Is Franchising For Me?

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Franchises are one of the fastest-growing types of businesses in the U.S. and can be purchased for as little as a few thousand dollars, to over a million dollars. There are franchises for all kinds of products and services—food, pet grooming, massage services, auto repair, etc. Although exact statistics are hard to find, they also tend to have a higher success rate than independent businesses that are not franchises.

Although franchises tend to have higher success rates, they also have risks too, and can fail for any number of reasons just like any other business. You must investigate *Joe's Restaurant Franchise* just as thoroughly as *Joe's Local Diner* before buying it. There are a number of great resources in addition to this article to help you determine if a franchise is the right way for you to go. The U.S. Small Business Administration (SBA) has some excellent resources (www.sba.gov and www.sba.gov/opc/pubs/fran.pdf), as do several other services like business brokerage websites. Enter "Is Franchising For me" in any Internet search engine, and you'll retrieve links to a large number of resources.

What is a Franchise?

The SBA resource I mentioned above offers the following definition for a franchise:

> *A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name or advertising symbol and an individual or group seeking the right to use that identification in a business. The franchise governs the method of conducting business between the two parties. Generally, a franchisee sells goods or services supplied by the franchisor or sells goods or services that meet the franchisor's quality standards.*

As a business model, franchising is essentially a finance vehicle for expansion of the concept. You, the franchisee, finance the start up of the individual franchised unit and pay licensing and royalty fees to the franchisor. This is as opposed to the franchise company bearing the costs of opening its own units (many franchises do have company-owned stores along with franchised stores). The franchise agreement is a contract that governs the manner in which you will do business.

For the fees you pay, the franchisor licenses to you the use of the name of the business and provides other support. Typically there is a business operating system in place, contracts for products or services sold, equipment packages, store design packages, etc. Many franchisors will also arrange for financing relationships. Some franchisors supply the product directly and make money on the sale of that product to you. Such an arrangement usually reduces or eliminates the royalties you would otherwise pay. Typically, you will pay an upfront license fee and then pay ongoing royalties—usually as a percentage of your sales—plus contribute to regional and/or national advertising funds. The franchisor will hopefully provide business expertise as well—operations management, marketing, selecting locations—and should provide training, typically at their corporate headquarters for one to two weeks, plus training and support as you plan and get your franchise unit ready to open.

As a franchisee you own the business, but you are subject to the guidelines of the franchise agreement—products, store décor, uniforms, where product is purchased, certain advertising guidelines, etc. Franchising may be a good option if you prefer a business with existing brand recognition and defined processes you can follow, instead of creating the business from scratch on your own.

The service and support offered by a franchisor varies from chain to chain—and may not always live up to your expectations. But the essence of the value of a franchise is the following:

- Existing brand value (unless brand new to the market)
- Existing operating system
- Existing product/service selection
- Supplier relationships (sometimes with favorable terms)
- Training
- Proven locations up and running based on the concept (unless brand new to the market)
- Cooperative advertising and cross-traffic with other franchisees

These things, like all things of value, have to be earned. In the case of a franchise, in addition to all the work you will have to do to be successful in any business, you have to pay the franchisor for the right to use their systems and trademarks. As noted above, this payment typically takes the form of an upfront “franchise license fee” and then a payment of ongoing royalties, plus a contribution to local and/or regional and national advertising funds. Upfront fees can be fairly nominal, like $5,000, or can be in the tens of thousands of dollars. Royalties (charged as a % of your revenue) vary by chain, but are often in the 5% - 8% range. Advertising contributions are also typically charged as a percentage of sales and can vary substantially, but typically range from 1% to 5%, with 3% - 4% being the most common in my experience. In addition to contributions to regional or national advertising funds, you will have to spend additional local marketing dollars to be a success—don’t assume you can rely on your percentage contributions to provide adequate marketing resources to make you a success.

What's the Right Franchise?

Only you can answer that question, but some things to bear in mind are:

- What are your interests?
- How much capital do you have?
- Do you want to develop multiple units?
- What days or hours do you want to work?
- How easy is it to re-sell your franchise and what are the restrictions or costs from the franchisor?

The financial value a franchise brings to you is an important question to ask yourself. For example, if you are giving up 10% of your revenue in the form of 6% royalties and a 4% advertising co-op fee (which, in theory, comes back to your benefit in the form of marketing resources and advertising), you need to objectively assess what you get back for that 10%. 10% right off the top is a significant amount of money. Will you have a higher probability of success? Will you make more money on the bottom line in spite of the 10% expense? It may be simply that a franchise makes it possible for you to be in business for yourself because of your comfort level with an existing concept, versus trying to create your own. This is why many people go with a franchise, and it's a good reason, but be sure you understand the financial costs and tradeoffs.

Brand Value

Once you are in the business and have some experience, the primary value (besides any ongoing support and training, which is usually minimal) is the equity of the brand you have franchised. A good franchisee is one who understands that the royalty % he or she is giving up each week is an investment in the brand equity of the chain. A brand that is consistent across its various units will tend to build a more positive reputation and therefore drive more customers—more revenue and more profits—to its franchisees. Think about McDonalds®, considered by many to be the model of a successful franchise system. Imagine if every McDonalds restaurant had a different menu with different products, inconsistent quality, and systems that were changed by every franchisee and therefore different. It would be impossible for the customer to know what to expect before they walked in, i.e., the brand "McDonalds" would have little or no value, sales would slide, stores would fail, and the chain wouldn't be what it is today (we might have never even heard of it!). By insisting that its franchisees conform to the principles of the brand, i.e., create consistency according to high standards, McDonalds and its franchisees have generally thrived (**NOTE:** *this is not an endorsement of McDonalds, nor is it a prediction of success with a McDonalds franchise. It is only the conclusions of an industry observer and, admittedly, long term customer!).* Franchisees that do not conform to the system are destroying their own investment by undermining consistency and therefore the brand. The difficult role of a franchisee is to be independent enough to be capable of owning your own business, but understanding at the same time that you are part of a larger system to which you need to contribute value (i.e., conformity and consistency) in order to be successful yourself.

