South Africa Siyasebenza

CASE STUDY SUMMARY: JOBS FUND PROJECT TO SUPPORT NEW FRANCHISEE BUSINESSES

Summary of a report prepared by DNA Economics for the Jobs Fund on supporting Franchisee development in South Africa.

Given the high failure rate of small, medium, and micro enterprises, franchising is seen as a means of enhancing an SMME's chance of success. Government, through the Jobs Fund, has put its support behind an initiative to expand the franchise sector by assisting targeted beneficiaries access the capital, skills and support needed to establish and sustain a franchise enterprise. This note highlights the key outcomes and findings that have emerged from a case study of this initiative.

Franchising as a means of success for SMMEs

Making up a significant proportion of enterprises in the South African economy, small, medium, and micro enterprises (SMMEs) are widely acknowledged to be a contributor to economic growth, a significant source of employment, and a key driver for more equitable wealth distribution. But the success of SMMEs is inhibited by several factors such as a lack of capital, high levels of debt, and poor management skills.

Franchising is seen as an attractive way of overcoming some of these challenges as it gives a small business owner ("the franchisee") the right to sell a product or service as an "independent" business, while operating under an agreed set of principles and processes set out by the franchisor (owner of the brand). Under this "hand-holding" model, the franchisor provides support to the franchisee in the form of well-developed business systems and brands, marketing, oversight and monitoring support.

Within South Africa, franchising took off in the 1960s, when a number of large franchise brands began operating in the fast food sector. Since then, the franchising concept has continued to grow. In 2014, franchising generated approximately R 465 billion in turnover, with close to 330,000 employees.[1]

While the franchise model is prevalent in many sectors, this system is still predominantly found in consumer facing sectors, such as food and consumer retail. This may be related to the fact that these sectors are brand-focused, are comparatively less capital-intensive and may be less operationally complex. However, these sectors are also most directly impacted by cyclical changes in economic activity.

What are the barriers to entry?

Franchising presents two key challenges to new entrants and prospective small business owners. First, the purchase and operation of a

[1] Based on the FASA's survey of the franchise industry in 2015.

franchise business can be costly, with the franchisee required to cover the total cost of the business (start-up costs and working capital requirements) upfront.

Franchisors often require that at a minimum of 50% of these total set-up costs be covered by the franchisee's own equity contribution. For a small business owner, unable to access finance through commercial avenues, the high start-up costs and substantial own contribution requirements may act as a barrier to entry.

Second, while the risks of business failure for franchise businesses may be lower when compared to starting a stand-alone business, poor management skills, limited entrepreneurial ability, and a lack of oversight and monitoring systems can still spell their failure.

How does the Jobs Fund aim to address these barriers?

Through the Jobs Fund's Enterprise Development window, grant funding has been provided to a project between Business Partners and the South African Franchise Warehouse to support franchise development. The project seeks to improve the success of franchisees over a 3-year implementation period, establishing 125 new franchisees and creating 717 jobs.

This is to be achieved by:

i. **Lowering business and operational risks**. This is done by ensuring that the franchisors selected to participate in the programme have a minimum level of systems in place, and that they are able and adequately capacitated to provide sufficient support to franchisees. The project aims to supplement this franchisor support with non-financial support such as business training and compliance monitoring.

ii. **Addressing the financial gap**. Using a mix of concessional finance and commercial funding, the own-equity contribution requirement for the upfront capital is reduced to 20%. While this does raise the level of gearing, the remaining 80% of the upfront capital requirement is provided as an unsecured loan by the project at concessional rates. Of the 80%, 30% is funded directly from the Jobs Fund grant, while 50% is provided by the commercial financing partner of the project. The concessional rate is aimed at reducing the cost of capital, thus reducing the debt repayment burden on the newly established franchise business.

The project has introduced concessional funding for franchising at a time when one of the largest public funders for franchise businesses has exited the sector as a result of a strategic shift in focus. This suggests that, while other sources of development finance are available to potential franchisees, the project has been established at an opportune time.

