May 2005

CASHING IN OR CASHING OUT … THE FRANCHISING WAY

With the explosion in the number of franchises, both locally and globally, franchising is gaining recognition as an industry sector in its own right. As a result, the industry-specific risks need to be explored. This is particularly the case in Australia, which has become the franchising capital of the world, now with more franchises per capita than the United States of America.

Potential investors or lenders must asses the franchise industry-specific risks in conjunction with the risks of the underlying business of the franchise.

The effect of the combined risk analysis is that an investor, whether debt or equity, will adjust their required rate of return or lending criteria accordingly to ensure they achieve the maximum return possible from their funds and for the risks they are taking.

This risk assessment should begin with the investor or lender forming an opinion as to the viability and/or sustainability of the underlying business. The next step would be to examine the Franchise Agreement ("**the Agreement**") to determine the risks associated with the particular franchise model employed.

In this article, we are focussing on the risks associated with the franchise model and not those of the underlying business.

Investing in the Franchisor

The underlying business is crucial to the success of the Franchisor, as it relies on its ability to sell franchises to be able to grow/expand and therefore to create value for its investors.

The royalty charged by the Franchisor will not only determine the short-term profitability of the Franchisor but also the sustainability of each franchise. This comes as a result of the potential for royalties to severely affect the ability of the Franchisee to meet financing obligations and should the Franchisee fail, the source of revenue for the Franchisor will be reduced. Potential Franchisees will then avoid the franchise in the knowledge that the liability to the Franchisor is excessive and this will again reduce future sources of income. Competitors may then emerge and impose less onerous royalties on their Franchisees to win market share.

The Agreement should identify where the value of the franchise lies and what measures the Franchisor has in place to secure that value, whether it be in the form of the level of investment in and maintenance of the brand, the level of security obtained over physical assets or protection of proprietary knowledge, processes or sale territories.

Any such terms will aid in the preservation of the value of the investment, by establishing the future ability of the Franchisor to sell franchises and in a worst case scenario, to secure the value during an exit.

Investing in the Franchisee

The underlying business is crucial to the success of the Franchisee, as it relies on the business to generate profits and therefore to create value for its investors.

The Agreement should indicate where the value of the franchise lies for the Franchisee, including but not limited to the assets being acquired or rented that will be used to generate revenues, the level of support that the Franchisor will offer in setting up and conducting day-to-day operations, the level of royalties payable to the Franchisor and the extent to which the Franchisee is bound to the Franchisor in terms of restriction of trade and the duration of the Agreement.

The extent to which the Franchisee owns the assets and is obligated to pay royalties to the Franchisor will determine the level of risk of the investment. The more the Franchisee is required to pay to the Franchisor, the less funds it will have available to cover its costs of operations and financing.

A recent development, though not altogether new to the industry, is the advent of the multiple franchise owner. This Franchisee owns several franchises from one or more groups. For an investor in a multiple franchise owner, the risk has been decreased relative to a single franchise owner. Portfolio theory suggests that location risks and potential business risks of one franchise will be able to be offset against another franchise. This would, however, also be dependent on the risk of the underlying business, given some areas are inherently more risky than others and the franchise owner's field of expertise may not extend to the new franchise business.

Warning Signs and Potential Problems

Taylor Woodings can assist in identifying the warning signs and potential problems with particular investments.

A checklist of warning signs of the more common risks to investors in the franchise industry follows:

- The royalty in the Agreement is excessive by individual (underlying) industry standards.
- The cost of purchasing a franchise is high.
- The Franchisor operates company-owned stores in addition to franchising out new stores, thus reducing its focus on marketing and potentially stretching Franchisee loyalties.
- The Franchisor expands its business to new businesses unrelated to its core business.
- Franchise territories are small or overlap.
- The Agreement is poorly drafted and is unclear on property rights.
- There is no screening process for Franchisees in terms of business and operational experience.
- There is little support offered by the Franchisor to Franchisees.
- The franchise has a short history, meaning little brand recognition and no proven profitability.

The Agreement

As the Agreement forms the basis for the business relationship between the Franchisor and the Franchisee(s), any preliminary analysis or monitoring of the performance of an investment in a franchise business should begin with a review of the terms of the Agreement. This will identify warning signs and potential problems that may arise that are not listed above.

Not surprisingly, not all Agreements are the same. Terms that may differ and thus alter the risk profile of the franchise investment include (but are in no way limited to):

- The term of the Agreement;
- The upfront cost of purchase of the franchise territory/name;
- The ongoing rental charge for the franchise territory/name, normally referred to as a royalty (typically a percentage of revenue);
- The territory size and specifications;
- The ongoing contribution to marketing funds (typically a percentage of revenue);
- The holder of the property lease (typically, the Franchisor);
- The terms of the licence to the Franchisee (if the lease is held by the Franchisor);
- Supplier negotiations and management;
- Specifications on décor, fit-out, etc;
- Restriction of trade during and post-involvement with the franchise;
- Number of franchises able to be held;
- Pre-emptive rights for existing franchisees to purchase additional franchise territories over new potential franchisees;
- Pre-emptive rights for the purchase of the franchise should the Franchisee wish to exit their investment; and
- Costs of preparing franchise and other agreements (typically born by the Franchisee).

How can Taylor Woodings assist?

For an investor or lender who is uncertain of their position with regard to an investment in a franchise, regardless of whether the investment is in the Franchisor or the Franchisee, Taylor Woodings is able to assist in several ways.

- A pre-investment or pre-lending report – to identify the risks of a potential investment.
- An investigating accountants' report – to identify the risks and the sustainability of the business. A security position can also be included to assess the impact of implementing various exit-strategies.
- General business advice and financial modelling – to aid in the investment decision of whether to expand a business opportunity through the use of a franchise model or through the use of a conventional ownership structure, to invest in a franchise or to pursue an opportunity independently and to exit an investment in a franchise by sale or by termination of the Agreement.

These services outlined above are not an exhaustive list and can be tailored to suit individual needs.

Should you wish to discuss this matter or require more detailed advice on a particular situation please contact Quentin Olde, Partner, Quentin.Olde@twcs.com.au.