IS MY CLIENT'S BUSINESS REALLY FRANCHISEABLE?
or
BUSINESS CONSIDERATIONS IN DECIDING WHETHER OR NOT TO FRANCHISE

by

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BUSINESS CONSIDERATIONS IN DECIDING WHETHER OR NOT TO FRANCHISE

This paper presents, in very brief form, some of the major business considerations in the decision of whether or not an existing business should utilize franchising as a means of expansion and market penetration. Of course, the decision to franchise is a significant one and should be made only after substantial study. In particular, your client should have in-depth conversations with other business people who have utilized the franchising method to learn from their experiences.

WHAT IS FRANCHISING?

From a business standpoint, a franchise can be defined as a long-term, continuing business relationship in which one person or company (the Franchisee) (1) pays another person or company (the Franchisor) for the right to do business (2) under the Franchisor's trademark, trade name, logo or other form of identification and (3) the Franchisor prescribes how the Franchisee organizes, markets and/or operates the business.

While not part of the legal definition of a franchise, many franchises include features such as periodic royalties paid to the Franchisor on a percentage of the Franchisee's gross sales, a common national or local advertising fund and the grant of an exclusive, or other type of "protected" territory.

WHY FRANCHISE?

Historically, franchising offers the means of most rapid possible expansion for a business with limited financial or human resources, allowing a significant number of units to be opened and managed without extensive investment by the Franchisor. In essence, the expansion and related market penetration is accomplished "with somebody else's money," and without giving up equity in the Franchisor, although direct operational control and ownership of operating units, along with any profit potential, is transferred to the Franchisees.

In addition, in a number of franchised businesses, the bottom line contribution to the Franchisor from franchised units may actually be greater than the profitability of Franchisor-owned and -operated stores, due to the greater time, energy and diligence which a Franchisee puts into an operation he or she owns, as compared to a manager who is only an employee.

Finally, a business with limited resources, and operating a concept which can be easily duplicated by others, may face the choice between (a) aggressive growth through franchising or otherwise to gain or protect market share and (b) exposing themselves to competitors or other entrants in the market taking a leadership role and placing your company in a permanent second- or third-level position. Business people often refer to this as the "window of opportunity" scenario.

Historical reasons for the success of franchising include:

- Top-of-mind retail awareness generating a dominant marketing position.
- Brand name drive customer loyalty.
- Consistency and efficiency in operations.
- Ongoing support and controls.
- On-site personal management by the Franchisee.
- Franchisee as source of capital.

What's critical from a business standpoint is that franchised units have enough competitive advantage over non-franchised competitors, deriving from the factors listed above, to more than make up for the costs (royalties, etc.) inherent in operating in the franchised format.

WHAT ARE THE NEGATIVES OF FRANCHISING?

Franchising involves a long-term relationship with people (Franchisees) who are neither your partners nor your employees. The relationship is delicate and, to some degree, "political"; if you're not comfortable working in that environment, you shouldn't go into it.

Franchising is a "legalistic" industry and, while an experienced franchising attorney can guide you through the applicable requirements, you need to be willing to work within various legal restrictions that don't apply to other types of businesses. As always, legal compliance does mean some legal costs but the costs of non-compliance are always higher!

In connection with the decision to franchise, most new Franchisors will need to incorporate the entity actually offering the franchises (generally it's a good idea to make this a separate corporation from any of the client's existing businesses), obtain audited or reviewed financials for the franchising corporation and prepare a franchise agreement and Uniform Franchise Offering Circular, as well as file documents and receive approval from the Department of Corporations in California. Many Franchisors will sustain additional costs in preparing operating and training manuals and marketing materials.

Finally, Franchising is a separate skill, above and beyond the skills needed to successfully operate your underlying business. To be successful, your client will have to make a commitment to learning those skills and applying them on a daily basis. For some businesspeople, their current success level may be high enough that the personal effort necessary to be successful in franchising simply doesn't "pencil out."

IS YOUR CLIENT'S BUSINESS QUALIFIED TO BE A FRANCHISE?

Has your client actually operated a profitable business using the same concept he/she plans to franchise and for a long enough period to eliminate most “bugs” or does he/she merely have a good idea that’s not yet been proven?

Is your client’s product/service sufficiently superior or different to find a valid market niche?

Is the business practical only in a limited geographic or other market or can it expand to enough units to generate adequate royalty income to the Franchisor?

