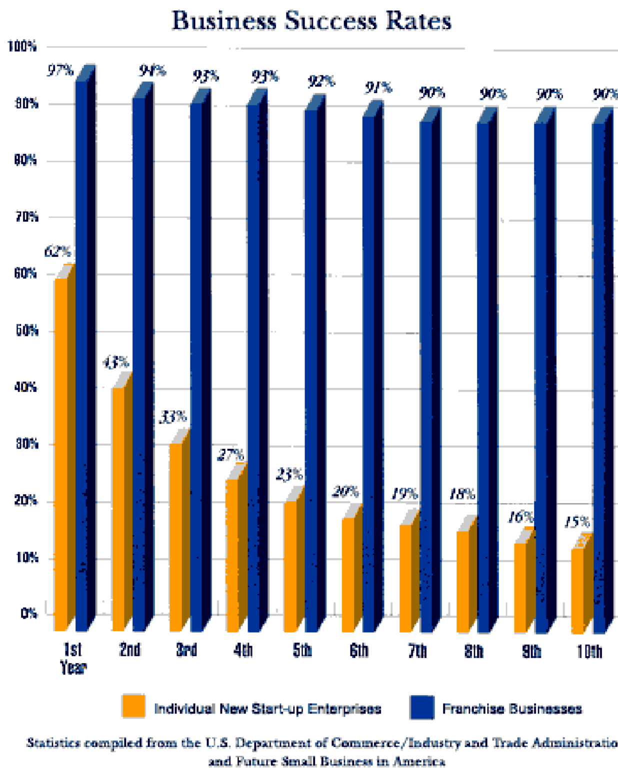
Financing a Franchise

Redefining the "Great American Dream"

Do you own your own home? Chances are that you do; in fact, almost 70% of adult Americans have achieved that "Great American Dream". But did you pay cash for the purchase? Probably not. You likely applied for a mortgage and were approved based on your financial state of health and the lending organization's perception that you were investing a reasonable amount of capital and had sufficient regular income to pay off the loan. Is that *really* the "Great American Dream" – financing a major purchase like your home and then relying on regular employment to make your ongoing mortgage payments? In essence, to depend on *the decisions of others* to ensure that you will be able to afford your own residence?



Do you own your own business? Probably not. In fact, A recent FedEx survey found that only about 10% of Americans do. And since one out of every 12 businesses is a *franchise*, only 1 of every 100 American operates a franchised business. What do these people know that the other 99% do not? Well, they realize that franchises are, in general, an excellent investment. Statistics show that 93% of franchised businesses are still operating and successful after four years. Thus, they understand that the income generated by the business will likely be sufficient to pay for the costs of financing a business loan. In today's tough economy, how many people (who work for someone else) have 93% confidence they will keep their job and thus be able to fund a *mortgage* loan?

In the twenty-first century, owning a business is fast catching up with owning a home as the "Great American Dream". In that same survey, two-thirds of respondents said they dreamed of owning their own business some day, and an astonishing 55% said that they would leave their current job and start a business if they had a chance to do so. Almost half of the respondents said that the primary reason they would start a business was that they wanted to do something that they loved or enjoyed. But while nearly 7 out of 10 people dream of

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owning their own business, only 1 out of 10 actually does. What stopped the others? Why do two thirds of people decide to own their own home and yet two-thirds of people decide NOT to own their own business?

In an earlier FCI Business Journal (volume 102), we presented some of the common reasons many entrepreneurs never move beyond the dreaming stage. High on the list: "I can't *afford* it!" In some cases they may be right; after all, any business requires *some* investment, no matter how small. However, while many assume that the cost will be prohibitive, they can never be sure until they investigate specific businesses and the benefits of financing those opportunities.

ARE FRANCHISES REALLY ALL "THAT EXPENSIVE"?

Before looking at financing a franchise, let's look at overall value. After all, you wouldn't buy a house if you didn't believe you were getting your money's worth. Investing in a business should be no different.

If you are determined to run your own business, you have 3 options. We live in a society with a do-it-yourself mentality, so one option is to begin your own start-up enterprise. After all, why pay someone else a premium to get into a business in which you feel you can be self-reliant and successful? But unfortunately, how many of us have tried to repair a leaky faucet ourselves, only to call a professional in to finish the job we could not?

