

Money talks



While many people find the idea of being their own boss an alluring option, time and aspiration alone won't necessarily help make their dream come true. Tim Kilham explores the fundamentals of financing for franchise fulfilment.

You've decided that you're tired of working for somebody else. You want to make a fresh start and be your own boss. You want financial independence. So you've decided to buy a franchise. One word comes to mind and it's the dreaded 'F' word.

No, not franchisor! The franchisor is your partner. If you're going to make a success of your franchise then you are going to have to work with the franchisor. Franchising is often described as a marriage; with the two spouses – you and the franchisor – having (after an initial honeymoon period) to work together on the marriage to make sure it succeeds. If only one partner is going to work, then it is unlikely the marriage will succeed. So it is with franchising.

No, the dreaded 'F' word is actually FINANCE. How much will you need? Do you need a business plan? Who will lend you the money? How much will they lend you? What happens if you need more? Do you need an accountant to help you with finance?

How much will you need?

That begs the question: how much should you pay? But a detailed discussion of that question is outside the scope of this article. The price you pay should allow you to get paid a fair salary plus a return on your investment. I like to see a return on investment of at least 25 per cent, but I commonly see people buying franchises with returns as low as 15 per cent, which in my opinion is too low.

Don't pay too much. If you are buying a franchise from an existing franchisee, the price is negotiable – even if the franchisee or the broker tells you it is not! If you are buying a new franchise from the franchisor, the price is likely to be less negotiable, but may still be.

Assuming that you have decided to buy your franchise, there will be the obvious costs of purchase – the franchise fee, plant and equipment, and so on. These are the obvious costs, but there may well be other costs (many of which will be mentioned

in your franchise disclosure document so read that document carefully). These costs could include:

- the costs of accounting, legal and other advice, and perhaps the costs of forming a company and/or trust;
- A bond on the premises you will be leasing;
- Working capital – particularly if you hold stock and sell goods on credit; and
- A contingency reserve, in case the business does not initially go according to plan.

Do you need a business plan?

The answer is yes. If you are going to go to the bank to borrow money, the bank will require you to prepare a well-considered business plan.

Even if you are not going to borrow money, you need a road map – and that is what a business plan is. You are more likely to end up where you want to be if you have a plan for getting there.

The most important parts of the business plan are the detailed profit and loss and cash flow projections for the first 12 months of operations. These projections should be used:

- ▲ As a basis for determining whether you should buy the business;
- ▲ As a basis for how much you should pay for the business; and
- ▲ As a basis for how much you will need to borrow.

You will need detailed profit and loss and cash flow projections. The two are not necessarily the same. When you sell an item on credit, you make a profit (presumably!), but you do not get any cash until the debtor pays you. So you might record a profit, but have no money in the bank. Profitability and cash flow are two different things. Profitable businesses can and do collapse because they have no cash.

As an example, a while ago a prospective franchisee came to see me and asked me to look over his projections. He had done profit and loss projections that showed the business would be

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profitable, and I am sure it would have been. However, he had not done cash flow projections. He needed to hold stock, and some of his sales would have been on credit.

As a result, he had cash flow and working capital requirements well in excess of the initial purchase cost of the business, and well beyond what he was able to borrow. He ended up buying another franchise (with lower working capital and therefore lower borrowing requirements), but one that he could afford.

Who will lend you the money?

The traditional suppliers of finance to franchises in Australia have been the four major banks.

In recent years, BankWest has also been an aggressive supplier of finance to the franchise industry. Financiers, other than the banks, have also entered the market in recent years, with the major non-bank financier being GE Commercial Finance.

Most banks now have franchise specialists who will take your call and be able to help you or, if not, point you in the right direction. To find these specialists, do some research on the internet or talk to the manager at the bank that you deal with and ask them to find out for you who the franchise specialist is. Wherever possible, it is better to deal with a franchise specialist, rather than your normal bank contact.

Stewart Creighton, Executive Manager in charge of franchising at the Commonwealth Bank, notes that: "One of the key components of franchising is consistency of the customer experience (product and service). This is one of the reasons why Commonwealth Bank has established dedicated franchising teams.

When you deal with franchising specialists at the bank, you know that he/she has expertise on franchising and can add value to your business because they understand it. In many cases, the franchising specialist would have helped a number of other franchisees in the same situation."

Brokers, too, often have a role to play, particularly where your ability to borrow the

money you need is not clear-cut.

Brokers know the requirements of different financiers and often have good contacts, which may enable them to get a deal over the line that you would not get over the line yourself.

Ben Oppy, the principal of B Capital – brokers that work extensively in the franchise industry – notes that: "With more lenders entering the market and the proliferation of loan products readily available, more customers are turning to finance brokers to help arrange their required funding.

While most clients are more than happy with the underlying products offered by the many institutions, they are seeking a consultative approach to clearly establish their finance options before committing to a lending institution. This process is often best achieved through a reputable broker."

How much will they lend me?

