strapping at the local level to take care of their own first. Furthermore, these institutions are focused on broader relationships with borrowers extending beyond just a lending relationship. Credit card and merchant services, cash management and depository accounts, payroll and trust services are important profit centers to regional banks and are important considerations in considering new clients. Reach out and develop a relationship with those local and regional banks in your area as you may find them to be increasingly open to taking a place within your capital structure.

Initiate a Franchisor Sponsored Lending Program

Whether you are a franchisor or a franchisee, encourage the use of resources to establish a franchisor-sponsored lending program for your system. Earlier this month, U.S. Bank announced a partnership with McDonald's to promote financings for the system's U.S. based franchisees for a wide range of uses. In the current environment, efficient access to capital can be a substantial determinant of overall system health, growth and success in the next cycle. The participation of the franchisor in such a program can provide the necessary encouragement to individual banks or finance firms to distribute capital on a widespread basis where otherwise they may not. Often, franchisors that have sponsored established financing programs benefit from accelerated growth with new and existing franchisees.

Consider Seller Financing

If you have the flexibility, be your own bank. For those business owners seeking an exit strategy, taking on some seller financing to help facilitate a transaction may be the difference between success and failure. Given the lack of liquidity in the debt capital markets, seller financing has emerged in more creative and sophisticated forms in recent transactions. Today, sellers are structuring such financing to match their risk tolerance. Given the lower levels of senior financing available, some sellers are structuring relatively secure second lien financing yielding returns at a slight premium to senior debt. Others with a higher tolerance for risk or a desire to take a "second bite of the apple" are structuring mezzanine type securities with equity participation features.

This enables a more substantial return on debt capital and the ability to participate in the upside of the business when conditions improve. In either scenario, sellers may find compelling returns within their own business versus other investment opportunities. Such creative structures also provide a unique solution to a variety of hurdles in this marketplace including bridging the gap between buyer and seller valuation expectations, providing higher overall return levels for sellers and giving the new buyer added confidence in the forward opportunities of the business.

Listen for New Opportunities

Just like the economy, the finance industry has periods of contraction and expansion. Given the years of consolidation followed by the dearth in current activity, the market conditions are ripe for new entrants. Typically, such consolidation gives rise to added market control raising the barriers to entry, but with the current paralysis, all bets are off. We have seen this in prior cycles and expect an increase in smaller, more nimble finance companies designed to address the needs of franchisees and franchisors. We have also seen firms that were once solely focused on equity investments entertain debt financings. Overall, the number of franchise companies in need of debt capital is overwhelming. In this environment, don't hesitate to explore new relationships with groups you may not have heard of before and continually talk with your industry resources to learn about emerging groups.

As we observe the current recession and its ultimate evolution into recovery, companies seeking to thrive in this environment need to understand and adapt to the current landscape. Successful companies will secure new financing alternatives while others wait on the sideline until the market returns to some semblance of what it was before the recession began. The companies that reach beyond familiar borders will be well poised to take advantage of opportunities that arise in the early stages of an economic recovery. The entrepreneurial and innovative spirit that has driven American business for decades will produce new solutions for growth and prosperity. For the strategic, well positioned and prepared entrepreneur, this cycle can provide opportunities for long term success.

<p>Dean Zuccarello <i>President & CEO</i> 303.680.4141 x111 dzuccarello@cypressgroup.biz</p>	<p>Carty Davis <i>Principal</i> 910.692.9176 cdavis@cypressgroup.biz</p>	<p>JB Hewetson <i>Vice President</i> 303.680.4141 x112 jbhewetson@cypressgroup.biz</p>	<p>Steve Ogrin <i>Associate</i> 303.680.4141 x113 sogrin@cypressgroup.biz</p>
--	--	--	---