Over the 20 – plus years that Westpac has been involved in funding franchisees, we’ve found a number of areas that can be overlooked when planning to buy a business.

These can have a significant effect upon the resources needed to fund some businesses, or on the cash flow of a business once established. It’s therefore worth exploring if any of these apply to your chosen franchise when you start getting serious.

Set-up and Start-up Costs
The costs of getting into a franchise vary a lot depending on the type of industry you choose. Generally, service franchises tend to be less complex and require less capital. Retail stores, fast food outlets or restaurants require leases and relatively expensive fit-outs; there may be construction, remodelling, leasehold improvements and decorating costs. There will also be equipment, fixtures, stock and fit-out. Fit-out contributions from the landlord can counter some of these expenses, but you need to allow for all eventualities.
“The business may need 6 - 12 months to reach break-even. This means that the franchise has to be able to fund the balance of the expenses for a considerable period.”

Ian Watt | Senior Business Development Manager - Franchising, NSW & ACT | BUSINESS BANKING, WESTPAC

Other items that may be neglected include:

- the interest on the funds required during the building process - there can be a long period before any money comes in.
- the rent during the same time (except where able to negotiate a rent free period).
- the time and cost that the consent process may take.
- working capital for other pre and post opening expenses as well as legal fees. In most instances, retail/food outlets tend to be overstaffed during the launch phase so there are additional wages. There will also be initial marketing costs.
- insurance and licencing costs.
- upfront funding of the GST component of many expenditures will be required until it is claimed back in the next available BAS.

In some business models, the business may need 6 - 12 months or longer to reach break-even. This means that the franchise has to be able to fund the balance of the expenses for a considerable period. It’s better to know how much you will need, and have the appropriate funding strategies in place before you start, to save worries and surprises later on.

Guarantees and Rental Bonds

Another aspect that is regularly required these days, but tends to be overlooked by potential franchisees (and their financial advisors) until the last moment, is the need for guarantees like rental, stock, or other bonds. This can create huge issues with funding. Some examples are:

- Rental Bonds: increasingly in the form of a bank guarantee with relatively large amounts required by some landlords, especially in mall locations. A rental bond in the form of a bank guarantee is called on when the business can’t afford to pay the rent – in other words, is in financial trouble. That means that, in general, the bank guarantee can’t be secured against the business (which would be failing when the guarantee is called on), so the franchisee may need more hard security in the form of equity in a property or even a cash deposit. This is hardly ideal if you’re trying to invest all possible funds into the set-up of the business and suddenly need to come up with another $20,000 to $150,000 for example. Effectively it means a franchisee needs more equity than was previously the case.

- Guarantees for stock: some systems or suppliers now require franchisees to provide a guarantee to a certain level - for example, a month’s stock, or two drops of fuel for a petrol station. In many cases this also comes in the form of a bank guarantee. This can create a double funding requirement where payments are taken by direct debit; the business or franchisee has to arrange an overdraft with
the bank to cover any direct debits that come through and then also has to provide a guarantee. The effect is that instead of buying the stock on terms and getting the cash before you need to pay the supplier, you may have to secure an overdraft and provide a guarantee! That would certainly change the business model of many franchises, as well as the resources required to enable a new franchisee to come on board.

**Other bonds:** such as custom bonds for importers which are likely to affect franchisors who import directly.

You would need to calculate the additional equity requirement (and cash flow implication) of any guarantees and rental bonds required. One would expect franchisors to take this into account when providing typical set-up figures and for experienced franchise accountants and bankers to address this.

**Tax Payments**

Inexperienced franchisees going into business sometimes get caught out when going into business by not keeping up to date with GST or even PAYG and other statutory payments.

An even bigger problem for the franchisors is when franchisees start to use the ATO as a bank by not paying, or delaying paying, tax to fund lifestyle or other expenses. This almost inevitably has a bad outcome when the business gets overextended and can’t catch up; penalties are levied and the franchisee is in trouble. The franchisor may be surprised to find that a franchisee is doing well on sales can suddenly fall over, owing the suppliers and the franchisor a lot of money and with the ATO first in the queue to get paid.

For this reason many franchisors will have their operations managers monitor tax compliance. When re-financing an existing business, the bank will also ask for proof that the normal tax cycle is up to date.

**Selling the Business**

This is an area often under-investigated by franchise buyers, ‘what happens when the time comes to sell?’ There are a number of issues that influence what you can get for a business when you sell and we have seen many that make a sale fall through including:

- Does the business need a refit or is there a re-fit requirement imminent?
- Will the franchisor approve the potential buyer?
- What term is left on the franchise agreement and/or can the buyer get an extension or a new agreement?
- Is there a transfer/training fee payable?
- If there are sign-written vehicles, in what condition are they and does the franchise agreement require them to be replaced soon?

One other area to be cautious of is under-reported sales. Some franchisees think it’s smart (albeit illegal) to under-report sales in an attempt to avoid tax and percentage-based franchise royalties. When wanting to sell however, they still want top dollar, based on the ‘actual’ rather than professed sales.

In the current environment, however, buyers are rightly a lot more conservative and less inclined to pay for unproven sales. Apart from the obvious dangers of taking the seller’s word for it, paying more than the figures justify will make it more difficult to obtain funding against the business.

**The Franchise Advantage**

Of course, most of the items mentioned here apply to all businesses, not just franchises. The advantage of choosing a franchise is that, in general, experienced franchisors will be aware of – and have solutions for – many of these issues and will be able to ensure new franchisees make allowances for them from the start. By choosing a franchise which has strong management information systems, and taking good professional advice, franchisees can also help to guard themselves against the unexpected.

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Westpac continues its long-term commitment to franchising in Australia through a national network of franchise specialist business bankers who are able to deal with the specific needs of the franchise sector.

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The information contained in this article is intended as a guide only and is not intended as an exhaustive list of matters to be considered. Persons entering into franchise agreements should seek their own independent legal, accounting and other advice.