FRANCHISING YOUR BUSINESS

An Owner's Guide To Franchising As A Growth Option

By
Donald D. Boroian and L. Patrick Callaway

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FRANCHISING YOUR BUSINESS
A Francorp Publication

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To all the exciting, dynamic entrepreneurs we have known.

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Thanks Dick,
The Authors

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Introduction

In our first book, *The Franchise Advantage*, published in 1987, we attempted to broadly describe the franchise phenomenon, including its history and its impact upon the American economy and economies around the world. In it we predicted that "franchising will make the world smaller." Thomas Friedman came up with a better metaphor twenty years later in *The World is Flat*, but we think that the "flat" world he described was not so different from the "smaller" one we foresaw. *The Franchise Advantage* was directed to business owners, prospective franchisees and the general reader. It remains, in our humble opinion, as comprehensive a study of franchising as has been written. Although out of print, it can be downloaded free by anyone interested in the subject from our web site, francorp.com.

In our second book, *How to Buy and Manage a Franchise*, co-authored with Joseph Mancuso and published in 1993, we addressed franchising from the franchisee's perspective. It can also be downloaded at no cost from francorp.com.

What has changed since publication of *The Franchise Advantage?* Many things cultural and economic, some of which we have attempted to address in Chapter 1. One thing not described in detail in Chapter 1 is the increased complexity of franchising itself. That subject is indeed the primary reason for this present volume and is dealt with at length in the remaining chapters.

This book is not for the general reader. It is specifically designed to answer at length a critically important question that ought to be asked by any owner of a successful business who needs additional distribution outlets in order to grow. That question consists of three parts:

- Should I consider franchising?
- Is my business franchiseable?
- If it is, how do I create a franchise program?

If you are such a person and are curious about the answers, we invite you to read on.

The Rules Have Changed

The author Isaac Asimov has said, "It is change, continuing change, inevitable change that is the dominant factor in society today." Nowhere is that more true than in the business world, and especially true in the past decade. Computers, the Internet, and hand-held communication devices have vastly altered the way we process and store information and, of course, communicate. But changes have occurred in all business sectors. In retailing, the downtown department store as the major focal point for shopping was replaced by the enclosed mall. Later, enclosed mall development slowed as "big box" mega-discount stores gained popularity. Chains that had been flourishing began to founder. They could not compete in an atmosphere of steep discounts sustainable only by extraordinarily high sales levels. By the end of the millennium the restaurant industry, which exploded during the second half of the twentieth

century with considerable help from franchising, hit a saturation point. Many of the biggest chains staggered under competitive pressures. In the petroleum industry, major consolidation reduced the number of well-known brands to a few. The airline industry faltered as its leaders faced insolvency driven by rising fuel costs, increased security costs and a discount mania. Ultra large law firms merged into ultra, ultra large law firms. People began moving from the suburbs back to the city (how unusual!). The health care industry underwent major trauma in the crossfire between insurance rates, rising hospital costs, nurse shortages, capitation of insurance coverages and outrageous malpractice awards.

No wonder then that franchising has also changed. For one thing, traditional mom and pop franchise buyers gave way to more sophisticated candidates with better education, more capital and more business experience. These people were the laid-off victims of downsized, merged, bankrupt or obsolescent companies, and they started buying franchises in record numbers. And as franchisees they were ideal! No franchise operators have a better chance of success than people who come from a structured big-company environment. Those who are accustomed to following a system, adapting to procedures, observing dress code, and obeying the employee manual and rules of behavior become ideal candidates for a franchise, where the ability and willingness to follow rules is crucial. But the nature of franchising has changed, too. Franchising was once the domain of small maverick entrepreneurs, such as Ray Kroc of McDonald's, Kemmons Wilson of Holiday Inn and Colonel Sanders of Kentucky Fried Chicken. They have

been replaced in the modern era by more sophisticated entrepreneurs whose names are less familiar than their companies. Today's entrepreneurs are often armed with MBAs, meaningful work experience, sufficient capital, and a new alien object called a "business plan." But don't think we still don't have our share of wide-eyed junior Ray Krocs, Kemmons Wilsons or Colonel Sanders. We do. And even this new breed of franchisor is more highly qualified than his or her predecessor. Of course all new franchisors have a wealth of experience to fall back upon: the experience of predecessors who came up with the right way – or in some cases the wrong way – to become a franchisor. The early folks had no role models. A banker in Hong Kong told us in the early 1980's, when we were considering taking some of our US clients into China: "The companies who will succeed in China will be those who step over the bones of the pioneers. Don't be a pioneer." Ray Kroc, Kemmons Wilson and Colonel Sanders were pioneers, but the graveyards are full of the unmarked headstones of pioneers who didn't make it. We often characterize our company, Francorp, Inc., which since 1976 has been the largest developer of franchises in the world, as an observer watching thousands of entrepreneurs parachute into a jungle. We simply wait to see who can make it through the jungle to safety. Out they come, crawling on their hands and knees, heads bandaged, arms in slings, bruised and bleeding, but in the process their businesses have survived and may indeed be ready for exceptional growth.

The lessons learned from what worked and what didn't work in business became the basis for the

standards for the franchising industry. The successful companies were those who learned from their own experience or that of someone else. Those who tried to shortcut the process or left out an important part of the recipe failed. That part has not changed. But what has changed is the fact that it is much more difficult to become a franchisor today than it was in the past. Registration and filing requirements are more stringent and lawsuits have proliferated. The economy forgives fewer mistakes and profit margins are lower, making it harder for companies to survive prolonged cyclical changes. Meanwhile, increasing numbers of companies with huge market share and economic clout exert additional pressure on new and growing companies.

At one time having a large business tended to insure survival in any economy. That, too, has changed. Of the top one hundred businesses of fifty years ago, only a handful exist today. The others have been acquired, merged, or are bankrupt. Our good friend, Arthur Lipper, publisher of Venture magazine and Chairman of New York and Foreign Securities Corporation, once said: "The best way to have a small business is to buy a big business and wait." In the past, most of the growth in the economy was from big businesses getting bigger, adding more people and more branches in more cities and more countries and adding new products and services. Today the growth of the business sector stems principally from small and new businesses. It is comical to hear politicians point to layoffs by big companies as indicative of the problems in the economy. Let's not blame the economy when the real culprits are businesses with outmoded business models and inappropriate

products and services that fail to adjust to changes in the marketplace. Politicians look for ways to help these big companies survive, when in reality they should be doing more to encourage small business development, because that is where the real growth is taking place.

Of course, one force that has dramatically changed the face of business in general and franchising in particular is technology, with special emphasis on the Internet. Newspapers, magazines and franchise shows, which were the principal sources of prospective franchise leads, have given way big time to the Internet. For the price of one ad in the Wall Street Journal or Entrepreneur magazine, a franchisor can be listed on eight different franchise-sales portals on the Internet. The results have been mind-boggling. We will deal with this whole Internet phenomenon in a later chapter, but it certainly has had a major impact on the growth of franchising and in the way franchise companies operate. The Internet has also given rise to a large number of new Internet-related businesses that are franchising.

The changes that are occurring are not simply reactions to recessions or booms. There are always three cycles that create the highs and lows. The first *expansion* cycle typically lasts from two to five years, during which time the economy gets better and better. This cycle is inevitably followed by *recession*. At that point the balloon bursts into a death spiral, sometimes causing a depression, but at the very least a drop in the economy characterized by unemployment, unfavorable business climates and cutbacks in spending and employment. Eventually, cycle two bottoms out and then we have *recovery*, the link between recession and expansion that

usually lasts a few years before the economy starts to heat up again and we go through the process again. *Expansion, recession, recovery… expansion, recession, recovery.* This progression has not changed, but what has changed is that expansion cycles are lasting longer and the recession cycles are less severe – that is unless you happen to be unemployed. And, indeed, the principal casualty of recession has been the large company employee. Pardon us for drooling, but for people in the franchising business this couldn't be better. As we noted earlier, ex-large company employees make ideal franchise candidates. Not only do they come from the right work environment, they are usually financially qualifed, with 401K cash, severance pay and equity in their homes. (Fully 70 per cent of the people who buy a franchise refinance their homes.) Today, these folks buy franchises from small businesses and entrepreneurs who started their businesses, began to grow them, but lacked capital to open more stores or offices. Unable to borrow or persuade people to invest in their companies, they decided to franchise.

2004 saw what we like to call Franchising's Perfect Storm, the confluence of three phenomena that fueled explosive franchise growth in the franchising industry. In the previous few years, more than twenty-one million people age 25-54 had dropped out of the US labor force. Then, in the first six weeks of that year, twenty-two IPOs were issued compared to an average of two each during the same period in the three previous years. In March of 2004 alone, forty-four companies went public. Meanwhile, interest rates for business loans had dropped from 22 per cent in 1980 to 10 per cent in 2004 and mortgage rates from 14 per cent in 1980 to 6 per cent in 2004. So you had a perfect opportunity for franchisors to find franchise buyers who could borrow money inexpensively in a strong economy with a rising stock market. Notwithstanding the political rhetoric in the primary election campaigns between George W. Bush and John Kerry, people felt confident in the economy and many of them – even the unemployed – had available capital. This Perfect Storm environment lasted through the end of 2006.

