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FRANCHISING IN AMERICA

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EXECUTIVE OVERVIEW

- This article is one of a continuing series on the business and legal aspects affecting Australian and New Zealand companies considering franchising into the United States and Canada.
- Franchising in North America represents a unique combination of business opportunities and challenges, along with legal issues, and should be initiated only after a detailed consideration of resource requirements and individual company readiness, and with preparation of a clear plan for North American expansion.
- Risks related to the unique American legal environment can be reasonably minimized and should not act as an insurmountable barrier to entry into the North American market.
- A regional subfranchising strategy, as commonly used, presents both risks and advantages as compared to direct franchising or other models.
- Careful planning and consideration of the market, as well as operation of a test retail unit prior to franchising, will be critical to success.

INTRODUCTION

Mature and successful franchise systems in Australia and New Zealand generally come to a point where they seriously consider expansion into North America, whether as a result of saturation of the local market, natural desire to add additional units or through receipt of inquiries from the U.S. or Canada. This article, one of a continuing and expanding series, investigates some of the considerations appropriate to such a decision.

[For the purposes of this article, we will consider the US and English-speaking Canada to be essentially similar markets from the Australian and New Zealand perspective, although there certainly are subtle but highly relevant differences between the two countries. French-speaking Quebec is, on the other hand, quite distinct, although US-based franchise systems have been able to expand into that market with appropriate adaptations.]

OPPORTUNITIES AND CHALLENGES

North America represents perhaps the most attractive market for franchise expansion in the world, particularly for companies with mature and successful systems in Australia and New Zealand. Some of the reasons for this include the following:

- A combined Gross Domestic Product (U.S. and Canada) in excess of ten trillion US dollars (US\$10,000,000,000,000), the largest in the world and a

total population above 300,000,000, with high levels of savings and disposable income, and readiness to accept new concepts.

- Ready acceptance of, and familiarity with, the franchise form of distribution by prospective Franchisees, retail customers, suppliers, landlords, lenders and even government agencies.
- (Nearly!) identical language, culture, legal systems and methods of doing business as compared to Australia and New Zealand, with highly educated and literate employees and professional support networks.
- A stable and low-risk political and economic environment, as compared to many other countries in the world.

At the same time, expansion into North America presents a series of unique challenges and questions to be answered, among them the following:

- As the countries in the world most familiar with franchising, prospective consumers, Franchisees and others will expect a level of sophistication which may be above that in other markets.
- Prospective Franchisees (and, particular, Regional Master Licensees) will have a wide variety of alternative franchise opportunities available to them and may even have prior franchising experience, leading them to demand a superior franchising concept and high levels of after-sales service and support.
- While the US and Canada represent a vast market and, therefore, opportunity, that market is also highly competitive. Few concepts will not face competitive challenges, particularly if the concept proves successful and there are few (if any) barriers to entry by competitors.
- The US legal system, even more than that of Canada, is complex and more prone to litigation than it should be. While those complexities and litigation exposure can be dealt successfully dealt with (as thousands of US franchise systems, as well as “imported” systems, do every day), in part through support of experienced legal counsel, doing business in the US legal environment is both more complex and expensive than in most other countries.

The result of all this is probably a unique blend: The largest and most attractive combined market in the world, as well as the one presenting the most challenging business and legal issues on the planet! The bottom line for most Australian and New Zealand franchise systems is that **if** they are at an appropriate stage of development and do their homework, and are supported by competent US and Canadian professionals with local knowledge, expansion into North America is a viable strategy.

As with any major development in corporate strategy, sound planning is nearly always critical to a successful result. With respect to expansion into

North America, this includes (among many other things) consideration of the depth of financial and (perhaps even more important) human resources available to the Franchisor, adaptability of the concept to the North American market, US/Canadian regulatory issues affecting retail units, costs/availability of real estate, supply sources and other resources necessary for retail operations and other requirements we'll discuss in greater detail in our next article.

This analysis should be reviewed by professionals familiar with the North American market and fine-tuned for the individual franchise system. Australian and New Zealand companies should **not** accept a "cookie-cutter" approach to franchising into the North American market, but should instead insist on a detailed review and analysis particular to their industry and the competitive environment they plan to enter. That will, in the best of cases, result in a clear plan for North American expansion.

ALTERNATIVE STRUCTURES AND STRATEGIES

There are three primary structures Australian and New Zealand companies may use for franchising in North America:

Direct Franchising

In this model, the Australia or New Zealand-based Franchisor (or, as we generally recommend, a company formed for the purpose) directly awards operating unit franchises in the US and Canada so that, for example, a Franchisee in Atlanta has essentially the same relationship to the Franchisor as a Franchisee in Adelaide.

This structure maximizes control by the Franchisor and minimizes certain risks, but can involve slower growth and will often require a higher level of financial commitment and allocation of management resources.

Area Franchising

Here, the structure is largely similar to the direct Franchising model, but with the variation that area franchises are awarded (for example, for all of Dallas), with the requirement that the Area Franchisee open a specified number of units over a defined period of time. Generally, the Area Franchisee pays an area fee, above and beyond the franchise fee for each individual unit, and receives territorial protection for the entire area, for at least the time he or she is required to meet their development obligations.

This approach can result in capital infusions to the Franchisor (in the form of area fees) and may attract more sophisticated and better financed Franchisees, as well as advancing the schedule for franchise unit roll-outs, but experience indicates that a substantial number of Area Developers fail to meet their development schedules, requiring that the Franchisor have an appropriate pre-designed exit strategy to deal with such situations.

Regional Subfranchising

This is the model most often used in international franchising, although it is not always the one we recommend.

In this approach, the Australia or New Zealand-based Franchisor does not award any unit-level operating franchises but instead only awards regional subfranchises covering large areas (all of Southern California, for example, or a single state or group of states), for which it may be paid hundreds of thousands of dollars each. The regional Subfranchisor, in turn, offers and awards, and provides nearly all after-sales service and support to the unit-level operating franchises. Initial franchise fees and royalties are split between the Franchisor and the regional Subfranchisor.

This methodology offers the possibility of rapid expansion, along with substantial fees to the Australia or New Zealand-based Franchisor, but also poses special risks. Errors in complying with complex legal requirements may haunt the development of the system and even pose risks to the Franchisor, and the universe of potential regional Subfranchisors, who can ethically, competently and effectively sell franchises and support the adequately is highly limited.

Note that this overview of alternative structures is limited (it omits, for example, a variation known as Area Representative arrangements.) Look for one of our future articles for more depth and detail on this topic.

Planning, Market Research and Test Units

As noted above, solid planning and professional support will be vital to any expansion strategy. In particular, the Australia or New Zealand-based Franchisor must do the hard work of determining both the attractiveness of its concept in North America and the adaptations necessary to make retail units viable in a new environment. Labor requirements, real estate matters, availability of supplies, government regulations, actual and potential competition and a host of other factors will enter into the changes necessary to adapt a concept and sophisticated Franchisees will want evidence that, as they say in Texas, “this dog will hunt” in a new environment.

One method of performing this adaptation, which we generally recommend, involves the setting up and operation of a model or test unit in the US. Frankly, nothing substitutes in the adaptation process for actual operation of a unit in the area in which one intends to franchise, or can be as powerful a sales tool when the time comes to award franchises.

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.