Chapter 1

The Power of the Brand: Franchising and You

In This Chapter

- What is a franchise?
- What are the roles of the franchisor and the franchisee?
- What are franchise wannabes, and why should you avoid them?
- Does the franchise agreement grant ownership and a guarantee of profitability?

Franchising is the engine that drives much of the world's entrepreneurial train, but it's more than just fast food. Today, you can't drive down a major street anywhere in the world and not pass by some business that is part of a franchise network, and those businesses can be in any of more than 120 distinct lines of businesses today. This chapter begins your exploration of franchising, not by looking at any particular franchise but by looking at how well you will fit in as a franchisee or maybe as a franchisor. We explore with you what franchising is and what the franchise relationship is all about.

The Birth of Franchising

Franchising has a long history stretching back to ancient China. The crowns in Europe even used it to control their lands and to explore and conquer the globe. The history of franchising is pretty interesting. But, before we jump right into the thick of things, we want to share the story of Benjamin Franklin.

Now, every grade-school student knows about one of the most important of our founding parents — the bifocaled inventor of seemingly everything, including the lightning rod, the flexible catheter (we don't want to know what they used before), swim fins, the odometer, daylight saving time, the Franklin stove, and even a library chair that converted into a stepladder. Old Mr. Franklin even invented a musical instrument called the armonica for which Beethoven and Mozart both composed music. Ben Franklin gave us our first understanding of the properties of electricity, founded the nation's first hospital, charted the temperatures of the Atlantic Ocean, drafted the Albany Plan, cowrote the Declaration of Independence, and on top of all that found time to create the first franchise system on these pre–United States shores.

It was back on September 13, 1731, 45 years before the United States was even a nation, that Benjamin Franklin and Thomas Whitmarsh entered into the first franchise, or what they called a "Copartnership for the carrying on of the Business of Printing in Charlestown in South Carolina." The printing shop published *The South Carolina Gazette* and was the local printer of many of Franklin's writings, including his *Poor Richard's Almanack*. Franklin went on to establish other franchises in the colonies in the years before the revolution.

Without Ben Franklin, the French likely never would've entered into our War of Independence against the British. Without the income Ben earned as a franchisor, he may not have been able to support himself while living in France. So, have a celebration each September 13 to honor the first franchise because it and Ben were important contributors to the birth of this nation.

So What Is a Franchise, Anyway (And What's the Big Deal)?

Franchising is a system for expanding a business and distributing goods and services — and an opportunity to operate a business under a recognized brand name. It's also a relationship between the brand owner and the local operator. For example, Wendy's doesn't franchise hamburgers, and Midas doesn't franchise car mufflers. They franchise business systems that provide hamburgers and mufflers to customers — with consistent delivery of products, services, and customer experience.

A franchise occurs when a business (the *franchisor*) licenses its trade name (the brand, such as Wendy's or Midas) and its operating methods (its system of doing business) to a person or group (the *franchisee*) who agrees to operate according to the terms of a contract (the *franchise agreement*). The franchisor provides the franchisee with support and, in some cases, exercises some control over the way the franchisee operates under the brand.

In exchange, the franchisee usually pays the franchisor an initial fee (called a *franchise fee*) and a continuing fee (known as a *royalty*) for the use of the trade name and operating methods.

Franchising: Method of distribution, or industry?

We, your coauthors, use the term *industry* when discussing franchising. Purists may remind us that franchising is really a method of distribution used by a variety of industries, and they're right. But continually describing franchising as a method of distribution is cumbersome, and so we beg forgiveness for this slight literary allowance.

The effects of franchising on modern business

Consumers everywhere love the consistency that comes from shopping in a franchised business. From the cleanliness of the rooms at a Courtyard by Marriott to the fun that children will have at a Kidville, people know what they'll get when they purchase under a franchisor's brand. The number of industries bringing goods and services to customers through franchising is growing, limited only by the imagination of the businesspeople who are beginning to understand the potential of this ancient method of distribution. Franchising creates opportunities for business ownership and personal wealth — both part of the foundation for the growth of peace and democracies.