Buying habits have also changed. Today, millions of people buy products off the Internet. But even that phenomenon has been altered in recent years. More and more Internet companies have developed a "click and brick" presence as they came to recognize that buyers want a place where they can actually see and touch merchandise offered on the Internet and return merchandise purchased there.

The relatively new phenomenon of outsourcing also brought significant changes to the economy. Outsourcing affected businesses positively by enabling companies to buy products and services more cheaply and eliminate higher priced products and employees. And while outsourcing brought consumers lower prices, it caused many employees to lose their jobs. In addition, many old war-horse industries that pulled the economy out of the doldrums in the past were very much weakened or even banished. The steel and automobile industries, although making a comeback after a severe decline, would never own the market again. Defense spending, while still present, was no longer a dominant factor positively affecting the economy. Housing, while

still in demand, would never attain postwar baby-boom levels.The whirlpool caused by business downsizing during and after recessions became a death spiral in which budget and personnel cuts were the norm. Only the more efficient businesses and those that were counter-cyclical, such as Wal-Mart, Home Depot and other niche businesses, flourished.

So where do these changes leave you, today's business owner? For one thing you must be more flexible. You don't have the slack in the line to stay with an entrenched strategy if it isn't working. You have to be able to monitor, evaluate, analyze, correct, change and adapt. You must also have a clear view of this changing world from a big picture perspective. You can't operate with a shopkeeper's mentality, thinking that the world consists of the block where you are located and the people who are your customers. You have got to read the major publications, stay in touch with what is going on in the economy, be aware of industry trends and changes. You must constantly reassess the traditional strategies of business expansion and pick and choose those that fit your mode of doing business most effectively. Never let your competition run your business. Just because a competitor is giving away its products at a ridiculously low price does not mean that you should try to match them. Boston Chicken made that mistake. The original Boston Chicken units were strictly carry-out restaurants that made rotisserie chicken and served delicious corn, baked beans, and salads on the side. They operated in small spaces with minimal staff and because they roasted several chickens on a skewer at the same time it was easy to take them off the skewer, chop them in half

and throw half on each plate, adding sides. Low food costs, low labor, efficient operations. Along came McDonald's. They opened a competing business called Hearth Express, which offered the same products that Boston Chicken served but added meat loaf, baked ham and seating. Boston Chicken panicked. They, too, added meat loaf, ham and seating and raised $1 billion to finance their growth and that of their franchisees. Within two years after opening Hearth Express, McDonald's realized that the units were not meeting their financial goals and shut the company down. By this time Boston Chicken had hundreds of units operating that were also under-performing financially. At last, Boston Chicken folded. And who bought them out of bankruptcy? Who else? McDonald's!

The Way To Get Left Behind

For many business owners, the decision to look at franchising as an expansion alternative comes when they find themselves at a crossroads. Their business is successful. It is making money. The question is: how best to make it grow? One man we met recently found himself in just such a situation. He had devised a new business concept that he believed could be expanded nationally. But he lacked the capital to undertake an aggressive growth program. He knew, however, that time waits for no man. "Whenever I pick up a trade journal my heart stops," he told us. "I'm afraid somebody else will do it before I do."

Hundreds, perhaps thousands of CEOs, corporate executives and business owners have similar dilemmas. Whether they have a new concept to introduce, an existing business in need of faster growth, or just more demands on capital than they can satisfy with

existing resources, they all face critical decisions. Should they take the plunge and risk losses – even the loss of the business itself – or proceed cautiously and perhaps miss the chance of a lifetime? Actually, most managers in this situation have little choice. They cannot risk betting the company on an exciting new concept. Like our friend, they mutter wistfully, "If only there were a way to get the job done without excessive risk." So what are the options? Should you consider expanding at all? Our feeling is that if you own a business and are reading this book to learn more about franchising, you have already answered that question. You do want to grow your business. Your specific goal may not be the same as someone else's. You may want to expand your company in order to sell it. You may want to eventually pass it on to your children. You may have a dream to take it public. But the question "Should I?" has already been answered. What remains is the question "How?"

The answer to that will depend greatly upon your individual personality, experience and abilities. We frequently conduct seminars on franchising for business owners and executives. But even if all of the people in attendance at our seminars owned the same type of business, no two would be in precisely the same situation. One might have a lot of capital, another very little. One might have extensive experience in running a sizeable company, another limited experience at running a small one. One might have family working in the business. One might have a burning desire to grow this business as fast and as far as possible. Another might be conservative and have a comfort zone only for slow growth. All of these factors contribute to the decision on how to expand.

But for a moment let's consider the consequenes of not expanding. The first consequence is loss of momentum. In business, you don't simply stand still if you're not moving forward; you begin to fall behind and may soon be out of the game.

Why don't companies expand? Three reasons:

1. Lack of capital
2. Lack of dedicated people
3. Lack of vision

Ironically, these are almost the same three reasons companies franchise:

1. Lack of capital
2. Lack of qualified people
3. The need or desire to move more rapidly.

The major impediment to your ability to expand is probably capital. To expand takes money. Whether you are driving an 18-wheeler, an SUV or a passenger car, you need fuel. Money is the fuel you need to drive your expansion. We know of only four ways to get it.

The four ways to raise expansion capital

1. Internally generated capital. This is the money that you make in your business. We hate to be the bearers of bad tidings, but here are a few facts: Fact #1 – You will never make any real money running your business. Fact

#2 – You will never generate enough liquidity out of your current business to open several company-owned units out of cash flow. Fact #3 – The better your business does, the more money you will need to invest or borrow to fuel your expansion.

Hard to believe? Let's take a look. Review your own financial statements from last year. Are your profits reflected in your bank account today? Probably not. Why? Because you continue to put cash back into your business to add inventory, hire people, advertise, and update equipment. In doing so, you do increase the value of your business on the balance sheet, but you do not really increase your liquidity and therefore lack the cash to fund expansion. You would agree, we are sure, that 20 percent earnings on your invested capital would be an excellent return. The companies on the New York Stock Exchange average only about a 7.5 percent return annually. Not on sales; we are talking about return on invested capital, the money it takes to establish a new store, branch, restaurant, office or whatever. Even if you were able consistently to earn 20 percent and keep it in your bank account, it would be five years before you would have enough cash to open the next unit without debt or outside financing.

So the sad truth is, you will never make any real money running your business on a day-to-day basis, even with a handsome 20 percent return on investment. You can make a good living, but you will never make any real money.

Internally generated capital is simply not sufficient to fuel any kind of aggressive expansion.

2. Borrowed Capital. Of course, you can try to borrow the money. But borrowing has two major disadvantages. First, you can only borrow up to your net worth or possibly 1½ times your net worth, depending upon current banking standards. But the net worth/collateral of most companies and individuals is simply too small to allow expansion at a level aggressive enough to capitalize on market opportunities. Second, borrowed money must usually be paid back. Banks are funny that way. And payback can be really tough when you are putting money into a new business that will probably lose money in the first year and barely break even in the second.

Most bank loans are five-year loans, requiring that you pay 20 percent of the principal each year for five years in addition to interest. The interest can run from as low as 8 percent to as high as 22 percent, which we saw in the 1980's. On that basis, you must repay an amount equal to 30 percent (20 percent on the principle plus 10 percent interest) of the loan in each of those first two years when you are not making any money! Where will that money come from? From your present business, of course. Now if you should be so fortunate (or unfortunate) as to have sufficient collateral to open two or three new units, you then find yourself having to pay a whopping 58 percent of those loans for the first two years. This could be disastrous. Opening multiple units, whether with borrowed capital, cash flow, or a combination of both is sort of like having quintuplets. They all wake up at the same time, cry at the same time, have to be fed at the same time, changed at the same time, and go through the same baby steps at the same time. It is a lot easier when you space your children two years apart, so that by the time you have the third one the four-year old can run and answer the phone for you while you are changing the baby.

Borrowing money to open additional units is the worst answer to a difficult problem. First, it does not allow you to employ a sufficiently aggressive roll-out strategy. Second, borrowing to open any new units places enormous stress on your existing business. You must service these loans at a time when you are least capable of doing so, while increasing the burden of retaining employees, training them, and expecting them to perform at maximum levels.

Bankers, it seems, are always there when you don't need them. When interest rates are high and unaffordable to small business owners, the banks are quick to offer money at those exorbitant rates. After all, banks recognize that small or rapidly expanding businesses have a higher risk, but they reason that high rates make it worth that risk. But when interest rates are very low and enticing to business owners, banks don't want you. Banks would rather lend $1 million to one large company than $200,000 each to five small

or medium size businesses. There is only one account to service, and the minimal odds of the large company defaulting on a loan reduce the risk.

3. Equity capital. For most business owners, the odds of getting someone to invest in their company for expansion, particularly for opening additional company-owned units, are slim to none; and Slim just went home. Why? Because as was stated earlier, there is no real money to be made in operating company-owned units – at least not the kind of money investors and venture capitalists are looking for. They are looking for a return of 50-70 percent annually on their investment, which is possible only by getting it in waysother than by operating units. Your dream of finding investors who will give you the money to open ten more stores is simply not realistic. Investors may invest in your business, but only because within three to four years they expect you to implement an exit strategy with three options:

a. You sell the company and they cash out.
b. You buy them out and they cash out.
c. You take the company public and they cash out.

