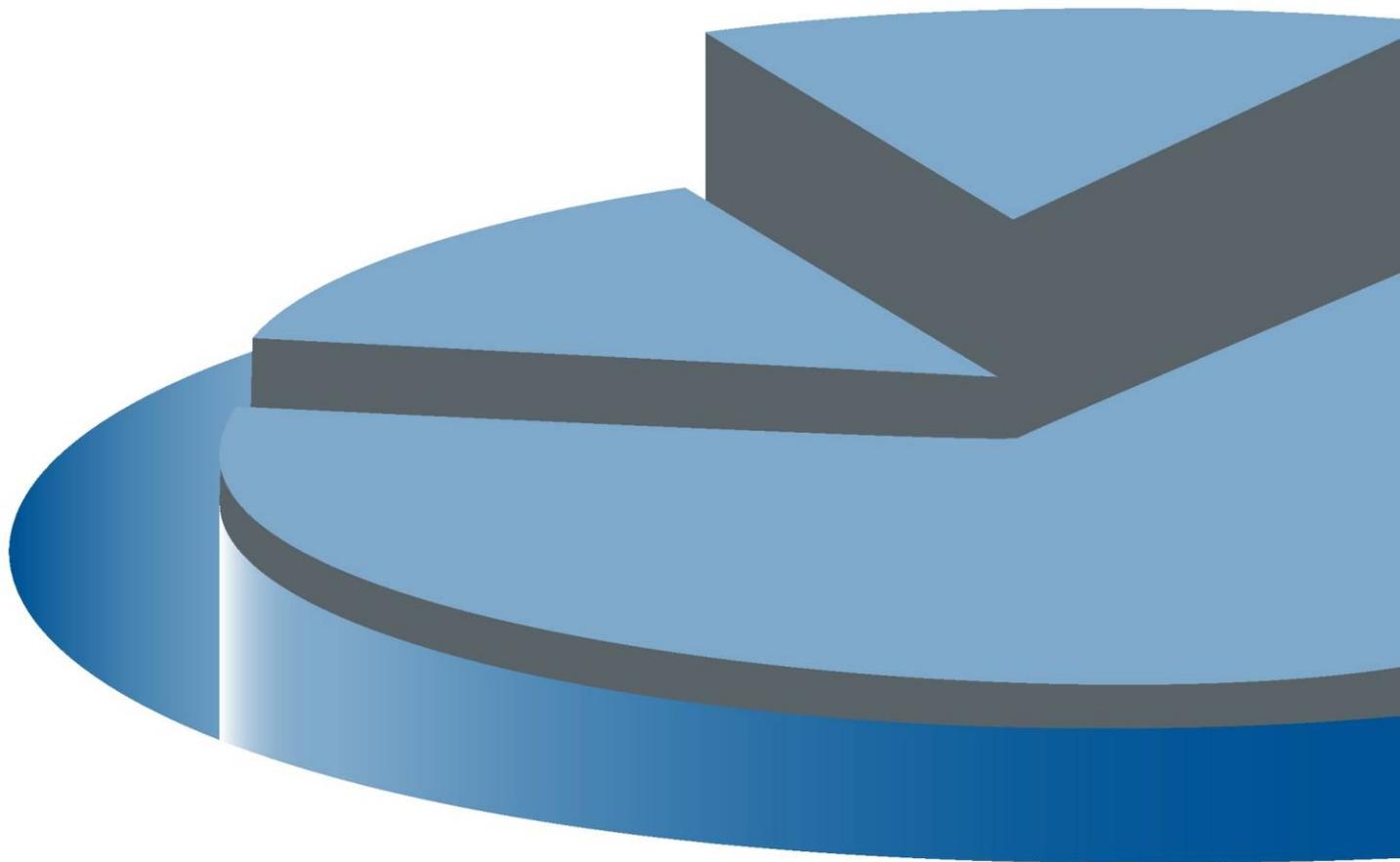


Small Business Lending Matrix and Analysis

The Impact of the Credit Crisis on the Franchise Sector

Prepared for the International Franchise Association
Educational Foundation

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Source Material

Information for this report is based on SBA data, the Economic Impact of Franchised Businesses Study (Volume 1 and 2) 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.

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EXECUTIVE SUMMARY

FRANdata projects a more positive climate for franchising in 2011 than in 2010 and 2009 based on these factors –

- Increased investor demand for franchises, both new units and transfers
- Unconstrained franchisor capacity for growth
- Significantly increased lending ability by banks to franchisees
- Moderately increased willingness by banks to lend to franchisees
- Slow to moderate pace of economic recovery through 2011 and beyond

Despite these positive factors, FRANdata predicts a shortfall of more than \$2 billion in lending to franchise businesses in 2011. Franchises will require \$10.4 billion in new lending capital to fulfill 100% of the forecasted demand for new and transfer units in 2011. At the same time, banks are projected to make available only \$8.4 billion to lend to franchising.

With access to \$8.4 billion in lending, FRANdata projects that 33,016 franchises, both new units and transfers, will create or maintain more than 250,800 jobs and generate \$32.5 billion of annual economic output.

The 20% gap in lending is an improvement over the estimated gap of 23% in 2010.¹ Nonetheless, the \$2 billion shortfall will result in a loss of nearly 8,000 unit transactions, both new and transfers, and a loss of more than 82,000 jobs and \$10.7 billion in annual economic output.

The 3rd Volume of the *The Small Business Lending Matrix and Analysis* provides a framework to estimate how the lending environment will impact the demand for and supply of capital to finance franchised unit transactions, both new and transfer units, excluding lodging. The report examines the main factors noted above and their inter-relationships.

The connection between sufficient capital for franchise transactions, job creation, and sustained economy recovery is a critical one. Historically, as unemployment rises, the pool of prospective franchisees increases. Franchising as a business model has shown extraordinary resilience to economic slowdowns. In past recessionary and post-recessionary periods franchise units have grown by 6% (between 1999 and 2006) and 5% (during the 1999 – 2002 Tech Bubble). Because franchising represents an opportunity for individuals to switch jobs or expand their business, it has helped spur the pace of economic growth and also recovery from economic downturns.

With unemployment levels near the 9% mark since 2009, the potential pool of people willing to start franchising has been sustained at high levels. During the economic recession, however, banks have been left with limited funds after accounting for declines in their home real estate loans. As a result, entrepreneurs' access to capital has been limited, constraining franchise growth and slowing down the recovery. Thus, lending has a direct effect on franchise small business jobs and economic output, and consequently, on economic recovery.

¹ FRANdata 2010 projections were based on two scenarios, a 34% shortfall assuming no SBA policy changes and a 23% shortfall with such changes. The changes considered included an extension in the increase of loan guarantees to 90%, eliminating or reducing SBA fees, and increasing the cap on guarantees from \$2 million to \$5 million. Since the SBA policy changes were enacted during the year, bank willingness to lend increased from \$6.7 billion to \$7.8 billion, thereby reducing the shortfall. For this reason, FRANdata uses this scenario as a reference point throughout the report.

Increased Investor Demand for Franchises

FRANdata predicts an increased investor demand for franchises of nearly 25% from 33,302 units in 2009, to 41,001 units in 2011. From 2010 to 2011, we estimate an increase of average investor demand for new units by 11% and for transfer units by 14%. The higher demand for transfer units is due to a historically higher demand from existing franchisees for units with a proven cash flow and better lease negotiation opportunities. These transactions will require capital of almost \$16 billion, up 17% from the total required capital of \$13.6 billion in 2010. Of the total required capital in 2011, \$10.4 billion will need to be borrowed to meet the full demand for transactions, representing an increase of 3.3% from \$10 billion in 2010.

Unconstrained Franchisor Capacity for Growth

Franchisor capacity, including staff and resources to support franchisee recruitment efforts, will not be a limiting factor in 2011 as it was for 2010 and 2009. Interviews with franchisors and evidence of franchisor budget increases points to expanded franchise development efforts in 2011.

Lending Environment — Ability and Willingness

Banks will have sufficient funds available to meet the demand for franchise unit transactions in 2011. As in previous years, the limiting factor will be their willingness to lend. Banks have not yet thrown open the doors to small business lending and are taking a cautious approach. Competition for financing will remain tight as lenders remain risk averse and credit standards have not significantly changed since 2009. For applicants to 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 recovery. As a result, lending has a direct effect on franchise small business jobs and economic output and consequently, on economic recovery. If banks make use of the new Small Business Lending Fund Act of 2010 — a \$30 billion fund managed by the U.S. Department of Treasury that can support several multiples of that amount in new credit to small businesses in both SBA and conventional loans — a substantial amount of new financing could be extended to current and future franchised unit transactions, which will boost job creation and economic output.

FRANdata estimated that in 2010, banks would have an available pool of over \$11.9 billion to lend in conventional and Small Business Administration (SBA) loans to experienced and new franchisees. In 2011, the SBA will continue to be a major driver in small business lending, representing an estimated 20% of lending to franchises. The SBA budget for FY2011 is \$994 million and represents a 21% increase from FY2010. With these funds, the SBA can support \$28.025 billion of loan guarantees to small businesses.

Based on the assessment of SBA franchise activity sources, FRANdata estimates that from 15% to 20% of SBA loans are made to franchisees. Assuming that about 35% of franchisees' funding will come from SBA-guaranteed loans in 2011, FRANdata forecasts that there will be a pool of over \$12 billion of conventional and SBA funds to lend to franchisees.

In 2011, bank willingness to provide conventional loans is projected to remain largely unchanged from its 2010 levels, as confirmed by the Fed's Survey of Senior Loan Officers. At the same time, bank willingness to provide SBA-guaranteed loans will increase by 25% in 2011. This is due primarily to a cap increase of the eligible loans for SBA-guaranteed funding of 2.5 times enacted in October 2010, together with incentives provided by the Small Business Lending Fund of 2010.

Slow to Moderate Economic Recovery

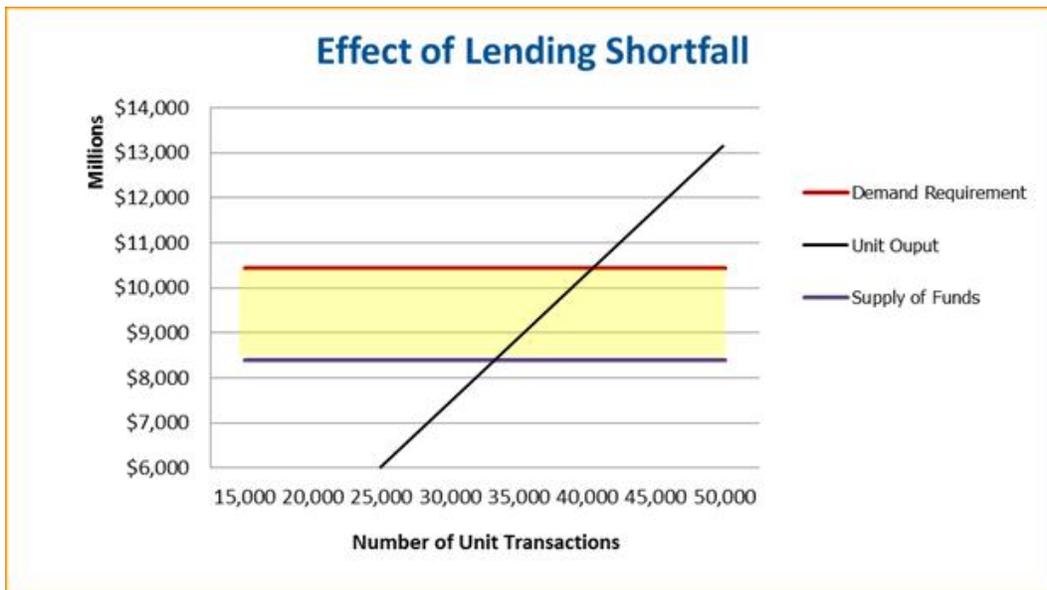
The economic recovery, currently under way, is expected to continue with a slow to moderate pace through 2011 and beyond. GDP is expected to grow by 3.3% in 2011 and inflation is expected to remain within 1-2%. Unemployment is projected to hover around 9% in 2011 and then start to gradually decrease. These positive economic signs, coupled with general consumer optimism offer a better climate for franchising in 2011 compared to 2010. Other crucial economic indicators were all up in 2010 including various confidence indices, same-store sales and retail sales. These trends are expected to continue through 2011. However, the road of recovery is expected to be long, and lending to franchising will play an important role in its development.

