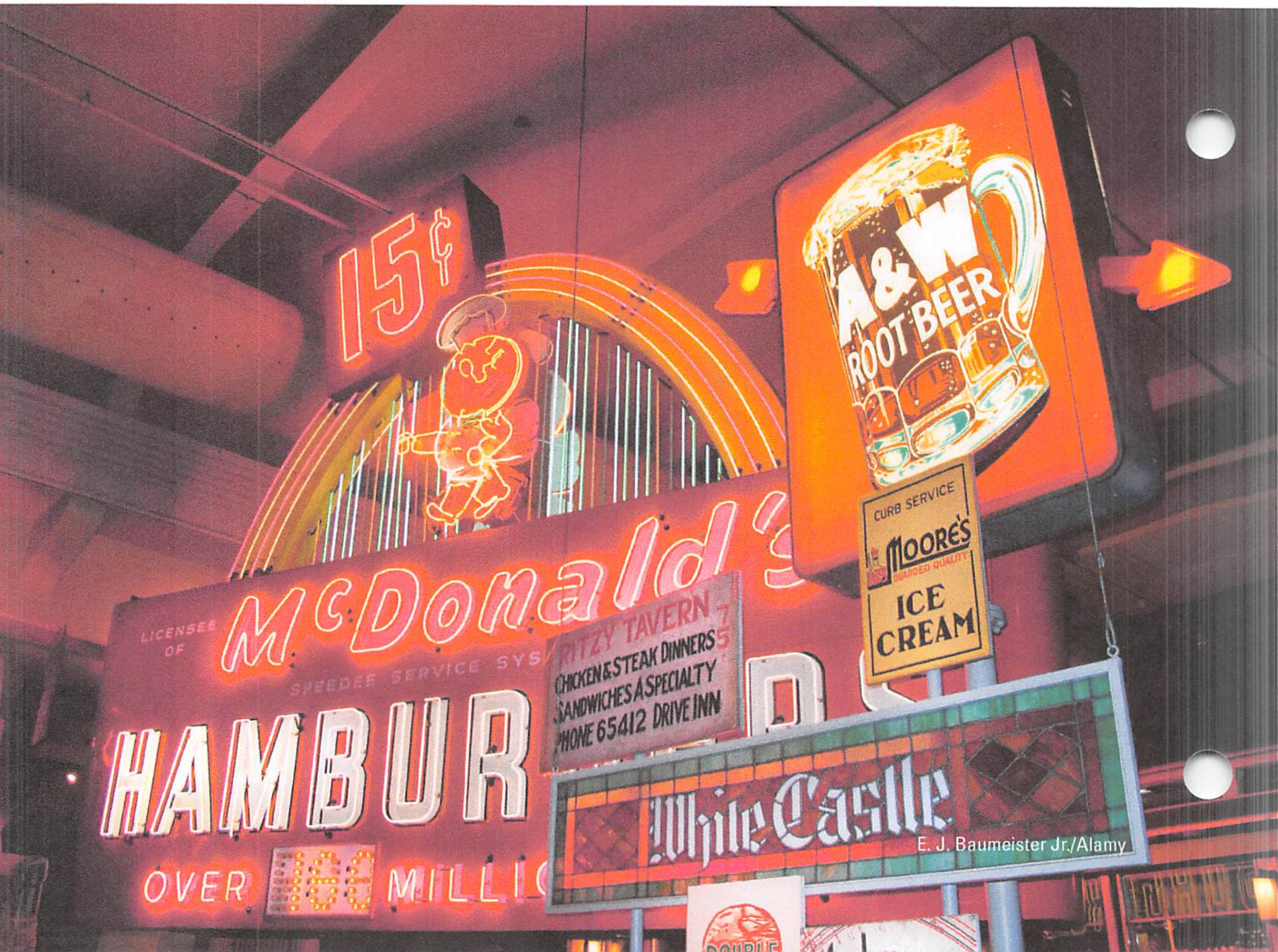
Chapter 2

FRANCHISING

Learning Objectives

1. Define and describe franchising.
2. Identify the positive and negative aspects of franchising.
3. Understand the structure of the franchise industry.
4. Recognize the legal aspects of franchising.
5. Learn how to research franchise opportunities.
6. Explore international franchising.



E. J. Baumeister Jr./Alamy

"The two most important requirements for major success are: first, being in the right place at the right time, and second, doing something about it."

—Ray Kroc, McDonald's Restaurants

In 1965, Fred de Luca was a 17-year-old high school graduate looking for a way to earn money for college, when a family friend, Dr. Peter Buck, provided him with $1,000 of start-up capital for a submarine sandwich shop.[1] With the opening of Pete's Super Submarines came the start of what has grown into a franchise operation, with 39,618 franchised units in 102 countries.[2] The SUBWAY restaurant chain continues to be a privately held company with the original franchisor, Doctor's Associates Inc., and de Luca as president. The company is a consistent leader in *Entrepreneur* magazine's annual listing of top franchises.

SUBWAY franchisees operate in traditional stand-alone units or in such nontraditional locations as convenience stores, shopping malls, and military bases. Franchisee candidates receive two weeks of classroom and on-site training and must pass a comprehensive examination before being accepted. With the initial franchise fee of $15,000, the costs of start-up range from just under $100,000 to over $250,000. The company offers equipment leasing and a franchise fee assistance program for minorities. It also offers loans to existing franchisees for relocation, expansion, and remodeling. Franchisees pay a percentage of weekly sales (approximately 4.5 percent) into an advertising fund and an additional 8 percent royalty on all sales, regardless of profitability. The company provides national and regional advertising. Franchises are being added continually.

Defining Franchising

Learning Objective 1

Define and describe franchising.

franchise a business that markets a product or service developed by a franchisor, typically in the manner specified by the franchisor.

franchising the system of operating a franchise governed by a legal agreement between a franchisor and franchisee.

franchisor the person who develops a franchise or a company that sells franchises and specifies the terms and particulars of the franchise agreement.

franchisee the second party to the franchise agreement, the owner of the unit or territory rights.

Whereas many individuals want to start their businesses from the ground up, others are happy to begin with a tested formula. Although there is no guarantee of success, for many, franchising is the best business start-up option.

A **franchise** is a business that markets a product or service developed by a franchisor, typically in the manner specified by the franchisor. It is also a commercial and legal relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group wishing to use that identification in a business.[3] The franchise agreement determines the specific parameters of the relationship between the parties.

Franchising is the system of operating a franchise governed by a legal agreement between a franchisor and franchisee. The **franchisor** is the person who develops a franchise or a company that sells franchises and specifies the terms and particulars of the franchise agreement. The **franchisee** is the second party to the franchise agreement and is the owner of the unit or territory rights. For example, Liberty Tax Service (the franchisor) franchises tax-preparation businesses to local/territory owners (franchisees).

What Are the Types of Franchises?

