



# Franchising: An Overview

**Chain Store Guide**

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## Franchising: An Overview

By Linda Helman, Research Editor, Chain Store Guide

Although franchising is typically associated with restaurants, the concept of franchising has grown far beyond foodservice. According to the most recent statistics from the International Franchise Association (IFA), there are more than 765,000 franchised businesses in the US that employ almost 10 million people and generate revenues in excess of \$624 billion.

If you've ever had your car serviced at AAMCO Transmissions or your hair cut at Fantastic Sam's, shopped at retailers Plato's Closet or Play It Again Sports, bought a screwdriver at Ace Hardware or nutritional supplements at GNC, sat with a Decorating Den consultant or a Jenny Craig counselor, had your house exterminated by Truly Nolen or your home cleaned by a Merry Maid, you've probably dealt with a franchisee operation. Children are tutored by franchisees at Huntington Learning Centers or Kumon Math & Reading Centers, play at franchised BounceU locations, develop their artistic natures at Abrakadoodle and get their exercise at Gymboree or Little Gym International. Businesses can get printing services and signs from franchisees, have their offices cleaned by franchisees, have their books balanced, their computers repaired and their Web sites maintained by franchisees. There are franchises to groom your pet, fix your plumbing and repair your car's bumper. Franchise opportunities range from Abbey Carpets to Zyng International and provide an almost unlimited number of goods and services to both consumers and businesses.

*USA Today* reported that what we know as franchising evolved from the Middle Ages practice of tax collectors being allowed to retain part of their payments before sending the remainder to the Pope, or possibly from local rulers authorizing select individuals and groups to hold trade fairs. In the 1840's, German brewers sold the rights to sell their brew to select taverns, and in 1851 the Singer company granted exclusive distributorships for their sewing machines. From these beginnings, the multi-billion dollar industry we now know as franchising evolved.

The IFA has developed 18 broad categories (automotive, baked goods, building and construction, business services, child-related, education-related, fast food, lodging, maintenance services, personnel services, printing, real estate, restaurants, retail food, retail, service businesses, sports and recreation, and travel) which comprise the nearly 2,500 franchise systems that were active at some point between 2002 and 2006. In the past three years alone, the IFA estimates that nearly 900 new concepts started franchising. Illustrating the variety of businesses available for ownership, the *Franchise Times* list of the Top 20 franchise operations includes nine restaurant companies, but the other 11 companies offer franchises for hotels, convenience stores, travel agencies, hardware stores, real estate offices, movie rental stores, and consumer-electronic stores.

So what exactly is franchising? Who are the typical franchisees? What are the upsides and downsides of this method of business? What does the future hold for the franchise industry? And what role does **Chain Store Guide** play in helping its customers do business with this vital segment of the economy?

## Defining Franchising

Franchising is defined by the state of California as “an agreement that grants [you] the right to sell goods or services under the franchisor’s method of operation (‘marketing plan’). It involves the use of the franchisor’s trade name (or similar mark or symbol) and the payment of a ‘franchise fee.’” What many people don’t realize is that there are two basic types of franchising: Product/Trade Name Franchising and Business Format Franchising:

- Product/Trade Name Franchising is typically employed between manufacturers and retailers (car dealerships), manufacturers and wholesalers (soft-drink bottlers) and wholesalers and retailers (similar to a cooperative type of arrangement). Product/Trade Name franchisors allow their franchisees to use the trade names and trademarks but provide little other support or structure. These agreements may also be known as dealerships and distributorships.
- Business Format Franchising is the most commonly known form of franchising and provides the franchisee with a complete business plan that details all aspects of operating a business within that system. The specifics are spelled out in the Uniform Franchise Offering Circular (UFOC), a disclosure document required by the Federal Trade Commission. The UFOC has 23 elements that the franchisor must address, including a detailed business description, start-up costs, franchisor and franchisee obligations, products and services provided, senior level personnel at the franchisor’s main office, current franchisee contact information, growth plans and financial information for the franchisor.

## Who Are Today’s Franchisees?

While there is no “typical” or “prototype” franchisee, there are some groups that tend to be more prevalent among those that go into franchising.

- Many are former managers and executives whose jobs were outsourced or downsized. These people want to feel that they have at least some measure of control over their own professional and financial destinies.
- Military veterans are increasingly making their ways into the franchise systems because they are used to following specific rules and have the self-discipline needed to work within the systems.
- Retired baby boomers are turning to self-employment in increasing numbers – the Kauffman Foundation Study on Entrepreneurial Activity shows that in the past ten years, adults aged 55-64 have been the most likely to start a new business.
- Minority entrepreneurs have become the target of many franchisors, with the realization that there are significant areas of urban neighborhoods that are under-served.
- In addition to its MinorityFran and VetFran programs, the IFA is also targeting women to join the ranks of franchisees through its Women’s Franchise Committee and the efforts of current female franchisees to mentor up-and-coming businesswomen.

