

# Franchise Funding Strategies



**FRANOCITY**



Funding options for franchises vary based on factors like your timeline, risk tolerance, and credit history. Your optimal choice may involve a single funding solution or a combination of alternatives.

## **NAVIGATING FUNDING OPTIONS FOR YOUR FRANCHISE**

Given the diverse funding landscape for franchising, it's crucial to tailor your strategy to meet your specific needs. A common mistake among franchise entrepreneurs is underestimating their capital requirements, leading to undercapitalization and business setbacks. Some erroneously believe covering franchise startup costs is sufficient, assuming ongoing operations will be sustained by customer revenue. However, every franchise has a "breakeven" point, requiring ample working capital until revenue covers all expenses. Owners often miscalculate this timeline, and their resources may prove insufficient during this pivotal phase.

Fortunately, today there are a variety of funding programs available to suit every entrepreneur's unique funding needs. Understanding all of your options and the pros and cons of each is the first step in determining the best way to fund your business venture. The following pages detail several of the most popular options.

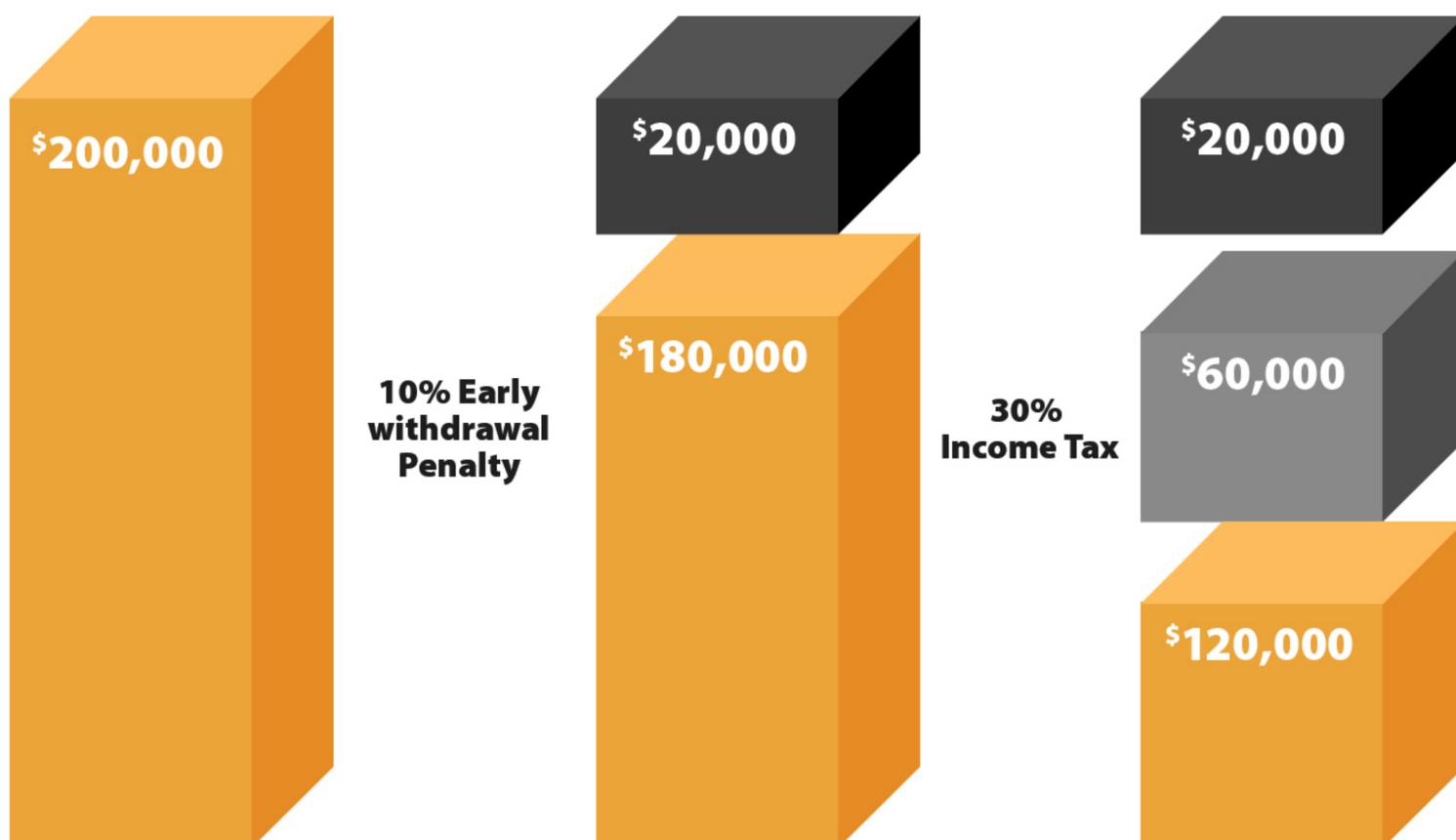


## 1) USING YOUR RETIREMENT FUNDS

It's a common misconception that you can only use your retirement funds to purchase investments like publicly traded stocks, bonds or mutual funds. In reality, you can use most retirement plans to buy a business tax-deferred and penalty-free.

In fact, tens of thousands of entrepreneurs have used their retirement savings as a viable resource for funding a business. Called Rollovers as Business Startups (ROBS), this method of funding allows you to use your 401(k), IRA, 403(b), or other qualified retirement account to fund a business - with no penalties, upfront taxes, or debt. It can also be used as the necessary capital injection for a Small Business Administration (SBA) loan.

Due to the significant tax advantages, many individuals have their savings locked away in retirement plans such as IRA's and 401(k)'s, which carry severe penalties and tax consequences for early withdrawal. For example, as shown in the illustration below, if you have \$200k in an IRA or 401(k), and take an early withdrawal, you may be required to pay a 10% penalty and as much as 30% in ordinary income taxes, leaving you with only \$120k of your original \$200k. However, with ROBS funding, you would retain the full use of your \$200k savings to start your business, in essence saving you \$80k!





## 1) USING YOUR RETIREMENT FUNDS *(Continued)*

In addition to the tax benefits, there are other advantages to this program. For example, because it reduces or eliminates the need for a loan, your business becomes profitable sooner and has quicker cash flow. It also provides you the ability to pay yourself a salary until your business becomes profitable. What this means is that you are able to pay your mortgage and other living expenses, as well as put food on the table, from the start. Other funding methods don't provide this same advantage.

