## FRANCHISING

In January 2016, the bfa/NatWest Franchise Survey found that franchising contributed £15.1bn to the UK economy, an increase of 46% over the past 10 years and up by 10% since 2013.[1]

The survey also found that the total number of people employed in franchising is 621,000, of which 321,000 are in full-time employment. Ownership changes in franchisee businesses are also correspondingly low (4.6%), with failure rates significantly lower than for other SMEs. The number of franchisee-owned businesses topped 44,000 in 2015, over one-third of which are run from home. The performance of those businesses also set new benchmarks, with 97% reporting profitability.[2] Clearly this is a successful & growing segment of the economy.

This article is designed as a preliminary guide to those who are considering becoming a franchisee or a franchisor. As Chartered Accountants, we have also provided specific financial considerations with for both franchisors & franchisees.

### What is a franchise?

A **franchise** is an agreement giving an individual or business (**franchisee**) the right or obligation to market a product or service using the trademark or trade name of another business (**franchisor**). The franchisor will provide advertising, marketing, training, rights & other services. The **franchisee** is obliged to pay the franchisor fees for these rights.

The venture is governed by a legal agreement (or contract) and gives the franchisee, the right to operate in accordance with their business format for a specific period of time and place. All aspects of the franchise owner's business are strictly controlled including image, products or service, systems and administration.

This article will discuss issues faced by both franchisors and franchisees.

### Types of franchise formats

**Product distribution franchises** simply sell the franchisor's products and are effectively supplier-dealer relationships. The franchisor licenses its trademark and logo to a franchisee but does not provide them with a system for running their business. Although this format represents the largest percentage of total retail sales, most franchises available in the UK are business format opportunities.

**Business format franchising** are a well-established and proven business format franchise which, not only use a franchisor's product, service and trade-mark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals.

[1] British Franchise Association, Jan 2016
[2] Ibid.

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They are most common in the following industries: fast food, food retail, restaurants, business services & trade services.

**Types of franchise agreements**

A **single-unit (direct-unit) franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate one franchise unit. This is the simplest and most common type of franchise. Franchisees may then be able to purchase additional single-unit franchises, which in turn would become a multiple-unit relationship.

A **multi-unit franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate more than one unit and may be structured as an area development franchise or a master franchise.

An **area development franchisee** has the right to open more than one unit within a specific time and area.

A franchisee under a **master franchise agreement** also has the right to sell franchises to other people within the area (sub-franchises). Therefore, the master franchisee takes over many of the tasks, duties and benefits of the franchisor, such as providing support and training, as well as receiving fees and royalties. This is most common for large national or multi-national chains.

**Advantages (for a franchisee)**

- Benefit from an **established business name or brand**, trademarks, proprietary information, patents, and designs. This gives the franchisee the benefits of customer awareness which would ordinarily take time to establish.
- **Established format** with marketing and operational procedures. This helps increase the chances of business success because you are associating with proven products and methods.
- **Owning your own business** and making day-to-day operational decisions yourself provides independence while also benefiting from a franchisor's strategic experience & guidance.
- Franchises consistently offer **quality and consistency** as mandated by the franchise agreement. Therefore, all franchises will likely share the same interior and exterior physical appearance, the same products, service and quality
- **Pre-opening support** - site selection; design and construction and possible assistance with finance.
- **Training and support** - you will likely be trained in all aspects of the operation including product knowledge, customer service standards, book-keeping, VAT returns and legal matters such as health and safety. It is these areas that often cause the newly self-employed the greatest difficulty and are often neglected because of the day to day pressures of running and expanding a business.
- **Advertising and promotional support** - both local and national. This means that your business can be promoted in a way not normally available to the small business proprietor.

**Disadvantages (for a franchisee)**

- **Lack of independence -** Franchisees are required to operate their businesses according to the procedures and restrictions set forth by the franchisor in the franchise agreement. These restrictions usually include the products or services which can be offered, pricing and geographic territory.
- **Fees** - in addition to the initial franchise fee, franchisees must pay ongoing royalties and advertising fees.