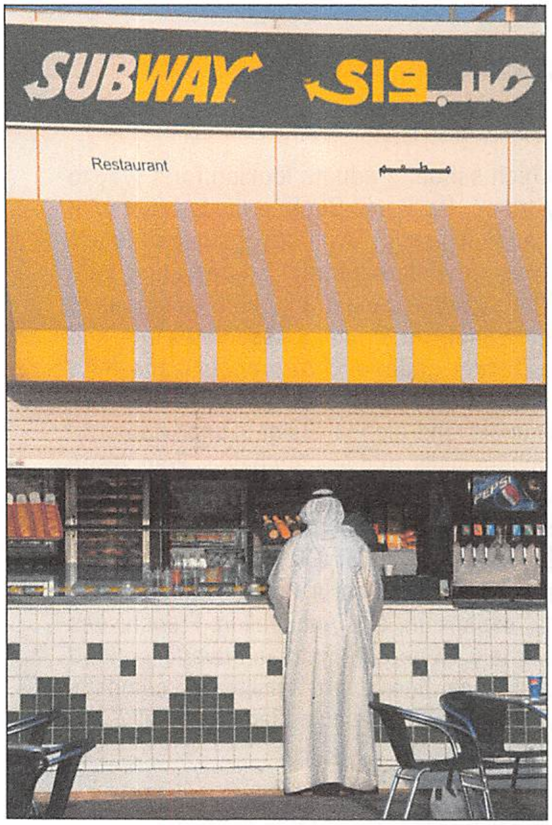
All franchises involve legal agreements between the parties, and these are as varied as they are numerous. The types of franchises are defined by the Federal Trade Commission (FTC). Two main categories are

- Product and trade-name franchising, and
- Business-format franchising.

[1] *Subway*, accessed July 1, 2013, http://www.subway.com.

[2] As of July 2013.

[3] "Franchise Businesses," U.S. Small Business Administration, accessed July 1, 2013, http://www.sba.gov/content/franchise-businesses/.



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product and trade-name franchising the licensing of the product or the production of the product and the use of the trademark, logo, or other identity of the franchise.

business-format franchising a form of franchising in which the franchisee secures the product and trade-name benefits but also the operating, quality assurance, accounting, marketing methods, and support of the franchisor.

master franchise a specific type of franchise that allows individuals and organizations to buy the right to subfranchise within a delineated geographic territory.

area franchise or **multiple-unit franchise** a type of franchise that gives the exclusive rights to open franchisee-operated units within specified areas.

Product and trade-name franchising is the licensing of the product, or the production of the product, and the use of the trademark, logo, or other identity of the franchise. The franchisee usually sells products that are manufactured by the franchisor. It is essentially a supplier-dealer relationship with some level of exclusivity. In other cases, the franchisee sells products or services that are expected to meet the quality standards established by the franchisor. The operations of the business itself are at the discretion of the franchisee within the constraints of the agreement. Automobile dealerships are generally trade-name franchises, for example.

Business-format franchising is a much broader and more extensive form of undertaking. The franchisee secures the product and trade-name benefits, along with the operating, quality assurance, accounting, and marketing methods and support of the franchisor. Typically, this is the purchase of an entire business model and system, including access to management expertise. Some well-recognized business-format franchise systems include Krispy Kreme, Circle K, Pizza Hut, and Jani-King. Some unethical product and trade-name franchises will attempt to sell themselves as being business-format operations, making it particularly important for the prospective franchisee to understand exactly what is being provided. To get a better idea of the range of legitimate franchises available, you may want to explore the Franchise Registry at http://www.franchiseregistry.com.

In addition to the two primary models described previously, other variations on licensing and ownership structures are offered. For example, **master franchises** allow individuals and organizations to buy the right to subfranchise within a delineated geographic territory. Such franchises generally require the franchisee or area developer to take on additional franchisor responsibilities, such as providing training and support and recruiting subfranchisees. Master franchises have higher initial franchise fees than those charged for a unit franchise with the same franchisor. It is typical for the master franchisee to form two companies, one for the operation of a primary, single franchise and another for expansion through subfranchisees.

Also, rather than purchasing a single unit, a franchisee may elect to own multiple units, effectively blanketing one or more territories with the franchise brand. Such an **area franchise** or **multiple-unit franchise** gives the purchaser exclusive rights to open franchisee-operated units within specified areas.

BizFacts

Facts to Know Before Investing in a Franchise

Even though investing in a franchise seems like a sure bet, it isn't. Several key issues must be considered before making the decision:

1. *Pick a franchise you're familiar with*—it has a more recognized brand with the public.
2. *Know the upfront costs*—which vary significantly and are distributed differently.
3. *Know your restrictions*—what the rules are and how they will affect your bottom line.
4. *If you want to get rich, plan to expand*—permission to grow protects you.
5. *Read the fine print*—know what is required so you know what to expect.

Source: Patricia Laya, "Five Franchise Facts You Need to Know Before You Buy," *American Express Open Forum*, June 15, 2011, accessed May 7, 2013, http://www.openforum.com/articles/5-franchise-facts-you-need-to-know-before-you-buy/.

Positive Aspects of Franchises

Learning Objective 2
Identify the positive and negative aspects of franchising.

Entrepreneurs who want to start up with a formula for success—and you may be among them—may find numerous advantages in franchising. The most significant advantage is the increased probability of success, given that franchise brands have positive track records and instant recognition in most communities. Some other advantages include training and financing assistance, purchasing power, advertising and promotional support, and operating guidelines and management assistance. Some factors to consider are presented in **Exhibit 2-1**.

Start-Up Assistance

Sound franchisors provide a significant quantity and excellent quality of start-up assistance to new franchisees, as well as ongoing education and support for established ones. In many cases, there is mandatory training and technical assistance before a franchise is granted. Some franchisors require examinations on the training content. Others require work experience with established franchisees. These forms of support are intended to foster franchisee success.

The FTC has specific requirements with respect to support that franchisors must provide, including:

- one week of training to the franchisee and a manager,
- an operating manual for the franchise,
- ongoing support and assistance, and
- guidelines on audits.

Beyond the obligatory training and information, franchisors can provide other valuable start-up assistance. They may provide site-selection help to ensure that the location selected is likely to be successful. With business-format franchising, franchisees may have access to the entire package of components, making the start-up essentially a turnkey operation (a business that is ready to start immediately). In some

Exhibit 2-1 *Factors to Consider before Becoming a Franchisee*

1. **Franchisor success**—How many similar franchises are nearby? In total? How are they performing? What name recognition exists? What's its reputation? Ask franchisees and consumer protection agencies.
2. **Franchisor durability**—Determine the length of experience. Is this a long-term opportunity or a fad? Does the franchisor own any intellectual property?
3. **Franchisor financial health**—How healthy is the company? Financial statements should be in the disclosure documents. Be certain you understand them.
4. **Start-up investment**—What is the amount and what does it buy? Ask about all potential franchise costs. Be certain that ongoing costs and start-up costs are clear.
5. **Financing support**—Does the franchisor offer competitive financing? How much do you need until you reach positive cash flow? Do the financial projections under various conditions and know your options.
6. **Purchasing requirements**—Do you have to buy from the franchisor or its list of suppliers? Are there minimum purchases? Can you purchase from others? How does the pricing from the required suppliers compare?
7. **Term of the agreement**—What is it? What, if any, are the terms for selling the franchise rights to another operator? What are your renewal rights?
8. **Competition**—Are there any restrictions on how you can compete within your territory? Is there assistance to help you compete? What kind? What is the level of competition?
9. **Management fit**—Does the management style and level of control exerted by the franchisor fit for you? Is the loss of independence worth the potential gains?

cases, franchisors provide financing support, whether in the form of application assistance, agreements with third-party lenders, or direct financing. Hundreds of franchisors are certified through the U.S. Small Business Administration's FranData Franchise Registry program (http://www.franchiseregistry.com), thereby streamlining the loan application process you and other prospective franchisees would encounter. Some franchises listed on the registry include AlphaGraphics, Cici's Pizza, Snap Fitness 24-7, and Jenny Craig.

