BEYOND THE COVENANT:

A Franchisee's Guide to the Fixed Charge Coverage

A new lens on franchisee financial health—and how the right advisors, engaged early, can provide flexibility and avoid distress,

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Executive Summary

Franchisee failures rarely arrive by surprise. The financial signals—not the operational ones—telegraph distress 12 to 24 months before options run out. This paper defines the single most predictive ratio (Fixed Charge Coverage) and introduces a more conservative "Management" version of that ratio built specifically for franchisees to avoid distressing situations. Further, this paper maps the spectrum from normal operations to the point where choices collapse to a forced sale or bankruptcy.

Two findings anchor the analysis. First, standard bank covenants often overstate a franchisee's financial health because they exclude obligations such as remodeling reserves and fixed franchise fees that are contractually unavoidable. Second, the franchise model itself is structured as a marketing relationship rather than a partnership, which means franchisees are rarely given an honest account of the risk of failure from the party best positioned to provide it. Together, these dynamics explain why so many operators are blindsided by distress that, in hindsight, was visible well in advance.

"If you had only called me six months earlier, we could have done something"—the refrain of nearly every restructuring advisor, in nearly every first meeting. This paper is intended to change that timeline.

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I

A STRUCTURAL REALITY:

The Franchise Relationship Is a Marketing Relationship

Before addressing the numbers, it's worth naming a dynamic rarely discussed openly in franchising: the relationship between franchisor and franchisee is not a partnership in the conventional sense. It's a marketing relationship, and that distinction has direct financial implications.

A franchisor's growth model depends on proving a concept works, then selling that proof to entrepreneurial, motivated operators. This is not a criticism of the model—it's simply a faster path to scale than building and operating every location directly. But it also means franchisors have little structural incentive to publicize underperforming locations, or to attribute failure to concept economics rather than operator execution.

Practically speaking, many franchisees benchmark their performance against an overly optimistic view of what's normal, one their underlying unit economics can't actually support. The remainder of this paper is designed to offer a more conservative, self-contained way for a franchisee to read the numbers rather than an opportunistic view drawn from a franchisor's or lender's sales narrative.

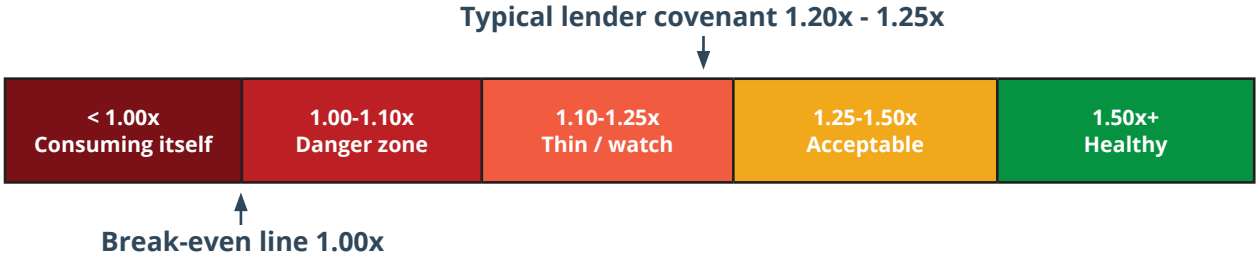
II

THE CORE RATIO:

Fixed Charge Coverage (FCCR)

FCCR = EBITDA ÷ (Debt Principal + Interest + Rent* + Maintenance Capex)

**If rent is placed in the denominator, add it back to the numerator (EBITDAR) to avoid double-counting.*



The ratio answers one question: for every $1.00 of obligations you cannot avoid or defer, how much cash does the business generate?

Lenders typically covenant FCCR at 1.20x–1.25x, tested quarterly on a trailing-twelve-month basis.

Why a Franchisee Is Not a Normal Small Business

The same FCCR reading means something different in a franchisee's hands than an independent operator's, for five structural reasons:

1. **Less flexibility when margins compress.** Menu/pricing, use of suppliers, promotions, and remodel timing are partly dictated by the franchisor, leaving fewer levers to pull in a downturn.

