THE BUSINESS OF FRANCHISING

Franchising is perhaps one of the most widely misunderstood phenomena in American business. Judging from coverage in the popular media, for every story of wild success – every McDonald's or Holiday Inn – there seems to be a story of a crashing failure, or even outright thievery, all carried on under the banner of "franchising."

Franchising is frequently, but erroneously, described as an "industry." It has been characterized both as the enemy of the American entrepreneur and as the "last, best hope" of American small business to compete against integrated chain retailers.

Can franchising be all of these things? Is it any of them? The answer is "yes." It has been virtually all of these diverse things, in different times and at different places, and in different manifestations. What franchising really represents is a powerful business tool to distribute goods and services, and to expand a business. It can be a potent investment device for franchisees.

This book provides an overview of franchising as a business tool and the limited public regulation of franchising. It seeks to give the reader a starting point for understanding franchising and evaluating franchise opportunities.

METHOD OF DISTRIBUTION

Franchising is primarily a ***method of distribution*** of goods or services. In this sense, franchising is simply a business technique, a means of distributing or providing goods or services to the consumer. Franchising appears in four primary modes:

Business format franchises for products:

These are businesses where the franchisor does not actually produce a product but instead dictates to a franchisee how to conduct a business providing a prescribed product to consumers. Examples include franchised quick service restaurants and automotive aftermarket support businesses.

Business format franchises for services:

As in business format product franchises, the franchisor does not itself actually produce or provide a service for resale, but dictates to the franchisee how to conduct a business providing prescribed services to consumers. Examples include franchised motels, quick printing shops and home cleaning services. Even nonprofit service organizations can use this form of franchising to expand the reach of their programs into new communities.

Product franchises:

In product franchises, the franchisor itself manufactures and distributes a tangible product offered to consumers through franchised retail dealerships, where the franchisor/ manufacturer also dictates to the franchisee/dealer how to conduct the dealership business. These may be found not only where the franchisor itself manufactures the product, but also where it has products produced for its account by a third party, or acts merely as a distributor of products whether or not it actually handles the physical distribution of them. Examples include franchised ice cream “dipping shops,” soft drink bottling companies, chain hardware stores, and some specialty merchandise retailing chains.

Affiliation franchises:

An affiliation franchise is a uniquely American business phenomenon. The franchisor recruits into its franchise system (in almost any business category, offering goods or services) a retailer who is already engaged, as a successful independent operator, in the franchisor's line of business. Examples include some of the franchised real estate brokerage chains, some franchised health care providers, and franchised travel agency systems.

METHOD OF EXPANSION

In addition to being a method of distribution, franchising is also used as a ***method of expanding*** an existing business. In this sense, we are simply looking at franchising from a different perspective: namely, that of a business seeking ways to expand the scale of activity in which it is engaged.

Franchising used as a method of expansion is an alternative means of capital formation. A business seeking to expand the scale of its operations needs growth capital. Traditional ways of raising such capital include venture capital lenders, various forms of bank and commercial financing, or public or private placement of securities through investment banking channels. Franchising may be thought of as an alternative to these more traditional means of raising growth capital. Using franchising, the business in effect appropriates to its enterprise the capital, as well as the managerial talent and effort, of the franchisee. This is most commonly accomplished by inducing franchisees to invest in additional retail outlets, usually in new geographic market areas, but all in support of and customarily identified by the franchisor's trademarks. The franchisee, therefore, makes a significant capital contribution to the strengthening and expansion of both the scale and the goodwill associated with the franchisor's business enterprise and brand.

To be sure, capital formation through franchising entails some significant equity trade-offs. This is discussed later in "Choosing Franchising as a Method of Distribution."

Franchising as a method of expansion is especially attractive to a business seeking to expand into foreign markets or markets that are geographically or culturally remote from the franchisor. This would be every bit as true for a Minnesota-based company seeking to expand into Texas or California as it would be for expansion into Canada or Europe, or for a foreign business seeking an effective means of penetrating the U. S. market.

Finally, because of its inherent capital and managerial leverage, franchising is often attractive as a means of expanding a business more rapidly than might otherwise be possible. Rapid growth is a goal often cited by firms that elect to expand using franchising.

OTHER BUSINESS GOALS

Franchising sometimes is attractive to a business not as a primary business goal, but as a means to other ends. In this mode, franchising can be a catalyst to the achievement of other, more primary, business goals.

A company may find that for technological, regulatory, or other business reasons, it is desirable for the manufacturer to attain a much higher level of presence or involvement in retail operations involving its products or services than might otherwise be the case. The business, nevertheless, cannot always afford or even desire to vertically integrate its distribution program by owning the retail level of operation. For such companies, franchising can be an attractive compromise. It provides many of the advantages of equity ownership of a retail operation but avoids much of the capital cost and managerial responsibility that can be burdensome to companies lacking unlimited capital.