**How it works:** This program is similar to buying stock in a public company, except instead you're investing in your own privately held company. A leading ERISA (Employee Retirement Income Security Act) attorney named Len Fischer, pioneered this method of funding in 1983 to help small business owners maximize the benefits of their retirement plans. Thus, the very first IRA/401(k) rollover business funding plan called The Rainmaker Plan<sup>®</sup> was born. The four key steps are as follows:

### Step 1

Establish a corporation with customized retirement plan.



### Step 2

Rollover your current plan into new corporation's plan.



### Step 3

Your new plan purchases stock in new corporation.



### Step 4

Your new corporation now has the capital to start.





## **1) USING YOUR RETIREMENT FUNDS** *(Continued)*

### **THE PROS:**

- Tax-deferred and penalty-free
- Debt-free or reduced debt funding - can significantly shorten your time to profitability, and maximize your potential success
- Can pay yourself a salary from the start (enabling you to pay living expenses from your salary)
- No interest payments or repayment of loans
- Can secure funding fast - typically 3-4 weeks
- Gain cash flow and build equity faster
- Powerful wealth-building vehicle - as a successful entrepreneur you can build for the future and protect your profits
- Not dependent on your credit score (you still qualify even if you have bad credit or bankruptcy)

### **THE CONS:**

- Does not make financial sense to use if haven't accumulated more than \$50,000 in retirement savings
- Involves ongoing administration to stay compliant so it's recommended you hire an experienced provider
- Must be carefully structured to comply with ERISA provisions and the Internal Revenue Code (IRC).
- Involves an element of risk with your retirement savings

When using your retirement funds to start a business, keep in mind that ROBS are not the same as Self-Directed IRAs, and it is important to understand the differences between the two. Two court cases in 2013 stirred up unnecessary fear and concern about using retirement funds to fund a business. In both cases, the court ruled against entrepreneurs who had used their Self-Directed IRAs to start a business. However, these court cases only pertain to Self-Directed IRAs and not to ROBS arrangements. The rules are very different for each, and ROBS arrangements were not affected by either court decision.



## 2) SBA LOANS (SMALL BUSINESS ADMINISTRATION)

The SBA's mission is to help entrepreneurs start or grow their business, and an SBA loan may provide the longest-term and lowest-interest loan available for your business. The most common one for small business owners is the 7(a) program, which is more generally focused on helping small businesses start and grow.