2. **Royalties and ad funding behave like senior debt.** Typically, 4–6% of sales in royalties, plus 2–4% of ad funding, come right off the top like a mandatory senior payment. They're variable costs inside EBITDA, but missing them can trigger default notices under the franchise agreement.

3. **The franchise agreement IS the enterprise value.** Real estate, equipment, and inventory are worth a fraction of going-concern value without the brand. Termination vaporizes value to the franchisee, forcing a pivot at the least opportune time.

4. **Mandatory future capex.** Reimages every 5–7 years and major remodels every 10–15 years are contractual—deferred fixed charges that never appear in this year's covenant math.

5. **The franchisor holds a veto on every exit.** Any buyer—in a healthy sale, an Article 9 sale, or a bankruptcy Section 363 sale—needs franchisor approval to keep the brand.

A Worked Example (5-Store Franchisee)

At 1.29x, the business earns $1.29 for every $1.00 of mandatory obligations—a 29-cent cushion for taxes, surprises, and reinvestment. Now, let sales slip 6% while food and labor costs rise: EBITDA falls to $880,000, and FCCR drops to 1.04x. Nothing has "broken"—every bill still gets paid—but the cushion is gone. One equipment failure or wage increase pushes it below 1.00x, where fixed obligations exceed cash generated and the gap must be funded by stretching vendors, drawing the revolver, deferring taxes, or owner injections. Below 1.00x, the business is consuming itself.

EBITDA (rent already deducted)	**$1,100,000**
Annual debt principle due	$400,000
Annual interest	$250,000
Maintenance capex	$200,000
Total fixed charges	**$850,000**
Covenant FCCR	**1.29x**

III

The Playbook as FCCR Deteriorates

FCCR Band	What it means	What to do
1.50x+ — Normal	Genuine cushion; full strategic freedom.	Bank surplus cash. Fund the remodel reserve. Refinance on your terms. This is when growth or a premium sale is possible.
1.25–1.50x — Acceptable	Where most covenants sit; adequate but not roomy.	Build a rolling 13-week cash flow now, while it's a tool rather than a triage device. Stress-test a 6% sales decline.
1.10–1.25x — Thin/Watch	Managing to the covenant, not the business.	Deferrals begin. Talk to your lender before a breach—waivers are cheap when requested early. Cut discretionary spend; evaluate closing the weakest store; get a valuation.
1.00–1.10x — Danger	Cushion gone. One shock from break-even. The sale window is open but closing.	Engage a restructuring or franchise-savvy advisor. Seriously evaluate a marketed sale (takes 4–6 months—runway is needed). Protect the non-negotiables: payroll taxes, sales tax, royalties.
< 1.00x — Default Likely	Business consumes itself; someone else funds every month (vendors, taxman, revolver).	Liquidity runway—not the ratio—now dictates choices. If cash cannot cover 2–3 payroll cycles and no new money exists, options collapse to the forced paths in Section VII.

The behavioral red flags that accompany the numbers:

Trade payables stretching past 60–75 days; revolver draws funding operating losses rather than timing; falling behind on royalties and ad fund; skipping required remodels; and—the brightest line of all—dipping into trust-fund taxes (payroll withholding, sales tax), which can create personal liability for owners and officers.

IV

THE MANAGEMENT FCCR:

Why the Bank's Number Isn't the Real Bar

A bank covenant functions as a floor. It was never designed to measure whether a business is thriving or showing early signs of distress, only whether the loan passes required covenants.

The covenant FCCR is whatever the credit agreement defines it to be. For a franchisee, it often overstates a franchisee's health, because it excludes obligations that are contractually unavoidable yet absent from the bank's definition. The Management FCCR is a conservative alternative that management can use to judge financial health on a quarterly basis and take action earlier if necessary.