Is the business relatively simple, so that Franchisees be effectively trained, in a reasonable period of time, to deliver the product/service while maintaining quality?

Can the business be systematized and effective operations and other manuals be developed to guide operations in remote locations?

Will the franchised business develop enough revenues to (1) satisfy a typical Franchisee regarding return on their investment and personal net income and (2) support long-term payments of royalties and advertising fees to the Franchisor?

Will the business be affordable, i.e. requiring a low enough investment that your client can attract a significant number of prospective Franchisees?

Will your client be able to provide support services, low-cost products, advertising or other continuing value to its Franchisees over the life of the business so that they will continue to pay royalties and advertising fees and not “break away” from the Franchisor’s system?

Is the industry disorganized, with many small participants, so that a chain with national identity will have a significant marketing advantage and not be dominated by large competitors?

Is the concept relatively simple, so that it can be easily grasped by potential Franchisees and customers?

IS YOUR CLIENT QUALIFIED TO BE A FRANCHISOR?

Does your client work well with and through other people or does he/she prefer to have complete control over the enterprise? In other words, are they comfortable with participatory management or only with a “top down” style of doing business?

Can your client cause other people to perform as he/she wishes without having the ability to “order” them about and fire them if they don’t follow directions?

Can your client manage the relationship with the Franchisee with mutual respect and a clear understanding of respective areas of responsibility and authority?

Is your client comfortable answering the question (on a daily basis sometimes!): “What have you (the Franchisor) done for me lately?”

Can your client provide strategic guidance for your franchise system, thinking about where the industry will be 5 years from now and assisting his/her Franchisees in meeting unanticipated future challenges?

Can your client work effectively in a legalistic and highly regulated atmosphere?

Does your client have the ability to draft an effective business plan and follow it, while being willing to modify it where experience proves it necessary?

Has your client “run the numbers” to validate that they have the financial resources to enter franchising and will not need to award a franchise to a marginally qualified candidate merely to meet next month’s payroll?

Can your client accept and implement suggestions from others without damaging his/her ego?

Is your client personally an effective salesperson? Initially, in many cases, franchise sales will need to be done by the founder of the Franchisor.

Can your client communicate effectively, remembering that communication primarily involves effective listening, not simply waiting for the other person to finish speaking?

Are your client willing to work night and day to make the concept a success, with financial rewards deferred for a number of years?

Can your client teach other people how to effectively run the business?

WHAT SHOULD A “GOOD” FRANCHISE OFFER?

Obviously, the answer differs from business to business, but some of the things offered by many successful franchise systems include:

- Site and/or Market Analysis
- Lease or Purchase Assistance
- Building Design
- Build Out or “Turnkey” Services
- Equipment Selection, Layout and Purchase/Lease
- Management and/or Technical Training - Owner and/or Staff
- Assistance in Recruiting Staff
- Advertising and Other Marketing Support
- Operations Manual
- Centralized Purchasing
- Financial Assistance/Guidance
- Business Plan Development and Tracking

- Recognized Name/Logo
- Ongoing Support - "What will you be doing for me five years from now?"

WHY SHOULD A PROSPECTIVE FRANCHISEE BUY YOUR CLIENT'S FRANCHISE?

First of all, the prospective Franchisee must be convinced that there is a valid need for the product or service offered by the franchised business.

Second, the prospective Franchisee will have to decide whether the initial franchise fee, any royalty obligations and other restrictions under the franchise agreement are balanced by the advantages of a shortened learning curve, economies related to multiple-unit buying power, assistance in finding a site, name recognition or other benefits of belonging to the franchise system.

[Among other things, the prospective Franchisee will want to know if the Franchisor's company-owned units (and any franchised units) have been making money. Note that while this information can be given to the prospective Franchisee in some circumstances, there are significant legal restrictions as to when and how it is presented.]

Third, the prospective Franchisee will need to be comfortable with actually operating the business.

Finally, the prospective Franchisee will probably examine your client's track record (if any) in working with Franchisees that have already joined the system. Since your client will be required to give each prospective Franchisee a list of all of his/her current Franchisees, and any who have left the system in the last 12 months, this is what makes "validation" by existing Franchisees so important and why it's critical that your client's first Franchisees are successful and speak well of the Franchisor's support of them.

SOURCES OF ADDITIONAL INFORMATION

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.)