The particular combination of start-up assistance and ongoing support provided by franchisors is a vital reason for opting to pursue a franchise rather than starting a venture from the ground up.

Instant Recognition

A strong advantage of purchasing a franchise is the instant name and brand recognition that a well-known and reputable franchisor has to offer. A new McDonald's franchise has the instant recognition that a unique, stand-alone business, such as Bubba's Bountiful Burgers, would not. With a franchise, the name and image are well established and widely understood. You purchase the use of the company's logo, trademark, and advertising, as well as the physical design, layout, and décor that ensure this recognition.

Purchasing Power

As a franchisee you will benefit from the purchasing power of the franchisor to get lower costs and favorable vendor service. Because franchisees are part of a potentially large group of customers for any one vendor, they have more clout with respect to pricing, delivery terms, and product quality. In addition, where custom-designed products or components are used, the costs of research, prototype creation, and testing are distributed among a far greater number of parties than for a stand-alone business. Any cost savings you realize will assist in offsetting ongoing franchise fees and may support greater profitability.

Advertising and Promotional Support

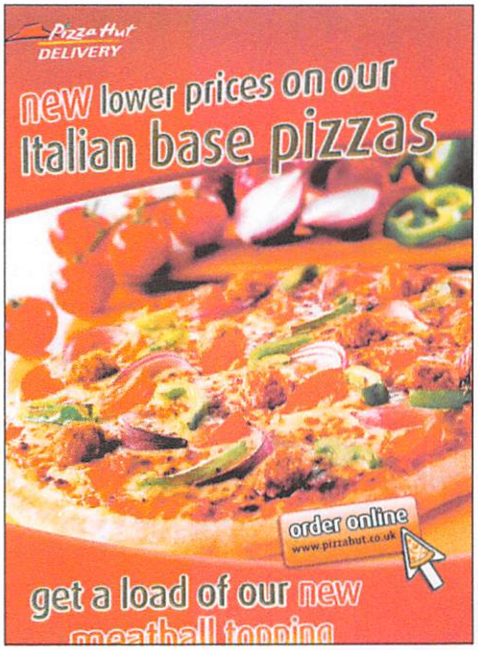
Advertising and promotional support is frequently included as part of the franchise opportunity and is crucial to brand identity and name recognition. Franchisees may pay a fee that is separate from the royalty fee, often called a **cooperative advertising fee**, to contribute to a shared advertising fund. Franchisors engage advertising and public relations firms to create strong, memorable, and effective national and regional advertising campaigns. They handle the national and regional media purchasing. Franchisors also provide you with templates and promotional materials for local use. The quality and quantity of advertising support is one of the most valuable aspects of franchising.

cooperative advertising fee a fee paid by franchisees to contribute to a shared advertising fund that is separate from royalty fees.

Many franchises have professional associations, which take an active role in determinations with respect to the cooperative advertising fund. They provide insight and feedback to the franchisor. Ideas may travel back and forth between franchisors and franchisees. For example, Ronald McDonald was created by a McDonald's franchisee and became one of the most recognized characters in the world.[4] At the same time,

[4] "Top 10 Advertising Icons of the Century," *Advertising Age*, March 29, 1999, accessed August 18, 2010, http://www.adage.com/century/ad_icons.html.

franchisors may decide to create promotions to boost their flagging revenues that will have the effect of causing problems for franchisees. For example, a franchisor could promote a discounted price that succeeds in generating revenues, but insufficient profits. You may appreciate revenue generation but not at such a low price, because you will actually lose money after royalties are paid. Royalties are paid on top-line sales (gross revenues), not profits.



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Operating Guidelines and Assistance

Franchisors are required to provide operating manuals and training to their franchisees, which are valuable factors in success. In addition, ongoing operating training and assistance also increase the probability of positive franchisee performance. Further assistance with regulatory compliance, site selection and development, product research and development, and utilization of technology can all prove invaluable.

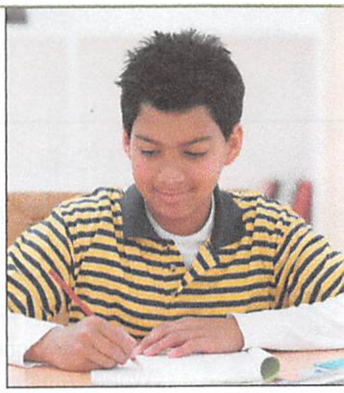
Some of the greatest challenges facing entrepreneurs are establishing and maintaining solid operations while maintaining structured quality assurance, sound financial record keeping, and sound human resources policies. Franchisees have the distinct advantage of benefiting from the years of experience and success of their franchisor, so that the learning curve is considerably less daunting. However, the start-up and ongoing assistance provided will not in any way guarantee your success.

Operating guidelines vary considerably in their breadth and depth. They may be as precise as the dimensions (with allowable tolerances) for food production, dress codes, and component specifications. They may reach across all functions of the business. Or, they may be relatively broad and nonspecific. The nature and quality of operating guidelines as provided by the franchisor is essential to understanding the value of the franchise and the flexibility afforded the individual franchisee. What is needed and desired will vary by franchisee and is based on individual experience, desire for operating specifics and flexibility, and the cost of participation; however, most franchisors do not individualize franchise packages. Franchisors have their manuals and methods, and that is what is presented to new franchisees.

Step into the Shoes . . .

Maritza Gonzalez and Noel Cruz—Kumon Math and Reading Center

Kumon Math and Reading Centers, a successful franchisor, had been providing supplemental academic support to students in Newark (New Jersey) Public Schools for four years, through the No Child Left Behind program, when Maritza Gonzalez and Noel Cruz opened a new center there. Maritza is a Kumon parent (that is, a parent of a child in the Kumon system), a product of Newark Public Schools, and a graduate of Montclair State University. For her, the opportunity to direct a Kumon Math and Reading Center is a chance to give back to the community. Noel Cruz headed up the No Child Left Behind program with Kumon and was an assistant principal at a charter school in Newark. Kumon is a 54-year-old after-school math and reading program with 26,000 centers in 47 countries (more than 1,500 in the United States) that totals more than four million students globally.[5]


Stockbyte/Thinkstock

[5]Kumon, accessed June 23, 2009, and July 1, 2013, http://www.kumon.com/AboutUs.