Venture capitalists are not interested in getting into a ten-year investment program, even though your business plan may forecast great returns by that point. They need to turn their investments over in a relatively short period of time, usually within

three to four years. Think about it. If you buy a common stock, do you buy it because you want the 23 cents per share quarterly dividend? No, of course not. You buy it at $2 because you expect it to go to $3, then $10 and then $20 in a few years. In other words, you expect to make money not on the company's earnings but on the appreciation of the company's value or of the market in general. Many of the stocks people buy and sell are in companies that never made money before they bought it and still had not made money when they sold it at a far higher price than they paid for it. A rising tide lifts all boats. When the market is up, all stocks go up. When the President has the sniffles, stocks go down. And, at the risk of redundancy, we repeat, real money is not made by operating units.

Sophisticated investors want to invest in businesses with strong management capable of building a company to many times its present size. If you are the vice president of marketing for a major food chain and you want to expand, start a new food concept, or acquire a new company, you can probably find investors to back you. But as a successful operator of a small restaurant chain seeking capital to open additional restaurants, your chances are far less favorable. That is the case even if you have a well-articulated business plan that clearly defines the concept, the company, the market, the competition, the opportunity, the alternatives for expansion, and your growth strategy. It is the case even if your plan includes

a five-year cash flow analysis that provides good evidence that an investment in your firm would be appropriate. But supposing you have such a business plan and do, against all odds, attract an investor. What that investor will demand as he turns over his money is the right to step in and take control of your company. No matter what percentage of ownership he acquires, if you do not attain the goals stated in your Business Plan or if, after you have achieved your goals, he feels you are not capable of managing the monster that you have created, he can exercise power over you. The conflict between owners and investors is endemic in the relationship. Owners want to build the company and investors want to cash out. Owners may also find it difficult to have to answer to the investor or even to give him a voice in the way the company is operated.

4. Franchising. Did we say franchising? Weren't we were talking about ways of raising money for expansion? Well, as a matter of fact, we are, and franchising may be the best-kept secret for acquiring expansion capital in the world of business. Think about it. Someone pays you a franchise fee – usually at least $35,000 – for the right to use your name, your system of operation, and to have you teach them the business and to help them get started. They also pay you a royalty – a percentage of their sales on an ongoing basis (usually about 6 percent) – for the right to use your name and your system and for your continued consulting and assistance in their ongoing operation. In other words, as a franchisor you are never dependent upon a single bank or a single investor. Every franchisee becomes both an investor and a vital, cooperative part of the growth of your business.

But franchising offers other advantages as well. It solves the unit management problem because franchises are almost always sold to owner/operators who become the managers of their businesses. You, the franchisor, get a much more highly motivated day-to-day manager than you could possibly hire, someone who has a huge (remember, 70 percent take out home equity loans) investment in the business and is totally committed to its success.

Franchising also allows you to grow at a much more rapid rate than would be possible with your own capital. We'll discuss these and other benefits later, but for now, let's focus on how franchising enables you to get the capital you need to expand your business so you don't get left behind. Do the math. Many companies sell more than ten franchises their first year. Ten buyers at $35,000 each gives you $350,000, without loan payments, and without giving up equity in your company. Each franchisee comes to your place of business at no salary and gets on-the-job training – usually for a few months. Then the franchisee goes out and buys the land and builds the building or rents the space, buys the equipment, buys the inventory, buys the fixtures, provides the working capital, and pays to advertise the grand opening – all without any contingent liability on your part.

Your responsibility is to be selective in choosing franchisees. You will train them intensively, assist them in finding a suitable site or defining their territory, and help them get started. Finally, you will be supportive as a consultant and will mentor them once they are in the operation. To put it simply, franchising may be the best way to raise the capital you need to expand your company. To go out and try to borrow money or attempt to bring in investors in today's market, you would have to be a masochist and love pain.

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But the bigger issue is that the world is not going to sit around and wait until you get ready to open ten or 100 or 1,000 clones of your business. So, if you don't have an unlimited bank account, you've got to find another way to expand – or be left behind.

Chapter 3

What Franchising Is And What It's Not

It is one thing to know that franchising provides an alternative to internally generated capital, borrowed money or equity funding and quite another to know whether franchising is the right growth system for any specific business or any specific business owner. To answer that, it's helpful to begin by learning precisely what franchising is and what it is not.

The Federal Trade Commission defines franchising as follows:

Franchising is a method of doing business by which the franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor and which is substantially associated with the franchisor's trademark, name, logo or advertising.

That's quite a mouthful. To summarize, a franchise exists when the following three elements are in place:

1. You permit someone to use your name.
2. You permit someone to use your system of operation or marketing program.
3. You receive payment of a fee, either initially or on an on-going basis.

If only two of these three elements are present, your business is not a franchise. In fact, some businesses avoid the compliance requirements that are attached to franchising by eliminating either use of the name or use of the system. They sell licenses instead of franchises. (Every franchise involves a license, but not every licensor is a franchisor.) For example, Coca Cola can license someone to imprint the name Coca Cola on T-shirts and sell them. The licensee pays an initial fee and a price for each shirt sold. The licensee has not bought a franchise. When it does sell a franchise (and they are expensive!), the Coca Cola company gives the franchisee the use of its name, its private syrup, the right to bottle and distribute its products in an exclusive territory, a marketing strategy, assistance in developing the market and other benefits – in short a package that includes all three elements listed above. Among other things licensed are technologies, such as software programs, and recipes for special food products that will be used in the licensee's business, providing that the business does not bear the licensor's name. If you are a famous chef such as Wolfgang Puck, for example, and have developed a special Wolfgang Barbeque Sauce, you can offer an

exclusive license to restaurants that might want to put a tag line "featuring Wolfgang Barbeque Sauce" beneath the restaurant name. The restaurants will use their own names, not Wolfgang Puck's, and will pay a license fee in addition to a price for the product.

The principal disadvantage of licensing compared with franchising is that the licensor has minimal control over the people to whom he or she grants the license. And the fact that licensors are relatively unregulated compared to franchisors does not compensate for the lack of control. However, the bigger issue is not how to devise a way to avoid being considered a franchise and therefore avoid complying with franchise laws, but rather what is the best business decision for the expansion of your business. If it is important for you to (1) create brand awareness by having people use your name and your system of operation, (2) ensure quality control, and (3) obtain ongoing income from the continued use of your name and system, then franchising is probably the way to go.

How franchising works

As we mentioned earlier, the concept of franchising is simple. Someone pays you an initial franchise fee for the right to use your name and system of operation, and to have you teach them how to operate the business and provide ongoing consulting and assistance. That person then works for you for a month or two learning the business at his or her own expense and pays all the costs of establishing a replica of your business. That includes buying the land, building the building, buying

the equipment, making the leasehold improvements, buying the inventory, furnishings, fixtures and signage, and providing all of the working capital needed to establish this business and operate it on an ongoing basis. The franchisee may, in addition, buy equipment and supplies from you, the franchisor. The franchisee will pay a continuing royalty as well. The term "royalty" refers mostly to the license concept of paying a fee for the continued use of the name or system. Royalties are usually paid weekly as a percentage of gross sales. The franchisee is allowed to use your trademark and system and you, in turn, will provide on-going consulting and support.

There are two broad categories of franchises: start-up and conversion. The vast majority of franchises are start-up, a new version of the franchisor's existing business at a new location. Most are sold to individuals who know nothing about the business. A few know nothing about any business. On the first day of training, the fast-food franchisor holds a chicken by the legs and says, "This is a chicken. It has two legs and usually weighs about 2 ½ pounds. We cut this chicken up into eight or nine pieces." etc., etc. Because many franchisees have little or no business experience, it is extremely important that the franchisee become completely familiar with the franchisor's business before opening the doors of his or her own establishment. It is also important to provide comprehensive Operations Manuals so that everything taught during training can be reviewed later. It is also invaluable for use by the franchisee in teaching employees.

Conversion franchises are sold to an individual or group already in the same business, operating under their own name. The most widely known application of conversion franchises has been in the real estate and hardware industries. A real estate owner would take down the sign that said Don's Real Estate and replace it with a new sign that said Century 21—Don's Real Estate. The name Century 21 would occupy 80 percent of the space on the sign and the name of the previous business 20 percent. Ace Hardware is another example. Independent hardware store owners replaced their signs with the Ace Hardware signs. They, too, often identified themselves by adding their own names so that people did not think they went out of business.

In recent years conversion franchising has been employed more and more often by manufacturers. Companies such as United Carbide (marble care), Novus Windshield Repair, Dahlberg, Inc. (hearing aids), and Four Seasons Marketing (solariums) have replaced independent distributors with franchises. The advantage to the manufacturers is higher quality, more dedicated distributors who market their products exclusively. The advantage to franchisees is improved service, including stronger advertising programs.

Most people who buy start-up franchises want to get into an established business that is operating successfully and be taught to operate that business by those who have made it successful. The driving force behind conversion franchises is usually advertising, business systems and purchasing power.

