

## **FRANCHISING 101 WHY BUY A FRANCISE?**

In a sense, franchising is a business model whose primary purpose is risk minimization. Every study ever done on the success rate of new (non-franchise) business startups concludes the same thing. Starting up a new non-franchised business has a much higher failure rate than starting a franchised business. The primary reason that the failure rate is so high is because the owners have to go through the learning curve of operating that specific type business.

Unfortunately, the market place is not very tolerant of the inexperienced neophyte trying to learn how to operate a new business. If you can't compete in the market place, you get eaten by the sharks very quickly, you go bust, you lose money, your credit, your home, your reputation and sometimes even your family. Failing in business can be a horrible experience. Unfortunately this happens to thousands of poor souls every year in the U.S., and it is so unnecessary. Unless you have considerable experience in the specific type business that you are considering going into, it is very probable that you will fail.

There are primarily two form of franchising:

- \*Product/trade name franchising and
- \*Business format franchising

In the simplest form, a franchiser owns the right to the name or trademark and sells that right to a franchisee. This is known as "product/trade name franchising. The more complex form, "business form franchising," involves a broader ongoing relationship between the two parties. Business format franchises often provide a full range of services, including site selection, training, product supply, marketing plans, and even assistance in obtaining financing.

Business format franchising is as close as you are going to come in today's market place to a guarantee of success. All the studies done have found that franchise new business startups rarely fail and when they do it is typically because the franchisee did not stick to the franchiser's systems. In all human endeavors, there is a learning process. This learning process requires going through a series of trial and error encounters wherein knowledge is gained by trying and failing, trying and failing, again and again, and eventually trying and succeeding. This process is generally called the learning curve.

In the context of franchising, the franchiser has already gone through the learning curve and has learned the secrets of success for the specific business. In franchising, all that has been learned by the original business in going through the curve is transferred to the franchisee. This is fundamentally why you buy a franchise: to minimize risk and give yourself the best possible chance to succeed.

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Another reason why it is prudent to buy a franchise is that a franchise investment can be thoroughly researched before any significant expenditures are made. With a new business startup (non-franchise) you are always operating in the dark. No matter how much research you do it is very difficult to get a handle on so many aspects of the new business. With a franchise the franchiser is a wealth of information about the business from how to prepare a pro forma to the best personality traits for the business. But the most important information comes from the existing franchisees. With a good systematic approach you can get answers to nearly all the really key questions. Such as, do you feel that you were properly trained, how long did it take before you reached break even, what is your annual return on investment, how do you feel about the day to day duties of the business, and if you had it to do over, would you do it again? You can in a very real sense try the business on before you buy to make sure it is a good fit for you.

Another very important reason to buy a franchise is intertwined into its basic nature. Franchising inherently leads to rapid growth, because the franchisees provide the expansion capital. There are few restraints to growth in franchising. As a franchise system expands into hundreds of units many positive things begin to happen. The name begins to become well known because people see it everywhere. Most people associate size with success. The bigger the franchise the better it must be.

The large number of units enables the franchise to advertise heavily, which tends to increase sales. A synergy begins to be created in which success begets success. The franchise begins to squeeze out competition through its sheer size. The franchise can buy products in large quantity at significant discounts, which it passes on to the franchisees. The synergy just grows and grows.

In summary the primary reason you should buy a franchise as opposed to starting up a non-franchise new business, is to minimize risk and enhance your chances of success.

## **WHAT IS FRANCHISING?**

Essentially franchising is a very specific method or way of distributing goods and services. It has been around in one form or another since man first began to engage in commercial enterprise. It has evolved from a simple grant of a right or privilege in the middle ages to the sophisticated business format called "franchising" today.

There are a number of different types of franchising. The type that developed early on was the product franchise wherein a manufacturer granted a franchisee the right to sell its products, i.e. car dealerships and service stations. Another type of franchise that developed in the U.S. was the name and process franchise. This format allows the franchisee to use a special process, or recipe and to use the franchiser's name. Originally Kentucky Fried Chicken was structured this way, as was One Hour Martinizing.

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Modern day franchising is primarily in the business format mode. This type of franchising not only grants the right to use the name and sell the products or services of the franchiser but it also involves the transfer of the total way of doing business that has been developed by the franchiser. Specifically, the franchiser transfers all its operating systems, technical expertise, marketing systems, training systems, management methods and essentially all relevant information, to the new franchisee. The franchiser also trains the new franchisee extensively up front and provides ongoing training and support throughout the life of the franchise agreement.

Business format franchising is what franchising is all about today and is essentially why franchising is the most successful method of distributing goods and services in the economic history of the planet Earth.

McDonald's best epitomizes the incredible power of franchising. Over time McDonald's learned how to absolutely maximize the sales potential of a fast food outlet. Their concept is one with a very high degree of systemization. McDonald's has an idiot proof system for every aspect of their business from exactly how many seconds the french fries are cooked, to the exact words the employees use when addressing the customers. McDonald's leaves nothing to chance or employee discretion, there is a "McDonald's way for everything and everything is done the McDonald's way".

The core of their business is the strict adherence to QSC, or Quality, Service and Cleanliness. Over time McDonald's developed a superb training program, which absolutely insured that every franchisee would implement their systems 100% of the time. Further they developed a unique relationship with the franchisees, which is based on the fact that McDonald's owns the land and building for all the franchise units. They in essence rent the business to the franchisee for a percentage of the gross sales of the unit. The beauty of this concept is that the interest of the franchisee and McDonald's are absolutely intertwined: the better the franchisee does, the better McDonald's does. McDonald's doesn't sell anything directly to the franchisees. All of McDonald's products are sold to the franchise by specified vendors. This way there is never a conflict of interest whatever is good for one is good for the other.