## The Advantages of Franchising

Why do so many people go the franchise route rather than start their own operation? Although there are significant advantages to following the business-format franchise model, perhaps most important is the knowledge that this is a business model that has proved successful. The actual rate of business failure is open to debate, but almost every expert agrees that it is high – the Small Business Administration reports that a Harvard University study showed that owners spending six months or less on their business plan had an 80% failure rate, while those with at least a year of planning ended up with an 80% success rate.

Contributing to this high rate of failure are inadequate funding, ineffective marketing and poor management skills. Unlike starting a business from scratch, most of the day-to-day financial and operational factors are well-studied and spelled out in the UFOC, so there should be fewer “surprises.”

Other advantages found in franchising:

- Franchisors want their franchisees to succeed so they provide ongoing guidance and training
- Existing franchisees can offer advice based on their own experience operating the same type of business
- Financing may be easier to obtain for startup and ongoing operations when the trade name and business method are well-known
- Product lines and suppliers are often selected by the franchisor so there is less time required to shop around and find a reliable distributor, and franchisees can often get price benefits from the collective buying power of the system
- The franchisor often specifies the computer technology and accounting systems required to run the business, making one less step in the process of getting a business up and running
- Research and development is typically done by the franchisor, allowing the franchisee to stay competitive and provide its customers with new products and services
- The franchisor has already determined what type of real estate locations best serve the needs of the business and can often provide guidance to its franchisees
- Consumers are more likely to shop at or spend money in an operation that is familiar to them, so having a recognizable trade name on the sign is an immediate marketing advantage
- Any advertising done by the chain is advertising for everyone in the chain. A local unit reaps the benefits of a national advertising campaign

### The Downsides of Franchising

Ironically, some of the same advantages listed above are also the very things that can be cited as the disadvantages of franchising:

- The extremely detailed and specific business plan a franchisee is required to follow often eliminates any possibility of innovation at the unit level. This lack of creative independence and the requirement for strict adherence to guidelines can stifle some people’s drive and need to experiment. For people who are used to making their own decisions, the lack of initiative can be frustrating.
- Some have noted that even though the franchisee is the business owner, the franchisor calls the shots and can terminate or chose to not renew a franchise agreement, leaving the franchisee with little of the long-term security he or she may have been seeking.
- Start-up and continuing costs projections are spelled out in the UFOC, so there should be no confusion about how much money will be required. However, franchising can also be very expensive, compared to the cost of starting a business from the ground up or buying another existing business – franchisors often require very large up-front initial franchise fees (sometimes in the hundreds of thousands of dollars). A new Fantastic Sam’s franchised location ranges between \$93.6 and \$191.1K, the initial investment in an Ace Hardware will run between \$236K and

\$1.051M, while the current Bennigan's UFOC estimates start-up costs between \$1.5 and \$2.7M.

- In addition, franchisors typically require a certain level of net worth and liquidity from their new franchisees (in the case of Brinker restaurants such as Chili's or On The Border, a minimum net worth of \$5 million is required with liquidity of at least \$1 million per restaurant).
  - On top of the franchise fee, most franchisors charge an ongoing royalty based on gross sales – the amount can vary but is typically in the 4-6% range – as well as an advertising fee. The latter goes into a fund that is used for advertising expenditures for the entire chain.
  - Franchisors may also charge for technical support for the IT system and may require franchisees to purchase proprietary products from the corporate office, sometimes at a significant markup.
- Just as advertising for one is advertising for all, so too is what occurs when negative news is attached to the trade name. In the foodservice industry, news of an outbreak of salmonella related to one restaurant can trigger a consumer aversion to all stores in the chain. The old adage of "one bad apple spoils the whole barrel" is never more applicable than in the franchising industry.
  - Successful franchise operations continue to develop new products, new ways of doing business, new ideas to improve the customer experience. When franchisor management is unable to develop the business, the franchisees have little recourse but to continue to follow the old rules and watch their competitors pass them by.
  - While system growth increases brand recognition, a chain that grows too rapidly runs the risk of outstripping its franchise support organization.
  - Alternatively, a chain that terminates or stops renewing franchisees adversely affects the remaining operators.
  - Unless the franchisor grants exclusive rights to a specific territory, a franchisee may find himself competing against his own concept right around the corner with no freedom to distinguish his business from the other. On the other hand, limiting a franchisee to a designated territory may restrict his ability to expand into an adjacent area. Franchisors also maintain the right to site approval, a procedure that could impede a franchisee's ability to operate in what he knows is likely to be a profitable area.

