FEDERAL RESERVE BANK OF DALLAS

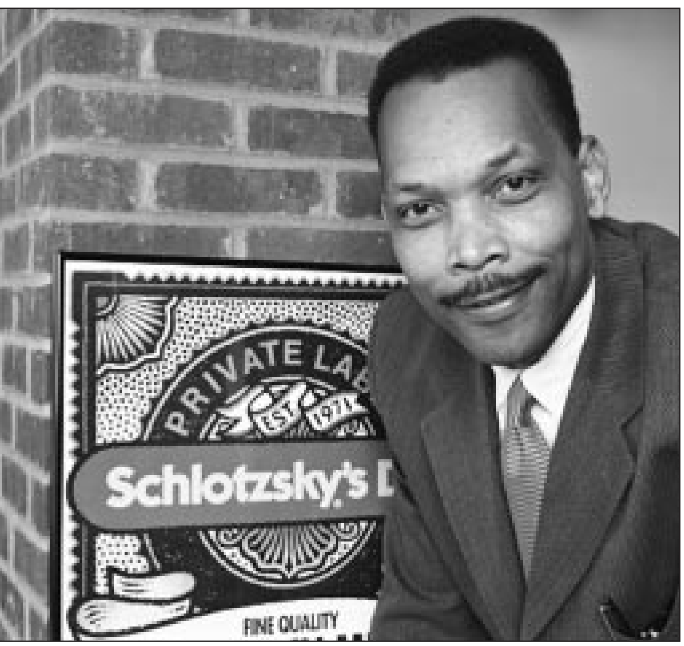
BANKING & COMMUNITY

Perspectives

FOURTH QUARTER 1998

Taste of Success

Entrepreneur Bites into Independence with Schlotzsky's Deli Franchise



Entrepreneur Theo Rolfe found the ingredients for success in a Schlotzsky's Deli franchise. He now operates three stores.

For Theo Rolfe, the all-American pie looks like a sandwich. When he decided to trade his career in big business for entrepreneurship, Rolfe chose a Schlotzsky's Deli franchise as his charter for independence.

During his 15 years with IBM, Rolfe worked with several small businesses, some of them franchises. He had observed the franchise structures that were most successful, the problems encountered, and what worked and what didn't.

At a franchising fair, Rolfe investigated several organizations and learned of an opportunity to purchase an established Schlotzsky's franchise. "The timing was good," Rolfe says. "My purchase in 1993 coincided with Schlotzsky's corporate initiative to appeal to a broader market by expanding the menu (adding pizzas to the traditional sandwich line) and remodeling its restaurants, called stores. My 10-year-old store received a complete facelift."

Rolfe says it was always his intention to own a number of locations; consequently, he is constantly looking for the next opportunity. In 1995, he was attracted to a shopping center under construction on Interstate 30 at Eastchase Parkway in southeast Fort Worth. It was in a high-growth area, and a number of national retailers were opening stores in the center. Rolfe negotiated a spot at the end of the building, referred to as an "end-cap" location, as well as a lane in the parking lot for a drive-through window. Schlotzsky's also offers freestanding stores.

Unlike purchasing an existing franchise, building a new location meant Rolfe had to buy everything that went into the new store—plumbing, equipment, floor and wall coverings, furniture, cash registers—everything. And there were licenses, permits and signs to buy. The cost of opening the second store required substantial financing in addition to Rolfe's $40,000.

Again, Rolfe's timing was good. At a Fort Worth Metropolitan Black Chamber of Commerce after-hours networking reception, Rolfe met Joe Reyes from the local Small Business Administration (SBA) office. Because the shopping center was located in the target area for the William Mann Jr. Community Development Corporation (WMCDC), Reyes suggested Rolfe contact the WMCDC about financing.

The multibank CDC was formed in 1994 with capital from nine banks and

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INSIDE

Helping Schlotzsky's franchisee Theo Rolfe, center, celebrate the growth of his venture are, from left, Charles Comer of Wells Fargo Bank, LaVan Alexander of the Small Business Administration, Ted Sparks of Wells Fargo Bank and Dan Villegas of the William Mann Jr. Community Development Corporation.

