Franchising faces shakeout

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The franchise industry is likely to go through a huge ownership shakeout over the next 12 to 18 months and will require a large surge in capital, says the head of a major advice group.

Adrian McFedries, the head of DC Strategy, which advises major clients such as Boost Juice, Fernwood Women's Health Clubs and Mortgage Choice and is expanding into the US, believes that it's the season of the seven year itch as more franchisees look to on sell their businesses and corporate executives, made redundant, seek to find a job through purchase.

Rod Nuttall, National Account Manager of corporate financial services for the Commonwealth Bank, agrees that the pressure for funding will increase over the next decade.

"The franchising sector is growing more rapidly than GDP over the past ten years; it's an expanding market and therefore a larger slice of the economy," he says.

Some lenders have established accreditation programs for franchise systems, which allow automatic approvals on a franchise business loans.

For example, if a Subway franchise was worth $300,000, Nuttall's team would lend up to $210,000, based on a multiple of the earnings.

Fernwood Women's Health Clubs says their accredited finance will cover 50% of the average $800,000 purchase price from any of the major four banks.

Franchise lending accreditation teams at each of the major banks and BankWest have traditionally seen the lucrative 'greenfields' market (new sites) as a great place to lend.

But that is about to change.

The secondary market is much larger with between 60,000 to 80,000 franchisees, McFedries says, and this is where the bulk of capital will be sought.

"If you ran the business for four or five years, you will probably sell for between $500,000 and $700,000 but you may be sitting on high levels of finance.

"That means the net amount of finance is increasing because the size of secondary market and the fact that they turn over every seven years.

"So if (as a lender) you just had a "greenfields" (loan book), you'd still see the amount of finance increasing."

Not all of owners are aged 45 plus; there are many in their late 30s, he adds.

One recent example is a physiotherapist in his late 30s who was granted master rights to the Pack & Send franchise in New Zealand.

"So it's still a bit bi-polar (in terms of demographics) with the early 30s well represented...and then there are the more mature ones."

The average life cycle of a franchisee is about six or seven years, McFedries says, and many

owners are close to the seven year mark already.

''Boost Juice has had staggering growth and you'd expect to see a number (of franchisee businesses) on the market as they approach five or six years.

Boost Juice bars average value ranges between $240,000 and $320,000, depending upon the value of the kiosk and earnings.

''They won't all sell at the same time but you will see a trend for multiple unit holders too so finance may be sought by existing franchisees to buy their colleagues' operations in say, three locations.

''People are self-selecting; if it's quite well managed by franchisors then the franchisees will follow. That multi-unit trend has a long way to go...only less than 10% of networks so far but it's growing quickly.

''Franchisors don't always get involved in the multiple support structure and running 50 owners with two locations can be quite different to a single-unit operator.

''There are a number of system owners who aren't making that change; that means the franchisee will be in the box seat to drive the business and some franchisors may lose touch with their network.

''So you may see clusters of multiple units doing well and franchisors who are less engaged.

''What you may also see is more restructuring and aggregation of the networks. For example, Retail Food Group Australia now owns Brumby's and Michel's Patisserie.

''We've seen Lenard's (food franchise) with private equity involvement and all the master franchises have been bought back on a state-by-state basis. That kind of change can be healthy for a business but for other mature networks, it won't happen until they've been sold.''

According to McFedries, private equity financiers often misunderstand franchise systems and as a result, have been badly burnt and then shied away from any new opportunities.

''At the top end, franchising is a sophisticated HR strategy rather than a capital strategy.

''A lot of the mature systems have been around for a while; private equity market grossly misunderstands franchising; they don't execute at the grass roots.

''I believe that it's an emerging trend in a tight labour market. We haven't even scratched the tip of the iceberg.

''Putting capital in and growing (it) can be successful but understanding them (the systems) well is different.

''Retail detail can be an issue. The operating model for private equity is to leave management to run it but then they'll bring directors in...because if you've been in franchising, there's the assumption that you know it and understand it but your model may be out-of-date.

'''So you just repeat the cycle. A number of PE firms have been burnt in retail and didn't go back but franchising has its greatest penetration in retail - 25% is franchised and works well in highly dispersed models.

''Subway and KFC are all examples which drive that. Angus & Robertson (170 book stores) and Pacific Equity Partners (private equity player) have done well together and SuperNews in Qld is another one of their joint ventures plus they also have the sell-off rights of Borders (books) so there are pockets of brilliance.

''It's a missed opportunity in a way when people just see it as small business.''

Flight Centre, ANZ Mortgage Solutions, Luxottica (eyeware retailers with systems, such as Sunglass Hut, OPSM and Bright Eyes Sunglasses - a 150 store franchise system - and representing overseas brands, such as Oakley) using franchise model successfully to grow big brands, he said.

If Harry Triguboff's view on the secret of success for entrepreneurs is ''more capital', then any boom in the franchise industry is likely to be based on capital and liquidity rather than just regulation, McFedries adds.

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