

# Franchising at a Glance

## The Numbers

2,000.....	Franchise systems actively selling franchises (FRANdata- approximate figure <sup>1</sup> )
622,272.....	Business- format franchise locations (PricewaterhouseCoopers study “The Economic Impact of Franchised Businesses” sponsored by the Int’l Franchise Assoc.)
\$460 billion.....	Economic output created by business- format franchises (PWC study)
7,787,454.....	Total workforce employed by business- format franchises (IFA study)

## Show me the Money

Franchise Fees:	Franchise fees are paid to secure initial licensing rights to use the brand, systems, etc. <u>\$20,000 - \$50,000 per first location with decreased amounts for ensuing locations</u>
Franchise Royalties:	Ongoing fees computed as a percentage of GROSS SALES <u>3% - 8% of sales</u>
Ad Fund:	Regional and local ad funds act as a purchasing coop to help finance advertising expenditures for the system <u>1% - 3% of sales (in addition to royalty payment)</u>

## Franchisor Value Proposition

Systems:	Brand recognition, operational manual, proven unit economics, group purchasing/ <u>coop principals, risk management, research and development, new product testing</u>
Development:	Franchise development executives are trained to identify franchisees that fit the mold of successful operators in a given system. They identify territories ripe for system <u>development and negotiate both single unit and multi-unit development contracts.</u>
Real Estate:	The real estate dept of franchisors understand specific site demographics that are well suited for the system (traffic counts, median income, day- part, convenience vs. <u>destination, etc). Help with permitting, zoning, construction, architecture, re-imaging.</u>
Biz Consultants:	Operations execs trained to identify strengths and weaknesses in the system. Staff travels throughout system to help with grand- openings and revamp struggling stores. Eventually staff helps decide which locations are suited for termination, non- renewal, <u>repurchase, closure (in conjunction with senior franchise staff)</u>
Finance Execs:	Franchisor CFO create financial projection templates for franchisees and structure financing arrangements with lenders to offer franchisor-guaranteed program or in other cases a preferred lender list. These preferred lenders are familiar with the system and help franchisees obtain needed start-up and growth capital. SBA, conventional, equipment lease financing, receivables financing, sale- leaseback financing are all common franchise finance products.

## Regulatory

Federal Trade Comm.	The FTC became involved in franchising in the 1970’s when various states began enacting franchise disclosure laws. This led the FTC to enact the Franchising and Business Opportunities Rule in 1979. The FTC’s Bureau of Consumer Protection gives jurisdiction to its Division of Marketing Practices to enforce the Rule. The FTC created requirements for the UFOC in 1993 to standardize disclosure and plans to revise the document in 2005 or 2006.
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## Franchise is Safer

Independent & Franchise	IFA and leading franchise industry groups support franchising as a safer model compared to independent business. Conversely, there are some studies that remind entrepreneurs that it’s not a fail- safe system (research papers and books by two experts <b>Scott Shane</b> , Wharton PhD and professor at U of MD Smith School of Business and <b>Timothy Bates</b> of Wayne State University)
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<sup>1</sup> Franchising is difficult to measure for several reasons. 1- Lack of unique SIC code to identify a business as a franchise, 2- Many businesses stop actively franchising & buy franchised locations from franchisees (e.g. Avis Car Rentals) 3- Many new franchises file a UFOC and never follow through on offering franchises to the public.

# N o t e s   f r o m   L e c t u r e U P E N N /   W h a r t o n   S c h o o l

## F r a n c h i s i n g   F U N D A M E N T A L S

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By John D. Dikos

FRANCHISING can be an ingenious System when executed properly. Great for franchisees and franchisors alike.

The resilience of the system can often withstand poorly run franchisors or parent companies. Franchising can often withstand hundreds of closed locations, a fickle economy, etc.

With thousands of locations running on the budget of thousands of franchisees..... It's amazing what can be done!!!!

I've heard comparisons with the software business. Large, one-time set up fees (franchise fee) and ongoing royalty/ licensing streams (franchise royalties) without the need for massive reinvestment in R&D. Don't get me wrong, franchisors need to engage in R&D but not at the same level of investment as software companies.

## C A S E   S T U D Y -   K K D

Krispy Kreme Donuts.

I believe the current/ Interim CEO Stephen Cooper spoke here at Wharton on Friday.

He obviously has his work cut-out for him. The company has already anteed up \$3 MM in legal fees for an investor lawsuit, they are restating earnings, there's an SEC probe, the company is bleeding cash, same store sales comps are down 18-20% month- to month.

The company is looking at a default on their \$150 MM credit facility if their restated earnings (coming out by March 25<sup>th</sup>) don't look good.

The company dates back to 1937 when the founder decided to tear a wall out of his donut shop so he could get the fresh, hot donuts to his patrons quicker.

Needless to say it worked!!!! For 63 years, this Southern company with it's Carolina roots and 1950's décor continued to grow slowly, carefully and successfully throughout the South.

