

CHOOSING FRANCHISING AS A METHOD OF DISTRIBUTION

PLANNING A DISTRIBUTION PROGRAM

Businesses can choose among a wide range of distribution and expansion strategies. Sometimes, the choice is obvious. At other times, the choice is the consequence of an analytical process.

Every business faces core structural decisions: form of business organization, definition of strategic business goals, capital structure, and basic tax planning. Equally critical to any business or service organization is the choice of a method of distribution. Often subordinated to other issues, this decision has significant implications for the organization's allocation of resources, staffing needs, regulatory burdens, and ultimate success or failure. The need for careful analysis applies equally to product and service providers.

The characteristics, resources, and strategic objectives of a business sometimes dictate its method of distribution. Firms with ample capital resources may choose a vertically integrated system. Firms with sharply constrained capital often cannot afford vertically integrated systems or the regulatory and managerial costs of highly structured, regulated methods such as franchising. Firms with highly bureaucratic or autocratic decision making systems should not rely upon a distribution method that uses delegated entrepreneurial centers such as franchising or independent dealers. Firms in sensitive industries (health care, high tech, etc.) often try to avoid the risks associated with autonomous resellers such as independent dealers.

For most business organizations, the selection of a method of distribution turns on an analysis of the entity's goals and resources, and cost-benefit-burden trade-offs of the available alternatives. In some cases, the analysis may lead to a particular method only because other alternatives are less feasible or desirable. Franchising may be especially attractive if the business calls for rapid expansion, a structured or highly integrated distribution system, or expansion into a foreign or geographically remote area. Other choices that meet the same goals within the same resources (such as a "business opportunity" program, or costly debt financing for a vertically integrated approach) often appear decidedly less attractive than franchising.

If the choice is to use franchising, based on the factors outlined below, an enormous number of structures are available to establish a franchise program, affording a great deal of flexibility in tailoring a franchise distribution program to the exact goals and resources of that business. The more commonly used franchise structures include:

- Single unit franchises for a single location, or defined market area.
- Multiple unit franchises to develop a series of individual retail locations, usually in a defined market area, over a prescribed period of time.
- An area franchise in which a franchisor grants another the right to carry on the licensed business within a defined geographic market area.
- A franchise sales agent relationship, where a licensee solicits sales of franchises to others, but the resulting franchise runs directly from the franchisor to the retail operator.

- An area subfranchise relationship granting the right, within a specified geographic territory, to grant subfranchises to others to establish individual retail operations.
- Dual distribution systems in which the franchisor itself engages in distribution and retail sale of the goods or services that are also being offered by franchisees, either in adjacent market areas or sometimes even in the same market areas, but usually through a separate channel of distribution.

SUITABILITY OF FRANCHISING

A business considering franchising in its analysis of alternative methods of distribution or expansion must assess the suitability of its choice for the product, service or business format it intends to distribute. The business should choose a method that advances its marketing goals. If the company is primarily involved in manufacturing and selling a product, even under a brand identification that is important to the manufacturer, franchising may not be the most appropriate method. In many such cases, the commercial goals and distribution needs of the producer do not require, or justify, the level of involvement and control (and the resulting regulatory costs and burdens) of franchising. A franchise might be appropriate, however, if the marketing plan entails a relatively high degree of control of or participation in retail operations, greater brand prominence as an identification device at the retail level, or a more closely integrated product support function at the retail level.

Franchising is more likely the appropriate choice if the prospective franchisor's main goal is to prescribe a business format – even if the franchisor intends to supply goods or services to the franchised businesses. In those cases, alternatives are available such as providing consulting services or licensing intellectual property rights apart from any brand identification.

ADVANTAGES AND DISADVANTAGES OF FRANCHISING

Franchising affords significant benefits, but also brings considerable costs and risks compared to other methods of distribution. The costs and regulatory burdens associated with franchising make it a poor choice for a very small-scale program or short duration efforts.

It is very difficult to test market a franchise program. Entry barriers in the form of regulatory hurdles are high, and exit barriers in states with harsh anti-termination laws are extremely challenging.

