Additional information on Franchising

Raising finance for a franchise

Franchising can often prove to be costly, and individuals able to fund this investment from their own pocket are few and far between. If you are franchising your business, looking for financing solutions for your potential franchisees or planning to buy a franchise, Franchising from FNB has developed solutions to meet your specific requirements.

Your owner's contribution

When applying for finance, you may be asked to contribute up to 50% of the investment amount, as we need to ensure that the lending of funds is balanced with the fact that these funds must be repaid on time and with interest. This means that unless you can make a significant contribution, your finance application might not be approved.

There are a few reasons for this:

- Having accumulated cash indicates your ability to handle finances well.
- If borrowed capital is the only source of finance, the cost of capital (interest) can place undue strain on your business' cash flow, which could strangle the viability of a sound business.
- Unless you have a meaningful stake in the business, your commitment could be suspect, as you would be able to walk away in the event of the business hitting a rough patch.

For these reasons, your business needs to be funded through a mix of equity (own capital) and borrowed capital. We have various solutions to help your business with regards to borrowed capital, for example **SEFA**.

Types of funding

When applying for financing, make sure that you understand the various types of funding available to you and their respective advantages and disadvantages.

A. **Equity finance**
   - **Own cash resources**
     Having your own equity available is a must. For us to invest in your business, you need to be willing to invest in your own business.

   - **Soft loans**
     You might have the opportunity to borrow funds from family or friends. For these funds to qualify as soft loans (also known as off-balance-sheet financing), it needs to be unsecured, open-ended (no fixed repayment date has been set) and possibly interest-free. Keep in mind that should your business fail, the lender/s will most probably not receive any of their funds back. Although it is an informal agreement, you should enter into a written agreement drawn up by an attorney, which sets out the terms of the loan and the rights and obligations of the parties. If you don't, the lender could for example decide to ask for his money back at a time when your business' cash flow cannot support this request.

   - **Taking on a business partner**
     You could invite others to join you in the venture through forming a partnership, a CC or a limited company in exchange for a share in the business. Taking in partners has the advantage of sharing the burden of building the business; however, you need to select the individual/s involved with care by ensuring that they share your vision for the business and possess complementary business skills.

   - **Joint venture arrangements**
     Some franchisors are prepared to enter into joint venture arrangements with suitable individuals. This means that these franchisors take a large share in the franchise, which reduces the amount of cash you need to invest. This arrangement also makes it easier for

you to access loan capital, because we know that the franchisor has an extra incentive to ensure the business' success. You can also attempt to negotiate a deal, where you make your initial contribution in the form of "sweat equity", meaning that instead of investing cash you will work in the franchise, usually at a nominal salary. The shares in the franchise company are held in trust, pending payment. Profits generated in the franchise are allocated towards this until you eventually own the franchised business outright.

B. Bank finance

We understand that your business is unique, and offer various forms of financing to suit your business' specific financing needs.

- **Overdraft**
  An overdraft is intended to take care of short-term dips in your business' cash flow. This need may arise around month-end for example, when you need to make payments but your customers haven't paid you yet. Overdrafts are usually more expensive than loan capital, however, interest is charged on a daily basis in line with the account balance. Any cash deposit you make reduces the balance and with it the interest charges. The balance will fluctuate throughout the month, but the problem with an overdraft is that it can be called up at short notice, leaving your business exposed. For this reason, overdrafts should only be used to supplement working capital requirements (short-term finance), never to fund fixed assets (long-term finance).

- **Term loan**
  Term loans are used to fund long-term capital needs, and are usually granted for a period of 60 months. If you adhere to the conditions of the loan and make repayments at agreed intervals, we will not call up the loan. On the downside, you have to keep the loan for the full period, even if you have surplus cash at your disposal (should you wish to terminate a term loan, a penalty payment will apply.)

- **Asset finance**
  The purchase of capital equipment and cars can be financed through asset finance, which can be structured to suit your business' specific needs. The expected life of the item to be financed influences the repayment period, with the added advantage that the item to be purchased can serve as surety for the loan, at least in part. However, in most instances, a deposit will have to be paid. Forms of asset finance are:
  - Rental agreement – You enjoy the use of the item for a fixed period but never gain ownership. This form of finance is suitable for businesses where equipment has to be replaced on a regular basis, for example companies that operate in a hi-tech environment.
  - Financial lease agreement – This type of arrangement offers tax advantages, as lease payments are fully deductible. At the end of the pre-arranged lease period, you can opt to purchase the item outright, usually at its written-down value.
  - Instalment sale – We purchase an item of equipment and on-sell it to you. You pay monthly instalments, including interest. Initially, we own the item outright, but at the end of the agreed period ownership passes on to you.