One example of such a business would be a manufacturer of a high tech product who determines that demonstration, sale, installation, and after-market customer support of its products dictate a more "hands on" presence by the manufacturer than would be possible through the use of unaffiliated, independent wholesalers and retailers. A second example is a company selling products that have significant consumer safety or public regulatory implications. For those reasons, the company might choose not to place its product in the hands of independent and essentially uncontrolled retailers. In both cases, franchising offers an attractive middle ground between merely selling the products to distributors or wholesalers for unconstrained, unsupervised redistribution, or a vertically integrated, "company owned," retailer network.

MULTIPLE FORMS OF FRANCHISING

Franchising takes many forms. Across the primary modes of business format franchises, product franchises and affiliation franchises, franchising is found in an almost limitless variety of structural arrangements. These include traditional single-unit retail franchises, multiple-unit franchises, franchises with or without exclusive or protected territories, franchises with or without growth options or rights of first refusal, trade area franchises, mobile and home delivery franchises, and one or more tiered subfranchising arrangements. A variety of hybrid ownership arrangements, such as joint ventures and other shared equity business arrangements, also appear in franchise systems.

INVESTMENT OPPORTUNITY

Franchising can be viewed from another major perspective: that of the prospective franchisee, to whom a franchise may represent a shortcut to establish a new business opportunity. For many Americans, the dream of autonomy and financial independence associated with owning and operating one's own business provides a motivating goal, but one of somewhat daunting proportions. Forgoing the relative security and comfort of a salaried position with a larger business entails significant risk.

Franchising offers a middle ground between salaried employment and the essentially open risk of launching one's own independent small business. Again, franchising in this manifestation involves significant trade-offs, discussed later in "Considerations in Buying a Franchise." Nonetheless, it offers the potential to reduce the risk of business failure and loss of investment associated with launching an unfamiliar new business.

Increasingly, even very large business organizations choose franchise investment as a shortcut to entry into an unfamiliar line of business. It provides faster and easier brand recognition than might be possible through internal development of a house-branded line of business. For example, Target Stores might invest in a Subway or McDonald's franchise, or Marriott in a Pizza Hut franchise. Franchised national brands are increasingly prevalent in institutional host entities such as airports, museums and schools.

ECONOMIC IMPACT

Franchising is a major contributor to the growth of the U.S. and world economies. The International Franchise Association believes that as many as 750,000 franchise businesses operate in the U.S., employing more than 15 million Americans. Franchising generally accounts for as much as 50 percent of all U.S. retail sales (including motor vehicles and motor vehicle fuel). Franchise businesses (again, including motor vehicles and fuel) are now responsible for more than $1.5 trillion in retail sales. These figures are growing at a steady annual pace, roughly in proportion to the rate of expansion of the U.S. economy as a whole.

In foreign markets, franchising represents a major constituent in the growth of U.S. foreign trade, contributing steadily to stabilizing the nation's foreign trade deficits. Studies indicate that as many as 450 U.S. companies offer franchise programs with more than 35,000 outlets in numerous foreign countries. Many U.S. companies increasingly depend upon foreign franchising for continued growth in sales, earnings and shareholder value.

In this context, it is worth noting again that franchising is one of the best possible tools for U.S. businesses to use to enter foreign markets, and for foreign businesses to enter the American marketplace.

NEGOTIATING A FRANCHISE

While some franchises are offered on a "take it or leave it" form contract, most are negotiable to one extent or another. Franchises offered by smaller or start-up franchisors are usually susceptible to some degree of negotiation to accommodate the franchise offering to the needs and market circumstances of the prospective investor.

"BUSINESS OPPORTUNITIES" LAWS

Anyone interested in franchising must also be aware of public regulation of a distinct but related business phenomenon known as "business opportunities." This subject is generally outside the scope of this book. Briefly stated, a business opportunity is a business investment program in which the seller of the opportunity offers to provide goods or services to the buyer to enable the buyer to start a business, and the seller assures the buyer that the business opportunity is essentially free of risk, based on a variety of features. For example, the seller may make representations that it will (1) find locations for racks or vending devices for selling the products produced or distributed by the business opportunity buyer; (2) "buy back" the buyer's output of goods or services produced with materials or assistance provided by the seller; or (3) refund the buyer's payments or investment if the buyer becomes dissatisfied with the investment. Or, the seller may indicate that a market is assured for the buyer's output of goods by virtue of a "marketing plan" to be provided by the business opportunity seller.

Although business opportunity regulation was an outgrowth of a number of often fraudulent "business" scams, such as chinchilla ranches, worm farms, "work-at-home" schemes and other dubious arrangements promoted to naive and unsophisticated consumer investors, the law now sweeps in a much broader array of business and distribution programs. Today, many legitimate businesses use structured business arrangements that are classified as "business opportunities" under one or more states' laws. Business opportunity regulation is discussed further in a later section.