Effect of Lending Shortfall in 2011

Overall, FRANdata projects that in 2011 banks will lend about \$8.4 billion to franchisees, \$2.9 billion of which will be in SBA-guaranteed loans. The difference between the lending required to meet 100% of the demanded franchise transactions and the lending capital banks will be willing to make available to franchises will create a shortfall of \$2 billion, or 20%. The shortfall in lending is projected to result in 7,985 unit transactions, both new units and transfer units that will not be completed due to restrictive lending policies.

The following graph presents the effect the projected lending shortfall will have on the number of new and transfer unit transactions. The yellow area defines the shortfall in lending due to the difference between bank willingness to lend, presented by the Supply of Funds line, and franchise capital borrowing requirements, presented by the Demand Requirement line.

Figure 1. Effect of Lending Shortfall.



New Units

FRANdata estimates that in 2011, the 15,191 new unit transactions possible would create 284,785 direct and indirect jobs and add \$36.9 billion in annual economic output. This also means that the shortfall in lending would cost the economy 3,993 new units or 74,849 jobs and \$9.7 billion in annual economic output.

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

Base Scenario	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing
Maximum Level	15,191	284,785	\$36,911,542,645
Effect of Shortfall	(3,993)	(74,849)	(\$9,701,371,038)
Reduced Level	11,199	209,936	\$27,210,171,606

Transfer Units

The lending shortfall has a similar but more muted effect on transfer units. FRANdata assumes that if a unit that needs to transfer is unable to get funding, 90% of the time the unit would continue to operate for the next year, while 10% of the units would be unsustainable. The 10% unsustainability assumption reflects the prolonged effects of the economic downturn on business. This means that 25,810 transfer unit transactions would allow 2,581 units to stay in business that would otherwise close. These protected units would maintain 48,385 direct and indirect jobs and \$6.27 billion in annual economic output. However, due to the shortfall in lending and the 3,993 transfer unit transactions that would not occur, the cost to the economy would be 7,485 direct and indirect jobs and \$970 million in annual economic output that could otherwise be protected.

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

Base Scenario	Transfer Units	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing
Maximum Level	25,810	48,385	\$6,271,282,622
Effect of Shortfall	(3,993)	(7,485)	(\$970,137,104)
Reduced Level	21,817	40,900	\$5,301,145,518

*The number of jobs maintained was calculated by taking the 25,810 total demanded unit transactions and multiplying them by the estimated 18.7 (direct and indirect) jobs. The product is then multiplied by 10% to get the number of jobs lost from the units that would have closed without financing.

Total Units – New and Transfers

In 2011, the 41,001 unit transactions seeking capital could create or maintain 333,170 total direct and indirect jobs and could create or maintain \$43 billion in total direct and indirect annual economic output. However, due to banks' unwillingness to lend, the 7,985 unit transactions that will not be able to obtain funding will cost the economy 82,334 direct and indirect jobs and \$10.7 billion in economic output.

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

Base Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(7,985)	(82,334)	(\$10,671,508,142)	-25%
Reduced Level	33,016	250,836	\$32,511,317,124	75%

More Aggressive Lending Scenario

The above estimates are based on FRANData's analysis of a combination of factors that affect bank lending to small businesses in different ways. In addition to the projected 25% increase in SBA loans, it is worth examining the effects on the economy that would result if banks took a more aggressive or a more conservative approach to lending than the base scenario discussed above.

Under an aggressive lending scenario, banks will increase their lending to \$9.7 billion (from \$8.4 billion under the base scenario). This scenario would be possible if banks took advantage of the incentives to increase lending offered by the Small Business Loan Fund of 2010, and if the economy accelerated its pace of recovery, reflecting higher consumer demand, stabilizing housing market, and strengthening household net worth. This would lead to an additional 50,000 jobs created or maintained and an additional economic output of \$6.7 billion, over the base scenario described above.

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

Aggressive Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(2,959)	(30,505)	(\$3,953,799,115)	-9%
Reduced Level	38,042	302,666	\$39,229,026,151	91%

More Conservative Lending Scenario

On the other hand, banks may take a more conservative approach to lending than the expected base scenario and tighten their lending further. Under the conservative scenario, this would reduce the total lending available to \$7.2 billion. The resulting shortfall increases the number of unit transactions that will not obtain financing to 12,553 and costs the economy an additional 47,099 direct and indirect jobs and \$6 billion in economic output as compared to the base scenario. The total jobs and economic input that will fail to be created or maintained will be nearly 130,000 and \$16.8 billion, respectively.

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

Conservative Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(12,553)	(129,433)	(\$16,776,071,963)	-39%
Reduced Level	28,448	203,737	\$26,406,753,304	61%

INTRODUCTION

This report was created to provide a framework to estimate how the current lending environment will impact the demand for and supply of lending capital to finance franchised unit transactions (defined as an investment in a new unit or a unit transfer all excluding lodging) in 2011. Each franchised unit accounts for an estimated average 19 direct and indirect jobs and \$2.4 million direct and indirect annual economic output. The ability to create and protect jobs is paramount and franchising plays an important role in ensuring the continued recovery of the U.S. economy after the worst recession since the 1930s.

Since 2009, FRANdata's first *Small Business and Lending Matrix and Analysis* has projected lending capital requirements for franchise systems across all industries excluding lodging based on the following factors:

1. Average initial investment for a unit transaction
2. The number of unit transactions defined as both new units and transfers
3. Distinctions between prospective franchisee and experienced operator franchisee willingness and ability to start new units and acquire existing units
4. Bank loan terms

The lending environment for franchising has been tight but has shown improving trends since 2009 due to various reasons. In 2010, the U.S. GDP is estimated to have grown by 2.8% and is expected to grow by 3.3% in 2011 while inflation is expected to remain within 1-2%. The CEO Confidence Index and the closely related Consumer Confidence Index are both up as is the index of Small Business Confidence. Retail sales, including all retail and food service sales, increased 7.8% to \$4.5 trillion during 2010.

During 2010, same-store sales increased on average with 3.3% on a yearly basis for the leading national retail brands. This figure compares with a 2.5% decline in 2009 and a 4.7% growth in the pre-recessionary economy of 2006. Furthermore, the latest numbers for February 2011 show that same-store sales increased by 4.2% for the past month, beating expectations of a 3.6% jump. Additionally, 52% of Americans believe the U.S. economy is going to improve measurably in 2011. Last but not least, increases in the stock markets have positively impacted investment portfolios, a possible source for funding for new franchisees.

On the "downside", the unemployment rate has not changed significantly since 2009 and as of February 2011 stands at 8.9%. Banks remain cautious but the Small Business Lending Fund Act enacted in September 2010 could have a pronounced positive influence on banks willingness and ability to extend loans to small businesses. For these reasons, FRANdata projects that 2011 will see marked improvements in lending for franchising, even though lending capital demand will still outstrip supply.

For the 2011 projections, FRANdata used the same methodology as in its previous studies, but made changes to some underlying assumptions. The most significant changes include the following:

- FRANdata assumes a backlog of transfer units. Supply is up and operators trying to transfer their units are selling them at a lower price because of lower cash-flows as a result of the recession.
- Previously, FRANdata assumed that 5% of transfer unit transactions that did not happen due to capital constraints would result in the closure of a unit. For 2011, this percentage is projected to increase to 10% because of the backlog and the fact that a larger number of franchisees who had waited for better economic conditions to achieve higher multiples will see better opportunities or will just find it hard to remain in business.

As in the previous study, potential new unit owners were divided into two groups, first time owners and experienced franchisees. FRANdata took into consideration possible changes in both the ability and the willingness to invest in a unit transaction for each group separately. It was assumed that both had decreased due to the effects of the economy on housing prices, the unemployment rate and investment portfolio losses.

For 2010, FRANdata estimated existing operator willingness to invest in a unit transaction to increase by an average 20% over 2009 levels, while the willingness to invest for new franchisees increased an average 15%. On the other hand, experienced operators saw a 5% increase in their ability to invest in a unit transaction, while new franchisees were faced with an estimated 5% decline in their ability to invest. For 2011, FRANdata projects existing operator willingness and ability to increase by an average 27.5% and 7.5%, respectively. For new franchisees, FRANdata projects an average increase of 15% in their willingness to invest in a unit transaction, while their average ability to do so will remain unchanged over 2010 for reasons discussed below.

FRANdata estimated that 33,302 units applied for financing in 2009. In 2010, FRANdata estimated a demand for 36,345 unit transactions. In 2011, the number of unit transactions is projected to be 41,001, up 12% over 2010. The above factors were all identified to be relevant for the demand side of the lending equation.

As with the previous studies, FRANdata relied on actual data, sample data, industry knowledge as well as franchisor interviews and discussions with lenders to assess lender willingness and ability. Based on these and the discussed assumptions, FRANdata built the projections for 2011. FRANdata forecasts that 90% of the transfer units projected will be able to continue operations throughout 2011 regardless of whether they receive financing. For this reason, only the impact of the 10% of the transfer transactions that would close without financing is included into the total jobs created or maintained through financing and into the economic output created or maintained through financing.

The table below shows the different scenarios FRANdata projects for 2011, based on the above considerations.

- The Maximum Level presents the total number of units that are demanded and the number of jobs and economic output that would be created or maintained if all transactions received the financing they demand. In other words, the Maximum Level outputs are constrained by the investor willingness and ability to make a franchise transaction but not by the lending environment.
- The Base Scenario presents the outcomes that FRANdata considers most likely to develop based on the current economic situation. It shows a 25% gap from the maximum possible level of outputs.
- The Aggressive Scenario is the scenario that could result if the economy strengthened and banks eased their lending standards further from the current expectations. This would lead to a 9% gap from the maximum level of outputs, which is the most desired scenario that is possible to develop within 2011.
- The Conservative Scenario, on the other hand, could result if the economy worsened and banks tightened their lending standards in 2011. Under these circumstances, there will be a 39% gap from the maximum level outputs.

Table 6. Scenarios Comparison.