Schlotzsky's *Continued from page 1*

the city of Fort Worth to encourage economic development in the area. The WMCDC joins with banks to provide financing to small businesses in its target area.

Dan Villegas, executive director of the WMCDC, directed Rolfe to area banks, including First Interstate Bank, now Wells Fargo. The bank loaned Rolfe $216,500 to open the second Schlotzsky's store. The WMCDC then loaned Rolfe an additional $30,000 in operating capital.

According to Villegas, Rolfe's proven entrepreneurial spirit and business acumen and his willingness to invest $40,000 of his own money were strong factors in the WMCDC's deciding to participate in the loan package. Those same factors helped Rolfe obtain the bank loan, which has an SBA guarantee.

While franchising has been around since the Civil War, franchises have really flourished in the past two decades. According to an SBA study titled "Franchising's Growing Role in the U.S. Economy, 1975–2000," franchise sales could make up 38 percent of total retail sales by the year 2000. Capital Financial Corporation, a Memphis-based company that provides financial services to national and international businesses, estimates that a new franchise opens every eight minutes of every business day. Restaurants now account for one-third of business format sales.

Franchising generally takes two forms — product/trade name and business format. In the simplest form, a franchisor owns the right to the name or trademark and sells that right to a franchisee. A more complex, and the most common, form is the business format model, which promotes a broader, ongoing relationship, often with a full range of services.

Designed to improve the franchisee's odds for success, the business format model provides a well-developed business concept, brand name and business expertise—marketing plans, management guidance, financing assistance, site location and training. Franchisees share the economies of scale in mass advertising and purchasing. The SBA study places median costs to open a franchised small business in a $25,000 to $150,000 range. And franchisees pay royalties to the franchisors, usually 4 percent to 6 percent of sales.

"In 1996 Schlotzsky's required a $10,000 franchise fee, with $7,500 due at closing and $2,500 due later," says Rolfe.

Most of the franchisees contacted in the SBA study were satisfied with income levels and their relationship with the parent franchisors. Still, individuals considering franchising should study a franchise's disclosure statements closely and investigate the organization carefully before signing any papers. Even with the best franchises, conflicts arise. Many companies have franchisee councils to resolve issues such as renewal rights, noncompete clauses, transfer rights and other aspects of the franchising relationship.

Despite the success of many small business franchisees, escalating costs make it increasingly difficult in some industries for small-business owners to become franchisees. Some franchisors require franchisees to purchase a package of locations. The fact that Schlotzsky's offered franchises on a single location was one of the reasons Rolfe chose the corporation.

"Building a franchise one store at a time is about the only way a person with limited access to capital can get started," says Rolfe.

Today his Fort Worth store is among the top three end-cap Schlotzsky's in the country in sales. It employs 17 people — seven full time and 10 part time. And Rolfe recently opened his third location, in Weatherford, Texas. He arranged his own financing for all three stores and says that by building on each success, financing has gotten a little easier with each new franchise.

Fast Facts

Entrepreneur Theo Rolfe was lured away from corporate America by the idea of being his own boss and running his own business. Franchising provided the opportunity. With one successful store in operation, Rolfe had the chance to open a second location in a Fort Worth CDC's target area. Through a chance meeting with Joe Reyes, a local SBA representative who directed Rolfe to the William Mann Jr. CDC, Rolfe opened the second location with a unique financing package.

Loan Closed:
April 1996

Loan Package:

Owner's Equity:	$ 40,000
Wells Fargo	216,500 (floating prime + 2.25% for 7 years; SBA guaranteed the bank loan)
William Mann Jr. CDC	30,000 (at 11% for 5 years)
Total	$286,500

For more information:
William Mann Jr. CDC
(817) 332-8575

RESOURCE

SBA Franchise Registry

Since 1993, the number of SBA-guaranteed loans has doubled, and lending to small-business franchisees has steadily increased. During this period the SBA has approved almost 12,000 loans to franchisees in nearly 1,200 franchise systems. In 1996 alone, SBA lenders approved 3,708 loans for more than $978 million.