- **Factoring**
  If you have a stable customer base in the business-to-business arena, do recurring business with them and individual transactions are of relatively high value, you could "sell" your debtors book to a factoring house. This means that you will receive an agreed percentage of the total amount upon ceding the invoice, with the balance (minus finance charges) paid to you once your customer has paid the finance house. This form of finance is expensive, but it allows businesses to expand rapidly. Note that the credit risk remains with you – should your customer fail to pay, the finance house will expect you to reimburse them.

- **Venture capital**
  Venture capitalists look for opportunities to inject money and expertise into businesses with high-growth potential, but their decision to become involved is linked to a clear exit strategy. They gladly forego interest payments and profit pay-outs during the early years, as their objective is to build the business into a substantial entity and realise a substantial capital profit five to seven years down the line. This explains why venture capital funding does not play a major role in the SME sector, especially not during the start-up stage.

Working with your bank

It's important to present a comprehensive business plan when you apply for financing. At the very minimum, we will expect you to provide realistic answers to the following questions:

- **How much money do you need and how much will you contribute from your own resources?**
  Carefully consider the amount you are applying for. Borrowing more than you need means wasting money on interest payments, while borrowing too little means you will soon have cash flow problems.

- **What precisely do you intend to spend the money on?**
  Your answer affects the value of the items bought, which can serve as collateral. If the equipment prescribed by your franchisor is highly specialised and does not have an established market, the value that can be realised in a forced sale may well be close to zero.

- **How do you plan to structure repayments, and what alternatives can you offer should the business' cash flow fail to keep up with ongoing financial obligations?**
  What we would ideally like to hear is that you have put aside a nest egg, which you can liquidate, or that you have arranged a soft loan facility should the need arise for it.

- **What can you offer as collateral?**
  Prepare a list of items you own and are willing to offer as collateral or security, their realistic market value and how much equity (market value less outstanding finance) you hold in each.

The loan application

Following your initial discussion with a Business Manager, you will be asked to complete a loan application. As part of the loan application, you will be asked to submit your business plan and a cash flow projection.

Business plan

A business plan is an indispensable requirement for going into business, as it forms the basis of your planning. When compiling a business plan for raising finance, ensure that it covers the following:

- Your own credentials – as the operator of the business, we will place reliance on you to ensure that the business succeeds. We also need to know that you will be hands-on in terms of managing the business, or if not, what the credentials of the operating members of the business are.
- Competitors – provide an analysis of the competitors in your area and an estimate of realistic market share.
- Area analysis – indicate the research done to determine the potential of the geographic area, the demographics and income levels in the area, as well as macro and micro factors influencing the catchment area and consumer behaviour.
- The basis for financial projections must be clearly explained and all assumptions must be included.
- If the franchise is bought from a previous owner and the new owner is forecasting a turnaround, the turnaround strategy must be explained.

Cash flow projection
The cash flow projection is an essential element of a business plan and finance application. You will need to submit at least three years' cash flow projections when applying for finance. The ability of your franchise to generate adequate cash flow is an important indicator of its viability; unless the cash flow generated by your franchise can comfortably sustain ongoing operations, you may run out of cash and will have to close your business' doors.

The term cash flow means the amount of cash that flows in, less the amount of the cash that flows out during a specific period. Sales or any other form of paper assets or liabilities do not count as part of your business' cash flow, in other words, no matter how high your sales figure may be, until your customers actually pay you for the goods they have purchased, the transaction has no impact on cash flow. (An exception is if you discount your invoices through a factoring company, but this method of raising finance is not accessible to every business.)

However, this also means that no matter how much you purchase from your suppliers, cash flow remains unaffected until you actually pay them. This sounds reasonable enough, but isn't always as simple in practice, for the following reasons:

- Most of your customers will expect you to grant them credit terms, especially if you are active in the business-to-business sector.
- By contrast, unless you convince your key suppliers of your creditworthiness, many of them will expect you to pay them Cash On Delivery (COD) or at the end of the month during which purchases were made.
- You will also have to pay almost all expenses including salaries, wages, utilities and other operating costs in cash, and some expenses like store rentals in advance.
- Keep in mind that even if you have arranged credit terms with your suppliers, a situation could arise where goods remain in your store for longer than anticipated. As a result, you could be forced to pay your suppliers' accounts for goods you have put in stock long before you have made the corresponding sale. At that point, you still have to give your customers terms.

To project the cash flow of your business, calculate the amounts of money you expect to receive during a specific period and deduct the amounts you expect to pay out. Remember that while a strong cash flow is important, it is not an indication of profitability. Growing sales can generate positive cash flow for a while even if the business operates at a loss, but this is not sustainable.

Source: **www.whichfranchise.co.za**