What most people don't understand is the sheer size and impact franchising has on the economy in the United States. According to the 2010 Franchise Business Economic Outlook, prepared by PricewaterhouseCoopers for the International Franchise Association Educational Foundation (IFAEF), business-format franchising — before including product-distribution franchises, such as automotive and truck dealers, gasoline service stations, and beverage bottlers — is projected to generate in 2010 more than 9.5 million jobs in the United States and account for over $8.6 billion of the economic output in the United States.

Franchising is becoming an increasingly significant force in the overall U.S. economy — take a look at the economic impact of franchised businesses on the U.S. economy shortly after the turn of the millennium on the bonus CD-ROM (CD0101).

Today, even in the current economic downturn, it is projected that more than 900,000 business-format franchised businesses exist in the United States up from 847,000 when the recession began in 2007. PricewaterhouseCoopers is now completing for the IFAEF its most current study of "Franchising in the Economy”; it will be available on the International Franchise Association (IFA) Web site at `www.franchise.org` later in 2010.

Although industry facts and statistics are fun and somewhat useful, the only truly meaningful statistic when you’re examining a franchise opportunity is how well the franchisees in that system are doing. Think of it like looking at the stock market. Do you really care whether the market went up if your stock lost six points?

The success of franchising for business owners

For years, the IFA kept statistics on the success of franchising. However, many of the studies that those widely published statistics were based on — including those claiming that franchisees have a success rate of 95 percent versus a failure rate of 85 percent for nonfranchised start-ups in their first five years in business — turned out to be inaccurate and usually misleading. The IFA no longer publishes those statistics and has asked its member companies not to refer to them any longer. You should be wary of any franchisor or franchise broker that still uses these claims of franchise industry success statistics.

What’s the Big Deal about Brand?

Brand is the franchise system’s most valuable asset. Consumers decide what and whether to buy at a particular location based on what they know, or think they know, about the brand. Unless they have a relationship with the local franchisee, they probably don’t give any thought to who owns the business. In their minds, they’re shopping at a branch of a chain.

In the consumer’s mind, brand equals the company’s reputation — the experience they expect to get. Franchisors spend a lot of time, energy, and money developing their brands so that consumers know what to expect before they even come in the door. A good brand communicates a message to the customer. When you see an advertisement for a Wendy’s hamburger, you immediately associate it with your experience of ordering and eating a Wendy’s hamburger. You may think of a Cheddar Lovers’ Bacon Cheeseburger or maybe a baked potato or the freshness of the product. Maybe you think that the line moves just a bit faster, that the service is better, or the staff is friendlier. You may remember seeing Dave in that last commercial or think back to Clara Peller and her sidekicks, Mildred Lane and Elizabeth Shaw, in the “Where’s the Beef?” ads. (“Where’s the Beef?” registered the highest consumer awareness levels in the advertising industry’s history. It stole the show at the 1984 Clio Awards, winning three of the industry's highest honors, and was voted the most popular commercial in America in 1984.) The experience of visiting a Wendy's, supported by the message in its advertising, communicates to the public just what Wendy's is. You can visualize and almost taste the experience.

The same can be said for other companies, such as Meineke. When you see an ad for the brake services that Meineke offers, you can almost feel your car stopping safely at the light. That's the power of a brand.

Brand recognition is part of what a franchisee hopes to get when purchasing a franchise. A good brand is immediately familiar in consumers' minds. With a well-known brand, you don't have to build brand awareness in your market. The franchisor and the other franchisees have taken care of that for you. This is one of the major advantages of investing in a larger, well-established franchise system. Smaller systems with limited brand recognition can't deliver that until you help them grow.

Ongoing advertising and marketing programs help ensure that the brand remains strong and growing. And if the franchise system is successful in making the brand mean something positive to the consumer, that success means possible increased sales for you.

REMEMBER

Brands are not born fully grown. Almost every start-up franchisor begins with some local brand recognition (it may be only a neighborhood) and has to grow that brand to achieve regional or national status.

A company can provide the best dry cleaning in town, have a system for one-hour service, be loved by its customers, and yet be known only locally. For start-up franchisors with limited brand recognition outside of their home markets, this is an issue. Franchisees in markets where the franchisor's brand has little or no consumer recognition use advertising and promotions provided by the franchisor to build brand recognition in their markets. Those franchisees that must build brand recognition need to spend more on advertising and promotion and may require a different message than franchisees who enter a market in which the franchisor's brand is well known.