> **"Nearly 7 out of 10 people dream of owning their own business, but only 1 out of 10 actually does. What stopped the others?**

Entrepreneurs sometimes overestimate their own abilities, and even if they have experience with the day-to-day aspects of a business, they sometimes lack the sales and marketing background to make that business successful. Independent start-ups have the lowest rate of success, especially when the enterprise is something in which the owner has no specific experience. As well, lending institutions are especially leery of financing such initiatives.

A second option is to buy an *existing* business, either directly from the owner or through a traditional business broker. However, the records documenting the historical performance of that enterprise may not be sufficient or accurate enough to enable you to truly gauge your chances of financial success.

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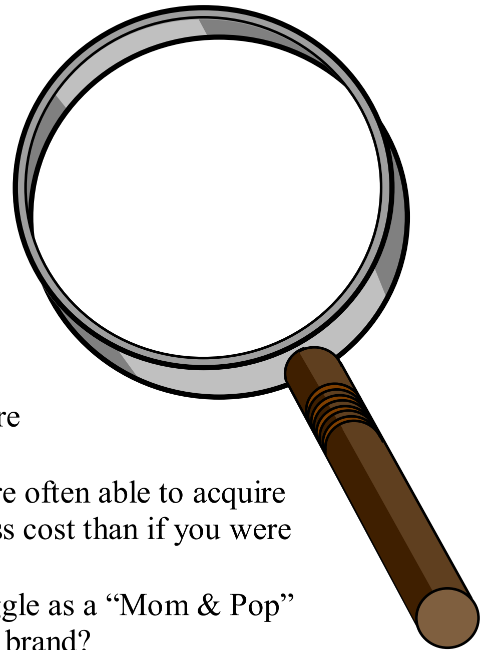
Franchising is the third option, and as already noted, the one with the highest *documented* success rate. In fact, franchises are mandated by the federal government to provide specific details of their overall operation through their Uniform Franchise Offering Circular (UFOC), the contents of which are regulated by the Federal Trade Commission. And when it comes to financing, the UFOC is often an important and positive element of the business plan. In fact, lending organizations welcome the submission of the UFOC as evidence that you are following a proven formula for success.

But what about that "Franchise Fee", the amount you'll pay on top of the expenses you'd incur starting your own business? Is it an unnecessary premium to be avoided if possible, or is it truly worth the investment? The answer is: it depends. Have you run your own business in the past? Do you have specific experience in the particular industry? Are you familiar with processes, practices and technologies required to make your new enterprise successful? Do you have relationships with suppliers and vendors who can provide high-quality, economical services. If not – and sometimes even if you do -- the franchise fee might be a bargain.

GETTING YOUR MONEY'S WORTH

Franchise fees can range from $5,000 to $50,000. That's a lot of money, so it's critical to ensure the fee justifies the value. Here's typically what you're paying for:

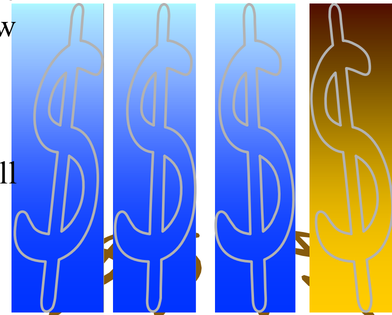
- **A proven business model** – Usually one that has been refined and adapted throughout the life of the franchise. This enables you to learn from both the successes and mistakes of others.
- **Training and ongoing support** -- This enables you to stay atop industry trends and allows you to benefit from aggressive product development and adaptive business remodeling.
- **Network of experts, peers and co-franchisees** -- Strong franchises endeavor to keep strong networks in place to enable franchisees to learn from each other.
- **Proprietary technologies** -- Many franchises have developed vertical market software and other technologies designed to make their franchisees more productive and profitable.
- **Buying power --** Because of volume, franchises are often able to acquire equipment, inventories, goods and services at far less cost than if you were doing it on your own.
- **Brand name recognition** -- Would you rather struggle as a "Mom & Pop" independent business or benefit from an established brand?
- **Co-op advertising** -- Many franchises drive national or regional advertising initiatives designed to bring business to your doorstep. Some even provide funding to assist with your own local advertising and marketing.



And finally, franchises involving fixed retail operations usually also provide valuable assistance with site selection (commercial real estate professionals who ensure that your new business is optimally located), lease negotiations assistance, and sometimes even established relationships with construction resources and equipment suppliers.