Then, in April of 2000 the company decided to go public. It went public and raised some \$60 million in the offering. Not sure what the offering price was but at it's peak the stock hit nearly \$60 a share. It's trading around \$6 dollars right now.....

For a while, same store sales were exploding. It seemed everywhere you looked another Krispy Kreme was opening it doors.

I looked back at some interviews and comments by bankers and analysts just before the company went public. It was the same old stuff.

Investment bankers who buoyed the offering as a great opportunity...

I was impressed with some experts though, one in particular at Technomic (a restaurant-industry consultancy). The consultant posed the question,

“Is this another Starbucks or another Boston Market?”

That is yet to be determined.

Their wholesale business was taking off. We later have learned that the CFO allegedly padded sales figures in the wholesale business each quarter to make their numbers.

It took 63 years to build this great company. And after going public, they took their cult following and in just 4 years they damaged it but hopefully did not destroy it.

Clearly there was some creative accounting. There were “odd franchisee sales and repurchase agreements.” A fair amount of franchisor lease liability- something franchisors often do to help franchisees is guaranty the leases and in this case, it might come back to haunt them!

There are a number of large, well- known franchisors with a large amount of lease- liability from the 1980's still on the financial statements. It can become a tough line- item to get rid of.

One thing that is obvious to me is they started with a very selective distribution model.... I remember seeing people boarding airplanes with dozens of Krispy Kreme donuts since they couldn't get them back home. They took that cult and went mainstream.

They built new stores fast. They had around 130 or 140 stores at the time of the stock offering.... That took over 60 years. In just 4 years they more than doubled the store count and entered markets that were outside it's proven footprint...

You'll hear franchise execs talk about LEGS. A common franchise- concept question is,

“Does the concept have legs outside their core market?”

Well, in the case of Krispy Kreme it clearly has legs. People bought donuts in New England, the South, the West & the East.

Perhaps they should have changed their message or their image from a marketing standpoint?... Something about their offering is disjointed... To go from selective distribution to mainstream is a paradigm shift. There was an allure to eating Krispy Kreme donuts. They couldn't be found just anywhere. Now with over 400 stores, it's not as challenging finding the product.

There is certainly plenty of brand equity, plenty of goodwill left. The question is can they fix their financial issues, regulatory issues and customer/ partner relationships all at the same time. Hopefully so.

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DUNKIN DONUTS on the other hand... is a brand in the same business that has used a much more conservative growth plan.

With 5,500 locations... This is a company that *understands franchising* and how to use it as a model for growth. Dunkin is a subsidiary of Allied Domecq. They have full saturation in the northeast and are now expanding their southern territories.... Opposite the Krispy Kreme migration pattern oddly enough.

They were smart.... They waited.... Tested the markets.... Proved the concept before barging in and selling territories to franchisees...

Dunkin also owns Baskin Robbins and a mostly west Coast concept called Togos. I remember when they introduced a co-branded storefront where a franchisee could have a Dunkin a Baskin and a Togos under one roof.

It seemed the 3- store plan (dubbed “Trombo Units” by Allied) would be a home- run. Easier to train staff at all 3 businesses in order to allow them to keep well- trained (cross trained) employees (huge turnover challenge in the rest biz- a business where 100% turnover is a great figure!).

Well, in short- it didn't work. Togos didn't grab hold in the East. Lenders stopped financing East Coast Togos units. Dunkin listened. They acted quickly and fixed the problem. They shut down the expansion of these Trombo Units. They helped those who already made the investment and stopped selling more stores.

# C A S E   S T U D Y -   B O S T O N M A R K E T

Boston Market.

The company was very successful in generating buzz.... This concept had one very serious flaw.... The execs never perfected unit economics.... They didn't take the time to work out the kinks in the system. So franchisees were buying territories and developing stores and losing money...

Boston Market (Then Boston Chicken) lent money to its franchisees. They raised the money in the bond market and lent it at a mark-up. This interest income along with franchise royalties (which, keep in mind, are computed off the top line number not the bottom line) kept them afloat for a few years.

Finally, it caught up with them and the working capital reserves of their franchisees eventually dried up and they couldn't make royalty payments or loan payments any more. Stores closed, others continued to operate without making payments and had to be shut down through court orders.

This went on for some time and eventually the company declared bankruptcy. Obtained some debtor-in-possession money and sold its assets to McDonalds who owns it to this day.

## SECURITIZED ROYALTY STREAMS

You know.... One way to look at these failures is that franchise companies (as stocks) can be simplified as securitized royalty streams. If the franchisees begin to fail, it won't be long before the parent follows.

## C L O S I N G

In summary, I think a great way to look at franchising is,

**“Entrepreneurial Equity at the Point of Sale.”**

It's a great way to expand a successful, proven business for franchisors. For franchisees, it can be a It's a great cash cow once the brand All investors, entrepreneurs and managers just need to be cognizant about which franchise they.