The growth in the number of franchisees seeking SBA loans has placed a burden on the review process. The SBA identified potential problems, which led to formation of the Franchise Registry. With 69 local SBA offices, the same contract might be deemed eligible in one office and not in another. The heavy volume of applications could extend the review process, and industry differences in financial and operational procedures could cause confusion.

Since by law the SBA can only lend to small businesses, it must verify that its borrowers are indeed small businesses. When a franchisee seeks an SBA loan, the SBA or one of its lenders must review franchise documents to ensure the franchisor does not exert so much control over the franchisee's daily operations and profits that it becomes the real owner of the business.

Because local SBA lenders or offices lack the resources to react to so many different industry-specific situations, the SBA developed the Franchise Registry. Under the new process, franchises that meet the SBA's requirements are placed on the registry. Those seeking loans to open franchises listed on the registry enjoy an expedited review process. Of course, the lender must still approve the transaction independently. Currently 36 franchises are on the registry, and another 46 are in the application process. The SBA has posted a list of franchises approved for the registry on its Web site, <www.franchiseregistry.com>.

For more information on franchising, see the SBA Web site, <www.sba.gov>.

Did You Know. . .?

HMDA and CRA Data Available

Data on 1997 mortgage lending activity required by the Home Mortgage Disclosure Act (HMDA) and data on small-business, small-farm and community-development lending required by the Community Reinvestment Act (CRA) are now available on the Federal Financial Institutions Examination Council (FFIEC) Web site at <www.ffiec.gov>.

Also available on the FFIEC's Web site are CRA ratings for all subject financial institutions. The address is <www.ffiec.gov/cracf/crarating/main.cfm>. The site allows the user to search and sort the CRA ratings under a variety of options, including bank name, city, state and regulatory agency.

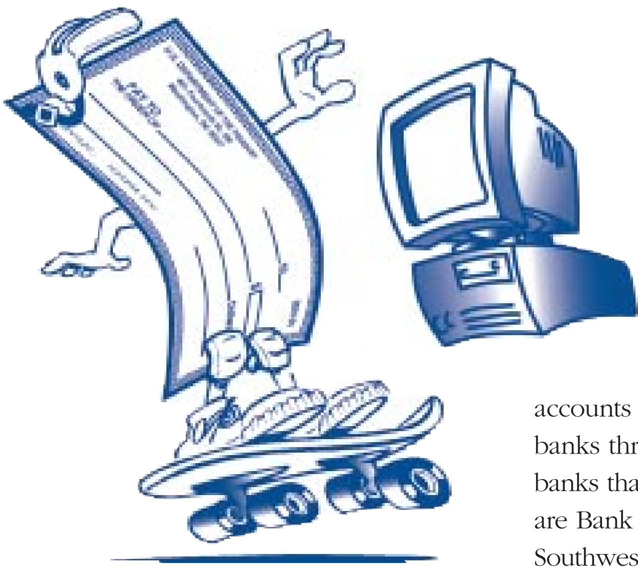
Community Affairs on Web

Enhancements to the Dallas Fed's Web site have made it easier to access information about the Eleventh District's Community Affairs Office. The address for the site is <www.dallasfed.org>.

Inner City 100 Award

Initiative for a Competitive Inner City is seeking nominations for the Inner City 100, which will recognize the fastest growing private companies located in America's inner cities.

The Inner City 100 list will be published in the May 1999 issue of *Inc.* magazine, and companies will be honored at an awards gala. The deadline to submit applications is October 31, 1998. You can download the application from the Internet at <www.inc.com/inner100>. For more information, contact Ann Habiby at (617) 292-2371.



Down to the Wire

Electronic Funds Transfer 99

The federal government's deadline for converting the nearly 1 billion payments it makes annually from paper checks to electronic funds transfer is less than three months away. The conversion will affect millions of U.S. citizens who receive government checks, such as veterans and railroad retirees, as well as vendors.

The Electronic Funds Transfer 99 (EFT 99) initiative, which goes into effect in January 1999, affects all federal government payments except income tax. Because payments will be deposited directly into the recipient's account in a financial institution, EFT is a safer, more convenient and reliable way for recipients to obtain their money than getting a paper check through the mail.