Scenario	New Units	Transfer Units	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	15,191	25,810	\$333,170	\$43,182,825,267	100%
Base Scenario	11,199	21,817	\$250,836	\$32,511,317,124	75%
Aggressive Scenario	13,721	24,331	\$302,666	\$39,229,026,151	91%
Conservative Scenario	8,915	19,533	\$203,737	\$26,406,753,304	61%

Note: The jobs created or maintained through financing include the jobs created with opening a new unit and the jobs maintained with financing a unit that would have closed if no financing was provided. FRANData estimated that 10% of the transfers that do not receive financing will close in 2011. To estimate only the number of jobs that would be created or maintained dependent on receiving financing, FRANData applies 18.9 (indirect or direct) jobs per unit to the total number of new units and to 10% of the number of the total number of transfer units.

To provide further perspective to FRANData's 2011 estimates, the table breaks out previous estimates vis-à-vis this year's projections. Assuming the base scenario projection for 2011, there will be a dramatic increase in the willingness and ability to invest in a unit transaction since the 2009 estimates. Back then, willingness and ability were down. In 2010, FRANData estimated an increase again from 2009 levels, except for the ability of first time owners. For 2011, willingness and ability are projected to increase further, again except for the ability of new operators which is likely to remain unchanged.

Table 7. Estimated and Projected Investor Willingness and Ability.

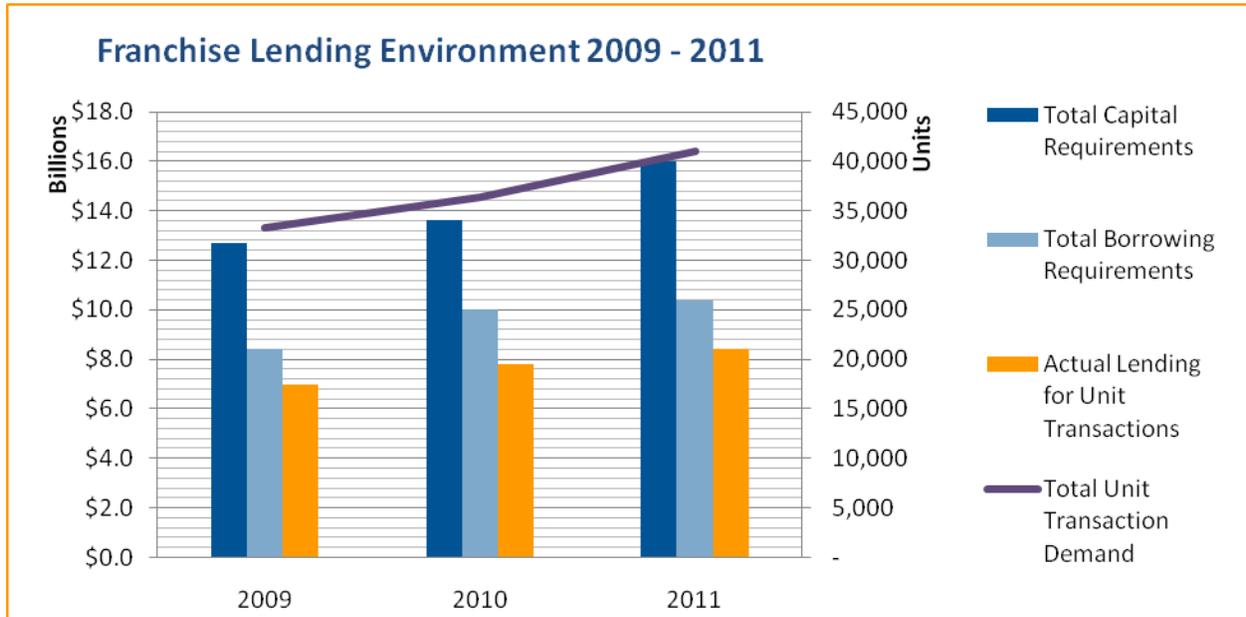
Investor Willingness and Ability	Estimated		Projected
	2009	2010	2011
Willingness (experienced franchisees)	-30%	20%	27.5%
Willingness (first-time owners)	-17.5	15%	15%
Ability (experienced franchisees)	-35%	5%	7.5%
Ability (first-time owners)	-25%	-5%	0%

FRANData projects that demand for unit transactions will increase at a compound annual growth rate (CAGR) of 11% from 33,302 in 2009 to 41,001 in 2011. This will increase demand for total capital at a CAGR of 12% from \$12.7 billion to \$16 billion over the same period. In 2011, investors and banks are still struggling to recover from the worst recession since the 1930s. While a consecutive increase in their respective ability (except for new investors) allows for optimism, it comes at the heels of a sharp drop in 2009. Thus, the relatively high growth registered over the three years should be considered in the context of its low levels in 2009.

Actual lending for unit transactions is projected to increase at a CAGR of 10% from \$7 billion in 2009 to \$8.4 billion 2011. This means that the gap between demand for and the supply of lending capital will drop from 23% in 2010 to 20% in 2011. The estimated 23% lending shortfall in 2010 is based on the scenario FRANData developed at the end of 2009, under which certain SBA policy changes would take effect in 2010. Most of these policy changes did take effect in 2010, for which reason FRANData uses this scenario as a reference point throughout the report.

The following figure summarizes the projected development of the franchise lending environment from 2009 to 2011.

Figure 2. Franchise Lending Environment 2009 - 2011.



Under FRANdata’s base scenario projection for 2011, a total 7,985 unit transactions will not occur resulting in a total of 82,334 direct and indirect jobs not created or not maintained and a total of \$10.7 billion in direct and indirect economic output not generated or not maintained.

PROJECTED FRANCHISED UNIT TRANSACTIONS FOR 2011

FRANdata determines the projected number of franchise unit transactions that would occur if there were no constraining factors in the market by using the estimates for the previous year as a baseline and adjusting these estimates based on assumptions about franchisors and franchisees willingness and ability to develop new units or to invest in a transfer unit. For the purpose of this analysis, the lodging industry is removed as an outlier. The lodging industry is highly capital intensive and its financing comes primarily from capital markets activities that are not often available to other franchise segments. The main factors impacting the likelihood for a unit transaction to take place are franchisor capacity, investor willingness and investor ability to open or purchase a unit.

The recession officially ended in June 2009. Throughout 2010 and increasingly in early 2011, signs of economic recovery, such as GDP growth, increase in demand for products and services, and plans for hiring and capital spending, have increased consumer and business optimism. At the same time, however, small business entrepreneurs still experience the effects of prolonged economic difficulties and the actual benefits of increased economic activity are still to materialize. These factors have influenced and will continue to influence franchisors' capacity to grow, as well as investor ability and willingness for new unit transactions throughout 2011.

Factors Affecting Unit Transactions: Franchisor Capacity

In 2010, franchisors started to recover from the economic downturn. After a period of low business activity due to economic instability and uncertainty, the first signs of economic recovery are encouraging franchisors to start cautiously rebuilding their capacity for growth. FRANdata's Franchisor Compensation Study from October 2010 shows that franchisors project a 4% increase in their budgets for 2011. FRANdata expects that with the improvement of the economy, albeit slowly, franchisors will resume hiring the training and development staff needed to support the new expansion of their systems. Since franchisor capacity for growth depends primarily on employing an adequate work force rather than capital investment, FRANdata believes that franchisor growth capacity will not be a limiting factor for growth in 2011.

Factors Affecting Unit Transactions: Investor Willingness and Ability

Besides franchisor capacity, the two main factors affecting the demand for unit transactions are investor ability and willingness to develop new or to acquire transfer units. Investor ability is determined by the investors' access to credit and personal financial position. However, in addition to the availability of capital, the demand for a unit transaction will be affected by the investors' willingness to do so, 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 investor. FRANdata distinguishes between new owners and experienced franchisees who wish to add another unit to their existing one(s). For these two types, ability and willingness to invest may differ.

In order to assess the change in investor willingness and ability for unit transactions in 2011, FRANdata has developed the following matrix, based on the factors discussed below. The change in investor willingness and ability for unit transactions was used to determine the demand for new and transferred units assuming that franchisor growth capacity is not a constraining factor.

Table 8. Existing Operator and New Franchisee Changes in Willingness and Ability.

Franchisee Type	Changes in Willingness and Ability	
	New Unit Transactions	Transfer Transactions
Existing Operator Willingness	25%	30%
Existing Operator Ability	5%	10%
New Franchisee Willingness	15%	15%
New Franchisee Ability	0%	0%

Willingness

In 2010, FRANdata estimated that existing operator willingness to invest in new and transfer unit transactions increased by 15% and 25%, respectively. New franchisee willingness was also estimated to increase, although to a smaller extent — 10% and 20% for new and transfer units, respectively. These predictions were based on improving consumer and business confidence levels, new operators' higher risk aversion as compared to existing operators, feedback from franchisors over the course of the year, and partial year activity unit data from FDDs and directly from franchisors. In 2011, FRANdata forecasts that willingness for both new and existing operators will increase even further than in 2010 due to higher economic indicators and confidence levels discussed below.

In 2011, existing operator willingness to invest in new units will increase by 25% over 2010 levels. Existing operator willingness to invest in transfer units will be even higher, 30%, based on past patterns of business activity. New franchisee willingness will also increase, although not as much as that of existing operators because of new operators' lower confidence due to their lack of franchise business experience. New franchisee willingness to invest in transactions is estimated to increase by 15%.

One of the most important factors that are influencing the willingness to invest in 2011 is the fact that the recession has officially ended and the worst of the economic downturn is behind us. According to a 2011 Gallup poll, more than 52% of Americans believe the U.S. economy is going to improve during 2011. The CEO Confidence Index in the economy rose to 6.25 basis points in January 2011 (out of 10 total), an increase of 6.9% since December 2010. What is more, this represents the highest level of CEO's confidence in the economy since the start of the recession in 2007. Consumers also have better sentiments towards the future of the economy, as shown by the Consumer Confidence Index. The Index, tracked by The Conference Board, jumped to 70.4 basis points in February 2011, from 60.6 in January and 53.3 in December 2010. This has exceeded analysts' expectations and clearly underscores the consumers' optimism in the undergoing recovery.

Growth in sales has also a strong positive effect on existing and new franchisee willingness to develop franchise units as an indicator of higher potential profitability. Over the last year, retail sales have increased 7.8% and now stand 0.4% above pre-recession levels. Additionally, same-store sales have also increased compared to decreases in 2009 and 2008. As a result, actual new units and transfer data tracked by FRANdata has been trending upward since late 2009.

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

Ability

In 2010, FRANdata estimated that, investor ability to develop new and acquire existing units would be limited by the slowly recovering household wealth levels and restrictions on the source of funds caused by the weak housing market and underperforming investment portfolios. For 2010, existing operator ability to open new units was estimated to improve by 5%. For the same year, new operator ability was estimated to decrease by 5%, affected by tighter credit standards that emphasized personal industry experience and higher liquidity levels.

In 2011, FRANdata forecasts that existing operators' ability will improve by another 5% for new units and by 10% for existing units. New franchisee ability is expected to stop its downward trend from 2010 and to remain flat in 2011.

The factors that will affect operator ability to invest in franchised unit transactions in 2011 only show marginal improvement. On the positive side, the economy is growing: GDP is estimated to have grown by 2.8% in 2010, an improvement from 2009 when the economy suffered its worst decline in more than 60 years. In 2011, the economy is expected to grow by 3.3%. Additionally, investment portfolios, which traditionally are a small possible funding vehicle for new franchisees, are expected to recover from their 2009 decreases and return around their pre-recession levels. The stock market has also recovered from the bottom it hit during the recession in 2009. The NASDAQ increased 15% during 2010 and DOW Jones Industrial Average increased 9.5% in the same period, having a positive effect on individuals and families' investment portfolios. The increase in retail sales, registered in 2010 and expected to continue to rise in 2011, has a direct impact on existing franchisees net worth and ability to invest through the increased profit margins of their existing businesses.

