DUE DILIGENCE

THE CASE STUDY SERIES: Volume 3

The essential case study helping you to evaluate if Franchising is the right choice for your next business venture.

Discover key issues and perspective as we introduce real cases of small business ventures and franchising.

THE METAMORPHOSIS PROJECT

BE MORE GIVE MORE HAVE MORE

ABOUT THE AUTHOR

EMMANUEL MARTIN

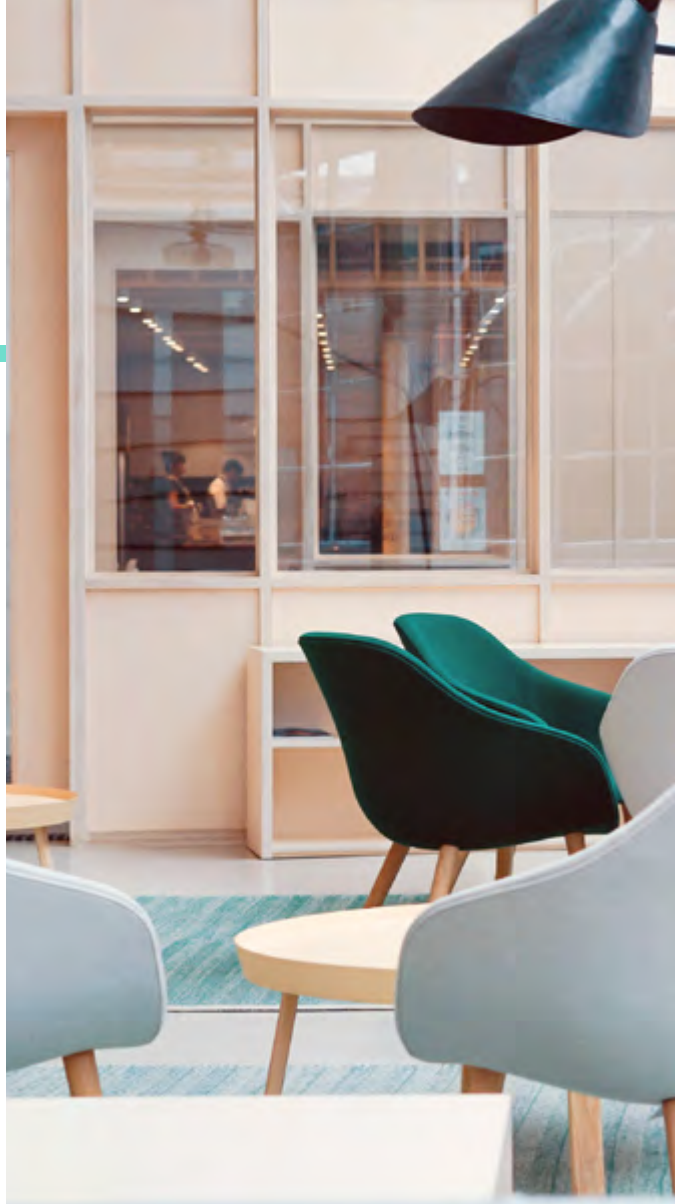
Founder and CPA
Metamorphosis Project

Emmanuel Martin, a franchise expert and coach has had an extraordinary journey working with both franchisors and franchisees in building profitability for their businesses. He has seen both the successes and hardships of franchising over the years.

In 2016, he founded The Metamorphosis Project, a consulting business that specialises in helping franchisors and franchisees minimise risk in their business. The company's vision is to 'create a world where franchisors and franchisees fall in love and stay in love.'

Recently, the company has branched into providing an effective and value-added Franchise specific due-diligence process that will help prospective franchisees make informed choices.

The lack of an effective due-diligence process is one of the major reasons of franchise failure.



The Metamorphosis Project helps and nurtures select 'Franchisors of Choice' who believe in putting their 'Franchisees First' through the belief that Franchisors prosper when Franchisees thrive, both financially and emotionally.

Currently, the company is excited to be launching a ground breaking Due-Diligence service for aspiring franchisees in association with Eden Exchanges.

brought to you by eden exchange.com

INTRODUCTION

Owning and running a franchise business can bring a lot of satisfaction, both financially and emotionally. I know this because I have spent the last few years dedicating my time and energy helping franchisees and franchisors grow their business.

Over these years, I have smiled with joy and felt a sense of immense pride when Franchisees reap the rewards of running very good businesses.

But there are two sides to every story.

I have also seen the ugly and depressing side of Franchising when things go horribly wrong. Too many nights, I have come home with sadness that is hard to describe. These nights of gloom and a sense of despair have been all too common recently.

I can rattle off several and logical reasons, through my experience, of why Franchise businesses fail. And more often than not, the Franchisee is doomed for failure from the very beginning, that's right, from the very beginning.