Direct Deposit into Banking Accounts

Recipients with direct deposit options on their current checking or savings accounts can have their payments directed into those existing accounts.

However, the U.S. Treasury Department estimates that more than 10 million federal benefit recipients do not currently have banking accounts. The Treasury is investigating a number of options for delivering payments electronically to recipients without bank accounts.

One alternative is to encourage recipients to open a banking account. An analysis of 15 banks in Texas indicates that a number of low-cost or no-cost accounts are available to customers at banks throughout the state. Examples of banks that offer these low-cost accounts are Bank One, Texas in Dallas and Southwest Bank of Texas in Houston.

Bank One, Texas offers a basic checking account that requires no minimum deposit to open and has a $3 monthly maintenance fee, which is waived if the customer uses direct deposit. Southwest Bank of Texas offers a no-minimum-deposit checking account to individuals 55 and older with unlimited automated teller machine usage for a $4 monthly maintenance fee.

Accounts Specified by the U.S. Treasury

The Treasury Department is developing its own low-cost account to allow recipients to use EFT. Named the Electronic Transfer Account (ETA[SM]), it will be offered through federally insured financial institutions to anyone receiving a government payment, regardless of whether the recipient has an existing account. However, recipients who elect not to use an ETA or another account in a financial institution will be paid by check.

In addition, the Treasury Department is working with states to link federal payments to state programs that provide electronic benefit payments on a type of debit card. Recipients would receive both state and federal benefits on one card.

The Treasury Department is also monitoring the development of arrangements between financial institutions and nonbank entities such as check cashers and money transmitters to ensure the recipients are fully aware of all fees and costs imposed by all parties.

Public Awareness

To ensure the program is successfully implemented, the Treasury Department has created an extensive nationwide public education campaign. The department has scheduled conferences and workshops with various bankers' associations, community-based organizations, financial institutions and government agencies that work directly with recipients to educate them about EFT 99.

Waivers

The Treasury Department will grant financial hardship waivers to recipients for whom EFT will cost more than receiving a paper check. Recipients with physical or mental disabilities or geographic, language or literacy barriers can also receive waivers from EFT requirements. Any recipient without a bank account will receive an automatic waiver until the Secretary of the Treasury announces the ETAs are available.

Federal agencies will notify all current payment recipients of all their EFT options, including enrolling in direct deposit, opening an ETA or applying for a waiver to continue receiving paper checks.

EFT 99 Workshops and Seminars

For information on conferences and workshops in the Southwest region, which includes the Eleventh Federal Reserve District, contact Dora Hernandez or Tabitha Guydon, with Financial Management Service, a bureau of the U.S. Treasury.

Financial Management Service
1619 E. Woodward St.
Austin, TX 78741
(512) 342-7310

Banking on Habitat

Dallas Chapter Develops Loan Program for Banks

Volunteers work with the Dallas chapter of Habitat for Humanity to construct a house for an area family.

Habitat for Humanity is known for its innovation in creating home ownership opportunities for low-income families. Building on that innovation, the Dallas chapter has developed an entirely new way for financial institutions to partner with Habitat in its commitment to making mortgage loans available to homeowners at zero percent interest.

The Banking on Habitat (BOH) program is the result of a collaboration between Daryl Kirkham, retired chief banking officer for Northern Trust Bank of Texas and president of Dallas Area Habitat for Humanity, and the Dallas chapter's executive director, Jim Pate. Because of Habitat's policy of not charging homeowners interest on their mortgages, banks have been unable to offer their existing low-interest mortgage products to Habitat families. The BOH program is a two-level strategy to involve banks in mortgages that are consistent with Habitat's policy.

Homeowners associated with Habitat are active participants in the actual construction of their homes (and those of other Habitat families) through sweat equity. Each Habitat homeowner spends 400 hours working on his or someone else's home. Through donations of funds, material and labor from individuals and organizations, Dallas Area Habitat is able to sell most of its homes for about $50,000.

