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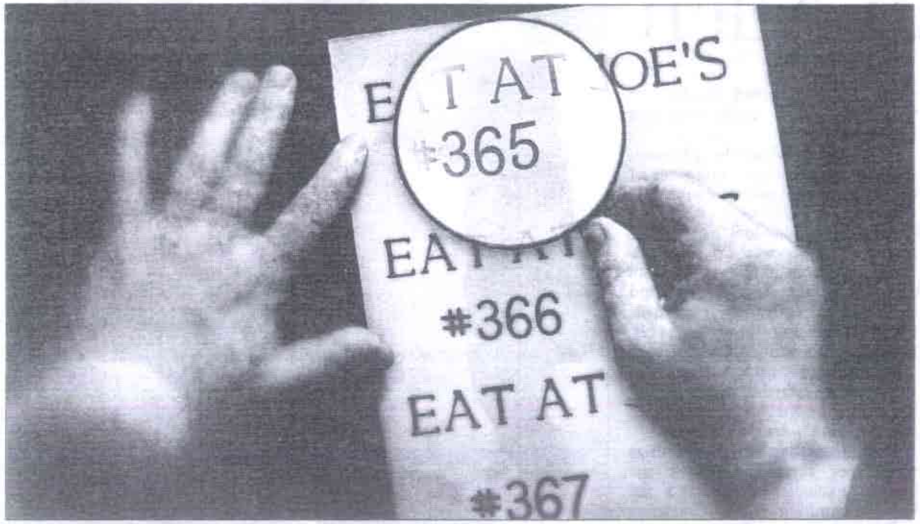
Fresh approach to franchise funding

In the first of a three-part series on franchising, **Mark Fenton-Jones** reports on how Australian banks are changing the way they are going after the franchise market.



Under the microscope franchisees look very different to other small businesses.

Photo-illustration: KARL HILZINGER

Lending to franchisees is nothing new. What is different, however, is that rather than being conducted on a case-by-case basis, banks are now taking a more intimate look at franchises. This lets banks identify those that present them with less risk of business failure and more opportunities for their new streamlined deposit and lending packages.

Macquarie Research Equities, in a 2002 study, found that after five years in business, 70 per cent of small- to medium-sized enterprises had left the market. In contrast, just 12 per cent of franchises go down the tubes in that period, says Gary Johnson, director of BankWest's Business Express division.

Because banks had previously lumped franchises together with all small businesses, the high failure rates and lack of understanding of franchises had produced a conservative lending philosophy.

Like many independent, stand-alone small business owners, franchisees had to put up their homes as security for a loan, gaining no recognition for the systems and brand names built up by the franchise system.

Macquarie reported: "The primary factors of success for a small business are the structure of the industry they are in and the skills/ability of the SME's managers. The banks lose out when they are not on top of the problem and/or cannot see the failure coming."

Franchise systems present banks with established management structures that they can evaluate.

"The primary driver is that lending to small businesses is enormously risky," explains Rod Young about the banks' new approach to dealing with franchises.

Young, the managing director of Deacon Consulting, says the banks are focusing on systems with a finite number of franchises, a two- to-three-year track record and profitable franchisees.

"Franchises represent the best performing part of the small business loan book for most banks," Young says.

"By the middle of this year, all the major banks will offer franchising packages of some form."

Since 2000, ANZ has built a team of 50 national franchise specialists, 15 to 20 of them in the past year.

"Four years ago we identified franchising as a high growth/lower risk industry compared with other small- and medium-sized businesses," head of ANZ's franchise business Robert Graham says.

The bank identified 200 to 250 of the 700 odd franchise systems which met its small- to medium-sized enterprise criteria.

Further analysis, often with franchisors' help, whittled the final number of ANZ accredited systems to 72. After carrying out its due diligence, the bank established benchmarks for potential borrowers.

While borrowers can follow the typical small business strategy of securing the loan against their home, analysis of franchise systems allows banks to undertake higher unsecured lending against the continuing value of the franchise.

The average loan secured against cash flow is 50 per cent, but can be significantly higher for strong systems.

"Franchisors want franchisees to put in at least 30 per cent of their own money," the head of Westpac's franchise lending, Greg Pithers, says. Westpac has 51 systems on its approved list.

Recognition of the value of the business also means that franchisees can use the equity in an established business to buy additional franchise sites.

ANZ is also developing corporate banking and private equity products for large franchisees with multi-sites.

Westpac is considering a lending product for mobile franchisees that have been historically overlooked, Pithers says.

In the past three months, the Commonwealth Bank has appointed a national executive manager for the franchising sector and is building a dedicated team with a national focus.

"Franchising offers the bank positive revenue and risk benefits," says Andrew Watson, general manager of corporate banking for CBA in NSW and the ACT. The bank also engaged an external consultancy to help it understand the risk in the franchise sector and identify the opportunities.

"Our research shows that within the Australian economy franchising is becoming a relevant and effective means for the retail and services sectors to grow," Watson says.

Now finalising its franchising strategy, CBA plans to have a list of accredited franchise systems. The bank will look at the franchises' profitability and sustainability, along with an assessment of their operating systems, management and risk management systems.

Franchisees in accredited systems will be eligible for financial packages that will include debt and transactional products, sometime in the next three months.

Last year, National Australia Bank began to develop a streamlined suite of products for franchisees, also due for release within three months. Products will be available for both "approved" and "preferred" franchises.

The head of NAB's business financial services division, John La Marca, says the objective is to capture 30 per cent of the franchise market.

BankWest is further advanced, with the rollout of its product.

Since appointing a senior executive last April to develop internal procedures to support a franchise package, the bank is leveraging off its existing Business Express mobile lending network. One or two mobile lenders in each state will specialise in franchising.

The bank sees franchising as an opportunity to diversify away from bricks and mortar lending.

"We're prepared to recognise the value of a franchise system," Johnson says.

Franchise systems on the bank's expanding approved list are Bakers Delight, Subway Sandwiches, Red Rooster, Gloria Jean's, Autobarn and Pirtek.

While traditional lenders jockey to increase their penetration of the franchise market, more innovative financing is likely to appear.

Now viewed as the most franchised country in the world on a per capita basis, Australia has more than 700 franchise systems and at least 50,000 franchised outlets. The sector turns over $80 billion a year and accounts for 12 per cent of the economy. And the number of franchised units has grown by 8.5 per cent since 1999.

"It's a market that continues to grow," says Graham Hodges, managing director of small to medium business at ANZ.