So are you capable of "re-inventing the wheel", and even if you are, do you have the time and energy to do so? If not, then the Franchise Fee is usually money well spent and an investment that can save you time, frustration and additional costs down the line.

Prospective franchisees also commonly ask "Why should I pay royalties?" Actually, royalties are what makes the formula work. What would it cost you to hire a management, marketing, advertising and customer support team? The answer is…a lot more than the typical owner would ever spend! How much would you put back into the business? You certainly couldn't hire this group for under 10% and the vast majority of all royalties are between 4 and 8%. The strength of royalties is that instead of the individual owner footing the bill to run his or her business, the expense is shared with all of the franchisees within the organization. Royalties are a good thing – without them, a franchise has no stake and thus no interest in your ongoing success.



FRANCHISE FINANCING OPTIONS

By now, you may have decided that franchising is the way to go. But even if you choose another path, the following guidance should be of help in your efforts to finance a new business.

First, just as it's rare to pay cash for a home, most entrepreneurs would never think of buying a business outright. Low interest rates and tax incentives make financing the logical option. Your credit history, net worth and liquid assets will play a part in the financing process. Unlike a home mortgage lender, however, a commercial lending organization (just like the franchise itself) will also want to qualify you based on non-financial qualifications. Do you have an entrepreneurial passion, confidence in your own abilities, a collaborative working style, and skills that are transferable to successfully operate the business (even without specific prior experience)? Any good commercial lender will look at the " Four Cs" - cash, collateral, credit and also *character*. Answer these questions for yourself, and then be prepared to answer them for the lender.

But who will the lender be? You have several options there. One option is the franchise itself. In 2004, nearly three-fourths of 2004's Franchise 500 companies offered some type of

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financing for franchisees. 16% offered in-house financing, 42% provided third-party financing, 15% offered a combination of both, and 27% offered neither. Bottom line: most franchises want to ensure that you are not under-capitalized without sufficient funds or working capital required to begin and stay afloat while you build your business. On the other hand, most franchises will bend over backwards to help you find financing.

It's important to recognize that commercial banks and other third party lending institutions sort prospective applicants into several camps. The preferred group, which might be called "Camp Success," consists largely of individuals who have significant hands-on business experience and are looking to purchase a business with a documented track record of success, like a franchise. They look at objective measures of the business's health, such as its average cash flow, growth rate and profitability. Then they try to assess, based on your resume and financial history, how suitable you are for the business you have in mind.

If you and the franchise have good track records, you can almost count on banks to court you. "Nothing makes a lender happier than a proven cash flow and customer base," says R. Neal Westwood, a business consultant with Alpine Business Brokers LLC in Orem, Utah. In fact, some lending organizations have "pre-qualified" certain franchise companies, having already familiarized themselves with those companies' financials and historical rates of success.

As another option, many entrepreneurs opt to work with their own lending institutions, leveraging an existing line of credit or a home equity loan. This can sometimes help avoid the need to re-qualify and forge new relationships.

Finally, many applicants secure loans through the U.S. Small Business Administration (SBA). This is an independent agency of the Executive Branch of the Federal Government. It is charged with the responsibility of providing, among other services, financial assistance to small businesses. SBA sets the guidelines for the loans, while SBA's partners (lenders, community development organizations, and micro-lending institutions) make the loans to small businesses. SBA backs those loans with a guaranty that will eliminate some of the risk to the lending partners.

The SBA loan guaranty transfers the risk of borrower non-payment from the lender to SBA. Therefore, when you apply for an SBA Loan, you are actually applying for a commercial loan, structured according to SBA requirements. Like any lending organization,

the SBA has guidelines to qualify applicants. However, given that the organization's charter is to assist small businesses and that their guaranty reduces the risk to their partners, qualifying for SBA funds is often an easier path for prospective franchisees.

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In conclusion, success in franchising requires being a smart business person. And a smart business person recognizes the need to enlist assistance – both by teaming with the right franchise *and* by choosing the best financing options. There are many highly-qualified organizations to help you realize *this* Great American Dream. Do your homework, depend on professional assistance, and rely on your own abilities to turn your dreams into reality. If you want it enough, it will happen, and we are standing by to assist in any way possible.

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