Banks participate in the BOH program in two ways. "Under BOH I, the bank makes a charitable contribution to Habitat in the form of foregone interest," says Pate. "The bank provides a $50,000 90-day construction loan that is converted to a 25-year note at closing. The loans are made at zero percent interest, and they are secured with the Habitat mortgage to the homeowner."

Once a bank has participated in BOH I, it can then participate in BOH II, which allows the bank to earn interest. At closing, Habitat pairs a $25,000 donation with a $25,000 bank loan at zero percent interest. Habitat then assigns its $50,000 mortgage on the house to the bank, allowing the bank to earn an imputed interest rate of 6.36 percent over the 25-year life of the loan. Habitat continues to service the loan.

According to Pate, 10 local banks currently participate in the Dallas BOH program, and other Habitat chapters around the country are now duplicating the Dallas program.

Kathy Magee, a private banker with Northern Trust Bank of Texas and treasurer for Habitat in Dallas, says Northern Trust holds a BOH portfolio of 43 loans totaling approximately $1.1 million.

"Northern Trust has a long-term commitment to Habitat and its philosophy of helping people help themselves," says Magee. "BOH is an innovative program that provides participating banks with performing loans while preserving Habitat's no-interest-mortgages philosophy. It also provides Habitat with a way to leverage its mortgages to build more houses."

The big winners in this innovative collaboration are low-income families, who, through hard work and determination, get the chance to own their own homes.

For more information, contact Dallas Area Habitat for Humanity at (214) 827-4037.

Guide to Portfolio Risk-Management Design for CDFIs

Prepared by Shorebank Advisory Services for NationsBank Community Investment Group

Shorebank Advisory Services (SAS) is an advisory and consulting subsidiary of Shorebank Corp., a bank holding company and a leading development finance institution. SAS based the report on the lending experience of Shorebank financial institutions and the many other community development financial institutions with which SAS has worked. This article was excerpted and adapted from the report.

Currently, hundreds of community development financial institutions (CDFIs) are helping meet the credit needs of low- and moderate-income communities. To help these organizations better manage their loan portfolios, the NationsBank Community Investment Group had Shorebank Advisory Services develop a practical guide on portfolio risk management design for CDFIs. The guide provides an overview of the basic tools in risk management, with a special focus on CDFIs as lending intermediaries.

Banks, as well as other private and public funders, have capitalized CDFIs with the expectation that CDFIs will make loans without extensive losses. A particular challenge for CDFIs is that their mission often includes taking greater lending risk than a traditional bank might, making it imperative that CDFIs have effective portfolio risk-management systems.

Portfolio risk management is an essential part of lending. Risk management is a process of adequately identifying and characterizing risk, then managing the relationship with the client to maximize the success potential of both the client and the CDFI.

Since most CDFIs are dependent upon borrowings or other third-party financial arrangements for funding, portfolio risk-management policies and guidelines need to be in writing.

The standard risk-management tools of commercial and real estate finance include

- credit policies that define the goals, business lines and risk parameters of the organization.
- clear lending and underwriting guidelines to adequately identify, characterize and price risk.
- appropriate loan monitoring and review systems to detect changes in credit quality and the more important changes in the borrower's circumstances (both favorable and unfavorable).
- internal controls to evaluate the performance of both individuals and the entire organization.
- active oversight by both management of the CDFI and its board of directors.

The successful CDFIs have adapted these standard tools to fit the particular market niche in which they operate and the special financial and developmental impact goals they adopt.

The guide divides portfolio risk management into three primary tasks—identifying risk, managing risk and monitoring risk.

Identifying Risk: Credit Policies and Management Guidelines

Credit policies and lending guidelines should define boundaries for credit officers. They also drive risk rating systems. It is important that written credit policies be broad in scope to allow for individual discretion and, at the same time, be narrow enough to provide direction to credit officers.

While the written credit policies will reflect the specific mission, there are, nonetheless, traditional components that all credit policies should address, including

- diversification in loan product mix and loan structure mix.
- maximum loan size and maximum exposure to a single borrower.
- lending authorities and the board of directors' role in reviewing loan requests.
- management guidelines that identify the kinds of lending transactions the CDFI will engage in and the terms and conditions the CDFI will require from its borrowers.