A few years ago, working for one of Australia's largest Franchised coffee chains, I used to run Financial Management and Profitability Induction workshops for new Franchisees. These sessions lasted for a couple of days. The first day was all very exciting, the prospective Franchisees were on a high although anxious, which is understandable. However, as the sessions progressed there would always be worried looks when I started talking about the concept of "Breakeven" which simply means the level of Sales the Franchisee needs to generate to cover all the costs of the business.

At the end of the two-day course, on several occasions, prospective franchisees, who had already paid a significant deposit, would come to me with their 'breakeven' figure (which in many cases they had just worked out from my course). They would painfully explain to me that they didn't think they would be able to sustain the business that they had just paid a non-refundable deposit for, with the forecasted costs (including loans). During that time, it was a conflict of interest for me to provide them with independent financial advice so I would ask them to speak to their accountants.

Franchisees would actually forfeit their deposit and walk away from their franchise! My bosses obviously were not too happy, but I would explain to them that we avoiding long-term pain for short-term gain. In my heart and mind, I knew that some of these prospective franchisees made the right choice. They were the lucky ones.....

For the countless of franchisees, who did not undertake a professional and effective due-diligence process, the ramifications are enormous when things go pear-shaped. Yes, millions of dollars of hard earned savings go down the drain, but I was traumatised by the human costs, the marriage break-ups, emotional disorders such as depression and anxiety, self-harming addictions, just to name a few.

I can tell you that one of the biggest reasons of franchise failure is the absence of a proper, well thought out and effective due diligence process, one that is focused specifically on the nuances of the franchise industry.

Emmanuel Martin CPA, June 2018

INTRODUCTION Cont.

Yes, there are requirements for all new franchisees to carry out an 'independent' financial assessment of future franchise business performance. But in many cases, prospective franchisees rely on finance professionals who are not ' franchise street smart.' Even worse, many decide to take a shortcut and skip this process altogether.

Due-Diligence is often focused on financial considerations, but in my experience, the critical factor often neglected is the honest and heartfelt assessment of whether the franchise business is suited to the franchisee's; mindset, personality, strengths, and lifestyle.

Effective Due-Diligence is about matching a prospective franchise opportunity with the aspiring franchisee's body, mind, and soul.

The Nightmare Chronicles

When Things Go Wrong as a Result of Not Undertaking an Effective Due Diligence Process.

CASE STUDY 3

Case Study 3: Cashflow and Due Diligence: It's about the long game. 1950

I define Due-Diligence as the systematic, structured and conscious process that allows you to make an informed and timely choice on whether a given opportunity is the right one for you. To bring this to a franchise perspective, Franchise Due-Diligence is the process that a prospective franchisee undertakes to determine if a particular franchise opportunity is suited to them.

In the first two case studies, I highlighted the human element of why proper and effective due diligence is a critical exercise that needs to be carried out before a franchise opportunity is taken up. Running a successful franchise or any business, for that matter, involves playing a well planned and strategic game of managing people, product and money.

So why am I using the term game?

Running a franchise is like playing a game. A game usually involves competitors playing against each other to win. A game also has a time constraint. There are spectators, a coach and sometimes even a referee. Like a game of sport, the game of Franchising is usually based on multiple competitors. If the franchisee were a player, the coach would be the franchisor and the crowd the potential customers. Of course, the opposing team would be the franchisee's competitor, and the referee reflects the Franchising Code of Australia. Most franchise businesses are offered for a set time period based on the franchise agreement.

Unfortunately, I have seen many cases of franchise agreements terminated before the end of the franchise term. From our sporting analogy, the franchisee couldn't make it till full time.

While one of the main reasons why Franchises fail, as you may have read in previous case studies, involves the human equation, that is that the franchise did not suit the lifestyle, values, and expectation of the franchisee, an equally important factor for franchise survival is good old-fashioned Cashflow.

During the due-diligence process, it is very important for the prospective franchisee and their business advisors to formulate an accurate cash-flow projection.

Emmanuel Martin CPA, June 2018

STUDY 3 Cont.

However, coming up with an accurate cash-flow projection is not a straightforward process. I will explain the reasons.

1. Many prospective franchisees are new to franchising and running a business, and for prospective franchisees who come from a corporate nine to five environment, understanding cash-flow requirements for operating a franchise could be very difficult. This is simply because they have not been exposed to running a business.

2. I have seen many examples of existing franchise businesses sold by manipulating financial statements through incorrect or creative accounting.

3. When investing in a greenfield franchise model, where there are not many existing franchisees who have traded for a reasonable amount of time, historical financial information may not be available or may be incomplete.

4. Even in larger franchise systems, extra care needs to be taken when assessing new store or territory opportunities as sales and other financials can only be forecasted due to unknown variables at play.