Record of Success

Any reputable franchisor can demonstrate a record of success that would provide a significant advantage for your business start-up. In essence, the business formula has been tested and the product or service established. In addition to the name recognition afforded by the franchisor and the disclosure information the franchisor must provide, you can and should explore the record of success of the franchisor and existing franchisees. An investment of time in online and other research on your part will identify the genuine track record of the franchisor. Strong franchisors have established multiple franchises, positive relationships with their franchisees, and years of experience. They also have few, if any, legal disputes with franchisees and have garnered positive press reports. Such a record of success will bode well for a prospective franchisee, which will become a new component of the success equation.

Drawbacks of Buying a Franchise

Whereas purchasing a franchise has quite a few advantages, it is not without its drawbacks. Franchising is an excellent choice for many business start-ups, but it is not a good choice for many others. Franchising provides a higher probability of business success, but success is not guaranteed and is not without costs. Constraints on the creativity and freedom of the owner, high start-up and ongoing costs for franchise participation, and potential for termination of the agreement are all factors to be weighed. The quality and strength of the franchise brand and its program also matter.

Constraints on Creativity and Freedom

For the individual who wants to start a business to break away from the corporate mold and the rigors of a management and supervisory structure that restrict creativity and flexibility, franchising is unlikely to be the best option. Franchisees are required to comply with franchise rules and processes, and autonomy is not a consideration. Products and services may not be altered, added, or dropped without franchisor agreement. In many instances, products or ingredients must be purchased from the franchisor or designated suppliers. Whereas the franchisor cannot require the individual franchisee to adhere to a pricing structure, purchasing requirements can lock in costs at higher than desired levels. Also, the layout and design of the franchise outlet are often defined by the franchisor.

While the formula provided by the franchise guarantees brand recognition, eases the issues of start-up development, and ensures ongoing

Global Impact . . .

Franchising Worldwide

Want to be an international mogul? Check out these Web sites:

International Franchising Opportunities—
http://www.internationalfranchisedirectory.net/
World Franchising——http://www.worldfranchising.com

International Franchising's directory lists more than 1,000 North American franchises that train and support franchisees overseas. It also provides contact information for consultants and attorneys specializing in international franchising. World Franchising lists the top 100 franchises worldwide, as well as the top 50 franchises that have fewer than 50 operating units.

support, it removes the creativity and freedom that many entrepreneurs crave. You will have to decide whether the trade-off is worthwhile.

Costs

The costs of franchises vary significantly, depending upon the type of franchise, its brand recognition, popularity, and capacity to secure franchisees. Franchise costs are divided into initial franchise fees and ongoing fees. The typical franchisee can expect to pay start-up fees that range from about $3,000 for Jazzercise, $1.0 million to $2.2 million for a McDonald's outlet, or $3.7 million to $13.5 million for a Hampton Hotel.[6] Ongoing costs generally include royalties of 1–12 percent (most are between 3 and 7 percent) of top-line revenues payable weekly or monthly, regardless of profitability or cash flow. In addition, cooperative advertising fees of 1 to 5 percent (or a flat fee) are payable periodically. Some franchisors require franchisees to spend a minimum amount on local advertising as well. Additional start-up cost considerations are the legal costs required for franchise agreement review and any required plant, property, equipment, inventory, or marketing requirements. **Exhibit 2-2** includes some of the items that may be included as fees associated with franchises.

It is important that you understand and fully identify all costs, so that you completely understand the legal obligations and the financial projections that reflect them. This is particularly true for the fees that are payable regardless of profitability or cash flow. Franchisors are focused on creating wealth for themselves. Good faith franchisors are also focused

Exhibit 2-2 *Selected Franchise Fees and Costs**
Initial costs (categories will vary considerably)
Right to use the company name, trademark, or service mark (licensing fees)
Royalty fees
Training
Management assistance
Use of operations manuals
Signage
Insurance coverage (general liability, fire, inventory, burglary, worker's compensation, accident and health, use and occupancy, and possibly vehicle)
Advertising and promotion
Equipment
Furniture
Fixtures
Site selection assistance
Site purchase and preparation
Land lease, if not purchased
Construction or renovation
Initial inventory
Financing (initial costs plus interest)
Renewal of franchise
Transfer

*Must be disclosed in the Franchise Disclosure Document.

[6] "Franchise 500," *Entrepreneur*, accessed July 1, 2013, http://www.entrepreneur.com/franchises.

on the success of their franchisees, but a word to the wise is to be wary of franchisors that have a track record of high turnover among franchises and a reputation for "churning" their franchises for the upfront fees. A quick search on the Internet will disclose such companies. Current required disclosures will reveal some of the legal issues as well.

Standards and Termination

Franchisors have standards and obligations that franchisees and prospective franchisees must comply with, initially and on a long-term basis. The start-up standards may include specific types of experience and skills, as well as net worth and liquidity requirements. The ongoing constraints typically are financial and performance-based.

Each franchisor establishes specific experience requirements for new franchisees. Typically, these are based upon the type of franchise and experience with success and failure among franchisees. Some of the more established and successful franchisors require less education and experience prior to becoming a franchisee, because of their highly developed and effective training programs. For example, Circle K, Jani-King, and Liberty Tax do not require specific industry experience but do want general business experience.

The financial requirements for becoming a franchisee depend upon the nature of the franchise and the type of franchise agreement. For example, home-based franchises have far lower net worth and liquidity requirements than retail establishments. Jan-Pro requires a net worth of $1,000 to $14,000-plus, and liquid assets of greater than $1,000 for franchisees who will expect to make a total investment of $3,100 to $50,405.[7]

At the other end, Panera Bread requires a net worth of $7.5 million and liquid assets of $3 million, and it requires a potential franchisee to commit to opening multiple units, generally 15 of them over 6 years.[8] Master franchisees and area franchisees, such as those associated with Panera Bread, must pay larger upfront fees and must have substantially greater net worth and liquidity than single-unit franchisees.

The ongoing compliance and performance standards and requirements of franchises also come with penalties and termination options for noncompliance. Franchisors may conduct periodic inspections, announced or unannounced, to evaluate compliance and conditions of the unit. Franchisees that stray from the company formula, fail to comply with quality standards, or do not pay their fees are subject to termination and repurchase. Franchisors cannot afford to tarnish their brands with underperforming or noncompliant franchises. Also, they must produce revenue and earnings, manage their finances successfully, and be dependent upon the financial returns from their franchises for success.

The Structure of the Franchise Industry

Learning Objective 3

Understand the structure of the franchise industry.

Various forms of franchising have existed in the United States since the mid-1800s (beginning with the Singer Sewing Machine), with the industry evolving and growing over time. Most of the growth has occurred since 1960. A study for the International Franchising Association reported 747,359 franchise establishments in the United States in 2012, with revenues of $769 billion and providing a total of more than 8.1 million jobs.[9]

[7]Jan-Pro Franchising Int'l. Inc., *Entrepreneur* magazine. Accessed July 1, 2013, http://www.entrepreneur.com/franchises/janprofranchisingintlinc/282471-0.html#

[8]*Panera Bread*, accessed July 1, 2013, http://www.panerabread.com/about/franchise.