- Franchisees must also balance **restrictions and support** provided by the franchisor with their own ability to manage their business.
- **Devaluation of trade name** - if the franchisor fails or systemically damages the brand this will have major implications for all franchisee owners.
- **Duration** - the term of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination.
- **Restrictions on business sale** - while the franchise contract normally allows you to sell the business it will be subject to conditions & you will not be able to sell without approval.

**Franchisors - is franchising right for you?**

Franchising is a model for expanding your business and just like any model, there are many advantages and disadvantages.

Franchising is a business model designed to achieve multi-unit business expansion by “leveraging” the assets that you have already built. These assets include your products, services, trade name, business systems, business know how and marketing knowledge.

While franchising allows for rapid maximum expansion with minimum capital expenditure, there are other **advantages** as well.

Direct management responsibilities become the franchisee’s obligation allowing the franchisor to focus on strategic concerns. The franchisee also has pride of ownership and self-motivation because of his or her capital investment and stake in future profits.

The **primary disadvantages** are:

1. Lower net income
2. Less control
3. Difference in required business skills

**Net income** from franchisees may be less than from a successful, company-owned operation. Although the company-owned office retains 100% of net income, it has obligated itself to an initial capital indebtedness that it would not have been the case if the unit were a franchise.

If you are relatively sure that company-owned operations can produce an early income and have surplus capital and highly qualified & motivated staff, company-owned outlets are generally more profitable.

Franchisees are entitled to receive both **independence & support**. Ideally, only enough control to ensure that your franchised service or product will be marketed to the consumer with the same quality that made it a success.

Ensure care is also taken when selecting a franchisee or allowing a franchisee to transfer their franchise to someone else. Consider each franchisee as an **economic substitute** for a company manager insofar as assisting and supporting that franchisee.

While the primary goal of any franchisor is to sell their service or product. The use of franchisees is a method of attaining this goal. Consequently, one’s **required business skills** must now be focused on marketing and operating a franchisor system.

**Alternatives**

A **company-owned unit** requires considerable capital investment. Time spent on site location, general administration, lease negotiation, and interviewing and hiring managers and employees all require considerable time and money that are not anywhere near the amount required for expansion through franchising. Long term leases are an additional liability.

Capital may be provided by equity investment and an ideal investor should be chosen for their ability & willingness to provide new skills to the business. The downside is the natural dilution of your stock.

Timing also favours franchising, opening company-owned units, requires long-term lease payments, employee benefits, construction costs etc., while with franchising, one immediately receives a franchise fee at the outset and then possible royalties if the franchise can generate sufficient sales during the first six months to a year.

One must train the franchisees, but you would also have to train managers and employees of company-owned outlets. If expanding through company-owned offices, an entrepreneur also must evaluate the efficiency of his or her own personnel, since he or she most probably will be transferring this personnel to the expansion location.

A less common alternative to franchising is association through **licenses or joint ventures**. Most licenses or JV develop through negotiations where one party is supplying capital & will insist upon some control over major decisions, while the other provides expertise and exercises the majority of control

Under either franchising or the alternatives, anyone must first consider **available capital** and then **prepare a business plan** that delineates the amount of capital needed to attain the desired level of expansion and the availability of efficient and management personnel.

**Franchisee financial considerations**

Financial considerations are not dissimilar to commencing a new business and a comprehensive, business plan must still be prepared. There are however specific franchising considerations.

- Has the initial franchisor / other franchisee been financially successful? Consider key financial ratios & actual trading figures from existing franchisees? Are your own projections realistic and achievable?
- What is the initial upfront franchise cost and does this include initial training, working capital, fit out cost or other PPE?
- How will this be financed? Most commercial banks will lend up to 70% to an established franchise with a good track record, but for a new franchise maximum LTV will likely drop to 50%.
- The initial franchise fee may range from 5 - 10% of the total investment cost & should not include a large profit element for the franchisor.
- With respect to premises it is not uncommon for the franchisor to take the head lease and grant the franchisee a sub-lease. There will sometimes be a premium and/or advance rent to pay.
- Do ongoing charges include management or marketing fees? Is there a mark-up on goods or services or any other costs?