Management FCCR = **EBITDA** / Debt Service + Rent* + Maintenance Capex + Remodel Reserve + Fixed Franchise Fees

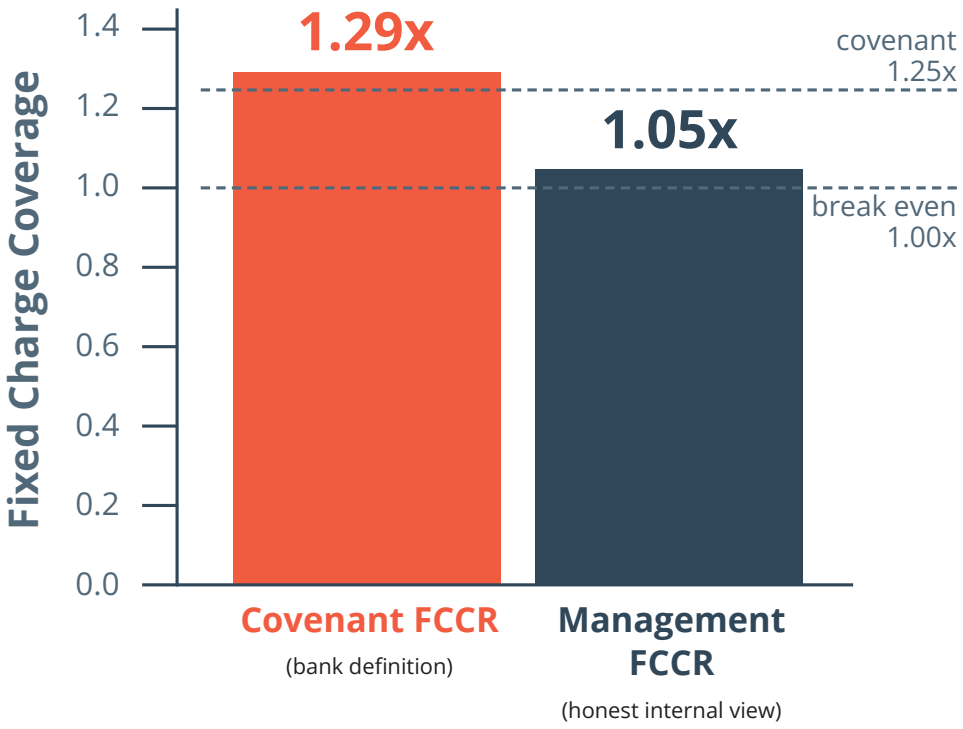
Add to the denominator:
Annual remodel/reimage reserve (total obligation ÷ years until due); fixed technology & POS licensing fees; any minimum royalty floor; required training/ conference fees; scheduled franchise-fee or transfer-fee payments.

Leave in EBITDA as a variable:
Percentage-of-sales royalties (4–6%), ad fund (2–4%), local co-op (1–2%)—they flex with revenue. But treat them as senior in any cash-priority plan: missing them starts the termination clock.

Redoing the Worked Example the Honest Way

Covenant fixed charges (from p.1)	$850,000
+ Remodel reserve ($875K due in 5 yrs)	$175,000
+ Fixed POS/tech & training fees	$25,000
Management fixed charges	**$1,050,000**
Management FCCR ($1.1M ÷ $1.05M)	**1.05x**

SAME BUSINESS, TWO ANSWERS



Same business with two different answers: the bank sees a comfortable 1.29x, but the honest view is 1.05x—already in the danger band. One ratio says to take no action; the other flags an operator to reassess now, early, while options are still available. This is why franchisees are "surprised" by distress the covenant never flagged: a remodel cycle was quietly approaching while the bank math looked fine.

RULE OF THUMB:

Run the Section III playbook off the Management FCCR, not the covenant, and hold to a higher target than the bank requires—1.50x+ where an independent business might accept 1.35x, since a franchisee has fewer levers to pull once trouble starts.

V

THE COMPANION DASHBOARD:

Metrics That Move Before the FCCR Does

The FCCR—covenant or management version—is a composite. It tells you coverage is eroding, but not why, and it often confirms trouble later than the underlying drivers reveal it. In retrospective analyses of our engagement experience with failed franchisees, the metrics below begin crossing their warning thresholds 12–24 months before the FCCR breaks 1.25x. Tracking these metrics quarterly using trailing-twelve-month data, alongside the Management FCCR, provides a franchisee with crucial visibility before the FCCR confirms signs of distress.