5. Due to legal liability imposed by the Franchising Code and other regulatory safeguards, Franchisors generally do not share historical financial information for fears of legal action through possible misrepresentation.

So with the above reasons in mind, producing an accurate short term and long term cash-flow projection is an important part of effective due diligence.

Through my journey, mentoring and coaching franchisees I have come across many examples of franchise failure because they simply ran out of cash in operating the business.

I remember in one instance a franchise in Perth had borrowed close to 100% of the initial franchise investment through a combination of a business loan and a drawback on equity of a residential property. The young couple had grossly understated the breakeven (sales needed to cover their costs) of the business. Less than 12 months after purchasing a franchise, they were broke and

Case Study 3 Cont.

When I worked through the numbers with them, it was obvious that they did not properly review the existing financials of the business they had purchased. They also didn't take into account increasing rent and competition in the shopping centre. They told them that they used their family accountant who did not have experience in the franchise industry. They had borrowed to a point where they could not cover their loan repayments due to the slow growth in sales.

I worked with a franchisee in Melbourne who was struggling to make ends meet. She opened a brand new café in a neighbourhood shopping centre and after three years was ready to throw in the towel. When I reviewed her books, it was apparent to me that she had borrowed too much money to start off with and her profit barely covered her repayments. She started falling behind of GST and Superannuation payments (which is very common) after the first year. By the end of the second year, she owed the Tax Office close to $50,000. She negotiated a payment plan with the Tax Office, but rising overheads lead her into more financial distress. Luckily with some coaching and mentoring, she managed to turn her business around and eventually sold it with over two years left on the lease. She was one of the lucky ones.

As part of the due-diligence process, I recommend as a rule of thumb, a three-year cash-flow projection is a bare minimum.

The Cash-flow forecast should take into account:

1. A thorough investigation of any historical financial information that has been provided. If there is minimal financial information provided, I would be questioning the profitability of the existing business.

2. Any financial information that is represented during the due-diligence process should be ideally benchmarked against the specific franchise network's or industry-wide financial ratios. Don't be afraid to ask the prospective franchisor for as much information as possible. If it doesn't feel right, you should consider looking for an alternative franchise model.

3. When forecasting future financial performance, the rate of sales growth should be scrutinised in line with the amount of competition, market conditions and franchisee's experience in running a business. Other cost considerations such as Repairs and Maintenance, Rent Increases and changes to Employment Awards and Legislative changes are important.

4. The number of hours an owner will actively work in the business and how they will remunerate themselves for their time working in the business. Sadly, there are too many instances of franchisees working in the business with no or minimal drawings and wages, just to keep the business operating.

Emmanuel Martin CPA, June 2018

Case Study3 Cont.

At the end of the day, the old saying, Cash is King, is very relevant in franchising. The prospective franchisee needs to predict long-term cash-flow of the prospective franchise business as long-term planning is key to achieving ultimate success.

Here is a simple rule. When choosing an independent business advisor or accountant during due-diligence, make sure they understand franchising. Just like doctors who specialise in various fields, it makes a lot of sense to choose a financial professional with a proven track record in helping franchisees and understands the complexities of the franchise industry.

This is the last volume of the first 3 volume edition of The Metamorphosis Project The Nightmare Chronicles: When Things Go Wrong as a Result of Not Undertaking an Effective Due Diligence Process.

We would be happy to hear from you!

We hope that this series has inspired you to continue with your business journey and has given light to the logistics of any future endevour in small business or prospects into franchising.

Click here
To give feedback or request more case studies

We work with many different clients in the small business sector and have valueable insights into more specific case examples of poor and good due dilligence. If you have not found the answers that you have been searching for, please submit your feedback and let us know.

Did you miss the first two case studies? No worries. Download them below now.

Case Study 1: When Business Partners are not aligned on the decision to buy a franchise.

Case Study 2: When A Franchise Purchase is not aligned to the changing lifestyles.

Emmanuel Martin CPA, June 2018

SUMMARY

Before you start your journey

If you are reading this section, hopefully, you have gained a lot of value and insight into the franchise Journey, and how it can all go wrong.

I am a big fan of franchising. Watching franchisees succeed gives me a thrill. In fact, my big WHY, in relation to my consulting business, was to see franchisees succeed so that I can live a prosperous and happy life. As I mentioned, we are very excited, in association with Eden Exchanges to provide exceptional due-diligence services to prospective franchisees.

I do hope to see you further on your journey as a very successful franchisees.

Remember, effective due-diligence is crucial before you choose a franchise.

I hope you make a well informed, thoughtful and productive choice.
Happy journey,

Emmanuel Martin
Founder
The Metamorphosis Project

Phone: +612-96275130
E-mail: emmanuel.martin@metaproject.com.au
http://metaproject.com.au/

Eden Exchange
Phone: +61 3 8658 2292
E-mail: info@edenexchange.com
www.edenexchange.com