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Les Stewart | consulting

April 12, 2006

Mr. Peter G, Webber
Director, Small Business Financing
Industry Canada
Financing
235 Queen Street
Ottawa, Ontario
K1A 0H5

Regarding: Service Proposal

Mr. Webber,

Please find attached my proposal to provide consulting services regarding the Canada Small Business Financing program.

I would be happy to discuss this and look forward to assisting you with this project.

Les Stewart

Service Proposal

Statement of work

The purpose of this study is to provide preliminary information to Industry Canada on the delivery of Canada Small Business Financing loans (CSBF loans) to the business-format franchising marketplace.

Special emphasis will be placed on the registration process and the lenders' compliance with due diligence requirements as defined by the *Canada Small Business Financing Act, Regulations and Guidelines*. In 2003-04, the CSBF Program paid out 1,579 claims which were worth over \$73-million.

The primary mechanism for the study will consist of structured interviews with current and former franchisees. By using a standardized questionnaire, a preliminary survey of the borrowers' profile and financial outcomes will be accomplished.

Ideally, the franchisees will come from a non-random sampling of the greater Toronto and central Ontario regions. The cases could be drawn from: random samples or specific files as directed by the client or existing vendor files or even a combination. Simple statistical analysis will be completed from the completed surveys.

Further work will concentrate on more detailed analyses when the scope of issues is clarified. Recommendations for policy changes will be made with further study.

Background

The CSBF loans fulfill a much-needed source of debt financing for Canada's small business sector. The program is undergoing a review.

Current situation

The CSBF program has become an important support to the franchise industry. Franchise system owners, the franchise bar, financial institutions, suppliers and their attendant supporters have shown consistent growth in both size and profitability over decades.

The benefits to franchisees or the end-users (CSBF borrowers) are less certain. Anecdotal evidence indicates some problem areas do exist. The availability of supported credit, potentially without full due diligence to justify such support, may encourage franchisees to enter into ventures with often little chance of success. Industry Canada has not traditionally measured the success of franchise loans compared to other loans.

Credence goods

Commercial lending, as well as franchise systems and legal services are credence goods. Lending officers, in consultation with their national program franchisors, are experts who determine the buyers' needs.

Borrowers are often unable to assess how much of a good or service they in-fact need; nor can they assess whether or not the service was performed or how well. Borrowers can be exposed to opportunism by the lender and franchisor.

It seems obvious that the franchisor and lender acting in concert, pose a much higher potential risk to the investor.

The purpose of franchising

Franchising is primarily a method of financing: small business investors rather than corporate investment in a branch network fuel the trademark system's expansion.

It is possible that some franchise systems actually encourage the failure of their franchisees. Potentially, franchisors can be financially rewarded by the rapid sale, failure and resale of stores. Re-selling the same store five times in five years is far more lucrative to the franchisor than keeping the same original franchisee in place.

CSBF loans have evolved to become almost entirely the only debt-financing instrument for franchisees. Most franchisors advertise that financing is available to qualified candidates. The CSBF program accounts for almost all of this financing. Candidates are told that they are only responsible for 25% of the loan.

For financial institutions, CSBF loans are just one of a suite of services such as deposit accounts, operating lines, overdraft protection, term loans, personal accounts, RRSPs, merchant credit and debit cards, credit cards, payroll services, etc. that can be sold to a franchisee.

Taken on their own, CSBF loans may not be as profitable as the financial institutions would prefer, but combined with the other banking services, the franchise industry, in fact, represents tens of billions of dollars - with a corresponding very low default risk. This may in fact be an incentive for loans officers to relax their due diligence in the processing of franchisee loan reviews.

Higher risks

When compared to independent businesses, franchisees in fact are more vulnerable primarily because of the risk of opportunism: they own the assets but have no effective control over them (Hadfield).

While there is very little Canadian academic literature comparing financial outcomes for independent or franchised businesses, Dr. Timothy Bates of Wayne State University found in a study sponsored by the U.S. Department of Commerce that:

...the franchisee route to self-employment is associated with higher business closure rates and lower profits for the young, largely noncorporate firms, relative to independent business ownership.

Survival Patterns among Franchisee and Nonfranchised firms started in 1986 and 1987, U.S. Department of Commerce, 1996.

Franchise candidates are left to ask: *Will my franchise system exercise their discretion within this incomplete, long-term contract so as to strip away my family's life savings?*

Franchise banking

Potential franchisees carry these largely unknown, but very real, business risks with them into the CSBF Program lender's office.

Unfortunately, some franchise systems are managed to opportunistically extract the maximum wealth (i.e. loan proceeds, labour, family money and/or the investor's life savings) in the minimum time. A successful CSBF applicant can be seen as a much more attractive target.

Many franchise offerings in the \$300,000 to \$400,000 purchase price range result in a consistent negative return on investment. Some industry observers claim this class of franchises would largely vanish if CSBF funds were offered only for sustainable business and expansion.

Lack of standards

Franchised lenders and borrowers suffer from a serious information hardship. How is it possible to do adequate due diligence when the lender and borrower don't know if the franchisor will exercise their discretion, over a ten to fifteen year period, against the interests of the borrower and the lender?

There are currently no enforced or effective codes of industry behaviour in Canada.

The American Association of Franchisees and Dealers has invested significant energy into trying to work toward a market solution to this problem. The A.A.F.D. has developed their Total Quality Franchising practices, Fair Franchise Standards and Fair Franchising Seal in consultation with franchisors, franchisees and their lawyers.