Further, McDonald's has a very strong franchise agreement that is biased in favor of McDonald's, which is as it must be. If a franchisee doesn't adhere to McDonald's high standards, McDonald's has the contractual power to force the franchisee out of the system. McDonald's has never hesitated to do this if a franchisee has failed to bring it's unit up to the high standards of QSC required after being duly warned to do so.

McDonald's is incredibly successful because it has implemented the business format franchise model to near perfection. This is franchising in essence, the perfection of a business concept and the transfer of the knowledge acquired through the process of reaching that perfection and a follow up mechanism that insures that the systems and procedures are properly executed over time.

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## WHAT IS THE HISTORY OF FRANCHISING?

The word Franchise comes from old French meaning privilege or freedom. In the middle ages a franchise was a privilege or a right. In those days, the local sovereign or lord would grant the right to hold markets or fairs, to operate the local ferry or to hunt on his land. This concept extended to the Kings granting a franchise for all manner of commercial activities such as building roads and the brewing of ale. In essence the king was giving someone the right to a monopoly for a certain type of commercial activity. Over time the regulations governing franchises became a part of European Common Law.

Over the centuries the franchising concept has evolved as the economies of the nations of the world have evolved. In the 1840's in Germany certain major ale brewers granted franchises to certain taverns, giving those taverns the exclusive right to sell their ale. This was the beginning of the concept of franchising as we know it today.

The first American franchise is reputed to be the Singer Sewing Center, developed by Isaac Singer in 1858. After Singer invented the sewing machine, he encountered two significant obstacles in bringing it to market. Consumers had to be taught how to use, the new invention before they would buy, and Singer lacked the capital to manufacture his machine on a mass basis. Once Singer seized upon the idea of selling the rights to local business people to sell his machine and train users, his enterprise expanded rapidly. Fees for the license rights helped fund his manufacturing, and because each franchisee was self-financed, Singer was spared the expense of hiring each center's manager. Singer had written franchise contracts, which were the forerunners of modern franchise agreements.

In the 1880' s cities began to grant monopoly franchises to streetcar companies and utilities for water, sewerage, gas and later electricity. Around the turn of the century, the oil refinery companies and the automobile manufacturers began to grant the right to sell their products. At this stage in the evolution of franchising it was essentially just the granting of the right to distribute and sell a manufacturer's products.

Business format franchising, which is the dominant mode of franchising today, came onto the economic scene after World War II with the return of the millions of US servicemen and women and the subsequent baby boom. The baby boom is still driving the economy and will continue to do so into the next century. There was an overwhelming need for all types of products and services, and franchising was the ideal business model for the rapid expansion of the hotel/motel and fast food industries.

During the explosion of the 60's and 70's there were many abuses in franchising. There were a number of totally fraudulent franchise companies that literally took peoples money and ran, and there were a number of companies that were undercapitalized and poorly managed which went bankrupt, leaving a trail of failed franchisees who had lost everything.

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It became clear that the franchise industry had to change in order to remain a viable business concept. On the industry side, The International Franchise Association was created with the specific intent of uplifting the entire industry. The IFA holds training in all aspects of franchising which greatly enhances the professionalism of the industry. Members of the IFA are required to adhere to the IFA's Code of Ethics which set a high standard. The IFA works closely with the U.S. Congress and the Federal Trade Commission on improving how the industry relates to the franchisees.

On the government regulatory side, the Federal Trade Commission, in 1978, required that all franchisers submit to all potential franchisees a disclosure document called the Uniform Offering Circular or UFOC, before receiving monies. The UFOC provides very detailed information on the franchise company, such as its history, information about the officers, litigation history, audited financial statements, the franchise agreement, which is the contract between the franchiser and franchisee and a current list of franchises with owners names and telephone numbers. The intent of the UFOC is that it provides enough information so that the prospective franchisee can make an informed decision. The FTC doesn't actually review the UFOC unless there is a complaint and it decides to conduct an investigation.

Also there are a number of states called registration states which have their own requirements that must be met before a franchiser is allowed to sell franchises in their states. In some cases these requirements are more stringent than the FTC's.

## **WHAT IS THE FUTURE OF FRANCHISING?**

The growth of franchising is inevitable, because of the inescapable logic of the underlying concept. Franchising clearly offers aspiring, new business owners the best possible chance of succeeding with the least risk. Within a decade or less, franchising is expected to comprise over 50% of the retail economy, will employ millions of people, and will enable hundreds of thousands to realize the American dream of successful business ownership. As the U.S. and world economies grow with the ever increasing populations, and the move toward free market economies, new franchise concepts will come on the scene and the solid, well managed existing franchise companies will continue to grow.

There is a move toward better protection of franchisee rights and over time this will push more franchisers towards structuring their relationships with their franchisees in a totally win/win manner. Most franchise agreements in today's market are written strongly in the favor of the franchiser. Franchising is evolving: it's getting better conceptually and in reality. There are greater opportunities for wealth creation among both franchisees and franchisers today than ever before. The future of franchising is as bright as the sun and if you want to take the big step and go into business for yourself or if you have an existing business that you want to optimize, then you should look closely at franchising as the vehicle to take you to where you want to be in the 20<sup>th</sup> century.

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