Advantages of Franchising

Franchising allows the *rapid expansion* of a distribution network. Because franchising entails the application of capital, managerial talent, and personnel resources of independently owned franchisees, it permits growth of a distribution system more rapidly than would be possible if the manufacturer relied on its own capital and personnel resources. Regulatory compliance may slow this effort down, but it may still be a faster growth vehicle than a vertically integrated business or a system comprised of unaffiliated distributors or dealers.

Franchising requires the commitment of *lesser amounts of capital* to a distribution system than methods such as vertically integrated schemes, joint ventures or other forms of shared equity arrangement. This can help a manufacturer's own financial and capital structure and allows a greater proportion of its resources to be devoted to its manufacturing, marketing, and administrative needs. Less structured methods (dealerships, sales agents, etc.) may require much less capital investment than a franchise program. Lesser capital requirements do not mean low or no capital. Indeed, startup franchise programs often require \$50,000 to \$100,000 or more in capital on their own.

Franchising involves application of the *management skill and loyalty* of a dedicated owner-operator. The franchisee has a direct, substantial, and continuing personal and financial stake in the success of the franchised business. This is not always true of hired managers, and is unpredictable in independent dealers who may have other interests. A franchised business therefore often reflects a greater level of intensity of management at the retail level. In many lines of business, the reduced labor cost that results from personal managerial involvement by a franchisee can be the difference between the commercial success or failure of the franchised business.

The franchisee's personal stake and involvement also has a downside if the franchisee's expectations and aspirations are not met. If that occurs, the franchisee may experience an intense disaffection for the franchisor and its program, which may exceed that of a fired manager or terminated dealer. The personal and financial stake of the franchisee-investor thus can be a two-edged sword. This risk can be a serious barrier to an organization discontinuing the use of franchising. It definitely represents an ongoing administrative and managerial challenge to the franchisor, sometimes on a daily basis.

Franchising usually reduces the *cost of compliance* with the myriad local legal requirements for operating a retail business, such as payroll taxes, foreign corporate qualification, sales and use tax permits, employment laws, environmental compliance, zoning laws, local licensing requirements, and local consumer protection rules. These compliance obligations can be a significant burden to companies engaged in multi-state or international distribution. Unlike some other methods such as vertical integration or use of sales agents, franchising shifts the cost and responsibility for compliance with these requirements to the local franchisee. Ordinary dealership and distributorship programs can also shift these burdens and risks, and at a lower cost to the producer than through franchising.

Franchising also offers significant *advantages to the franchisee*. This can make a franchise a more attractive investment vehicle to the franchisee-investor. Franchising offers the franchisee instant trade identification through use of the licensed trademark. It also generally offers professional training, marketing assistance, a proven operating system, on going system support functions, and enhanced resalability compared to running an unaffiliated business.

Downsides of a franchise to the investor, as compared to some of the other alternatives, include higher costs associated with franchise fees, the risk of encroachment by other outlets of the franchisor, sourcing restrictions that may impose supra-competitive costs, and vulnerability to mandatory reinvestment in the franchised business. Further, many franchise programs are characterized by an overbearing intrusiveness in entrepreneurial decision-making. Other choices, even acting as an independent dealer, can combine some degree of equity appreciation and hedging of business risk without the costs and hassles that accompany a franchise. The choice is an entirely subjective one for the franchisee.

Other characteristic disadvantages include the cost of the fees paid to the franchisor; the difficulty associated with relocating or reformatting the business; significant hurdles to selling the business; risks associated with highly restricted, or non-existent, renewal rights; costs associated with restricted sourcing of equipment and supplies; and a panoply of other problems flowing out of often one-sided contracts favoring the franchisor.

On balance, however, these considerations suggest that franchising can be an exceptionally effective means of expansion – especially into a foreign or geographically remote market, and even for a foreign enterprise entering the U.S. market.

DISADVANTAGES OF FRANCHISING

Franchising also has several distinctive disadvantages. These include certain risks and cost factors not found in some other methods of distribution. Industry propaganda about franchising rarely addresses these features, which are not always apparent to or carefully analyzed by inexperienced franchisors or their attorneys.