Managing Risk: Risk Ratings and Loan Loss Reserves

Managing credit risk is the process of obtaining both formal and informal information on borrowers and evaluating the accuracy of the initial risk estimates. It also recognizes that the quality of any given loan will change frequently.

The aggregate change in the risk estimates of the overall portfolio is determined by the change in quality of each loan in the portfolio. The aggregate change determines the adjustments that must be made in lending policies.

Managing credit risk enables the CDFI to effectively lend in markets where the risks are perceived to be too great for traditional lending institutions. This typically involves the following actions:

- characterizing the risk of a loan at the time it is approved, using the risk rating system. (Most CDFIs begin with a simple rating system, then enhance and refine it to reflect their own ongoing experience.)
- reviewing the risk classification of each loan on a regular basis, and raising or lowering the rating accordingly.
- using the risk ratings to determine whether adequate resources are available to work closely with those borrowers that require the most time and attention.
- reviewing the "riskiest" loans on a more frequent basis, ensuring adequate attention.
- using the portfolio evaluation to evaluate the loan loss reserve adequacy and the adequacy of the CDFI's liquidity and capital.

Loan Loss Reserves. In managing the loan loss reserve, the CDFI should follow generally conservative practices, including

- growing the loan loss reserve quickly so it can absorb early losses.
- maintaining a consistent policy on charge-offs of delinquent loans—usually loans delinquent more than 90 days are charged off.
- reviewing the adequacy of the loan loss reserve on a quarterly basis.

Monitoring Risk: Portfolio Evaluation, Reporting and Maintenance

Once a loan has been booked, its subsequent performance must be monitored. Each loan carries a risk rating, which is really nothing more than an estimate of future behavior. Monitoring allows for subsequent changes in the rating, when warranted, and serves as a process to validate the risk rating system's accuracy. Monitoring also permits ongoing review of the adequacy of the CDFI's loan loss reserve.

Loan maintenance is the administration of individual loans through a direct relationship with the borrower.

Any individual borrower will repay or not repay a loan regardless of the particular risk that the CDFI has assigned to it. Consequently, sound loan maintenance is critical to the portfolio's performance.

The importance of portfolio reporting is to measure the performance on an aggregate basis. Reporting also allows board members and CDFI lenders to evaluate the CDFI's performance against its goals and objectives.

Managing credit risk enables the CDFI to effectively lend in markets where the risks are perceived to be too great for traditional lending institutions.

Portfolio Reporting. Generally, the reports include comparative information, particularly year to year and current year to budget. The comparisons are essential to identifying trends in the direction the portfolio quality is heading. While there is no predetermined number of reports, or formats, each CDFI will develop those that are most meaningful for its unique mission and purpose. The commonly used reports include

- total loans outstanding.
- new loans made for the period.
- delinquent loans.
- summary of changes in loan risk ratings.
- analysis of loan loss reserve and loan charge-offs.
- missing documentation.
- problem-loan list.

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Portfolio Maintenance. If borrowers are current on payments and are complying with financial reporting requirements (that is, monthly financial statements and collateral value and/or accounts receivable reports) and loan covenants, the loan officer may be able to devote more time to marketing and to other loans.

Unfortunately, loans do not always perform the way they are projected. Late payments usually are the first indicator of underlying problems. Loan officers need to respond quickly to delinquencies, making the delinquent loan report one of the most important management tools.

In dealing with delinquencies, it is important to recognize that the inability to make a scheduled payment is only the indication of more severe problems. The first step should be to review the loan's risk rating and, if appropriate, change the rating.

CDFI directors should review delinquent loan reports in detail and be provided with information that explains the actions the loan officer is taking.

Conclusion

Successful development-oriented lenders recognize that there is some degree of risk in all of their loans. They simply acknowledge this and use their creative energy to make these risks acceptable. The successful CDFI will define its own standards of performance, monitor itself against its standards and adapt to changing conditions.

For a copy of *Guide to Portfolio Risk-Management Design for CDFIs*, please contact Shorebank Advisory Services at (773) 288-0066 or <sas1sbk@aol.com>, or write

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