The Franchise Siblings: Two Types of the Same Blood

Two types of franchises exist: product-distribution franchises and business-format franchises. In *product-distribution franchising,* the most important part is the product that the franchisor manufactures. The products sold by a product-distribution franchisee usually require some pre-sale preparation by the franchisee before they're sold (such as you find with Coca-Cola, where the franchisee manufacturers and bottles the soda) or some additional post-sale servicing (such as you find at a Ford dealer with your periodic maintenance programs). But the major difference between the two types of franchising is that, in the product-distribution variety, the franchisor may license its trademark and logo to its franchisees, but it typically does not provide them with an entire system for running their businesses. Providing a business system is the hallmark of *business-format franchising.*

Product-distribution franchises represent the largest percentage of total retail sales coming from all franchises, but the majority of franchises available today are business-format opportunities. More than 80 percent of franchises in the United States are the business-format type.

Because most franchisees buy a business-format franchise, this is the type of franchise we focus on in this book. However, we give you a glimpse into the world of product-distribution franchises in the following section.

Product-distribution franchises

In a product-distribution franchise, the franchisee typically sells products that are manufactured by their franchisor. The industries in which you most often find product-distribution franchising are soft drinks, automobiles and trucks, mobile homes, automobile accessories, and gasoline. For example, Coca-Cola, Goodyear Tire, Ford Motor Company, and John Deere distributors are all product-distribution franchises.

Product-distribution franchises look a lot like what are called *supplier-dealer relationships* — and they are. The difference between a product-distribution franchise and a supplier-dealer is in the degree of the relationship. In a product-distribution franchise, the franchisee may handle the franchisor's products on an exclusive or semi-exclusive basis, as opposed to a supplier-dealer who may handle several products — even competing ones. With the growth in auto dealerships that sell multiple brands, this distinction is getting just a bit clouded. The franchisee in a product-distribution franchise, though, is closely associated with the company's brand name and receives more services from its franchisor than a dealer would from its supplier. Supplier-dealer relationships often exist in business opportunities relationships (which we discuss in the following section).

TECHNICAL STUFF

Conversion franchising

Although not truly a third type of franchising, conversion franchising is a modification of the standard franchise relationships. In *conversion franchising,* an independent operator in the same business as the franchisor adopts the franchisor's service marks or trademarks, and its system. In many cases, the new franchisee, who is likely an experienced operator, is reluctant to make all the changes or conversions required to make it identical to all other locations in the system, and the franchisor may not be able to require those changes. However, the franchisee adopts the system's service marks or trademarks, the advertising programs, the buying relationships, the training, and the critical customer service standards. Examples of industries that have used conversion franchising extensively are real-estate brokers, florists, and the trades (home remodeling, plumbing, electricians, and so on).

Business-format franchises

The business-format franchisee gets to use the parent company's trade name and logo just as the product-distribution franchisee does, but more important, it gets the complete system for delivering the product or service and for doing business. This system is what produces consistency — and consistency is a franchise's foundation for success. Wendy's, Kidville, Dunkin' Donuts, The UPS Store, Meineke Car Care Centers, and Maaco are all great business-format franchises. The business structure of a business-format franchise offers a detailed plan that explains how to do almost everything from the ground up. A franchisee is trained to manage the construction of the building, order the right equipment, and even hang the signs.

The confidential operating and procedures manuals (the how-to guides of every great franchise) generally give such specific information as how to market and advertise; open the front door; recruit, hire, train, and dress the staff; and greet customers. To ensure quality and consistency, most franchisors provide business-specific information in the manuals on how and where to order inventory, how to prepare products, and how to present them to customers. The franchisor sometimes even includes procedures for taking out the garbage, turning out the lights, and closing up at night. All these components are part of a business-format franchise's unique system. The franchisor may provide the system, but the franchisee is responsible for managing all the day-to-day affairs of the business. The goal is for customers to get the same brand experience each and every time they shop in one of the franchise's locations.