[9]*Franchise Business Economic Outlook*, HIS Global Insight for the International Franchise Association, May 2013. Accessed July 1, 2013, http://www.franchise.org.

The same study projects economic contributions of a significant multiple of this base.

The industry is led by several mammoth franchisors, accounting for thousands of franchisees worldwide. At the same time, there are numerous smaller franchisors with local and regional franchisees. *Entrepreneur* magazine publishes an annual issue devoted to franchising that provides insight into the industry. It is informative to compare the *Entrepreneur* rankings from year to year to understand the trends affecting industries and specific companies.

In addition to the types of franchises described earlier, several other kinds have emerged and are growing in popularity. **Internet franchises**, such as We Simplify the Internet (WSI; http://www.wsimarketing.com) have taken hold as the World Wide Web has become ubiquitous. Internet franchises are franchise companies that do not depend upon physical location for the delivery of their products or services; rather, they are virtual businesses. Also, **conversion franchising** has gained popularity, wherein an existing stand-alone business or local chain becomes part of a franchise operation. Another trend is **piggybacking**, or **co-branding**, in which two franchises share locations and resources. Examples of this include Baskin-Robbins and Dunkin' Donuts. The franchising industry continues to expand and reach new entrepreneurs.

Internet franchise a type of franchise company that does not depend on physical location for the delivery of its products or services; rather, it is a "virtual" business.

conversion franchising a stand-alone business or local chain becoming part of a franchise operation.

piggybacking or **co-branding** occurs when two franchises share locations and resources.

Franchising and the Law

Learning Objective 4
Recognize the legal aspects of franchising.

Franchises are governed by state and federal laws and regulations. The Federal Trade Commission (FTC) is the primary government agency involved in oversight. The FTC primarily serves to protect the interests of franchisees by directing the disclosure rules for franchisors. The process and specific requirements have evolved significantly over the past century, with the most recent changes occurring in 2008.

Step into the Shoes . . .

Buying a Franchise: College Hunks Hauling Junk—Miami

Christopher Poore and Ron Rick (Chris Poore, College Hunks Hauling Junks Inc.)

Ronald Rick III and Christopher Poore, students in an entrepreneurial consulting class at the University of Miami, were assigned to assist a company in finding a U of M franchisee. They chose a junk-removal company called College Hunks Hauling Junk, a company cofounded by an U of M alumnus nearly a decade earlier.

Rick and Poore investigated the College Hunks system and ultimately saw the potential of the company for themselves. The business duo met cofounder Omar Soliman when he spoke about entrepreneurship at U of M. Meeting with Soliman gave them the confidence—both in themselves and in the system—to apply for a franchise.

Less than a year later, Rick and Poore launched their College Hunks location in Miami. Now, these two twenty-somethings appear to be retracing the steps of CEO Soliman and his cofounder, President Nick Friedman, who were in their early twenties when they started the company.

Soliman and Friedman launched College Hunks Hauling Junk in 2005 and by 2007 had become the youngest franchisors in America. They later added College Hunks Moving to increase revenue through synergy and the dual brand has since grown exponentially. Now, their franchise system includes 46 locations covering 25 states and counting.

The HUNKS (Honest, Uniformed, Nice, Knowledgeable Students) for the most part still are students from local colleges and universities.

Soliman and Friedman seek franchise owners from all walks of life. The company is adamant that the most important attribute for a potential franchisee to possess is the passion to grow a business through a client-focused approach.

Source: College Hunks Hauling Junk, accessed July 1, 2013, http://www.collegehunkshaulingjunk.com. Alexandra Leon, "From students to start-ups: Local college grads open businesses," *Miami Herald*, January 7, 2013, accessed May 7, 2013, http://www.miamiherald.com/2013/01/07/3171513/from-students-to-start-ups-local.html#storylink=cpy.

Franchise Disclosure Document (FDD) the primary source of information for prospective franchisees regarding franchisors.

The **Franchise Disclosure Document (FDD)** has replaced the Uniform Franchise Offering Circular (UFOC) as the primary source of information for prospective franchisees regarding franchisors. It is registered with the FTC and must be organized into a common format so that prospective franchisees may more readily compare franchise opportunities. The FDD which discloses the terms of the franchise relationship and any pertinent financial and legal issues affecting the franchisor, must be provided by the franchisor a minimum of 14 days before the signing of a franchise agreement. As a practical matter, as a prospective franchisee, you should secure this document as early in the exploration and negotiation process as possible. The FDD includes such information as:

- ***Overview and background.*** Company review and offer, background information on key personnel and directors, and disclosures of current and past litigation or bankruptcy.
- ***Fees and costs.*** All initial fees, all anticipated operating fees, and a table of the potential cost ranges for every part of the initial investment.
- ***Contractual obligations.*** Table of franchisee responsibilities with specific reference to the franchise agreement and the FDD, and an extensive list of franchisor obligations, from pre-opening through ongoing operations. Also included are details about training programs and any required point of sale, advertising, or other required franchise systems, along with a list of personal obligations of the franchisee.
- ***Territory.*** Terms regarding the limits of the protected territory that the franchisee will receive. This could be a very large or very small area. Or, there could be no protected territory. This has huge significance for the franchisee because franchisors have often put franchisees so close together that they compete with one another for business.
- ***Financial performance.*** Franchisor discloses the performance of franchisee units by providing statistical information with clearly stated assumptions and explanations of limitations. Prospective franchisees are best served by taking this data and carefully analyzing it to secure a better understanding of what is and is not stated and to use it as a launching point for further research.
- ***Data regarding existing units.*** Table data regarding the existing units in the franchise system and the units that have closed or transferred ownership can assist in understanding both the franchisor's success rates and "churn."
- ***Financial statements and contracts.*** Past three years of the franchisor's audited financial statements and all contracts the franchisee is required to execute. Contracts include the franchise agreement and those for advertising co-op rules and conditions, real estate, personal guarantees, and territory development. Prospective franchisees should acquire legal and accounting review for these.
- ***Termination, renewal, transfer, and dispute resolution procedures.*** Policies regarding exit strategies, including fees and restrictions, as well as rules regarding mediation and/or negotiation versus legal action are the best ways to understand the reality of costs, fees, requirements, and other conditions set by the franchisor. The refusal of a prospective franchisor to provide this information should be a red flag for any franchisee. Regardless of what a salesperson or franchise broker says to you, the FDD conveys the pertinent information.

In addition to the FDD, each franchisor and franchisee must enter into a **franchise agreement**, which is the legal document governing the specific franchise. Included in the franchise agreement are the following:

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- the term of the agreement—length of time the franchisor and franchisee agree to work together;
- standards of quality and performance;
- an agreement on royalties—usually a percentage of the franchisee's sales paid to the franchisor;
- a noncompete clause stating that, for instance, if you are licensing a McDonald's franchise, you cannot also own a Blimpie's;
- a "hold harmless" clause that may release the franchisor from specific actions or violations of state laws;
- integration clauses that may block the franchisee from suing the franchisor for misrepresentation or deception that occurred prior to the signing of the agreement;
- choice of venue or other provisions that require the franchisee to settle disputes with the franchisor in the franchisor's state;
- clauses regarding termination, renewal, and transfer of the franchise;
- territories—franchisors usually assign a territory in which an individual franchisee can do business; within the assigned area, no other franchisee from that company will be allowed to compete.

franchise agreement contract that determines the specific parameters of the relationship between the parties in a franchise.