Most of the major banks and other lenders now have an accreditation system for franchises. If a system is accredited, then the financier will lend money against the business, with the business itself being the security for the loan. The financier will normally lend somewhere between 40 per cent and 70 per cent of the value of the business, with you having to supply the balance of the finance.

If you are dealing with a system that is not accredited, then you will probably have to provide security for the full amount of the loan.

The most common form of security is residential property, but bear in mind that the bank will usually lend you only up to 80 per cent of the value of the property.

Creighton points out that: "Franchise system accreditation undertaken by lenders is a form of due diligence and helps lenders to gain a greater understanding of the robustness of franchising.

Important considerations of lenders include the number of years the business has been operating, the number of years the business has been franchising, the number of outlets and store closure and transfer activity.

The benefit of system accreditation for franchisees is a better understanding of the franchisees' business compared with its peers, a faster turnaround of decisions and a higher loan than might otherwise be available."

In rare cases, the lender might provide you with some unsecured borrowing even when the system is not accredited. You will have to put up a very strong proposal to the lender to obtain unsecured finance for a system that is not accredited.

WHAT FRANCHISE CAN YOU AFFORD?

You have decided to buy a franchise. The only asset you have to provide as security is your residential property.

What franchise can you afford? The answer will depend on:

- ▲ The value of your residential property;
- ▲ The existing mortgage; and
- ▲ Whether or not the franchise you wish to buy is accredited with a lender.

Assume that you have a house worth \$350,000 and the current mortgage is \$120,000. The lender will supply some finance with the security being the business itself. You will need to provide security over your residential property for the balance of the loan.

If the system is accredited, the lender will usually lend 40 per cent to 70 per cent against the business itself. Assuming in this case that the lender will lend 60 per cent, then the following borrowing limits will apply:

▲ The bank will lend up to 80 per cent of the value of your home – ie.	
\$350,000 x 80 per cent	\$280,000
Your current mortgage is:	\$120,000
 Your equity is therefore:	 \$160,000

Your equity represents 40 per cent of your total borrowing capacity (because the lender will lend 60 per cent against the business itself).

So you have provided equity of:	\$160,000
The bank will lend:	\$240,000

So you can afford to buy a franchise costing \$400,000.

Non-Accredited Systems

If the system is not accredited, you will have to provide security for the full loan. The bank will lend up to 80 per cent of the value of your home, ie:

\$350,000 x 80 per cent	\$280,000
Your current mortgage is:	\$120,000
 Your equity is therefore:	 \$160,000

So you can afford to buy a franchising costing \$160,000.

If the system is accredited, you can afford a franchise costing up to \$400,000 and, if it is not, you can afford a franchise costing up to \$160,000. The difference is significant.

One word of warning: note that the cost of a loan that is secured over the business itself will be several per cent more expensive than a loan that is secured over residential property.

What happens if you need more?

Try to avoid this situation. It is embarrassing to have to go back to the financier just after you have borrowed money to ask for more. Allow for a contingency reserve in case of unexpected initial expenses, or in case the business does not perform as well as expected.

Having said this, situations do arise where, despite the most careful planning, you may find that you need additional finance. If this is the case, don't wait until the last minute to approach your financier. Redo your projections and amend your business plan as early as possible. Work out what you need, and approach your financier as soon as possible to explain the situation and arrange the extra borrowings.

Do I need an accountant to help me with finance?

The answer is 'almost certainly'. An investment in an accountant who knows franchising (and beware, many say they do when they don't) will produce spectacular returns:

- ▲ An accountant will help you with the preparation of your business plan to ensure you can raise the finance.
- ▲ An accountant will assist with the decision of whether you should buy the business and how much you should pay.



- ▲ An accountant will ensure that your profit and loss and cash flow projections make sense, and are based on solid assumptions. This will increase your chances of getting finance.
- ▲ An accountant will help you structure your borrowings to make sure you get the maximum tax deductibility (thereby reducing the amount that you need to borrow).
- ▲ An accountant will help put you in contact with appropriate financiers.

So will you get the finance you need? If you know what you're doing, if you get the right advice, if you prepare projections and a business plan, you will maximise your chances of getting the finance and make the process as painless as possible. There need be no dreaded 'F' word. 'F' is for finding finance. 'F' is for franchise fulfilment.

This article was written by Tim Kilham, a partner-in-charge of McLean Delmo Franchising – the specialist franchising division of McLean Delmo and Partners Accountants. You can contact Tim on (03) 9819 4666 or at tim.kilham@mcleandelmo.com.au

If you get the right advice, you will maximise your chances of getting the finance and make the process as painless as possible.

KEY TIPS

1. Don't pay too much for your franchise.
2. Work out how much you will really need.
3. Prepare a business plan.
4. Prepare profit and loss projections.
5. Prepare cash flow projections.
6. Deal with franchise finance specialists from finance institutions.
7. Deal with an accountant who knows franchising.
8. Work hard, and enjoy running your own business.



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