REMEMBER

Each franchise system is different, each franchisor does not prescribe identical levels of controls, and each does not strive for the same level of consistency. But most franchisors do have standards that define the minimum levels of service and operations required from the franchisee. Every location — whether it's owned by a franchisor or a franchisee — no matter where it is in the world, should look and feel the same; in restaurants, the food should taste the same. Ever wonder why every Courtyard by Marriott room has a coffeepot, and a bar of soap and bottle of shampoo in the bathroom? It's one of the brand requirements set by the franchisor. In other words, with some minor variations, and even if the menu is a bit different in different areas of the country or the world, your *experience* at every location should be the same. Every well-managed franchise system strives to achieve a high degree of consistency so that the buying public knows what they'll get just by looking at the brand.

The Roles and Goals of Franchisors and Franchisees

The owner of a franchising company — the entity that grants the franchisee the right to operate their business under the franchise system's trademarks and service marks — is called a *franchisor.* The *franchisee* is the person or entity that becomes the licensee of the franchisor. The franchisee runs the day-to-day business using the franchisor's brand and the franchisor's system of doing business.

In this section, we lay out both sides of the coin for you; however, because most readers will likely be looking to buy into an already established franchise, we focus on the franchisee's point of view throughout most of this book. (For the nuts and bolts of the franchisor's business process, check out Part V.)

Looking at the world through franchisor lenses

Franchisors can be companies founded by individuals with a great deal of experience (such as Dave Thomas) or by individuals with little or no experience and who are just concluding an arrangement with the company's first franchisee. Consider the following points regarding franchise sizes and franchisor levels of experience:

- Often, the owners are large public or private companies with their founders still at the helm, such as John Schnatter of Papa John's.

- Sometimes, the franchisors are former franchisees who bought the companies from the founders (as Tom McDonnell did with U-Save Car & Truck Rental, Jack Hollis did with Computer Renaissance, and Abe Gustin did with Applebee's).
- Sometimes, the franchisors are huge conglomerates (such as Yum! Brands, which owns Pizza Hut, Taco Bell, KFC, A&W, WingStreet, and Long John Silver's, and operates restaurants all over the world).
- Sometimes, the franchisors are small and relatively new to offering franchises (such as Firehouse Subs or Oogles n Googles).
- Sometimes, the franchise system is large but seems almost brand new (such as Quiznos or Panera Bread Company).

A good franchisor gives its new franchisees the system and training they need to run their business without having to figure out everything on their own. The franchisor has already made most, if not all, of the mistakes. Franchisees get the benefit of the franchisor's experience, so they can take a shortcut through the minefields that start-up businesses usually face. The franchisee purchases the right to use the franchisor's expertise, brand name, experience, methods, and initial and ongoing support.

Businesses don't usually fail because their products or services are of low quality — they usually fail because the owners aren't prepared and make mistakes from which they can't recover. Great franchisors have already made the mistakes — and have survived. Their survival is the basis for the road map they provide, and that map is part of what franchisees pay for when they buy a franchise.

REMEMBER

You have to remember, though, that the franchisor isn't providing all this assistance out of the kindness of its heart. The franchisor wants the whole system to grow, prosper, and turn profits. So the goal of a great franchisor is to provide a great system. If it does, the franchisees make money, stay in business, expand, and pay fees. And the franchisor's brand value grows as more people shop at its branded outlets and more people want to become franchisees. The franchisor is relying on the franchisee to manage the local business well so that each location will contribute to the entire system's success.

The franchisee's end of the bargain

You need to understand the following distinction: When you buy a franchise, you don't own the business. You own the rights to do business using the franchisor's trademark, brand name, product or service, and operating methods. What you typically own are the physical assets, the land, and the building and equipment, but not the brand or systems. In many systems, in fact, the franchisor may even have the right to buy the assets you do own if the relationship ends.

Doesn't sound like much of a deal? Here's what you do get when you join a well-established franchise system:

- A proven and successful way of doing business
- A nationally known brand name
- A complete training program with advanced training and updates
- Research and development into new products and services
- Professionally designed local, regional, and national advertising and marketing programs
- Often, a chance to own more than one franchise
- A shortcut around the common mistakes of start-up businesses
- Frequently, a buying cooperative or negotiated lower costs from suppliers for many of the things you need to run and operate the business (ingredients, advertising, insurance, supplies, and so on)
- Your fellow franchisees as a network of peer advisors
- Thorough and ongoing field and headquarters support
- Often, a protected market or territory