The project follows a multi-stage process. First, potential beneficiaries complete a mandatory five-day business management training programme in which they receive a range of business skills necessary to develop a viable business plan for their chosen franchise. Approved business plans move on to the second stage in which they are considered and approved for funding. Once the business is established, the franchisee receives ongoing support from both the franchisor and the project.

Effectiveness of the project

The franchisors accredited to participate in the project were primarily mid-tier franchise brands, where expansion and growth opportunities are higher. In addition, these franchisors are willing to lower their own-equity requirement (accepting a high gearing ratio), something Tier 1 brands find an unacceptable risk.

The challenge however, is ensuring a balance between a franchisor's focus on growth and store roll-out and the need for adequate operational and franchise systems to effectively support new franchisees.

The beneficiaries selected to participate in the project also affects the likelihood of the franchisee's success. As such, the project aimed to attract beneficiaries with some level of entrepreneurial ability. This was achieved, with 85% of participants in the business management training programme considered to be skilled[2], while almost 50% had prior experience in running their own businesses.

The 5-day business management training (BMT) provided at the onset of the beneficiary's participation was found to be useful by 94% of participants. The major challenge encountered during the training stage and the development of the viable business plan, is the heavy reliance by the potential franchisee on the franchisor for revenues and sales forecasts. In some instances, franchisors have not provided rigorous forecasts, resulting in franchises established on overly optimistic projections.

There is a key disjoint between the number of beneficiaries trained and the number of applicants that have been approved for finance. This high rate of attrition is due to a number of factors, including the unavailability of, and inability to secure, sites. The ability to negotiate effectively with property owners was identified as key hurdle in for this project, as well as for other, development finance institutions that provide loan financing for franchisees.

There appears to also be a high rate of rejection by the financing committee of the project, and it appears that the various partners within the project can improve the alignment of expectations and desired outcomes from the beneficiary selection process. This includes agreeing upfront on the sectors to be targeted and the exact profile of candidate that needs to be targeted. Improving this process can increase the project's efficiency.

Once the business is established, the franchisee, and success of the business is heavily dependent on both the franchisor and the project for ongoing mentorship & support. More established, successful (Tier 1) franchisors employ a comprehensive franchise system that both guides the franchisee and restrains it from undertaking activities outside of the accepted franchise procedures.

However, newer, less established franchisors (including those being targeted by this project), often have systems and support processes that are less developed and refined. As such, the level of business support provided by the franchisors in the project is significantly below franchisee expectations. The project's franchisor accreditation system aimed to identify those franchisors that have

[2] Occupying a managerial or professional position.

adequate systems and direct support from the project was intended to be supplementary.

After ensuring that the business is properly established and that the relevant agreements are in place, the project would provide ongoing mentoring and virtual monitoring (through proprietary software) of franchisees for a period of 3 years after the establishment of the franchise operation. This post-implementation support was intended to act as an "early warning system" rather than to provide operational and business coaching support to the established franchisees.

It was expected that accredited franchisors would intervene and provide the necessary support as and when necessary. However, given the limited support provided by the franchisors, the support from the project has generally been "above and beyond" the services and support provided by the franchisor.

Issues of sustainability and impact

At the time the case study was completed, the project was **well short of its franchisee establishment** targets. As at April 2015, only 17 franchises had been established, against a target of 107[3] (16%). This in turn meant that the project was also falling well short of its job creation target, with only 142 jobs created at the time, against a target of 615 jobs[4] (23%). On average each franchise established had created roughly 8 jobs. At that stage, it appeared unlikely that the project would achieve its full 3-year job creation targets, particularly given the significant risk that a number of the 17 established franchisees were expected to fail in the following months.

In terms of the sustainability of the funded and established enterprises, **almost all franchisees funded at the time of case study were performing below expectations**. The number of franchisees that had failed, or were close to failing, was also substantially higher than originally envisioned by the project. The poor performance of franchisees appeared to be largely due to external factors (such as the poor overall economic climate) and early internal factors linked to the business application (such as substantial delays in the process and overly optimistic sales forecasts provided by franchisors) rather than because of poor management and operation by the franchisee. Furthermore, a significant number of franchisees that were still in existence at the time had also stopped loan repayments to the project, either by agreement with the project or unilaterally

By June of 2015, it was clear that the **sustainability of the** project was a concern, as the higher than expected failure rate (and overall poor performance of franchisees) has a number of implications. The first and most obvious implication is that failed franchisees are not likely to be able to repay the loans that have been provided. This is an immediate and direct loss to the project's funds available for financing beyond the project's term.