On the negative side, however, an economic growth of less than 5% is considered insufficient to make a noticeable impact on unemployment and overall economic stability. In 2010, the number of unemployed dropped to 9.4%, down from 9.9% the previous year, and decreased even further to 8.9% as of February 2011. However, unemployment still remains very high, impeding investor ability to borrow capital from personal sources, slowing down consumer sales, and exposing existing franchisees to a decline in private assets and business equity. Household net worth decreased from its 2007 peak at \$64.2 trillion and as of the third quarter of 2010 stands at \$54.9 trillion, a 2% increase from second quarter of 2010. House prices continue to decrease in many parts of the country, and this will make it harder for prospective franchisees to use their housing properties as collateral for business loans, something that funded much of the economic expansion of the last decade.

The combination of these factors affects new and existing operators differently. Current operators will be able to take advantage of the marginal growth in consumer demand for goods and services. Additionally, they will be able to take advantage of an increased pool of transfer units in the market. The number of transfer units is expected to increase during an economic recovery because business owners who want to sell their business tend to wait for more favorable economic environment in order to realize a higher profit.

New franchisees will be less able to take advantage of the higher availability of transfer units due to their unfamiliarity with the business. Furthermore, the general growth of the economy will affect them to a smaller extent because many of them will lack a steady income source. In addition, the high unemployment rate will continue to put pressure on their net worth. Another factor to consider is that the job losses have hit unskilled workers the hardest, whose income and assets are lower to begin with. For these reasons, the ability of existing operators will increase by 5% for new and 10% for transfer unit transactions, while that of new franchisees will remain unchanged.

Projected Franchised Unit Transactions

Based on the economic factors discussed in the previous two sections, FRANdata projects that in 2011 the ability to purchase a new or existing unit will continue to be a more limiting factor than the willingness to do so. FRANdata forecasts that the demand for new unit transactions will increase by 11% from the 2010 baseline of 13,655 to 15,191 in 2011. The demand for transfer unit transactions will increase by 14% from a baseline of 22,690 in 2010 to 25,810 in 2011, both excluding lodging. The higher investor demand for transfers than for new units is due to a historically higher demand from existing franchisees for units with a proven cash flow and increased lease negotiation opportunities. All estimates are up from the increase in willingness and ability in 2010 because of improved economic indicators and confidence throughout 2010 and in the beginning of 2011.

This results in a total of 41,001 projected unit transactions in 2011, up 13% from 36,345 in 2010. This means that 41,001 new and transfer units would be acquired by new and existing operators if there were no additional constraints on capital access imposed by banks. In other words, 41,001 unit transactions, excluding lodging, will seek financing in 2011. Following trend statistics, it is assumed that there will be about an equal number of new franchisees and existing operators involved in unit transactions in 2011.

ESTIMATED CAPITAL REQUIREMENTS FOR UNIT TRANSACTIONS

Estimated Average Initial Investment

In order to estimate the capital requirements for the projected 41,001 unit transactions in 2011, FRANdata examined the average initial investment per new unit and per transfer. In 2011, FRANdata forecasts that a new unit will have an average initial investment of \$402,473 and a transfer will have an average initial investment of \$382,607, both excluding lodging.

At the end of 2009, FRANdata assumed that transfer unit purchase prices would be similar to the creation of a new unit. Any difference in price would be based on individual sales performance, which cannot be measured. At that point, the signs of economic recovery were yet to be felt, which caused current operators who wanted to transfer their units to wait for a more favorable economic environment to increase their unit's sales price.

With the economic recovery, many small business owners will feel more confident to sell their units now due to suppressed revenues and business valuations. FRANdata expects that the increased number of units for sale will temporarily decrease the average price for a transfer as compared to the average new unit initial investment. With the further recovery of the economy, the backlog of transfer units will eventually clear out. The price of a transfer will then rise and is expected to surpass the level of initial investment in a new unit, due to the existing sales performance for transfers. However, FRANdata believes that this increase is unlikely to occur by the end of 2011.

The calculations of the average initial investment exclude units with initial investment levels of less than \$50,000, as in FRANdata's previous Small Business Lending Matrix and Analysis studies. The assumption holds that these lower investment levels would finance through non-institutional sources or would not require any debt to start. The lodging industry is also excluded as an outlier.

FRANdata calculates the average initial investment per new unit and per transfer for 2011 through the following steps:

- 1) FRANdata takes the unadjusted averages per industry calculated for 2009 based on a sample of nearly 2,000 franchise brands and applies the actual percent change of the initial investment per industry based on a sample of 700 franchise brands with consistent availability of data for 2010 initial investment estimates.
- 2) FRANdata observed that the actual average initial investment for new and transferred units in 2010 was \$397,308. This average excludes lodging and brands that require initial investment of less than \$50,000 based on the assumptions discussed previously.
- 3) Based on recent trends for initial investment and projected price increases for 2011, FRANdata estimates that the average initial investment for new units will increase by an average of 1.3% during 2011. Because of larger availability of transfer units in the market in 2011, as discussed above, their average cost is estimated to decrease by 3.7% from 2010 levels.
- 4) FRANdata applies the relevant estimated change in the average initial investment requirement to the actual initial investment of new and transfer units in 2010 to calculate the respective initial investment for 2011.

Using the projected average initial investment of \$402,473 for new units and \$382,607 for transfers and the respective number of units transactions, excluding lodging, FRANdata projects that investors will require capital of \$6.1 billion for new and \$9.9 billion for transfer units. This leads to a total of \$16 billion needed for the

projected total demand for 41,001 unit transactions in 2011. This represents a 17% increase from the \$13.6 billion estimated for 2010.

Advance Rates

Of the calculated nearly \$16 billion in required capital in 2011, excluding lodging, only a portion will come from lenders because lenders require borrowers to provide a portion of the capital themselves. The advance rate banks expect on franchise transactions is based on the type of transaction. Since SBA loan transactions have a government guarantee protecting the bank from default, they often have a higher advance rate than conventional loans. This means franchisees have to provide a smaller cash piece to qualify for a loan.

Based on lender and franchisor feedback, FRANdata projects that conventional and SBA advance rates in 2011 will not change materially from their 2010 levels. This expectation is confirmed by the Federal Reserve Survey on Senior Bank Loan Officers, which shows that banks do not expect any major changes in the lending environment in 2011. Conventional loans are still in the 55% to 65% range while SBA advance rates are in the 65% to 80% range.

In 2010, FRANdata estimated that due to the cap increase in SBA loans, SBA lending increased significantly from the 16% ratio in 2008 reflecting an increase in the SBA loan guarantee budget and a raise in the cap for SBA eligible loans. The permanent cap increase in 7(a) and 504 loans was enacted in the last quarter of the year, and its effects are to be seen increasingly throughout 2011 and after.

FRANdata projects that the portion of SBA-guaranteed loans to franchisees will increase to 35% in 2011. This is based on lender feedback, as well as current reports by the SBA confirming the increase in SBA lending, the higher guarantee caps, and the proposed SBA budget for 2011. As banks continue to become more comfortable with making larger transactions, the 2.5 times increase in the cap for SBA-guaranteed loans will have an increasing impact over the SBA-guaranteed portion of financing. FRANdata predicts that in the following years, the percent SBA loans will rise further.

FRANdata projects that total borrowings required to meet demand in 2011 will be \$10.4 billion, up by 3.3% from \$10.1 billion in 2010.

The Lending Environment

The lending environment is determined by two main factors. First, the amount of money banks have available to lend and second, how much of that money they are willing to lend and at what rate. This section provides a review of both the banks' ability and willingness to lend.

Ability to Lend

FRANdata estimated that in 2010, banks would have an available pool of over \$11.9 billion to lend in conventional and SBA loans to franchisees. In 2011, the SBA's budget guarantees \$28.025 billion in loans to small businesses. Based on the assessment of SBA franchise activity sources, FRANdata estimates that from 15% to 20% of SBA loans are made to franchisees. Assuming that about 35% of franchisees' funding will come from SBA-guaranteed loans, FRANdata forecasts that there will be a pool of over \$12 billion of conventional and SBA funds to lend to franchisees. Over \$4.2 billion of it will be available from SBA and over \$7.8 billion from conventional lending.

In addition to these funds, banks will be able to take advantage of a supplementary source of funds

coming from the Small Business Lending Fund Act of 2010 — a \$30 billion fund managed by the U.S. Department of Treasury, which can support several multiples of that amount in new credit to small businesses in both SBA and conventional loans.

Thus, the estimated bank lending ability will be well above the total borrowing requirements of \$10.43 billion in 2011, following the trend from 2010. As in the previous year, banks should have the ability to meet 100% of demand for funds. This trend represents a change compared to 2009, when banks' ability to meet small business loan demand was constrained.

The projected increase in the available supply of funds is a continuation of the increase that started to occur in 2010. In 2008 and 2009, the available amount for small business lending 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%, the steepest drop since 1942.

In response to these concerns, the government implemented a number of stimulus measures to protect the banking industry and to increase lending. The February 2010 Recovery Act set aside a \$375 million funding pool to temporarily eliminate fees for SBA loans and increase the portion of each loan that the government guarantees, up to 90%. In December 2010, an additional \$125 million were added to the program. Other stimulus loan programs have also taken place and the SBA plans to push for more funding to continue the stimulus measures. The House of Representatives passed a jobs bill late last year that includes another \$354 million to fund an extension of waived fees and increased guarantees.

Willingness to Lend

For the past three years banks have focused on not losing money. As the recovery takes hold, banks will gradually start to consider ways of making money again. Because the economic downturn was precipitated by a financial crisis, the change in banking mindset will be a gradual process and will span the next three to five years.

Franchised businesses have an advantage over independent small businesses from a willingness to lend perspective. That advantage is the ability to statistically and quantitatively measure performance history across a brand's many similar small businesses as compared to generalized data on independent small businesses. This is a big advantage as credit committees consider loan requests.

The key to lender willingness to lend to franchise businesses in this environment centers on information. Lenders have created tighter credit qualification boxes over the past couple of years. They will not have more liberal terms quickly. However, qualifying under these more restrictive terms is not sufficient in this economic period. When banks have a mindset of not losing money, greater underwriting due diligence is a direct result. As anyone who has applied for a home mortgage in the past two years can attest, much more analysis and paperwork is required.

In the case of franchising, the issue that must be addressed is the creditworthiness of the system, not just the borrower. A franchise system has historical performance attributes that suggest levels of risk to lenders. There are three areas that lenders want to assess in addressing system creditworthiness: unit economics; system performance; and franchisor performance. To the extent that franchise systems have good credit risk performance attributes, lender willingness to lend will be higher than for other franchise systems and especially for other independent businesses competing for loan dollars.

While banks will be able to meet 100% of franchise demand for funds, the limiting factor again will be the banks' willingness to lend. In 2011, FRANdata believes bank willingness to provide SBA loans will increase by 25% from its 2010 level. Their willingness to lend conventional loans, on the other hand, is expected to remain unchanged.

