EXPERT ADVICE

'To Franchise, or Not to Franchise?'

By Thomas M. Pitegoff

Franchising can be a highly successful approach to growing a business. But entrepreneurs should weigh success stories such as those of McDonald's, which had $28.1 billion in revenues and $5.6 billion in net income in 2013, or Subway, which now has more than 67,000 shops across the globe, against cautionary tales that tend to reinforce realism. Sbarro and Quizno's both filed for Chapter 11 bankruptcy protection in March 2014. This highlights the truth that adopting the franchise model is no guarantee of success.

For starters, let's take a look at the complexity of franchising overall. While franchising evokes thoughts of fast food (the largest franchise sector), the franchise model has been embraced by a broad range of industries, from hotels to gyms to home health care to business services. The popular conception of the franchise owner as "the little guy" also is an oversimplification. In fact, multi-unit franchise owners are commonplace and can be large companies in their own right. Carrols Restaurant Group, for example, owns more than 570 Burger King locations. Multi-unit ownership allows the franchisor to work with a comparatively small number of franchisees whose common ownership promotes economies of scale. It's no wonder that franchisors like to work with multi-unit owners.

Many new franchise concepts enter the scene every year. Some won't make it. Others will enjoy moderate success. Still others will succeed fabulously and develop into large companies. To support their rapid growth, a number of companies have turned to public markets or private equity for funding. In the foodservice arena, for example, the long roster of publicly owned franchisors includes such names as McDonald's, Dine Equity (Applebee's and IHOP) and Yum! Brands (KFC, Taco Bell and Pizza Hut). Private-equity giants owning franchisors include 3G Capital (Burger King), Bain Capital (Dunkin Donuts and Dominos) and Roark Capital (Cinnabon, Arby's, Auntie Anne's, Carvel and others).

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Franchising, then, truly is "big business." But this does not negate its potential advantages for startup entrepreneurs. Indeed, franchising continues to be an appealing way for business owners to grow their brands using other people's money. Opening a new location can entail significant real estate costs. In franchising, these costs are usually borne by the franchisee, along with the cost of labor. Thus, franchisors can clone their businesses many times over through the investments made by their franchisees. Likewise, the owners of restaurants, carpet-cleaning companies or tax firms—the possibilities are endless—can become franchisees and grow their businesses by opening or acquiring franchised outlets with established business models. Typically, franchisees focus on operations and local brand development; franchisors handle concept-development, systems and regional and national marketing. This mix of roles packs a punch. It can be appealing both to single-unit owners and to experienced, multi-unit franchisees. Meanwhile, passive investors (as distinguished from active franchise owners) like franchising because of its promise of consistent royalty income and lower perceived risk.

Importantly, though, not every type of business is tailor-made for franchising. The first ingredient of a successful franchise is market acceptance. The concept must be one that is unambiguously successful. This is especially crucial for the startup franchisor. To sell that first franchise, you have to be able to point to the company's success. Beyond that, the concept must be one that can be duplicated. The business format must be easily described in an operating manual and teachable in a training program. Cloning a business is obviously

easier to do with, say, a quick serve restaurant (QSR) concept than with a high-end restaurant. A chef who enjoys developing creative dishes is not likely to be interested in mass production. In the same vein, a service-oriented business that requires employees with a high degree of expertise will be more difficult to franchise than one operated via simple, automated equipment. An exception would be conversions of existing businesses to franchises, such as real estate brokerage offices, employment agencies, hair salons or tech service shops. The business should also have some feature that clearly distinguishes it from the competition. A strong brand identity is more than just a trademark—brand identity may include the look and feel of the shop, the distinctive way of doing business and even the culture of the business.

But what if a business owner does want to expand and happens to have a simple, replicable format that requires feet on the ground in geographically diverse local markets? In that case, the choice is between being company-owned or franchised. The owner can raise capital by finding sources to invest in the company. Or the investors can be franchisees who invest in their own businesses under the terms of a franchise agreement designed to help preserve the quality and consistency of the brand. Compare Starbucks and Dunkin' Donuts. Starbucks raised capital through equity financing and public offerings. Dunkin' Donuts grew by franchising. Starbucks devotes a portion of its legal budget to compliance with the securities laws. Dunkin' Donuts must comply with the federal and state franchise registration and disclosure laws. On closer analysis, though, the distinction between Starbucks and Dunkin' Donuts as company-owned vs. franchised breaks down. Starbucks does enter into arrangements with others to operate its stores. Just look at all of the Starbucks operations in Barnes & Noble stores and in the lobbies of Starwood Hotels and Resorts (like Sheraton and Westin). These and other Starbucks arrangements with third-party owners are done through exemptions to the franchise laws. That requires legal monitoring to be sure that none of those arrangements crosses the line and requires registration or disclosure. In some countries, Starbucks openly franchises.

Starbucks actually began with an aversion to franchising. In Howard Schultz's book, Pour Your Heart into It, the Chairman and CEO of Starbucks writes that the company initially refused to franchise. Why? He did not want to risk losing control of the all-important link to the customer. To Schultz, franchisees are middlemen who would "stand between us and our customers." But Dunkin' Donuts has grown nicely using the franchise model and has a loyal following. Success in managing franchised stores requires effort, but so does success in managing company-owned stores. They are just two different ways of doing business.

Quality Control is Key

Whether the brand grows by franchising or through company-owned units, quality control is key. The method of exercising that control, though, is different depending on whether the location is owned or franchised. Managing franchisees is quite different from managing employees. Franchise owners can be independent minded. But this is not always a problem. In fact, the best franchisees can sometimes be the most stubborn. They may object to franchisor policies they perceive as helping the franchisor's bottom line but not helping the bottom line of franchisees. But cooperation can be profitable for everyone, and franchisees often innovate in ways that improve the entire franchise system. A franchise should not and need not be an obstacle that keeps the brand owner at arm's length from the customer. Franchises represent the brand in the same way that company-owned locations do. Accordingly, selecting excellent franchisees is just as important as selecting excellent employees. Moreover, franchisors often maintain some company-owned locations. And they should be tracking the franchisee customers and the performance of the franchisee locations just as they do at company locations. Independent franchise owners are motivated to succeed, which helps the brand be successful. Franchisees also know their local markets and will be quick to let the franchisor know what works and what falls flat.

Company stores do have at least one advantage. The brand owner can place them near one another without fear of encroachment claims. Just look at all of the Starbucks stores that are clustered close to one another—a situation that franchisees would do their best to prevent. Likewise, when its business declined, Starbucks closed a large number of its stores. If those stores had been franchised, simply closing them would have been out of the question, and the franchisor would have been forced to deal with hundreds of failing franchisees and possible lawsuits. This underscores how important it is for franchisors to ensure that their franchisees are successful. If the franchisees are not profitable, the system will not succeed. Happy franchisees are the best referral sources and help fuel further growth.

The bottom line is that franchising has advantages and disadvantages. The decision to franchise involves business questions and personal preferences. If franchising is the path you take, there are many successful people who went before you. You can learn from their successes—and their missteps.