### Where Is The Franchising Industry Heading?

So what does the future hold for the franchising industry? The IFA says that franchising is booming – according to its recently-released *Economic Impact of Franchised Businesses*, the industry's trickle-down economic impact is more than \$1.5 trillion a year.

- Personal service franchise systems seem poised to continue their rapid growth, as time-squeezed consumers look for additional ways to get their needs taken care of. Between 2003 and 2005, the IFA reports that only retail food franchising exceeded the service-business sector in the percent change in the number of systems.
  - Within the personal services segment, businesses focused on senior care are thriving as more baby boomers start reaching an age where additional assistance will be required
  - Child-related offerings are also growing rapidly as large numbers of dual-income families are seeking ways to continue to enrich their children's physical, mental and social well-being.

- Business service franchising is also taking off, accounting for more than a quarter of the total revenue generated by business-format franchising. In an era of stripped-down business organizations, companies are finding it increasingly cost-effective to hire someone else to repair their computers, build and maintain their Internet home pages, screen their job applicants, balance their books and clean their offices.
- Other industries showing significant growth in the number of franchise systems are building and construction, real estate and sports and recreation.

As noted above, franchisors are reaching out to minorities and women in acknowledgment of their under-representation in the ranks of franchise operators. And as the IFA points out, these target populations are finding that franchising is one way of overcoming a lack of entrepreneurial experience and a shortage of investment capital.

Another significant trend is the globalization of US brands through franchising, especially in the foodservice industry. A study published in August 2006 by the IFA and the Rosenberg International Center of Franchising reported that more than half of the US companies surveyed currently operate units in other countries and nearly 80% plan to open new units in the next three years. Preferred target areas are Canada and Europe; the Pacific Rim and China are also attractive growth areas.

- Yum! Brands Inc., franchisor of KFC, Pizza Hut and Taco Bell, among others, has long operated an international business segment for SEC reporting. However, several years ago the company set up a China segment that is legally separate from its original international business segment. At the end of its most recent fiscal year, international locations accounted for almost 43% of the company's total locations, with Chinese restaurants accounting for more than one out of every six international stores.
- At the end of fiscal 2005, McDonald's Corporation was operating restaurants in 118 countries, and US restaurants accounted for only 43% of the total system units and generated only a third of the company's total revenue. Of the more than 17,000 international McDonald's restaurants, almost 36% were company-operated vs. 64% franchise or affiliate operated.
- Conversely, some foreign-based companies are beginning to set up business in the US, with Guatemalan Pollo Campero now established in CA, TX and DC, Filipino Jollibee operating in CA and British retailing giant Tesco planning to open stores in the Los Angeles area in the near future.

#### Chain Store Guide and Franchising

In recognition of its prevalence and the immense impact franchising has had on the foodservice industry, **Chain Store Guide** has been capturing information about franchising in the chain restaurant industry for many years. **CSG** data include such elements as number of units franchised to and from another company, systemwide sales (sales from all units in the franchise system, regardless of ownership) and franchise affiliation. In addition, **CSG** reports complete contact information, trading areas, trade names, primary wholesaler, foodservice sales, and key personnel for all companies. The current Chain Restaurant Operators database includes contact and operational information on almost 1,900 franchisees and on 975 franchisors.

This information is important to businesses because:

- The franchising agreement is typically very strict and covers almost every aspect of the entire operation. It often even specifies the brand of equipment and the suppliers or types of products the franchisees must use. If a distributor has the specs for one restaurant in the chain, that distributor has a good understanding of what products and services all the other restaurants in the chain need. Therefore, if the distributor is looking for additional accounts, it will be much easier to land a customer whose business he already knows and comprehends.
- Franchisors can use **CSG** information about existing franchisees to find prospective franchisees.
  - It is very common in the restaurant industry for a company to operate more than one concept because, aside from the external differences, the operations of one QSR are often not significantly different from those of another QSR.
  - Territorial restrictions can also lead a franchisee to seek additional growth opportunities in other franchise systems.
- Franchisees and franchisors can use the **CSG** franchisee information to search for managers with industry experience to fill leadership positions.

Technology is increasingly important in the franchise world. It allows franchisors to communicate quickly with their existing franchisees, to advertise their products/services to customers and prospective franchisees and to purchase products. Because of its importance, franchisors are increasingly specific about the types/brands of software and hardware their franchisees must use. In addition to the retailers and foodservice databases, **CSG** also publishes the *Foodservice Technology* and *Retail Technology* studies which present solutions providers with a wealth of information that will help them understand the needs of the retailers.

**Chain Store Guide** now collects franchise-related data in all of the retail channels that it surveys, so that **CSG** can continue to meet its customers' needs better than anyone else in the marketplace. If you would like additional information about **CSG** and its many product offerings and custom research capabilities, please visit [www.csgis.com](http://www.csgis.com) or call the company's toll-free number, 800-778-9794.