

FINANCING YOUR FRANCHISE PURCHASE

How do you do it?

Making the decision to invest what is sometimes your life savings, into a business, is a major step and one full of perils. As such, this process should never be taken lightly.

Assuming that you have completed your due diligence and reviewed the franchise system, the support, the product offering and you understand the financial commitments of the purchase, the next question you need to address is the finance.

Obtaining finance for any purpose is not a simple process, especially in the wake of the global financial crisis. Franchising is, however, very well regarded by the banking sector and, luckily for us all, there are usually policies in place that help obtaining finance easier.

As with any lending product, there are a number of factors that must be addressed before you will get the loan. Can you afford the loan – called servicing? Is there enough security? Are the borrowers reputable? Is the franchisor reputable?

All of the major lenders have policies on the strength of a franchise system. They have previously reviewed the franchisor and the system and assessed the market's appetite for the purchase of that type of franchise. Effectively, they rank the franchise system in a tier that ranks the risk for the lender providing the funding and not getting their money back. The tiers are very much a simple A, B or C level and dictate the

maximum amount that the lender will allow for the purchase of a particular franchise.

A banking example

One of the major banks has a policy in place that states a certain franchise retailing mobile phones and other aligned products to consumers is a good risk. This franchise produces significant recurring income, their marketing works quickly, it is a growth product and there is very little stock required to be held in the shop. The bank, therefore, will lend up to 60 per cent of the total cost of the franchise system, plus stock.

So if the franchise fee, fitout and stock would total \$500,000, they will gladly provide you with \$300,000 of that as a loan, purely against the security of the franchise itself. This is called a fixed and floating charge.

Similarly, this bank has rated a system that sets up mobile dog washers as a risky venture. This franchise usually does not sell easily, cash starts slowly and builds only with increased marketing and good operators (who get many referrals by word of mouth). The bank is reticent to provide any sort of lending, but will give 25 per cent of the cash, with a personal guarantee from the franchisee and a proven existing franchise close to the territory being set up.

The balance of the funds required will have to come from the franchisee, either with their own funds or from equity released from property that they own.

Can the finance work?

This is all very good, but unless you are comfortable with the business model, it is irrelevant what the lenders will provide.

In my experience, it is critical that anyone going into business prepares for that move properly. Whether it is franchising or a non-aligned business, understanding where your sales will come from and what the costs of your operations will be, is critical in determining whether the business can afford your time, let alone the costs of a loan.

Setting up an achievable forecast or budget is critical to understanding the cash flow requirements of your business. Unless you are a highly competent management accountant, I strongly suggest that you work with an expert to get this right. That expert is neither your tax accountant nor the franchisor. It needs to be an individual or company who is experienced in franchising and strategically driving businesses. Too often forecasts that I come across have numbers which are rubbery – i.e. can't be argued strongly, lack the understanding of when cash will come into and go out of the business, or are too aggressive at achieving positive cash flow and profits. Cash is king. If you don't have enough, it is irrelevant trying to be profitable. Your sales figures should be based on market research, existing franchisee performance or some other identifiable method of determining your potential market share.

“Obtaining finance is not simple, but also not impossible. Prepare your budgets correctly and be prudent.”

Colin Linke, Managing Partner,
Bentley Partners.



Being honest

Whilst the major lending institutions will have policies that make it easier to obtain finance, your ability to service the loan will depend on the forecasts and the performance against those forecasts. I often tell clients that this forecast is a little like losing weight. You can cheat and manipulate the numbers to provide a picture that, when hung on the fridge, looks OK. However, you are only cheating yourself if you put something up that is not completely honest.

How banks decide

The banks will look at a number of factors. The one that appears to be utilised extensively is times interest cover. This is simply the amount of profit generated by the business in a year, divided by the interest charged on the loan. The magic number recently is 2.5 times. So, as an example, if the total interest charged for the year is going to be \$100,000, the bank will want to see that there is \$250,000 of profit left before interest and tax is charged.

The definition changes between lenders. I have also seen recently a need to cover the capital repayment as well, so the above example is very much a guide only.

Words to know

The next critical factor in obtaining financing is determining the actual facilities that are required. Here is a list of a few words you should be familiar with when considering financing.

- **Mortgage** – loans secured against property. Usually limited to 80 per cent of

the value of a residential property and 60 per cent of a commercial property's value.

- **Overdraft** – a loan applied to your bank account that is usually secured against the business.
- **Business loan** – a loan that is provided for business purposes and usually secured with a combination of a right over the business and/or against real estate.
- **Chattel mortgage** – a loan provided for an asset purchase, such as a car, that is secured against the asset only.
- **Commercial bill** – this is a high level loan, usually more than \$1 million, which is secured against the business, real estate and the director's personal guarantees.
- **Debtor or stock funding** – this loan is provided against the stock or the debtors of the business. It can be an onerous form of funding and usually requires regular reporting and potentially audits.

Getting it right

Getting the type of finance right is important, as the costs of each of the above differs wildly. The less security you have, the higher the interest rate charged AND the fees charged. You need to watch this carefully.

A final word about guarantees. Many new businesses will be asked to sign director's guarantees for loans provided, often for trading accounts with suppliers. My recommendation is to at least try to NOT sign any of these with suppliers. You will need to do so with a formal lender, but often suppliers will trade without these in place.

Each guarantee that you provide will increase

the amount you are personally liable for and in bad times this can be an issue if a default is issued against yourself personally. Just be careful.

And finally, there is a second tier of lenders that provide access to private equity funding, usually via second mortgages against your properties. This is a very costly form of funding and is never the right solution, in my opinion. However, it is available as a last resort.

Conclusion

Obtaining finance is not simple, but also not impossible. Prepare your budgets correctly and be prudent. Where possible, provide the lender with as much security as possible and be patient. It can take time to close a lending deal for business purposes.

Colin Linke is a CPA and Managing Partner of Bentley Partners, which specialise in business growth, franchising operations and performance management. He has over 20 years of experience in the area.

Bentley Partners is associated with Alliance Financial Group, which is a specialised finance broking business that assists franchisees and small business owners in obtaining finance.

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