In addition to deriving income from initial franchise fees, royalties and, sometimes, the sale of products

or services, the franchisor also collects advertising fees from franchisees. These fees are kept in a separate fund and spent only on advertising aimed at generating customers for all franchisee-and company-owned outlets. They should not be used for any other purpose. Strict records must be kept of all expenses associated with creating or administering the franchise co-op advertising program. Typically, franchisors provide quarterly and annual reports showing the state of the advertising fund.

In both the start up and conversion categories, there are three types of franchises:

Individual Franchise. Most franchises are sold to one individual for one physical location or one territory. A restaurant, muffler shop, beauty salon, or hotel, of course, operates in a fixed location. But for some businesses, such as temporary office placement, carpet cleaning, industrial products sales, or accounting services, the precise location is irrelevant, even though the franchises are assigned a specific territory. Businesses with fixed locations must select sites where demographics will support the business. For example, even though Sun City, Arizona has a population of 40,000, you would not put a USA Baby's Room store in that market. Notwithstanding Viagra, there probably hasn't been a birth there in thirty years! Some businesses base their customer demographics on population density, i.e. one store for every 25,000 people. Other businesses base their customer demographics on the number of cars that drive by the location each day. Population density might be a good criterion for a physical fitness establishment. Drive-by density might work better for a quick lube or fast food operation.

Multiple Unit Franchises (also called master or territorial franchises): The multi-unit franchisee, unlike the individual franchisee, is given a specific territory in which they are required to open a specific number of units on a scheduled basis. Typically you discount the initial franchise fee and require the multi-unit franchisee to pay half of the aggregate amount due for all of the franchises at the execution of the contract. As each unit is opened, they pay the balance of the franchise fee due on that unit. For example, if the individual franchise fee were $35,000, you might discount it to $30,000 for a multiple buyer. Thus, if the multiple buyer buys a ten-unit territory for $300,000, you would collect $150,000 when the contract is executed and $15,000 as each unit is opened. The franchisee might be required to open one unit in the first year, two units in the second year, three in the third year and four in the fourth year. If at any time they did not open a unit on schedule, they would forfeit the money paid in advance but could continue to operate units already opened, so long as those units remained in conformance with operating standards.

Subfranchising: Some franchisors over the years have sold large territories to sales oriented individuals or groups who, in turn, sell individual franchises in their market and service them. Subfranchising, as this method is called, has been used primarily by conversion franchises or franchises with low volume businesses. In the past, Century 21, for example, would sell a large geographical territory – sometimes a whole state – to an individual who set out to persuade independent real estate brokers within that territory to become Century

21 franchisees. The people who bought the rights to these markets had two basic functions. First, they sold the franchises and split the franchise fees with the franchisor. Second, they provided ongoing consulting services to these offices and split the royalties with the franchisor. They usually did not operate a real estate office themselves.

The goals of franchising

Whatever franchise strategy is chosen, the goal of the franchisor is to create value for everyone involved. The franchisor must create a network of franchises that produces enough revenue to return a profit on the licensing of its name, technology, system and ongoing assistance. The franchisees must also benefit through profits and through the achievement of the American Dream of business ownership. Though franchisees use the franchisor's name and business system they are nonetheless independent owners. Ultimately, consumers must also benefit by gaining access to a well-managed business that provides desirable, fairly-priced goods or services.

One of the bywords of franchising is "consistency." The very term "franchising" has come to be regarded as synonymous with consistency. Franchises are almost always used by middle of the road businesses that seek to attract the broadest possible market. Holiday Inns are not usually the very best hotels in every town, although in some towns they may be. They are not aimed at the high profile market sought by the Four Seasons or the Ritz Carltons of the world. McDonald's is not a

"fine dining, white tablecloth" restaurant. Great Clips is probably not where the stars go to have their hair done before they appear on a late night television show. But all of these businesses have one thing in common, consistency. If you drive into a strange town with your family looking for a place to eat, you are less likely to pull in at Don's Diner than McDonald's. If you saw Don's Motel or a Comfort Inn, you would probably go to the Comfort Inn. If you needed a haircut, and you saw Don's Barbershop or Great Clips, you would go to Great Clips. Need we say more? So don't believe the myths that franchising is fast food only, that consistency is to be scoffed at, that only small businesses franchise, or that franchises quality is sacrificed. We have heard all of the disparaging comments. All one needs to do is to look at how franchising has grown in the United States and around the world in the past half century. Franchising continues to be utilized as a growth system by a wide variety of businesses, including healthcare, high tech, the automotive aftermarket, Internet-related businesses, home furnishings industry, medical, legal, banking, and myriad others. Even big businesses make use of franchising. Krystal Hamburgers had 400 units in operation when it decided to franchise. Mrs. Fields Cookies had hundreds of units in operation when it started franchising. Hyatt Hotels was already a large chain when it started franchising.

Of course, franchising has always been the perfect vehicle for the undercapitalized small entrepreneur with a good idea. Kemmons Wilson of Holiday Inn, Ray Kroc of McDonald's, and Colonel Sanders of Kentucky Fried Chicken were franchising pioneers. All were small

entrepreneurs who grew wealthy by sharing their ideas with ambitious people eager for a piece of the American Dream.

Far from sacrificing quality, franchising usually raises it. Our experience before becoming franchise consultants was in managing companies that both operated company-owned units and sold franchises. In nearly every instance when our companies sold off a company-owned unit to a franchisee, sales went up. In almost every instance in which we bought out a franchisee and put in our own manager, sales went down. There is simply no substitute for the owner-operator with a vested interest in his or her business. They are highly motivated people who stick it out because their financial lives depend on it.

Who qualifies

But let's face it, franchising is not for everyone. As a business owner, if you like to keep total control over your business, or if you believe that no one in the world is going to operate that business as well as you do, then you should probably not franchise. You should probably not even expand to any extent, even with company-owned units. You are probably better off staying as you are. Or, if you expect franchising to be an easy, quick way to untold riches, you may also be disappointed. Some people we talk to say they want to be as big as McDonald's or bigger. Yet, after a little probing, it's apparent that they have little understanding of the financial, operational, infrastructure, marketing, and overall expansion realities. Let's face it. Some of us are

just not destined to be Number 1 in our class. That doesn't mean that with more realistic expectations we can't be extremely successful. At our Francorp offices in Chicago, we get thousands of calls from people who want to franchise their businesses. But when some who come in for a meeting talk about getting rich quick and having thousands of units, we press a secret button opening a trap door that drops them twenty floors to their death in the alligator pit. Although we have exaggerated a bit and don't really have an alligator pit or a trap door, sometimes we wish we did. The truth is, just as in your business, there is no secret get rich quick scheme. In franchising, as in every other endeavor, hard work and talent propel you ahead. "Techies" who lack marketing or people skills or others who are good at giving orders but not good at teaching, are not going to succeed in franchising. "Superstars" and "loners" don't work well in franchising. Your success in franchising will be related more to how good a coach you are than how good a player you are.

In summary, franchising can offer a wonderful opportunity to the right person with the right business. Let's explore in greater detail how a successful franchise is created.

Chapter 4

Creating A Franchiseable Business

Whether or not you own a business or simply have an idea for a business, it is important before making a decision to use franchising as a growth system to know what qualities that business needs to be successful in franchising…and what qualities it does not need. In assessing the franchiseability of any business, three broad areas are critical:

1. The business concept and structure
2. The marketability of the business
3. The abilities and commitment of the owner/franchisor

Let's take them one at a time.

The business concept and structure

What is the single most overrated requirement for franchising? Answer: A Great New Concept. Sound crazy? Think about it. Some of the most successful franchise companies are McDonald's, Subway, Holiday Inn, Midas Muffler, Service Master, Great Clips, and Jani King. But all of these businesses had many predecessors. None of their concepts was unique. Next question: What is the second most overrated requirement for franchising? Answer: A Great Quality Product. Consider the giant hamburger franchises. In voting for the highest quality hamburger, McDonald's has consistently been picked third behind Burger King and Wendy's in consumer surveys. Yet in an industry in which these three companies have a combined 72 percent market share, Wendy's, which surveys say has the best burger, owns only a 12 percent share. Burger King, which came in second has a 19 percent share, and McDonald's, picked last of the Big 3 has a whopping 41 percent share. So, before you bet the farm, mortgage the house, quit your job and withdraw all of your savings to start franchising your existing business because you believe you have a great concept or a fabulous product, consider what those companies that have succeeded in franchising do have. If the concept isn't always great and the product isn't always fabulous, what's their secret? Answer: their operating systems. Of the three, McDonald's not only has the biggest market share, it has the best operating system. That's why 97 percent of all Americans go into a McDonald's every year and 59 percent every month.

