

a good INVESTMENT?

DANIEL CLOETE LOOKS AT BUYING A FRANCHISE AS AN INVESTMENT FOR THE FUTURE

⇒ Compared to property and the share markets, a business with a strong positive cashflow is suddenly looking attractive. People see a franchise as their superannuation fund, or a good place to invest their surplus money. And you frequently see advertising by franchisors along the lines of 'Secure Your Future'.

A franchise can indeed be very profitable. However, if one of your reasons for buying a franchise is as an *investment*, there are a number of unique issues that have to be taken into account. The following suggests some of the things that you ought to consider.

THE ECONOMIC ENVIRONMENT

Changing economic times mean that some industries are under pressure whilst others are growing and expanding. There are some great opportunities in previously over-competitive industries, and the prices paid for existing profitable businesses have come down to more realistic levels. More good news is that rents are trending down, funding cost has dropped dramatically and better quality employees may be more readily available. All these reasons underpin the business models of many franchise groups, making it a good time to look at investing.

This has to be balanced by the facts that sales may be a lot lower in some industries and some of the existing businesses may be for sale



because they are not economically viable. This means you may need to carry out even more due diligence than normal to find the genuinely great opportunities out there.

ACTIVE INVESTMENT

Buying a franchise is not like putting funds on Term Deposit with a bank; that is a passive investment which consumes very little of your time. Conversely, if you invest in a franchise, it is highly likely that you will have to devote the majority of your working time to it – in fact, the franchisor may insist upon it. In other words, it is an active investment. You will be involved on a day-to-day basis – and the time you spend on your business is time when you won't be earning elsewhere.

RISK FACTOR

All businesses carry risk. The risk factor of a good *proven* franchise is significantly less than that of a non-franchised business, but nevertheless there is still an element of risk. Some risks are within your control – for example, your own ability to run the business – but others are not. These others might include competitor activity, product or location failure, and so on. Consequently, you must be aware that there *is* risk, and allow for it in determining what level of return you are looking for. From an investment point of view, you would want to achieve

a higher rate of return on your franchise investment where there is risk involved than you would expect from a term deposit where the risk is very small.

WORKING WAGE

We have already mentioned the active nature of a franchise. This means that *before* looking at the investment return you can expect, you should allow for a reasonable working wage commensurate with the type of work you will be doing. After all, this is a real cost of running the business. Furthermore, it's a cost that would not apply to a passive investment.

PROFITABLE AND GROWING BUSINESS

Making money is the purpose of business. It is better to buy a more expensive, good profitable business than to buy a low-cost business that offers little or no profitability, growth potential, franchise support or renewal prospects. When assessing an application for finance, banks don't just look at the security you can offer. They take into account factors such as the *profitability, quality, debt servicing potential* and *risk* of the business - and so should you.

In any particular sector of franchising, there may be ten different systems of which only some will be truly profitable and growing businesses. The others may be marginal, at best. This means that you should take your time to identify the true jewels out there. The contrast could not be stronger. A marginal business will paint the owner into a corner with negative cash flow and mounting debt ratios. On the other hand, the biggest problem created by a profitable and growing business could be avoiding paying too much tax!

CAPITAL GAIN UPON SALE

In addition to the ongoing return upon your investment, the other consideration is how much you will get for your business when you sell it. A successful business in a high-performing franchise operation is likely to attract a considerable premium and offer a good capital gain, but there are some other factors that may have a material bearing on the sale price. These include restrictions on re-sale, the value of goodwill, the franchise term and the market. *You can read more about these in an expanded version of this article at www.franchise.co.nz – keyword investment.*

IT'S UP TO YOU

There are all sorts of reasons for buying a franchise, from working with a partner to following a passion. But even if you are buying into something you have always wanted, you should still ensure that you are spending the money wisely. The truth is that some franchises prove to be good investments while others do not. Before buying any business, therefore, take care to do your research, take legal and financial advice from experienced professionals, and ask lots of questions. Then choose wisely.

At the end of the day, the return on your investment will be determined by the performance and profitability of the franchise. If you've chosen well, that is often determined by the franchisee's own effort and motivation. Unlike that term deposit, it's up to you. ■

ABOUT THE AUTHOR

Daniel Cloete is National Franchising Manager for Westpac. He or the Franchise Team can be contacted on Email: franchising@westpac.co.nz and is available on 0800 177 007. The views and opinions expressed in this article belong to the author and do not necessarily reflect those of Westpac. 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 professional advice.