**How it works:** The SBA does not directly lend money to business owners. Instead, small business owners secure an SBA loan through an authorized SBA lender (such as a bank), and the SBA provides the bank a guarantee for a portion of the loan; thereby mitigating some of the risk and incentivizing financial institutions to lend money to small businesses.

### THE PROS:

- Typically offer more attractive payment terms and interest rates than other types of loans
- Lower down payments
- Funding available from \$5,000 to \$5 million (only non-profits can offer microloans under \$50,000)
- Typical loan terms of 7-10 years, up to 25 years available if the project involves real estate (this is generally longer than conventional loans)
- No prepayment penalty

### THE CONS:

- Complex and lengthy application process requiring significant documentation
- Capital injection of 10%-30% typically required (Note: ROBS/401(k) rollover funding can be used to satisfy this requirement)
- Stringent use terms
- Strict acceptance criteria based on the 5 "C's"
- ✓ Character: Past payment history, no criminal record
- ✓ Cash flow: Business must have sufficient cash flow to cover debt service
- ✓ Credit: FICO score
- ✓ Collateral: Assets available to secure the debt should you default on the loan
- ✓ Conditions: Economic environment



### 3) CONVENTIONAL LOANS

Conventional loans can be provided by bank and non-bank lenders, but are not guaranteed by the SBA or other government entity. Any small business or franchise can apply; however, they can be difficult to obtain for startup businesses. Approval depends largely on the overall credit risk of the business.

**How it works:** With conventional loans, the interest rate, term length, and loan amount depend on your credit rating and business revenues. Some of the most popular conventional loans include term loans and commercial real estate mortgages. The lender, whether it's a big bank, community bank, credit union or other type, will typically require you to share an extensive amount of financial information including: personal credit history, the financial background of the business, future growth plans, and any other relevant information.

#### **THE PROS:**

- Several options are available: term loans, commercial real estate mortgages, factoring, etc.
- Shorter closing times than SBA loans, in most cases
- If successful in securing a loan, it becomes easier to get loans renewed or increased
- Suitable for a wide range of business purposes (there is a little more freedom on what you can do with the money)

#### **THE CONS:**

- Extensive paperwork required to process loan
- Typically require collateral, good credit and a personal guarantee from business owner
- Many lenders don't like to work with small businesses who need smaller dollar loans
- Shorter repayment time SBA loans
- Potential prepayment penalties
- Approval rates are fairly low





#### **4) SECURITIES BACKED LINE OF CREDIT**

This type of loan is backed by securities held in an investment portfolio. It is similar in concept to a home equity loan, but rather than the loan being backed by the equity in your home, it is backed by the securities held in your investment portfolio.

**How it works:** Whether you want to launch a new business, expand one you already have, or utilize a bridge loan, this type of funding can provide you with the immediate funds to do so by allowing you to collateralize your investment portfolio, without disrupting your long-term investments or asset allocations or creating unexpected tax consequences. This type of funding is a popular option because rather than selling stocks to buy a business, you can simply borrow against them, and generally pay only 2-6% interest. Compare this to historical appreciation on investments which is typically around 9% on investments (as seen by the S&P 500 since World War II), and you can see why it can be a valid option of funding.

#### **THE PROS:**

- Cash needs are satisfied without selling securities/assets/investments
- Keep your long-term investment strategy in place, with all investments remaining in your name
- You keep all appreciation and dividends from your portfolio
- Easier to obtain and have lower rates than other alternatives (SBA loan, unsecured loan, and other forms of credit)
- Avoid selling stocks and generating capital gains
- Typically receive approval within 48 hours and are fully funded within 10 days
- Ability to borrow 70%-95% of investment portfolio

#### **THE CONS:**

- Can be risky since market fluctuations could cause the value of pledged assets to decrease
- If market value of pledged securities drops below certain levels, payment may be required or you could be made to sell securities to maintain equity



## 5) HOME EQUITY LOANS

Entrepreneurs still rely on their biggest asset for cash - the equity in their homes - to finance a franchise or business purchase.