McDonald's is the poster child for franchising simply because McDonald's outperforms everyone else. Location, layout, consistency, product quality (one virtue among many), speed of service, advertising, focus on the kid market, Beanie Babies, McFlurries, NFL and Disney promotions, and the fastest drive-thru in the business are all characteristics of McDonald's. In units with drive-thru windows, up to 85 percent of sales are made at those windows. In many markets, McDonald's has increased unit efficiency, lowered costs and overcome the shortage of help by outsourcing the voice on the squawk box to India. That's right. When you pull up to the speaker in the drive-thru, the voice that welcomes you to McDonald's and asks for your order may well be that of someone in Bangalore. With this one innovation, McDonald's has cut thirty seconds off the drive-thru time and increased sales system-wide by millions of dollars. It's not about the burgers, the mufflers, the whatevers. It's about systems of operation that work smoothly and are duplicable. Those who thrive – or even survive – are the ones that put it all together: the concept, a strong pilot unit, marketing, advertising, operations, pricing, consistency, profitability, locations, and, in franchising, selection, training and support of their franchise owners. The marketplace is a vast field full of land mines for businesses. Trigger one, and it could be fatal. Make a mistake on products, location, advertising, pricing, size of your market, the competition, and it could all be over.

Of course, if you do have a great concept, like Curves, or a fabulous product, like Starbucks (not a franchise), it can't hurt. In fact, it can help make you wealthy and famous. But even then, a great concept

is the frosting on the cake. First, to be successful in franchising, you need the cake.

The Prototype

To franchise you must have a profitable operating prototype. The prototype may be your principal business or it may be a version of it designed for franchising. You may decide, for example, that your business will be easier to operate and more profitable if you eliminate some of the marginal products or services you offer now, maybe even reduce its size and place it in a different location. How long should you be in business before you franchise? Of course, the longer you've been established, the greater your credibility. But, like concept and product, age is not a critical factor. If you have no business and are still in the concept stage, you can follow the suggestions given here to build a business worthy of being franchised. But whatever stage you are in, you will not be ready to sell franchises until your prototype is up and operating and until it is generating positive cash flow. Until you have proved that the business works and can make money, you are not ready for prime time. The last thing you want to do is sell tickets for the Titanic!

The prototype needs to be lean and mean, which means that before franchising you must examine it for weak spots. Like a pinhole in a balloon that becomes larger as the balloon inflates, expansion will expose the weaknesses in your operation. If you wait until you start franchising to fix those problems, the likelihood is that the franchisee will not be able to patch all the holes as well as you can—if you can sell franchises at

all. If your company has multiple units now, you have a different challenge. You may have central purchasing, central payroll and even centralized hiring. When you franchise, your franchisees will have to do things your current managers do not do now. One of the first tasks Francorp does when we take on a new client is to identify operational areas that need to be corrected, changed or adjusted for franchising. We often recommend POS (point of sale) systems, equipment, procedures, and policies that make a business more franchiseable.

We mentioned earlier the McDonald's system. Every franchise company actually has two operating systems. One is the franchise system, encompassing all of the elements necessary for creating and operating a franchise. We will address that type of system in later chapters. The second, of course, is the unit operating system. And the McDonald's unit operating system is one that every business would do well to emulate, whether or not it franchises. That system begins with effective procedures for establishing the business and operating on a day-to-day basis. It means selecting the right location or market, having an effective marketing and sales strategy, employing capable people and training them adequately. It includes quality control, good products, the right environment and atmosphere, buying processes, pricing, maintenance, capital … and on and on. But more than that, it means achieving consistency in all of these activities. A system that works one way this week and another way next week is not a system. It's a recipe for disaster. If you are a business owner who likes to make it up as you go along, even though your business is successful (perhaps because of

your own hard work and personality) it is probably not ready for franchising.

Financial controls

Good financial controls are essential to any operating system. Small companies that do their own bookkeeping or accounting should incorporate accounting categories that allow both you and your franchisees to monitor accounting and performance data on a "real time" basis. Hardware and software for this purpose is available and affordable. It can even be tied into video cameras, located in key areas of each unit, that enable both you and the franchisee to observe operations from a remote location. Through these systems, you can obtain up-to-the-moment register readings, number of employees on duty, product mix, customer accounts, payroll, crew hours and other relevant information important to the operation and management of the business.

Large companies will have a different problem. Although good financial controls are likely to be in place, for franchising purposes some direct financial and operational functions heretofore executed at the corporate level may need to be transferred to the unit level. Payroll, accounts payable, accounts receivable, purchasing, depreciation, corporate G&A (general and administrative charges to the individual operating units), and differences in COG (cost of goods) might all be candidates for transfer. For example, if the parent company has been charging an individual store its actual costs of goods purchased or manufactured, but will now

take a markup over these costs when it sells them to its franchisees, the accounting system will need to be adjusted accordingly.

Whether your company is large or small, if you eventually have units located in remote areas your financial and operational reporting systems will be of critical importance—not only to your franchise program, but to your existing business. Time and time again clients have told us that some of the best things they got out of franchising were the financial and operational changes we helped them make and the operations manuals we drafted while putting their franchise program together, which strengthened their business in so many ways.

Profitability

And speaking of financial matters, we said that the prototype should have positive cash flow. In other words, be profitable. How profitable? In our opinion, no business should be franchised unless the franchise owner, after the second year of operation, can make the same salary he or she would pay a hired manager of that business, plus a 15 percent return of the franchisee's invested capital. Not 15 percent of sales, but a 15 percent return of invested capital. For example, if a franchisee would need $200,000 to open one of your units, and if the manager's salary for that unit if non-franchised would be $50,000, the franchisee should earn by the end of the second year of operation $80,000 before taxes and debt service. That's $50,000 in salary, plus $30,000, which is 15 percent of their $200,000 investment. We assume it takes two years to get a unit to a mature level.

By the way, when we speak of "profitability," we're referring to the operating unit that will be franchised, not to the corporation that owns it. Your company may be operating at a loss for a variety of reasons that have no bearing on the operating unit. You may have excess staff while you are developing the business, or doing research and development on new products that may or may not be in the franchisee's unit. You may be paying higher than required salaries to family members or to people that you are grooming for higher levels of responsibility. You may also be paying higher rent than your franchisees will pay. These adjustments need to be taken into account, in order to determine if you have a credible model to franchise.

The marketability of the business

We said earlier that age is not a vital factor in franchising. Neither is size. It is wonderful to have been in business for years, have a large number of units in operation, and have brand identity and a growing reputation. But most businesses that start selling franchises have only one operating unit. That fact can actually be attractive to potential franchisees, because it suggests that your business may be in an emerging new industry or that it may cater to an unserved or underserved market niche. Big companies highlight their corporate resources, their training center, their field support, and other corporate strengths. If yours is a one-unit operation and has not been in business very long, you will stress your hands-on assistance and your personal accessibility – the fact that the franchisee will

be working directly with the founder, who has a vested interest in their success. Bigness may actually have some disadvantages, which may be one reason that 70 percent of all companies selling franchises have fifty or fewer units. Some of the behemoths of franchising, especially in fast food, are finding it harder and harder to find locations for new units. The same is true of Starbucks, which has all company-owned units. Yet the success of Starbucks has benefited a number of single-unit coffee shop owners who have franchised into a market that didn't exist until Starbucks came along.

If concept and product are not critical, it is nonetheless helpful when thinking about franchising to be able to demonstrate a point of difference between your business and that of your competitors. You may have a unique store design, a special marketing program, a particularly effective way of displaying or delivering your products or services. Sometimes only one element needs to be different to ensure success. For example, price. You may have found a way to offer the same products as other stores but at significantly lower prices. On the other hand, be careful lest the competition adjusts and your advantage evaporates. For example, Checkers, a strictly drive-up, walk-in hamburger-only concept with a 99-cent burger took a run at McDonald's in the 1980s. Within a short time, McDonald's, whose burgers were in the $2.00 range, came out with a 99-cent burger and blew Checkers away.

If you are still at the concept stage and haven't yet established a prototype, be sure that there is a market for your exciting, new, or different product or service. This is especially true if you need to educate

the consumer about what you offer. Educating the market is expensive. It takes a great deal of capital to introduce a new concept. Ask yourself if there is a real need for this product or service, which if properly explained to people would sell, or whether you simply believe it to be a great idea. Larger companies do test marketing and focus groups. McDonald's, in selected locations, tested pizza and cheddar cheeseburgers on a whole-wheat bun. Both disappeared after tests did not confirm or justify their continuance. It's always best to back up even a good idea with research. Margot Chapman, one of the top marketing and concept development consultants in the United States, regularly conducts focus groups and market tests for companies like DuPont, NurtaSweet and Allstate. She may be an expert, but that didn't deter her from spending a year researching the market before opening her own Swirlz chain of cup-cake stores.

If you intend to roll out your franchise program nationally or internationally, you should know what you're getting into. Business people in other countries often look at the United States and see a single market. We know better, but US companies often make the same mistake when looking at other countries. For example, Tokyo and Osaka, though only 300 miles apart, are very different. Tokyo is a sophisticated, cosmopolitan city, Osaka more industrialized. Mexico City and Cancun are vastly different. Be sure that the products or services your business sells will be welcomed in whatever markets you intend to enter. Barbeque in Chicago means baby back pork ribs in a red sauce. In Texas, it means beef ribs. In South Carolina, ribs come with a mustard sauce. If your business is water-proofing basements in Chicago, good luck in Florida. They have no basements! Dig two feet and you have water! When Popeyes chicken ventured out

of Louisiana, where hot and spicy is a normal and expected component in foods, into Northwest and Midwest markets, unit sales lagged. In time, they learned that they needed a milder version. Do your homework in new markets and see what products and services are being sold successfully by competitors. In the process, you may also learn about opportunities not being addressed in those markets that you can capitalize on. But above all, don't use a franchisee as your guinea pig to see whether or not your concept is adaptable.