The estimated changes in SBA and conventional lending are based on the following combination of factors. On the positive side:

- continuation of the increase in overall SBA lending in 2010;
- 2.5 times increase in the cap for SBA-guaranteed loans that took effect in October 2010;
- incentives for increased lending by the Small Business Lending Fund; and
- pressure to lend based on a prolonged period of suppressed lending;

On the negative side:

- banks' expectations for levels of lending to remain unchanged in 2011;
- large pool of unqualified loan applicants;
- continuous distress in the housing market; and
- increased number of bank failures.

These factors are discussed in detail in the Appendix.

Based on FRANdata's assessment of the SBA-guaranteed loans provided to franchisees in 2010 and assuming a 25% increase to SBA lending, FRANdata projects that banks will be willing to provide a total of \$8.4 billion in 2011. This is a 7.5% increase from the estimated \$7.8 billion for 2010. The \$8.4 billion will consist of over \$2.9 billion of SBA-guaranteed loans. The expected increase in bank willingness to lend is a big change from the previous matrix studies when FRANdata estimated a decrease in both 2010 and 2009 bank willingness to lend.

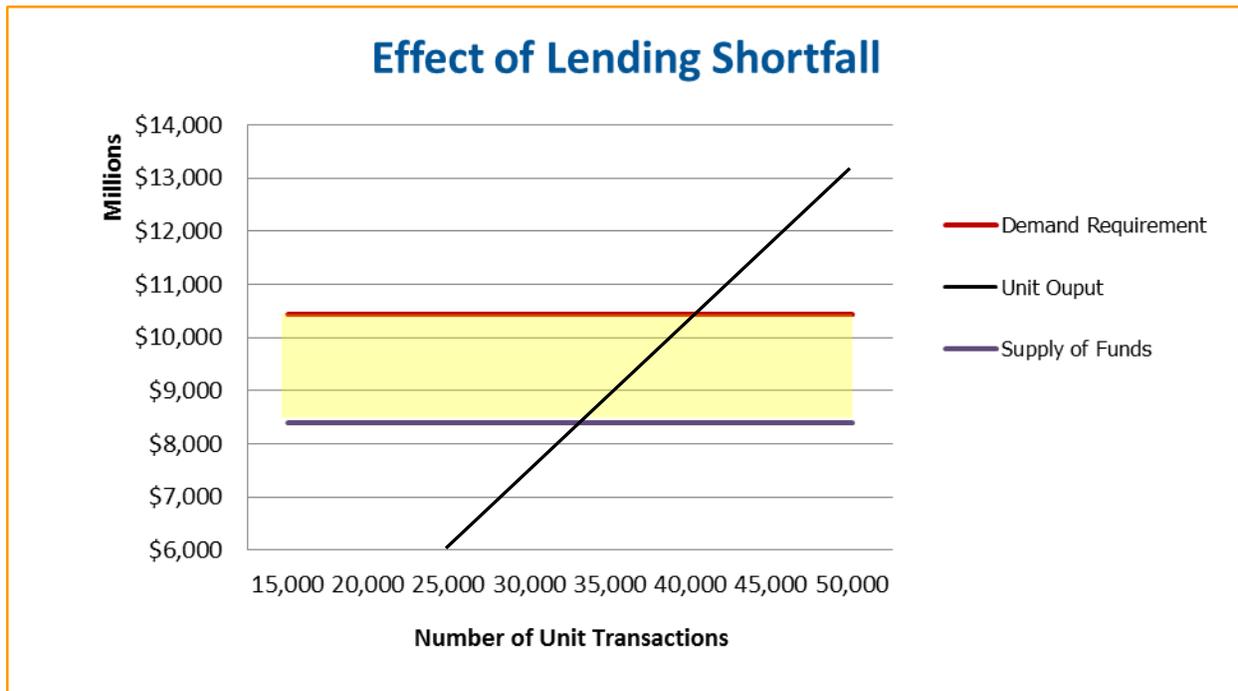
In 2010, FRANdata estimated that the bank willingness to lend during the year would provide franchises with capital of \$6.7 billion, which pointed to a 34% gap between the funds that would be provided and the funds that would be demanded. FRANdata further estimated that if certain SBA policy changes were enacted during the year, such as an extension in the increase of loan guarantees to 90%, eliminating and/or reducing SBA fees, and increasing the cap on guarantees from \$2 million to \$5 million, bank willingness to lend would rise to \$7.8 billion, contracting the gap in lending to 23% of the demanded \$10.1 billion. The assumed SBA policy changes were actually enacted during the year, causing an increase in SBA lending. For this reason, FRANdata uses the \$7.8 billion lending and 23% gap in lending in 2010 as a reference point.

SHORTFALL IN LENDING

FRANdata predicts a shortfall of more than \$2 billion, or 20%, in lending to franchise businesses in 2011. Banks are forecasted to lend \$8.4 billion to franchises in 2011 versus the \$10.4 billion that would meet 100% of the demand.

The following graph presents the effect the projected lending shortfall has on the number of franchise unit transactions, cumulative of new and transfer units. The yellow area defines the shortfall in lending due to the difference between bank willingness to lend, presented by the Supply of Funds line, and franchise capital borrowing requirements, presented by the Demand Requirement line.

Figure 1. Effect of Lending Shortfall.



FRANCHISE ECONOMIC IMPACT IN 2011

Based on the Economic Impact of Franchised Business Study, the average franchise unit provides approximately 10 direct jobs and 9 indirect jobs (excluding lodging) and creates \$933,998 of direct economic output and \$1,494,396 million in indirect economic output (excluding lodging)². This section examines the economic impact of franchising in 2011 if borrowing capital requirements were met by lenders.

Table 9. Franchise Direct and Indirect Jobs and Economic Output per NAICS Code.

NAICS Code	# of Direct Jobs per Unit	# of Indirect Jobs per Unit	Direct Economic Output per Unit	Indirect Economic Output per Unit
Auto	6	5	\$1,257,563	\$2,012,100
Commercial and Residential	4	4	\$653,082	\$1,044,931
Quick Service Restaurants	20	18	\$1,270,756	\$2,033,210
Table Service	30	27	\$1,664,127	\$2,662,603
Retail Food	8	7	\$627,866	\$1,004,586
Lodging	27	25	\$2,721,925	\$4,355,081
NEC	4	4	\$589,692	\$943,507
Retail Products	4	4	\$296,209	\$473,934
Business Services	9	8	\$1,388,140	\$2,221,024
Personal Services	5	4	\$658,543	\$1,053,669
Average Excluding Lodging	10	9	\$933,998	\$1,494,396

The projected 15,191 new unit transactions for 2011 would create 149,887 new direct jobs and 134,898 indirect jobs³, a total of 284,785 jobs. This compares to 281,427 new total jobs that could have been created in 2010, or a 1.2% increase. The new unit transactions projected for 2011 account for \$14.2 billion in direct total annual economic output and \$22.7 billion in indirect economic output, a total of \$36.9 billion annual economic output. By comparison, the estimated total annual output possible in 2010 was \$29.4 billion, thus the 2011 projected increase of economic output is 26%.

Transfer units do not generate new jobs or additional economic output because at existing units all employees have been hired and are already creating output. However, some units that are looking to transfer ownership might not find a buyer. While some franchisors may re-acquire these units and ensure continued operations others will be closed. FRANdata assumed that 10% of such units will be closed in 2011, which is an increase from the previous year's estimate of 5% due to the prolonged effects of the economic slowdown as discussed above. Thus, the 25,810 transfer unit transactions that would occur without the limitation of lending sustain 25,466 direct jobs and 22,919 indirect jobs, resulting in a total of 48,385 jobs. These transfers also maintain \$2.4 billion of direct annual economic output and \$3.9 billion in indirect economic output, resulting in total economic output of \$6.3 billion.

In total, FRANdata estimates that unit transactions seeking capital in 2011 would account for 333,170 total direct and indirect jobs either created or protected and over \$43 billion in total direct and indirect annual economic output either created or protected.

² Franchise Business Economic Outlook report and the Economic Impact of Franchised Business, Volume 2, published by the IFA Educational Foundation.

³ 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 services it produces.

ECONOMIC IMPACT DUE TO SHORTFALL IN LENDING IN 2011

FRANdata predicts that franchises will require \$10.4 billion in new capital to fulfill 100% of the forecasted demand for new units and transfer units in 2011, excluding lodging. At the same time, FRANdata forecasts that banks will only make available \$8.4 billion to lend to franchising. The estimated 20% shortfall in lending will lead to a shortfall of 7,985 unit transactions that will not be completed due to restrictive lending policies. The following section examines the negative impact on economic output caused by the shortfall in lending capital. Lodging is excluded from this analysis.

Each franchise unit, excluding lodging, is estimated to employ 19 people (10 directly and 9 indirectly) and to create \$2.43 million in annual economic output. Carrying this forward, the 15,191 new unit transactions possible in 2011 would create 284,785 total jobs and add \$36.9 billion in annual economic output. This also means that the shortfall in lending would cost the economy 3,993 new units or 74,849 jobs and \$9.7 billion in annual economic output.

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

Base Scenario	New Units	Total Jobs Created thru Financing	Total Annual Economic Output Created thru Financing
Maximum Level	15,191	284,785	\$36,911,542,645
Effect of Shortfall	(3,993)	(74,849)	(\$9,701,371,038)
Reduced Level	11,199	209,936	\$27,210,171,606

The lending shortfall has a similar but more muted effect on transfer units. FRANdata assumes that if a unit that needs to transfer is unable to get funds, 90% of the time the unit would continue to operate for the next year, while 10% would be unsustainable. The 10% unsustainability assumption reflects the prolonged effects of the economic downturn on business. This means that 25,810 transfer unit transactions would allow 2,581 units to stay in business that would otherwise close. These protected units would maintain 48,385 jobs and \$6.27 billion in annual economic output.

However, due to the shortfall in lending and the 3,993 transfer unit transactions that would not occur, the cost to the economy would be 7,485 total jobs and \$970 million in annual economic output that could otherwise be protected.

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

Base Scenario	Transfer Units Transaction	Total Jobs Maintained thru Financing*	Total Annual Economic Output Maintained thru Financing
Maximum Level	25,810	48,385	\$6,271,282,622
Effect of Shortfall	(3,993)	(7,485)	(\$970,137,104)
Reduced Level	21,817	40,900	\$5,301,145,518

*The number of jobs maintained was calculated by taking the 25,810 total demanded unit transactions and multiplying them by the estimated 18.7 (direct and indirect) jobs. The product is then multiplied by 10% to get the number of jobs lost from the units that would have closed without financing

To summarize the above points, the shortfall of 7,985 unit transactions, assuming they are spread out evenly among new and transfer units, will cost the economy 82,334 total jobs and \$10.67 billion in annual economic output.

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

Base Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(7,985)	(82,334)	(\$10,671,508,142)	-25%
Reduced Level	33,016	250,836	\$32,511,317,124	75%

These projections represent an increase in total jobs created or maintained of 16% and an increase in economic output created or maintained of 43% from the 2010 levels.

Note: Transfer unit transactions involve less risk, from a lender's perspective, than new unit transactions. This is due to the established financial performance existing units have. However, the exact way in which the shortfall in lending will affect transfer vs. new unit transactions is not possible to project because it depends on the banks' individual underwriting considerations. For simplicity purposes, FRANdata assumes that an equal number of new and transfer unit transactions will not be developed due to the shortfall in lending. This means that out of all transfer unit loan applications, 15% will not receive financing, while out of all new unit loan applications, 26% will not receive financing.