As with any legal agreement, professional legal counsel skilled in this type of contract should be hired and engaged to explore fully the contents prior to signing it, or paying any money to the franchisor. In addition, prospective franchisees may want to hire an accounting professional to provide a review of the franchise agreement and proposed business plan.

Steps for Franchise Selection

Learning Objective 5
Learn how to research franchise opportunities.

Deciding to purchase a unit franchise, or a master or area franchise, is a major decision that is best undertaken after complete due diligence. Numerous steps are involved in becoming a franchisee and it is important to pursue each. Skipping any one step, or not fully completing it, may create short-term and/or long-term barriers to success.

- ***Self-reflection and engagement of core supporters.*** Franchising is not for everyone who wants to enter into self-employment. Taking the time to reflect on individual goals and objectives, as well as lifestyle and financial considerations, is vital. The FTC provides a readiness assessment tool for franchise ownership in its *Buying a Franchise: A Consumer Guide* (http://business.ftc.gov/documents/inv05-buying-franchise-consumer-guide). It should take about five minutes to complete and may provide valuable insights for prospective franchisees. Also, having the genuine, enthusiastic support of a core group of friends and family is critical to achieving and maintaining desired personal factors when deciding whether to buy a franchise.

- ***Industry, type, geography, or brand selection, brand name, or business-format franchising.*** If the outcomes of the reflection and analysis suggest franchising would be an excellent option for you, choosing the franchise will be the next step. Some individuals have a desire to be associated with a particular industry. Others would prefer a retail firm, a service company, a home-based organization, or the like. Still others have more interest in the geographic location of the franchise operation than the particular industry or type of business. Another set of prospective franchisees might have a franchise in mind with the geographic location more flexible, such as Insomnia Cookies. For certain people, the greater flexibility of brand-name franchising is more desirable than business-format franchising. You can weigh these and other factors (such as the start-up franchise fee) to arrive at a set of guidelines for selection.
- ***Research.*** The decision-making process above will require some research, but it will be more focused on internal factors. With the results of this effort in hand, you can conduct further research to narrow the list of franchise choices to a manageable level before conducting in-depth analysis. The research need not be costly or complex, but it should be thorough enough to avoid traps and missteps at this early stage. A number of resources are listed in **Exhibit 2-3**.
- ***Narrow the list of options.*** The research should provide enough information to narrow the list of potential franchises down to a few. Now it is time to conduct in-depth research and hone in on the individual companies.
- ***Make the broker decision.*** Prospective franchisees can decide at any point whether or not to use a **franchise broker**, which is a

franchise broker an individual acting as an intermediary between the franchisor and prospective franchisee.

Exhibit 2-3 *Resources for Franchise Research*

Documents	
Franchise Opportunities Guide	http://www.franchise.org
A Consumer Guide to Buying a Franchise	http://business.ftc.gov/documents/inv05-buying-franchise-consumer-guide
Web Sites	
http://www.entrepreneur.com/franchises.html	*Entrepreneur* magazine
http://www.franchisetimes.com	*Franchise Times* magazine
http://www.inc.com	*Inc.* magazine
http://www.money.cnn.com	*Money* and *Fortune* magazines
http://www.worldfranchising.com	*World Franchising* magazine
http://www.internationalfranchisedirectory.net/	International franchising opportunities
http://www.franchising.com	Franchising opportunities
http://www.franchisehandbook.com	Franchise database
http://www.bison.com	Franchise information
http://www.FRANdata.com	Franchise information services
http://www.ifa-university.com	IFA University
Trade Associations	
International Franchise Association	http://www.franchise.org
American Association of Franchisees and Dealers	http://www.aafd.org
Trade Shows	
International Franchise Expo	http://www.mfvexpo.com
National Franchise and Business Opportunities	http://www.franchiseshowinfo.com

third-party consulting company that prescreens prospective franchisees and matches them with franchisors. Broker and consultant fees are generally paid by the franchisors.

- ***Visit franchise operator(s).*** Before contacting the short list of franchise companies directly, those who are considering franchises with physical sites open to the public can strategically visit one or more units to observe them. Such visits are for information gathering and to observe such aspects as traffic flow, environment, quality of franchise décor and materials, management, and so forth. This is more akin to acting as a secret shopper than a formal visit. Try not to visit locations in your neighborhood or in the immediate area where you would be operating.
- ***Contact the franchisor.*** You should request basic preliminary information from each franchise company. Typically, this information is available through a Web site or franchise development staff. The basic information will permit the screening of the small pool of franchise possibilities and narrowing it to one or two finalists. The steps from this point on will become intense and time consuming.
- ***Perform due diligence on a specific franchise.*** A franchise company will probably require completion of a qualification questionnaire, which will enumerate your experience and financial qualifications. Once this is accepted, the franchise company will share its FDD, and you should analyze and understand it completely before moving forward. Calls to existing franchisees, possibly including a visit to the franchise company headquarters, will be important next steps. Internet research and Web buzz about a franchisor can also be taken into consideration, although these are best considered with a healthy dose of skepticism. Have people who are familiar with FDDs review them and other documents to check what you are looking at before agreeing to anything.
- ***Explore financing options.*** Each prospective franchisee will have a different personal financial situation. It is essential to know what your personal resources will be—from friends and family, financial institutions, private investors, and the franchisor. Identifying financial capacity can and should begin in the early-research phase.
- ***Make a decision, negotiate the franchise agreement, and engage professional counsel.*** The timing of this will depend upon the individual franchisee but is an essential step. The FDD and franchise agreement will be sufficiently complex that even the most sophisticated franchisee should engage legal and financial advisors.
- ***Make it work!*** The franchisor can provide the brand, the products, and even the system, but the franchisee has to make the business work. Astute franchisees will take advantage of all the training and assistance they have received and will reap the benefits of being part of a successful franchise.

Exploring Global Franchising Opportunities

Learning Objective 6

Explore international franchising.

Franchising is a global phenomenon and opportunities abound in all areas of the world. It is common for franchisors to strategically identify countries or regions in which they plan to expand and to seek out franchisees in those areas. Some franchisors require the franchisees to be citizens of the countries in which they are developing franchises. Most franchisors prefer to expand through master franchises or area franchises rather than single units, selling franchise rights to large geographic areas or to entire countries. It is also common for franchisors to create joint ventures with existing firms in the markets they are entering.

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Franchisors such as McDonald's and Intercontinental Hotels have been selling international franchises for decades. As of 2013, they have 15,365 and 1,408 international franchises, respectively.[10] Subway has 13,549 foreign franchises, and The UPS Store has 331 Canadian units, according to *Entrepreneur.com*. Other franchisors have just begun to reach out beyond the borders of the United States. At the same time, franchisors from overseas have extended their reach beyond national borders to span the globe.