Franchisors often give their franchisees an area around their location in which no other company-owned or franchisee-owned location is allowed to operate. This is called a *protected market* or *protected territory.* Protected territories may be defined by the following:

- The radius or area around the franchisee's location
- The number of households or businesses in an area
- The number of people who live in an area
- Zip codes
- Boundaries using highways and streets
- Any method that defines the area in which no other same-branded location may be established

If the territory is too large, the total market won't contain enough locations to achieve brand recognition. If it's too small or if other locations are too close, there may not be enough customers to support the business. The goal in a good franchise system is to establish the right number of units in the right locations to ensure that consumers see the brand frequently, which is known as *brand penetration.* When too many units are close by, and that proximity negatively affects unit sales, it's called *encroachment.*

Not all territorial rights are permanent, and the franchisor may be providing you with those rights for only a limited period of time. You may also have to reach certain levels of performance to keep those rights. Also, when a franchisor provides you with a radius around your location, your radius and another franchisee's radius may and usually will overlap. The franchisor will not, however, establish another location within your protected area. Make sure you read and understand your contract, and consult with a lawyer to make certain that you do.

The Nuances of the Franchisor/ Franchisee Relationship

Franchise systems are built on the relationships that the franchisor establishes with its franchisees. ***Remember:*** Just as every franchise system isn't the same, the relationship between franchisor and franchisee in every system isn't the same. And this relationship may change as business conditions change.

Lately, more and more franchisors and franchisees share some of the decision making — but in limited circumstances. According to Rupert Barkoff, Partner, Kilpatrick Stockton LLP, of Atlanta, Georgia, "Holiday Inn, for example, is contractually committed to submit certain proposed changes in its system to its franchisee association before they are implemented, and the franchisees of Sylvan Learning Center have a veto right over marketing programs." At both Arby's and Subway, management shares marketing decisions with their franchisees.

Following are a few of the terms franchisees use to describe their relationships with their franchisors.

Franchisor as partner

In a certain sense, although not a legal one, a franchisor and franchisee are partners. After all, they're in this business arrangement together. Each partner has a role, and each partner depends on the performance of the other. But are they equal partners? No.

Both partners have their roles in the relationship; the success of the relationship rests on their interdependence. Only one, though, can make the systemwide decisions, and that is the senior partner — the franchisor. As part of this "partnership," the franchisor provides the system, and the franchisee supplies the capital, the labor, and the day-to-day enthusiasm that makes the brand live. In great systems, the partners discuss individual issues both one-on-one and communally through franchisee advisory councils (FACs; see Chapter 9), but the franchisor ultimately makes the brand decisions.

Most great franchise systems that work as partnerships have FACs in place to assist the franchisors in evolving and improving their systems. Often, one of the FAC's functions is to review ideas for new products and services, whether the ideas come from the franchisor or from a franchisee. FACs also work with franchisors to review system advertising and cooperative-buying arrangements, and they help to make other changes to improve the system for the benefit of both partners. When you're looking at franchisors, look for a system that has an active and participatory relationship with its FAC and one in which the FAC plays a constructive role.

Don't read too much into a franchisor's use of the word *partner.* Legally speaking, you aren't a partner. You can still have a good working relationship with your franchisor, but remember that a franchisor has a responsibility to look out for its — not necessarily your — best interests. Of course, over time, a franchisor can't succeed without successful franchisees, so your interests do coincide to some degree.

Franchisor as parent

Just like parents and their children, franchisors provide the early guidance necessary for their franchisees' healthy growth. A franchisor provides franchisees with a safety net in the form of training and nurturing during the franchisees' early days in the system. Like parents, the franchisor offers a support mechanism that franchisees can turn to for help when they're off track. The franchisor provides a set of training wheels to keep new franchisees balanced until they can pedal on their own. And, like real parents, the franchisor is usually a continuing source of advice, ideas, and wisdom as franchisees mature.

But franchisors aren't parents, and franchisees aren't children. Children don't get to choose their parents; franchisees do get to choose their franchisors, and franchisors get to choose who is allowed to join the family. And unless parents today are a lot different from ours, parents usually don't make their children sign a lengthy agreement at birth, spelling out the obligations each party has to the other, when the relationship will end, and what you need to do to keep it going. Franchising is a business relationship.