How it works: Home equity loans remain relatively easy to obtain, assuming you have the required equity in your home, as well as good credit and income for repayment - but the requirements have tightened up recently. There are two types of home equity loans: a standard home equity loan that is just like a regular mortgage in that you borrow a single lump sum and repay at a fixed monthly rate; and a home equity line of credit (HELOC), where you have access to borrow smaller funds-when needed-up to a predetermined fixed amount. The best option for business owners depends on the type of business or franchise you choose.

### THE PROS:

- Easier process and lower interest rates than other non-secured options
- Interest is most likely tax deductible, but cannot be used as a business expense

### THE CONS:

- If you don't have equity in your home, this option is not available to you
- HELOCs can have variable interest rates (based on the prime rate) that can make your monthly expense unpredictable
- Risky, especially if there is another housing market collapse
- Your home is at risk if you fail to make payments (and your business, too)
- There are typically closing costs and fees, which can vary greatly by lender





## 6) EQUIPMENT LEASING

With this type of funding you can finance up to 100% of the value of the equipment needed to start or run a business, including: computers, office furniture, company vehicles, machines, or special service equipment. This option typically includes a buyout for \$1 at the end of the lease.

How it works: Most businesses can qualify for this type of financing, but the loan amount and interest rate are determined by the value of the equipment, business history and credit score. By leasing equipment, you'll have less initial costs than if you were to purchase outright, as well as easier, more predictable payments.



### THE PROS:

- If you need a piece of equipment whose technology becomes obsolete quickly, leasing is usually a better option because you can acquire updated technology more easily
- Allows you to conserve capital thereby potentially allowing better cash flow
- Simple application and quick approvals
- Typically only need the first month's payment upfront
- Perfect credit is not necessary
- Potential tax advantages

### THE CONS:

- Could tie up credit so you can't apply for other loans
- Leasing oftentimes costs more in the long run
- Doesn't build equity in the equipment since you don't own it



## **7) UNSECURED LOAN**

A personal unsecured term loan is a type of loan that is not backed by collateral, meaning the borrower does not need to provide any assets (such as a car or house) as security for the loan. Instead, the approval and terms of the loan are primarily based on the borrower's creditworthiness, income, and other financial factors.

### **TERM LOAN PROGRAM**

- Rates range from 9-15% (Dependent on strength of personal credit)
- No minimum length of time in business
- Fixed monthly payment
- No upfront fees
- Full liquidity immediately
- Funding in 7-15 business days

### **REQUIREMENTS**

- 680+ Personal Credit scores in all 3 bureaus
- 2 years personal tax returns showing \$50,000 or more of taxable income

### **THE PROS:**

- No Collateral Required
- Fixed Term and Fixed Interest Rate
- Faster Approval
- Predictable Payments

### **THE CONS:**

- Higher Interest Rates
- Credit Dependency
- Lower Loan Amounts
- Shorter Repayment Periods
- Potential for Prepayment Penalties



## FUNDING STRATEGIES

Now that you know what your options are for funding, it is equally if not more important to fully plan and integrate a funding strategy appropriate for your individual needs. There are many things to take into account when planning your short- and long-term funding strategy:

- » Are you a first-time business owner or a multi-unit operator?
- » Do you have the cash necessary to cover the capital injection needed for most loans?
- » What are your short-term and long-term goals?
- » What is your exit strategy? How long will you own the business?
- » Are you buying an existing business vs. a startup?

All of these variables factor into determining the most appropriate funding strategy for your unique situation.





## **FUNDING STRATEGIES FOR MULTI-UNIT OPPORTUNITIES**

The most important thing to know if you want to become a multi-unit operator is that how your first unit is funded affects your ability to fund future units. So if you are arranging financing for the first unit without considering how it is going to affect your ability to get additional financing, you may find yourself without any options to fund additional units. And in the case of franchises, many larger franchises require a three-unit commitment, the most common scenario being a "three-pack" over a two- to three-year window. Here are some general tips to consider for multi-unit operators:

- Retain as much of your current liquidity as possible when funding the first location. Inject the smallest amount of capital allowed and borrow the largest amount you can qualify for.
- Make sure your initial projections are reasonable and achievable. Your success in meeting/surpassing those initial projections will weigh heavily in future loan decisions.
- Be willing to inject a larger percentage of the project costs into a second location if the first has not yet reached sustained positive cash flow, another critical reason to hold onto liquidity at the beginning. Your increased "skin in the game" increases the lender's willingness to say yes.
- Be able to explain "why now" to the lender who wants to know why you want a second location if the first is not yet profitable. Know the economics of the concept. A second location in reasonable proximity to the first can reduce expenses and increase profitability; be able to explain how.