The decision to franchise globally is far more complex than addressing local and regional variations. Ethnic, cultural, and religious diversity compels variations in the business format and operations. For example, menus must be adjusted for dietary preferences and restrictions, uniforms may have to vary, advertising and promotion will be different, as will hours and cost structures. In addition, human resources issues and policies must be altered for governing law and custom. However, there are many lucrative and rewarding franchising opportunities around the world.

Chapter Summary

Now that you have studied this chapter you can do the following:

1. Define and describe franchising.
   - A franchise is a business that markets a product or service developed by the franchisor, typically in the manner specified by the franchisor.
   - Product and trade-name franchising is the licensing of a product or the production of a product, and the use of the trademark, logo, or other identifying feature of the franchise.
   - Business-format franchising takes place when the franchisee secures the product and trade-name benefits, and the operating, quality assurance, accounting, marketing methods, and support of the franchisor.

[10]Entrepreneur 2013 Franchise 500, *Entrepreneur* magazine. Accessed July 1, 2013, http://www.entrepreneur.com/franchises/mcdonalds/282570-0.html and http://www.entrepreneur.com/franchises/subway/282839-0.html.

2. Identify the positive and negative aspects of franchising.
   - Start-up assistance (+)
   - Advertising and promotional support (+)
   - Operating guidelines and assistance (+)
   - Record of success (+)
   - Constraints on creativity and freedom (−)
   - Costs (−)
   - Standards and termination (−)
3. Understand the structure of the franchise industry.
   - Large franchisors control most of the industry.
   - Types include Internet franchises, conversion franchising, and co-branding.
4. Recognize the legal aspects of franchising.
   - Franchise Disclosure Document (FDD) is essential.
   - State and federal regulations govern franchising.
   - A franchise agreement and other legal documents will be involved.
   - Use good legal counsel.
5. Learn how to research franchise opportunities.
   - Self-reflect and engage core support people.
   - Explore industry, type, geography, or brand selection and brand name, or business-format choice.
   - Research using available resources.
   - Narrow the list of options.
   - Make the broker decision.
   - Visit franchise operator(s).
   - Contact the franchisor.
   - Perform due diligence on the specific franchise.
   - Explore financing options.
   - Make a decision and negotiate the franchise agreement, engaging professional counsel.
   - Make it work!
6. Explore international franchising.
   - Opportunities are available worldwide.
   - Decision is more complex than domestic franchising.

Key Terms

Entrepreneurship Portfolio

Critical Thinking Exercises

2-1. What are four positive aspects of franchising for a business start-up? Why are they important?

2-2. What are some challenges faced by franchisees?

2-3. Describe the type of franchise you might want to open.

2-4. Franchisees agree to pay a variety of fees to franchisors, initially and ongoing. Describe these fees, and discuss why understanding their impact on profitability and cash flow is important to franchisees.

Key Concept Questions

2-5. Compare and contrast product and trade-name franchising with business-format franchising.

2-6. Explain why the FDD is critical to analyzing a franchise opportunity.

2-7. What, if any, trends in franchising suggest continued expansion of the industry? Contraction? Cite your sources.

Application Exercise

2-8. Identify an industry or type of business that interests you. Select a community where you would like to locate such an organization (select a business that would have a physical presence). Find two competitors already in that market space and one franchisor that is not. Would it or would it not make sense to open a franchise in the community?

Exploring Online

2-9. Visit the Wahoo Fish Taco Web site at http://www.wahoos.com. What are the advantages of a Wahoo Fish Taco franchise according to the site? What franchise opportunities are available?

2-10. Visit the International Franchise Association Web site at http://www.franchise.org. Find a franchise organization that is unfamiliar to you. Find the following information about the franchisor:

a. When did it begin offering franchises?

b. How many company-owned units does it have?

c. What are its initial financial requirements (start-up fee, net worth, liquid resources)?

d. What type of franchisor is it (product or trade-name or business-format)?

If the information is not available on the International Franchise Association (IFA) Web site, try others from the list in **Exhibit 2-3**.

Case Study | SarahCare of Snellville—A Franchise Opportunity in Adult Day Care

Aysha Treadwell Cooper transitioned from her role in advertising sales in Tampa, Florida, to the ownership of a SarahCare franchise in the Atlanta area in 2010. For Cooper, an Indiana native, this was a return to her professional roots and personal passion. Cooper has a degree in public health and worked in a children's hospital prior to leaving Indiana. She also has strong feelings for her community of Snellville, Georgia. She became active in the community prior to opening her franchise, saying, "I knew that to open the business, I needed to learn about the community. . . . It taught me about how to make a difference as an individual and a community advocate." Today, she is the owner and Executive Director of SarahCare of Snellville.

SarahCare of Snellville is a franchisee of SARAH Adult Day Service, Inc., a Canton, Ohio-based franchisor that has franchisees in 18 states. The company "offers a franchising opportunity that meets the two criteria for a successful and socially responsible business: a booming demographic market with even more potential for growth, and excellent senior care. The SarahCare Adult Day Care Services franchise allows entrepreneurs to become part of this expanding industry, while enriching their lives as they help seniors age in place." Currently, the company is adding locations through the existing network, rather than through new franchisees.

Specifically, Cooper describes her SarahCare facility as "a place that provides a stimulating environment and a place for entertainment and relaxation for those whose lives are impaired by cognitive impairment, such as Alzheimer's disease and dementia. It aims to keep communities strong and families together."

According to the SarahCare Web site, the Complete SarahCare® Franchise Package includes:

- State of the Art Operational System
- Site Selection Assistance
- Space Design
- Adult Day Care Business Plan Template
- SarahCare Marketing System
- Advertising and Promotional Materials
- 5-Day Operations Training
- Ongoing Support and Training by Experienced Professionals

The company was founded in 1985 by Dr. Merle Griff, a gerontologist, when she opened her first center. She opened a second center in nearby Massillon, Ohio, after a few years. In 2004, the second center was relocated for growth and named SarahCare of Belden Village. That same year, SARAH Adult Services began offering franchises. The company now recommends that there should be a defined driving radius that includes about 10,000 adults aged 60 and above for each facility that opens.

SarahCare works with franchisees and their real estate brokers to find sites and make them ready for a SarahCare Adult Day Care facility. The franchisor provides guidelines, checklists, and answers to frequently asked questions. It also offers prototype centers and will create an initial space plan as part of the franchise fee. The décor has been designed for the SarahCare centers with two color palettes and a preferred vendor who offers equipment and furnishings. The centers are meant to "offer [a] warm and home-like environment and are designed to accommodate the varied needs of our participants." A final site inspection is performed by SarahCare personnel.

SarahCare of Snellville is managed by Cooper, who has a background in healthcare. However, this is not required. Some centers are managed by executive directors who are not the owners. In these instances, the franchisor assists in the hiring process. One benefit that the franchisor promotes is that center hours are from 7:00 a.m. to 6:00 p.m. on Monday through Friday, leaving time for family. For Cooper, the mother of a young child, this is quite appealing.

