SO YOUR CLIENT IS THINKING OF BECOMING A FRANCHISEE

A Business Overview and Some Practical Considerations

Presented on behalf of the
Business Law Section of the California State Bar
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AN INTRODUCTION

Franchised businesses accounted for in excess of One Trillion Dollars in sales in the United States in 2000, making up over 40% of all retail sales and employing in excess of 8,000,000 people. One out of every twelve business establishments is a franchise, in almost 80 different industries, of which fast food is only one. A new franchised outlet opens every 8 minutes, adding to the existing base of 472,206 franchised units.[1]

It could be fairly said that franchising is "only" the most successful method of product and service distribution developed during the past hundred years. Notwithstanding that, its visibility among business lawyers is probably still at the level of a stealth aircraft. Its visibility among businessmen and women is at an entirely different level, however.

Given the tremendous success of the franchised form of doing business, it's understandable that a significant number of people consider franchising their businesses or purchasing a franchise. Many of them view it as an almost "automatic" road to success.

The reality is different. No method of business operation, including franchising, guarantees success, either for the Franchisor or the Franchisee. Substantial numbers of franchise systems never evolve beyond 15 or 20 units, some ultimately collapse and individual Franchisees can fail in their businesses, just as non-franchised operators do.

For the Franchisor, success will be based not on his or her knowledge of the underlying retail business, or even the quality of the product or service, but on the ability of the Franchisor to learn the skills related to franchising, which is a profession in and of itself.

For the Franchisee, success will be based on three primary factors:

1. the Franchisee's ability and willingness to work within a pre-existing system, helping to build the value inherent in the brand,
2. the inherent validity of the business model, and
3. the skill of the Franchisor in managing the franchise system and development of the brand.

[1] Figures courtesy of the International Franchising Association.

The challenge for this presentation is to summarize, in a few minutes, some of the more important considerations that lawyers for both Franchisors and Franchisees should be aware of in advising their clients and which I believe drive the potential success of franchise systems. Let's begin by discussing some overall business realities as they relate to franchising.

SOME FRANCHISING BUSINESS REALITIES

1. Franchising makes sense at the retail level only if belonging to a franchise system gives the retail units competitive advantages, over other participants in the industry, that more than make up for the costs of belonging to the system.

2. If belonging to the franchise system does not give the Franchisee a competitive advantage, as compared to other participants in the industry, the franchised units will not be successful, since they have to bear the additional costs of royalties, mandatory advertising contributions, etc., may be less nimble in responding to market changes, etc. And, if the retail units are not successful, the system will not be successful.

3. The primary factor in increase in value of a franchised retail unit is the component related to the value of the brand. This is why a McDonald's restaurant is more valuable than a David's diner! If the brand does not increase in value, the franchised units will not increase in value.

4. The Franchisor and its Franchisees have, therefore, a single, unifying objective: **Building the value of the brand**, which should be their top priority. All other business objectives are secondary. Retail chains that do not build the value of their brand will — to be blunt — fail.

5. **Brand value is more important than anything else**, including (perhaps especially) product quality. McDonalds and Century 21 did not become industry leaders based on supplying a superior product; they did so through successful retail marketing and system-wide uniformity in presentation of their products and services to the customer.

6. Successful franchise systems are uniformly characterized by the overall strength of the system and consistent application of standards, operating systems and uniform presentation of a retail experience to the buying public.

The brand is valuable only to the degree that a strong system, with competitive retail advantages, is present.

There just aren't any examples of successful franchise systems where they have varying standards, a poor record of Franchisees following the system, inconsistent presentation of the product or service, etc. (McDonald's triumph over Burger Chef, and KFC's triumph over Chicken Delight are representative examples.)

In a successful franchise system, the customer's loyalty is, in general, to the brand, **not** to the individual unit, as emotionally difficult as that may be for Franchisees to accept. (Note that, in some service businesses, this effect may be somewhat reduced.)

7. What's critical from the retail consumer standpoint is creating a "comfort zone" through consistent operational and marketing systems. A franchise system does this by doing two things:

- Making itself unique as compared to the competition.
- Avoiding confusing the customer.

The system does this through building brand identity and providing a consistent presentation of the product/service and the marketing message.

The job for the Franchisor is to think deeply about how the system will maximize its uniqueness, as compared to competitors, in a way that positively distinguishes the brand from competing systems and thereby gives its Franchisees a competitive business advantage.

The job for the Franchisee is to consistently implement that system and build value in the brand, while providing "real life" input back to the Franchisor as to how the system can be improved from an operating standpoint.

8. All franchise systems face what we call "centrifugal pressures": Without strong standards and the Franchisees' emotional commitment to them, human nature is such that people will go their separate ways and the system will fail due to inconsistent messages to the consumer and a loss of strong brand identity.

9. Individual Franchisees are tied to both the Franchisor and the other Franchisees in the system; if Franchisees fail to present a uniform retail experience to the customer, the Franchisee's investment in the brand will be wounded, just as if the Franchisor fails to enforce strong system standards or fails to adapt to changing business realities.

IMPORTANT THINGS A FRANCHISEE NEEDS TO KNOW AND DO BEFORE PURCHASING A FRANCHISE

1. A Franchisee needs to have done "due diligence" in investigating the Franchisor and the satisfaction (or dissatisfaction!) level experienced by current and past Franchisees.