The manufacturer's or distributor's *managerial discretion is more limited* than in a vertically integrated system with respect to controlling retail pricing, redistribution of products, tie-in and full-line marketing, and exclusive dealing. For companies that believe that retail pricing, controlling redistribution of their output, or other highly restrictive marketing techniques are indispensable aspects of their marketing plan, franchising is probably not an appropriate method. This is partly due to the risk of violating state and federal antitrust and trade regulation laws by imposing such controls on independent franchisees.

Franchising is an increasingly *regulated form of business* activity. Franchise regulation is expected to grow, not diminish. Franchise registration in some states may be conditioned on compliance with unpublished, undiscoverable regulations imposed as "policies" by franchise law administrators. Courts have not developed an entirely consistent and predictable body of common law dealing with franchise business relationships. Regulation and occasional litigation, however, are not unique to franchising, and this is rarely a dispositive consideration. Certainly, many hundreds of franchisors have navigated these waters successfully. Because of state laws governing termination and renewal rights, however, franchising is an awkward choice if the producer's intent is to enter into a short-term program or a "test" program of any kind, or if the producer anticipates the possibility of discontinuing a franchise program in one of the many states with franchisee-protective anti-termination laws. The overhead and ongoing administrative costs of franchising can be a significant problem for

firms that are unfamiliar with the area. These concerns, both regulatory and scale, often suggest that franchising, despite its advantages, is simply not worth the “price” to some prospective franchisors or for particular marketing efforts.

Franchising can be relatively *inflexible over longer periods* in rapidly changing competitive, regulatory or technological environments. Because of the nature of the franchise relationship, the long-term contracts that govern the relationship, and the investment commitments and legal independence of franchisees, it can be difficult for a franchisor to make significant or rapid changes in the trade identification, operational method, product mix, retail image and marketing strategy that constitutes the franchise program at its inception.

Franchisors may find themselves subject to *concerted* and sometimes hostile *franchisee actions*. This can be expressed through various means including independent franchisee associations, franchisee-sponsored advisory councils, franchisee-operated cooperative buying associations and private labeling programs, franchisee bargaining groups, franchisee legislative advocacy, or class action lawsuits.

Franchisors must be especially vigilant of *trademark infringements* and misuse by their own licensees and others. Business format franchisors in particular must be aware of the ongoing legal steps necessary to protect their trademarks against misuse, infringement and dilution. Experienced professional trademark advisors must be engaged in this effort.

Franchisors have a growing exposure to *vicarious liability* for the torts of their franchisees. While this risk ordinarily can be insured, usually at the expense of the franchisee, it is a phenomenon that many franchise programs are not economically structured to reflect. It is also a risk to which some other forms of distribution arrangements are not subject, especially to the same degree.

Only *certain “personality types”* make good franchisors, whether as individual entrepreneurs or mature corporations. A successful franchisor recognizes the collaborative nature of the franchise relationship, and respects the investment objectives and aspirations of its franchisees. Dictatorial command-oriented firms will not succeed in franchising.

Public disclosure of sensitive information can be a strong disincentive to franchising. Much inside information can become available to competitors. Companies with weak financial statements, unfavorable litigation histories, a record of a past bankruptcy or reorganization (or involvement in management by individuals with an unfavorable litigation or bankruptcy history), a poor track record of getting franchisees open for business, or a history of termination and non-renewal of franchises may find it difficult to draft an FDD, or, having done so, to sell their franchises. The FDD is disclosed on the public record once it is registered in one of the registration states. This includes the financial statements of the franchisor together with all the other information required by the FDD guidelines, including information concerning the structure and method of operation of the company’s distribution program.

Historically, public regulation of the offer and sale of franchises has *not* meshed well with other (and usually much older) public *regulation of substantive business activities*. This is most notable in such fields as mortgage banking, optometry, real estate brokerage, law, medicine, accounting, and securities. Franchised distribution systems in these and other licensed or regulated trades are challenging to plan and implement safely and effectively.

A similar disincentive to franchising can occur in particular industry segments which either have had a *previous bad experience* with franchising or have had no prior experience whatsoever with franchising. In these sectors, prospective investors may regard franchising with suspicion.