Facilities and personnel

One of the keys to successful franchising is your ability to assist franchisees in finding locations for their franchises. In fact, some franchisors do not sell franchises unless the physical location has been identified beforehand, as in a shopping mall. If you have a fast-food concept that requires a food court location, space in existing malls may be extremely hard to find. Typically, mall owners offer available locations to operators with whom they have had experience in other locations and whose operations are high-volume performers, exceeding base rents and thus paying the mall a percentage of total sales. Affordability can also be a factor. A 2,000 square foot location may cost four times as much in New York City as in suburban Denver. For location-sensitive businesses, land costs, liquor licenses, construction costs, availability of suppliers, building codes, personal services licenses, legal requirements, political factors, and other issues need to be explored before entering a market. In some areas, for example, a cosmetologist does not need a license to do procedures such as nails, skin care, or massage. In others, separate licenses are required for each. You also need to be reasonably sure that franchisees

will find the personnel they need to operate the business. In markets you intend to enter, what does the job market look like? Are there available cosmetologists to staff your hair salon? Are there experienced chefs for your Hibachi Flat Grill restaurant? Are teenagers available to work in your fast food downtown locations? Will you have to pay higher wages than in your current markets? What affect will this have on unit economics? At worst, it could mean that your business, as you currently operate it, may not be adaptable in certain markets. When they first start to expand, some companies deliberately avoid large urban locations in favor of low-cost land and labor in less-competitive rural and suburban markets. Wal-Mart is the perfect example.

Teachability

To be franchiseable, your business must be marketable not only to consumers but to franchisees. And one of the most critical qualifications for readiness to franchise is teachability. You must be able to teach a franchise owner of normal intelligence how to run the business within four to eight weeks. Some franchises require longer training periods. A McDonald's fran-chisee works two years in a restaurant, often on evenings and weekends, plus three weeks at Hamburger Univer-sity. Domino's Pizza sells franchises only to people who have been managers for two years. Culver's, an outstanding fast food operation featuring frozen custard and their famous Butter Burgers, requires four months of training. Training is absolutely critical. A person might learn to lubricate a car in two days, but it takes much longer to teach that person how to find a site, obtain permits, oversee construction, hire and train staff, do marketing and then run an auto lube business on a day-

to-day basis. In franchising, there is a direct correlation between success of franchises and quality, intensity, and duration of training.

Credibility

Another aid to marketability is reputation. Prospective franchisees are human. They respond to success stories. Any favorable publicity, letters or even customer comments about your business will enhance the marketability of your franchise. News stories about your personal accomplishments – whether in business endeavors or contributions to your community – will add to your credibility and make worthwhile additions to your franchise sales brochure. Video clips from TV broadcasts and articles from trade publications or national magazines and newspapers are worth their weight in gold. And if you don't have such publicity – or enough of it – there are ways to get it. You may be surprised to know that much of what you read and see in the media has been generated by public relations people. That's why you hire them. They do write-ups and submit them to the media. You can even do it yourself. Just write a headline accompanied by a story about your business and send it to every media source you can identify in your market. Give it a try. It works. And the reason it works is that print and broadcast media have space and time to fill. Supporting new businesses that may become advertisers can be an excellent way to fill it.

Another way to promote your business is to regularly scan major newspapers and magazines and clip articles and quotes that validate your concept or

industry. For example, The Wall Street Journal may report that "widgets are the fastest growing new product in the U.S. this year" or that "pet daycare centers are the newest and most popular trends in the pet industry." If you're in one of those businesses, make sure you retain the articles. If you own a salad restaurant and see an interview on your local TV station that validates your business ("Studies show that vegetarian diets are healthier and contribute to weight loss," for example), call the station and ask for a copy of the interview. Bottom line: media endorsement, whether reported or manufactured, is important and obtainable.

Cost

One would think it goes without saying that the more expensive the business the smaller the pool of prospective franchisees. And yet, that statement is not necessarily true. More important is the amount of up-front cash required of the franchisee investor. And more important yet is the ratio of that investment to the total cost of the business. For example, a franchise that requires the franchisee to pay up-front the total cost of a $100,000 business will be, other things being equal, far less attractive than the franchise that requires a franchisee to pay $100,000 down on a business worth $1,000,000.

Consider the two situations. Franchisee A pays $100,000 down and gets a business worth that amount. But the salary will be low until the buyer can raise sales and profits and therefore increase the value of the business. Yet even if the value doubles, it's still worth

only $200,000. Franchisee B, meanwhile, pays the same amount down but must take on debt service. However, the cash flow from a business worth $1,000,000 will both pay the franchisee a higher salary and pay off the debt service. By the time the debt is paid, the franchisee owns a business worth $1,000,000 – and probably a lot more. Who would you rather be?

So one key to marketability is leverage. The higher the percentage of your business that can be financed, the easier it is to sell franchises. Land and buildings, of course, can be financed. So can products and equipment purchased from suppliers. Custom-built equipment and proprietary products are not financeable, nor are leasehold improvements, although often landlords will factor payments on leasehold improvements into the lease. Your goal, then, is to minimize up-front cash required and maximize leverage. Be careful, however, not to allow your franchisees to become over-leveraged with debt service payments that strain their ability to operate comfortably. Understand that before you even begin to offer the first franchise for sale, you should line up financing sources for your franchises. We formed Francorp Capital just for that purpose: to provide financing for our clients' franchises for everything from vehicles to equipment, inventory, computers, working capital, and even for customers of the franchisees who may be purchasing large or costly products. We even arrange credit card processing, which is critical for a new franchise to obtain easily. All these elements make your franchise more saleable and more successful.

The ability and commitment of the owner/franchisor

Do you consider yourself a good manager? Of course you do. But why? Is it because you have built your business single-handedly from the ground up? Is it because no one in the business has worked as many hours as you have? Is it because people genuinely like you and want to be your customers? These are all laudable qualities; but the very traits that have made you successful as an entrepreneur can work against you as a franchisor. We've said it before and we'll say it again:Your success in franchising will depend more upon your teaching and coaching skills than on your ability to carry the company on your shoulders, no matter how broad they are.

Franchising will also test your organizational skills, including your ability to create and manage a complex infrastructure. It may even test them a lot sooner than you expect. For the unprepared, a franchise can very quickly become a monster that's hard to manage. We've seen it happen with our own eyes. Our client, Discovery Zone, sold 160 franchises in the first six months. Another client, Hurricane Wings, sold 65 franchises in the first month. You can readily imagine the impact on these companies. Initial training, site acquisition, construction, startup assistance, grand opening assistance, ongoing field consulting support, coordination of equipment and supplies, printing materials, financing arrangements. All this with companies that had only one unit in operation! Thankfully, there is help available.

This book will help you to understand the elements of franchising. But more important is the meeting you need to have with yourself in a phone booth to decide what it is you really want to do and whether or not you have the ability, desire, and commitment to strap yourself into the pilot's seat of a rocket ship. You will need to shift your style of management from the "hub and spokes" model where all elements report directly to you, to a more structured paradigm, with the eventual establishment of franchise sales, marketing, training, real estate, finance, operations, and legal departments. By no means should you establish and staff any of these departments, initially. You should sell, train and open the first ten units yourself. You need to learn the franchising business before you start adding people. When you – or someone with franchise experience – develop your franchise Business Plan, it will identify the departments you will need, indicate when and how to staff them, and state the cost. Because so much of your income from franchising comes up front, you will be able to fund these positions as needed.

Finally, there's the matter of integrity. For some uninformed or unscrupulous operators, franchising has been a "fast buck" vehicle. Just come up with a good-sounding idea and sell franchises! Lots of them! P. T. Barnum once said, "there's a sucker born every minute!" Let's dispel that postulate before we go any further. Franchising is not about a hunt for suckers, collecting fees, handing out manuals, providing a week or two of training, sending them off and then waiting for the royalty checks to come in. It's about understanding that you are going into a different business – a business

in which you are expanding your company by carefully selecting "managers" with at least the same qualifications you would require to operate your own company-owned units. However, these "managers" will not only manage their businesses, they will own them. They will not be your employees; in a real sense, they will be your partners.

If you are not physically and mentally prepared to accept only highly qualified applicants, you and they will fail. Tempting as it is to take a check for $40,000 from a buyer when you really need the cash and payroll is on Friday, selling a franchise to an unqualified buyer is a recipe for failure. It immediately "poisons the well," because failed franchises scare away other prospective buyers. And in the long run it can lead to very nasty lawsuits. For more than thirty years, Francorp consultants have served as arbitrators, mediators and expert witnesses in more than eighty lawsuits involving franchise disputes. In most of these cases, defendant franchisors unscrupulously sold flawed concepts to unsuspecting buyers, sold franchises to unqualified buyers, or provided inadequate training and/or support to their franchisees. Ask yourself this question: "Would I hire as manager a person who knew nothing about my business, give him two or three weeks' training, hand him the keys to the business and take a six-month vacation?" We think not.