At a minimum, the Franchisee should have spoken with a significant number of the existing Franchisees (including anyone who has been in a relationship with the Franchisor such as a “license”), and those who have left the system, to ask them a series of questions regarding their satisfaction level, <u>after</u> verifying that the person the Franchisee is speaking with has no connection (family or otherwise) with the Franchisor.

Also, remember that face-to-face meetings are generally far superior in eliciting information than telephone calls.

For example, answers to questions such as the following would be very relevant:

- Are the Franchisees satisfied with the performance of the business?

- Are they making the amount of money they expected to? (They may even be willing to share sales figures with your client.)

- Would they recommend the franchise to their best friend or a close relative?

- Do they see any problems with starting this business in the area where the prospective Franchisee will be operating?

- What would they tell a prospective Franchisee to be concerned and/or careful about?

- Do they plan to expand to additional locations?
- Do they enjoy the daily operation of the business or has it become unpleasant and stressful?

- How would they rate the performance of the Franchisor on a scale of 1 to 10?

- Did what the Franchisor tell them prior to their purchase turn out to be complete and correct or was anything untrue or was anything important left out?

- Does the Franchisor honor its commitments?

- How satisfactory was training, site selection assistance, pre-opening and post-opening support?

- Is there an advertising program and how is it working?

- Are fair prices being charged for any items sold to the Franchisee by the Franchisor or any affiliated company?

• Are the estimates of costs to open the business, as set out in the UFOC, accurate and match their experience? In particular, is the amount shown in Item 7 of the UFOC as “Additional Funds” an adequate capital reserve to reach profitability or were they required to dip into savings to support the business?

• Have they reached breakeven yet and how long did it take?

• If they had it to do all over again, or if they could push a magic button and get <u>all</u> their money back, what would they do?

• For Franchisees that have left the system, why did they leave and how relevant were their problems to what a prospective Franchisee might face?

• Who are the primary competitors and who are the primary customers?

2. The Franchisee needs to think about whether or not he or she will be happy operating this business, day in and day out, for a number of years. I’ve seen situations in which a franchised business may be generating adequate returns for the Franchisee but the actual operation of the business (making submarine sandwiches and supervising 19-year old employees, for example) becomes less and less rewarding as time goes on.

3. Even if the business is attractive to a Franchisee, he or she should think clearly about whether franchising, in general, is right for him or her. While franchising can have many benefits, it does involve a significant surrender of freedom to the Franchisor and a Franchisee must be willing to take direction from the Franchisor in a number of areas. There are some businesspeople who may be very effective as independents but who would chafe at the restrictions involved in a franchise or license system and a prospective Franchisee needs to look at him/herself carefully in that regard. True entrepreneurs probably should not apply! Note also that different franchise systems will exhibit a range of control over Franchisee’s operations, with some Franchisor’s exercising a very high level of control, while others may “ride with a looser rein.”

4. In addition, while the Franchisee can, in well-run systems, receive significant benefits from the Franchisor, the Franchisee will have to pay for those, typically through a periodic royalty. Can the retail business support this “load” and do the advantages of being part of a franchised/licensed system more than compensate for this expense, which will otherwise reduce net income from the business? Ultimately, this is related to the question of whether the benefits of participating in the industry as part of a franchised/licensed system more than overcome the costs and restrictions involved.

5. Is this the right Franchisor for your client, assuming he/she wants to participate in the industry and wants to do so in a franchised or licensed mode? Has the prospective Franchisee investigated other Franchisors in the field and

made an objective determination that this one is the best franchise available for the cost?

6. Is the Franchisor a "baby Franchisor," with little experience in franchising? If so, there may be risks that the Franchisor will be unskilled in managing a franchise system, notwithstanding that they may have had many years of experience in the relevant industry.

7. Conversely, is the Franchisor new to the industry? If so, what level of experience and expertise will the Franchisee be tapping into?

8. The Franchisee should be prepared for the fact that the Franchise Agreement and the related business deal will be non-negotiable, which is typically the case with established systems. While baby systems may be willing to negotiate, that may be an indication that they don't understand what elements of their system are critical to success, are willing to compromise core values and are primarily motivated by the need to sell a franchise and meet next month's payroll.

9. The Franchisee should have the UFOC and Franchise Agreement reviewed by experienced franchise counsel.

10. The prospective Franchisee should develop a business plan with conservative financial forecasts, including draft P & L, balance sheet and cash flow forecasts, and then have them reviewed by an accountant operating from a devil's advocate position.

SOURCES OF ADDITIONAL INFORMATION

www.franchise.org (Website of the International Franchise Association.)

Publications Catalog, International Franchise Association. IFA Publications, P.O. Box 1060, Evans City, Pennsylvania, 16033. 1-800-543-1038.

Franchising: The How-To Book, Lloyd T. Tarbutton. IFA Publications, P.O. Box 1060, Evans City, Pennsylvania, 16033. 1-800-543-1038.

The Franchise Option: Expanding Your Business Through Franchising, Ginalski and Henward, III. IFA Publications, P.O. Box 1060, Evans City, Pennsylvania, 16033. 1-800-543-1038.

Franchise Relations Handbook. IFA Publications, P.O. Box 1060, Evans City, Pennsylvania, 16033. 1-800-543-1038.

Franchising for Dummies. IDG Books Worldwide, Inc. (Particularly Chapters 16 and 17.)