Master Franchising

I'll only touch briefly on master franchising, but you may want to follow up in detail on your own, as master franchising can be a very powerful and lucrative business opportunity for the right person. One company that specializes in master franchising is Franchise Growth Systems (FGS), and you can retrieve additional information on master franchising at their website, franchisegrowth.com.

The role of the Master Franchisee:

Many franchise systems have three overall levels to the organization:

- Corporate Franchisor—this is typically the entity that that developed the concept and from whom you are buying your franchise license.
- *Master Franchisee*—this is the entity that buys the right to develop franchisees in a given territory, like a state.
- Franchisee—this is the person who buys the franchisee license and operates the actual franchise unit.

There are two major aspects of the master franchisee you need to understand:

- Is it an opportunity that makes sense for you; and
- If you become a franchisee, what is the impact of the master franchisee on your success?

FGS calls master franchising "the best kept secret in franchising," and it is a pretty unique type of opportunity. Basically, the master buys from the franchisor the rights to develop franchisees in a territory. For each franchise license the Master Franchisee sells, it typically receives one half of the upfront license fee—and that's not even the good part! It then receives up to *half* of the ongoing royalties paid by all franchisees operating in its territory. If the master gets a number of units open in his or her territory, 3% (or whatever his or her share of royalties is) of the annual sales in the territory can grow very quickly. The master typically has to open the first unit in the territory, which increases the capital required. The cost of Master agreements can vary widely, but typically sell for about $.03 to $.10 per head of population in a territory. A state with 3,000,000 people at $.05 per head would require a $150,000 investment. With the first unit to be opened by the master added in, significant capital can be required. If the cost to open a retail store in a retail franchise is $150,000, the total upfront cost to the master is $300,000 in this example. A good Master Franchisee has multiple qualities:

- A strong financial position to invest in the territory and a unit upfront, and wait for the chain to grow over 2 – 5 years.
- Sales/business development skills.
- People management skills.
- The ability to understand and manage the franchisor/franchisee relationship.
- An appreciation for good franchisee operations.
- A commitment to the success of his or her franchisees.

Master franchisees that lack these skills can be very detrimental to a market and actually undermine the success of the market by creating discord among franchisees, and even turning franchisees against their own concept. Talk in depth with existing franchisees about their experiences with their master franchisee. The master role is sometimes called a Development Agent or Area Developer and, while there can be variations, the role is essentially the same. Bottom line: find out who the “middleman” is, and make sure they are a person with good values and a commitment to the success of their franchisees. This can be even more important than the quality of the franchise parent.

A last note: not all franchise systems have the middle role. Some master franchisees also are the ones who open and own all the units (versus recruiting other franchisees to do so).

Choosing A Franchise

If you determine that franchising is a good avenue to business ownership, one of the most important considerations is this: don’t let your excitement about going into business for yourself, or about a certain concept, cloud your judgment or make you skip a proper investigation of the concept. There are thousands of franchises in the United States. Be open minded when first investigating types of franchises, and don’t have tunnel vision about which one you think interests you. Once you narrow down your choices, investigate more than one at least semi-thoroughly. The franchisor is required by law to provide you with a Uniform Franchise Offering Circular (U.F.O.C.). It should contain a list of existing franchisees. Contact as many as you can! See what their experience has been. If possible, get them to let you review their financial statements and see how they are really doing. If you can’t review actual numbers of other franchisees, don’t rely on the franchisor’s projections. *Franchisees typically like to share their success—if they are doing well*. Plus, getting a new franchisee in the system is good for the chain, which should motivate them to share. Some will be sensitive about the confidentiality of the information, but if no one will let you see their books, that’s a warning sign that the franchise may not be doing well in your market or overall. Never get hasty—you will strongly regret it if you do, and end up making a bad choice. Also investigate resells of existing franchise units—they can represent a great opportunity and a smaller financial investment. Franchising can be an excellent avenue to business ownership. Investigate carefully, make objective judgments, and make sure the franchise is delivering value to its franchisees for the royalties and independence they require you to give up—and then get started!

Conclusion

There is value in both new and existing franchise concepts. Obviously, the newer a chain is, the more untried and risky it is. Early entrants into one that becomes successful will enjoy higher returns, but don't deceive yourself about the risk just because it's a franchise (with either new chains or established ones). Franchise chains can and do fail, just like individual units do.

One of the big benefits a chain offers is brand recognition. The training and systems are of only nominal value once you know what you are doing. You may even find that your abilities outstrip the franchise's (but don't forget it's consistency with your fellow franchisee's operations that builds brand value over time!). Brand value is a big part of what you are paying for over the life of your relationship with the franchise. So a more established chain will have less risk (both as a chain and an individual unit), and deliver more quickly on brand value due to their market presence. Your first choice should be to go with a more established chain with proven successes and lots of franchisees that can share their financial results with you before you commit. There are thousands of franchises in the United States. Utilize the Internet and print publications on franchises to review as many as you can while trying to discover the one that seems like the best fit for you.

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