Selling a franchise is not unlike having a child. Your responsibility doesn't end with the birth. It begins there. With a child, you have a lifelong responsibility to grow, nurture, support, guide, and be involved. The same is true of a franchise for at least the term of the

franchise agreement. The best companies are those who fully understand the necessity of recruitment, training and support. Companies like McDonald's, Culver's, and Midas have success statistics to validate this practice. Done right, franchising works well for everyone—franchisees, suppliers, consumers, and, not least, franchisors.

The Franchiseability Test

By now you should have some idea as to where your business stands in the spectrum between Totally Unfranchiseable and Eminently Franchiseable. But it may help you to get a more precise idea of your place along this spectrum by taking a brief quiz. Answer each of the following questions, add up your score and read the results below.

Points

1. *Do you have an operating prototype?*

No	1 point	
Yes	10 points	_________

2. *How many units do you have in operation?*

Assign 1 point per unit up to 10. _________

3. *How long since you first opened your business?*

Not in operation yet	0 points	
Less than six months	2 points	
One year	4 points	
Two years	6 points	
Three years	8 points	
Four years or more	10 points	_________

4. *To what degree is your business distinctive from its competitors?*

Not very	0 points	
Somewhat	3 points	
Very	7 points	
Unique	10 points	_________

5. *How much would it cost to open one of your locations, not including franchise fees.*

$400,000 or more	2 points	
$200,000 to $399,000	4 points	
$100,000 to $199,000	6 points	
$50,000 to $99,000	8 points	
Less than $50,000	10 points	_________

6. *The market for your business is:*

Local	0 points	
Regional	3 points	
National	8 points	
International	10 points	_________

7. *Competition for the products or services you sell is:*

High	1 point	
Moderate	5 points	
Minimal	10 points	_________

8. How systematized is your business?

Not very.	0 points	
Some policies and/or handbooks.	2 points	
Very well systematized and documented.	6 points	
Highly systematized and computerized.	10 points	________

9. How long would it take you to teach someone to operate your business?

Special certification needed	1 point	
2 to 6 months	2 points	
1 to 2 months	4 points	
1 to 3 weeks	7 points	
1 week or less	10 points	________

10. How do your sales compare with those of comparable businesses in your industry?

Much lower	0 points	
Somewhat lower	1 point	
About the same	3 points	
Somewhat higher	7 points	
Much higher	10 points	________

Total points ________

Ratings

0 – 39 Time to step back and think about it. Your business needs to make significant strides – perhaps with the help of specialists in your industry – before franchising becomes a viable option. If a strong market for your business exists, look for ways to improve your score in other areas.

40 – 59 Fine tuning needed. You have made a promising beginning. Now is the time to work on areas critical to successful franchising, such as systematizing your business, boosting sales and adding elements that can make your business distinctive.

60 – 79 On the threshold. You have all of the elements in place for a successful franchise. At this point your own goals may be more of a determining factor as to whether or not you franchise than the viability of your business.

80 – 100 Look out McDonald's! There's no such thing as a Can't Miss Concept, but yours is about as close as a business can get to Total Franchiseability. Go for it!

Getting Ready

We have talked at length about attributes that make a business franchiseable. But it will help you to appraise franchising and your place in it if you understand some general truths about this peculiar growth system before you enter into it.

Timing

In business, as in life, timing is everything. Enter a market that is not ready for your idea and you fail. Enter a market too late and a golden opportunity may be lost. Early computer companies anticipated the day when there would be a PC in every home. They revved up production…only to go bust. They were ten years too early. Several companies were already testing miniature portable radios with earphones when Akio Morita, chairman of Sony, boldly rushed into the market

with Walkman, without field testing, focus groups, or market studies. He captured a new market at just the right moment. Whether or not the timing is right for your business is something to think about.

Quick vs. slick

Competition is also important. If you plan to compete in a market where a few companies dominate, you'd better be slick. We mentioned the burger market, where McDonald's, Burger King and Wendy's have a 72 percent market share. If you want to compete, you should have several very professional-looking units in operation, each of them highly organized with all systems perfected. You should also have extensive financial resources. After all, if you can't match the buying power, advertising, field support, R&D, and market visibility of your competitors they may very well eat you alive.

Which is not to say that you have no chance against them. There are many examples of companies that have taken on the "big boys" – and won! Wendy's came along when everyone said there wasn't room for another burger operation. But Wendy's used fresh ground beef, while everyone else used frozen hamburger patties. Wendy's was "hot and juicy," making burgers to order. And their "Where's the beef?" campaign illustrated their point of difference and helped them to elbow their way into the burger market, replacing the "Big Two" with the "Big Three."

Later, Jimmy Johns took on Subway and others by advertising "fresher and higher quality" ingredients and using the slogan, "Your mom wants you to eat

here." In a few short years, Jimmy Johns went from one to 1000 units and to this day is the only franchisor to run full-page ads showing unit sales and profits.

On the other hand, if you are competing in a market that has no leaders with a significant market share – what we call a fragmented market – then it is more important to be quick. You don't have to be perfect – just be there first, fast, and before the competition. Kentucky Fried Chicken was the first major chicken chain, Midas the first muffler chain, Holiday Inn the first motel chain, Century 21 the first real estate chain. All had flaws at the beginning, but when you are first you have time to work out the flaws.

So be sure you are ready before you compete with "the big guys." But if you are lucky enough to be in one of those fragmented sectors where no names stand out, and if your business has a new twist, don't dilly-dally. Rocking chairs are full of people who coulda, shoulda, woulda if only they had acted, but instead froze at the switch. It's a tough call. To move or not to move? That is the question. It's gut-check time.

Small can be saleable

Whether your method is slick, quick, or neither, you'll benefit if the cost of getting into your business is low. The greater the franchisee's investment, the more potential buyers you exclude. Service businesses and home-based businesses usually cost less to own, but so do small retail businesses that allow a franchise to go into a 1,000 to 2,000 square foot store space with minimal leasehold improvements. Low tech is also

desirable. Businesses that are simple to operate are easier to sell than those that require extensive training or certification that takes months to obtain.

Bad trends and good

Be careful of becoming identified with a celebrity or personality. Pepsi used Michael Jackson as a symbol, until he had legal problems. Jerry Lewis and Minnie Pearl were the figureheads for theater and chicken franchises that came to a bad end. Kenny Rogers' Chicken also tanked. Fads are also dangerous. There's just not much of a market anymore for hula-hoop stores.

Then there's the Bandwagon Syndrome, a vehicle that looks so good people jump on before it proves itself. Frozen yogurt stores, for example, opened across the country, but soon closed when they failed to make a profit. On the other hand lifestyle businesses, if they catch on, can be blockbusters—and, indeed, Blockbusters was one. But Starbucks is the poster child for lifestyle businesses. It's not about the coffee. It's about the ambience, the cache, and the cool. But let's face it, it sells. Curves, the no frills women's workout operation, does a counter-culture play on lifestyle. It's now cooler to go there than to high-priced Spandex-perfect environments of the chic health clubs.

Apply the polish

But back to the business you own, not the one you might wish for. If you have a physical location, retail or otherwise, it must be made attractive, neat, and

appealing to a prospective franchise buyer. Remember, first impressions are important to people who are about to quit their jobs, refinance their homes, and are looking at several potential franchises. They really have no way to evaluate which franchise is going to be the best fit, the most profitable, offer the most services, and provide the best chance for success. That's because few franchises make earnings claims in their Disclosure Documents. Prospects judge the franchisor based upon what they see and hear. The franchisor with the most persuasive brochure, most comprehensive web site, most engaging salesman, and most attractive place of business often gets the sale. So, if that's the game you're going to be in, you'd better understand how to play it. Start with décor and graphics, but don't neglect documents, operations manuals, brochures, DVDs, CD ROMs, computers and software. Observable, tangible elements are integral to your sales presentation. You might be an intelligent, funny, and interesting person, but if you show up at a black tie event in overalls, you may not get the chance to display all that charm.

Remember how you got here

Granted, franchising is a very different business than the one you're used to. Take just one example. The average sale in your business may be anywhere from $25 to $2,500. When you offer to sell a franchise, your buyer is likely to need between $150,000 to $500,000 in cash! If we come into your place of business, cause no trouble and pay for your goods or services, we are considered good customers even if we are complete

idiots. But if you sell a franchise to a buyer who offers you a check but lacks the necessary qualifications to operate your business, you will rue the day. If they fail, that negative effect can cause other potential buyers to shy away from your franchise offering. Franchise buyers are like deer in the forest – if they hear a twig snap, they are gone.

Don't allow the size of the sale to influence you. Go back to what made you successful. Hold to the basic principles that built your business: integrity, hard work, good marketing, and knowing and taking care of your customers and employees. Plus, exercising good judgment generally. Your goal is to propagate your company culture, not to lose it.

Get the help you need

We have stressed that franchising is a different business from the one you are now in. For that reason, it will almost certainly be necessary to obtain professional help in creating a franchise entity. Indeed, if the name of your business is Jones Products, Inc. you will most certainly need a new corporation to run the franchise program, say Jones Products Franchise, Inc.

