

## 6.15: Franchises

### Learning Objectives

- Define franchises as a form of business
- Discuss the advantages and disadvantages of franchising for the franchisee
- Discuss the advantages and disadvantages of franchising for the franchisor



A **franchise** is a business model that involves one business owner (the **franchisor**) licensing trademarks and methods to an independent entrepreneur (the **franchisee**) for a prescribed period of time. For the franchisor, the franchise is an alternative to expanding through the establishment of a new location, which avoids the financial investment and liability of a chain of stores. Ultimately, the franchisor's success depends on the success of the franchisees. If the franchisees are successful then the franchisor can grow its brand and market presence while the franchisee, in effect, does all of the work.

The United States is a leader in franchising, a position it has held since the 1930s when it used the approach for fast-food restaurants, food inns, and, slightly later, motels during the time of the Great Depression. Today, the world's largest franchise chains are U.S. companies:

- **Subway:** start-up costs \$84,300–\$258,300; 45,512 locations worldwide in 2017
- **McDonald's:** start-up costs in 2010: \$995,900–\$1,842,700; 37,855 locations in 2017
- **7-Eleven Inc.:** start-up costs in 2010: \$40,500–\$775,300; 68,236 locations in 2017
- **Great Clips:** start-up costs in 2010: \$109,000 – \$203,000; 3,694 locations in 2015
- **Hampton Inns & Suites:** start-up costs in 2010: \$3,716,000–\$15,148,800

### Buying a Franchise

The decision to purchase a franchise involves many factors, including how much you can afford to invest, what abilities you have, and what your goals are. Before you decide to purchase a franchise, it's important to do thorough research. You could lose a significant amount of money if you don't investigate a business carefully before you buy. By law, franchisors must disclose certain information about their business to potential buyers. Make sure you get all the information you need first before entering into this form of business.

The following strategies can help you gain a solid understanding of what to expect as well as the risks that could be involved:

- **Be a Detective.** In addition to the routine investigation that should be conducted prior to any business purchase, you should be able to contact other franchisees before deciding to invest. You can obtain a Uniform Franchise Offering Circular (UFOC), which contains vital details about the franchise's legal, financial, and personnel history, before you sign a contract.
- **Know What You Are Getting Into.** Before entering into any contract as a franchisee, you should make sure that you would have the right to use the franchise name and trademark, receive training and management assistance from the franchisor, use the franchisor's expertise in marketing, advertising, facility design, layouts, displays and fixtures, and do business in an area protected from other competing franchisees.
- **Watch Out for Possible Pitfalls.** The contract between the two parties usually benefits the franchisor far more than the franchisee. The franchisee is generally subject to meeting sales quotas and is required to purchase equipment, supplies, and inventory exclusively from the franchisor.
- **Seek Professional Help.** The tax rules surrounding franchises are often complex, and an attorney, preferably a specialist in franchise law, should assist you to evaluate the franchise package and tax considerations. An accountant may be needed to determine the full costs of purchasing and operating the business as well as to assess the potential profit to the franchisee.

## Franchise Taxes

The taxation of a franchise depends on the underlying form of ownership. Generally franchises are required by the franchisor to be established as a corporation or LLC. Ultimately, the franchise agreement governs this, and individuals looking to purchase a franchise should scrutinize any agreements with regard to prescribed legal ownership structure.

### ? Practice Question

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## Advantages for the Franchisee

- **Less Risk.** In certain industries, when compared with starting one's own business from scratch, buying a franchise enables the franchisee to own a business with a proven track record and an established market presence, thereby reducing the risk of failure. However, purchasing a franchise still doesn't guarantee success, and many franchisees go out of business, losing their initial investment and start-up capital.
- **Name/Brand Recognition.** The franchise has an established image and identity already, which can reduce or simplify marketing efforts. Many franchises are nationally advertised brands, shortening the time it takes for the franchisee to establish a market presence.
- **Access to Expertise, Ongoing Support.** Franchisee often receives help with site selection, training materials, product supply, and marketing plans. The franchisee gets to take advantage of a business model whose strategies and processes have already been tested and streamlined.
- **Relative Autonomy.** Franchisee must comply with the terms and standards of the franchisor, but otherwise has a fair amount control over the day-to-day operations of the franchise.

## Disadvantages for the Franchisee

- **Cost.** Buying and running a franchise can be very expensive. Jimmy John's Subs was listed as one of the top franchises in 2016, but the initial investment to open a location was \$325,000–\$555,000. Franchise fees generally run in the \$20,000-to-\$30,000 range, though they can top \$100,000 for higher-end, more established brands. Once open, there are ongoing royalties to pay, which typically range from 4 percent to 8 percent of gross revenues and include an ongoing assessment for marketing and advertising.
- **Unequal Partnership.** The franchisor sets the rules, and the franchisee must follow them. The franchisee doesn't have much leverage if the franchisor falls short on promises or makes unreasonable demands.
- **Rules and Enforcement.** Franchisor rules imposed by the franchising authority are becoming increasingly strict. Some franchisors are using minor rule violations to terminate contracts and seize the franchise without any reimbursement. Often this happens when a franchise location becomes very profitable or the franchisor sees an opportunity to profit by seizing and liquidating the location.

### ? Try It

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## Advantages for the Franchisor

- **Access to Capital for Growth and Expansion.** After the brand and formula are carefully designed and properly executed, franchisors are able to sell franchises and expand rapidly across countries and continents using the capital and resources of their franchisees.
- **Cash Flow for Operations.** In addition to initial franchise fees that can range from \$50,000 to \$5 million, franchisors receive payments in the form of royalties from each franchisee. These royalties typically range from 4 percent to 8 percent of gross revenues. In addition, franchisees are also assessed for marketing and advertising.
- **Economies of Scale.** Once a franchise is established with multiple locations, the company may be able to leverage its buying power to realize economies of scale with suppliers, advertisers, and vendors. If purchasing and distribution for the franchise locations can be centralized, then the cost savings will increase the franchisor's bottom line, particularly if the franchise agreement provides for a percent-of-sales payment to the franchisor.

## Disadvantages for the Franchisor

- **Lack of Control.** Despite the language of the franchise agreement, once the franchisee has established their location, the franchisor may have difficulty ensuring that quality standards are met and the franchise is operating in a manner that benefits the brand. A Dunkin' Donuts franchise in Russia had to be closed after it was discovered that instead of serving donuts and coffee, the franchisee was serving vodka and meat pies.
- **Trade Secrets.** If the success of a business is based on a trade secret, special process, or innovative technology, establishing a franchise may make the business vulnerable to knock-offs or imitation. Although the franchise agreement specifically prohibits the disclosure of trade secrets, the fact that the franchisee may see opportunities to improve upon the process and become a competitor is not expressly prohibited.
- **Overexposure, Brand Dilution.** One or two locations of a business is unique and may generate enough demand that the business can charge top dollar for goods or services. When franchises appear on almost every street corner, the allure of the business may fade and the brand or business may suffer.

### ? Practice question

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