BANK LENDING SCENARIOS

FRANdata projects that the constraints provided by bank willingness to lend throughout 2011 will reduce the number of jobs that could be created or maintained by 82,334 and the possible annual economic output by \$10.7 billion. These estimates are based on FRANdata's expected net effect of a combination of factors that affect bank lending to small businesses in different ways. Besides the expected increase of 25% in SBA loans while conventional loans remain unchanged, it is worth examining the effects on the economy that would result if banks took a more aggressive or a more conservative approach to lending than the base scenario discussed above.

Aggressive Scenario

The SBA reported that in the fiscal year 2010, lending rose 30% nationwide.⁴ In the aggressive lending scenario case, FRANdata assumes that in 2011, bank willingness to lend will continue to rise and both SBA-guaranteed as well as conventional loans will increase from their 2010 levels by 45% and 15% respectively. This scenario would be possible if banks took advantage of the incentives to increase lending offered by the Small Business Loan Fund of 2010, and if the economy accelerated its pace of recovery, reflecting higher consumer demand, stabilizing housing market, and strengthening household net worth.

Based on the forecasted increases in lending, the total funds banks would be willing to provide would be \$9.67 billion, which is an increase of 15% over the estimated funds projected by the base scenario. This reduces the number of unit transactions that will not be funded by 63% from a total of 7,985 under the base scenario to a total of 2,959 under the aggressive scenario.

The considerably lower number of transactions that will not be made due to lending constraints under this scenario results in the loss of a total of 30,505 jobs (27,732 from unfunded new units and 2,773 from unfunded transfers) and \$3.9 billion in output (\$3.6 billion from unfunded new units and over \$350 million from unfunded transfers) that will not be created or maintained in 2011. Over 50,000 more jobs and over \$6.7 billion more economic output will be maintained if banks took the aggressive approach to lending as compared to the base approach. This represents a 21% increase from the base scenario in both jobs and economic output created or maintained.

Under the aggressive scenario, 13,712 new franchise unit transactions will be funded, resulting in 257,054 jobs and \$33.3 billion in economic output. This represents 90% of the maximum demanded new units, total jobs and economic output created.

Table 10. Aggressive Scenario, Effect of Lending Shortfall on New Units.

Aggressive Scenario	New Units	Total Jobs Created	Total Annual Economic Output Created
Maximum Level	15,191	284,785	\$36,911,542,645
Effect of Shortfall	(1,479)	(27,732)	(\$3,594,362,832)
Reduced Level	13,712	257,054	\$33,317,179,813

⁴ CNN Money, October 2010

With regard to transfers, under the aggressive scenario, 24,331 transfer unit transactions will be funded, resulting in 45,612 jobs maintained and \$5.9 billion in economic output created. This represents 94% of the maximum demanded transfers, total jobs maintained and economic output created.

Table 11. Aggressive Scenario, Effect of Lending Shortfall on Transfer Units.

Aggressive Scenario	Transfer Units Transaction	Total Jobs Maintained*	Total Annual Economic Output Created
Maximum Level	25,810	48,385	\$6,271,282,622
Effect of Shortfall	(1,479)	(2,773)	(\$359,436,283)
Reduced Level	24,331	45,612	\$5,911,846,338

*The number of jobs maintained was calculated by taking the 25,810 total demanded unit transactions and multiplying them by the estimated 18.7 (direct and indirect) jobs. The product is then multiplied by 10% to get the number of jobs lost from the units that would have closed without financing.

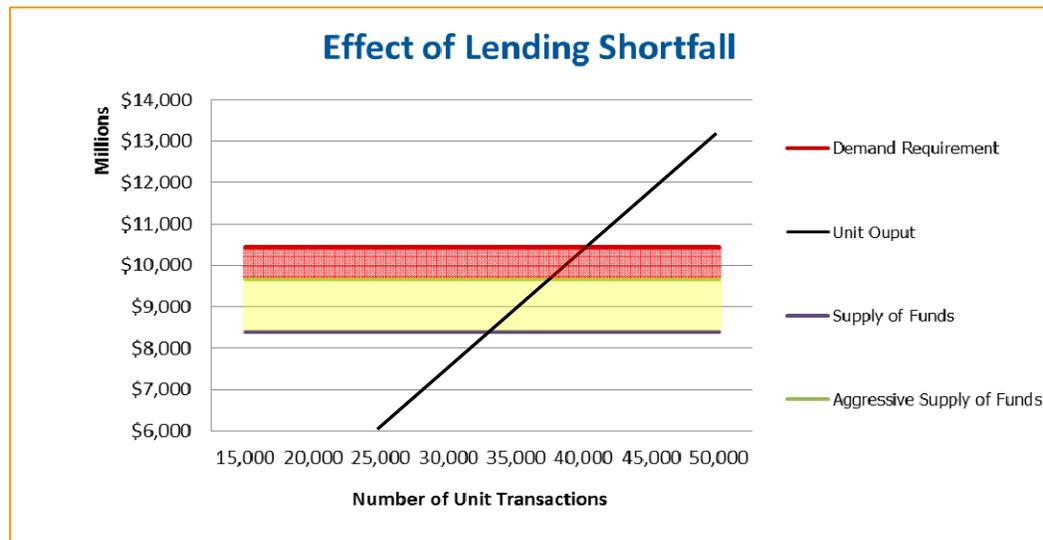
In total, provided that banks increase their lending to franchisees aggressively, 302,666 jobs and \$39.2 billion in economic output will be created or maintained in 2011. This represents 91% of the maximum possible jobs and economic output created or maintained by new and transfer franchised transactions.

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

Aggressive Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(2,959)	(30,505)	(\$3,953,799,115)	-9%
Reduced Level	38,042	302,666	\$39,229,026,151	91%

The shortfall under the aggressive lending scenario is presented by the pink area on the graph below. The yellow area presents the difference between the base and the aggressive lending scenarios.

Figure 3. Effect of Lending Shortfall, Aggressive Scenario.



Conservative Scenario

FRANdata assumes that under a conservative case scenarios, banks do not take advantage of the Small Business Loan Fund of 2010 incentives and tighten their lending due to factors such as an unqualified pool of loan applicants with eroding net worth and increased risk of bank failures caused by their problematic residential and commercial real estate investments. FRANdata assumes that under such circumstances, banks will increase their SBA lending by 10%, based primarily on the increase guarantee cap and other stimulus changes introduced in 2010. This increase, however, will come at the expense of a decrease in conventional loans by 15%, as banks are trying to redistribute their portfolios in favor of loans entailing lower riskiness.

Under these assumptions, banks will be willing to lend \$7.2 billion, which is a 7% contraction from the estimated funds for 2010 and a 14% contraction from the 2011 projection for the base scenario. The total number of franchised transactions that will not be funded under the conservative scenario is 12,553.

The conservative scenario projects that the unit transactions that will not be made due to lending constraints result in the loss of a total of 129,433 jobs (117,667 from unfunded new unit and 11,767 from unfunded transfer transactions) and \$16.7 billion in output (\$15.2 billion from unfunded new unit and over \$1.5 billion from unfunded transfer transactions) that will not be created or maintained in 2011.

Under the conservative scenario, 8,915 new franchise unit transactions will take place resulting in 167,119 jobs and \$21.7 billion in economic output. This represents 59% of the maximum demanded new units, total jobs and economic output created.

Table 12. Conservative Scenario, Effect of Lending Shortfall on New Units.

Conservative Scenario	New Units	Total Jobs Created	Total Annual Economic Output Created
Maximum Level	15,191	284,785	\$36,911,542,645
Effect of Shortfall	(6,277)	(117,667)	(\$15,250,974,512)
Reduced Level	8,915	167,119	\$21,660,568,133

With regard to transfers, under the conservative scenario, 19,533 transfer unit transactions will be funded, resulting in 36,618 jobs maintained and \$4.7 billion in economic output created. This represents 76% of the maximum demanded transfers, total jobs maintained and economic output created.

Table 13. Conservative Scenario, Effect of Lending Shortfall on Transfer Units.

Conservative Scenario	Transfer Units Transaction	Total Jobs Maintained*	Total Annual Economic Output Created
Maximum Level	25,810	48,385	\$6,271,282,622
Effect of Shortfall	(6,277)	(11,767)	(\$1,525,097,451)
Reduced Level	19,533	36,618	\$4,746,185,171

*The number of jobs maintained was calculated by taking the 25,810 total demanded unit transactions and multiplying them by the estimated 18.7 (direct and indirect) jobs. The product is then multiplied by 10% to get the number of jobs lost from the units that would have closed without financing.

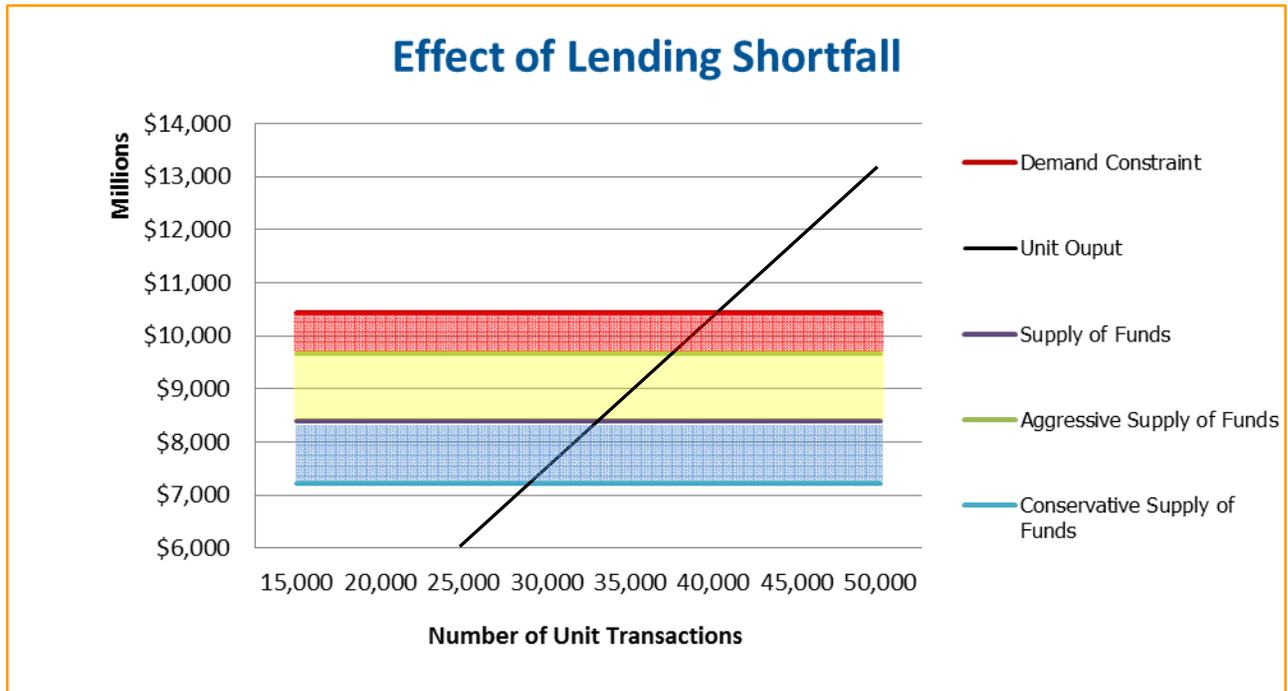
In total, provided that banks increase their SBA lending by 10% while decreasing their conventional lending by 15% from 2010 levels, 203,737 jobs and \$26.4 billion in economic output will be created or maintained in 2011. This represents 61% of the maximum possible jobs and economic output created or maintained by new unit and transfer unit transactions.