Metric	How to calculate	Healthy	Warning/ distress	Why it hits a franchise harder
Lease-adjusted leverage	(Total debt + 8x annual rent) ÷ EBITDAR	< 4.5x	> 5.5–6.0x	Franchisees are heavy lessees, and lenders capitalize rent when they size risk. A "modest" term loan stacked on large leases is still high leverage - and it quietly closes the refinancing door that independents with owned real estate keep open.
Occupancy cost ratio	(Rent + CAM + property taxes) ÷ gross sales	< 8% of sales	> 10% of sales	Sites are often franchisor-approved and long-leased; you cannot relocate to fix the ratio. Above 10%, the realistic remedies are a landlord concession or closure - and closure may itself breach a development agreement.
Prime cost	(Food/COGS + total labor incl. taxes & benefits) ÷ sales	< 60-63%	Sustained > 65%	Menu pricing, promotions, and approved suppliers are partly dictated by the franchisor. An independent facing 67% prime cost can reprice or switch vendors overnight; a franchisee often cannot.
Store-level EBITDA margin	4-wall EBITDA ÷ store sales, per location	> 12-15%	< 8%	Below ~8%, a store cannot carry its share of debt service, overhead, royalties, and the remodel reserve. Portfolio operators should rank stores by this metric - it identifies closure candidates before the whole enterprise is dragged down.
Same-store sales (SSS)	Year-over-year sales, constant store base, vs. brand average	Positive, at or above brand average	Negative 2+ consecutive years	Persistent underperformance vs. the brand average invites franchisor scrutiny and weakens your position in every future negotiation - remodel extensions, development relief, transfer approvals. You cannot cost-cut your way out of a traffic problem.
Days payable outstanding (DPO)	Trade payables ÷ (COGS ÷ 365)	< 30-45 days	> 60-75 days	Approved-supplier concentration cuts both ways: one distributor means one credit decision. When that distributor moves you to COD - and they talk to franchisors - the cash-conversion cycle collapses at the worst possible moment.
Royalty & ad-fund currency	Days past due on franchisor invoices	Always current	Any arrears	This is the termination clock. Bank debt can be amended, extended, and restructured; there is no workout market for royalty arrears. Arrears also surface immediately - the franchisor sees your sales reporting weekly.
Remodel reserve funding	Reserve funded ÷ pro-rata share of next remodel obligation	100% of pro-rata	< 50% or unfunded	The unfunded remodel is invisible leverage - it appears in no covenant, yet it is as contractual as the mortgage. This line is what separates the Management FCCR from the covenant version, and it is the most common blind spot in hindsight.

Reading the dashboard together

No single metric is a verdict. Each can have a benign explanation in isolation; however, a true signal is convergence among several indicators. One metric in the warning zone is a watch item; three or more crossing their thresholds in the same period means the decline is structural, not cyclical. When convergence appears, move down one full band in the Section III playbook even if the Management FCCR hasn't crossed the line yet.

The Quarterly Ritual—Thirty Minutes That Buys You the Timeline:

1. Pull trailing-twelve-month financials and compute both FCCRs—covenant and management versions, side by side.
2. Score all eight dashboard metrics green/yellow/red against the thresholds above.
3. Count the reds. Zero or one: stay on quarterly cadence. Two: tighten to monthly review and consider a 13-week cash flow. Three or more: drop one full band in the Section III playbook and open advisor and lender conversations now, while they are still conversations, not negotiations.
4. Re-date the next remodel obligation and refresh the reserve math—it quietly moves every quarter, and it's the input most likely to change your Management FCCR band.

VI

TIMING:

Why Earlier Engagement Changes the Outcome

The FCCR—covenant or management version—is a composite. It tells you coverage is eroding, but not why, and it often confirms trouble later than the underlying drivers reveal it. In retrospective analyses of our engagement experience with failed franchisees, the metrics below begin crossing their warning thresholds 12–24 months before the FCCR breaks 1.25x. Tracking these metrics quarterly using trailing-twelve-month data, alongside the Management FCCR, provides a franchisee with crucial visibility before the FCCR confirms signs of distress.