But even before that happens, you may want to obtain advice about the franchise marketplace. What are today's franchise buyers looking for? How much do they have to spend? Who else is selling franchises like yours? You'll learn quickly enough that companies selling franchises for the same type of business as yours are not necessarily your principal competitors. You are competing with everyone who has a booth at that

franchise show and everyone who has a franchise ad in a newspaper or magazine or is listed on a web site.

For these and many other reasons, it is important to have your Business Plan developed or, at a minimum, reviewed by professionals. A CPA can tell you if your plan is financially viable and help you to determine the amount of capital you will need to commit to the project. An attorney, preferably a franchise attorney, can inform you of the legal requirements for incorporating, registering your trade name, franchise compliance, and other legal issues. A franchise consultant can tell you if your business is even franchiseable and can assist you in developing the business plan, legal documents, operation manuals, marketing strategies and materials, and guide you through the process. But be sure to get references before you sign on the dotted line.

Finding money

In Chapter 2 we described various methods of raising funds for expansion, pointing out that franchising is indeed one of them and can outshine them all. But the capital that franchising provides goes primarily to the growth of your franchise system. Even if you do choose to franchise, you may need additional capital for such projects as opening company-owned stores or offices, adding computers, a web site, staff, inventory or new elements to your existing business. Here are some options:

Venture Capital

If your company is substantial and you decide to pursue venture capital, it's a good idea to know what you're getting into. Here is what venture capital firms are looking for:

1. **A capital infusion of minimally $1,000,000.** They don't usually do smaller deals.

2. **A well-articulated Business Plan** – not an inch-thick document loaded with statistics, but a compact presentation that includes an executive summary. The concept, the company, the management, the market, the competition, and the strategy must be concisely described. An assessment of capital needed and its use, plus a 5-year cash flow analysis, must be included. With a well-done, clearly articulated Business Plan, you at least have a shot. Without it, you don't.

3. **Strong management.** There is no shortage of good ideas. Venture capital firms look for a CEO and a management team that have managed their company successfully through strong and impressive growth. They want to know that you are capable of managing the monster you are liable

to create with the infusion of substantial capital. They also want to know how you and your management team will look in a Disclosure Document. Have you ever managed a public company or taken a company public? Have you ever done a deal involving investors, and how did it work out?

4. **Personnel needs.** If you have gaps in your management team, your Business Plan must clearly describe the type of people you will need, such as a financial person or Internet expert, and your plan to bring them in.

5. **Deliberate planning.** Define each stage of expansion and state its cost. You are not likely to get the entire million at once. Show that Phase I will require, say, $400,000, and that when it is complete Phase II will cost $600,000. Phase in your additional staff and hard assets. State that you plan to bring the CFO on board in month six and add the Christmas inventory in month ten.

6. **An understanding of the way venture capital firms structure their deals.** Percentage of ownership is not usually a vital factor. They are looking for 50 to 70 percent annual return on their investment, regardless of what percentage of ownership

they have. They want an *exit strategy* that gets them out in three to five years, tops. That may be acceptable to you if you are giving 10 percent of your company in the process. If you must give 80 percent of your company, it may not. But regardless of their percentage of ownership, if you fail to make your projections, they will have the right to take over your company. They may have other requirements as well. They may want a Revenue Participation Warrant (a percentage of your gross sales) off the top. Or, in return for their million dollars they may want their one million in equity treated as half equity and half loan, which needs to be paid back with interest.

If you decide to seek venture capital, control will be an issue. No matter what percentage a venture capital firm acquires, they will have a major role in all strategic or financial decisions. This often presents a conflict between entrepreneurs used to "calling their own shots" and making quick decisions and venture capitalists who want to minimize expenses to position the company for a sale.

Be realistic about your chances. According to a survey in USA Today, only 3,400 venture capital deals were done in the US in 2006. Considering that there are 20 million small businesses (to say nothing of large ones), the percentage is minuscule. Be careful of consultants who want a fee to help you acquire venture capital. Ask for the names of companies for whom they have helped to get funds and call them.

Finally, give yourself a deadline and have your Plan B ready. If venture capital is not forthcoming by a specific date, launch it. Otherwise you can spend years chasing your financial tail.

Equity funding

Businesses that seek equity funding are willing to exchange a share of their company, either in the form of a partnership, limited partnership, or for shares of stock in exchange for needed capital. While venture capital is the first kind of equity funding that usually comes to mind, there are other sources you may choose to consider. You might, for example, find a partner who is willing to invest in your company in return for a share of it. Many such people want a job in the company, which can work well if the person has skills that are needed. Some entrepreneurs are great at ideas, marketing and sales, but not so good at finance, accounting, or organization tasks. That kind of partner can be useful.

Another equity finance option is the private placement, a private offering to a limited number of sophisticated investors, called accredited investors. To make a private placement you will need to create a private placement memorandum, which is similar to the prospectus required for an Initial Public Offering. Only a few entrepreneurs with substantial businesses and strong track records can opt for IPOs. If either of these last two options are a consideration, RUN, don't walk, to your nearest securities lawyer. A psychiatrist might also be a good idea!

Debt financing

Debt financing, or borrowing money, is also an option for expanding your company. Typically, for starters, you will go to your current bank with your Business Plan in hand, and talk to a loan officer. If you have already borrowed money there and have a good payment record, you have an excellent chance of getting the loan, MAYBE. The "maybe" comes into play because no matter how wonderful your track record is with the bank or how well drafted and articulated your Business Plan, it all comes down to collateral. What is your net worth, business and personal, because banks will almost always require a personal guarantee on a loan. The other factor is the bank's loan ratio, which is usually 2 to 1, or even 1 to 1. This means that if you have a net worth of $100,000, the bank will probably lend you $100,000 or $200,000 at most. They will also usually require that your financial statements be audited by a CPA and that your real estate be appraised. Some banks are tied in with the SBA (Small Business Administration) and can go as high as 4 to 1, or even 5 to 1, lending ratios. They are "indirect SBA lenders." You can also go directly to the SBA. For more information, contact your local bank or the SBA.

Other options

If you need to buy or build buildings, money is generally fairly easy to obtain. Ten to 20 percent down payments usually get the job done with conventional mortgages. Typically, if you buy the land for cash you

can usually leverage it into a construction loan, and then it's a 20- or 30-year mortgage.

Equipment financing is also fairly easy to obtain, especially if you are using "off the shelf" equipment, fixtures, computers, machines, or vehicles. Financing companies view standard brands as collateral and readily marketable should they have to repossess them. Financing for customized equipment, on the other hand, is more difficult to obtain. Equipment financing is done at a substantially higher rate of interest than business or real estate loans and generally for a five- to seven - year period.

Receivables financing or "factoring" receivables may also be an option. In fact, some finance companies specialize in receivables financing. If a sizable amount of your assets is tied up in receivables from customers, you can pledge your receivables as collateral and borrow as much as 80 percent of their value.

Then, of course, there's always Aunt Martha. She may be willing to lend you money at 3 or 4 percent more than she is receiving at her local savings and loan. Of course, it's one thing to put yourself at risk and another to put Aunt Martha's life savings at risk. Be careful.

Many entrepreneurs and franchisees refinance their homes to establish, expand, franchise or buy franchises. A low interest, 30-year payback loan takes a lot of pressure off of a newly formed business enterprise.

Financing for franchisees

Now that we've explored some finance options for you as a franchisor, let's look at the financing needs of the franchise buyers we want to attract. The sale of a franchise almost always requires that a buyer obtain financing of some type. Moreover, the franchisee may need financing from more than one source. Some financial institutions limit transactions to real estate, others to equipment, and others to receivables. Some limit them to specific types of businesses, such as restaurants, or avoid specific businesses (such as restaurants). Fortunately, in recent years franchised businesses have been identified as generally attractive, irrespective of type, by financial institutions. As a result, companies like Franchise Finance Corporation, General Electric Credit Corporation and Francorp Capital were formed to put all of these finance needs under one roof.

In most cases, the sale of your franchises will hinge less upon total price than upon how much cash up front is needed. Therefore, it is incumbent upon you, the franchisor, to line up financing sources before you offer franchises for sale. The prospective buyer from another city who seeks financing locally may be turned down because their bank or finance company doesn't know you. It could cost you the sale. To avoid such problems, you can, if you have the money, provide financing yourself. If you don't, you may want to work with a company like the three named above to obtain single-source financing for all your franchisees' needs.

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In one respect, franchising is not so different from any other type of endeavor – business or otherwise. The better prepared you are, the greater your chance of success. In the next few chapters we will go into detail about specific preparations you must make to create your franchise program.

Chapter 6

Determining Your Franchise Structure

For the business owner who has decided

1. that his or her business is appropriate for franchising,
2. that the franchise market is right for that business,
3. that he or she is ready for the challenges of franchising, and
4. that franchising from a financial standpoint is the right way to go, there is just one step left: putting the franchise together.

At one time that was a no-brainer, or seemed to be. In the early days of franchising, on through the explosive 1950s and 60s, when new franchises were popping up everywhere, the process was simple. Put up a sign in your store and an ad in the paper offering franchises for sale. Find someone to pay you a franchise fee.