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

Conservative Scenario	Number of New and Transfer Unit Transactions	Total Jobs Created or Maintained thru Financing	Total Annual Economic Output Created or Maintained thru Financing	Percent of Maximum Level
Maximum Level	41,001	333,170	\$43,182,825,266	100%
Effect of Shortfall	(12,553)	(129,433)	(\$16,776,071,963)	-39%
Reduced Level	28,448	203,737	\$26,406,753,304	61%

The shortfall under the conservative lending scenario is presented by the total shaded area on the graph below — the sum of the pink, yellow and blue areas. The shortfall under the aggressive lending scenario is presented by the pink area on the graph below. The yellow area presents the difference between the base and the aggressive lending scenarios. The blue area presents the additional shortfall that would occur if banks were to tighten lending under the assumptions of the conservative lending scenario.

Figure 4. Effect of Lending Shortfall, Aggressive and Conservative Scenarios Combined.

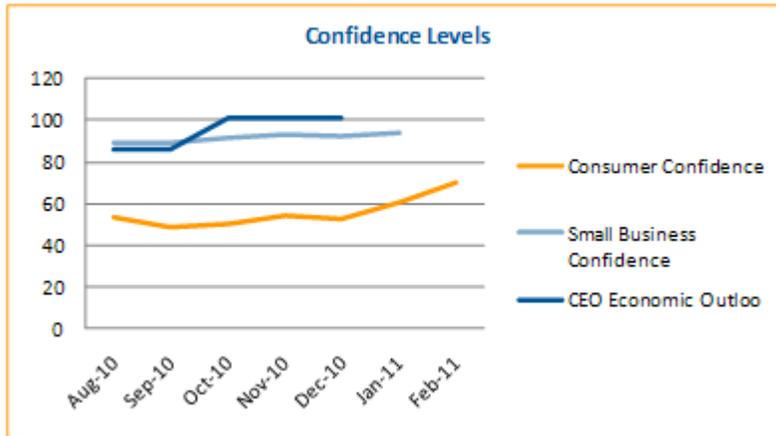


APPENDIX

Factors Affecting Investor Willingness

The longest post-WWII recession officially ended in June 2009 and the U.S. economy is slowly starting to recover. There are multiple indicators that show visible improvements in the economy's growth and future prospects. In 2010, the U.S. GDP is estimated to have grown by 2.8%. Some economists warn against the impact of the current political instability in North Africa and the Middle East and its potential negative impact due to rising oil prices. Still, the CEO Confidence Index rose to 6.25 (out of 10) in January 2011, an increase of 6.9% from December 2010.⁵ This is the highest reading of the Index since July 2007.

Figure 5. Consumer, CEO and Small Business Confidence Levels



The closely related Consumer Confidence Index is also rebounding, jumping to 70.4 in February 2011 from 60.6 in January.⁶ The index had its 17-month low reading of 48.6 in September 2010. The recent increase exceeded analysts' expectations and clearly indicates positive trends in consumer sentiment and general optimism in the undergoing recovery and job creation. Another Index on Consumer Sentiment – from Thompson Reuters/University of Michigan, rose to a three year high, reaching 77.5 in February.⁷ The survey shows that for the first time in

six years consumers say they heard more positive than negative news on the economy during the month of February. Consumer sentiment is important because consumer spending represents 70% of the U.S. economy.

The general "cautious optimism" points to an increased willingness of investors to invest in new franchise units or transfers.

Retail Sales

Retail sales, including all retail and food service sales, increased 7.8% to \$4.5 trillion during 2010. Furthermore, retail sales as of January 2011 are 0.4% above their pre-recession levels.⁸ Consumers are returning to stores suggesting a return to increasing spending patterns. The increasing retail sales trend has been consistent for the past two years and is expected to continue through 2011, helping stabilize the economy.⁹

Closely related to retail sales and an equally good indicator for the direction of the economy are same-store sales. During 2010, same-store sales increased on average with 3.3% on a yearly basis for the leading national retail brands.¹⁰ This figure compares with a 2.5% decline in 2009 and a 4.7% growth in the pre-recessionary economy of 2006. Furthermore, latest numbers for February 2011 show that same-store sales increased by 4.2% for the past month, beating expectations of a 3.6% jump.

⁵ CEO Confidence Index, January 2011

⁶ The Conference Board, February 2011

⁷ Thompson Reuters, February 2011

⁸ U.S. Census, January 2011

⁹ Direct Lending Solutions 2010

¹⁰ Thompson Reuters, November 2010

To summarize, the most widely used indicators about optimism in the economic recovery are positive and growing. Additionally, according to a January 2011 poll by Gallup, more than 52% of Americans believe the U.S. economy is going to improve measurably in 2011.¹¹ All of this should translate into a measurably better economic climate in 2011 compared to 2010.

Factors Affecting Investor Ability

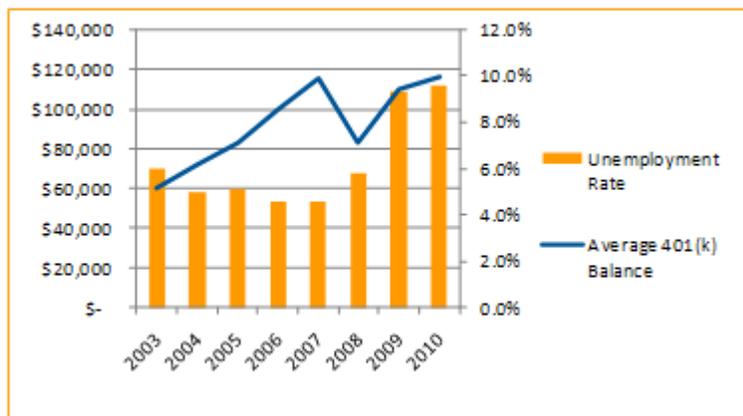
The current economic recovery is projected to be of moderate speed. At the same time, the stock market has recovered from worst of the recession in 2009 when the DOW Jones Industrial Average hit bottom at 6,550. In 2010, the NASDAQ increased by 15% and the DOW Jones Industrial Average increased 9.5%.

What remains to be seen is how those effects will translate into more economic growth. Last but not least, there is still a chance of possible echo-bubbles. Echo bubbles have usually followed the collapse of large bubbles and tellingly after governments artificially provide cash to fight the original bubble. According to Edward Chancellor, Echo Bubbles reach on average up to 40% of the original before going bust themselves.

Traditional Sources of Financing

Increases in the stock markets have positively impacted investment portfolios, a possible source for funding for new franchisees. For example, at the end of 2009, the average 401(k) balance was \$109,723¹², up from \$83,161 in 2008. Based on the usual allocation of stocks at 60% of the total balance and assuming the general stock market index growth for 2010 mentioned earlier, the estimated average 401(k) balance at the end of 2010 stood at \$116,000. Therefore, 401(k) account holders have modestly recovered their investments and those funds can potentially be used as collateral for a loan to start a franchise.

Figure 6. Unemployment Rate and Average 401(k) Balance



Traditionally home equity has been an alternative to fund investments of prospective franchisees. As of January 2011, 30% of home mortgages had negative equity, or homeowners owed more than the market value of their homes. The Case-Shiller Composite 10 Index is down 31% from its peak. For the most current year – November 2009 to November 2010, it declined 1.6%. What is more, the authors of the Case-Shiller Composite 10 Index believe that that housing prices could fall another 25%.

As home prices continue to fall slowly, banks will remain cautious about their lending practices. There are also lingering concerns about a “double-dip” of housing prices, which may result in a further tightening of credit lending. Overall, households’ net worth continued to erode from its 2007 peak of \$64.2 trillion. In the last quarter of 2010, it increased to \$54.8 trillion from \$53.7 trillion in the second quarter of 2010.¹³

¹¹ Gallup, January 2011

¹² Investment Company Institute, November 2010

¹³ Federal Reserve Board, December 2010

Furthermore, Commercial Real Estate (CRE) values also declined by 6.3% in 2010 bringing the total to 22% over the last two years. If this plunge continues, more building owners could default on an estimated \$500 billion to \$750 billion of mortgage debt, further exposing banks to bad debt¹⁴. Early 2011 data show a slight reversal of this trend but it remains unclear whether this change will be permanent.

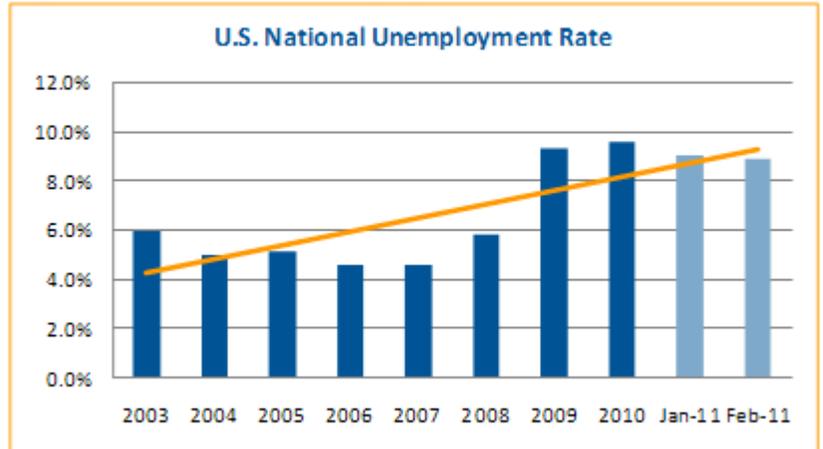
To summarize, prospective franchisees have lost important sources of financing in the past couple of years – investments and home equity. Although, investment portfolios have modestly recovered in the past year with the increase in the stock markets, home equity still remains at distressed levels. As a result, FRANData does not foresee any major changes for new franchisee’s ability to obtain funding.

Unemployment

The number one challenge facing the U.S. economy is job creation and how to decrease the elevated pool of unemployed people. The unemployment rate has started to come down in the first months of 2011 and as of February stands at 8.9%.¹⁵ This rate is projected to decrease to 5.7% only by 2016.¹⁶

In addition, there are twice as many unskilled workers than more skilled workers.¹⁷ Since the larger part of the unemployed pool consists of people without college degrees, this means banks will consider these people higher risk and their overall willingness to lend will decrease.

Figure 7. U.S. National Unemployment Rate



Franchisors as Sources of Funding

The current economic environment has pushed some franchisors to become lenders to their franchisees. For example, UPS has announced that it is making \$22.5 million available for franchised UPS Stores, arranged by Bancorp Inc. and Franchise American Finance. \$15 million will be available for new units and \$7.5 million for transfers.

¹⁴ The Atlantic: business.theatlantic.com “The Ugly Commercial Real Estate Picture” November 11, 2009.

¹⁵ Bureau of Labor Statistics, January 2011

¹⁶ Congressional Budget Office, 2011

¹⁷ Bureau of Labor Statistics

Bank Willingness and Ability to Lend

Ability

For the past three years banks have focused on not losing money. Because the economic downturn was precipitated by a financial crisis, the change in banking mindset will be a gradual process and will span the next three to five years.

Franchised businesses have an advantage over independent small businesses from a willingness to lend perspective. That advantage is their ability to statistically and quantitatively measure performance history across a brand's many similar small businesses. On the contrary, independent small businesses can mostly offer generalized data. This is a big advantage as credit committees consider loan requests.