## FUNDING STRATEGIES FOR MULTI-UNIT OPPORTUNITIES

(CONTINUED)

Questions to consider for additional units:

- Are you on target to hit your projections?
- Have you reached cash flow positive? If yes, have you sustained cash flow positive for six months?

If "yes" to both - you may qualify for a business expansion loan with an equity injection of only 10% into the new location.

If "no" - you may still qualify for funding with a higher injection if you are on target with your original projections.

Note that projected cash flow for the new location when combined with the existing cash flow from the current location must provide adequate debt service ability for the total debt of all locations.

The following is a typical scenario and a few strategies to accommodate for it:

**Scenario:** An individual wants to open three locations in 24 months and has the capital to fully self-fund the opening of one unit with a substantial amount of cash leftover.

*Note: For all the strategies on the next two pages, step 1 and 2 are the same. The difference is in Step 3 (opening location #3). The decision of using strategy #1, #2, or #3 is dictated by the success of each location. Using the strategies below ensures the opening of location #3. The only question is: How much personal liquidity will you need to inject? (10%, 30%, or nothing at all)*



## **FUNDING STRATEGIES FOR MULTI-UNIT OPPORTUNITIES**

*(CONTINUED)*

### Strategy #1

Step 1: Make a 20-30% equity injection of the total start-up costs for store #1 and finance 70-80% through an SBA loan. (For an emerging brand, you should count on 30% equity injection and 70% financing; for an established brand, 20% equity injection and 80% financing.)

Step 2: Nine months later, inject 30% of the total start-up costs for store #2 and finance 70% through a second SBA loan. This assumes store #1 is on target with or very close to projections and that breakeven has occurred, or it is obvious from the trends that breakeven is imminent.

Step 3: In 6-9 more months (15-18 total months), if store #1 is fully profitable and store #2 has broken even and is hitting projections, seek an expansion loan of store #1 and store #3 for 90% of the total project costs, and guarantee the loan with the cash flow and assets of stores #1 and #2.

This strategy enables you to open 3 locations with an injection of only 20% of the total project costs for all three locations and with financing 80% for an established brand (it would require an overall injection of 23.3% for an emerging brand since the initial injection would need to be 30% of the first store project costs).

### Strategy #2

Step 1 and 2: Same as Strategy #1.

Step 3: If store #1 is only slightly profitable and store #2 has broken even or is imminently ready to do so and is hitting projections, inject 30% of the total start-up costs for store #3 and finance 70% through an additional SBA loan.



## **FUNDING STRATEGIES FOR MULTI-UNIT OPPORTUNITIES**

*(CONTINUED)*

This strategy enables you to open 3 locations with an injection of 26 - 30% of the total project costs for all three locations. Financing would be obtained for the remaining 70-74% of the project. It is still possible to obtain financing for the third store, assuming neither of the previous stores is in financial difficulty and both can provide a guarantee for the third location.

### Strategy #3

Step 1 and 2: Same as Strategy #1.

Step 3: If significant time has passed (24 months), and the first two locations are doing sufficiently well to fully service the debt loan for all 3 locations, obtain an expansion loan (up to 100% of the total project costs) for store #3 if the cash flow from stores #1 and #2 can fully support the debt service for store #3. (If stores #1 and #2 can fully service the debt for store #3, then 100% financing is possible.)

This strategy enables you to open 3 locations with an injection of only 16% (established) or 20% (emerging) of the total project costs for all three locations. Financing would be obtained for the remaining 80 or 84%.

By following the injection method above that makes the most sense for your situation, you will have enough liquidity to accomplish a successful multi-unit launch.



## **A FEW LAST WORDS**

Whether you're looking to build a business from the ground up or you want to purchase an existing business or franchise, achieving funding will be one of your most important and difficult challenges. Knowing your options and choosing the best strategies for your unique situation will go a long way in ensuring the realization of your dream. And seeking the help of a professional funding company like Franocity will further ensure that your business gets the best start possible.

*NOTE: Every entrepreneur and situation is unique. What works for one may not be acceptable for another with the exact same financial circumstances. To come up with a personalized strategy that works best for you, you may want to consider consulting with a trusted funding expert who can review your personal financial statement and take into account your goals and preferences.*