

looking at the LONG TERM

DANIEL CLOETE OF WESTPAC HAS SOME ADVICE ON SETTING UP LOANS FOR A FRANCHISE



➡ With economic conditions looking to be easing up, many people are again considering buying their own business. Franchisors are equally keen to see growth resume and are welcoming enquiries from well-qualified people. It's important, though, to ensure that any new business forged in the heat of renewed confidence should still be a good long-term prospect.

One of the major differences between buying a franchise and buying your own business is that, in most cases, a franchise is granted for a fixed term rather than forever. Franchises are granted in this way because it gives the franchisor the ability to upgrade standards or equipment over time to ensure the franchise retains its competitive advantage and value. However, it does mean that purchasers of a franchise should be mindful of the commitment they are making, and careful to ensure that they will be able to achieve the return they seek on their investment within the term of the franchise. It is particularly important that they consider this aspect when raising finance.

THINKING ABOUT

Most people's largest asset is their house, and for this reason many banks will provide money for the purchase of a franchise by using residential property as security and providing the loan on standard housing loan terms. This allows for a payment period of up to 30 years

in some cases. If the franchise term is, let's say, five years with a right of renewal for a further five, it is clearly possible that the borrower will have sold the business before the associated loan has been repaid. In this case, the borrower will either have to go on paying the loan after selling the business, or the loan will have to be repaid from the proceeds of the business sale.

This is not at all unusual. Extending the term of the loan beyond the term of the franchise agreement can ease the pressure on the cashflow of the business during the crucial start-up period. It is important, however, not to forget why the money was borrowed and to focus on clearing the loan as business profits increase. The aim should be to have the loan repaid in full before the franchise term expires.

Floating rate loans typically provide the flexibility of lump sum or increased payments, while fixed rate loans can provide some certainty to your budget. Discuss a mix of the two with your bank to determine the most cost-effective and flexible option for you.

Let's look at an example:

A person wants to buy a franchise that will cost \$60,000. His house has sufficient equity for the bank to give him a home loan. The franchise term offered is five years with a right to renew for a further five. The table

sets out some payment options for the loan. We'll assume a \$60,000 loan at a floating interest rate of 6.5%, with payments on a monthly principal and interest basis – ie, a table home loan (please note, payments have been rounded to the nearest whole dollar).

TERM	MONTHLY PAYMENT	PRINCIPAL OUTSTANDING AFTER 5 YEARS	TOTAL PAYMENT OVER FULL TERM	INTEREST PAID OVER FULL TERM
3 years	\$1839	\$Nil	\$66,204	\$6,204
5 years	\$1174	\$Nil	\$70,440	\$10,440
15 years	\$523	\$46,030	\$94,140	\$34,140
20 years	\$447	\$51,354	\$107,280	\$47,280

If his loans are structured over 15 or 20 years it offers significant cash-flow benefits to the franchisee's business. However, at the end of their franchise term he will still have, respectively, \$46,030 or \$51,354 to pay. If his income were to stop at this stage because he could not agree on renewal terms with the franchisor, he would be left with a loan relating to a business they no longer own and must find alternative income to repay the loan.

In most cases when terms are renewed there is a fairly nominal renewal fee. However, should the fee be significant, the prospective franchisee in our example might have to increase his loan and reconsider the structure of his borrowings.

ALTERNATIVE FINANCE

Another finance option that can be considered is equipment finance. This is similar to leasing, except that you end up owning the security. Equipment finance enables you to use your company's funds more effectively and free up cash for working capital. The funding is secured against the asset(s) being purchased, thereby retaining equity in the franchisee's other assets and interest and depreciation are tax deductible. At the end of the funding cycle, you own the asset.

This is particularly suitable for equipment like sign-written vehicles, ovens, cool rooms, display units and other expensive machinery with a limited lifespan. In this case, it is particularly important that the term of the funding be adapted to the useful working life of the equipment, to ensure it can be replaced when required. Of course, you also need to take the franchise term and possibly property lease term into account as well – you may not need a large industrial oven at home if your business does not have a place to operate from!

TAKE ADVICE

If you're looking to buy a franchise, you should always seek professional advice. You should talk to a specialist franchise lawyer to ensure you understand the contents of the franchise agreement (including the terms and conditions of termination and of sale of the business) before signing. You should also discuss the financial implications of these terms with your accountant.

Even the best business can be brought down if it is struggling under the burden of too much borrowing. On the other hand, wisely structured borrowing can enable you to take up that opportunity, repay the loan and enjoy the income you earn. It's up to you and your advisors to ensure that you make the right long-term decision. ■

ABOUT THE AUTHOR

Daniel Cloete is the National Franchise Manager for Westpac. He or your local Westpac franchise manager 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.