Second, the costs of recovering funds through litigation may be higher than was anticipated by the project (given the higher than anticipated failure rate). The higher than expected administrative costs can diminish the potential scaling up of the project and may

[3] Target two years into implementation.

[4] Target two years into implementation.

make it averse to continuing with the project beyond the contracted term.

Additionality of the intervention

Funding is considered "additional" if it does not crowd out commercial providers of funding. A first indication would be if applicants actually attempted to access finance from commercial funders. Had they been rejected by the commercial funders, but funded by this Jobs Fund supported project, the funding would have some level of additionality. At the time the case study was carried out, this however is not the case as the survey of participants in the BMT suggests that participants did not approach other financing institutions.

In addition, one-third of respondents indicated that they would have been able to raise 50% own-equity required by their franchisor. This further suggests that the additionality of the project's funding was limited at the time. The re-structured model now places specific emphasis on this and a rigorous beneficiary selection process is in place.

Implications for franchise interventions

Given the number of internal and external challenges with the original model of the project, between October and December 2015, the implementing partners and the Jobs Fund team jointly embarked on a re-structuring exercise to improve the project performance. Many of the changes that have since been implemented were also captured in the case study.

The first change that was needed was to **broaden the portfolio of franchisors**, with the project targeting both mid-tier and top tier franchisors. The major benefit of this approach is that in addition to brand and reputational benefits, top tier brands (i) have greater market power allowing them the ability to better negotiate with landlords when securing sites; (ii) have a readily available pool of approved candidates who can participate in the project with the full backing by the franchisor; and (iii) are better able to assist in the development of business plans as they are more in tune with "on-the-ground" economic activity.

The original **accreditation of franchisors process needed to be strengthened** in order to better assess mid-tier franchisor business support systems, including the ability to provide more accurate and reliable forecasts for potential franchisees. The ideal franchisor would be those that are looking to expand (more aggressively than well-established franchises), while also providing sufficiently strong support to franchisees. This would provide a "sweet-spot" for new franchisees, who would be able to establish a sustainable franchise business with adequate support, at a substantially lower cost than top tier franchises.

From a financing point, the **original high level of gearing and capital repayment did not work**. The essence of the revised model implemented from April 2016 is that the Jobs Fund portion of funding for start-up franchises is now treated as in the nature of equity for the period in which the senior debt is repaid. This lower debt to equity ratio linked with the technical assistance/business skills training and mentoring offering immediately created traction amongst the top tier franchise brands in the country. An alternative approach which the current model did not adopt involves exploring ways to reduce the cost of capital for new franchisees to levels offered by other development financers.

The project team also identified an **opportunity for greater risk sharing across financier, franchisor and franchisee,** especially when targeting mid-tier franchisors that are focused on expansion and who may therefore be more amenable to alternative funding and ownership models. Here, the franchisors are encouraged to take an equity stake in the franchisee over the short- to medium-term, giving the franchisor a greater incentive to adequately support the new franchisee.

The re-structuring of the model is yielding impressive results. Since July 2016, 8 new top tier franchise outlets have been opened and these have created 164 jobs. Within the next three months another 216 jobs will be created from a further 9 investments in the project's pipeline.

Overall, franchising appears to be a useful model for SMME development. However, this model is not immune to the pitfalls that face other interventions targeting SMME development. These include ensuring that the intervention is correctly designed, partners and beneficiaries are carefully selected and that the right barrier is being addressed. Some critical design and market factors for effective franchisee support include the provision of upfront franchisee fees, lowering the cost of capital, reducing business risk for new franchisees, offering business support and mentorship and selecting franchisors that have well established systems and effective brand support.

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