SarahCare of Snellville is Cooper's opportunity to combine her interests in healthcare, the elderly, and her community into her profession through franchising.

Case Study Analysis

2-11. What type of franchise is SarahCare?

2-12. Using the Web sites listed under Case Sources or others that you can find, identify each of the following for a SarahCare franchise: franchise fee, net worth requirement, total initial investment, and ongoing royalty fee.

2-13. What are some of the distinctive advantages that would lead a franchisee to select a SarahCare franchise?

2-14. What might be some potential concerns about buying a SarahCare franchise?

Case Sources

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Case Study | Pietsch Siblings: Wahoo's Fish Taco® Franchisees

How Wahoo's Began

Before it became a successful franchise chain, Wahoo's was a small, Californian restaurant born from three brothers' craving for fish tacos. Growing up in Brazil and California, Wing Lam, Ed Lee, and Mingo Lee learned a lot about running a business by helping out in their family's Chinese restaurant. After discovering fish tacos while surfing in Mexico, the three brothers combined their knowledge of surfing culture and the restaurant industry into an entrepreneurial venture of their own.

When the first Wahoo's Fish Taco was opened in 1988, it was decorated with donated products from local surf businesses. The food was a combination of the Brazilian, Mexican, and Asian flavors and ingredients the brothers loved. The restaurant quickly became popular because of its unique, fresh, and healthy food. Today, there are more than 50 Wahoo's franchise locations in California, Nevada, Colorado, Nebraska, New York, Texas, and Hawaii. One of these restaurants was started by three other siblings from the Pietsch family.

Wahoo's Comes to Hawaii

Wahoo's first Hawaiian franchise came about in a roundabout way. While working in Los Angeles for the Angels baseball team, Stephanie Pietsch Gambetta met Wing Lam by chance, and a business friendship developed. Stephanie's brother Mike and sister Noel also liked the Wahoo's franchise concept. Born and raised in Honolulu, all three siblings thought a Wahoo's restaurant would do well in Hawaii's surfing-oriented culture.

To make a long story short, the Pietsches invited Wing and his brothers to Hawaii for a surfing trip and asked to be considered as franchisees. Even though the Pietsches' restaurant experience was limited, their knowledge of the local area, and Stephanie's extensive sports-marketing background, gave them an edge. The Pietsches opened their Wahoo's restaurant in 2006.

Wahoo's uses a hands-on approach with its franchisees. The company provides mandatory training for approximately one month. Thereafter, communications continue via telephone and visits from Wing. Wahoo's open-door policy allows for plenty of give-and-take discussions between franchisor and franchisee. According to Mike Pietsch, "Franchising is a good way to get into business because there are systems already in place." Stephanie adds, "The franchise provides a support system so there's a resource for asking questions, training, and growing the business."[1]

Learning Valuable Lessons

The Pietsch-owned franchise was an immediate success, with customers lining up clear around the restaurant. "The first six months were a blur," Noel recalls. "We were doing better than we ever expected, but at a frantic pace."[2] After only five months, the Honolulu-based franchise became one of the top sales leaders for Wahoo's Fish Taco.

In the process, the owners learned many valuable lessons as they gained more experience. For example, keeping the restaurant staffed with quality employees was difficult in Hawaii's tight labor market. During the first year and a half, almost the entire staff turned over about three times.

"Now," Noel says, "we are rarely hiring because we have a solid team of people who really want to be here and work hard at what they do." Stephanie adds, "We really learned to work on our efficiency. We're setting goals and controlling what we can, be it labor or food costs."[3]

Learning to improve their communication was another important lesson. Although they admit to having made mistakes, the Pietsches also feel they have learned how to make their business run smoother based on those experiences. They also schedule time to get together away from the restaurant to discuss how the business is working.

Marketing the Business

The Wahoo's franchise chain targets a particular customer mindset. This customer focus includes individuals who actually participate in extreme

[1]Susan Sunderland, *"Something's Fishy @ Wahoo's,"* Midweek Kau'i, accessed July 2, 2013, http://www.midweek.com/content/story/theweekend_coverstory/somethings_fishy_wahoos.

[2]Ibid.

[3]Jacy L. Youn, *"Lessons Learned - Wahoos Fish Tacos," Hawaii Business*, January 2009, accessed July 2, 2013, http://www.hawaiibusiness.com/SmallBiz/January-2009/Lessons-Learned-Wahoos-Fish-Tacos/index.php.

sports, such as surfing, skateboarding, and snowboarding. However, a much larger market segment is made up of those who simply want to live vicariously through others who are living a sports lifestyle.

Wahoo's encourages their franchisees to use regional sports and charity events, as well as other types of local grassroots opportunities, to help market their businesses. For example, the Pietsches' restaurant sponsors many surfing and body-boarding events. Noel remarks, "We support the youth a lot because if we get them eating at Wahoo's, they'll do it the rest of their lives."[4]

To help grow their business, the Pietsch team opened a catering division. One promotional method they use involves taking food samples to the offices of local companies. The Pietsches also came up with an idea, endorsed by Wahoo's, for placing a lunch wagon at one of the local beaches. These two additional arms of the business help generate revenue but have lower overhead costs than adding an additional restaurant.

Wahoo's Franchise Information

Wahoo's Fish Taco is looking for franchise candidates who have restaurant experience (in particular, multi-unit restaurant experience). However, as with the Pietsch siblings, applicants with other types of business backgrounds may be considered.

Wahoo's also prefers applicants with the financial means to potentially own and operate at least three restaurants in a particular geographical area. More than one restaurant provides the franchisee with a greater economy of scale. Because of Wahoo's national contracts with various vendors, larger volumes of ingredients can be purchased at a lower cost. In essence, the more fish tacos that are produced, the less expensive each one becomes, and so profits increase.

The initial franchise fee is $35,000 for the first restaurant and $27,500 for each additional one. The ongoing royalty fee is 5 percent of gross sales, paid weekly. Also, each franchisee must allocate 2 percent of gross sales for marketing and advertising. Wahoo's estimates that the cost of building a brand new restaurant will range between $425,000 and $715,000, depending on store location and size, materials used, and other local factors.

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On advice from Wahoo's, a franchisee should provide his or her own start-up money, rather than borrow it. In the restaurant business there are seasonal ups and downs that affect cash flow. So, it is always best to have some available working capital to help avoid getting caught in a financial crunch.

In the end, however, money and experience are only part of a successful equation. To be a peak performer in the restaurant business, owners have to love the work they do and know how to have fun doing it. That's the bottom line.

Case Study Analysis

2-15. Why did the Pietsches decide to purchase a Wahoo's Fish Taco franchise rather than start a restaurant on their own?

2-16. Name something the Pietsches could have done better to make their business start-up go more smoothly.

2-17. What does the Pietsch-owned franchise do on an ongoing basis to maintain and grow success?

2-18. What type of a franchise is Wahoo's Fish Taco? What makes this true?

[4]Ibid.

Case Sources

Allison Schaefers, "Yahoo for Wahoo's," *Honolulu Star-Bulletin*, June 11, 2006, accessed July 2, 2013, http://archives.starbulletin.com/2006/06/11/business/story01.html.

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