Briefing Paper

fieldfisher

Being Part of the Crowd:

Mini-bonds, crowdfunding and alternative financing for franchise growth

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The development and growth of franchise networks relies on the availability of accessible funding. When a business is ready to expand – whether organically and through a franchise model – it requires capital either to invest in its own additional sites, or to develop its franchise infrastructure such as writing its operations manual, preparing the necessary legal documents and franchisee recruitment programme.

Similarly, prospective franchisees require funding to purchase a franchise and make the necessary initial investments in it. Restricted access to traditional sources of funding in recent years has seen a growth in alternative finance sources for new franchise businesses and ventures. In particular, there has been growth in two areas; mini-bonds and crowdfunding.

Undoubtedly these alternative finance sources offer the franchise sector a real opportunity for growth but it is important that both the franchisor and franchisee appreciate how these alternative financings work and the potential consequences of using them.

Mini-bonds

Mini-bonds are an innovative and relatively low cost way for UK privately owned companies to raise funds from UK investors. The corporate mini-bond market has grown dramatically in the last few years, as companies search for alternative methods to raise funds.

Key features and benefits of mini-bonds

With mini-bonds, an investor makes an investment in a company in exchange for a "bond" – which is a form of loan. In return for lending money to the company the investor receives regular interest payments and repayment of the principal sum at the end of the term of the bond. So for example, a company may offer a 4 year bond providing 8% interest.

Whether it is a franchisor or a franchisee that is seeking funding, mini-bonds offer some attractive benefits over traditional funding options:

- an opportunity to raise much needed capital without diluting equity ownership of the franchise company – the shareholders remain unchanged;
- funds can be raised without incurring the costs and delay associated with an issue of shares;
- there is no restriction on the size of fundraising;
- mini-bonds are typically offered by more established franchise businesses – typically either the franchisor looking to expand or an established franchisee looking to fund the acquisition of additional franchises;
- the publicity generated by the offer of mini-bonds increases awareness of the company's brand and products and services;
- mini-bonds are a great way to involve customers, clients or fans in the development or growth of the issuing company;
- they provide access to non-bank finance; and
- there is much greater flexibility in the terms upon which the funds are raised and their purpose.

How do mini-bonds work?

Mini-bonds are small units of debt issued by a company. Subject to certain essential characteristics, the terms of the debt can be tailored to the requirements of the issuing company. They are very similar to a conventional retail bond, except they are not listed on the London Stock Exchange and are commonly not transferable.

The mini-bonds are created by way of a legal instrument, and offered to the UK public by way of an "invitation document". Within the limits set out below, there is scope for the mini-bonds to be structured so they suit the requirements of the issuing company. For example, the issuing company can set repayment terms, interest levels, and whether interest will be paid in cash or by way of products or services. It is not uncommon for the issuing company to offer incentives alongside cash interest, such as credits that can be used to pay for in-store items or discounted electricity rates.

There are two legal regimes that apply to the bond offer; the prospectus regime and the financial promotions regime.

Mini-bonds are classed as "securities". Ordinarily, any offer of transferable securities to the public requires the publication of a prospectus which has been pre-approved by the Financial Conduct Authority. The preparation of a prospectus is a costly and time consuming process so, to avoid this, mini-bonds are usually not transferable in any circumstances. Making the mini-bond non-transferable is sufficient to bring a mini-bond offer outside the prospectus regime. Note, however, that it is possible to offer transferrable mini-bonds, provided the total amount sought under the offer is restricted to less than €5 million.

Even though no prospectus is required, all communications promoting the offer will be regarded as "financial promotions". Under section 21 of the Financial Services and Markets Act 2000, no financial promotion may be issued unless it is issued or approved by an FCA authorised person. It is very likely that there will be no exemption available in the case of a bond offer open to the general public and accordingly, an FCA authorised person must approve the invitation document and all related promotional material as financial promotions.

If a company were in a position where it had to publish a prospectus, there are very detailed requirements for what should be contained in the invitation document. Because mini-bond offers do not call for a prospectus, but are instead financial promotions, there is no prospectus type list of mandatory content requirements. However, there is a general obligation that all elements of the promotion are "fair, clear and not misleading". There is some guidance as to what this phrase means but it is largely a matter for the FCA authorised person to determine as part of their approval process. There is no requirement to show financial information for a specific period, but the FCA authorised person will want to ensure that there is sufficient financial information to give investors a full understanding of the business they are being invited to invest in.

With effect from 2014, the FCA introduced additional requirements on the FCA authorised persons approving mini-bond offers. Before making a direct offer financial promotion, authorised firms now need to check that a retail investor is appropriately certified. In practice, this means that each person wishing to invest in mini-bonds must confirm that they will restrict themselves to investing only 10% of their net investible financial assets in 'non-readily realisable securities' such as mini-bonds. In addition, FCA authorised firms must conduct an appropriateness test before allowing any of these investors to invest.

These additional requirements can be satisfied by FCA authorised firms on an individual basis, but some crowdfunding organisations, such as Crowdcube, have built these features into their infrastructure and now offer an excellent forum for conducting mini-bond offers.

Crowdfunding

As the same suggests, crowdfunding is a way of raising capital from a large number of investors in relatively small amounts to fund a business, project or venture. This is often done through online platforms and can reach thousands of potential funders.

There are three principal types of crowdfunding:

- Debt;
- Equity; and
- Donation.

Debt investors lend for financial returns by way of interest, bypassing intermediaries such as banks. The investment can be by way of mini-bonds, as described above.