Franchisor as dictator

Ask some franchisees to describe their franchisor, and they may use a word such as *dictator* or *tyrant.* Why? A lot of reasons.

Some franchisees find the franchise relationship too constricting. They see themselves as entrepreneurs — someone who starts a business and can make all the decisions about how the business should operate. Almost from the day they become franchisees, they want to find a way to break free from the constraints that franchise systems impose on them. After all, don't they own their own businesses? Entrepreneurs have a lot more flexibility than franchisees. In a franchise situation, the franchisor owns the concept and the name, and the franchisor determines how the franchisee's business deals with consumers. Indeed, some true entrepreneurial franchisees have difficulty comprehending that the reason customers come to the location is because of the franchisor's brand. The customer, after all, is a customer of the brand.

TIP

The restrictions of a franchise can be overwhelming — like a dictatorship — for a true entrepreneur. So, if you see yourself as more of a true entrepreneur than as someone who can be satisfied following someone else's system, start your own business. You probably won't be happy as a franchisee.

Watch out for franchise wannabes

What's a franchise wannabe? It's a business opportunity (or *biz-op*) that looks an awful lot like either a business-format franchise or a product-distribution franchise. It masquerades at many franchise and business-opportunity trade shows. The most common types are rack jobbers, supplier-dealer distributorships, and vending-machine routes.

Although every franchise is a license, *not every license is a franchise.* The difference is in the definition of *franchise* established by the Federal Trade Commission. This definition requires the following elements to be in place before a license is classified as a franchise:

- The franchisee needs to distribute products or services that are identified or associated with the franchisor's trademarks or service marks.
- The franchisee is required to meet the franchisor's quality standards when using the marks; the franchisor has significant control over the business or provides significant assistance to the franchisee.
- The franchisee pays $500 or more to the franchisor.

Business opportunities have several advantages over franchising, most notably far more independence and flexibility. Business opportunities usually cost less to start up than franchises and don't require you to pay continuing royalties.

The biggest drawback of a business opportunity is that you seldom receive any significant help in setting up the business, in training, or in marketing, and you don't get much in the way of ongoing support, either.

Franchisors like to say that, in a franchise, you're in business *for* yourself but not *by* yourself. In a business opportunity, you're not only in business *for* yourself, but you're also usually in business *by* yourself. For most people looking for the support that comes from a franchise system, our advice is to stay clear of biz-ops and buy a real franchise.

Every order of Biggie fries should be the same. Every hotel room at Courtyard by Marriott should have a coffeepot, a couch, and high-speed Internet. That's consistency. To ensure that consistency, a franchisor has to make decisions about how the business operates globally. Franchisees may think that they have the next great idea, and often they do, but the franchisor must look at those great (and sometimes not-so-great) ideas and make systemwide decisions. Sometimes, the answer is no. But if the only reason a franchisor says no is that the franchisor didn't come up with the idea, the franchisor is not only a dictator but also a poor businessperson. On the flip side, if the franchisor lets the franchisee try every idea, the franchisor isn't a good parent, either; good parents protect their children from making unnecessary mistakes.

In most cases, however, franchisors aren't being dictatorial when they say no, and they're not being bad parents, either. They're usually looking at the big picture, deciding what's right for the brand, and acting as a senior partner should.

A Reality Check Before You Dive In: Franchises and Profits

If you buy a franchise, you get rich, or at least financially secure, right? We hate to burst your bubble, but that's a myth. Not all franchises are successful, not all franchises are profitable, and many fail.

Owning a franchise — like owning any small business — is hard work. Even though you get proven systems and training when you hook up with a solid franchisor, no one guarantees your success. Often, the variable in this equation is you. Business ownership is not a passive investment. It requires long hours and dedication. Even with the best franchise system and the most popular brand name, the franchisee is often the key ingredient to making the business successful.

Even with hard work, if you make the wrong choice and buy a franchise that you end up hating, chances are good that you won't be successful — or very happy.

Have we discouraged you? Scared you? Confused you? Don't worry. Franchising, when done right and entered into with eyes open, can be a profitable, highly enjoyable way to spend your future.

REMEMBER

What makes a hamburger great isn't the sizzle or the smell — it's the taste. The same goes for great franchises. The brochure may be hot and the salesperson may be persuasive, but you're not buying the sizzle — you're investing in the steak.