Two Points of Entry

1

Operational

engage early

A problem—margin compression, a lost key account, a labor cost spike—is visible and not self-resolving. At this stage, the full range of options remains available: operational adjustments, lender conversations, a marketed sale on the operator's own timeline, or recapitalization.

2

Financial/legal

often too late for the best options

Personal guarantees are in play, a lender is calling the note, and years of built equity are at risk. Engagement at this stage is still worthwhile, but the posture shifts from offense to defense.

Already having a conversation with an attorney or banker about a specific issue is a strong signal that a substantive advisory conversation is warranted. Absent that, any of the dashboard metrics in Section V trending unfavorably is itself sufficient reason for a short, confidential conversation—precisely the point at which it feels least urgent, and is therefore most often skipped.

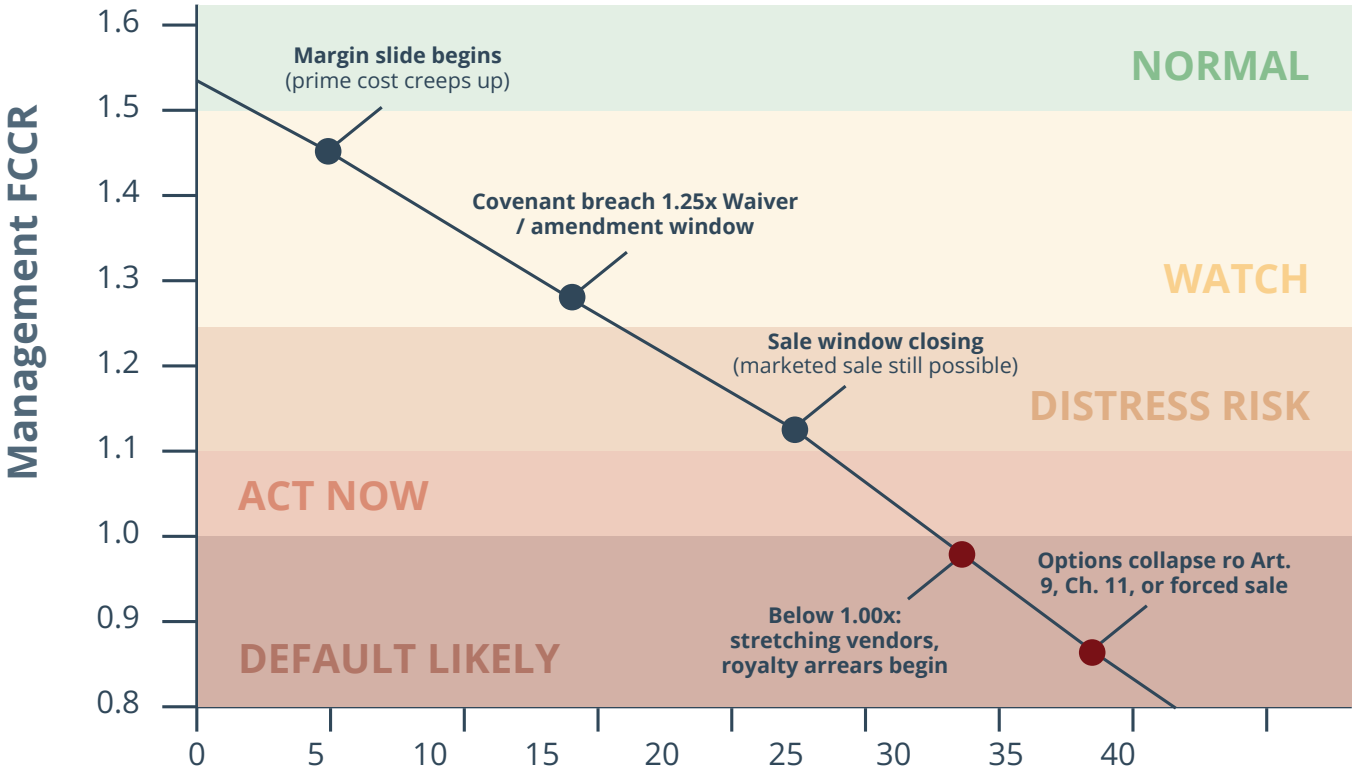
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VII. THE DISTRESS SPECTRUM:

What's Still Possible at Each Stage

The Typical Deterioration Arc

distress telegraphs itself 12-24 months out



	NORMAL	DISTRESSED	TOO LATE - DEFAULT LIKELY
Mgmt FCCR	1.50x+ (accept 1.25–1.50x)	1.00–1.25x	Below 1.00x, liquidity runway shorter than any process
Financial markers	Payables current; remodel reserve funded; positive same-store sales; occupancy <10% of sales; prime cost <65%	Payables 60-75+ days; revolver funds losses; remodels deferred; 2+ yrs negative same-store sales; leverage >5.5-6.0x EBITDA	Default Likely: Trust-fund taxes deferred; royalty/ad-fund arrears; enterprise value breaks inside the senior debt (equity out of the money)
Franchisor relationship	current on all fees, remodels on schedule	cure notices possible, remodel extensions being negotiated	Default/termination notices issued, franchisor holds veto over any transfer
Lender relationship	Covenants met; refinancing available on your terms	Waiver or amendment stage; forbearance possible; lender controls widen	Forbearance exhausted; lender fatigue after missed turnaround plan; remedies being exercised
Options still available	Everything: grow, refinance, recapitalize, or sell at a premium on your own timeline	Marketed going-concern sale (needs 4-6 months of runway); lender-consented discounted payoff; store closures / lease surrenders; new equity	Only the forced paths: Article 9 sale (fast, cheap UCC foreclosure - needs one clean secured creditor, a known buyer, franchisor consent); Chapter 11 / Subchapter V (needed to shed leases, sell free-and-clear under Sec. 363, or force what others won't consent to); or surrender / negotiated turnover. Owner is negotiating for personal-guarantee release, not value.
What to do	Track Management FCCR quarterly; fund the remodel reserve; stress-test a 6% sales decline	Engage advisors; open lender dialogue early; get a valuation; protect payroll taxes and royalties above all; decide on sale while the window is open	Whoever controls the cash controls the outcome. Cooperate to preserve going-concern value, protect against personal liability (trust-fund taxes, guarantees), and maximize franchisor cooperation

The single most costly mistake in hindsight

Refusing to sell during the window when a marketed sale still existed—typically while Management FCCR sat between 1.00x and 1.15x—and waiting until the only remaining choices were the forced ones.

WORTH WATCHING

A current lawsuit illustrates the sale-window risk this paper describes: a multi-brand franchisee alleges its lender declared a default and blocked a pending $30M sale of its locations, causing the buyer to cut its offer in half. The franchisee has since filed Chapter 11 and countersued.

Note: these are allegations in an active, unresolved case. Nothing has been decided by a court.

Conclusion

The financial signals of franchisee distress are visible well before the outcome is fixed, but only to those reading the right numbers, defined conservatively. A covenant that looks acceptable can mask a business already inside the danger band once remodel reserves and fixed franchise fees are properly accounted for. The gap between the two readings is often the difference between a marketed sale conducted on favorable terms and a forced one.

This applies equally to the operators managing these businesses and to the bankers, attorneys, and franchisors positioned around them, who frequently see the underlying data (sales reporting, royalty currency, unit-level performance) well before the operator raises a hand. Early, informed engagement is what preserves optionality for everyone involved.

JACO Advisory Group advises franchisees and the professionals around them on how to read these signals early and protect the options still on the table. Contact us for a confidential conversation.



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About Jon

Jon DeMoss is a seasoned financial professional with more than 25 years of experience in financial analysis, forensic accounting, dispute resolution, complex litigation, and business valuation. He brings deep, operationally grounded expertise in the franchise and hospitality industries, with a client base ranging from middle-market firms to Fortune 500 companies.

In addition to this work, Jon has served in interim CFO roles and led corporate restructuring engagements, guiding companies through financial distress and operational turnarounds. As an expert, he has testified in arbitrations and state courts, specializing in forensic accounting, financial modeling, and scenario analysis to support litigated and disputed matters.

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