Equity investors, depending on the policy of the crowdfunding platform, either receive shares in the company or contribute to a fund that invests as a nominated agent.

Key features and benefits of equity crowdfunding

Crowdfunding offers some attractive benefits to a franchise business, including:

- investors can share in the growth in the value of the underlying franchise, with the potential for additional dividend income;
- crowdfunding is typically offered by start-up, early stage and growth businesses so this model is a good fit for both businesses looking to kick start their expansion (either organically or through a franchise model, or typically a hybrid of both) and those looking to raise funds to buy their first franchise;
- although restricted to raising no more than €5 million this will not, within a franchise context, create any difficulties as the investments sought by both franchisors and franchisees is likely to fall significantly below that cap; and
- importantly, there is no requirement on the company to make interest repayments.

How does equity crowdfunding work?

The legal framework around equity crowdfunding is very similar to that of mini-bonds, except that the companies are offering shares in themselves, rather than units of debt.

The applicable legal regimes are the same; there is a prospectus and financial promotions regime. With regards to the prospectus regime, shares are always transferrable and therefore every equity crowdfunding offer must be restricted in size to less than €5 million. Thereafter, the financial promotions regime will apply exactly as described above – so an invitation document must be prepared and approved by an FCA authorised person, who will need to ensure that the document is fair, clear and not misleading and that the offer is only made to persons who satisfy the FCA's new criteria.

The differences between debt and equity crowdfunding

Debt and equity crowdfunding share many features, in particular the relative ease and cost-effectiveness with which they allow growing businesses to access finance.

However, by definition, debt fundraising calls for companies to deliver regular interest payments to investors. In order to be able to offer this, companies need to be confident that they will generate sufficient revenue to meet the interest payments, as well as repay the capital at the end of the term, and this will be a key element that the FCA authorised person will want to review as part of their approval process. This is of particular relevance to a potential franchisee considering using debt crowdfunding as a means to raise finance to acquire and fund a franchise. The franchisee must satisfy itself and the FCA authorised person that it can afford to make the interest payments in addition to the

payment of franchise fees to the franchisor. As a result, debt crowdfunding is more suited to established businesses with a track record of revenue generation that they can base reliable forecasts on. If they can meet these requirements, companies can enjoy the ability to seek any level of funding without diluting ownership of the business.

For potential franchisees or companies looking to fund their early franchise growth, equity crowdfunding may be more appropriate. With these propositions, there are no guaranteed interest or dividend payments and investors understand that capital appreciation is not guaranteed. Smaller sums can be raised and investors take a share of the ownership of the business – but this can provide vital capital at an early stage of a business's growth or when a potential franchisee is looking to raise funds needed to buy into a franchise.

The crowdfunding difference

There are a number of factors which make crowdfunding and franchising a natural fit. For a start, crowdfunding is aimed at companies with lower investment needs (less than €5 million) – ideal for a potential franchisee or a business looking to raise sufficient capital to fund the creation of a franchise network. It is also a great way to connect with existing and potential customers, particularly for a local franchisee. If a new franchisee is lucky enough to have a few hundred local investors funding its business, those investors provide a natural client base. It also serves to weaken the argument that franchise brands are really just big corporate players moving into local communities. That has never been the case when the franchisee is usually a local small business itself. However, having a group of local investors in the franchise can promote the sense that this business (and the brand) is local.

It's not only the local franchisee that can benefit from the loyalty of its investors; the brand-owning franchisor can experience a similar effect. The recent 8 per cent four-year mini-bond issued by Mexican restaurant chain Chilango is a good illustration of the two-way relationship between funders and the brand. Investors in their "burrito bond" are typically already fans of the brand or, if not, are likely to become so once they invest. Chilango tapped into this cross-over by offering giving all investors two free burrito vouchers and those investing more than £10,000 received free food for the entire duration of the bond.

Crowdfunding is not without its own risks. For example, if potential franchisees are now able to access funds where previously they could not have satisfied the bank's lending criteria there is a risk that franchisors might accept franchisees and locations that they otherwise would not consider to be viable. Crowdfunding does not impose the same controls as traditional bank lending. Franchisees that sourced finance from traditional routes were required to satisfy potentially strict bank lending requirements. In contrast, crowdfunding does not impose the same controls and therefore runs the risk of allowing less prepared franchisees to enter the network. Franchisees are often driven to succeed through a realisation that their own investment is at stake. If franchisees are not investing their own money then there is always a risk that their motivation – and fear of failure – will not be as acute as a franchisee who has invested everything into the venture.

Finally, crowdfunding has the potential to increase the existing natural tension between franchisor and franchisee. Franchisors typically calculate their service fees based on a percentage of the franchisee's gross revenues whereas in contrast the franchisee's focus is on net income. Crowdfunding investors share a similar perspective to the franchisee, with a focus on net income, and it is not hard to imagine the pressure that a large group of investors might exert on a franchisee to increase net income through, for example, aggressive price reductions and promotions.

Whichever route is chosen, it's becoming increasingly clear that crowdfunding has a role to play in financing growing businesses. Commentators talk in terms of "democratising finance" - allowing new businesses to bypass traditional banks, who may not be lending to small business in the current environment, and instead reach out directly to the public. It's a fast-moving and growing area that every franchise business should be considering when seeking funding for a new business idea.

Fieldfisher has worked on many corporate mini-bond issues, having been instructed on approximately a dozen corporate mini-bond issues to date. For further information please contact the authors:

David Bond
Partner - London

E: david.bond@fieldfisher.com

George Cotter
Partner - London

E: george.cotter@fieldfisher.com
T: +44 (0)20 7861 4531

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