Work plan

Ideally, the interviewees will come from three potential sources: list of borrowers taken at random, a specific list of borrowers and the vendor's existing database. Special emphasis will be given to the following sources: recent media reports, business broker customers and other high-risk trademark systems.

Methodology

1. There will be an initial meeting with the project coordinator. The questionnaire, interviewee list and need for ancillary documents will be established.

2. Potential interviewees will be contacted. The purpose of the study will be explained and an appointment made. The franchisee will be asked to bring a copy of their Loan Registration form. The interview will be conducted at a location convenient to the interviewee. Some unannounced appointments will be also be made.

This process will be repeated until approximately fifty per cent (50%) of the target total of interviews is achieved.

3. Industry Canada will be provided with the names and trademark systems of each interviewee. Industry Canada will determine the registration status of each file.

4. There will be a second (follow-up) meeting with the project coordinator.

Subsequently, the remaining fifty per cent (50%) of interviews will be conducted. Industry Canada will be given the names and trademark systems of this group. Industry Canada will determine if there are any non-registered loans.

5. A draft report will be created. The report will focus on the registration and due diligence findings. Areas of future study will be identified. There will be a draft report meeting.

6. A final report will be delivered.

Deliverables

Based on experience and given the sensitivity of the information obtained, we project the need to contact one hundred and sixty (160) small businesspeople with current or recent past CSBF loans to yield eighty (80) completed surveys.

Of those eighty, approximately fifty per cent (50%) will provide forty (40) completed surveys and documents.

Any unusual patterns will be reported as they emerge.

Cost

The professional fee for this work will be \$23,200.00, plus G.S.T.

Seventy per cent of the fee will be billed after the draft report is accepted with the balance due when the final report is presented.

Additional labour will be billed at the rate of \$100.00 per hour. An allowance of \$2,000 for local travel is included in the contract price. Travel and other costs will be charged at current Treasury Board rates.

Limitations

An introductory and explanatory letter will be required from Industry Canada. This will be an important tool in establishing trust, credibility, and reliable information.

Industry Canada will be responsible for providing direction regarding the protection of the respondents' rights to privacy throughout the process.

Conflict of Interest Statement

It is a term of this contract that any persons engaged in the course of this contract and subsequent to it shall conduct themselves in manner such that there is not and will not be any conflict arising from competing or opposing interest of other clients of the Contractor. Should an interest be acquired during the life of the contract that would cause a conflict of interest, the Contractor shall declare it immediately to the Departmental Representative.

Experience & Capabilities

Firm

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Ownership

Sole proprietor: Mr. Les Stewart

Language

English.

Resources

Les Stewart has been an active member of the American Franchisee Association since 1998.

Franchise Industry Archive: Stewart has developed a digital database of 2,500 newspaper, magazine, trade and government publications from 30 countries.

Library: Stewart has an extensive collection of franchise and small business material including: legal journals, The Franchise Annual, Society of Franchising Annual Papers, books, *Hansard*

citations, INFO Franchise Newsletter, *Franchise Times*, case studies, www.cafo.net, *Franchising: Remedies and Realities*, Harold Brown,

Capabilities

Les Stewart is a small business consultant focused on the franchise industry. Stewart received a B.A. from The University of Western Ontario, 1983 and an M.B.A. from the Richard Ivey School of Business (UWO) 1987.

Certified Management Accountants of Ontario, 1992, 4th Level.

Retained as industry analyst with current Country Style franchisee involving *PIPEDA*, R.C.M.P. and class action civil lawsuit, 2004.

Acted as consultant to seven Tupperware Canada Inc. former distributors and counsel, 2004.

Retained as industry and media analyst by twenty-one former franchisees of Grand & Toy Canada Inc., 2003.

Acted as an industry analyst and expert by *Islanders for Fair Franchising*, an association of Prince Edward Island franchise investors representing 32 trademark systems, 2001.

Retained as franchising analyst by eighteen Country Style Food Services Inc. franchisees. Analyzed a complex merger and acquisition involving CCAA application, lease defaults and up to 150 franchise agreement terminations, 2001.

Publications

Franchise Archive, On line investor education resource, forthcoming

Franchising Opportunism, Canada Small Business Financing Act review, Industry Canada, 2005

Franchise Information-Sharing Project, Ontario Ministry of Consumer and Business Affairs, 2003

Draft Franchise Legislation, Standing Committee on Community Affairs and Economic Development, Legislative Assembly of Prince Edward Island, 2001

Media Article Summary, Ontario Legislative Assembly, Standing Committee on Regulations and Private Bills, Bill 33, 2000

Franchise Industry Media Article: Volume A and B, Ontario Legislative Library, 2000

Work history

Stewart founded the Canadian Alliance of Franchise Operators in 1998. He was an expert witness to the Standing Committee on Regulations and Private Bills at the Legislative Assembly of Ontario. The public hearings led up to Ontario's first franchise law, the *Arthur Wishart Act (Franchise Disclosure)*, 2000.

He was a financial analyst at Victoria Hospital Corporation, London, ON from 1987 to 1992 and operated a lawn care franchise from 1992 to 1998.

He has advised individual and groups of franchisees in over sixty-five business format franchise systems. Stewart has assisted in the creation of over nine independent franchisee associations.

Evaluation requested

Yes