The key to lender willingness to lend to franchise businesses in this environment centers on information. Lenders have created tighter credit qualification boxes over the past couple of years and will not apply more liberal terms quickly. However, merely qualifying under these more restrictive terms is not sufficient in this economic period. When banks have a mindset of not losing money, greater underwriting due diligence is a direct result.

In the case of franchising, the issue that must be addressed is the creditworthiness of the system, not just the borrower. A franchise system has historical performance attributes that suggest levels of risk to lenders. There are three areas that lenders want to assess in addressing system creditworthiness: Unit economics; system performance; and franchisor performance. To the extent that a franchise system has good credit risk performance attributes, bank willingness to lend will be higher than for other franchise systems and especially for other independent businesses competing for loan dollars.

Compared to 2010, when FRANData estimated a pool of \$11.9 billion for banks to lend to businesses, in 2011 the estimate is up to over \$12 billion. Therefore, banks' ability to extend conventional loans will meet the demand for franchise lending capital. However, the limiting factor remains the banks' willingness.

In 2011, the SBA will continue to be a major driver in small business lending, representing an estimated 20% of lending to franchises. The SBA budget for FY2011 is \$994 million and represents a 21% increase from FY2010. With these funds, the SBA can support \$28.025 billion of loan guarantees to small businesses.¹⁸

Conventional lending from banks, on the other hand, presents a different picture. Banks' lending is projected to remain unchanged in 2011. Still recovering from the decline in housing prices, banks are highly risk-averse. In addition to the effects of declining housing values and decreasing equity, Commercial Real Estate (CRE) values have also been important indicators for bank willingness and ability to lend. Larger, nationwide banks have traditionally had more commercial real estate exposure than small community banks. Already reeling from home mortgage crisis, large banks will be less likely to lend if there is major decline in commercial real estate values.

According to CoStar's CRE Index, prices decreased 6.3% in 2010, bringing the total to 22% over the last two years. If this plunge continues, defaults on an estimated \$500 billion to \$750 billion of mortgage debt, further exposing banks to bad debt.¹⁹ Recent indicators point to increasing stability and event a slight growth in CRE values in the early months of 2011.

¹⁸ SBA Programs Overview 2011

¹⁹ The Atlantic: business.theatlantic.com "The Ugly Commercial Real Estate Picture" November 11, 2009.

Traditionally most franchise loans were made by large, national banks. Due to the real estate dynamics discussed previously, smaller banks with less exposure to residential housing and commercial real estate will be in a better position to make small business franchise loans in 2011. However, their lending decisions will be influenced by the performance and credit worth of the franchisor/investor.

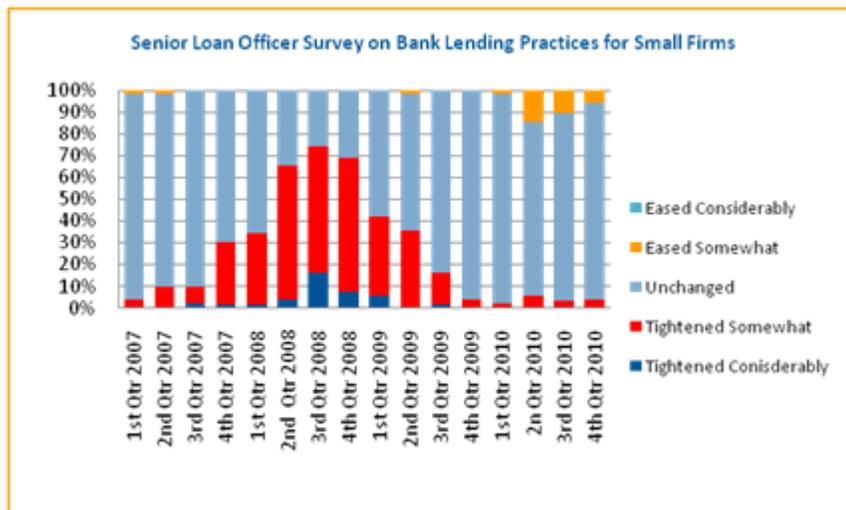
Capital Requirements

The Basel Committee on Banking Supervision will require banks to have common equity equal to at least 4.5% of assets. Regulators are also going to introduce an additional buffer of 2.5% to withstand future economic stress. Many banks have not welcomed these changes, as they may limit lending. Additionally, Tier 1 capital ratios, a common bank measure of financial strength, will have to be maintained at 6% minimum, up from the current 4%. These new regulations are not immediate, but they may impose limits on bank's ability to lend.²⁰

Willingness

In 2010, banks initially hinted at an increased willingness to lend. Wells Fargo issued \$3.9 billion in small business loans, 18% up from \$3.3 billion in Q3 2009. Bank of America made \$5.7 billion in small business loans, 39% up from \$4.1 billion in Q3 2009 and Chase made \$2.7 billion in small business loans, up from \$1.9 billion in Q3 2009, a 42% increase.²¹

Figure 8. Senior Loan Officer Survey on Bank Lending Practices for Small Firms



Despite the increase in lending just indicated, banks are still hesitant to make new loans to small businesses. The main reason for this is the high level of risk-aversion mentioned above. Between January 2010 and January 2011, 149 banks failed, and the total number of banks that have been repossessed by the Federal Deposit Insurance Corp. (FDIC) since 2007 is now at 314.²² Additionally, as of October 2010, 829 banks are at a higher risk of failure, roughly 10% of all banks.²³

The Federal Reserve Survey on Senior Bank Loan Officers further underlines that banks do not expect any major changes in the lending environment in 2011. The majority of loan officers claim credit lines will remain the same, in size, maturity, risk premium, and collateral. At the same time, 20% foresee some easing off in cost of credit. This is a continuation of banks cautious approach given the circumstance discussed previously as well as non-performing loans on the consumer side.

Banks report the following in regards to credit standards for approving Commercial and Industrial loans or credit lines for smaller companies (annual sales below \$50 million).²⁴ A factor that may decrease banks' willingness to

²⁰ Bank of International Settlements

²¹ The Wall Street Journal

²² Calculated risk

²³ FDIC

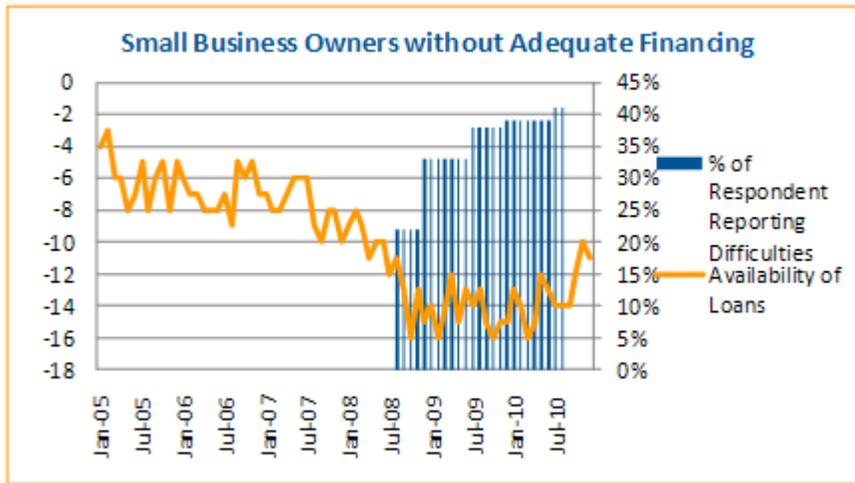
²⁴ The Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2011

lend is the elevated number of bankruptcies – business and personal as reported by the U.S. Bankruptcy Courts. The number increased by 27% from 2009 to 2010, making banks unwilling to extend credit to more risky investors.²⁵

Due to the uncertainty and risk banks face, in 2010, they decreased their lending to small as well as to large businesses. According to SBA, the amount of total loans outstanding to small businesses plunged by \$43 billion, or 6.2% from June 2009 to June 2010. From June 2008 to June 2010 this represents an 8.3% drop, or \$59 billion.²⁶

Even though banks pledge more money for lending, they still apply the same risk assessments. Since potential borrowers have lower assets today and potential cash flow remains uncertain due to the slow moving economy, borrowers often fail to meet credit standards. Therefore, despite an increase in ability to lend, banks are only slowly increasing their willingness to do so. This supported by the number of small business owners who continue to state that the number of available loans does not meet demand.

Figure 9. Small Business Owners without Adequate Financing



The Small Business Lending Fund Act enacted in September 2010 could have a pronounced positive influence on banks willingness and ability to extend loans to small businesses. It stipulates a \$30 billion fund to be managed by the U.S. Department of Treasury in order to spur small business lending. Its purpose is to provide mainstream banks with capital in order to encourage lending and job creation.

What is particularly attractive for banks is that they can use the funds

as a Tier 1 capital, which will enable them to lend more money to small businesses. As part of the bill, if banks increase their lending more than 10%, the cost of the funds they will be borrowing from the U.S. Treasury will decrease to 1%.²⁷ According to Congressional Budget Office estimates, the SBLF would disburse about \$23 billion of the available \$30 billion in fiscal year 2011.²⁸

The SBLF will be a continuous effect from the policies passed in 2010 that encourage banks to increase their lending in order to take advantage of the funds at a lower cost.

²⁵ U.S. Bankruptcy Courts

²⁶ SBA, February 2011

²⁷ U.S. Treasury

²⁸ CBO

Economic Projections for 2011 and 2012

The economic recovery, currently under way, is expected to continue with a moderate pace through 2012 and beyond. Banks have not yet thrown open the doors to small business lending and are taking a cautious approach.

Table 14. Summary of Economic Projections, 2011-2012

Summary of Economic Projections - 2011 to 2012								
Economic Indicator	Survey of Prof. Forecasters	Wells Fargo	WSJ	FED (min)	FED (max)	CBO	OMB	AVERAGE
GDP growth 2011	3.20%	3.20%	3.50%	3.40%	3.90%	3.10%	3.10%	3.30%
GDP growth 2012	3.10%	3.00%		3.50%	4.40%	2.80%	4.00%	3.50%
Unemployment (end of 2011)	8.80%	9.20%	8.60%	8.80%	9.00%	9.20%	9.10%	9.00%
Unemployment (end of 2012)	5.50%	8.80%		7.60%	8.10%	8.20%	8.20%	7.70%
Core CPI, 2011	1.30%	0.90%	2.10%	1.00%	1.30%	1.00%	1.40%	1.30%
Core CPI, 2012	1.60%	1.40%		1.00%	1.50%	1.20%	1.90%	1.40%

Extrapolating from the above sources, GDP is expected to grow by 3.3% in 2011 and inflation is expected to remain within 1-2%. Unemployment is projected to remain at around 9% in 2011 and then start to gradually decrease. These positive economic signs, coupled with general consumer optimism will mean a better climate for franchising in 2011 compared to 2010. Additionally, if banks make use of the new SBLF program, a substantial amount of new financing could be extended to current and future franchises, which will boost job creation and economic output.

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For the past twenty years, FRANdata has been the only source for objective research and information about franchising in the United States. FRANdata receives no advertising or other fee arrangements that might influence its objectivity. FRANdata supports the research and competitive intelligence functions of franchisors, helps franchisees evaluate different concepts, provides information and analysis for legal and financial organizations, and provides marketing access to franchisors and franchisees.